

## **The Wonder-Clause**

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### *Abstract*

The Greek debt crisis prompted EU officials to embark on a radical reconstruction of the European sovereign debt markets. Prominently featured in this reconstruction was a set of contract provisions called Collective Action Clauses, or CACs. CACs are supposed to help governments and private creditors to renegotiate unsustainable debt contracts, and obviate the need for EU bailouts. But European sovereign debt contracts were already amenable to restructuring; adding CACs could make it harder. Why, then, promote CACs at all, and cast them in such a central role in the market reform initiative? Using interviews with participants in the initiative and those affected by it, as well as observations at policy and academic meetings, we attempt to shed light on the puzzle and draw implications for the role of contract techniques in market construction.

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## **Introduction**

Contract terms are technical devices. In law and in finance literature alike, they allocate risks, map responses to future contingencies, and ultimately impact the price of the contracted product or service. This description is also the departure point for explaining the behavior of lawyers, bankers, and traders who deal in contracts. If we showed up to a contracts conference claiming that a famous contract term did little for the contracting parties, served primarily to communicate governments' role in a financial market, but had no capacity to play that role, we would be dismissed as crackpots. Yet this is what we found studying some of the best known financial contract terms of our time. For over a decade, the set of Collective Action Clauses (CACs) in sovereign debt contracts has acted more like a symbol than a technique, appropriated by parties and nonparties alike in an effort to shape the markets where they trade, and to negotiate their place in the markets. In this article, we trace how CACs evolved from one of many technical devices designed to operate between contract parties, to a prominent public symbol and policy tool in two financial crises. We use the story of CACs' rise to consider the uses of contracts and the law's role in the construction of modern sovereign debt markets.

As a technical matter, CACs enable creditor majorities to bind potential holdouts in a debt restructuring vote. Terms that limit the power of holdouts are valuable to sovereigns, which cannot restructure their debts in bankruptcy and must rely on sovereign immunity and contractual mechanisms to manage debt distress. Although CACs can be found in bonds going back decades, they were first mooted as a response to modern sovereign debt crises after the \$50 billion official rescue of Mexico in 1995. They were widely adopted soon after Argentina's record-breaking debt default in 2001. CACs' rapid market-wide adoption starting in 2003 was an achievement in global financial governance (Helleiner 2009); in private contract terms, it was

a revolution. The CAC revolution was prominently described as a triumph of market forces over clumsy, top-down state regulation: with a gentle nudge from the official sector, market actors changed their contracts *en masse* to make unavoidable debt restructuring more orderly, reduce coordination problems and deadweight losses from long default, and improve the incentives for sustainable debt management (Taylor 2007, Quarles 2010). To be sure, CACs had hardly been used, there was no empirical evidence one way or another connecting them to more orderly restructurings, and good reasons to doubt their promised effect—but the public story took hold. Part of our project is to understand how and why it did.

Seeking insight into the revolution, we conducted a series of interviews with market and policy actors between 2004 and 2006. We found that market participants did not view CACs with anything near the enthusiasm that their rapid diffusion and accompanying policy publicity might have suggested. All but a few policy makers were similarly skeptical. In public, CACs were touted as a private ordering coup that obviated the need for bankruptcy and bailouts alike. In private, those CACs that were adopted were often viewed as a minor change, unlikely to transform sovereign restructurings (Gelpern and Gulati 2007). The disjunction between public and private stories was jarring.

CACs were hard to explain as a policy tool. They also presented a contracts puzzle. Having interviewed dozens of people involved in drafting and negotiating CACs in 2003, we gained a measure of insight into the intent of the contracting parties adopting these clauses, and were in a position to chronicle something like a legislative history for this set of boilerplate provisions that seemed to channel the collective will of the sovereign debt market at the time (Choi and Gulati 2006). Drafters and negotiators told us that CACs got into their contracts for a variety of

contradictory reasons; scarcely any of these had to do with facilitating creditor collective action or even more broadly, the clauses' utility as among the parties.

Roughly a decade later, the puzzle returned. There was a debt crisis in Europe, and CACs were once again an early and prominent part of the policy response. This time, they looked even less suited to fight the crisis at hand or those that might follow. Based on our earlier interviews, we suspected that many or most of the policy makers invoking CACs as a potent fix knew better. Why did they resuscitate CACs?

The answer reveals a gap in the traditional conception of financial contract terms as technical devices that allocate risk or manage relationships. Contracts and contract terms can perform a more public role: in the events we study, we find that they have served as a tool for policy makers to construct an identity for a particular market, and the hierarchy of assets within it. CACs' principal early success was at preempting bankruptcy-style public ordering alternatives in the sovereign debt markets. As CACs spread and gained symbolic value as anti-bankruptcy, their technical value as restructuring tools looked minor by comparison. CACs' efficacy at restructuring was so unimportant by 2010, that when a new bailout-free sovereign debt market had to be constructed and sold to the taxpaying public in Europe, CACs became a featured building block even though as a technical matter, they were at best a costly distraction, and even risked undermining the new policy.

The fact that CACs had to be adopted for reasons apart from their capacity for creditor coordination did not make their technical attributes irrelevant. These attributes—the voting mechanics and thresholds, the similarities and differences between European and emerging markets CACs, and the way in which they fit in the institutional context of European debt and

crisis management—reflected CACs’ messaging task. CACs in Europe had multiple political missions, ranging from signaling a new economic bargain among the center, the periphery, and the market, to articulating uniform crisis management rules, to promoting market discipline, to helping European states differentiate themselves from their emerging markets counterparts. The way in which they were drafted had to support these multiple missions simultaneously. To channel the parties’ intent properly, CACs had to be many things to many people.

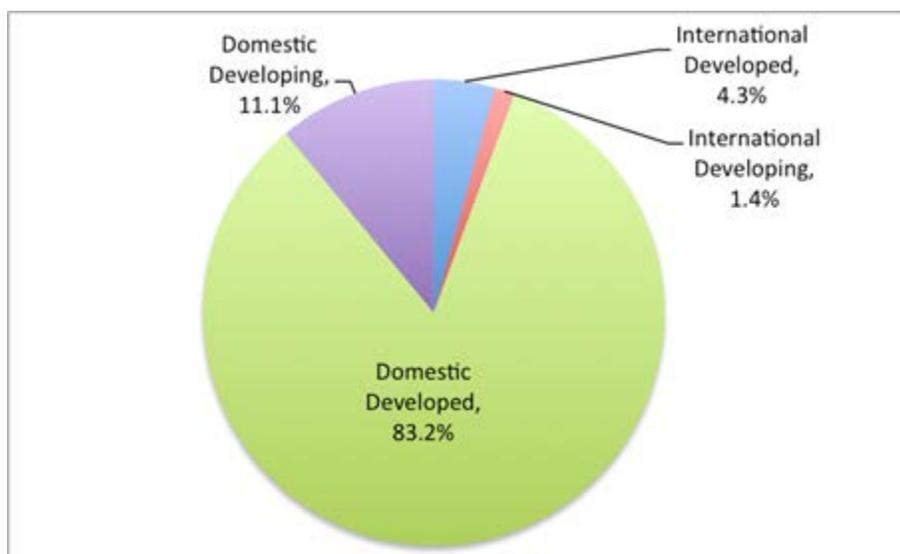
Our case study examines CACs both as a policy and as a contract phenomenon. It seeks to advance our understanding of how law constructs finance (Pistor 2013) by illuminating government actors’ use of private law techniques to shape the identity of financial markets (cf. Riles 2011). From the contracts perspective, we try to make sense of CACs’ capacity to channel multiple apparently conflicting party imperatives, and mediate between contracting parties and various political constituencies. Our study is based on over ninety interviews with officials, market participants, and lawyers, as well as observations at more than a dozen policy and academic meetings.

Part I of the article provides a brief overview of sovereign debt markets. Part II describes contract theories that might shed light on the CAC debate. Part III draws on our interviews to chart the ascent of CACs through successive financial crises. Part IV considers implications. CACs went from an arcane legal technique offered as a harmless “deliverable” in the late 1990s to a means for negotiating the allocation of risks, the terms of financial backing, and the scope of sovereignty in the world’s biggest financial markets. Their story testifies both to the potency and to the limits of private law techniques in constructing markets.

## Part I: Big Debt and Little Debt

At the start of 2012, the world’s governments had over \$40 trillion in outstanding medium and long-term debt securities. Of the total, 1.4% or just over \$600 billion represented debt issued by low and middle-income countries under foreign law. Debt issued by wealthy countries under their respective domestic laws accounted for 83.2%, attributable mostly to the United States, Japan, and Europe. Although the precise breakdown has varied, the overall relationship among the four categories of debt in Figure 1 has changed little throughout the period we discuss, between the mid-1990s and 2012.

**Figure 1: Domestic and International Sovereign Debt by Issuer Category<sup>1</sup>**



Source: Bank for International Settlements, BIS Securities Statistics and Syndicated Loans

Governments have traditionally placed the bulk of their debt with their own citizens, at home, in their own currency, and under their own laws (Reinhart and Rogoff 2009). However,

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<sup>1</sup> BIS Securities Statistics and Syndicated Loans, Tables 12D and 16A, as of December 2011, available at <http://www.bis.org/statistics/secstats.htm>. Data exclude short-term securities, with remaining maturity under one year.

wealthy countries have long had the privilege of selling their local currency, local law debt to foreign creditors. For example, the United States as the issuer of the world’s reserve currency owes slightly less than half of its debt in the hands of the public to foreign creditors (U.S. Treasury 2012). Developing countries have only recently begun to issue significant amounts of domestic debt to foreign creditors (Inter-American Development Bank 2006). For some Eurozone members, this capacity to issue domestic law debt to a global audience coincides with adopting the Euro (Gulati and Smets 2013).

