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Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring

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VULTURES OR VANGUARDS?: THE ROLE OF LITIGATION IN SOVEREIGN DEBT RESTRUCTURING

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ABSTRACT

The market for sovereign debt differs from the market for corporate debt in several important ways including the risk of opportunistic default by sovereign debtors, the importance of political pressures, and the presence of international development organizations. Moreover, countries are subject to neither liquidation nor standardized processes of debt reorganization. Instead, negotiations between a sovereign debtor and its creditors lead to a voluntary restructuring of the sovereign's debt.

One of the greatest difficulties in restructuring claims against sovereign debtors is balancing the interests of the majority of the creditors with those of minority creditors. Holdout creditors serve as a check on opportunistic defaults and unreasonable restructuring terms, yet their presence can interfere with the restructuring process. In this Article, we examine the role of holdout creditors within the context of the international capital markets. In particular, we consider the effect of a litigation remedy on the power of holdout creditors to influence current restructurings of sovereign debt.

Recent commentators have criticized holdout creditors and proposed mechanisms designed to reduce their power—particularly their power to enforce contractual claims against sovereign debtors through litigation. We argue that these proposals may undervalue the role of holdout creditors in facilitating the restructuring process and in promoting the functioning of the international capital markets. Accordingly, we suggest that, prior to the implementation of broad reforms, the value of holdouts be tested through a market-based

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approach. We propose several modifications to the terms of agreements governing sovereign bonds that can be tested in the market as a mechanism for assessing the value of holdout litigation in the international financial architecture.

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INTRODUCTION

Recent financial crises in Latin America, Asia, Russia, and the Middle East hve resulted in widespread restructurings of sovereign debt. The resolution of these sovereign insolvencies differs from the resolution of corporate insolvencies in several key ways. Most significantly, because countries are not subject to liquidation or standardized processes of reorganization such as those provided by bankruptcy law, the process involves a series of negotiations between the sovereign debtor and its creditors to devise a voluntary restructuring of the debt. Lacking both the threat of liquidation and regulatory oversight, a sovereign debtor may choose to default on its obligations to its creditors rather than to make the internal financial sacrifices that would enable it to make the required payments on its debt. A default of this type, when the sovereign debtor is unwilling, but not unable, to pay is often termed an "opportunistic default." Even in cases in which a sovereign debtor is truly experiencing financial distress, the absence of a formal proceeding for evaluating the debtor's financial condition creates a risk of unreasonable restructuring terms. Finally, because a restructuring plan need not adhere to legislative standards or secure judicial review, it may discriminate against minority creditors.

Political factors may also influence the restructuring process. For example, by manipulating banking regulations, the governments of the countries in which creditor banks are chartered may pressure those banks to provide additional financing to strategically important sovereign debtors. At the same time, international development organizations, including the International Monetary Fund (IMF) and the World Bank, can influence the restructuring process by imposing conditions on the loans that they provide to resolve temporary liquidity crises. These conditions typically include mandated changes in macroeconomic policies and may include the privatization of state-owned entities.

The challenge in restructuring sovereign debt is to manage these complexities so as to engineer a voluntary process by which a sovereign debtor and its creditors can negotiate a workable schedule of debt payments without irreparably damaging market confidence. Extended restructuring processes during which payments on existing debt are suspended, repayment terms that appear to be unreasonably low, and unequal treatment of creditors, all threaten not only the success of individual restructurings but also the long-term strength of the international capital markets.

Given the voluntary nature of the restructuring process, creditors may refuse to participate in a restructuring and instead "hold out" in the hope of receiving better repayment terms or even the full value of their claims. These recalcitrant creditors may seek payments from the sovereign debtor, or they may seek to have their claims purchased by other creditors that are anxious to complete the restructuring. In any event, holdout creditors are typically subject to significant pressure to accede to the terms that are acceptable to a majority of the creditors in the restructuring. They are also often subject to extensive criticism. Holdout creditors have been charged with delaying the restructuring process, thereby imposing unnecessary burdens on the citizens of the sovereign debtors. They have also been denounced for seeking payments for themselves at the expense of other creditors and at the risk of jeopardizing the restructuring.

Over the course of the past several years, holdout creditors—particularly vulture funds—have increasingly used litigation as a means of pursuing their interests.[1] Specifically, these creditors have filed lawsuits to enforce their contractual claims against sovereign debtors.[2] In some cases, the litigation has been remarkably successful. The use of litigation has heightened concerns regarding holdout creditors. Anne Krueger, the First Deputy Managing Director of the IMF, observed that:

1 The term "vulture funds" generally refers to investment funds, particularly hedge funds and mutual funds, that purchase the debt of countries, or companies, that are in financial distress. These funds thus become creditors of the countries, or companies, through purchases of debt in the secondary market, rather than as primary lenders.

2 Due to the financial distress of the country, vulture funds are typically able to purchase the country's debt at substantial discounts from its face value. Upon purchase of the debt, the vulture funds become entitled to the full value of the claims—typically unpaid interest plus the principal amounts. Consequently, vulture funds have strong incentives to hold out. For a discussion of the nature of the investments that vulture funds make in distressed debt, and the incentives that they face, see John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1214, 1233-40 (1991).

> the more recent success of an aggressive legal strategy employed against Peru by a vulture company . . . underlines the power the holdout creditors retain. The threat of disruption [of the restructuring process] remains likely to deter countries from seeking a necessary restructuring for longer than is desirable for either the country itself or the international community.[3]

Concerns about holdout litigation have acquired new urgency in the wake of Argentina's current financial crisis. This crisis, which includes the largest sovereign default in history, came to a head in December of 2001 when Argentina defaulted on billions of dollars of outstanding bonds.[4] Months later, in September of 2003, Argentina proposed to restructure approximately $94 billion in public debt through a debt swap resulting in a seventy-five percent reduction in the face value of the debt and forgiveness of past due interest.[5] The proposal has been widely denounced by creditors, particularly vulture funds,[6] and it has spurred an unprecedented amount of litigation.[7]

The increasing prominence of holdout litigation has invigorated proposals to limit the power of holdout creditors. Recent reform proposals include (1) a

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3 Anne Krueger, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at the National Economists' Club Annual Members' Dinner, American Enterprise Institute (Nov. 26, 2001) [hereinafter Krueger, New Approach], *at* http://www.imf.org/external/np/speeches/2001/112601.htm. In a later speech, Dr. Krueger warned that "recent legal action against Peru shows that holdouts can try to extract full payment from the sovereign [debtor] by threatening to interrupt payments on the restructured debt, rather than by trying to seize assets. This possibility may make potentially more cooperative creditors more reluctant to participate in a restructuring." Anne Krueger, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Address at the Conference on Sovereign Debt Workouts: Hopes and Hazards?, Institute for International Economics (Apr. 1, 2002) [hereinafter Krueger, Update], *at* http://www.imf. org/external/np/speeches/2002/040102.htm.

4 John Barham, *Cooking Up a New Solution*, LATINFINANCE, June 2003, at 10; *see also* Richard Lapper, *Argentina Plans Bonds Linked to Future GDP*, FIN. TIMES, June 18, 2003, at 2 (discussing the financial crisis in Argentina and the default on Argentina's sovereign debt).

5 *Argentina: Minister, Official Reveal More Details of Debt Proposal*, BBC MONITORING INT'L REPS., Sept. 25, 2003; *see* Angela Pruitt, *Argentine Bonds May Weaken More*, WALL ST. J., Sept. 24, 2003, at C15 (describing the proposed reduction in the face value of the debt).

6 Dennis Small, *'Vulture Funds' Descend on Dying Third World Economies*, EXECUTIVE INTELLIGENCE REV., Oct. 10, 2003, *available at* http://www.larouchepub.com/other/2003/3039vultur_fnds.html.

7 *See* Joshua Goodman, *Argentina President Berates Bondholders*, FIN. TIMES, Feb. 9, 2004, at 2 (describing legal challenges to Argentina's restructuring proposal); Angela Pruitt, *U.S. Ruling a Setback for Argentina*, WALL ST. J., Jan. 2, 2004, at B4 (describing judicial approval of "the first class action motion . . . in a major sovereign debt restructuring" and explaining that Argentina is facing lawsuits from disgruntled investors involving claims of more than $750 million); Jenny Wiggins, *Hopes Remain for Negotiated Settlement*, FIN. TIMES, Dec. 5, 2003, at 45 (describing negotiations regarding Argentina's restructuring proposal and noting that "[a]n increasing number of investors are filing lawsuits to try to recover the principal and interest on their bonds, and the bondholders' committee this week warned of 'a flood of litigation by retail and institutional bondholders globally' if Argentina fails to reach some kind of consensual transaction").

market-based approach in which a sovereign debtor restructures its debt through an exchange offer coupled with amendments to the terms of the debt effected through exit consents, (2) a contract-based method involving the use of collective action clauses (CACs) that permit the majority of the creditors to amend the terms of the debt over the objections of minority creditors, and (3) a regulatory-based mechanism in the form of an international bankruptcy procedure, which is known as the Sovereign Debt Restructuring Mechanism (SDRM). Despite the differences in approach, discussions of the merits of these reforms have focused almost exclusively on their capacity to constrain the ability of recalcitrant creditors to enforce their claims against sovereign debtors by filing lawsuits.

This focus on curtailing holdout litigation, however, overlooks the benefits that holdout creditors, particularly vulture funds, confer on the restructuring process as well as the role that legal actions play in empowering creditors relative to debtors and minority creditors relative to the majority of the creditors. Holdout creditors, by refusing to participate in restructurings of sovereign debt, serve as a check on opportunistic defaults and onerous restructuring terms. Moreover, the prospect of holdout by minority creditors may limit collusive behavior among the majority of the creditors. Holdout creditors, particularly vulture funds, also promote the functioning of the international capital markets. For example, by reducing the likelihood of opportunistic defaults, holdout creditors increase capital flows to sovereign debtors. Holdout creditors also provide value independent of the restructuring process by increasing liquidity in the market for sovereign debt, especially distressed debt. The extent to which holdout creditors provide those values in these ways depends upon the power conferred through judicial enforcement of their claims against sovereign debtors.

Yet, holdout litigation is not an unqualified good. In some cases, the disruptive effects of holdout litigation outweigh its positive effects. We argue, however, that critics of holdout litigation have not made the case for broad reforms that would eliminate holdout litigation. Instead, the potential for detrimental litigation can be reduced through more narrowly tailored refinements to the litigation remedy implemented through market-based changes in the terms of agreements governing sovereign bonds. The reaction of the market to these changes offers a valuable opportunity to evaluate further the role of holdout litigation.

This Article proceeds in Part I by describing the salient features of the restructuring process, beginning with the nature of sovereign default and then turning to the historical developments leading to the use of litigation in response to defaults. Part II reviews the development of litigation by holdout creditors. Part III considers the primary proposals for limiting holdout litigation, offers an evaluation of the role of holdout creditors and, based upon this assessment, suggests modest alterations to the restructuring process. Specifically, we emphasize the role holdout creditors may play in maintaining the balance between the interests of majority creditors, and those of minority creditors, while recognizing the importance of maintaining the integrity of the international capital markets. We suggest, therefore, modifications to the agreements governing sovereign bonds, as a means of promoting the balance between these interests and protecting the markets.

I. THE RESTRUCTURING PROCESS

A. The Possibility of Opportunistic Default

Sovereign debt resembles commercial debt in many ways. From the creditor's perspective, in determining whether to make a loan to a particular debtor, the creditor must assess the likelihood the debtor will default on the loan and the likely recovery in the event of a default. The creditor is constrained, however, in its ability to acquire full information about the debtor and its financial condition. Additionally, the probability of default and the amount of recovery upon default will vary with events that occur after the making of the loan, including both events resulting from the debtor's actions and events that are beyond the debtor's control.[8]

Sovereign debt, however, differs from commercial debt in important ways. In the sovereign debt context, the creditor's ability to assess the probability of default and the probable recovery upon default is further hampered by the fact that the sovereign debtor may default on the loan simply because it is unwilling to make the required payments; that is, the debtor may default opportunistically.[9] A sovereign's choice of macroeconomic policies is the

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[8] Professor Fischel designates the former "debtor misbehavior" and the latter "exogenous events." Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 134 (1989).

[9] Nouriel Roubini & Brad Setser, Bailins Versus Bailouts: Financial Crises in Emerging Markets, Private Sector Involvement in Crisis Resolution and Alternative Approaches to Debt Restructuring, ch. 3, at 3 (Oct. 2003) (unpublished manuscript, on file with authors) (describing difficulties in making loans to sovereign borrowers).

product of a variety of political factors that may, in some cases, outweigh pressures for fiscal conservatism. Moreover, when a default occurs, the creditor may be subject to pressure from regulators and the IMF regarding the restructuring of the loan.

These factors will often interact with one another, complicating the creditor's analysis. For example, a sovereign debtor dependent upon export taxes for revenues may experience difficulties in making payments on a loan following declines in the prices of its exports. These difficulties may be exacerbated by poor macroeconomic policies that result in stagnation.[10] In this situation, the sovereign debtor may, regardless of its ability to make payments on the loan, opportunistically default on the loan.[11] The default frees funds for the debtor to use to ameliorate the effects of the shock in prices and the misguided policies. Using the funds to alleviate discontent within the sovereign debtor's borders may be preferable to using the funds to make payments on a loan owed to a foreign creditor.[12] At the same time, because the debtor is a government, with political and economic ties to other governments, the default may cause those governments to impose political pressure on creditors to make additional loans to the sovereign debtor.

The risk that a sovereign debtor may opportunistically default on a loan aggravates the problem of "debtor moral hazard"[13] in the context of sovereign debt. Yet, creditors have few remedies when the sovereign debtor defaults on

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[10] Conversely, poor macroeconomic policies that result in stagnation may aggravate the risk that declines in export prices result in difficulties in making payments on the loan.

[11] As one commentator notes, determining a sovereign debtor's "ability to repay is in the end not a very difficult task. In all but the most extreme cases, [debtors] have the ability to repay their debts. . . . In the end, willingness to repay is the key to sovereign [debtor] credit analysis." Vincent Truglia et al., *Sovereign Risk: Bank Deposits vs. Bonds*, MOODY'S INVESTORS SERVICE, GLOBAL CREDIT RES., Oct. 1995, at 4-5. Thus, an opportunistic default refers to a default "driven by unwillingness to pay rather than inability to pay." Nouriel Roubini, Do We Need a New International Bankruptcy Regime? Comments on Bulow, Sachs and White 10 (Apr. 2002), *available at* http://www.stern.nyu.edu/globalmacro/bankreg.doc.

[12] *See, e.g.*, François P. Gianviti, *Resolution of Sovereign Liquidity Crises: Basic Concepts and Issues*, *in* 5 CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 309, 312-13 (Robert C. Effros ed., 1998) (describing negative consequences to citizens of measures taken to assure payment due on loans by sovereign debtors); *see also* Truglia et al., *supra* note 11, at 5 (noting that "the real question is—what level of resource mobilization are [sovereign debtors] willing to undertake to repay their debts?").

[13] Once a creditor makes a loan to a debtor, the creditor is subject to moral hazard on the part of the debtor, as the creditor lacks the ability to control the debtor's actions and, in most instances, the creditor also lacks the ability to observe the debtor's actions. For a general description of the problem of moral hazard, see PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 166-67, 195-96 (1992). In the parlance of Professor Fischel, these conditions give rise to debtor misbehavior. Fischel, *supra* note 8, at 135-37. The problems engendered by the inability to control or to observe the debtor's actions are exacerbated when the creditor makes a loan to a sovereign debtor. Roubini & Setser, *supra* note 9, at 4.

the loan. Creditors may not force a sovereign debtor into involuntary bankruptcy, nor may they seek liquidation of the sovereign debtor's assets in satisfaction of the amounts due under the loan. Instead, the typical remedy for sovereign default is a voluntary restructuring of the loan.[14]

If creditors cannot protect themselves from opportunistic defaults, access to loans will be restricted and borrowing costs will be higher.[15] Both creditors and sovereign debtors, then, have interests in developing mechanisms for limiting the possibility of opportunistic defaults.[16] As a general matter, these efforts, together with the other bargains between the creditors and the debtor, are reflected in the terms of the agreement governing the loan.[17] In particular, a loan agreement provides creditors with the right to enforce claims against the debtor under specified circumstances, and the agreement contemplates that enforcement will involve filing suit in court. The specific elements of a typical loan agreement that explicitly contemplate enforcement litigation include the sovereign debtor's waiver of sovereign immunity, choice-of-law provisions through which the debtor submits to the laws and jurisdiction of a country with a well-developed judicial structure, and provisions that specify the requirements for the initiation of litigation. Litigation, then, may be seen as a

[14] William W. Bratton & G. Mitu Gulati, *Sovereign Debt Restructuring and the Best Interest of Creditors*, 57 VAND. L. REV. (forthcoming 2004).

[15] *See* Roubini & Setser, *supra* note 9, ch. 3, at 4 (discussing the relationship between the risk of opportunistic default and the availability of credit).

[16] A costly restructuring process will also deter opportunistic defaults by raising the cost to debtors of defaulting. *See, e.g.*, William Cline, The Role of the Private Sector in Resolving Financial Crises in Emerging Markets (Oct. 2000) (noting that international arrangements that convey the impression that default is painless will tend to depress capital flows to governments of emerging market economies), *available at* http://www.nber.org/~confer/2000/wisef00/cline.pdf; Michael Dooley & Sujata Verma, Rescue Packages and Output Losses Following Crises (June 2001) (expressing concern that reforms that would make the restructuring process more orderly, and so less costly, for sovereign debtors would result in fewer loans to the governments of emerging market economies), *available at* http://econ.ucsc.edu/~mpd/dooleyverma.pdf. The value of increasing the costs of the restructuring process is limited, of course, because a costly restructuring process also hinders restructuring by sovereigns with truly unsustainable debt burdens. *See* Roubini, *supra* note 11, at 10 (arguing that "subject to the caveat that defaults should not be too easy (to prevent opportunistic defaults), an orderly debt restructuring should be the objective of an international regime that allows countries with unsustainable debt profiles to restructure their liabilities").

[17] For a loan traded in the capital markets, the terms of the agreement, together with all of the other factors affecting the loan—the difficulty in obtaining information regarding the financial policies and position of the sovereign debtor, the likelihood of default and the likely recovery on default, the possibility of political pressure, and the probability of involvement by the IMF—are reflected in the price of the loan. *See* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 347-51 (7th ed. 2003) (describing the efficient capital markets hypothesis, which predicts that, for all securities traded in the capital markets, the prices reflect available information); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 565-88 (1984) (describing the role of trading in efficient capital markets).

check on the possibility of opportunistic default, which in turn facilitates the functioning of the international capital markets. Litigation may also operate as a check on the terms of a proposed restructuring, giving a creditor recourse against a restructuring that provides insufficient value to creditors or that unduly favors some creditors over others.