Domestic and foreign sovereign bond contracts look different. Domestic contracts are often short, sometimes no more than a few lines in a law or regulation. The terms are not always readily accessible to the public—and not always in English (ICMA 2011).<sup>2</sup> Drafting work on these terms is generally done in-house by finance, economy, or justice ministry lawyers, who work with the sovereign’s debt managers. Domestic sovereign debt is generally exempt from securities disclosure rules applicable to private issuers and tends to be sold in public auctions, rather than through investment bank-managed or underwritten offerings. Domestic debt offerings also do not normally use outside fiscal agents or trustees—representing the issuer and the bondholders, respectively—to transmit payments, information, and otherwise manage the day-to-

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<sup>2</sup> Information on domestic debt issuance in Mexico and Brazil is instructive. These countries’ governments have become the leaders in emerging market public debt management and investor relations; however, their websites—much as the U.S. Treasury’s—reference domestic laws, regulations, and auction rules, with no links to anything that looks like a traditional debt contract. *Compare* Secretaria de Hacienda y Credito Publico, Domestic Debt, at [http://www.hacienda.gob.mx/English/public\\_credit\\_new/domestic\\_debt/Paginas/DOMESTICDEBT.aspx](http://www.hacienda.gob.mx/English/public_credit_new/domestic_debt/Paginas/DOMESTICDEBT.aspx) (Mexico), Ministerio da Fazenda, Tesouro Nacional, Domestic Debt, at <https://www.tesouro.fazenda.gov.br/en/domestic-market/domestic-public-bonds> (Brazil), and U.S. Department of the Treasury, Bureau of Public Debt, TreasuryDirect, Treasury Marketable Securities, at <http://www.treasurydirect.gov/RT/RTGateway?page=institMktbles> (United States). Contrast this to the disclosure and documentation of public external debt, for example, in Mexico, where contracts are extensively described in the readily-available prospectus. Secretaria de Hacienda y Credito Publico, External Debt, Government Securities Issued in the International Market, at [http://www.hacienda.gob.mx/English/public\\_credit\\_new/external\\_debt/Paginas/GOVERNMENTSECURITIESISSUEDINTHEINTERNATIONALMARKETS.aspx](http://www.hacienda.gob.mx/English/public_credit_new/external_debt/Paginas/GOVERNMENTSECURITIESISSUEDINTHEINTERNATIONALMARKETS.aspx).

day administration of the debt instrument once it is issued. Instead, such administrative work is typically done within the government or by special arrangement with domestic institutions.<sup>3</sup>

Governments usually have the largest and most liquid domestic debt markets, and are generally regarded as the safest issuers in their jurisdiction. Their debts serve as benchmarks for pricing the debt of all other issuers. At home, government debt is often the closest thing to money. But its attraction to investors is not always due to its sterling credit quality. Governments can create markets in their debt by regulating financial institutions within their jurisdictions. For example, regulators let banks hold no capital against their own government debt, in contrast to private sector loans. Pension funds are told to keep a portion of their investments in safe, liquid assets, comprising mostly government debt. Central banks lend against government debt collateral. Put differently, the “money” status of government debt can be decreed, at least at home.

A government’s capacity to create a market in its debt weakens beyond the national borders. Favorable regulatory treatment abroad requires international cooperation, which is hard to achieve. Although the Basel Committee on Bank Supervision and the European Union each provide for the risk-free treatment of some foreign government debt for bank regulatory purposes (Basel Committee on Banking Supervision, 1999; European Parliament, 2006; Hannoun 2011), it is not the general rule. The result is a paradox: at the extreme, particularly in poorer countries, the same instrument can be risk-free and in demand at home, but unwanted abroad. In the global hierarchy of financial assets, some sovereign debt is clearly more money-like than the rest, a state of affairs reinforced by regulatory harmonization via Basel and Brussels.

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<sup>3</sup> For example, the Federal Reserve Bank of New York serves as fiscal agent for the U.S. Treasury.

Some government debt enjoys similarly high status at home and abroad. Owing to their deep markets, wealthy economies, regulatory reach, and other factors, the United States, the United Kingdom, and Germany among others, are able to issue debt that is considered risk free and serves as a reliable store of value for *foreign* individuals, institutions, and central banks. Market participants beyond these issuers' regulatory reach have come to treat their debt like cash. It sits atop of the asset hierarchy.

Contracts do not figure prominently in the life of government debt held within the issuer's jurisdiction, and money-like debt described in the preceding paragraph. Factors other than contracts— an abundance of resources and political stability, deep markets, or a captive audience, among others—are assumed to guarantee its safety. This “information-insensitive” quality (Cf. Gorton 2009) may explain market tolerance for poor and heterogeneous documentation of domestic debt, notably in the Eurozone (Gulati and Smets 2013). On the other hand, debt contracts with acknowledged credit risk, such as those used by developing countries to raise money from foreign investors, tend to be standardized, elaborate, and mind-numbingly long. Their issuance is concentrated for the most part in two jurisdictions, England and New York. Whereas money-like debt at the core of the global financial system is documented in-house, contracts for debt on the periphery of the system are drafted by elite law firms, and their marketing is done by top investment banks. Even though the disclosure requirements for foreign sovereigns are looser than those applicable to private issuers, foreign debt disclosure is substantial and much more readily accessible compared to its domestic counterpart.

Apart from money-like debt, all other government debt derives its value from a mix of the debtor's capacity and willingness to pay, contractual safeguards, and third-party backing.

Such backing is rarely explicit.<sup>4</sup> However, creditors have long relied on rich governments for repayment of their loans to the less fortunate. In the early 20<sup>th</sup> century, this might have meant “gunboat diplomacy,” or taking over debtors’ customs houses to collect revenues for the creditors’ account (Ahmed et al. 2010). In the late 20<sup>th</sup> century, this meant “bailouts,” or rescue financing from rich countries and multilateral institutions, which went to repay foreign bondholders when their debtors ran out of funds (Bulow and Rogoff 1988b, Roubini and Setser 2004). Unlike gunboat diplomacy, latter-day bailouts were never justified in terms of helping the creditors. Rather, the implicit backing of sovereign debt was a response to externalities from sovereign debt crises, notably the fear of financial contagion.

In the late 1990s, the foreign bond contracts of developing countries became the site of a legal and political reform campaign initiated by the rich countries. As financial crises proliferated, pressure for bailouts intensified, and rescue packages grew bigger, the rich decided to step back. In lieu of bailouts, or at least as a complement to them, Group of Seven officials insisted that sovereign debtors and their creditors renegotiate their contracts and absorb some or all of the resulting losses. Reform advocates in the official sector needed a tangible way to advance this policy: it is one thing to say that debtors and creditors were on their own, quite another to make them believe you would stand idly by as contagion wreaked havoc on the world economy. Ideally, the promise to back off should come with a package of concrete policy initiatives that would make it more credible. This search for concrete initiatives prompted a turn to legal technique.

## **Part II: Theory and Opportunity**

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<sup>4</sup> For example, developing countries issued “Brady Bonds” partly backed by U.S. Treasury securities as part of the initiative to end the 1980s debt crisis. (Buckley 1998)

*A. Theories for the Revolution*

The term “Collective Action Clauses” emerged in the late 1990s to describe a set of contract provisions that make it easier for bondholders to coordinate among themselves in a sovereign debt crisis. They include, among others, provisions to facilitate amendment of debt contracts by majority vote, structures for collective representation of bondholders, and procedures to initiate negotiations in debt distress. While most of the clauses have been around in some form for many decades, they became a team, got their name, and shot to stardom when officials started pushing for their adoption in the wake of the 1995 financial crisis in Mexico—and even more so after Argentina’s default in 2001. CACs were part of the public sector’s program of promoting orderly crisis management, an antidote to bailouts. However, they also had a very specific technical job in the policy program: according to rich-country officials, CACs were needed to overcome the New York custom of giving individual bondholders veto power over amendment. About half of all emerging markets foreign sovereign (including most Latin American) debt was being issued under New York law at the time. These contracts were presumed immutable.

As the clauses began to figure prominently in official pronouncements, the “CAC” label stuck, though the content behind the label has shifted over time. One category of CACs—the majority amendment provisions, which specifically counter the unanimous consent practice in New York—has progressively eclipsed representation, initiation, and the rest in market and policy discourse. Majority amendment above all solved multiple theoretical problems at once. Law practitioners, market participants, and policy makers debating CACs on the merits readily deploy the theoretical arguments. We begin by following their lead to consider the theoretical

explanations of CACs' function as a contractual device to improve the performance of sovereign bonds. These fit in two major categories: coordination and modification.

***Coordination.*** At the most basic level, as their name suggests, collective action clauses are designed to solve coordination problems. These problems are not limited to modification but are simply present whenever multiple parties to a contract (such as all bondholders in a bond issue) cannot agree on a course of action in the common interest. For example, a variant of a collective action clause requires a subset of bondholders to agree to accelerate the debt in the event of default—and a larger subset to rescind acceleration. Other collective action problems in bond contracts might involve decisions to sue or waive minor infractions; solutions include delegating powers to a bondholder representative such as a trustee, or a separate majority vote. If each bondholder acted in its individual interest, the result might be a fire sale, a rush to the court house, or a race to strip a debtor's assets—all of which are ruinous for the bondholders as a group, not to mention the debtor. Where each creditor has veto power—as was the custom in New York law bond contracts before 2003--individual bondholders might be tempted to disrupt or free-ride on a debt restructuring, prolonging a crisis and delaying recovery.

Bankruptcy law (inapplicable to sovereigns) offers a set of solutions to such problems; some or all of these may also be replicated with contract clauses. (Eichengreen 2003, Jackson 1986) From this vantage point, CACs are a private and selective adaptation of bankruptcy technique, which does not necessarily import the structure, values, or many other functions of a statutory bankruptcy regime.

Some of CACs' appeal might be explained by the textbook quality in which they paired expected problems with accepted answers. Empirical evidence of coordination problems in modern sovereign bonds was limited and anecdotal at the time CACs first came up as a policy

initiative in the mid-1990s. The emerging market sovereign bond market which they were meant to reform had only been in existence in its modern form for a few years. Rich country bonds were thought to be risk-free and were spared the need to think about distress. While market participants groused about policy makers solving imaginary problems, officials pointed to a few high-profile lawsuits and predicted more to come. Empirical evidence so far has not borne out these predictions (Bi et al 2011). Bond restructurings have been relatively quick and smooth (Sturzenegger and Zettelmeyer 2007), and litigation relatively rare (Enderlein et al 2012).

It bears emphasis that this evidence does not suggest that CACs were useless as a technical device to help restructurings go more smoothly. Rather, the claim is that they were not essential to solve a pressing problem in sovereign debt management. Either the problem was not big, or some combination of background law and market adaptation had found good-enough ways to solve it (Panizza et al., 2011). Nevertheless, CACs retained both common sense and high-end theoretical appeal as a solution to coordination problems.

**Modification.** As noted earlier, the majority amendment provision is by far the most famous CAC of all. In its most common form, it allows a majority of bondholders to amend the financial terms of a bond and bind the dissenters. Advocates for CACs argue that it is irrational for sovereigns to omit modification provisions in their contracts, because the result is a high cost of negotiating with creditors in crisis. The counter argument here is that, in theory, rational debtors seeking to raise funds might want to make renegotiation tough to signal their confidence that they will never have to restructure. Advocates respond that sovereign debtors are already deeply reluctant to restructure; additional incentives would make no difference (Buchheit and Gulati 2002). Other explanations for why CACs were not adopted earlier and more widely

include first-mover problems, network externalities causing contract stickiness, and bounded rationality (Eichengreen 2003).

Again, the public debate about CACs has been a textbook reflection of the academic debate. If CACs materially increased moral hazard on the part of sovereign debtors, causing weak ones to restructure willy-nilly, then it made sense for creditors and strong debtors to oppose CACs. If all sovereign debtors already had adequate incentives against default, CACs would be a welcome tool to reduce deadweight losses in distress.

In sum, CACs came with an impressive theoretical pedigree. But while theory framed arguments for and against CACs, it did not dictate an outcome. Empirical evidence of coordination and modification problems would take years to collect, and even then would prove inconclusive. CACs' rapid and widespread adoption beginning in 2003 did not come about because anyone had found proof of coordination problems, nor because sovereigns had dispensed with creditors' warnings of moral hazard. Instead, CACs owed their success to a peculiar confluence of events and personalities that turned the next financial crisis into political opportunity.

### ***B. Tequila Sunrise***

CACs were first mooted as an answer to sovereign debt crises after the 1995 U.S. and IMF rescue package for Mexico, which topped \$40 billion.<sup>5</sup> Although the loan was quickly repaid and made money for the U.S. Treasury, it caused much political, policy, and academic

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<sup>5</sup> There is some, albeit sparse, evidence that CACs had a prior incarnation as a solution to the world's problems in the early 1920s. The Czech Republic used what we believe to be the first CAC in a sovereign bond issued in 1922; a bond that was subsequently restructured in 1946. That initiative did not, however, result in widespread adoption of CACs. See Weidemaier (2012).

consternation (Rubin 2003). Critics complained that the package bailed out reckless private lenders and sovereign borrowers, and created expectations that public money would be on offer from here on out, along with perverse incentives to accumulate unsustainable debts. The response was twofold: first, the rescue package was the only alternative to a Mexican bond default, which would have untold consequences for the global markets and the U.S. economy; and second, to avoid future bailouts, emerging market governments would change their bond contracts to make restructuring a plausible option.

The view that bond restructuring would be unfathomably messy was generally held, and had an air of a truth that went without saying (Euromoney 1995, Buchheit 1998, 1999). Some of the explanations stressed the nature of bonds as widely held, tradable instruments prone to coordination problems (even though some bonds are more closely held and less liquid than loan participations). But most practitioners, market participants, and academics ultimately blamed the New York custom of requiring each bondholder to approve a change in financial terms, which made sovereign bonds effectively immune to restructuring.<sup>6</sup> Mexico was the prime example of the problem, since it was one of the biggest issuers of sovereign bonds in New York. Once the problem was identified as New York contracts, it had a ready solution: either to change the contracts themselves, or to trump them with statutory bankruptcy.

The glitch in characterizing the problem as New York contracts in 1995 was that this particular Mexican debt crisis did not implicate its New York law bonds. The culprit instruments were domestic *Tesobonos*: Mexican-law, dollar-indexed debt that exploded as the Mexican peso fell. To this day, no policy or academic work has reproduced or analyzed the restructuring

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<sup>6</sup> No statute or case law mandated this practice; we return to this point in the next section.

provisions of *Tesobonos*. Everything we know about the 1995 crisis suggests that such provisions, if they existed, did not figure prominently in the rescue decision. And even if *Tesobonos* had contained a flat bar to restructuring, Mexico had a trump card against its bondholders—the power to enact a law to restructure the bonds by fiat. To be sure, creditors would have complained, and might even have shut Mexico out of the markets. Moreover, a restructuring might have caused contagion. But a majority “cramdown” of new terms over the objections of some creditors could have had much the same result. Reluctance to restructure *Tesobonos* was not for lack of legal tools, but for fear of economic consequences.

In fairness to the policy makers and academics who pressed for CACs then, many of them looked beyond *Tesobonos* at the large stock of New York law foreign sovereign bonds, and tried to expand policy options for the next sovereign crisis. But the next crisis, which struck in 1997, happened in Asia and involved corporate and bank debt, which could be restructured in bankruptcy. Corporate bankruptcy reform was the answer (Halliday and Carruthers 2009). By 2000, it became apparent that even sovereign bonds with unanimity provisions were not restructuring-proof. That year, Ecuador engineered a debt exchange that produced record levels of debt relief with the participation of over 90% of its bondholders, notwithstanding New York-style unanimity in its debt contracts. Not until Argentina’s default in 2001 did collective action problems in foreign sovereign bonds begin to sound like a plausible obstacle to restructuring, with CACs as a plausible, though hardly a critical, solution.

Five years after their public debut,<sup>7</sup> CACs had become familiar to policy wonks from the late 1990s summit statements and expert reports. The academic research machine had revved up to

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<sup>7</sup> The academic and policy effort to promote CACs started with Eichengreen & Portes (1995), whose paper fed into the Rey Report (1996).

produce theoretical and empirical studies for a decade to come. However, few high-level officials would spend political capital on their implementation. According to one U.S. official, “it was not number one, number two, or number three” on the policy agenda.<sup>8</sup> To most, CACs were a harmless legal technique that made the customary litany of deliverables sound specific and constructive, and might help on the margins in crisis. Politicians might praise CACs in the occasional speech, but they would not antagonize investors to mandate them. And when markets calmed down, CACs receded from public view to collect dust in the files of law firm associates and mid-level bureaucrats.

### *C. Contract Control and Contract Autonomy*

By the turn of the 21<sup>st</sup> century and the onset of Argentina’s debt crisis, the academic and policy consensus had shifted in CACs’ favor. This was less a function of empirical proof than of bureaucratic repetition; CACs had become embedded in the G-7 crisis agenda. With the new consensus in place, sovereign bond contracts now embodied a double theoretical conundrum: they were written to exacerbate coordination problems among bondholders, and failed to change when these problems were publicized in the late 1990s. Although investors continued to insist that states restructured opportunistically, and therefore that CACs were undesirable, law practitioners routinely attributed the persistence of unanimity to blind copying by bleary-eyed associates from corporate bonds (Cf. Weidemaier, Gulati and Scott 2012, Gelpern and Gulati 2007).

The combined diagnosis of coordination problems and “stickiness” of apparently suboptimal terms suggested a market failure, and mobilized theories for public intervention. Government

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<sup>8</sup> Interview 102105.

action in the form of education, coordination, and moral suasion was especially appropriate if unanimity in New York had been a product of blind copying, rather than a deliberate effort to discipline the debtor, signal commitment, or extort the public sector. Officials had tried some educating, coordinating, and suading back in the 1990s. But that public relations campaign failed to convince market actors to shift to CACs.

We have argued elsewhere that the shift in New York bond contracts in 2003 came in response to a more muscular proposal by the IMF to resolve coordination problems with a treaty-based sovereign bankruptcy regime (Gelpern and Gulati 2007). The enduring policy salience of the Sovereign Debt Restructuring Mechanism (SDRM) was a surprise to many observers. It was in large part a product of the idiosyncratic leadership at the U.S. Treasury and the IMF, the U.S. political transition, Argentina's debt crisis, and even the attacks of 9/11 (Setser 2010). U.S. Treasury Secretary Paul O'Neill raised sovereign bankruptcy at a getting-to-know-you breakfast with top IMF officials in August 2001, while discussing Argentina. He publicly proposed it shortly thereafter, in his first testimony after September 11. O'Neill's senior staff present at the breakfast said they did not expect the IMF to run with the idea, which came up spontaneously and had not been vetted within the George W. Bush Administration. But that is exactly what the IMF did, led by Deputy Managing Director Anne O. Krueger, encouraged by the perception of support elsewhere in the Administration, among European governments and some debt relief advocates in the civil society (Setser 2010, Gelpern and Gulati 2007).

As the bankruptcy proposal gained speed, O'Neill's deputy, Treasury Under Secretary John B. Taylor, did what no official before him had done: orchestrate an all-out campaign to implement CACs. Taylor was a passionate opponent of recent IMF interventions in financial crises. He was uncomfortable with O'Neill's bankruptcy lurch, which was a top-down public fix

to sovereign debt problems, inconsistent with Taylor's and the Administration's free market outlook. A prominent academic economist, Taylor was also the only senior official who consistently and forcefully made a case for CACs as a direct path to stopping bailouts. To be sure, no one seriously contested CACs' capacity to encourage coordination in some states of the world, and no one in the official sector argued that they were harmful. But Taylor was unique for his genuine faith in CACs' bigger policy potential, and his willingness to devote personal and political capital to making them happen. He called finance officials, met with investors and investment banks, hosted seminars, gave speeches, and commissioned contract drafting ideas under the auspices of the G-10—the group that first mooted CACs in a 1996 report (Taylor 2002, 2007, Quarles 2010). The G-10 experts, led by Taylor's deputy Randal Quarles, asked a group of eminent lawyers to prepare sample clauses. (Group of Ten 2002) These became influential in shaping market adoption of CACs in 2003, and in their European revival in 2010.

The SDRM proposal remained on the international policy agenda for over a year, and came to be seen as a formidable threat by opponents of official intervention in the sovereign debt markets. The awkward combination of O'Neill's bankruptcy mandate and Taylor's commitment to the contractual alternative, aided perhaps by higher-level inattention, meant that both bankruptcy and contracts were being pursued on parallel tracks. Partly thanks to the inevitable competition between the two policy tracks, the outreach campaign intensified tremendously, with studies, meetings, and public events on both sides.

For their part, investors suddenly faced a problem much bigger than contract clauses that might, on the margin, help opportunistic sovereigns restructure: they faced a treaty proposal that could be the first step to more muscular public ordering in the global sovereign debt market (Kaiser 2010). It is doubtful whether the SDRM, which entailed rather modest steps to overcome

collective action problems and resolve disputes, ever had the potential to turn into real sovereign bankruptcy (IMF 2003). But mere talk of bankruptcy was threatening and disruptive, if allowed to go on. Debtors and private creditors appeared united in their opposition to the SDRM on the grounds that it (and even the talk of “it”) would raise borrowing costs and dramatically reduce the availability of funds for emerging markets sovereigns. As with other positions in this area, this was at best a hunch; there was no empirical evidence one way or another for the cost of bankruptcy. But when a treaty regime seemed ever so slightly plausible—and with it a more fundamental overhaul of the global sovereign debt market—borrowing governments and their bondholders became more enthusiastic about adopting CACs as a means of foreclosing further discussion of such a regime.

By late 2003, CAC proponents in the official sector declared victory. Mexico issued a New York law bond with CACs in February; within months, issuers were switching in droves, and by year-end, 70 to 80% of all new emerging markets sovereign debt issued in the New York had CACs (Bradley and Gulati 2012). This singular success story unfolded against the background of protagonists, including Mexican officials, stubbornly claiming that they saw no need to solve phantom coordination problems, but instead adopted CACs to destroy the bankruptcy initiative. One apocryphal story has a high-ranking Mexican finance official declaring after the pilot issue, “We killed the motherfucker!”, referring to the SDRM. (Int.C7)

Killing the unmentionable was only part of the story. The way in which the early adopters went about introducing CACs revealed different political tensions. Large emerging market sovereigns such as Mexico and Brazil resented the official sector’s attempts to meddle with their market and their private bond contracts. On the other hand, the G-7 and the IMF saw such intervention as their prerogative: the bailouts of the 1990s and early 2000s proved that the

market rested on their implicit guarantee, and they wanted at least a say on the terms of the guarantee (Cf. Bulow and Rogoff 1988). By 2003, the newly creditworthy issuers saw any guarantee as a relic of the past, and claimed sovereign autonomy over their debt markets, including their contracts. Mexico's decision to move first, with their own language and minimal advance notice even to the most fervent advocates of CACs in the G-7, was explicitly described by Mexican debt managers and their lawyers as a claim to autonomy: they were going to thwart the IMF bankruptcy initiative and preempt foreign meddling with their contracts in one fell swoop (Gelpern and Gulati 2007).