B. The Sovereign Debt Market

Concerns regarding the likelihood of opportunistic defaults, and the best means of ensuring the effectiveness of the restructuring process in limiting these defaults, have long been part of the fabric of the sovereign debt market. These concerns have been prudent. The history of sovereign lending, particularly to the governments of the emerging market economies of Latin America, reflects a series of crises—one in the 1930s, one in the 1980s, and the current crisis. A review of the past crises provides a framework for analyzing the role of holdout litigation today.[18] In particular, a historical perspective highlights the importance of developments in both the capital markets and the courts to the emergence of holdout litigation.

1. The Crisis of the 1930s

Following World War I, foreign governments, particularly the governments of Latin American countries, began to issue large amounts of bonds in New York City.[19] In the early 1920s, the principal issuers of sovereign bonds were Argentina, Brazil, Chile, and Cuba.[20] Over the course of the decade, as the bond market grew, banks established an extensive network of branches "that successfully marketed the bonds to individual investors, eager for the large premia they offered over domestic returns."[21] Between 1920 and 1929,

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[18] *See, e.g.*, Deepak Lal, *The Structure of International Capital Markets*, *in* SOVEREIGN DEBT: ORIGINS, CRISES AND RESTRUCTURING 61, 61 (Vinod K. Aggarwal & Brigitte Granville eds., 2003) (describing a historical perspective as essential); Truglia et al., *supra* note 11, at 6 (describing study of past sovereign defaults as a useful tool in providing insights into possible future developments).

[19] During the 1920s, the governments of Latin American countries issued over $2 billion in bonds in New York City, accounting for approximately one quarter of the new capital issues floated in the United States. Erika Jorgensen & Jeffrey Sachs, *Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period*, *in* THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE, 48, 51-52 (Barry Eichengreen & Peter H. Lindert eds., 1989). As a general matter, banks arranged loans that were then floated as tradable securities in the market. Truglia et al., *supra* note 11, at 7.

[20] Jorgensen & Sachs, *supra* note 19, at 53.

[21] *Id.* at 56.

sovereign debtors in Latin America issued bonds totaling $2.1 billion in value.[22]

With the beginning of the Great Depression, these sovereign debtors experienced difficulty servicing their bonds.[23] In December 1930, Bolivia failed to meet sinking fund requirements on its bonds, and in January 1931, the fiscal agent for the bonds declared Bolivia to be in default.[24] This default was soon followed by defaults on bonds issued by Peru and Chile.[25] By 1933, twelve Latin American debtors suspended at least part of their debt servicing,[26] and by 1934, only Argentina, Haiti, and the Dominican Republic had not suspended normal debt servicing.[27]

In an effort to resolve the crisis, bondholders formed committees to negotiate with sovereign debtors.[28] Initially, in the United States, these committees were ad hoc committees formed by bondholders to negotiate with each sovereign debtor in default. These informal committees suffered from high administrative expenses, lack of authority to speak for the bondholders, and only limited contact with the federal government.[29] In addition, a proliferation of committees created competition in negotiations with sovereign debtors.[30] In response to these problems, and because many bondholders

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22 JOHN T. MADDEN ET AL., AMERICA'S EXPERIENCE AS A CREDITOR NATION 77 (1937).

23 *See* Vinod K. Aggarwal, *The Evolution of Debt Crises: Origins, Management and Policy Lessons*, *in* SOVEREIGN DEBT, *supra* note 18, at 11, 13 (noting that the depression "crushed the [debt] servicing prospects of Latin American debtors"); Jorgensen & Sachs, *supra* note 19, at 57 (stating that the combined effects of the worldwide economic depression, protectionist measures in the United States and Europe, and the disruption of the international capital markets devastated not only trade but also government revenues).

24 Jorgensen & Sachs, *supra* note 19, at 58.

25 *Id*. at 58-61.

26 Aggarwal, *supra* note 23, at 13.

27 H. C. Wallich, *The Future of Latin American Dollar Bonds*, 33 AM. ECON. L. REV. 321 (1943).

28 Rory Macmillan, *Towards a Sovereign Debt Work-Out System*, 16 NW. J. INT'L L. & BUS. 57, 84 (1995) [hereinafter Macmillan, *Debt Work-Out System*]. Some bondholders pursued redress through the banks that participated in the issuance of the bonds. The banks, however, lacked incentives to seek meaningful compensation for the bondholders. They were the fiscal agents for the bonds, and they desired to maintain favorable relationships with the sovereign debtors as a means of securing additional financing opportunities. As a result, the claims of the bondholders remained unsatisfied. *See, e.g.*, 5 SEC. & EXCHANGE COMM'N, SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES 512-31 (1937) (critiquing the pursuit of claims through the banks); Rory Macmillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 338 (1995) [hereinafter Macmillan, *Debt Crisis*] (describing the shortcomings of pursuing claims through the banks).

29 Barry Eichengreen & Richard Portes, *After the Deluge: Default, Negotiation and Readjustment During the Interwar Years*, *in* THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE, *supra* note 19, at 12, 16.

30 Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, *in* CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 3, 21 (Barry Eichengreen & Richard Portes eds., 1995).

sought the assistance of the federal government in resolving their claims against sovereign debtors, the Department of State, the Department of the Treasury, and the Federal Trade Commission invited a group of prominent citizens to meet with governmental officials to discuss the formation of an unofficial council to assist bondholders.[31] Several months later, on December 13, 1933, the Foreign Bondholders Protective Council, Inc. (Council) was incorporated as a nonprofit membership organization under the laws of Maryland.[32] The Council lacked the authority to bind bondholders to restructuring plans; instead "it initiat[ed] negotiations with [sovereign debtors] by virtue alone of its prestige as a semiofficial organization."[33] Upon completing negotiations with sovereign debtors, the Council recommended settlements to bondholders, which accepted or rejected the settlements.[34] Further concessions from sovereign debtors were rare once the Council recommended a settlement, because the Council ceased negotiations.[35]

The negotiations between bondholders, represented by the Council (or another association), and a sovereign debtor in default on its bonds were quite lengthy, taking years and even decades to complete. For example, the negotiations regarding the bonds issued by Bolivia were not completed until a

[31] *See* EDWIN BORCHARD, 1 STATE SOLVENCY AND FOREIGN BONDHOLDERS 193-94 (1951) (describing the initial plans for the formation of a council to represent bondholders); Michael R. Adamson, *The Failure of the Foreign Bondholders Protective Council Experiment, 1934-1940*, 76 BUS. HIST. REV. 479, 487 (2002) (describing the role of the State Department in the formation of the council). Before action on the group's recommendation could be taken, Congress authorized the creation of a quasi-governmental agency to assist bondholders. The effectiveness of the statute, however, was postponed "until the President found it in the public interest. Since the President never so found, [the statute] never came into force." BORCHARD, *supra*, at 194.

[32] BORCHARD, *supra* note 31, at 196. The members of the Council were divided into three classes: full members, who served as directors and were entitled to vote to recommend restructuring plans to bondholders; contributing members, who were entitled to attend meetings of the Council but were not entitled to vote on matters before the Council; and founders. The work of the Council was accomplished through an executive committee and its officers. The executive committee members and officers, who were chosen for their expertise in international law and finance, received salaries for their services. Financing for the Council was initially provided by commercial banks. Upon successfully concluding settlement negotiations, the Council solicited contributions from the sovereign debtors and the bondholders. The Council also received contributions from the founders. *See id*. at 193-98 (describing the formation and operation of the Council).

Similar associations designed to serve the interests of bondholders existed in the United Kingdom and France, as well as in other creditor countries. Most notably, in the case of the United Kingdom, the Corporation of Foreign Bondholders, founded in 1868 and reorganized in 1898 by an act of Parliament, became, by the 1930s, the universally acknowledged representative of British bondholders. Eichengreen & Portes, *supra* note 29, at 15-16.

[33] BORCHARD, *supra* note 31, at 198.

[34] *Id*.

[35] Jorgensen & Sachs, *supra* note 19, at 70.

settlement was reached in 1958.[36] As a consequence of these protracted negotiations, the market for sovereign bonds evaporated. In the years following the crisis of the 1930s, the majority of loans to the governments of emerging market economies in Latin America were made by public institutions, including the World Bank and the Inter-American Development Bank, as well as by other countries, notably the United States.[37]

2. *The Crisis of the 1980s*

A fundamental shift in this pattern of lending and borrowing occurred in the 1970s as international commercial banks located in the United States and Western Europe became the principal source of loans to sovereign debtors in Latin America. The oil crises of the decade, beginning with the dramatic increase in oil prices in 1973,[38] provided both the funds and the incentives for the commercial banks to make the loans. Oil-exporting countries, unable to spend on imports the revenues they received from their exports, deposited surplus "petrodollars" with the banks. The banks, seeking high rates of return on investments of the deposits, faced limited demand for loans among the industrialized countries as economic recessions in those countries reduced the need for capital. The governments of the emerging market economies in Latin America, however, desired loans to finance their more costly imports of oil. Consequently, the banks recycled the petrodollars into loans to these sovereign debtors.[39]

In August 1982, Mexico declared that the country could no longer service its debts to foreign creditors, especially commercial banks.[40] In the ensuing months, Brazil, Argentina, Bolivia, and Venezuela made similar

[36] The negotiations regarding the bonds issued by Bolivia, the first country to default on its bonds in 1931, were not completed until a settlement was reached in 1958. Eichengreen & Portes, *supra* note 30, at 21. Negotiations regarding the other twelve Latin American debtors to suspend at least part of their debt servicing continued into the 1960s. Aggarwal, *supra* note 23, at 13.

[37] Aggarwal, *supra* note 23, at 14; Eichengreen & Portes, *supra* note 30, at 22-23.

[38] The price of crude oil, which was less than \$3 per barrel at the end of 1973, rose to over \$17 per barrel by the end of 1979. LEX RIEFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 154 (2003).

[39] *See id*. (describing the impact of the oil crises on commercial banks); Stephen Bainbridge, *Comity and Sovereign Debt Litigation: A Bankruptcy Analogy*, 10 MD. J. INT'L L. & TRADE 1, 5-7 (1986) (discussing the factors resulting in the recycling of petrodollars).

[40] RIEFFEL, *supra* note 38, at 156.

announcements.[41] In subsequent years, many other sovereign debtors fell into arrears on their debts, and several sovereign debtors suspended debt service altogether.[42]

In working to restructure their debts, these sovereign debtors engaged in negotiations with bank advisory committees regarding their commercial loans.[43] Typically, a sovereign debtor designated the commercial bank that had extended it the largest loan to serve as the chair of a bank advisory committee.[44] The chair of the committee, in consultation with the sovereign debtor, invited other commercial banks that had made loans to the debtor to join the committee.[45] The composition of the committee was important, as members of the committee had to be able to reach a consensus among themselves regarding a plan to restructure the commercial loans that was acceptable to the sovereign debtor. The committee also had to be able to convince the other commercial banks to support the plan.[46] To facilitate these efforts, committee members were chosen based on the geographic location of the bank and the size of the loans made to the debtor.[47] The members of each bank advisory committee were generally large commercial banks located in the United States, the United Kingdom, Germany, Japan, Switzerland, France, and Canada that had made large loans to the sovereign debtor.[48]

The official role of the bank advisory committees was to serve as conduits of information between sovereign debtors and commercial banks.[49] Bank

41 *See* Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2708 (1996) (describing defaults among sovereign debtors in Latin America).

42 *See* Truglia et al., *supra* note 11, at 10 (stating that "[a]ll told, approximately [fifty] countries have defaulted on their sovereign and commercial obligations since August 1982"); *see also* RIEFFEL, *supra* note 38, at 154 (stating that the oil crisis of 1979, coupled with the recession of the early 1980s and a rise in borrowing costs, hindered the ability of Latin American countries to service their debt).

43 The use of bank advisory committees began, and the process developed, with a series of five negotiations taking place from 1976 to 1980 involving loans made to Zaire, Peru, Sudan, Turkey, and Poland. *See* RIEFFEL, *supra* note 38, at 97, 295-316 (describing the evolution of bank advisory committees).

44 RIEFFEL, *supra* note 38, at 116.

45 *Id*.

46 *See* Charles Lipson, *Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, *in* COOPERATION UNDER ANARCHY 200, 207 (Kenneth A. Oye ed., 1986) (describing the role of bank advisory committees).

47 RIEFFEL, *supra* note 38, at 116. Typically, bank advisory committees consisted of between ten and fifteen members. *See* James B. Hurlock, *Advising Sovereign Clients on the Renegotiation of Their External Indebtedness*, 23 COLUM. J. TRANSNAT'L L. 29, 39 (1984) (describing the composition of bank advisory committees).

48 *See* Lipson, *supra* note 46, at 217-18 (describing the composition of bank advisory committees).

49 *See* Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank*

advisory committees described their function as serving as "communications link[s]" between sovereign debtors and commercial banks.[50] In practice, however, bank advisory committees negotiated the terms of restructurings of commercial loans with sovereign debtors.[51] Bank advisory committees lacked formal authority to bind the commercial banks to restructuring plans.[52] The bank advisory committees instead advised the commercial banks of the terms of the plans and then sought their ratification.[53] These informal arrangements—the use of bank advisory committees and the standard process they followed in negotiating with sovereign debtors—are often referred to as the "London Club" to differentiate them from the formal negotiations between governments, known as the "Paris Club."[54]

The bank advisory committees, in negotiating restructurings of sovereign loans, adhered to a principle of treating all commercial banks equally.[55] More specifically, the committees sought to ensure the uniform treatment of all commercial loans—like types of debt were to be treated alike[56]—and they also

Advisory Groups and Servicing Banks, 23 COLUM. J. TRANSNAT'L L. 59, 65-66 (1984) (describing the function of bank advisory committees).

50 Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 506.

51 *Id*.

52 The commercial banks did not designate the bank advisory committees as their representatives. Moreover, upon the declaration of a moratorium on the servicing of obligations, including commercial loans, the commercial banks retained the right to pursue legal remedies against the sovereign debtors. *See id*. at 504 (describing the consequences of a moratorium).

53 *See* Lipson, *supra* note 46, at 217-18 (describing the process by which bank advisory committees operated).

54 *See* Daniel McGovern, *Different Market Windows on Sovereign Debt: Private-Sector Credit from the 1980s to the Present,* in SOVEREIGN DEBT*, supra note* 18, at 82-83 (describing characteristics of the London Club).

55 Sovereign debtors also followed the principle of equal treatment of creditors. Buchheit & Reisner, *supra* note 50, at 504-05. In announcing that a restructuring had commenced, a sovereign debtor included assurances that all commercial banks would be treated equally. *Id*. Lee Buchheit and Ralph Reisner note:

> These assurances have one objective—to engender moral responsibility among the various creditors that will forestall more disgruntled banks from resorting to legal remedies. Partly for this reason, telexes from [sovereign debtors] announcing the commencement of a generalized debt restructuring are often accompanied by a communication from the largest commercial bank lenders to the [debtor] confirming their willingness to forebear from exercising their legal rights *if* the international banking community as a whole evidences a similar restraint.

Id. at 504.

56 Lipson, *supra* note 46, at 211. The restructuring process generally encompassed commercial loans, while other types of debt were excluded from the process. Very short-term obligations such as suppliers' credits and trade-related credits were generally not included within the restructuring process. Buchheit & Reisner, *supra* note 50, at 515-16. Officially guaranteed loans were generally the subject of negotiations with the creditor governments, working informally through the Paris Club. Lipson, *supra* note 46, at 212. Publicly

sought uniformity in "the important areas of pricing, fees, tenor, amortization, and legal documentation."[57] By following a basic principle of uniformity, the bank advisory committees minimized the time period needed to complete the negotiations with sovereign debtors.[58] At the same time, "the emphasis on uniformity also appeal[ed] to 'simple-minded equity among banks,' . . . and so [made] it harder for individual banks to hold out for special treatment."[59]

Although the members of the bank advisory committees and the other commercial banks supported the principle of treating all banks equally, all of the banks did not necessarily agree as to the most desirable treatment—that is, although the banks promoted the notion of a uniform agreement, they did not necessarily prefer the same terms. The principal reasons for disagreements among the banks were differences in the sizes of the loans they had made relative to their total assets, differences in the regulations to which they were subject, differences in the nature of their business relationships with sovereign debtors, and differences in their level of participation in the international capital markets.

The large commercial banks located in the United States had made enormous loans to sovereign debtors in Latin America—loans with an aggregate value, in many instances, in excess of the total value of their assets.[60] These banks faced a very serious threat of insolvency. They also confronted a difficult regulatory environment. For banks in the United States, applicable regulations required that a loan be declared "nonperforming" in the event interest accrued on the loan was not paid within ninety days after its due date.[61] Regulations also required that all banks set aside adequate reserves for

issued bonds were "good candidates for exemption from a restructuring," Buchheit & Reisner, *supra* note 50, at 515, "because they [were] widely disbursed, and because each holder [had] legal rights to petition for default if payments [were] not made as scheduled." Lipson, *supra* note 46, at 212.

57 Buchheit & Reisner, *supra* note 50, at 505. Mr. Buchheit and Professor Reisner also note that "[d]eparting from this practice risk[ed] arousing the latent suspicion of the [commercial banks] that some banks will be favored over others, thereby jeopardizing the success of the entire restructuring program." *Id*.

58 Charles Lipson describes the norm of uniformity as having "'the great advantage of speeding negotiations'. . . [that] not only minimizes negotiating time in the first rescheduling . . . but [also] makes subsequent [reschedulings] much easier." Lipson, *supra* note 46, at 211. By creating a clear standard, it also "eases negotiations with other [sovereign debtors]." *Id*.

59 *Id*. at 212.

60 *See* Macmillan, *Debt Crisis*, *supra* note 28, at 312 n.38 (noting that the loan exposure in respect of the five largest sovereign debtors in Latin America, as a percentage of shareholders' equity, was 254.7% for Manufacturers Hanover, 198.3% for Chase Manhattan, 179.6% for Chemical Bank, 178.6% for CitiCorp, 166.8% for Bankers' Trust, 145.1% for Bank America, and 134.5% for Morgan Guaranty) (citing ANATOLE KALETSKY, THE COSTS OF DEFAULT 112 tbl.6.3 (1985)).

61 *See* Power, *supra* note 41, at 2710 (describing applicable regulations).

nonperforming loans, called "loan-loss reserves."[62] Since the total value of the loans made by large commercial banks in the United States exceeded the total value of their assets, the banks could not create adequate loan-loss reserves.

To prevent the insolvency of the largest commercial banks in the United States, the bank advisory committees worked diligently to avoid defaults.[63] Specifically, the committees devised a general plan for the restructurings in which sovereign debtors continued to pay interest on loans as it came due.[64] This approach, however, required commercial banks to make additional loans to sovereign debtors because the debtors lacked sufficient foreign currency reserves to pay the interest on their troubled loans. The new loans provided the sovereign debtors with the cash needed to make interest payments on their existing loans in a timely manner.