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The need for CACs and the need for government intervention to implement CACs both rested on a solid foundation of economic theory, albeit in something of an empirical vacuum. However, emerging markets debt managers who inserted CACs in their contracts, as well as the market participants and the law practitioners involved, most often attributed the market shift to different kinds of factors: political and institutional imperatives to defend private markets from public regulation and to preserve national autonomy. For their part, most officials who publicly promoted CACs and fluently recited the background theory, also privately expressed puzzlement at how they came to be so prominent in the policy mix. Our interviews after CACs had conquered the New York market seem to suggest that their success had a tenuous connection to their function in sovereign debt contracts, untested at the time. Instead, CACs acquired multiple contingent, constructed meanings: depending on the context, their job might be to signal an end to bailouts, to defeat SDRM, or to reassert national autonomy over government debt contracts. CACs were not just socially embedded; they were contract tofu—capable of taking on multiple policy flavors to carry political messages under the guise of market-based technique. These

messages in turn helped market participants and governments negotiate crisis management, loss distribution, and their respective places in the foreign sovereign bond market in the late 1990s and early 2000s.

In sum, CACs in 2003 neatly illustrated established contract theories and theories for government intervention, and a parallel anti-theory where debtors and creditors alike insisted that they did not change their contracts to improve the way they worked. A decade on, we heard the same story in a very different setting.

### **Part III: Into the Mainstream**

Below we recount the story of CACs' return in Europe beginning in 2010. At this writing, European member states are on track to adopt CACs across the board in their long-term bonds issued after January 2013. In terms of market size and global economic significance, the European initiative dwarfs the contractual revolution of 2003. If successful, it would bring uniform CACs to a \$10 trillion market in rich-country domestic debt, with virtually all new issues instantly bound to use them. The earlier wave of adoption successfully targeted roughly \$300 billion in New York-law debt of developing countries. As before, we heard conflicting accounts of why policy makers and market participants turned to CACs. We relate them below. *First*, CACs were a mechanism to encourage private creditors to restructure and a signal that Europe would not bail out weaker members and their creditors. *Second*, CACs were a commitment that European crisis managers would be guided by clear and transparent rules and a distinct commitment that these rules would be uniform across the union. *Third*, for some European policy makers, CACs were a path to market discipline, opening the prospect that Greece would no longer hide behind German credit. *Fourth*, CACs were a means of negotiating

asset hierarchy and loss distribution among European member states as they constructed an integrated market in government debt – they had become (somewhat incredibly) part of the language for negotiating the distributive bargain of federalism in Europe. The *fifth* story is about CACs as a legal and debt management technique, and the challenge of reconciling a functional contract provision with multiple overlapping political missions.

By itself, each account is at best incomplete, and often wrong. Together, they offer a window into the role of private law in the construction of financial markets and the management of financial crises.

#### *A. CACs as Burden Sharing*

Greece’s debt troubles came to light in the fall of 2009. For much of the next year, European politicians stuck to four positions in growing tension with one another and the facts: first, Greece was solvent and did not need a debt restructuring; second, Greece would not get a bailout because EU treaties barred fiscal transfers and central bank financing; third, Greece was unique; and fourth, the Euro was safe. After two reform programs, EU and IMF rescue packages, and an ECB bond buying initiative failed to stem the bleeding, consensus began to shift in favor of a comprehensive European crisis response mechanism. What shape that mechanism would take was an open question in mid-2010. One thing was clear: it would involve large-scale emergency transfers among member states, which in turn created the twin political imperatives of conditionality and “private sector involvement,” or PSI.<sup>9</sup> Conditionality meant big policy

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<sup>9</sup> The acronym had been used in the 1990s primarily to connote emerging market bond restructuring, part of the effort to reform “international financial architecture” in the wake of the Mexican and Asian crises (See e.g., Roubini and Setser 2004). It was revived and took on broader significance in the European crisis from 2010 on.

concessions on the part of crisis-stricken members. PSI was a 1990s euphemism for concessions from private creditors, or debt restructuring.

Institutional design options included a version of the 2003 SDRM, proposed by Krueger and colleagues, and a regional monetary fund with debt resolution powers (Sapir et al. 2010; Gros and Mayer 2010). Both were public ordering moves, and implied ceding sovereignty on the part of member states. With these proposals in the background, French and German leaders held an emergency summit in Deauville in October 2010 to chart the way forward. By all accounts, it was the turning point that brought CACs to Europe.

When they returned from their iconic beach walk in Deauville, President Sarkozy and Chancellor Merkel instructed their staff to prepare a statement that included, among other crisis measures, a promise to adopt “necessary arrangements for an [sic] adequate participation of private creditors” in financing the recovery programs of crisis-stricken countries (Franco-German Declaration 2010). PSI revival had begun. CACs were not mentioned publicly by name until a month later, but they had been in the air for some time: an Italian member of the ECB Board even publicly supported their adoption in remarks before the European parliament in September (Bini Smaghi 2010). Officials present at Deauville recalled that specific instructions to adopt CACs came then, and from on high. According to one, “If the President of France and the Chancellor of Germany say something, you have got to do it. To me—I am not a lawyer—it was a political instruction to us ...” (Int.A38). Soon after Deauville, a Finnish paper advocating CACs was leaked to the press (Strupczewski 2010). A European journalist quoted anonymous officials reporting that after Deauville, “[t]hrough subsequent meetings this was then adopted and adapted by the European Council, leading to the agreed standard form euro area CACs for adoption from 1.1.2013.” (Int.B13)

The post-Deauville mandate might strike an outside observer as odd for four reasons. First, it primarily (if implicitly) addressed itself to the domestic debt of rich countries—the “Big Debt” category we identified earlier in the paper, which accounts for over 80% of all outstanding government securities, as compared to the 1% representing all foreign debt securities of developing countries. What little foreign debt Europe had issued was mostly under English law, and already had CACs. European governments had already committed to use CACs in their foreign law debt in April 2003 (EFC 2003, 2004). To our knowledge, before Deauville, no policy maker had tried to use the CACs in Greek or any other European debt, or to take advantage of accumulated research on the subject to see whether they could be used in the Greek crisis. Second, in contrast to the 1990s and 2000s, no policy maker had identified a collective action problem for Collective Action Clauses to solve in Europe. Eurozone government debt was held overwhelmingly by large regulated institutions, and increasingly by other governments and central banks. These are not hard to locate, and relatively easy to coordinate through informal suasion, regulation and diplomacy. In some countries such as Spain and Ireland, most of the problem debt was private, and technically could be restructured using domestic corporate bankruptcy and bank resolution laws.<sup>10</sup> Third, CACs had been sold in 2003 as a market solution. Once debtors and creditors decided to move, everyone expected a healthy competition among clause designs, with the market eventually choosing the best. To this day, not all issuers use CACs in New York, and emerging markets CACs exhibit significant variation (Bradley and Gulati 2012, Gelpern and Gulati 2009). In Europe in 2010, the rhetoric of CACs was used instead to dress up a centrally-mandated set of uniform clauses. Why?

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<sup>10</sup> To the extent these laws were inadequate to the task, the response would be to reform them, not to tinker with sovereign debt contracts.

A remarkable number of observers attribute CACs to a mix of ignorance, desperation, and failure of planning. When we asked how CACs made it onto the policy agenda in 2010, we typically heard similar answers from those involved in the previous iterations of contract reform:

*[S]ounds like someone needed something to say about orderly/market friendly restructuring and CACs came out of their mouths... (Int.C1)*

*Someone remembered the debates of the 1990s and pulled a German memo from the 1990s ... (Int.A31)*

*One person in the room ... says, 'Wait, I remember fifteen years ago there were four letters ... and three letters ... I don't remember the four, but the three is CAC ...' It was totemic – says there will be some burden-sharing. (Int.A13)*

*How many lawyers do you think they had in that room?? (Int.A35)*

The outside story was that European politicians, especially those in Germany, realized that they were on the hook for future rescue operations, and needed to show their voters that greedy bankers would share some of the financing burden. With policy makers thus pushed against the wall, someone remembered that CACs stood for burden-sharing, and stuck them in a statement as proof of seriousness or somesuch.

Several outside accounts attribute the compromise to ECB head Jean-Claude Trichet taking advantage of the others' ignorance. One version dates the agreement on CACs to the Eurogroup statement in November. It was well-known by then that German officials had favored statutory bankruptcy, but faced vigorous opposition from most of their European counterparts, who shared Trichet's worry about market contagion from a Eurozone debt restructuring. Trichet drew on his experience overseeing official debt restructuring decades earlier, and used CACs to diffuse German radicalism:

*On November 28th, at that meeting, Trichet was there. He had been [head of] the Paris Club. He is a gifted technocrat. That was a high level meeting and the others there*

*might not have known what they were signing off on when they agreed to CACs. But Trichet knew.* (Int.B10)

Those claiming to have had direct or indirect involvement in the events at Deauville credit German Finance Minister Wolfgang Schauble with the rise of CACs. Far from a last-minute scramble, they describe a delicate compromise that took months of planning and bureaucratic maneuvering. It is true that German officials were under domestic political pressure to stick it to private creditors, as more and more people realized the Greek crisis would not be solved quickly. One official described the realization that led to CACs this way: “The Greek black hole is getting bigger. And we are going to keep paying to bail them out.” (Int.A30) By then, forswearing bailouts was hardly an option: No-Bailouts was the starting position, enshrined in EU treaties, and one that looked increasingly untenable. It would have to be modified to introduce flexibility to finance distressed countries in crisis, provided the financing burden was shared, and flexibility were contained within clear institutional boundaries under the new standing European Stability Mechanism (ESM).

It so happened that German officials were already committed to an institutional design of sorts. The German Government Coalition Agreement in the summer of 2009 contained a pledge, included at the behest of debt relief advocates, to promote international sovereign bankruptcy to address the problem of illegitimate debts in poor countries. Some of the implementation papers written in connection with this domestic political undertaking were making rounds in the finance ministry just as the Greek statistics scandal broke. They were put to immediate use, though not quite the one that the original authors had expected. (Int.A14)

At least some of the people involved in crafting the German position in the finance ministry were well-aware of the CAC-SDRM controversy and the challenge that other

bankruptcy proposals had faced. CACs were a familiar and logical back-up. Economists and lawyers from inside and outside Germany, who attended European negotiating sessions, all suggest that the German team had a better understanding of CACs than any of the others.

(Int.A23) Moreover, most were convinced that Schauble (a lawyer by training) was personally informed and involved in the decisions involving CAC advocacy. German finance ministry staff were tasked in the summer of 2010 at the latest with researching CACs down to the technical details. One U.S. practitioner reports being summoned to the German finance ministry that summer, and seeing a desk covered with a decade’s worth of academic research on CACs. (Int.A4, Int.B7). This put Germany in a position to offer an alternative when the others rejected bankruptcy.<sup>11</sup>

Ultimately it is unimportant whether the Germans outwitted the French, or vice versa. All accounts converge around the idea that CACs were a fallback, a compromise meant to signal that Europe would ask private creditors to contribute, but “at least signal that we were not doing something extraordinary.” (Bini Smaghi 2010, Int.A38) But of course they *were* doing something extraordinary and different: European CACs were proposed as an integral part of the standing European crisis resolution mechanism and the new political bargain underpinning the European sovereign debt market. They would be mandated by those who had the power to enforce their adoption and uniformity, in a category of debt that did not seem prone to coordination problems, even in theory.