Consistent with the principle of treating all commercial banks equally, the new loans were to be made by the commercial banks ratably based upon the value of the loans previously made to the various sovereign debtors. Each commercial bank having made loans to a sovereign debtor "as of a specified date [was] asked to participate in [the] new money loans in an amount that [was] proportional to the bank's aggregate credit exposure in the country on that date."[65]

Large commercial banks located in the United States readily supported the approach, including the new loans, as it provided a means for these banks to avoid insolvency.[66] These banks had two additional reasons for supporting the approach. First, the banks had business relationships with the sovereign debtors, and they were eager to broaden those relationships. For example, these banks arranged loans for sovereign debtors, and they held deposits for both governmental agencies and local businesses.[67] These services, however,

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62 *Id.*

63 Alexander Nicoll, *Latin American Debt Crisis: Solution Passes the Test of Time*, FIN. TIMES, July 30, 1992, at 4 (describing the essence of the strategy as one to "buy time: stretch out the problem so that [sovereign] debtors could introduce economic changes necessary to restore creditworthiness, and allow [commercial banks] to build up their capital sufficiently to absorb the shocks").

64 The plan also included rescheduling of the principal amounts of the loans. *See* Power, *supra* note 41, at 2709 (describing the restructuring process).

65 Buchheit & Reisner, *supra* note 50, at 508.

66 *See* Lee C. Buchheit, *Alternative Techniques to Sovereign Debt Restructuring*, 1988 U. ILL. L. REV. 371, 385 (noting that "[b]etween the two evils of making an involuntary loan to a less-than-creditworthy borrower, or allowing existing loan assets to slip into the 'non-performing' category, most banks tend[ed] to prefer the former").

67 Lipson, *supra* note 46, at 210.

were only the starting point for the businesses the banks hoped to develop; the banks were also interested in providing short-term credit for private-sector importers and exporters and in opening branches in emerging market economies.[68] Second, these banks were permanent participants in the international capital markets, and they expected to continue working with other large commercial banks in a variety of settings. The members of the bank advisory committees "viewed debt restructuring as a regrettable but normal business activity,"[69] and so they expected to participate with one another as repeat players in restructurings. In addition, these banks participated together in many loan syndications,[70] and they were linked to one another through the financial network comprising the international capital markets.[71]

Other commercial banks located in the United States, smaller banks with small portfolios of loans to sovereign debtors, were less inclined to support the restructuring plans negotiated by the bank advisory committees. For these banks, the total value of their loans to sovereign debtors was small relative to the total value of their assets. Thus, these "smaller banks ha[d] no impending 'nightmare scenario.'"[72] Declaring the loans to be nonperforming loans would not have threatened the solvency of these banks because they had adequate loan-loss reserves. In addition, the smaller banks did not have business relationships with sovereign debtors, and they were not regular participants in the international capital markets. Accordingly, these banks were not concerned about jeopardizing the development of future international business.[73]

The smaller commercial banks were particularly opposed to making new loans to troubled sovereign debtors, a practice they viewed as "throwing good

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68 RIEFFEL, *supra* note 38, at 106-07. In fact, Lex Rieffel characterizes the "desire to continue doing business" with sovereign debtors as the "driving motivation for most banks represented on [bank advisory committees]." *Id.* at 111.

69 *Id.*

70 *See* Lipson, *supra* note 46, at 210-11 (describing the relationships among commercial banks). In a syndicated loan, a group of commercial banks join together to advance funds to a particular debtor under one loan agreement. *See* Buchheit & Reisner, *supra* note 50, at 500 (describing nature of loan syndication process); *see also* Macmillan, *Debt Crisis*, *supra* note 28, at 323 n.95 (describing the nature of syndicated loans).

71 *See* Lipson, *supra* note 46, at 210-11 (describing the relationships among commercial banks).

72 Macmillan, *Debt Crisis*, *supra* note 28, at 324.

73 Lipson, *supra* note 46, at 214 (describing the role of smaller commercial banks). These banks did, though, have an effective means of recourse against sovereign debtors. For some of these banks, loans were so small that the assets of the debtors located in the United States, and subject to attachment, were sufficient to satisfy any judgments they may have won. *See* Bainbridge, *supra* note 39, at 18 (describing the availability of litigation remedies to smaller commercial banks).

money after bad."[74] In addition, these banks recognized that the larger commercial banks were facing threats of insolvency. The smaller banks, thus, viewed the larger banks as having strong incentives not only to make new loans as specified in the restructuring plans but also to commit additional funds to cover any shortfalls in the values of the total loan packages arising from the refusal of the smaller banks to make new loans.[75]

The bank advisory committees viewed the opposition of the smaller commercial banks, particularly the resistance to making new loans to sovereign debtors, as a threat both to the principle of treating all commercial banks equally and to the success of the restructuring plans. Because the committees could not bind these banks to the terms of the agreements reached with sovereign debtors, they sought the voluntary cooperation of the smaller banks. Each member of the bank advisory committee bore responsibility for securing the cooperation of a specific group of smaller commercial banks, typically determined by geographic location.[76] The principal focus of each large commercial bank in securing the cooperation of the smaller commercial banks located in its region was the immediate banking relationships on which each smaller bank relied.[77] For example, officials of the large bank would warn their counterparts at a smaller bank that failure to cooperate might create

[74] Power, *supra* note 41, at 2711. The sovereign debtors, after all, were "self-declared insolvent debtors." Macmillan, *Debt Crisis*, *supra* note 28, at 324; *see also* Nancy P. Gibbs, *A Regional Bank's Perspective: An Analysis of the Differences and Similarities in the U.S. Banking Community's Approach to and Participation in the Mexican Restructuring*, 23 COLUM. J. TRANSNAT'L L. 11, 18 (1984) (noting that, in the restructuring of the loans made to Mexico, "the banks with very small exposures were reluctant to increase their exposure by a penny even if it meant writing off their existing [loan] portfolios").

[75] WILLIAM R. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE 75 (1984); *see also* Macmillan, *Debt Crisis*, *supra* note 28, at 324 (describing this situation as "the 'free-rider' problem in inter-bank relations"); Robert K. MacCallum, Note, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks* Inter Sese, 1987 COLUM. BUS. L. REV. 425, 435 (noting that the smaller banks, many of whom acquired portfolios of loans to sovereign debtors through participations in syndicated loans at the invitation of the large commercial banks, argued that the large banks should bear the burden of making new loans).

[76] The large commercial banks generally recognized that service as a member of a bank advisory committee included working to secure the cooperation of the smaller commercial banks. Lipson, *supra* note 46, at 215-18.

[77] These banking relationships were vital to the businesses of the smaller commercial banks, as they provided access both to participations in syndicated loans and to banking services. These relationships were also tremendously important in the context of loans to sovereign debtors, including restructurings of those loans, because the smaller banks generally lacked access to information regarding the financial positions of the debtors and, in restructurings, the repayment intentions of the debtors. For a description of the banking relationships on which the smaller banks relied, see *id*. at 220. For a description of the difficulties of the smaller commercial banks in gaining access to information regarding sovereign debtors, see Power, *supra* note 41, at 2712.

difficulties for the smaller bank in purchasing participations in new syndicated loans, including loans to domestic borrowers.[78]

This pressure was often sufficient to cause reluctant smaller banks to ratify the agreements with the sovereign debtors and to support the proposed restructuring plans.[79] In the event that it was not, federal banking regulators could exert additional pressure.[80] In particular, the International Lending Supervision Act of 1983 granted regulators significant powers to require banks to set aside higher reserves against loans to sovereign debtors experiencing a "protracted inability . . . to make payments on their external indebtedness."[81] The statute gave regulators broad discretion to determine whether or not a bank was required to maintain greater reserves, enabling regulators to pressure reluctant banks to support restructurings.[82]

Finally, the IMF also exerted pressure, albeit indirectly, on dissenting smaller banks. In 1982, the IMF initiated the practice of conditioning its loans to any troubled sovereign debtor on a commitment from all the commercial banks that had made loans to the debtor to make new loans.[83] At the same time, the IMF continued its policy of requiring each sovereign debtor to implement austerity programs, monitored by the IMF, as a condition of receiving IMF loans.[84] The commercial banks, in turn, required each debtor to adopt the austerity program proposed by the IMF and to submit to monitoring

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78 *See* Lipson, *supra* note 46, at 220 (describing the tactics used by large commercial banks in pressuring smaller commercial banks to support restructuring plans negotiated by bank advisory committees).

79 "The whole point [was] to break down the large . . . game, involving hundreds of banks and considerable opportunities for free-riding, into a series of bilateral games pitting a few small holdouts against the major money-center banks." *Id*. (emphasis omitted).

80 These regulators included the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. Keith A. Palzer, Comment, *Relational Contract Theory and Sovereign Debt*, 8 NW. J. INT'L L. & BUS. 727, 742 n.82 (1988).

81 12 U.S.C. § 3904(a)(1)(A) (2000). *See generally* Cynthia C. Lichtenstein, *The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983*, 25 VA. J. INT'L L. 401 (1985) (describing the International Lending Supervision Act).

82 Power, *supra* note 41, at 2713; *see also* Palzer, *supra* note 80, at 745 n.97 (noting that regulators used their authority "to impose a minimum level of reserves on banks which refuse[d] to follow the market").

83 *See* Lipson, *supra* note 46, at 223 (describing the role of the IMF in pressuring smaller banks to support restructuring plans negotiated by bank advisory committees); *see also* Macmillan, *Debt Crisis*, *supra* note 28, at 319 n.76 (noting that, "[i]n the case of Mexico, the IMF refused to give financial assistance until all 1400 of Mexico's commercial bank creditors had agreed to extend additional loans of $5 billion new money, which amounted to seven percent of their existing loan exposure").

84 The austerity programs typically involved efforts to balance current accounts by restricting imports, devaluing local currency, and balancing domestic budgets. *See* Bill Orr, *After a Decade Bankers Say "Adios" to Latin Debt Crisis*, A.B.A. BANKING J., July 1992, at 36.

by the IMF as a condition to receiving new loans.[85] This structure of interrelated conditions among the IMF and the commercial banks served as a means of exerting pressure on smaller banks.[86]

Commercial banks located outside the United States also were not inclined to support the restructuring plans negotiated by the bank advisory committees. As a general matter, commercial banks located in Western Europe had made relatively small loans to sovereign debtors in Latin America, particularly as compared to the total value of their assets. Thus, the exposure to the crisis in the sovereign debt market was significantly lower for the Western European banks than the exposure of the large U.S. banks.[87] In addition, the regulatory environment was, in important ways, more favorable in Western Europe than in the United States. Banks in Western Europe were not required to degrade the value of a loan in the event that accrued interest was not paid within ninety days after its due date.[88] The banks in Western Europe, as a result, preferred to capitalize accrued but unpaid interest rather than to make new loans to sovereign debtors. The tension was resolved in favor of the U.S. banks simply because they were able to commit credibly to supporting only restructuring plans that provided for new loans to sovereign debtors. The Western European banks, on the other hand, could not credibly refuse to support these restructuring plans because, although they were not the most preferred plans, they would not result in tremendous losses to the banks.

The large commercial banks in the United States also appealed to the interests of the Western European banks by urging them to support the plans as a means of enhancing their relationships with sovereign debtors and their roles in the international capital markets.[89] Once the large commercial banks in Western Europe agreed to the restructuring plans, they used their relationships with smaller commercial banks to pressure the smaller banks to ratify the

[85] *See* Lipson, *supra* note 46, at 211 (noting that "[t]he difficult issue of the [sovereign] debtor's future policies [was] removed from these negotiations [regarding the restructuring of the loans made by commercial banks]" and that "[t]he [commercial banks] simply insist[ed] on I.M.F. conditional lending and economic supervision").

[86] *See, e.g.*, McGovern, *supra* note 54, at 74 (describing this system of "concerted lending" as "essentially a gentleman's agreement: where (a) banks made new loans to troubled sovereigns; (b) the sovereigns adopted sound economic policies; (c) multinational institutions provided new adjustment lending; and (d) the sovereigns remained current on payments to creditors").

[87] *See, e.g.*, Lipson, *supra* note 46, at 210-13 (describing the greater vulnerability of U.S. commercial banks as compared to Western European commercial banks).

[88] *Id*. at 212.

[89] *Id*. at 209-14 (discussing the strategy of the U.S. banks in convincing the Western European banks to support restructuring plans that included new loans to troubled sovereign debtors).

agreements and to support the plans.[90]

Using the various forms of pressure available to them, the commercial banks concluded forty-two debt restructurings with the governments of thirty-two countries during the period from 1982 to 1984.[91] Some of the restructurings were completed within a few months, while other restructurings took several years to complete.[92]

These restructurings, however, were followed by more restructurings. The restructuring of Mexico's debt was regarded as a model for other restructurings, yet three years later, in 1986, Mexico was unable to service the obligations on the loans that had been previously rescheduled. As a result, Mexico entered into a new series of negotiations that resulted in rescheduling loans in excess of $97 billion.[93] Between 1983 and 1990, Mexico restructured its debts to foreign creditors twelve times, and many countries in Latin America restructured their foreign debts many times.[94]

The repeated restructurings caused strains among the participating commercial banks. As Lee Buchheit notes:

> The first round of debt rescheduling for a particular country may have enjoyed unanimous participation, but the second, third and fourth round did not. Within two years of the first rescheduling, fissures appeared in the cohesion of the banking community: big banks versus little banks; regional banks versus money centre banks; banks in North America versus banks in Europe, Japan and the Gulf; banks with large loan loss reserve provisions versus banks without such provisions.[95]

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[90] Once the large commercial banks in Western Europe agreed to support the restructuring plans, they had strong incentives to induce the smaller commercial banks in their regions to support the plans, because the support of the smaller banks would reduce the size of the new loans the large banks would be required to make.

[91] RIEFFEL, *supra* note 38, at 159.

[92] *Id*. Although the restructuring of the debt Mexico owed to foreign creditors was completed within one year, in the case of Argentina almost three years were required to conclude the restructuring process. *Id*.

[93] *See* Macmillan, *Debt Crisis*, *supra* note 28, at 333 (describing the restructuring of Mexican debt).

[94] *See* Martin Wolf, *On Sovereign Bankruptcies—Economic Eye*, FIN. TIMES, May 15, 1995, at 22 (discussing repeated restructurings and noting that eleven countries, including Mexico, restructured their debts ten or more times between 1980 and 1994).

[95] Lee C. Buchheit, *Majority Action Clauses May Help Resolve Debt Crises*, INT'L FIN. L. REV., Aug. 1998, at 13. The bank advisory committees worked to minimize these strains. For example, commercial banks were occasionally granted permission to allocate their new loans to debtors of their choice within the country. In this way, the banks were permitted to maintain relationships with existing clients. In addition, the restructuring plans provided a cushion in the event smaller banks refused to make new loans. These plans provided for a total amount of new loans slightly greater than the amount needed to reschedule the loans.

Notably, these strains did not result in significant litigation.[96] As a general matter, the commercial banks "weighed the low odds of recovering more money against the costs of litigation, taking into account their varying tax and regulatory regimes," and they apparently concluded that "[t]he attractions of negotiated solutions were . . . far superior to the attractions of litigation."[97]

The strains within the banking community led, instead, to the development of a secondary market for loans made to sovereign debtors. Indeed, shortly after the first round of debt reschedulings, commercial banks began to develop a small market for sovereign loans that consisted of interbank swaps.[98] As the debt crisis deepened, many commercial banks became eager to sell, in the secondary market, the loans they had made to sovereign debtors.[99] By selling

Thus, if all the commercial banks were to make new loans as required by the plans, a small amount of excess financing would be provided. *See* Lipson, *supra* note 46, at 219 (describing these efforts). Under this approach, an agreement negotiated with a sovereign debtor was considered to be ratified, and the restructuring plan was considered to be approved, upon the acceptance of a "critical mass" of commercial banks, usually representing more than 95% (but less than 100%) of the total value of the loans made to a sovereign debtor. RIEFFEL, *supra* note 38, at 122.

The bank advisory committees did not, though, purchase the loans made by the dissenting banks. As Professor Lipson reports the views of a syndications manager in London, "no banks have been bought out of a rescheduling. 'If we did that . . . that would be the end. [The rescheduling] would unravel like a cheap sweater' as other smaller [banks] stood in line for the same deal." Lipson, *supra* note 46, at 219 (footnote omitted).

[96] *See, e.g.*, Bainbridge, *supra* note 39, at 3 (noting that the debt crisis of the 1980s "produced remarkably little litigation"); Cleary, Gottlieb, Steen & Hamilton, New York & Clifford Chance, London, *Avoiding the Nightmare Scenario*, INT'L FIN. L. REV., Aug. 1992, at 19 (stating that "[w]hen one considers that the debt crisis has offered more than U.S. $500 [billion] of provocation to potential plaintiffs, the number of lawsuits actually filed . . . over the last decade has been astonishingly small").

[97] RIEFFEL, *supra* note 38, at 159 n.17. Although any commercial bank, upon an event of default, had the right to accelerate the loan and to sue for the entire unpaid balance of the loan, the banks recognized that the likelihood of recovering amounts owed by sovereign debtors was very small. The difficulties associated with attaching the assets of sovereign debtors are discussed *infra* in Part II.

In addition, the terms of the syndicated loan agreements pursuant to which many of the loans were made limited the actions of the banks in the syndicate by requiring a majority vote, or a supermajority vote, to declare an event of default. Buchheit & Reisner, *supra* note 50, at 496. The syndicated loan agreements also contained sharing clauses and cross-default clauses, both of which limited the recovery that any bank might receive through litigation. *See, e.g.*, *id*. at 502 (describing sharing clauses); *id*. at 496 (describing cross-default clauses).

[98] *See* Michael M. Chamberlin & Thomas E. Winslade, *Regulating the LDC Debt Markets*, INT'L FIN. L. REV., Aug. 1992, at 16 (describing the development of the market for interbank swaps). The swaps were generally accomplished through assignments, and the assignment agreements typically provided that the assignee bank assumed, in addition to the right to payments on the loans, the responsibility for participating in future restructurings of the loans, including the making of new loans based upon the exposure level represented by the assigned loans. *See* Lee C. Buchheit, *The Evolution of Debt Restructuring Techniques*, INT'L FIN. L. REV., Aug. 1992, at 10 (describing the mechanics of the secondary market).

[99] *See* Macmillan, *Debt Crisis*, *supra* note 28, at 328 (noting the means by which commercial banks exited the sovereign debt market).

its loans, a bank was able to reduce its proportion of the total loans made to that debtor, thereby reducing the amount of new loans the bank would be required to make in future restructurings of the loans.[100]

The debt crisis continued, fueled in part by continuing weaknesses in the emerging market economies of Latin America.[101] At the same time, the total value of new loans made to the governments of these countries by commercial banks declined drastically, exacerbating the problems these countries faced.[102] To alleviate the continuing crisis, not only commercial banks but also the U.S. government sought ways to improve both the restructuring process and the outcomes of the restructurings.

The commercial banks, operating through the bank advisory committees, introduced multiyear rescheduling agreements. These agreements were designed to reduce the time and expense of annual restructurings and to form a basis for commercial banks to exit the sovereign debt market.[103] In October of 1985, Treasury Secretary James Baker announced a new plan for resolving the debt crisis entitled "Program for Sustained Economic Growth" (Baker Plan).[104] The purpose of the Baker Plan was to provide additional loans to sovereign debtors, from both official sources and private sources, subject to the commitment of each recipient to implement specified programs deemed important for achieving long-term growth.[105] Several restructurings were

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100 For sovereign debtors, the sales also provided a mechanism for eliminating the objections of dissenting commercial banks.

101 *See* INTER-AMERICAN DEVELOPMENT BANK, ECONOMIC AND SOCIAL PROGRESS REPORT IN LATIN AMERICA: 1990 REPORT 15 (1990) (describing the difficulties confronting these countries).

102 *Id*. Although bankers often attributed their refusal to make new loans to poor macroeconomic policies on the part of these governments, at least one commentator has suggested that the decline in new loans was due, in part, to the recalcitrance of smaller commercial banks in refusing to support restructuring plans that provided for new loans to sovereign debtors. *See* Paul Krugman, *Private Capital Flows to Problem Debtors*, *in* DEVELOPING COUNTRY DEBT AND ECONOMIC PERFORMANCE 299, 307-17 (Jeffrey D. Sachs ed., 1989) (describing the trends in lending during the period from 1982 to 1986).

103 As a general matter, the agreements consolidated payments falling due over several years, lengthened repayment periods to as long as twenty years, reduced the interest on both rescheduled loans and new loans, and eliminated the restructuring fee that was imposed in earlier restructurings. In addition, some of the agreements contained debt-equity conversion clauses, on-lending, and trade-facility options for new-money commitments. Mexico negotiated the first multiyear rescheduling agreement in 1984; the agreement covered principal payments over six years, from 1984 to 1989. In addition, Argentina, Chile, the Dominican Republic, Ecuador, Jamaica, Uruguay, Venezuela, and Yugoslavia also negotiated multiyear rescheduling agreements. *See* RIEFFEL, *supra* note 38, at 162-63 (describing experiences with multiyear rescheduling agreements).

104 Christine A. Bogdanowicz-Bindert, *World Debt: The United States Reconsiders*, 64 FOREIGN AFF. 259, 267, 273 (1985).

105 *See* RIEFFEL, *supra* note 38, at 163 (describing the Baker Plan).

completed under the Baker Plan.[106]

During 1987, however, "the Baker Plan was effectively abandoned as [commercial] banks began to experiment with a variety of debt-restructuring techniques that included elements of debt reduction."[107] Significantly, in April of 1987, Citibank, N.A. announced that it would record a loss of $2.5 billion in order to increase its loan-loss reserves from $2 billion to $5 billion, an amount equal to twenty-five percent of the bank's exposure to loans made to sovereign debtors in the emerging market economies.[108] Other large commercial banks in the United States soon made similar adjustments, and a second round of adjustments was announced later in the year.[109] These decreases in loan exposure eliminated the threat of insolvency for the U.S. banks.[110] Similarly, in 1988, commercial banks located in Western Europe and Japan increased their provisions for loans made to sovereign debtors in emerging market economies thereby reducing their exposure.[111] Through these changes, commercial banks dramatically reduced the losses they would incur upon a reduction in the total value of the loans made to sovereign debtors.[112]

On March 10, 1989, Treasury Secretary Nicholas Brady articulated a series of new principles for resolving debt crises, which became known as the "Brady

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106 The countries completing restructurings of their debt under the Baker Plan include Mexico in March of 1987, Argentina in August of 1987, and Brazil in November of 1988. *Id* at 164.

107 *Id*.

108 *See id*. at 165 (describing changes in provisionings for loans to sovereign debtors in Latin America); Macmillan, *Debt Crisis*, *supra* note 28, at 327 (same).

109 RIEFFEL, *supra* note 38, at 165.

110 In 1982, the exposure of the nine largest commercial banks located in the United States to developing-country debt was over 250% of their capital. By 1986, the exposure had been reduced to 167.2%, and with respect to only sovereign debtors in Latin America, the exposure was 97.7%. Stanley Fischer, *Sharing the Burden of the International Debt Crisis*, 99 AM. ECON. REV. PAPERS & PROC. 165, 166-67 (1987). In addition, from 1985 to 1988, U.S. commercial banks reduced their exposure to loans made to sovereign debtors in Latin America by 30%, and they lowered the ratio of the value of these loans to the total value of their assets from 245% in 1981 to less than 100% in 1989. INTER-AMERICAN DEVELOPMENT BANK, *supra* note 101, at 14. In 1989, reserves represented 30% of the value of loans to these sovereign debtors. *Id*. The result, of course, was to weaken an important force for cohesiveness among the commercial banks that had made loans to sovereign debtors.

111 RIEFFEL, *supra* note 38, at 165.

112 These changes also had an immediate impact on the secondary market for sovereign loans. Specifically, the reductions in the values of the loans recorded on the balance sheets of the banks resulted in large declines in the prices of the loans in the secondary market. *See id*. at 167 (presenting data regarding prices for sovereign loans in the secondary market). The decreases in the prices of the sovereign loans in the secondary market, in turn, provided additional trading opportunities and so further eroded the incentives for cooperation among commercial banks.

Plan."[113] These principles included a reduction in the total amount of debt owed by sovereign debtors in exchange for both a commitment on the part of the debtors to adopt specified reforms designed to achieve sustainable growth, notably the privatization of state-owned enterprises, and greater assurances of the collectability of the debt. In addition, these principles included the use of different forms of debt to increase liquidity in the international capital markets. Finally, the principles included complementary support from a variety of official sources, including the rescheduling of loans owed to official creditors and new loans from bilateral aid agencies and export credit agencies.[114]

To implement these policies, the loans the commercial banks made to each sovereign debtor participating in the Brady Plan were securitized. The loans were pooled together, and then they were exchanged for Brady Bonds. The bonds were sold publicly to investors. The proceeds from the sale of the bonds were used to repay the loans. As a result of these transactions, the commercial banks exited the sovereign debt market, and they were replaced by investors holding Brady Bonds.[115]

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113 *See* Nicholas F. Brady, Remarks to the Brookings Institute and Bretton Woods Committee Conference on Third World Debt (Mar. 10, 1989), *in* BROOKINGS DIALOGUES ON PUBLIC POLICY, THIRD WORLD DEBT: THE NEXT PHASE 69 (Edward R. Fried & Philip H. Trezise eds., 1989) (outlining principles for resolving debt crises).

114 *See* RIEFFEL, *supra* note 38, at 170-74 (describing the Brady Plan). In connection with the Brady Plan, the IMF altered its policies regarding loans to sovereign debtors in times of crisis. Specifically, the IMF began providing loans to sovereign debtors so long as they were implementing a credible adjustment program and negotiating in good faith with the commercial banks that had made loans to them (even though the negotiations were not complete), and it abandoned the policy of requiring sovereign debtors to eliminate arrears before it would disperse new loans. *Id*.

115 To reduce the total amount of debt owed by the sovereign debtor, the bonds were issued at a discount, in terms of either principal or interest, from the loans with which they were exchanged. In a typical restructuring under the Brady Plan, the bank advisory committee negotiated with the sovereign debtor to provide a menu of options, each of which was carefully tailored "to fit the varying regulatory and tax regimes of the banks involved, while remaining financially equivalent." *Id*. at 172. The two most common options were par bonds, which were exchanged for the same principal amount of the loans but bearing a fixed interest rate below the prevailing rate in the market, and discount bonds, exchanged at a substantial discount from the principal amount of the loans but bearing an interest rate based on the market rate. In addition to these two options, debt-equity swaps, which resulted in the banks holding a claim in the local currency that could be exchanged for shares of an entity subject to privatization, and cash repurchases of the loans, at substantial discounts from the principal amount of the loans, were also available. The bonds usually had a maturity of thirty years, which was substantially longer than the maturity of the loans. *Id*.

The collectability of the bonds was enhanced through assistance provided by multilateral (and bilateral) agencies. The most common form of enhancement related to the principal amount of the bonds. Typically, a sovereign debtor purchased, with a combination of credit from the IMF and loans from the World Bank and the Inter-American Development Bank, as well as with its own reserves, thirty-year, zero-coupon Treasury bonds. The Treasury bonds served to collateralize the bonds by ensuring full payment upon maturity. The collateral for the principal of the bonds, however, was not available to the bondholders until the maturity of the

Although regulators initially viewed Brady Bonds as "appropriate only for a limited audience of speculative investors," the high rates of return provided by the bonds attracted many investors.[116] As the market for sovereign bonds grew,[117] the governments of emerging market economies, particularly in Latin America, realized that they could access the bond markets for a significant portion of their financing needs and implemented strategies to do so.[118]

One of the most important advantages of bonds is their flexibility as compared to loans from commercial banks. Bonds have longer maturities than commercial loans, and the covenants in the agreements governing the bonds are generally less restrictive than the covenants contained in the agreements governing commercial loans. In addition, bonds are easily listed and traded on the stock exchanges, and they have relatively simple clearing and settlement procedures. Finally, the rating agencies assign credit ratings to sovereign bonds, providing investors with intercountry comparisons of the risks associated with the bonds. This information, in turn, facilitates daily market pricing and trading, both of which serve to increase the attractiveness of sovereign bonds to investors. As a result, during the 1990s, bonds issued to investors in the capital markets replaced loans from commercial banks as the

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loans. A second common form of enhancement related to the interest accruing on the bonds. As in the case of the collateral for the principal amount of the bonds, Treasury securities were pledged to ensure that the interest on the bonds was paid. Typically, this collateral was limited to the interest accruing on the bonds over a period of eighteen months (or perhaps two years), and the collateral was not available to bondholders for a period of eighteen months following a default on the bonds. Finally, the bonds also contained covenants pursuant to which the sovereign debtors promised to refrain from requesting restructurings of the bonds. Any request to restructure the bonds would thus constitute an event of default. *See id*. (describing the menu of options offered under the Brady Plan); Power, *supra* note 41, at 2721-22 (describing the characteristics of the Brady Bonds).

116 McGovern, *supra* note 54, at 75. In this way, the investors were similar to the purchasers of sovereign bonds in the 1920s.

Many investors also tended to underestimate the risk of default on the bonds. In miscalculating this risk, investors relied on a variety of factors, including the absence of defaults on sovereign bonds during the period from the early 1940s to the early 1990s and the exclusion of sovereign bonds from the restructurings of the 1980s. *See* RIEFFEL, *supra* note 38, at 192-94 (describing the historical experience with sovereign bond defaults). *But see* Truglia et al., *supra* note 11, at 10 (describing six defaults on marketable security debt, including bonds, between 1982 and 1990).

117 According to some estimates, between 1988 and 1995, twenty-one countries restructured their debt under the Brady Plan. These restructurings involved a total of $170.2 billion of debt, and resulted in a reduction in total debt service costs of $76 million, reflecting an average of approximately 45% of the total. Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103, 106 (2003).

118 Initially, countries exchanged their Brady Bonds for Eurobonds, in both public exchanges and private exchanges. Over time, countries issued Eurobonds to serve a variety of financing needs. *See* Jane Brauer & Ryan McDuffy, *The Decline of Brady Debt*, MERRILL LYNCH EMERGING MARKETS RES., Apr. 5, 2004, at 1, 2.

main form of private capital flows to emerging market economies.[119]

3. The Current Crisis

By 1994, financial crises in several countries led to new crises involving sovereign debt.[120] Many of these crises involved restructurings of sovereign bonds. For example, in 1999 Pakistan restructured three Eurobonds with a face value of approximately $600 million; in 2000 Ecuador restructured Brady Bonds and Eurobonds with an aggregate face value of approximately $6.5 billion and the Ukraine restructured four Eurobonds with a face value of approximately $2.3 billion; and in 2003 Uruguay restructured international bonds with a total face value of approximately $5.45 billion.[121] And, of course, in 2001, Argentina defaulted on billions of dollars of bonds.[122]

The recent restructurings of sovereign bonds have involved a variety of approaches. In the cases of Pakistan, the Ukraine, and Uruguay, the restructurings were arranged prior to defaults on the bonds, while the case of

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[119] *See* RIEFFEL, *supra* note 38, at 190-92 (describing recent trends in financing in the emerging market economies). In addition to Brady Bonds issued in connection with restructurings of commercial loans, sovereign debtors also issued new bonds, particularly Eurobonds. *See* McGovern, *supra* note 54, at 78 (describing the components of the market for sovereign bonds). In 1993, Brady Bonds represented 27%, and Eurobonds represented 73%, of the bonds issued by the governments of the major emerging market economies. In 2003, Eurobonds represented 88%, and Brady Bonds represented 12%, of these bonds. *See* Brauer & McDuffy, *supra* note 118 (presenting data regarding issuances of Brady Bonds and Eurobonds).

[120] The first of these crises, the Mexican Peso Crisis in 1994, the Asian Crisis in 1997, and the Russian Crisis in 1998, arose from financial crises in which the values of local currencies declined substantially against the dollar. These crises were resolved with the significant assistance of creditor governments, notably the United States and Japan, as well as of multilateral agencies, including the IMF, and bilateral agencies, and, in the case of the Russian Crisis, the restructuring of loans made by commercial banks. For a description of the Mexican Peso Crisis and the Russian Crisis, see Scott, *supra* note 117, at 106-07, 108. *See also* RIEFFEL, *supra* note 38, at 198-211 (describing these crises). Largely due to a reduction in the access of governments of emerging market economies to the international capital markets in the wake of the Russian Crisis, in 1999 Brazil experienced a significant depreciation in the value of its currency. This crisis was resolved through the provision of additional funds by the IMF, the World Bank, and the Inter-American Development Bank, as well as a rescheduling of (short-term) loans made by commercial banks. *See id*. at 213-15 (describing the crisis in Brazil). In 2000, Turkey experienced a substantial decrease in its foreign currency reserves, which was followed by a significant decline in the value of its currency as compared to the dollar. This crisis was resolved with significant assistance from the IMF. *See id*. at 215 (describing the crisis in Turkey); Scott, *supra* note 117, at 109-10 (same).

[121] *See* INT'L MONETARY FUND, REVIEWING THE PROCESS OF SOVEREIGN DEBT RESTRUCTURING WITHIN THE EXISTING LEGAL FRAMEWORK 3-4, tbl.1 (2003) (summarizing recent cases of sovereign debt restructurings), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf; Roubini & Setser, *supra* note 9, ch. 4, at 30, 47 (same).

[122] *See* Barham, *supra* note 4 (describing the Argentine default); Lapper, *supra* note 4 (same).

Ecuador involved an extended period of default.[123] With respect to the terms of the bonds, the restructurings of the bonds of Pakistan and Uruguay involved extensions of maturities, the restructuring of the bonds of the Ukraine involved extensions of the maturities together with reductions in the interest rates borne by the bonds, and in the case of Ecuador, the restructuring involved a reduction in the principal amount of the outstanding bonds of approximately twenty-seven percent.[124] While all of these restructurings involved exchange offers, Pakistan and Uruguay relied on ad hoc consultations with bondholders to apprise them of the terms of the offer and to encourage them to accept the offer, the Ukraine engaged in an extensive effort to contact bondholders, and Ecuador essentially declined to speak with bondholders.[125]

C. Creditor Heterogeneity and the Divergence of Interests

The diversity in sovereign bond restructurings, in many ways, reflects the diversity among investors in sovereign bonds. Sovereign bonds are held by large commercial banks, smaller commercial banks, local banks, investment banks, insurance companies, pension funds, mutual funds, retail funds, hedge funds, nonfinancial companies, and retail investors.[126] Moreover, the extent to which these various investors hold bonds issued by any particular country differs markedly across countries and issues of bonds.[127]

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[123] Roubini & Setser, *supra* note 9, ch. 4, at 30.

[124] *Id*. at 31.

[125] INT'L MONETARY FUND, *supra* note 121, tbl.1; *see also* RIEFFEL, *supra* note 38, at 211-13 (describing the restructurings of the bonds of Pakistan, the Ukraine, and Ecuador); Michael Peterson, *Small Investors Flex Their Muscles*, EUROMONEY, Oct. 2000, at 20.

[126] *See* McGovern, *supra* note 54, at 77 (describing the various types of holders of sovereign bonds). The diversity of the investors in the Eurobond market has encouraged the development of new instruments. In addition to bonds, structured debt, collateralized bond obligations, and total-return swaps have all been created to satisfy the regulatory constraints imposed on investors. In addition, derivative instruments allow banks and hedge funds to enhance returns while dispersing risk. *Id*. at 78-79 (describing the variety of instruments traded in the market).

[127] For example, in the case of Pakistan, approximately one-third of the bonds subject to the restructuring were held by domestic residents and the remaining bonds were held by financial institutions and retail investors in the Middle East. *See* INT'L MONETARY FUND, *supra* note 121, at 3-4, tbl.1 (summarizing recent cases of sovereign debt restructurings). For Ecuador, the bonds were widely held by institutional investors in New York and London. *Id*. For the Ukraine, three of the bonds were held by a small number of investment banks and hedge funds, and the fourth bond was widely held by retail investors in Europe. *Id*. For Uruguay, the dollar-denominated bonds were widely held by institutional investors in the United States, but more than one-half of all the bonds were held by domestic investors, principally retail investors. *Id*. For Argentina, of the approximately $100 billion principal amount of debt subject to the (current) restructuring, approximately $50 billion is held by Argentine financial institutions, approximately $20 billion is held by retail investors in Europe, approximately $3 billion is held by retail investors in Japan, and the remaining $27 billion is held by institutional investors in the United States. *Id*.

These diverse investors, like the commercial banks that held sovereign debt in the 1970s, differ in their exposure, in the regulatory environments they confront, in the extent of their relationships with sovereign debtors, and in their involvement in the international capital markets. The level of heterogeneity among these investors, however, is greater than the differences among commercial banks. As a general matter, commercial banks follow a common business plan. They make loans to borrowers and hold cash deposits. They expect to make profits from the spreads between the interest rates charged on the loans and the interest rates paid on the deposits, as well as from fees for their services.[128] Investors in sovereign bonds, on the other hand, are engaged in a wide variety of businesses, and they purchase sovereign bonds for many different reasons. For example, most mutual funds strive to create a diversified portfolio of assets and so they invest only a small portion of their funds in sovereign bonds.[129] Hedge funds typically purchase relatively large positions in sovereign bonds.[130] Retail investors, in contrast, often hold sovereign bonds as part of a long-term investment strategy, such as to provide income during their retirement years.[131] Moreover, the institutions and individuals holding the bonds of any particular sovereign debtor continually change as the bonds are traded in the market.[132]

As the group of investors holding sovereign debt has become more diverse, vulture funds have achieved particular notoriety. Vulture funds typically trade in distressed debt—purchasing bonds at prices that represent substantial discounts from their face values.[133] In making these purchases, vulture funds typically seek short-term gains, either through the restructuring process or by

[128] *See* RIEFFEL, *supra* note 38, at 38 (describing the activities of commercial banks).

[129] *See id*. at 39 (describing activities of investment funds); *see also* INV. CO. INST., MUTUAL FUND FACT BOOK 3 (43d ed. 2003) (describing diversification strategy of mutual funds).

[130] HILARY ROSENBERG, THE VULTURE INVESTORS 25-36 (2000).