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<sup>11</sup> Some of our French and German interlocutors attributed the outcome of Eurogroup negotiations to the difference between French and German bureaucracies. Many French finance ministry staff serve a rotation on the secretariat of the Paris Club of official bilateral creditors, which may have given them insight into poor and emerging markets sovereign debt, and the CACs-SDRM debates of old. (Int.A37) On the other hand, German finance ministry officials are more likely to have legal training, and to be in contact with private law firms familiar with CACs from sovereign and German corporate bond reforms. (Int.B7)

The introduction of CACs was deliberate; however, those who attribute their appearance to uninformed desperation were right in one sense. CACs' function in late 2010 seemed to be mostly about market and political messaging: creditors were put on notice that they would be “involved” in debt relief, and voters in surplus states were told that private creditors would be footing some of the crisis bill. The success of the message at the outset depended on a peculiar mix of audience knowledge and ignorance. Markets would accept CACs if they remembered them as the benign reform that had diffused the last PSI flare-up and ended SDRM. Citizens would believe the new distribution bargain underpinning government debt markets if they saw CACs as a tool to extract concessions from private creditors. Both groups would do well not to ask hard questions about how emerging market foreign bond contract techniques might work in rich countries' domestic debt.

### ***B. CACs as Market Rules***

The 2003 CAC initiative went out of its way to show that CACs were an organic market development; its successor in 2010 was a universal mandate. In 2003, officials worked vigorously to “nudge” the market to its senses, but Taylor and his colleagues were scrupulous to avoid mandating any clauses, much less uniform clauses in any particular form. Anything different would have been inconsistent with their faith in market forces and their belief that all that the markets needed was a nudge. In their view, CACs issued with the G-10 report were a concrete alternative to unanimity, which could be adopted wholesale or could serve as the basis for customization. In fact, the degree of variation between and even within debt stocks after 2003 was remarkable (Gelpern and Gulati 2009). In contrast, in 2010, the “political instruction” to European officials was “that CACs should be standard and identical.” (Int.A37). One lawyer representing an early CAC adopter in the emerging markets observed:

*When we did CACs in 2003, we were careful about testing the markets with different types of clauses -- Mexico did 75%, Brazil 85%, . . . other variations as well. We wanted to see what the market would accept. The Euro CACs impose a mandatory scheme . . . will the market accept it?(Int. B2)*

To be sure, in 2003, the proponents of CACs were foisting them on other sovereigns they could not control. In 2010, European issuers were mandating CACs for themselves. But the mandate applied to all European issuers, was uniform in content, and was embedded in a treaty obligation, not case-by-case issuer choice. One explanation for the difference might be that CACs' job as bankruptcy deflector loomed large throughout 2002-2003, but was accomplished up front in 2010. SDRM lingered for over a year; European sovereign bankruptcy appeared to lose viability in a matter of months. But in the minds of their proponents, CACs had other work to do. Over and over, we heard that Germany in particular wanted a rulebook to manage future crises, and that CACs had an important place in the rulebook. In 2010, we found many more policy makers sharing John Taylor's faith in CACs' proto-bankruptcy potential, even though no new evidence for or against had emerged between 2003 and 2010. A German official described CACs as the opposite of "ex-post blackmail" that seemed to prevail in the ongoing crisis.

(Int.A30). A central bank lawyer echoed the sentiment:

*There is no such thing as a sovereign insolvency process. CACs are a way for sovereigns to create a process – an enlightened, pro-market [process]. ... The very creation of it is arguably against the sovereign. (Int. A21)*

An academic who consulted with German government officials at the time observed:

*I remember in 2010 that the guys from the Ministry of Finance were running around underlining their will to action and portraying the introduction of CACs as panacea to all the problems. The sense, at the time, was that the CACs would make everything more orderly. No holdouts, no ad-hoc rules by avoiding holdouts ... [T]here is a VERY strong sense here that we need better rules (we Germans love rules) and this whole restructuring thing looked chaotic. The gut reaction to about 95% of higher-ranking officials ... is that we need a new "orderly debt restructuring regime", setting rules and calming the chaos. Schäuble initially tried to push for a new type of SDRM, an initiative called the "Berlin Club" at the time, but the first (un)official whitepapers were a disaster,*

*so this was shelved. The alternative then was to rely on something that sounded easier and still like a rules-based crisis resolution mechanism. (Int.B7)*

This was much bigger than the caricature of rule-loving Germans. Creating a uniform rule-bound sovereign debt market in Europe, and giving contract clauses a leading role in advancing and harmonizing the rule system, is especially significant in light of the fact that the vast majority of all the debt at issue was governed by domestic law of the member states. The 2003 initiative expressly excluded domestic debt, and Europe's earlier promise to use CACs was scrupulously limited to foreign issues designed to create a demonstration effect for the emerging markets, "to lead by example" (EFC 2004). As we noted at the start of the paper, sovereign debtors wield enormous influence over the accounting and regulatory treatment of their domestic debt; they can do much by law, regulation, and political pressure to create captive domestic demand for their debt and to force its restructuring. Domestic debt contracts (where they exist and look like contracts) rarely provide for default, and with good reason: default in this category of debt is least likely to be determined by contract. Standardizing EU domestic sovereign debt documentation would be a big step in any case; it is radical to start the standardization process with modification provisions relevant only in the shadow of default.<sup>12</sup>

EU lawyers involved in the exercise observed that the idea of CACs as uniform rules constraining the sovereign stood in some tension with their role of signaling investor losses:

*Civilized countries such as the Euro area should have a process. But that was not the intent at all. It was about signaling of investor losses. (Int.A15)*

The tension spilled out into the open when Greece finally moved to restructure its debt. At the onset of the crisis, Greece like the rest of Europe had a debt stock that was over 90%

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<sup>12</sup> It is more radical still if one were to maintain the view of EU domestic debt as risk-free, with default out of the question.

local-law bonds. As we have noted earlier, such domestic debt in Greece and elsewhere had precious few contract terms. That in turn might have meant that they were not subject to restructuring at all (a signal of their risk-free status), or absent 100% consent from the creditors—or that the contract was silent on the matter and other sources of law would fill in the gap. Greece’s lawyers realized that they could use the fact that these bonds were governed by local law to legislate amendment provisions, including ones resembling CACs, across the entire Euro 350 billion stock of domestic government bonds. The idea was initially decried as crazy, contrary to European Human Rights laws, international law, the Greek constitution, and the German constitution among others. But as the crisis worsened between 2010 and 2012, the din subsided and, by February 2012, changing Greek law was one of the only options left for Greece. (Zettelmeyer et al. 2012)

The Greek parliament enacted the Greek Bondholder Law, which allowed two-thirds of its bondholders to amend its domestic bonds by a simple majority vote across series, and bind the rest. In one fell swoop, this move lifted the prospects of a successful restructuring, and transformed the CAC debate. It demonstrated sovereign debtors’ capacity to alter the terms of their domestic debt by fiat, and raised doubts about the relevance of *any* contract terms in domestic debt. It also reaffirmed the rhetorical power of CACs. Attaching the contractual label to retroactive legislation somehow made it more publicly palatable.<sup>13</sup>

At a large law firm gathering in London several months after the Greek debt exchange, the air was thick with outrage: over and over again, participants were asked whether retroactively

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<sup>13</sup> At least one member of the creditor committee in the Greek restructuring has pointed out that the Greek Bondholder Law was enacted following consultation with the creditors (or at least a substantial majority of them), and was therefore less coercive than it might seem. (Int.C11).

amending Greek bond contracts undermined the Rule of Law. Some called the move “heinous,” others foretold quick retribution from the markets. (Int.A40) Yet for others, the abusiveness of the Greek “retro-CACs” conclusively demonstrated the need for common rules, now represented by a package of real CACs purportedly fashioned after the G-10 template using “IMF best practices.”

There were three problems with this new rulebook. First, member states promised to adopt the new CACs, not to use them in crisis. A treaty commitment that “[c]ollective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical”<sup>14</sup> said nothing about the way in which a government would go about restructuring its debt if and when it needed to. Officials might have genuinely intended to bind themselves to use the new CACs, but they certainly did not by the terms of their treaty (Cf. Tirado 2012).<sup>15</sup> The second problem was that the new CACs did not in fact follow the G-10 template—quite the opposite. According to one lawyer involved in the drafting, while the G-10 CACs were for emerging markets countries where default was a regular occurrence, European CACs were “designed for debtors that do not default” (Greek restructuring notwithstanding) (Int.A27). They used lower voting thresholds, gave more procedural options, and imposed fewer voting qualifications on EU sovereign debtors compared to prevailing documentation standard for developing countries. Sovereign issuers at the top of the asset hierarchy would retain flexibility in debt restructuring—presumably on the theory that they could be trusted—even as they sought to appear rule-bound

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<sup>14</sup> Treaty Establishing the European Stability Mechanism, Art. 12(3).

<sup>15</sup> This is entirely consistent with CACs’ limited history in the emerging markets: sovereigns that have CACs in their contracts have the discretion to invoke them; some do, others do not, for strategic and tactical reasons of their own (Sturzenegger and Zettelmeyer 2006, Gelpern and Gulati 2009). *See also* note 17 *infra*.

in their contracts (Pistor 2013). Third, to the extent IMF best practices for CACs existed, Eurozone governments did precious little to figure out what they might be, let alone follow them. Those involved in the drafting tried and failed to get the IMF to endorse the new CACs' as conforming to their guidance. (Int.A12)

In sum, the crisis gave rise to genuine demand for a rulebook to govern European sovereign debt markets. Yet when it came time to draft the rules, the result was soft and noncommittal. European member states retain control in the next round of restructuring, notwithstanding all the treaty and contract work undertaken to create binding rules on their behalf. Even their invocation of market standards and policy practices turned out to be metaphorical. G-10 models and IMF practices might represent hard constraints for the developing countries on the global financial periphery;<sup>16</sup> in Europe, they were rhetoric.

### *C. CACs as Market Discipline*

The first question one might expect rational market actors to ask about proposals for new contract clauses is a simple one: How much will it cost? If a new provision reduces the cost of capital to the issuer, without causing externalities, everyone involved should want it – the issuer, the creditors and the regulators. CACs, according to their proponents, should make all three sets of actors happier. Issuers and creditors are better off because CACs should reduce ex post renegotiation costs without unduly increasing ex ante moral hazard costs. The official sector

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<sup>16</sup> Even on the global periphery, the choice to deploy CACs in a restructuring was to a large extent with the debtor. The decision to restructure may be driven by rich donors demanding burden-sharing; however, the method of restructuring was generally up to the country. Once the debtor chooses CACs as its preferred restructuring method, the extent to which it would be constrained depends on whether the contract follows emerging market or EU template.

reduces its costs because CACs should promote orderly restructuring, which has fewer spillover effects and reduces the pressure for bailouts.

There are skeptics. Their primary argument is that sovereigns already have plenty of restructuring techniques and bargaining leverage in the form of sovereign immunity to reduce their debts whether they need to or not: witness the successful restructurings of countries like Ukraine, Pakistan, Ecuador, the Dominican Republic, Uruguay, Moldova, and others (Sturzenegger and Zettelmeyer 2006). Tracking contract modification literature, they argue that making restructurings even easier would encourage debtors to misbehave more. The end result would be higher cost of capital and less market access, especially for the poorest nations. For believers in market forces, the fact that CACs did not find favor with investors in sovereign bonds for 200 years was telling evidence that they were not needed.

The question of the actual and optimal balance between moral hazard and renegotiation costs is empirically verifiable. A cottage industry of CAC pricing studies developed in the period between 1999 and 2003, with most of the studies emerging from the research departments of official sector institutions such as the IMF. By contrast, in the Euro CAC initiative context, there has been little impetus for new CAC pricing studies; almost as if the issue had been decided ... except that it hadn't.

In the first generation of CAC studies, the empiricists found two sets of results (Haseler 2009 reviews the literature). One group of studies reported that CACs had no impact on debt prices. In other words, they produced neither a benefit nor a penalty (Becker et al. 2003; Gugiatti and Richards 2003). The implication of these studies is either that the market perceived CACs to be worthless, or that the increase in moral hazard costs and decrease in renegotiation

costs were in perfect equipoise so as to cancel each other out. The second set of studies found that CACs lowered costs of borrowing for the richer nations (where moral hazard costs were likely to be low), but increased them for the poorer nations (where moral hazard costs were likely to be high) (Eichengreen and Mody 2004). Together, the two sets of studies prepared with an eye to CAC adoption by poor and middle-income countries suggested no real value for such countries in adding CACs. Pricing advantages for the richest nations were irrelevant to the first wave of initiatives, where the rich were foisting CACs on the poor so they would no longer need to bail them out.

In the 2003 initiative, the first set of studies (showing zero pricing effects) was used to show that CACs would produce no pricing penalty. No one seemed to care about the implication that CAC produced no benefits to the contracting parties. And the second set of studies was simply ignored.

When we did our first round of interviews in 2004-2006, we first assumed that these pricing studies had played a central role in the debates about CACs. They had not. When we asked officials and market participants about them, they dismissed the studies as meaningless. The majority seemed uninterested. Markets didn't price contract terms, seemed to be the dominant view among policy makers, market participants, and even the lawyers who put untold time and energy into designing them:

*There is lot of talk, it is overstated -- the extent to which investors in primary issuances look at the contracts, look at the dispute resolution provisions and say, 'It will cost another seven basis points.' ... They never look beyond first page of the prospectus. (Int.A4)*

Our interlocutors did not quite say that investors were stupid or irresponsible; merely that they were making a risk management decision. For some investors, the uncertainties surrounding any

given crisis path could make it impossible or not worth their while to price particular methods of restructuring. This assessment could change across countries and over time.

The first generation of pricing studies compared the prices of bonds under English law that had used CACs for over a decade, to those under New York law that had not. For the few who bothered to complain about these studies, there were three main issues. First, the early studies simply assumed that the contracts under English law and New York law were identical except for the CACs. But they were not. Not only were there other systematic differences between English law and New York law bonds (for example, the former typically required a mandatory meeting before any changes to the bond terms could occur), but there were also differences in the terms of bonds among issuers within those jurisdictions (Brazil, for example, might be using different dispute resolution terms than Mexico under English law). Second, the studies had assumed that the legal regimes were identical; but there are significant differences between English law and New York law (the same contract terms can mean different things under the two different regimes). Third, the early studies only examined one type of CAC – the votes required to alter payment terms. But there were at least four other types of CACs on the table (for acceleration, for the alternation of non-payment terms, for aggregation across different bonds, and for bondholder representatives/trustees). Maybe these problems with the first generation of studies were at the heart of justified skepticism about their findings.

When the most recent CAC initiative was unveiled for the Eurozone, we assumed that there would be a demand for a CAC study that remedied the problems in the prior studies. Nearly a decade into widespread adoption of CACs, the data was now available to control for the flaws identified. One of us attempted a study using the new data, and came up with results at odds with the prior studies. CACs appeared to bring a pricing benefit – they lowered the cost of

capital for the weakest countries, and made little difference for the stronger ones (Bradley and Gulati 2012).

For the most part, the reaction to the new study was much the same as to the old: a collective yawn. For advocates of CACs, the result was attractive. However, they did not need the data, because they no longer needed to sell CACs to issuers. Unlike 2002-2003, where the official sector had to plead with Mexico to adopt CACs, in 2010, Europe had made the decision for itself. It could then simply mandate CACs across the union and call it a market alternative to bankruptcy. Member state treasury officials were on board with CACs in principle, even if they grumbled about the timing:

*[CACs] are a positive in itself, but there is a question of timing. ... When you introduce CACs in a stressed time like this, you tell investors not to buy. CACs help organization, a positive in case you have to restructure. If you assume that sometime in the future there will be PSI, CACs make the process easier. ... We cannot say PSI will never happen. In the long-term, no one can say. (Int.A1)*

We were surprised to discover that debt managers in at least one small and vulnerable economy did not seem to know about CACs or their price implications, nor care about either. If CACs were relevant at all, it would be to issuers like this. On the other hand, some of the debt managers who were interested in pricing research as a general matter said that our studies of emerging market debt in the decade preceding the European crisis were simply irrelevant to Europe. From this perspective, the price effect was simply unknowable, since there was no closer analogue to be had. In any event, the political mandate to adopt CACs issued before any new studies could have been commissioned (Int. A25). The policy presumption in favor was overwhelming, presumably barring credible evidence of a price penalty.

We were in for a surprise, however, when we discussed the new pricing study with German officials and their occasional advisers. They offered a very different kind of skepticism: as part of the new rule-bound process, they wanted CACs to *raise* the borrowing costs for Greece and other borrowers on the periphery:

*Your pricing studies came up, but nobody believed them. People thought CACs would increase the borrowing costs for weaker Eurozone countries, and that was a good thing. (Int.A2)*

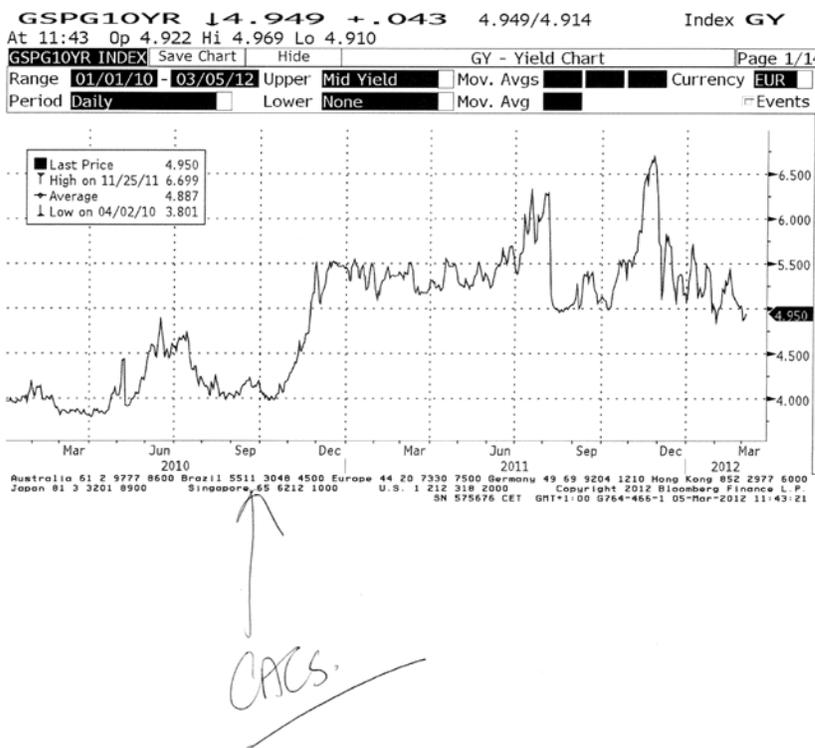
*CACs are a good idea – there will be an effect on the premium, and countries will watch their borrowing. (Int. A30)*

*Yet, only when viewed in the context of other permanent changes made to the EU institutional structure as a result of this crisis can the CAC introduction make sense. ... [T]hey are essentially a way in which “tail end risk” is left at the table to prevent excessive convergence of eurozone bond spreads a’la what was seen pre-crisis. ... As such, CACs are an instrument to make sure – unlike the case pre-crisis – that financial markets pay attention to EU fiscal surveillance. ... Unless the CACs ... help differentiate rates and raise the cost of borrowing for non-core countries vs. core, they will have failed. (Int.C10)*

At least for some German officials and European observers, part of CACs’ work was to discipline profligate states on the periphery. Introducing the same private law device across EU debt would lead to market discipline and hard budget constraints in the south, and preserve sovereign flexibility in the north. In stark contrast to the official proponents of CACs in 2003, the new group seemed to believe that CACs would make restructuring more likely, and saw that as a good thing. With a “civilized” restructuring route laid out before them, the markets would know the difference between Germany and Greece, which should put pressure on Greece to control its borrowing *ex ante*.

The view of discipline was kept private; publicly, CACs were being marketed as a win-win proposition for debtors and creditors alike. By announcing the decision three years ahead of expected implementation, the EU would prepare the markets to manage risks better. Finance officials and debt managers in more vulnerable countries pushed back vocally. Far from an orderly outcome down the road, officials in Spain, Portugal, and others on the periphery saw a dramatic increase in spreads today, which they attributed with varying degrees of emotion to the announcement of CACs and PSI. One of them pointed to a sharp spike on the chart, reproduced in Fig. 2, illustrating a jump in Spain’s borrowing costs, which he attributed to the PSI/CAC announcement. Virtually every debt manager with whom we met told the same story.

**Figure 2**



Spanish Government Bond Yields March 2010-March 2012 (Source: Bloomberg)

In sum, policy makers had divergent but equally instrumental interests in the pricing studies. Those in charge had made the policy decisions and needed pricing studies for marketing. In 2003, the marketing message was that CACs would not raise your borrowing costs, a view that Mexico sought to entrench with its offering. At least for some participants in 2010, the initiative had a thinly veiled subtext: it might ensure that Greece and others got their comeuppance after borrowing for years at near-German rates in the expectation of German backing.