[131] *See, e.g.*, *Argentina and the IMF: Which Is the Victim?*, ECONOMIST, Mar. 6, 2004, at 63, 64 (noting that purchasers of sovereign bonds issued by Argentina include pensioners living in Italy); Suzanne Miller, *Lessons from Argentina*, BANKER, Feb. 1, 2002 (describing the retail investors who purchased sovereign bonds issued by Argentina as ranging "from dentists in Belgium to housewives in Japan").

[132] *See* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1005-06 (noting the constantly changing identities of sovereign bondholders).

[133] *See, e.g.*, Deepak Gopinath, *The Debt-Crisis Crisis*, INSTITUTIONAL INVESTOR, Aug. 2002, at 36, 38 (describing the opinion of analysts that Argentina's "bonds, trading at the equivalent of 20 cents on the dollar, are still too expensive as a vulture play. The target: 12 cents [on the dollar]"). For a general description of the strategies used by vulture funds, see ROSENBERG, *supra* note 130. For a more detailed description of the role of vulture funds in the restructuring of sovereign bonds, see Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT'L L. 253, 254, 262-64 (2003).

holding out and seeking additional payments from the debtors through negotiated transactions or as a result of litigation.[134]

Investors in sovereign bonds also differ significantly in their levels of exposure to the risk of default on the bonds. The value of the bonds held in each portfolio as compared to the total value of the assets in the portfolio varies across the various types of investors as well as within the various classes of investors. Some investors may experience bankruptcy upon a default on the bonds, others may only experience a small loss.[135]

Due to the growth of the secondary market, investors purchase sovereign bonds in the market at different prices. Unlike the restructurings of the 1930s in which investors had purchased bonds from banks at equivalent prices, and unlike the restructurings of the 1980s in which most of the commercial banks made loans to the sovereign debtors through the syndication process, investors today may purchase bonds at substantial discounts from their face values. These differences in prices create substantial disparities among bondholders. For example, retail investors who purchase bonds at the time of their issuance, at prices near the face values of the bonds, are likely to be reluctant to accept the terms of a restructuring that substantially reduce the principal amounts of the bonds.[136] Other investors, notably vulture funds, who purchase the bonds once the sovereign debtor begins to experience severe distress, pay a much lower price for the bonds and so may be willing to accept restructuring terms that impose significant reductions to the principal amounts of the bonds.[137] In between these two extremes, institutional investors may be willing to accept limited reductions to the principal amounts of the bonds in a restructuring, depending upon the magnitude of the losses or gains they have sustained.[138]

[134] *See* Bratton & Gulati, *supra* note 14 (describing the strategic behavior of vulture funds).

[135] *See, e.g.*, McGovern, *supra* note 54, at 79-80 (describing the techniques banks and investment funds use to minimize the risk associated with investing in sovereign bonds); Richard Lapper, *Creditors Unite to Seek Better Deal on Argentine Debt*, FIN. TIMES, Dec. 10, 2003, at 3 (describing the small investors from Japan, Italy, Germany, and several smaller European countries as among the worst affected by the current crisis in Argentina).

[136] *See* Felix Salmon, *A United Stand for Retail Bond Investors*, EUROMONEY, June 2003, at 152, 153 (describing retail investors as "want[ing] to get their money back").

[137] *See Collective Indecision*, EUROMONEY, Nov. 2002 ("[B]ondholders are not like banks holding syndicated loans . . . . A hedge fund that bought at 25 [cents on the dollar] yesterday might be very happy with a work-out that would be worth 35 [cents on the dollar] next week; a retail investor who bought at par seven years ago would probably reject such an offer as out of hand.").

[138] *See* Salmon, *supra* note 136, at 153 (describing these investors as "want[ing] to maximize the present value of their paper"). The purchase of sovereign bonds in the market at different prices also engenders disagreements among investors as to the appropriate measure of the discount to be included in a restructuring of the bonds. In the event bondholders are able to reach an agreement regarding the appropriate discount, or

Investors in sovereign bonds also face significantly different regulatory environments. Banks and other institutional investors record the values of their portfolios of sovereign bonds at market prices, often daily and certainly monthly or quarterly.[139] Retail investors, however, typically do not perform this exercise. By "marking to market," banks and other institutional investors record their gains and losses almost as they occur.[140] Retail investors typically record gains and losses only upon sales of bonds. Because the values of their portfolios already reflect the losses due to financial distress, banks and other institutional investors may elect to exit a restructuring by selling their bonds in the market, rather than holding the bonds and working to complete the restructuring process.[141] These sales further depress the price and create losses for other investors, including retail investors. Moreover, as secondary trading leads to shifts in the ownership of the distressed debt, it hinders efforts to reach consensus among the bondholders.

Like the large commercial banks that guided the restructurings of the 1980s, only large investors, particularly commercial banks and investment banks, have relationships with sovereign debtors that they are eager to use as a basis for generating additional business.[142] These investors are also the most likely repeat players in the international capital markets with the resulting expectations that they will work with one another in a variety of settings.[143] As a result, these investors may support restructuring plans that are unacceptable

"haircut," to be suffered in a restructuring, they may disagree as to the point from which the discount is to be calculated. Rather than the principal amounts of the bonds, investors who have purchased bonds at prices equal to the face amounts may argue that the haircut should be applied with respect to the prices at which investors purchased their bonds. *See* Angela Pruitt, *Argentina's Debt Workout Is Complex*, WALL ST. J., Mar. 12, 2003 (reporting the comments of a lawyer who has represented parties in restructurings that "retail investors who bought Argentina's bonds at 100% of face value aren't going to agree to take the same losses as a vulture fund that scooped up the paper at distressed levels"), *available at* 2003 WL 3961535.

139 *See* McGovern, *supra* note 54, at 79 (describing this practice).

140 *See id*. (describing the consequences of this practice).

141 *Id*.

142 *See* Felix Salmon, *Argentina's Messy Debt Exchange*, EUROMONEY, Dec. 2001, at 58, 60 (quoting a senior banker at a large bank as stating: "Our firm has a much greater stake in Argentina's prosperity than in Argentina going off the rails. So, all things being equal, we're going to want to help them."); Anne O. Krueger, The Evolution of Emerging Market Capital Flows: Why We Need to Look Again at Sovereign Debt Restructuring, Address at the Economics Society Dinner (Jan. 21, 2002) (describing most investors in sovereign bonds as lacking long-term relationships with sovereign debtors), *at* http://www.imf.org/external/np/speeches/2002/012102.htm; Roubini & Setser, *supra* note 9, ch. 4, at 33 (describing the benefits of these relationships as including "fees and commissions . . . from ongoing and future underwriting of a country's bonds and the franchise value of their commercial banking operations in the debtor country").

143 Smaller investors, particularly retail investors, simply purchase sovereign bonds as part of their personal investment strategies, without any expectation of participating in the sovereign debt market in any other capacity.

to smaller investors, notably retail investors.[144] In particular, large institutional investors may be willing to suffer a greater loss in a restructuring to solidify relationships with a sovereign debtor and to establish a reputation for success in restructuring sovereign bonds, both of which are likely to lead to future business opportunities and future revenues.[145] Retail investors, like the smaller commercial banks that participated in the restructurings of the 1980s, invest in sovereign bonds only for the returns, not for the prospect of building future business relationships. As a result, they are unwilling to trade repayment of the bonds for future business opportunities.[146]

Importantly, investors in sovereign bonds, like investors in the 1920s, lack an effective means of reaching consensus regarding the terms of restructurings. Although these investors generally agree on a policy of uniform treatment of all bondholders,[147] they typically cannot reach agreement on restructuring terms. Moreover, unlike the restructurings of the 1980s, today's creditors lack a mechanism to impose their preferences on other investors.[148]

The absence of widespread support for the terms of a proposed

[144] In this way, the large institutional investors, many of which have sold sovereign bonds to retail investors, are similar to the banks that sold sovereign bonds to individual investors during the 1920s. Upon the advent of a financial crisis affecting the bonds, the large institutional investors, like the banks, have a greater interest in preserving and enhancing their relationships with sovereign debtors than in protecting the interests of small investors.

[145] Some commentators have suggested that sovereign debtors have an interest in proposing restructuring terms that are most favorable to large institutional investors, as these investors are likely to purchase sovereign bonds in the future, while retail investors, having incurred significant losses in the restructuring, are unlikely to include sovereign bonds in their portfolios in the future. *See* Salmon, *supra* note 136, at 152 (describing the reasons sovereign debtors may favor institutional investors over retail investors in restructurings).

[146] In the case of Argentina, concern for restructuring terms that favor large institutional investors to the detriment of small investors has led to the formation of the Argentine Bond Restructuring Agency to represent the interests of retail investors. *See id*. (describing the formation of the Argentine Bond Restructuring Agency); *see also* Deepak Gopinath, *Default Line*, INSTITUTIONAL INVESTOR, July 2003, at 29, 29-30 (describing concerns regarding unfair treatment of retail investors in the Argentine restructuring). These concerns have led Felix Salmon to propose that retail investors be "taught not to buy" sovereign bonds as a means of "get[ting] rid of the entire class of retail investors to as great a degree as is practicable." Felix Salmon, *Stop Selling Bonds to Retail Investors*, 35 GEO. J. INT'L L. (forthcoming 2004).

[147] *See* Salmon, *supra* note 142, at 58 (stating than "[i]f bondholders are concerned about one issue above all others, it's that of equal treatment").

[148] *See* Gopinath, *supra* note 133, at 37 ("[R]esolving debt crises has already become a more complicated tactical proposition than it was in the notorious Latin American default-a-month era of the 1980s. Then commercial banks were . . . susceptible to government suasion. They could be coerced and cajoled into undertaking elaborate debt restructurings that kept countries afloat. Now the vast bulk of emerging-markets debt is held by widely dispersed and difficult to identify bondholders who don't readily kowtow to government officials."); Krueger, *supra* note 142 (describing most sovereign bond investors as not "fear[ing] the arm-twisting of regulators").

restructuring contributes to the decision of some bondholders to hold out and to refuse to support the restructuring. These holdout bondholders may instead pursue their claims against the sovereign debtor in court. We next explore the developing role of litigation in the enforcement of claims against sovereign debtors.

II. THE ROLE OF THE COURTS

At the same time that the identities and interests of creditors have become more heterogeneous, increasing the likelihood of holdouts, the ability of holdout creditors to pursue litigation remedies has also increased. Courts in the United States have rejected the various defenses sovereign debtors have raised in suits brought by creditors, providing creditors with unprecedented access to litigation.

In the restructurings of the 1930s, litigation was not a viable option for holdout creditors. The agreements governing the bonds generally did provide protections for the holders of the bonds, including a pledge of the good faith and credit of the issuing government[149] and security clauses assigning specific sources of governmental revenues or specific governmental properties to fulfill servicing requirements.[150] Upon default, however, these contractual protections provided little real protection to the holders of the bonds. The sovereign debtors, with the powers and rights of nations, could not be sued without their consent.[151]

The power of the sovereign immunity defense to block creditor litigation in the United States was subsequently significantly reduced. In 1952, the Executive Branch of the United States adopted a restrictive theory of sovereign immunity, which was announced in the "Tate Letter."[152] The restrictive theory provided that sovereigns retained "immunity for their public or sovereign acts,

[149] Jorgensen & Sachs, *supra* note 19, at 61.

[150] BORCHARD, *supra* note 31, at 83-89.

[151] *See* Turkmani v. Republic of Bolivia, 193 F. Supp. 2d 165, 170 (D.D.C. 2002) ("Since the founding of the nation to the latter half of the twentieth century, foreign sovereigns enjoyed absolute immunity from suit in United States courts."); Macmillan, *Debt Crisis*, *supra* note 28, at 336 (stating that "[c]reditors had essentially no enforceable rights [during the 1930s], primarily because of the doctrine of sovereign immunity").

[152] Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman (May 19, 1952), *reprinted in* 26 DEP'T ST. BULL. 984-85 (1952), *and in* Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682, 712-13 (1976); *see Turkmani*, 193 F. Supp. 2d at 170-71 (describing Tate Letter).

but could be sued in U.S. courts for their commercial or private acts."[153]

Congress codified the Executive Branch's theory in the Foreign Sovereign Immunities Act of 1976 (FSIA).[154] Thereafter, in *Republic of Argentina v. Weltover, Inc.*[155] the Supreme Court held that issuing sovereign bonds constituted commercial activity within the meaning of the FSIA.[156] The Court further held that Argentina's rescheduling of its bonds, which involved the payment of interest through New York-based accounts, had a sufficiently "direct effect" within the United States to justify the exercise of jurisdiction under the FSIA.[157]

Following the adoption of the FSIA, courts widely interpreted the issuance of public debt as commercial activity for the purposes of sovereign immunity analysis. This interpretation significantly reduced the viability of a sovereign immunity defense.[158] At the same time, sovereign debtors increasingly waived their sovereign immunity and explicitly consented to the jurisdiction of U.S. courts.[159] The predictable consequence of these developments was an effort by creditors to enforce their claims against sovereign debtors through litigation.

The first of these efforts occurred in the early 1980s. Similar to other emerging market economies in Latin America, in 1981 Costa Rica experienced a shortage of foreign currency with which to pay its external debt, including loans owed to commercial banks.[160] In an effort to alleviate this crisis, in July of 1981, the Board of Directors of the Central Bank of Costa Rica passed a

[153] *Turkmani*, 193 F. Supp. 2d at 171.

[154] *Id*. A plurality of the Supreme Court had announced, six months prior to the adoption of the FSIA, that the restrictive theory of sovereign immunity would not prevent subjecting a foreign sovereign to suit for "participation in the marketplace in the manner of a private citizen or corporation." Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 614 (1992) (citing *Alfred Dunhill*, 425 U.S. at 698-705).

[155] 504 U.S. 607 (1992).

[156] *Id*. at 614-15.

[157] *Id*. at 618-19.

[158] The FSIA can still limit plaintiffs' attempts to attach assets located in the United States pursuant to a foreign judgment. *See* Corzo v. Banco Central de Reserva Del Peru, 243 F.3d 519 (9th Cir. 2001) (refusing to exercise jurisdiction over suit to enforce Peruvian judgment and concluding that submission to jurisdiction in foreign court did not amount to waiver of sovereign immunity in the United States).

[159] *See, e.g.*, Libra Bank Ltd. v. Banco Nacional de Costa Rica, S.A., 676 F.2d 47, 49 (2d Cir. 1982) (describing Banco Nacional as an instrumentality of the government of Costa Rica and recounting its waiver of "any right or immunity from legal proceedings including suit judgment and execution on grounds of sovereignty which it or its property may now or hereafter enjoy"); *see also* Proyecfin de Venez., S.A. v. Banco Industrial de Venez., S.A., 760 F.2d 390, 397 (2d Cir. 1985) (finding waiver of sovereign immunity in loan agreement); Nat'l Union Fire Ins. Co. v. People's Republic of Congo, 729 F. Supp. 936, 940 (S.D.N.Y. 1989) (same).

[160] *See* Bainbridge, *supra* note 39, at 29 (describing the financial crisis in Costa Rica).

resolution prohibiting all state-owned entities from paying interest or principal owing on debts to foreign creditors and denominated in foreign currency.[161]

The inability of a syndicate of commercial banks to obtain repayment of a $40 million loan made to Banco Nacional de Costa Rica (Banco Nacional) led the syndicate to seek an order of attachment in New York state court.[162] Banco Nacional first defaulted in the state court proceeding.[163] Then, after the syndicate obtained an order of attachment for Banco Nacional's property in New York and successfully attached $800,000 in assets, Banco Nacional entered an appearance, removed the action to federal court, and moved to vacate the order of attachment on the grounds of sovereign immunity.[164] The Second Circuit held that the foreign state had explicitly waived in writing all sovereign immunity and upheld the attachment.[165]

When the plaintiffs moved for summary judgment, Banco Nacional tried an alternative approach, arguing that events in Costa Rica constituted a defense to repayment under the act of state doctrine.[166] The court held that the act of state doctrine precludes U.S. courts from inquiring into "the validity of foreign seizures only when there is 'a taking of property within its own territory by a foreign sovereign government.'"[167] The court held that, in this case, the act of state doctrine did not apply because the property that was the subject of the litigation was located in the United States, not in Costa Rica. "[T]he situs of the debt owed by Banco Nacional was in this nation at the time that the foreign currency decrees were enacted."[168] Finding that the act of state doctrine was the only issue on which the parties disagreed, the court ordered summary judgment in favor of the syndicate.[169]

Although the court was ready to enter judgment against it, Banco Nacional moved for reargument in order to put forward a third defense, arguing that

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161 *See* Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1442 (S.D.N.Y. 1983) (describing the moratorium); Bainbridge, *supra* note 39, at 29 (discussing the response to the crisis in Costa Rica); *see also* Truglia et al., *supra* note 11, at 11 (describing events surrounding the crisis in Costa Rica).

162 *Libra Bank*, 676 F.2d at 48.

163 Libra Bank Ltd. v. Banco Nacional de Costa Rica, S.A., 570 F. Supp. 870, 875 (S.D.N.Y. 1983).

164 *Id*.

165 *Libra Bank*, 676 F.2d at 50.

166 *Libra Bank*, 570 F. Supp. at 876.

167 *Id*. at 877 (quoting Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428 (1968)).

168 *Id*. at 881. The court noted that the loan agreement provided for the application of New York law and that all payments under the agreement were to be made in New York. *Id*. at 881-82.

169 *Id*. at 896-97.

Article VIII, section 2(b) of the IMF Bretton Woods Agreement[170] prohibited enforcement of the loan agreement.[171] The Bretton Woods Agreement provides that "[e]xchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."[172] The court rejected this third defense. In reaching this result, the court considered two competing interpretations of the term "exchange contract," a broad interpretation and a narrow one.[173] Reasoning that a definition of the term sufficiently expansive to include loan agreements would "[do] violence to the text of the section," the court opted for the narrow definition.[174] The court therefore held that "a contract to borrow United States currency, which requires repayment in United States currency, and which designates New York as the situs of repayment, is not an exchange contract within the meaning of Article VIII, section 2(b)" and that the Bretton Woods Agreement was therefore inapplicable.[175]

The *Libra Bank* litigation illustrates both the growing potential of creditor litigation as a remedy against a defaulting sovereign debtor and the limitations of the remedy. The decisions recognized the validity of the syndicate's contractual claim and rejected a variety of defenses. Thus, the decisions made clear that enforcement litigation is a viable option for creditors. At the same time, the outcome of the litigation demonstrates the shortcomings of the option. Although at the time of the decision the syndicate was owed approximately $35 million in principal and interest, Banco Nacional only held about $2.5 million in assets in New York, of which the syndicate was only able to attach $800,000.[176]

A second case arising out of the financial crisis in Costa Rica, *Allied Bank International v. Banco Credito Agricola de Cartago*,[177] introduced the prospect

170 ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39 (as amended).

171 *Libra Bank*, 570 F. Supp. at 896.

172 *Id*. at 897.

173 *See id*. (describing broad and narrow interpretations).

174 *Id*. at 899 (citations omitted). The court noted that other courts had adopted the narrow interpretation and that the broader view had been supported primarily by commentators. *Id*.

175 *Id*. at 900.