#### *D. CACs as Hierarchy*

As October sun set over Montmartre, our interlocutor contemplated Europe’s decline. The few times he touched the merits of CACs, this prominent economist with public and private sector experience—scoffed at their theoretical virtues. But we hardly ever got to the merits. Instead, the conversation kept coming back to Belize and Zimbabwe. If France were to issue debt with CACs, French debt would become “on par with Zimbabwe and Belize ... a symbol of no more Europe—like Belize, not like the U.S. Treasuries.” (Int.A5) Variations on the abiding worry about Europe going the way of “Argentina, Pakistan, Ukraine, Zimbabwe, Cote d’Ivoire” dominate the latest chapter in the public life of CACs (Beesley 2011).<sup>17</sup>

In some ways, the debate in 2010 was no different from the one in 2003: it was all about whether CACs affected the probability of restructuring, and thereby the status of sovereign debt contracts with CACs in the financial asset hierarchy. Proponents insisted that CACs only made restructuring more orderly if and when it was already inevitable. Skeptics said either that “more orderly” meant “easier” and therefore “more likely,” or that, at a minimum, adopting CACs sent a signal that restructuring was no longer off-limits. We touched on both sides of the argument in our discussion of the pricing studies earlier. In Europe, it came with an additional twist. Before the Greek crisis, much or all Eurozone sovereign debt was treated as a risk-free reserve asset, in the same category as the U.S. Treasuries and in contrast to sovereign credit instruments issued by

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<sup>17</sup> All but one country in this list featured prominently in the recent history of sovereign debt restructuring. Zimbabwe stood out—and was oddly prominent in several accounts of our European interlocutors. As one multilateral development bank official observed to us, Zimbabwe’s problem was hyperinflation, not coercive debt restructuring using Collective Action Clauses. To our knowledge, no one has studied Zimbabwe’s debt contracts for CACs or any other restructuring terms. It was instead the perennial bogeyman in the European morality tales, the end of the slippery slope where Europe would end up if it did not stop in time.

countries such as Argentina or Belize. To many in Europe, acknowledging the possibility of restructuring would not be a matter of incremental change in the risk premium, it would be a qualitative shift in the nature of European sovereign debt: what had been money would instantly turn into ordinary IOUs. This position was most prominently associated with Trichet and frequently repeated by our French contacts. As the crisis wore on, policy makers from Greece, Portugal, and Spain objected to PSI and CACs on timing grounds; “the French objection” was absolute: if you had CACs in your debt, your debt would cease to be the equivalent of money, except perhaps for the captive banks at home.

Some French officials speculated that the Germans did not mind adopting CACs because they expected them to lead to a further healthy price differentiation. German government debt securities would come out on top and retain their information-insensitive “money status”. France was less secure in its prospects of retaining such status. But French reaction was hardly unusual. Adopting CACs in U.S. Treasury debt had been a red line for the U.S. Bureau of Public Debt in the late 1990s and early 2000s. When Treasury international staff floated the idea of “leading by example” to promote the adoption of CACs in the emerging markets, they were immediately rebuffed. U.S. Treasury securities would not have CACs, not because anyone actually feared restructuring, but because adopting them would signal that restructuring was conceivable. The Bureau did not mind committing to issue with CACs in foreign currency debt, but only because they expected it to be a null set, and thought the market would read the promise as meaningless: the United States had not issued in foreign currency since the Carter Bonds of the 1970s.

(Int.A28)<sup>18</sup>

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<sup>18</sup> A decade later, one of us attended a policy conference where a U.S. Treasury official was asked whether his country would follow Europe in adopting CACs; he made it clear that this was not on the agenda. It is worth asking

In what might be the ultimate irony of the CAC story, the large emerging markets issuers that had led the adoption of CACs in New York in 2003 had moved on by 2010. Brazil and Mexico now issued predominantly domestic debt, which did not have CACs. They had no plans to adopt CACs in the debt they really cared about. They did not mind having CACs in their foreign law debt, but it was unimportant in the grand scheme of things. A Latin American debt manager we interviewed had only the foggiest recollection of his country's pioneering foray into CACs in 2003 (he got the voting thresholds wrong), observing that he never had to think about them: about 98% of the debt stock he managed was domestic and CAC-less. (Int.A20)

One European commentator grouched that European officials pointedly refused to ask the Mexicans or the Argentines about their experience with CACs before deciding to adopt them. (Int.A23) John Taylor, the godfather of the 2003 revolution, was not consulted in the Euro-CAC enterprise any more than the Mexican, Brazilian, or Uruguayan protagonists of 2003. (Int.C2) But of course this made sense, because Europe's CACs were meant to set it apart from Mexico and Argentina, not blur the distinction between them.

The distinction was maintained, but not the way European policy makers had envisioned it. As if confirming the worst French nightmare, in 2010, CACs were a live issue for Europe and for the smallest and poorest developing economies seeking to restructure. The debt hierarchy had gone topsy turvy.

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why the U.S. reaction was so different from Germany's. We did not hear stories of latent vulnerability from anyone in the United States, in contrast to France. On the other hand, there was no "action-forcing event" that would make the United States reckon with the costs and benefits of CACs for its own sake, the way France and Germany had to do thanks to Greece and their initial foray into PSI. U.S. debt was still money; no one in the market bothered to consider its contract terms; and U.S. officials would do their utmost to keep it that way.

Some European officials suggested that the way forward was to promote CACs in the domestic debt of other rich countries, representing over 80% of the world's government securities, or over \$30 trillion outstanding. If one were to buy into the idea of CACs as status-negative, diffusing them to the United States and Japan could help remove the taint from Europe:

*Personally, I'm rather neutral about the introduction of CACs at the European level. I don't think they should have a significant impact on the financing conditions of European countries, since they don't, per se, change the probability of restructuring, and I think markets are aware of that, in the same way that they were aware of it when they were introduced in the Latin American markets. The question of the liquidity of the different strips is another question however. In any case, since we have decided to put them in place, our objective, now, is to have them generalize to other "domestic" bond markets in other developed countries. (Int. B14)*

We ran the prospect of adopting CACs in U.S. and Japanese domestic debt by one U.S. policy maker who worked with Japan. The response was an incredulous shaking of the head. (Int.C4) Coincidentally, another U.S. official had just been asked to address CACs in an international forum for the first time since the days when Taylor, Quarles, and O'Neill had led the CAC-SDRM battles. It turned out that the 2012 Treasury had no policy position on European CACs. Since Taylor had left at the end of the George W. Bush administration, the CAC portfolio lay abandoned:

*Between you and me, No One is following this here. I have not been asked about it in years. (Int.A28)*

When staff realized that Euro-CACs operated on domestic law debt, the objective became to steer clear of any implications from Europe for the U.S. Treasury securities. If CACs were to become the badge of European decline, the United States had no plans to share the pain.

### ***E. CACs as a Technical Challenge***

Once the political decision to alter contracts was made at the EU level, the task of drafting uniform European CACs and grafting them onto the existing debt management system went to the Sub-Committee on EU Government Bonds and Bills, a subcabinet-level technical group under the Economic and Financial Committee of the European Union then chaired by French Treasury chief Philippe Mills.<sup>19</sup> The sub-committee and individual members in turn engaged leading sovereign debt lawyers to produce CACs by late 2011, suitable for inclusion in the domestic bonds of 27 different governments, under as many governing law regimes, by January 2013.

The sub-committee was both a logical and a curious choice for CAC development. It comprises debt managers—the people in charge of issuing government debt in each member state. When it was first established in the late 1990s, the group’s principal task was to smooth the transition to a Euro-denominated government bond market across the region. Its mission has since expanded to include coordinating all manner of government debt market functions. The officials we interviewed who had represented their governments on the committee were unanimous in describing it as a gathering of technicians running the day-to-day operations of a risk-free debt market. Between the introduction of the Euro and the outbreak of the crisis, they compared notes on issuance and trading mechanics and market infrastructure, and coordinated relations with primary dealers in government debt obligations. Order, safety, routine, and technicality ruled the day. This was not an economic policy forum, nor one given to legal experimentation:

*The nature of this group is not optimal for legal issues. ... Other than in terminal state, debt management has nothing to do with legal issues. (Int.A23)*

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<sup>19</sup>[http://europa.eu/efc/sub\\_committee/pdf/mandate\\_en.pdf](http://europa.eu/efc/sub_committee/pdf/mandate_en.pdf), [http://europa.eu/efc/index\\_en.htm](http://europa.eu/efc/index_en.htm)

Although it was not a legal forum, the members of Bonds and Bills group had primary responsibility for marketing their governments' debt obligations. It was natural for them to be involved when the terms of these obligations had to change, even if the change was someone else's idea. As a result, the Bonds and Bills group played a part in the implementation of Europe's 2003 commitment to use CACs in foreign-law bonds. For that assignment, the committee conducted a member survey and published a report in 2004 (EFC 2004). Following the same logic, it was not surprising that the people in charge of debt management for each member government would also be in charge of developing CACs for their debt.

On the other hand, the group's apparent conservatism and discomfort with novel legal issues might have raised concerns about their capacity to develop CACs that worked in a hypothetical restructuring. In the emerging markets and Europe, debt managers were among the most vocal opponents of CACs and bankruptcy alike. Their core mission was to borrow funds in the market at minimal cost. In the early 2000s and again a decade later, debt restructuring was the last thing debt managers wanted to talk about when marketing new debt. At a 2003 conference we attended, the Mexican debt manager described the problem as "talking about morgues." Worse yet, as noted earlier, the French were among the most hostile to the idea of PSI. A CAC initiative under a debt managers' group chaired by the French might just be a slow train to nowhere—a possibility that had not gone unnoticed by CACs' German proponents. Although he never criticized CACs in public, in private Mills reportedly described his predicament as being handed a baby to dress – without knowing where the baby came from, or why it was there. (Int.A40, Int.B13) For all the rumors that Mills had reservations about the CAC project, we are told that his actions were those of a committed adherent to it; he had been given a task, and he was going to get it done.

The group's work went on largely under the radar screen, and it appears that German fears of inaction were largely misplaced. The Bonds and Bills Sub-Committee hired the London office of Cleary Gottlieb; and at least some of the member states came with their own lawyers in tow. Although Cleary Gottlieb had represented Mexico in its landmark CAC offering in New York and was an outsize presence in the sovereign debt market, there is no indication that the firm was hired for its Mexico expertise or had drawn on it in particular. The firm's representation of Greece in its ongoing restructuring had to be kept separate from the EU drafting work. The drafters engaged in extensive outreach to the financial industry (a process the committee documents described as public consultations), shared drafts, and received fifteen sets of comments to which they responded in the model CACs and the accompanying explanatory documents (EFC 2012).

Committee members from peripheral member states told us that they saw the political mandate as non-negotiable, and their job as limited to implementation:

*All the statements, all the political commitments were very very strong—the prime ministers, not technical support. It is very difficult not to implement such a high policy decision. ... The way this happened, it was not up to us to make decisions.... This group was implementing a strong political decision. The purpose was to conclude this procedure. And so we concluded it. (Int.A25)*

*What can we say – it was a political commitment of Heads of State – not always based on technical [advice]. I don't know how the technical knowledge of CACs came to the political level. (Int.A23)*

Yet the technical task was formidable, and even the leading lawyers steeped in CAC history and expertise were at a loss.