176 *Id*. at 882; *see* Joseph B. Frumkin, Comment, *The Act of State Doctrine and Foreign Sovereign Defaults on United States Bank Loans: A New Focus for a Muddled Doctrine*, 133 U. PA. L. REV. 469, 493-94 (1985) (arguing that the limited prospect of satisfying the judgment through assets located in New York should have led the court to dismiss the litigation under the act of state doctrine).

177 566 F. Supp. 1440 (S.D.N.Y. 1983) [hereinafter *Allied Bank*], *aff'd*, 733 F.2d 23, 1984 U.S. App.

of holdout litigation. Allied Bank International (Allied Bank), as agent for a syndicate of thirty-nine commercial banks that had participated in a loan to three banks wholly owned by Costa Rica, filed suit in federal court based on the failure of the debtors to make payments required by the loan.[178] As in *Libra Bank*, the failure to make the payments was a consequence of the imposition of the exchange controls prohibiting the servicing of obligations owed to foreign creditors.[179] The district court, relying on the act of state doctrine, which bars the courts of one country from sitting in judgment on the acts of the government of another, done in its own territory, denied Allied Bank's motion for summary judgment.[180]

While the case was pending before the district court, the parties entered into negotiations to restructure the loan.[181] Thirty-eight members of the bank syndicate were able to reach an agreement with the debtors to restructure the loan, but one member of the syndicate, Fidelity Union Trust Company of New Jersey (Fidelity), refused to ratify the agreement or to participate in the restructuring plan.[182] Allied Bank subsequently appealed the district court decision on behalf of Fidelity, the sole holdout creditor.[183] The Second Circuit initially agreed with the district court that the suit should not be heard, dismissing it on grounds of comity.[184]

Apparently, the New York financial community reacted adversely to the decision, fearing that New York would lose its status as a center for multinational financial transactions if New York courts were unwilling to enforce loan agreements against sovereign debtors.[185] In any event, the court subsequently agreed to rehear the case. The Justice Department submitted an amicus brief explaining that, although its position was to encourage the cooperative restructuring of sovereign debt, this position was "grounded in the understanding that, while parties may agree to renegotiate conditions of

LEXIS 23237 (2d Cir. 1984) (per curiam) [hereinafter *Allied Bank I*], *rev'd on rehearing*, 757 F.2d 516 (2d Cir. 1985) [*hereinafter Allied Bank II*].

178 *Allied Bank*, 566 F. Supp. at 1442.

179 *Id*.

180 *Id*. at 1444. Several weeks later, the action was dismissed by agreement of the parties after they stipulated that no factual issues remained with respect to the act of state doctrine. *Allied Bank I*, 1984 U.S. App. LEXIS 23237, at *5.

181 *Allied Bank II*, 757 F.2d at 519.

182 *Id*.

183 *Id*.

184 *Allied Bank I*, 1984 U.S. App. LEXIS 23237, at *12.

185 William W. Park, *Legal Policy Conflicts in International Banking*, 50 OHIO ST. L.J. 1067, 1075-76 (1989).

payment, the underlying obligations to pay nevertheless remain valid and enforceable."[186] The Justice Department explained that the imposition of unilateral exchange controls by Costa Rica was therefore inconsistent with U.S. policy.[187]

Fidelity's position was also supported by the New York Clearing House Association (Clearing House), which filed an amicus brief.[188] The Clearing House's position was seemingly motivated by a desire to establish unambiguous legal precedent for enforcing the rights of commercial banks and other creditors against sovereign debtors.[189] A judicial decision favorable to the claim, although detrimental to their general approach to restructuring plans, would provide bank advisory committees (and other commercial banks) with additional leverage in negotiating agreements with sovereign debtors and in developing restructuring plans in future crises.[190]

Upon rehearing, the Second Circuit concluded that the act of state doctrine did not bar the lawsuit because the situs of the debt at issue was New York, not Costa Rica. As the court explained:

> The Costa Rican banks conceded jurisdiction in New York and they agreed to pay the debt in New York City in United States dollars. Allied [Bank], the designated syndicate agent, is located in the United States, specifically in New York; some of the negotiations between the parties took place in the United States. The United States has an interest in maintaining New York's status as one of the foremost commercial centers in the world. Further, New York is the international clearing center for United States dollars. In addition to other international activities, United States banks lend billions of dollars to foreign debtors each year. The United States has an interest in ensuring that creditors entitled to payment in the United States in United States dollars under contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined

186 *Allied Bank II*, 757 F.2d at 519.

187 Brief of Amici Curiae United States at 6-7, 18, *Allied Bank II*, 757 F.2d 516 (No. 83-7714).

188 Bainbridge, *supra* note 39, at 30. The Clearing House was comprised of twelve large commercial banks located in the United States. Many of these banks had portfolios of loans to sovereign debtors in which the total amount of the loans exceeded the total value of their assets. As a result, these banks were deeply involved in the restructuring process, and they worked diligently to avoid defaults on the loans. *See id*. (describing the Clearing House).

189 *See id*. at 30-31 (discussing the likely motivations of the members of the Clearing House).

190 *Id*.

in accordance with recognized principles of contract law.[191]

The court went on to reject the argument that principles of comity should bar the suit, reasoning that "[t]he Costa Rican government's unilateral attempt to repudiate private, commercial obligations is inconsistent with the orderly resolution of international debt problems. It is similarly contrary to the interests of the United States, a major source of private international credit."[192] The court then granted Allied Bank's motion for summary judgment.[193]

The two Costa Rica cases thus opened the door to creditor litigation in general and holdout litigation in particular. Moreover, the positions of the Justice Department and the Clearing House, as articulated in *Allied Bank II*, suggest a clear relationship between the availability of judicial enforcement of loan agreements against defaulting sovereigns and the functioning of the sovereign debt market. In particular, as the amici observed, even if voluntary restructurings are in the interests of both creditors and debtors, judicial enforcement gives creditors valuable leverage to bring to the negotiating table.

As sovereign debt litigation continued throughout the 1980s and 1990s, courts adhered to the approach in the Costa Rica cases. In particular, courts found that neither international political considerations nor the plaintiff's unwillingness to participate in a voluntary restructuring operated to bar recovery. Instead, the courts evidenced a repeated willingness both to take jurisdiction and to resolve the cases promptly upon motions for summary judgment. *A.I. Credit Corp. v. Government of Jamaica*[194] is a typical case. Following three reschedulings of its debt in 1978, 1979, and 1981, Jamaica entered into a fourth rescheduling in 1984.[195] Like the previous reschedulings, this one did not prove workable, and almost immediately Jamaica and its lenders entered into a fifth and then a sixth rescheduling.[196] A.I. Credit Corp. (AICO), which had received approximately $10 million in debt, plus interest, through an assignment effected after the 1984 restructuring, did not participate in the fifth and sixth reschedulings and instead sued for payment based on the terms of the fourth rescheduling.[197] The court observed that although the reschedulings affected debts owed to some 113 financial institutions, AICO

191 *Allied Bank II*, 757 F.2d at 521-22.
192 *Id*. at 522.
193 *Id*. at 523.
194 666 F. Supp. 629, 630 (S.D.N.Y. 1987).
195 *Id*.
196 *Id*.
197 *Id*.

was the only party to bring suit.[198] The court found that the terms of the 1984 agreement explicitly provided AICO with an individual right to bring suit to enforce the agreement.[199] The court then concluded that there was no outstanding issue of material fact and granted summary judgment in favor of the plaintiff.[200]

Sovereign debtors, however, have not been entirely powerless in these lawsuits. In particular, carefully drafted debt instruments have enabled defendants to block holdout litigation. An example can be found in the litigation by CIBC Bank and Trust Company (Cayman) Limited (CIBC Bank), on behalf of the Dart family, against Banco Central do Brasil (Banco do Brasil).[201] Brazil negotiated a Multi-Year Deposit Facility Agreement (MYDFA) as part of the restructuring of its debt in the 1980s.[202] The MYDFA provided, among its terms, that the debt could be accelerated upon an event of default only if more than fifty percent of the creditors, calculated by amount of debt holdings, voted to accelerate.[203] Just a year after the MYDFA was consummated, Brazil was unable to meet its obligations to creditors and sought to restructure the MYDFA debt pursuant to the Brady Plan. The Dart family refused to go along with the new restructuring and instead filed suit seeking both to obtain the accrued and unpaid interest on their approximately $1.4 billion of MYDFA debt and to accelerate the entire principal amount of the MYDFA.[204]

CIBC Bank's effort to accelerate was blocked by Brazil's careful approach to the new restructuring. In connection with the restructuring, Brazilian officials ordered Banco do Brasil, a Brazilian commercial bank fifty-one percent owned by the Brazilian Treasury, to retain $1.6 billion of MYDFA debt rather than converting all of its holdings to Brady Bonds. By retaining a majority of the outstanding MYDFA debt, Banco do Brasil was able to prevent CIBC Bank from obtaining a majority vote in favor of accelerating the debt.[205]

In the litigation that followed, the court rejected Banco do Brasil's defenses of improper assignment and champerty, yet it upheld Brazil's move to block

198 *Id.*
199 *Id.* at 631-32.
200 *Id.* at 633.
201 CIBC Bank & Trust Co. (Cayman) v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995).
202 *Id.* at 1107.
203 *Id.*
204 *Id.*
205 *Id.*

acceleration of the debt. The court observed that the plain terms of the contract required a majority vote to accelerate and that CIBC Bank did not hold a majority of the outstanding debt.[206] Moreover, the court refused to imply an obligation of good faith and fair dealing in order to invalidate Banco do Brasil's actions to block the acceleration.[207] Significantly, the court observed that the implied covenants sought by CIBC Bank would have the effect of substantially altering the rights of the parties and would impair the ability of debtors and creditors "to order their relationships through contractual debt agreements."[208] Indeed, the court expressly acknowledged that the provisions allowed Banco do Brasil to retain and vote its share of the MYDFA debt in order to hinder another creditor's attempt to accelerate that debt.[209] The consequence of the court's ruling was to permit the litigation seeking accrued and unpaid interest to proceed, but to bar acceleration. This had the effect of reducing CIBC Bank's claimed damages from more than $1.4 billion to only $60 million.

Sovereign debtors in more recent cases have attempted to raise additional defenses. In virtually every case, however, courts have rejected these defenses in favor of protecting the enforceability of sovereign debt obligations through litigation. *Pravin Banker Assocs., Ltd. v. Banco Popular del Peru*[210] involved debt originally borrowed by Banco Popular del Peru (Banco Popular) from the Mellon Bank of Pittsburgh. The debt, which was guaranteed by the government of Peru, was subsequently sold to Pravin Banker Associates, Ltd. (Pravin) in the secondary market at a deep discount.[211] In addition to arguing that the case should be dismissed based on principles of comity, Banco Popular and Peru argued that the assignment of the debt to the plaintiff was invalid, barring the plaintiff's claim.[212] The Second Circuit rejected these arguments and awarded summary judgment to Pravin in the amount of $2,161,539.78 plus interest.[213]

On the issue of comity, the court expanded on its analysis in *Allied Bank*.[214] The court identified two competing U.S. policies implicated by sovereign debt

[206] *Id*. at 1113.
[207] *Id*. at 1115 (calling CIBC Bank's argument "quite creative, [but] wholly unpersuasive").
[208] *Id*. at 1116.
[209] *Id*.
[210] 109 F.3d 850 (2d Cir. 1997).
[211] *Id*. at 853.
[212] *Id*. at 854.
[213] *Id*. at 853-54, 856.
[214] *Id*. at 855.

litigation. On the one hand, the United States encourages the resolution of foreign debt restructurings through Brady Plan negotiations.[215] On the other hand, the United States has a strong interest in ensuring the continued enforceability of foreign debts owed to U.S. lenders.[216] The court concluded that the second interest limited the first so as to require that creditor participation in restructurings be voluntary, supported by the backdrop of the creditor's continued right to enforce the debt.[217] Accordingly, the court found that principles of comity did not preclude a grant of summary judgment.[218]

The court also considered the defendants' argument that the assignment of the debt to Pravin was improper. The terms of the debt instrument authorized the creditor to assign its interest in the instrument "to any financial institution."[219] Peru argued that this language should be interpreted to preclude an assignment to Pravin, which was not a bank.[220] The court rejected this argument, explaining that, under New York law, only express limitations on assignability are enforceable.[221] The court then concluded that the language in question permitted assignment of the debt to financial institutions but did not explicitly limit assignments only to those entities.[222] Accordingly, it concluded that the assignment was valid whether or not Pravin was properly characterized as a financial institution.[223]

Perhaps the best known instance of creditor litigation is the successful suit by Elliott Associates, L.P. (Elliott), a vulture fund, against Peru.[224] Elliott purchased in the secondary market approximately $20 million principal amount of letter agreements issued by Banco de la Nacion and Banco Popular and guaranteed by Peru for approximately $11 million, slightly more than fifty-five percent of the face value of the debt.[225] At the time Elliott purchased the letter agreements, Peru was in the process of negotiating a restructuring of its debt under the Brady Plan.[226] Elliott refused to participate in the

215 *Id.*
216 *Id.*
217 *Id.*
218 *Id.* at 856.
219 *Id.*
220 *Id.*
221 *Id.*
222 *Id.*
223 *Id.*
224 Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363 (2d Cir. 1999).
225 *Id.* at 366-67.
226 *Id.* at 368. Interestingly, Elliott purchased the letter agreements shortly after the favorable decision in *Pravin*. *Id.* at 367.

restructuring and demanded full payment of the letter agreements.[227] When Peru refused to pay, Elliott sued in New York Supreme Court, from which the case was subsequently removed to federal court.[228] Although the district court originally dismissed the suit, holding that it violated the prohibition on champerty under section 489 of the New York Judiciary Law,[229] the decision was overturned by the Second Circuit.[230]

As in *Pravin*, Peru argued that the assignment of debt to Elliott was invalid.[231] The district court, relying on the *Pravin* decision, rejected this argument.[232] Peru also argued that Elliott purchased the debt "with the intent and for the purpose of bringing" litigation, thereby rendering the purchase a violation of the prohibition of champerty imposed by the New York Judiciary Law.[233] The court dismissed the suit, finding that Elliott had, indeed, violated the statute.[234] The Second Circuit, however, reversed.[235] After an extensive review of the history both of the New York statute and the underlying principles of champerty, the court concluded that the "acquisition of a debt with intent to bring suit against the debtor is not a violation of the statute where . . . the primary purpose of the suit is the collection of the debt acquired."[236] Moreover, the court found that Elliott's primary purpose in acquiring the debt was to be paid in full, and that any intent to litigate was merely "incidental and contingent."[237] Upon remand, the district court granted summary judgment, awarding Elliott more than $55 million.[238]

Like the syndicate of commercial banks in *Libra Bank* (and most creditors that successfully sue sovereign debtors), Elliott then confronted the principal limitation of the litigation remedy: the inability to enforce its judgment.[239] For any creditor, the utility of a judgment depends upon its access to attachable assets. Defaulting sovereigns, however, rarely leave assets in jurisdictions in

227 *Id*. at 368.
228 *Id*.
229 *Id*. at 369.
230 *Id*. at 381.
231 *Id*. at 367-68.
232 *Id*. at 368 n.1.
233 *Id*. at 368-69.
234 *Id*. at 369.
235 *Id*. at 381.
236 *Id*. at 372.
237 *Id*. at 379.
238 Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. LEXIS 14169 (S.D.N.Y. Sept. 29, 2000).
239 *See* Bratton & Gulati, *supra* note 14 (describing difficulties associated with enforcement of claims against sovereign debtors).

which attachment is possible. A judgment is unlikely to be enforced in a sovereign's own courts, within whose jurisdiction most of the sovereign's assets are located. Moreover, contractual waivers of sovereign immunity may not enable the creditor to obtain orders of attachment in other jurisdictions. Elliott, for example, made several attempts to collect its judgment in New York by seeking orders of attachment against financial intermediaries, but those efforts were unsuccessful.

Consequently, Elliott took another approach. Peru was about to make the first interest payment on the Brady Bonds that it had issued in connection with the restructuring of its debt. This payment involved the transfer of funds from Peru to the Euroclear System, in Belgium, which would then make payment to individual bondholders. Arguing that the *pari passu* clause in the debt agreement precluded Peru from making payments on some of its debt contracts and not others, Elliott sued in a Brussels court to obtain an order of attachment on the transferred funds.[240] The court accepted Elliott's interpretation of the *pari passu* clause and ordered the attachment.[241] Faced with an inability to pay interest on its restructured debt and the prospect of being forced into another default, Peru settled, paying Elliott approximately $58 million.[242]

Recent decisions reflect both the outcome and the policy considerations of the earlier precedents. For example, in *Turkmani v. Republic of Bolivia*,[243] the District Court for the District of Columbia relied on the Second Circuit's interpretation of the New York champerty statute in *Elliott Associates*.[244] Moreover, the court acknowledged the importance of the policy considerations reflected in the New York courts' acceptance of litigation to enforce sovereign debt. Quoting the *Elliott Associates* decision, the *Turkmani* court explained that enforcement would serve the long-term interests of both sovereign debtors and the debt markets by reducing the nonpayment risk associated with an investment in sovereign debt.[245] After also rejecting the defendant's sovereign

240 Elliott's interpretation of the *pari passu* clause is explored at length in William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2004), and Lee C. Buchheit & Jeremiah S. Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004).

241 *See* Bratton, *supra* note 240, at 824 (discussing the outcome of the litigation). It is unclear why, even under Elliott's argument, the court needed to attach all the transferred funds. Elliott's right to payment under the *pari passu* clause, if established, should at most have enabled it to share in the payment in proportion to the share that its judgment represented of Peru's outstanding debt.

242 *Peru Settles Dispute with Elliott of U.S. on Brady Payments*, WALL ST. J., Oct. 2, 2000, at A21.

243 193 F. Supp. 2d 165 (D.D.C. 2002).

244 *Id*. at 179-80.

245 *Id*. at 181-82.

immunity defense, the court awarded summary judgment to the plaintiff.[246]

The restructuring of Argentina's sovereign debt has already created new tests for the scope of creditor litigation. A number of bondholders have filed breach of contract suits, both individual and class actions, against Argentina.[247] These lawsuits have been fueled, in part, by Argentina's proposed seventy-five percent haircut for existing debt. Although several of the class actions were dismissed by the court on the grounds that they were unmanageable or that the plaintiff class was poorly defined, the court has granted summary judgment to various individual bondholders.[248] The court's analysis is straightforward: "The obligations of [Argentina] on the bonds involved in these lawsuits is unconditional. Sovereign immunity has been waived. [Argentina] defaulted on the bonds when it ceased to pay the interest. This would seem to mean that [Argentina] now owes the three plaintiffs principal and accrued interest."[249]

In particular, the court explicitly rejected Argentina's defenses, including those based on the act of state doctrine, considerations of comity, and section 489 of the New York Judiciary Law.[250] In granting summary judgment in favor of various individual plaintiffs, the court temporarily stayed its judgment to permit Argentina to propose a restructuring plan.[251] In one of the most recent decisions, *H.W. Urban GmbH v. Argentina*,[252] the court granted a motion for certification of a class of holders of two series of Argentine bonds. The court's decision was the first to certify a class action in connection with a major sovereign debt restructuring.[253]

246 *Id*. at 182. The lawsuit against Bolivia for defaulting on its sinking fund bonds was initially filed as a class action. The class litigation was settled for payments of thirty-three percent of the face value of the bonds. At the same time, the Paris Club creditors entered into an agreement with Bolivia providing for a restructuring of Bolivia's debt on the same terms. *Id*. at 168. Turkmani opted out of the litigation class and pursued a separate lawsuit, seeking to recover approximately $266,000 in principal and accrued interest. *Id*. at 169.

247 *See* Pamela Druckerman, *Frustrated Argentine Bondholders Try Suing*, WALL ST. J., Aug. 23, 2002, at A6.

248 *See, e.g.*, Allan Applestein TTEE FBO D.C.A. Grantor Trust v. Province of Buenos Aires, 2003 U.S. Dist. LEXIS 7128, at *2 (S.D.N.Y. Apr. 25, 2003); Lightwater Corp. v. Argentina, 2003 U.S. Dist. LEXIS 6156, at *14 (S.D.N.Y. Apr. 14, 2003).

249 *Lightwater Corp.*, 2003 U.S. Dist. LEXIS 6156, at *10-11.

250 *Id*. at *11-13.

251 *See, e.g.*, Lightwater Corp. v. Republic of Argentina, 2003 U.S. Dist. LEXIS 14868 (S.D.N.Y. Aug. 29, 2003) (extending the stay).

252 2003 U.S. Dist. LEXIS 23363 (S.D.N.Y. Dec. 30, 2003).

253 Pruitt, *supra* note 7.

III. THE ROLE OF HOLDOUT LITIGATION

A. Responses to Holdout Litigation

These recent cases of holdout litigation have heightened the urgency of the ongoing debate regarding the best means of limiting the power of holdout creditors. Efforts by individual creditors, particularly vulture funds, to enforce their claims against sovereign debtors in court have been characterized as disruptive to the restructuring process and unfair to the creditors that participate in the restructurings.[254] Vulture funds, in particular, have been criticized for purchasing sovereign debt at distressed prices and then holding out of restructuring plans, including plans that are acceptable to the vast majority of the other creditors, in an effort to secure for themselves higher payments from sovereign debtors.[255] Holdout creditors may seek to be paid the total amounts owed on the debts.[256] Alternatively, they may seek a relatively small premium over the proposed restructuring terms in an effort to coerce the debtors to avoid the nuisance costs associated with holdout litigation.[257]

The resulting disruption in the restructuring process, critics argue, lengthens the time needed to complete restructurings and thereby increases the associated costs, burdening the citizens of the debtors and reducing the funds available to be paid to creditors.[258] Preferential payments to vulture funds

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[254] *See, e.g.*, Bratton & Gulati, *supra* note 14 (describing criticisms of holdout creditors in general and vulture funds in particular in the context of sovereign bond restructurings); Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 60-65 (2000) (describing strategies of holdout creditors in the context of sovereign bond restructurings); Coffee & Klein, *supra* note 2, at 1233-40 (describing criticisms of holdout creditors in general and vulture funds in particular).

[255] *See, e.g.*, ROSENBERG, *supra* note 130, at 32-36 (describing criticisms of vulture funds as disrupting the restructuring process); Suniati Yap, *Investing in Chapter 11 Companies: Vultures or White Knights?*, 2 SW. J.L. & TRADE AM. 153, 160-61 (1995) (describing the impact of vulture funds on the restructuring process).

[256] In this regard, Elliott's suit against Peru was typical. *See also* Arturo C. Porzecanski, *Dealing with Sovereign Debt: Trends and Implications*, *in* SOVEREIGN DEBT AT THE CROSSROADS (Chris Jochnick & Fraser Preston eds., forthcoming 2004) (manuscript at 30) (describing vulture funds as "hav[ing] been attracted to defaulted emerging-markets debt in recent years, buying paper (bank loans, supplier credits or bonds) with the intention of suing for full recovery"), *available at* http://www.law.georgetown.edu/international/documents/Porzecanski_000.pdf.

[257] *See, e.g.*, ROSENBERG, *supra* note 130, at 259, 259-66 (describing litigation strategies of vulture funds that are designed to "prompt other parties to throw them a morsel just so they'll go away").

[258] *See, e.g.*, Samuel E. Goldman, Comment, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159, 164 (2000) (describing the difficulties for sovereign debtors and other creditors created by holdout litigation); John Nolan, Emerging Market Debt and Vulture Hedge Funds: Free-Ridership, Legal & Market Remedies 7-8 (Fin. Policy Forum, Derivatives Study Ctr. Special Policy Report 8, Sept. 29, 2001) (describing the costs imposed by holdout

further reduce the size of the payments that can be made to creditors under restructuring plans, augmenting the sense of unfairness among the creditors that accept the terms of the restructurings.[259] Finally, critics argue that the potential for vulture funds to disrupt restructurings and to receive special payments not only discourages sovereign debtors from entering into the restructuring process but it also creates a collective action problem that dissuades other creditors from participating in the process.[260]

Participants in the restructuring process have long sought ways to constrain the ability of dissenting creditors to thwart efforts to restructure sovereign debt and to secure favorable outcomes for themselves. During the restructurings of the 1980s, bank advisory committees and sovereign debtors supported restructuring plans that treated all commercial banks equally as a means of minimizing both the costs of the restructuring process and the risks of individual banks dissenting from the plans and seeking higher payments on their loans. By credibly committing to supporting only these plans, and by exploiting the business relationships among banks, the bank advisory committees, working with governmental regulators and the IMF, were able to pressure dissenting banks into supporting the proposed restructuring plans.

Bondholders, particularly vulture funds, are not susceptible to these types of pressure.[261] They act independently, seeking the highest immediate return on their investments, including their purchases of sovereign bonds, without concern for developing relationships with sovereign debtors or with other

creditors), *available at* http://www.financialpolicy.org/DSCNolan.htm.

[259] As Mr. Buchheit describes the situation:

> It is only by virtue of the indulgence shown by the majority of creditors that the sovereign [debtor] has the money to pay—or settle on preferential terms—the claims of the more exacting few. This resentment can be aggravated where the [vulture fund] bought [its] claim on the secondary market at a small fraction of its face value, while the original [creditors] advanced 100 cents on the dollar. It is like giving up your seat on a crowded bus to an elderly woman only to watch a teenager jump on it.

Christopher Stoakes, *Beware the Maverick Sovereign Creditor*, EUROMONEY, Sept. 1996, at 42, 42 (quoting Lee Buchheit); *see also* Yap, *supra* note 255, at 162 (discussing criticisms of the "inherent unfairness" of payments to vulture funds while other creditors suffer losses); Nolan, *supra* note 258, at 7-8 (describing abuses by vulture funds).

[260] Dr. Krueger has made this point several times. *See* Krueger, New Approach, *supra* note 3; Krueger, Update, *supra* note 3; *see also* Wheeler & Attaran, *supra* note 133, at 259-60 (describing the role of holdout creditors, particularly vulture funds, in giving rise to the "classic collective action problem").

[261] In addition, even though bondholders voice support for restructuring plans that treat all bondholders equally, no dominant holder (or group of holders) is able to pledge convincingly to support only plans that provide for the equal treatment of bondholders.

investors. They are not swayed by the urgings of regulators or directors of multilateral institutions. As a result, they are often able to secure substantial payments—special treatment—for themselves, while disadvantaging other creditors and harming sovereign debtors.

The imperviousness of vulture funds to existing sources of pressure, coupled with the perceived success of vulture funds in suing sovereign debtors, largely based on Elliott's suit against Peru, have increased concerns that holdout creditors may disrupt restructurings. The Argentine restructuring is viewed as particularly vulnerable.[262] These concerns have led to widespread reform efforts to eliminate, or at least limit, the ability of recalcitrant bondholders to dissent from restructurings and pursue their claims against sovereign debtors in courts.[263]

There are three main approaches to addressing the holdout problem. The first is a market-based approach in which the sovereign restructures the debt through an exchange offer coupled with amendments to the terms of the original debt effected through exit consents. The second is a contractual mechanism, the use of CACs to facilitate the negotiation of a restructuring between the sovereign debtor and its creditors by enabling a majority of creditors to amend the terms of the debt over the objections of the holdouts. The third is an international bankruptcy procedure, the SDRM.

1. *Exchange Offers and Exit Consents*

Exchange offers permit debt to be restructured through a market process without the involvement of any legal tribunal and without any modifications to existing law.[264] Essentially, an exchange offer is an offer by the sovereign to exchange new debt for old. Because a bondholder's decision to accept an exchange offer is voluntary, debtors that conduct exchange offers face a potential holdout problem. Bondholders may refuse the offer in hopes of obtaining better terms as a holdout, either by forcing the debtor to buy them

[262] In discussing Elliott's successful suit against Peru, Dr. Krueger stated that "this case—and the possibility that rogue creditors will open other legal avenues—shines a spotlight on what is a missing element from the international community's current approach to the roles of public and private sectors in debt restructuring." Krueger, New Approach, *supra* note 3.

[263] *See* Gopinath, *supra* note 133, at 37 (describing the difficulties of the restructuring in Argentina and noting "[t]he vultures are circling Argentina now").

[264] *See* Buchheit & Gulati, *supra* note 254, at 62 (observing that exit consents, unlike other proposals to address the holdout creditor problem, are not "hampered . . . by the need to change existing laws, pass new laws, or alter long-standing documentation practices").

out at a higher price in order to proceed with the restructuring or by continuing to receive payments in accordance with the terms of the original debt.

Exit consents are designed to mitigate the holdout problem. As a condition of the exchange offer, creditors accepting the offer are required to consent to various modifications to the terms of the original debt that reduce its value. Although amendments to the payment terms—principal and interest—by fewer than all of the holders are not permissible if the bonds have a uniform action clause (UAC), other terms can typically be modified by a majority or supermajority. Waivers of sovereign immunity, submission to jurisdiction, financial covenants, and listing obligations are examples of such terms.[265] The amendments are designed to make the original bonds less valuable, thereby making their retention less attractive to investors.[266] Holders are thus pressured to accept the exchange offer rather than to hold out.

The use of exit consents was pioneered in the 1980s in connection with corporate recapitalizations that typically involved restructurings of high-yield bonds.[267] Courts generally accepted the approach. In the leading case, *Katz v. Oak Industries Inc.*,[268] the debtor offered to exchange its bonds for certificates guaranteeing (almost immediately) payment of cash sums that were greater than the market values of the bonds (but less than the face amounts of the bonds).[269] As a condition to accepting the offer, bondholders were required to vote in favor of amendments to the terms of the bonds that eliminated all the financial covenants protecting the value of the bonds.[270] Although the offer was challenged as violating the contractual obligation of good faith and fair dealing, the Delaware Chancery court upheld it.[271]

More recently, Pakistan, Ecuador, and Uruguay have used exchange offers coupled with exit consents to restructure their bonds. In the case of Ecuador, the approach resulted in approximately ninety-seven percent of the bondholders participating in the restructuring, which involved a substantial

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[265] *Id*. at 81-82.

[266] In addition, as more holders accept the exchange offer, the bonds become less liquid, further reducing their value. As the bonds lose value, they become even less attractive to investors.

[267] Buchheit & Gulati, *supra* note 254, at 67; *see also* Sris Chatterjee et al., *Coercive Tender and Exchange Offers in Distressed High-Yield Debt Restructurings: An Empirical Analysis*, 38 J. FIN. ECON. 333 (1995) (empirically examining price, success rates, and holdout rates in domestic exchange offers).

[268] 508 A.2d 873 (Del. Ch. 1986).

[269] *Id*. at 876-77.

[270] *Id*. at 877.

[271] *Id*. at 882.

reduction in the total stock of debt.[272] In accepting the offer to exchange Brady Bonds and Eurobonds,

> tendering bondholders automatically agreed to amend the old bonds to remove the cross-default and negative pledge clauses, to allow Ecuador to reacquire and to hold certain of its Brady Bonds (thereby making it impossible for remaining bondholders to accelerate those instruments after the exchange), and to delist the old bonds.[273]

Commentators report that the presence of the exit amendments played a "significant" role in "persuading" some bondholders to accept the exchange offer.[274]

Despite the successful use of exchange offers and exit consents, it is unlikely that this approach will be viable in all circumstances. The magnitude of the changes to the payment terms of the original bonds, particularly the reduction in the total principal amount of the bonds, necessary to relieve the sovereign debtor's financial crisis may be so great as to prohibit an exchange from being economically feasible. Alternatively, a court may find the exit amendments to be too substantial and refuse to enforce them against holdouts.[275] Finally, in some cases, the buoying-up effect of the restructuring may be sufficiently great to overcome the negative effects of the exit consents. By holding out, a bondholder retains the original bonds, with the original payment terms but without the protective covenants, so that the value of the bonds is reduced. Upon completion of the restructuring, however, the sovereign debtor's total debt burden is reduced, thereby increasing the value of the bonds. This increase in value caused by the restructuring, often called the "buoying-up" effect, may be greater than the decrease in value caused by the exit consents.[276]

2. *Collective Action Clauses*

CACs permit a majority or supermajority of bondholders to change the

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272 Buchheit & Gulati, *supra* note 254, at 83-84.

273 *Id*. at 84.

274 *Id*.

275 *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1346 (2002).

276 *See* Bratton & Gulati, *supra* note 14 (describing the buoying-up effect); Wheeler & Attaran, *supra* note 133, at 259 (presenting a numerical example showing the buoying-up effect). There is some evidence that the buoying-up effect may dominate the negative effect of the amendments. *See* Marcel Kahan & Bruce Tuckman, *Do Bondholders Lose from Junk Bond Covenant Changes?*, 66 J. BUS. 499 (1993) (offering such evidence).

payment terms of an issue of bonds. CACs have long been a standard contractual term for sovereign bonds issued under U.K. law. Sovereign bonds governed by U.S. law have, however, traditionally contained UACs, which require all creditors to consent to amendments of the payment terms. Because under a UAC a majority of the holders cannot force minority holders to accept the terms of a proposed restructuring, the minority creditors may hold out from the restructuring, even if it is in the best interests of the bondholders. CACs constrain this "tyranny of the minority"[277] by enabling the holdouts to be overridden by a majority or supermajority vote. In addition to addressing the collective action problem, CACs address the coordination problem caused by the fact that an increasing percentage of sovereign debt is held by dispersed public investors.

A variety of participants in the sovereign debt market have endorsed encouraging or requiring the universal substitution of CACs for UACs in new bond issues.[278] The advantages of CACs are straightforward. Once a sovereign debtor reaches agreement with a majority or supermajority of the holders of an issue of its bonds, the bonds can be restructured despite the objections, or refusal to participate, of minority holders. The negotiated terms bind all the holders. Thus, CACs lessen the problem of creditor coordination by allowing the debtor to negotiate with representatives of a majority or supermajority of the bondholders. In addition, CACs reduce the holdout problem by enabling a majority of the holders to force a restructuring upon a recalcitrant minority.

Commentators first defend CACs as a contractual approach that avoids the shortcomings of a more intrusive regulatory solution.[279] Indeed, supporters argue that, by solving the collective action problem and reducing the risk of holdouts, CACs should raise the value of debt.[280] Although some have argued that CACs may create a moral hazard problem for sovereign debtors by reducing the difficulty of restructurings, recent empirical evidence indicates that the market does not view CACs as less attractive than UACs.[281] This

[277] *Id*. at 1336.

[278] *See, e.g.*, Under Secretary of Treasury John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference on Sovereign Debt Workouts: Hopes and Hazards?, Institute for International Economics (Apr. 2, 2002) (endorsing the use of CACs), *available at* http://www.treas.gov/press/releases/po2056.htm.

[279] *Id*.

[280] *See* Bratton & Gulati, *supra* note 14 (explaining the basis for this argument).

[281] *See, e.g.*, Torbjörn Becker et al., *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?*, 61 J. INT'L ECON. 127 (2003); Liz Dixon & David Wall, *Collective Action Problems and*

suggests that creditors do not anticipate that the use of CACs will increase the likelihood of opportunistic defaults.

Attempting to reform the restructuring process through the universal use of CACs, however, has several disadvantages. CACs only enable the majority of creditors of a given issue to restructure that particular issue of bonds. They do not permit holders of one issue of bonds to force holders of another to accept the terms of a restructuring. They neither require that all issues be restructured nor deal with potential problems of unfairness among holders of different issues. Thus, while CACs may work effectively to change the terms of a single issue of bonds, or perhaps a limited number of issues,[282] they offer little help in dealing with coordination and collective action problems in a country like Argentina, which is attempting to restructure 152 different bond issues involving seven different currencies and the governing laws of eight different countries.[283] Moreover, the insertion of CACs into new issues of bonds does not address concerns regarding existing bonds, including the Argentine bonds, that contain UACs. Due to the long-term nature of sovereign bonds, the full utility of CACs would not be realized until a considerable point in the future.

Moreover, CACs may replace the tyranny of the minority with a tyranny of the majority. In particular, CACs create the risk that majority bondholders will deal unfairly with the minority. Although some commentators have argued that the majority's decision to restructure is constrained by the implied covenant of good faith and fair dealing,[284] it is not clear what content this doctrine has in limiting the right of any particular bondholder to base its voting decision exclusively on its own financial interests. Notably, in a recent decision evaluating the duties of majority creditors in negotiating in accordance with a CAC, a British court specifically found that majority creditors had no obligation to negotiate on behalf of all creditors rather than in their own self interest.[285] The court explained: "By signing up at the outset, each lender submits to the decision of the majority lenders at important forks in

Collective Action Clauses, FIN. STABILITY REV., June 2000, at 142; Anthony Richards & Mark Gugiatti, *Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets*, 6 INT'L FIN. 415 (2003); Kostas Tsatsaronis, *The Effect of Collective Action Clauses on Sovereign Bond Yields*, BIS Q. REV., Nov. 1999, at 22.

282 *See* David A. Skeel, Jr., *Can Majority Voting Provisions Do It All*?, 52 EMORY L.J. 417, 422-23 (2003) (observing that the value of CACs is limited to their ability to change the terms of a single class of debt).

283 Guillermo Nielsen, Secretary of Finance of Argentina, Remarks in Dubai 14 (Sept. 22, 2003), *at* http://www.argentinedebtinfo.gov.ar/documentos/discurso_gn_dubai_con_diap_english.pdf.

284 Bratton & Gulati, *supra* note 14.

285 Redwood Master Fund, Ltd. v. TD Bank Eur. Ltd., [2002] All E.R. (D) 41 (Dec) (Ch. 2002).

the road."[286] The problem of heterogeneous bondholder interest exacerbates the risk of unfairness to some bondholders.