Six months after Europe publicly committed to CACs, the Dutch government was due to host a seminar on Odious Debt—a theory in public international law that would excuse successor

states from paying the debts of corrupt or oppressive rulers that came before. The goal of the conference was to examine the role that the Permanent Court of Arbitration (PCA) in the Hague could play in sovereign debt resolution relating to Odious Debt problems. The two dozen or so invitees were mostly lawyers, including sovereign debt practitioners from leading London law firms, current and former lawyers from international financial institutions, a handful of academics, a couple of European debt managers, and executives from a leading Asian sovereign wealth fund. At the last minute, the seminar topic changed from Odious Debt to European CACs, and the question became: What role could the PCA play in sovereign debt resolutions in this new world where Eurozone nations were facing the prospect of restructurings and defaults? Inevitably, given that the Dutch debt office had co-sponsored the meeting, the mandate of the Bonds and Bills Sub-Committee became a major topic at the conference.

Unlike the policy makers, the lawyers quickly zeroed in on the problem of adopting standard-form clauses across non-standard and non-uniform debt contracts. The English lawyers, perhaps relying on the reference to the G-10 template in Eurogroup communiqués, had assumed that Eurozone countries would simply switch to issuing debt under English law and submit to the jurisdiction of English courts. To the continental Europeans in the room, this scenario was implausible bordering on insulting. The United Kingdom had opted out of the Eurozone; for member states that had opted in, going to English courts would be a humiliating concession. Others suggested Luxembourg law and Luxembourg courts—after all, some sovereign debt was listed on the Luxembourg stock exchange. But no one in the room knew much about Luxembourg law. Reconstituting a \$10 trillion market in an unknown and untested legal space felt imprudent. The participants finally settled on English law and dispute resolution in the PCA. This too was a radical move: until now, the debt had been overwhelmingly domestic law,

presumptively resolved in domestic courts of the issuing sovereign. Giving up the prerogative to issue under the state's own law would be a powerful symbol of ceding sovereignty—the problem at the heart of the European crisis and response. The lawyers' group forwarded the recommendation to the Bonds and Bills Sub-Committee.

Although the proposal appears to have been shelved, the incident is revealing. CACs were proposed by politicians as a potent message and an easy fix. The message was potent because CACs were known in the market, indeed, they were *of* the market. In the market, they meant consensual debt restructuring, at least for the majority of creditors, as opposed to mandatory haircuts in bankruptcy. The fix seemed easy because CACs had been vetted by the G-7 in the late 1990s and early 2000s, and have been used by the vast majority of emerging markets issuers abroad since 2003. The G-7 had explored adopting CACs in their foreign-law bonds as early as 1998 (a promise made easy by the fact that most G-7 issued little or no foreign law debt). Europe raised the stakes in 2003 with an undertaking to implement a wide range of CACs in members' foreign-law debt, and monitoring implementation through the Bonds and Bills group.<sup>20</sup> Germany even enacted legislation that made it possible for firms and foreign sovereigns to use CACs under German law—a move more symbolically than economically significant (few sovereigns issued under German law since the introduction of the Euro).<sup>21</sup> While it was not strictly on point, this history came in handy in 2010. Politicians saw CACs as technically safe based on the accumulated knowledge about CACs in foreign-law bonds. Even after the lawyers had chimed in to highlight the challenge of transplanting CACs into domestic debt and

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<sup>20</sup> ECFIN/CEFCPE(2004)REP/50483 final, at [http://europa.eu/efc/sub\\_committee/pdf/cacs\\_en.pdf](http://europa.eu/efc/sub_committee/pdf/cacs_en.pdf)

<sup>21</sup> In the grand scheme of things, these efforts seem ironic, since by the time Europe had decided to lead, Mexico had already set the only example that really mattered. And even before Mexico, no emerging markets issuer was ever deluded into thinking that CACs in G-7 debt had any bearing on the prospects of CACs in their own debt.

harmonizing domestic debt contracts, most policy makers we interviewed continued to conflate domestic and foreign debt.

From the contract drafters' perspective, politicians had painted themselves into a nonsensical corner. Like everything about CACs, the challenge was a blend of rational technicality (what would work and be acceptable in the markets) and political messaging (burden-sharing, sovereign autonomy). As a matter of fact and contrary to the G-10 reference in the communiqués, E.U. debt managers wanted clauses that would distinguish them from the emerging markets issuers. Worse yet, they professed commitment to change, but in the words of one lawyer involved in the market outreach, "They all want to keep doing exactly what they had been doing." (Int.A40)

Again and again we heard from the drafters and proponents of European CACs that they were for countries that did not default, the likes of Greece, Cyprus, and other tottering periphery economies notwithstanding. Euro-CACs would have fewer "reserve matters" whose amendment required the highest supermajority, would have no provisions for trustees and fiscal agents to coordinate creditors (normally absent in domestic debt, and apparently unnecessary in the absence of coordination problems), and would not disenfranchise powerful public actors such as central banks holding government debt, because their independence could not be questioned (EFC 2012). The sometimes-implicit claim was that Europe had the resources and institutional maturity, which should exempt it from discipline by contract. (Int.A27) The emerging markets needed to be controlled. Europe could be trusted.

At the national level, new awareness of contract documentation raised specific challenges. Dutch debt managers, used to raising billions of dollars under a one-page telex,

balked at collective debt enforcement provisions in the CAC package. Such terms might help control litigious creditors under New York and English law contracts, but for domestic law bonds with no enforcement provisions to begin with, collective enforcement would amount to a concession by the debtor. French lawyers, including both private practitioners and Treasury legal staff, said that the G-10 model simply did not fit French legal concepts. A lawyer working with the Bonds and Bills Sub-Committee concluded that CACs in France would require legislation, and were likely to be tested in the Constitutional court—even if they would certainly prevail in the end. (Int.C6) When pressed to balance their enthusiasm for uniform rules, burden-sharing and contract autonomy, European issuers preferred to keep their old contracts. (Int.A16) As in 2003, some trade groups sought to leverage the CAC project into more creditor-friendly reforms, such as greater transparency in EU sovereign debt documentation. For the drafting group though, CACs were a one-way message, not an invitation to bargain.

The project of drafting Euro-CACs for countries that did not default was in tension with two sets of inconvenient facts. First, the CAC initiative covered Greece, then in the midst of a deep debt restructuring. The claim of risk-free Europe was flatly contradicted by the very circumstances that prompted the CAC project. Second, the claim to good credit quality, implying no CACs, weak CACs, or nonfunctional CACs, was made in precisely the same terms by major emerging markets issuers such as Mexico and Brazil in the run-up to 2003. Moreover, Mexico and Brazil made the claim from a strong fiscal position, against favorable market sentiment. If anything, this made developing countries' claim more credible.

Greece was also a timing problem: its restructuring, which involved retroactive legislation and produced new English law bonds with CACs, dragged on in parallel with the work of the Bonds and Bills Sub-Committee. Several participants and observers told us that

European officials worried about the timing, which could undermine the claim that Greece was unique. If Euro-CACs were released before the Greek restructuring offer, they would prompt more questions about the difference between the European standard and the Greek exit instruments. If the exit instruments appeared before the new market standard, Europe could at least pretend to start on a clean slate. This helps explain the apparent delay in releasing Euro-CACs, which may have been ready as early as January 2012, until after the Greek exchange in March.

In sum, the political commitment to use CACs in the domestic bonds of EU member states appears to have been based on technical assessments of CACs in foreign bonds. This presented a slew of implementation challenges for debt managers and their lawyers. At the same time, the technical work of implementation ran up against a host of political messaging contradictions, some of which recalled Mexico in 2003. Despite committing to uniform CACs, each issuer save for Greece (which was cut out) wanted to maximize autonomy over its own documentation and restructuring process. Although most acknowledged the hypothetical benefit from CACs, no one would admit needing them – because no one would admit that they might restructure in the foreseeable future. The result was a brand new set of model clauses, distinct from what the G-10 had proposed in 2003, and from the models used by emerging markets issuers since. Although they made concessions to creditor concerns, notably raising several voting thresholds, Euro-CACs paid deference to the institutional imperatives of European member states and tried to minimize constraints on future crisis management options.

#### **Part IV: Conclusions**

Twice over the past twenty years, a group of contract clauses took on outsized policy importance in international finance. It is hard to fathom how a few paragraphs of legalese, buried

in hundreds of pages of similar language, could have become the medium for negotiating the relationship among states and markets in global and regional financial crises. The contract flipside is equally incredible: why would counterparties fight for or resist terms that, by their own admission, do nothing for them?

Two sets of answers to such questions have been advanced in the past. The first emphasizes the function of CACs in overcoming bondholder coordination problems and promoting efficient modification of contracts. Such answers run into objections by officials, investors, and even lawyers, who insist that they were not trying to solve coordination or modification problems, or their inability to identify such problems in Europe. The second set of answers claims that CACs were a historical accident, a blank slate on which a specific set of opportunistic policy makers and market participants projected their political messages. These answers are equally troublesome because they do not explain why so much work has gone and continues to go into the drafting of clauses to make sure that they function in particular ways.

The return of Collective Action Clauses in Europe years after the successful campaign to adopt them in emerging markets sovereign debt issued in New York suggests additional and more nuanced explanations. CACs in Europe took on many functions beginning in 2010. They signaled and helped negotiate loss-sharing in financial crisis between private and official creditors, and among European member states. They offered the promise of a uniform rule-based approach to crisis management, albeit one on which they were unlikely to deliver. For some in Europe they promised a way to discipline profligate governments. They were also a status symbol: some feared that adopting CACs in public debt could cost a state its coveted place in the global financial asset hierarchy.

All these meanings are essential to the attempted reconstitution of the European sovereign debt market where the implicit guarantee of the surplus member states is replaced by a more formal arrangement for risk mutualization, complete with standing crisis management institutions. CACs might be read as a condition on mutualization—or as a way of resisting it, to the extent they succeeded at facilitating PSI and constrained borrowing on the periphery. The ways in which the European CACs are drafted, and their (in)capacity to do the legal work and generate the price effects expected of them, are essential for their success as policy, political and communication devices. Put differently, what CACs did helped determine what they said. In this telling, CACs look less like a blank slate and more like a precision instrument.

European member states sought to use CACs to shape their debt market in particular ways. They wanted burden-sharing, but they also wanted to avoid the penalty of higher borrowing costs. They did not want to be disciplined, or to give up crisis management flexibility going forward, and—save for Greece—seemed to have the bargaining power to resist hard constraints that come with issuing foreign law debt. And they certainly did not want CACs to signal the demotion of their government debt from money to credit status. At this writing, the extent to which any of these goals can be achieved, and the ultimate shape of the European sovereign debt market, remain uncertain. Although CACs were introduced as a “lesser alternative” to bankruptcy, some European officials are attempting to reposition them as a stepping stone on the way to bankruptcy, which remains their ultimate goal. In an ironic twist, Europe may eventually end up with both CACs and bankruptcy, and the technical challenge of reconciling the two. The lesson of CACs so far is in the power of seemingly minor private law techniques to shape public markets and institutions, often in nontransparent ways—and in the way contracts are shaped by their public mission.



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