CACs are a contractual term, and so their inclusion must be acceptable to bondholders and sovereign debtors. The Treasury Department, the IMF, and other participants have argued for the use of CACs in all new issues of bonds, reasoning that CACs have not impaired the marketability of bonds that contain them. Yet, bondholders and sovereign debtors have not demanded this solution to the holdout problem on their own. Despite the official encouragement, only a small percentage of sovereign bonds, particularly emerging market bonds, contains CACs.[287]

Finally, CACs do not eliminate the strategic use of litigation, the stated goal of their inclusion in debt instruments. Unless and until courts develop a jurisprudence clarifying the rights and responsibilities of creditor groups in restructurings, holdout creditors will continue to enforce their claims against sovereign debtors in courts. In addition to holdout litigation, CACs may spawn a new class of intercreditor suits as dissenting bondholders challenge the restructuring terms imposed by the majority or supermajority of bondholders. Indeed, the uncertainty associated with judicial review of all these claims may offer a partial explanation for the failure of the market to attribute greater value to bonds subject to CACs.

3. *The Sovereign Debt Restructuring Mechanism*

Of the various proposals for some form of sovereign bankruptcy procedure, the one that has attracted the most attention is the proposal by Dr. Krueger.[288] In its most recent form, the SDRM would create a process by which a majority of creditors could negotiate a restructuring that would then be binding upon all creditors.[289] The advantages of the SDRM over the universal use of CACs include the SDRM's ability to deal with multiple issues of bonds and its

[286] *Id*. at 27.

[287] Yan Liu, Int'l Monetary Fund, Collective Action Clauses in International Sovereign Bonds 23 (Aug. 30, 2002), *available at* http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/liu.pdf. For recent examinations of this phenomenon, see Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 EMORY L.J. 691 (2004); Stephen Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004); and Int'l Monetary Fund, Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use (June 2002), *at* http://www.imf.org/external/np/psi/2002/eng/060602a.pdf.

[288] *See* Int'l Monetary Fund, Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Fact Sheet, *at* http://www.imf.org/external/np/exr/facts/sdrm.htm (Jan. 2003).

[289] *Id*.

applicability to existing debt, including bonds issued with UACs.

While Dr. Krueger and the IMF continue to develop the SDRM, the basic procedure would place primary responsibility for negotiating restructurings in the hands of creditors.[290] Practically speaking, the SDRM is more of a workout mechanism than an international bankruptcy court. The SDRM would group creditors into a single class that would have the power to restructure all debt subject to the SDRM (domestic debt would not be included) by vote of a qualified majority of the class.[291] A judge or some type of official would resolve disputes among creditors but, unlike the bankruptcy process, the judge would not evaluate the substantive terms of the restructuring for fairness.[292] A restructuring negotiated by the supermajority of creditors would be binding on all creditors subject to the restructuring.

Importantly, the proposal does not include a standstill or a stay on creditor enforcement of claims through litigation.[293] This reflects a change from earlier IMF proposals. Instead, the proposal provides that disruptive litigation will be discouraged through the application of the so-called "Hotchpot rule," whereby any amounts received by a creditor through litigation will be deducted from that creditor's approved claim under the restructuring agreement.[294] Although application of this rule would reduce the incentive for some litigation, it would not affect litigation by creditors who are able to obtain a greater recovery through litigation than through the restructuring.[295]

A substantial limitation of the SDRM is its failure to address intercreditor fairness in the restructuring process. The majority creditors are the ones who have a seat at the negotiating table. The SDRM offers no formal procedure to involve small or retail investors in the negotiations and, instead, offers a legal mechanism designed to reduce their power vis-à-vis the majority. To the extent that banks are the majority creditors, there are reasons to question their ability to act as effective agents for the minority. Indeed, there are substantial differences in creditor interests. Moreover, adoption of the SDRM would

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290 *Id*.

291 Anne Krueger, *Sovereign Debt Restructuring: Messy or Messier?*, AM. ECON. REV., May 2003, at 70, *available at* http://www.imf.org/external/np/speeches/2003/010403.htm.

292 Int'l Monetary Fund, *supra* note 287.

293 Krueger, *supra* note 291, at 72.

294 Int'l Monetary Fund, *supra* note 287.

295 *See* Kunibert Raffer, To Stay or Not to Stay—A Short Note on Differing Versions of the SDRM (Jan. 31, 2003) (demonstrating the effect of the Hotchpot rule through numerical examples), *available at* http://www.jubileeplus.org/latest/raffer310103.htm.

affect the price of outstanding sovereign debt. In particular, uncertainties about the implementation and operation of the SDRM are likely to reduce the price of debt, adversely affecting existing creditors.

B. Benefits of Holdout Litigation

Each of the three proposals to reform the restructuring process ignores the developments in the international capital markets and in legal doctrines that have engendered litigation by holdout creditors. More importantly, the proposals give short shrift to the positive effects of an enforcement remedy on the restructuring process and the sovereign debt market.

Holdout litigation appears to be the product of developments in two distinct, but related, spheres—the markets and the courts. As the sovereign debt market has developed to include diverse creditors with differing interests,[296] the judiciary has developed an approach that narrowly interprets the defenses asserted by sovereign debtors in suits brought by creditors.[297] Thus, as the likelihood of recalcitrant creditors has increased, the ability of these creditors to pursue their claims through litigation has also increased. The restructuring process, however, has not advanced to reflect these developments.

In the restructurings of the 1930s,[298] the bondholder committees, including the Foreign Bondholders Protective Council, lacked both the authority to bind bondholders to agreements with sovereign debtors and an effective means of pressuring recalcitrant bondholders to accept restructuring plans that had been negotiated with debtors. In addition, holdout creditors were unable to pursue their claims against sovereign debtors in court. As a result, restructurings were completed only over the course of long periods of time, causing additional distress for sovereign debtors as well as losses for bondholders. Ultimately, these difficulties led to the collapse of the market for sovereign bonds.

In the restructurings of the 1980s,[299] the bank advisory committees were able to pressure recalcitrant banks, generally smaller commercial banks, to assent to proposed restructuring plans and to refrain from litigating their claims. The terms of these plans, however, tended to favor the interests of the

296 These developments are discussed *supra* in Part I.B. and Part I.C.
297 The development of this approach is discussed *supra* in Part II.
298 These restructurings are discussed *supra* in Part I.B.1.
299 These restructurings are discussed *supra* in Part I.B.2.

large commercial banks over the interests of the smaller commercial banks, creating a tyranny of the majority. Moreover, the perception among the smaller banks that their interests were subsumed to the interests of the large banks created strains among the banks participating in the restructurings. The tensions led to the development of a secondary market for sovereign debt, and they may have also contributed to the reduction in the availability of loans to sovereign debtors.

For current and future restructurings, holdout litigation may provide a means of avoiding the failures evident in the restructurings of 1930s and the 1980s by allowing creditors to enforce their claims against sovereign debtors. If creditors can use lawsuits to challenge the terms of proposed restructuring plans, sovereign debtors may be limited in their ability to delay the completion of the restructuring process. Similarly, holdout litigation offers a mechanism by which minority creditors can challenge restructurings designed principally for the benefit of the majority of the creditors.

Holdout litigation may also indirectly introduce efficiencies into the restructuring process. By permitting recalcitrant creditors to reject the terms of a proposed restructuring plan, including a plan supported by a majority of the other creditors, and to pursue successfully their claims against the sovereign debtor in court, holdout litigation may entice vulture funds to enter the sovereign debt market.[300] To the extent vulture funds purchase significant blocks of claims, they may reduce the administrative burden associated with restructuring sovereign debt. By aggregating claims, vulture funds may serve as a forum for coordinating the actions of creditors, especially among the creditors who sell their claims to the funds.[301] At the same time, vulture funds may also provide a mechanism through which communications and

[300] For example, in describing Elliott's decision to purchase a portion of Peru's distressed debt, one commentator noted that "[t]he team at Elliott examined the situation, determined that Peru was getting away with paying banks rather less than it ought, and held out for a better deal. They also, of course, judged their chances of being able to win a court case against a sovereign." Felix Salmon, *Elliott Associates' Aggression Captures Low-Risk Returns*, EUROMONEY, Feb. 2004, at 36.

[301] *See, e.g.*, Coffee & Klein, *supra* note 2, at 1253-54 (noting the coordinating role of vulture funds in the context of exchange offers for corporate bonds that are coupled with exit consents); *see also* ROSENBERG, *supra* note 130, at 25-36 (describing the role of vulture funds in reducing the administrative burden associated with corporate reorganizations); Yap, *supra* note 255, at 219 (same). This aggregation function may, in many ways, be similar to the role of select investors in aggregating claims in class action lawsuits, particularly those involving securities fraud. *See, e.g.*, Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging*, 2003 BYU L. REV. 1239, 1250-52 (discussing the role of class action lawsuits in general, and lead plaintiffs in particular, in aggregating claims in cases involving securities fraud).

negotiating costs may be reduced.[302]

In addition to improving the restructuring process, holdout litigation may enhance the operation of the sovereign debt market. Specifically, holdout litigation may serve as a potential check on opportunistic defaults by sovereign debtors. If sovereign debtors expect that creditors, especially recalcitrant creditors, will enforce their claims through litigation, then they may be less likely to default when they are able to make the payments required on their debts. By reducing the probability of opportunistic defaults, holdout litigation may increase capital flows. Indeed, participants in the sovereign debt market appear to value judicial enforcement of debt claims. In *Allied Bank*, for example, the Clearing House supported the efforts of a single commercial bank to enforce its claims against Costa Rica, even though the litigation had the effect of disrupting the proposed restructuring plan.[303] Recent developments in the interpretation of the *pari passu* clause in sovereign debt instruments provide further evidence that creditors, and even sovereign debtors, value the curb that holdout litigation imposes on opportunistic defaults.[304] Despite widespread expressions of concern regarding the court's interpretation of this clause in Elliott's suit against Peru,[305] the court's decision did not result in changes to the language of *pari passu* clauses contained in new debt instruments to remove the power the interpretation gives to holdout creditors so as to render the decision ineffective.[306] Instead, as Stephen Choi and Mitu Gulati show, "the change that came was . . . the elevation of the importance of the [clause] . . . [a]s . . . in all but three of the new [debt] contracts, the vote required to change the *pari passu* [clause] was elevated from a 50% or 66.67%

302 Any reduction in the administrative burden of the restructuring process resulting from the consolidation of claims of many creditors, however, may be overshadowed by the costs incurred as a result of any litigation that the vulture funds pursue in respect of the purchased claims. *See Vultures the Truly Evil Face of Capitalism*, SUN. TRIB. (Ireland), May 12, 2002, at 9 (discussing the role of legal fees in sovereign debt restructurings).

303 This litigation is discussed *supra* Part II.

304 Recall that in connection with Elliott's suit against Peru, a Brussels court interpreted the *pari passu* clause in the letter agreements Elliott purchased as precluding Peru from making a payment on its Brady Bonds without making a pro rata payment to Elliott. The decision caused Peru to settle the case by making a substantial payment to Elliott.

305 *See* G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 638 (2000) (describing the interpretation as putting "a large hammer in the hands of holdout creditors, thereby enabling them to cause even more disruption in restructurings"). In fact, holdout creditors relied on the interpretation of the clause in pursuing their claims against sovereign debtors in courts located not only in Brussels but also in California, New York, and London. *See* Buchheit & Pam, *supra* note 240, at 877-79 (summarizing the status of the litigation).

306 Choi & Gulati, *supra* note 287, at 993.

vote threshold to the heightened 75% or 85% threshold."[307] The effort by creditors, and perhaps sovereign debtors, to preserve the availability of holdout litigation in the face of uncertainty may be particularly valuable in the context of the sovereign debt market in which other constraints on opportunistic defaults appear to operate poorly. In particular, a sovereign debtor's reputation may be of limited importance as, although the empirical evidence is mixed, studies indicate that a sovereign debtor's reputation for repayment has little effect on its ability to borrow.[308]

Holdout litigation may also increase the liquidity of the market for sovereign debt. By serving as a catalyst for vulture funds to purchase distressed sovereign debt, holdout litigation draws active participants into the market. These funds create liquidity for other investors by offering them a means of exiting the market for a fixed sum of money.[309] Retail investors, notably those with fixed incomes, may benefit from the ability to monetize their claims.[310] At the same time, these transactions provide information regarding prices that banks and other institutional investors require to mark their portfolios to market.[311] Moreover, even if these creditors do not wish to

[307] *Id*. at 994. As Professor Choi and Professor Gulati explain, "the *pari passu* [clause] that no one seems to understand and that provided for a heightened risk of holdouts, instead of getting clarified or eliminated in the new [debt] contracts, got elevated, thereby further increasing the risk of holdouts!" *Id*.

[308] Upon completing their study of the experiences with sovereign debt for a period over one hundred years, Peter Lindert and Peter Morton conclude that "investors seem to pay little attention to the past repayment record of [sovereign debtors]. . . . [T]hey do not punish governments with a prior default history, undercutting the belief in a penalty that compels faithful repayment." Peter H. Lindert & Peter J. Morton, *How Sovereign Debt Has Worked*, *in* DEVELOPING COUNTRY DEBT AND ECONOMIC PERFORMANCE, *supra* note 102, at 39, 40; *see also* Eliana A. Cardoso & Rudiger Dornbusch, *Brazilian Debt Crisis: Past and Present*, *in* THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE, *supra* note 19, at 106 (finding an absence of reputation effects in the sovereign debt market); Barry Eichengreen, *Historical Research on International Lending and Debt*, 5 J. ECON. PERSP. 149, 160-62 (1991) (concluding that reputation effects have limited impact in the market for sovereign debt); Jorgensen & Sachs, *supra* note 19, at 106 (same). *But see* Sule Ozler, *Have Commercial Banks Ignored History?*, 83 AM. ECON. REV. 608 (finding evidence of reputation effects in the sovereign debt market); Michael Tomz, How Do Reputations Form?: New and Seasoned Borrowers in International Capital Markets (Aug. 2001) (unpublished manuscript) (same), *available at* http://www.stanford. edu/~tomz/working/apsa01.pdf.

[309] Absent this option, the investors, like bondholders during the restructurings of the 1930s and the smaller commercial banks during the early years of the restructurings of the 1980s, must hold their claims through the completion of the restructuring. *See, e.g.*, Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990) (describing the role of vulture funds in providing liquidity in the market for distressed corporate debt); *Vulture Hunt*, FIN. TIMES, May 7, 2002, at 20 (arguing that vulture funds provide liquidity in the market for sovereign debt).

[310] Although these investors may be loath to sell their sovereign bonds at a loss, their financial positions may require them to sell the bonds to generate cash for immediate expenses. *See* Lapper, *supra* note 135 (noting the difficult position of retail investors who purchased sovereign bonds issued by Argentina).

[311] *See* S. Richard Orzy, *Secondary Market Players: Vultures or Value Enhancers?*, 20 NAT'L

litigate their claims against sovereign debtors, they may still obtain value from the litigation remedy by selling their holdings of sovereign debt to other investors that are more inclined toward litigation.

C. Tools for Managing Holdout Litigation

While protecting the ability of holdout creditors to enforce their claims against sovereign debtors through litigation enhances the restructuring process and the sovereign debt market, holdout litigation has the capacity to disrupt restructurings. The extent of the disruption is unclear.[312] Uncertainty regarding the relative benefits and cost of holdout litigation, and the role of the litigation option in future restructurings, calls for an incremental approach to reform.[313] Rather than broad proposals designed to apply to all sovereign debtors and all restructuring plans, limited reform efforts specifically tailored to the scope of the litigation remedy and the potential for abuse of the remedy are likely to have the greatest success in resolving the tensions created by holdout litigation. Instead of exchange offers coupled with exit consents, universal CACs, or the SDRM, we argue for relatively modest changes to the terms of sovereign debt instruments that would directly affect the ability of investors to pursue holdout litigation.

Focusing on the terms contained in debt instruments that are governed by

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INSOLVENCY REV. 1, 9-10 (2003) (describing the importance of bid and ask prices in indicating the value of distressed corporate debt), *available at* 2003 C.N.I.R. LEXIS 1.

312 On the one hand, Dr. Krueger has argued that holdout litigation so adversely impacts the restructuring process as to require the implementation of the SDRM to limit, or perhaps eliminate, holdout litigation. Krueger, New Approach, *supra* note 3. At the other end of the spectrum, Andrei Shleifer has argued that, by limiting the potential for holdout litigation and thereby weakening the rights of creditors, the SDRM will aggravate existing problems in the restructuring process. ANDREI SHLEIFER, WILL THE SOVEREIGN DEBT MARKET SURVIVE? (Harvard Inst. of Econ. Research, Discussion Paper No. 2000, 2003), *available at* http://post.economics.harvard.edu/hier/2003papers/2003list. html. Between these two poles, commentators have argued that "nearly a decade after it first became the focus of policy and academic attention, the holdout problem has all but failed to materialize." Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1119, 1143-44 (2004); *see also* Roubini, *supra* note 11, at 7 (identifying ten reasons "why the holdout problem is not a big problem in practice," including the desire of creditors, even vulture funds, to avoid the costs of litigation and the availability of side payments, or bribes, to remove the incentive to hold out).

313 In addition, the balance between the benefits and the costs of holdout litigation is likely to vary from case to case, depending upon the characteristics of the sovereign debtor. Sovereign debtors with relatively good prospects for stable growth may benefit from demonstrating a strong commitment to satisfy the obligations imposed by their debts. By subjecting themselves to a substantial risk of holdout litigation, these debtors may signal to creditors that they will refrain from defaulting opportunistically. Other sovereign debtors, those with poor outlooks for growth, may do better to direct their efforts to minimizing the likelihood of holdout litigation as a means of reducing the costs associated with restructurings of their debts.

New York law, we argue that sovereign debtors could readily offer bonds for which the threat of disruptive holdout litigation is constrained. Modifying these debt instruments in accordance with our suggestions would limit the prospect of harmful litigation while retaining the availability of the litigation remedy in cases of overreaching by either the majority of the bondholders or the sovereign debtor. Moreover, the extent to which investors demand higher interest rates to purchase these bonds would provide a means of measuring the extent to which investors value the litigation option. The value of our suggestions, then, could be tested directly in the sovereign debt market.

What type of modifications to fiscal agency agreements do we suggest? We first identify changes that are designed to reduce the power of bondholders to act individually. We next consider the designation of a representative, perhaps in the form of a trustee, to assist the bondholders in acting as a group. We then discuss refinements to limit the diversity among bondholders. Finally, we consider explicit enforcement rights for minority bondholders in the event of discriminatory treatment in connection with a default or a restructuring of the bonds.

Most sovereign bonds issued in the United States are issued pursuant to a fiscal agency agreement.[314] The agreement governs the relationship between the sovereign debtor and the fiscal agent, which is typically the investment bank, perhaps in connection with one of its affiliates, serving as lead underwriter for the offering of the bonds.[315] The fiscal agent is the agent of the sovereign debtor, as issuer of the bonds.[316] The agreement also governs the terms of the bonds.

The fiscal agent does not act for the bondholders. As a result, the bondholders typically retain the power to act individually in the event of a default on the bonds. The individual actions can include accelerating the principal amount of the bonds and suing to collect for breach of the agreement.[317] Each bondholder has the right, upon the occurrence of an event of default, to demand payment of the full principal amount of its bonds and to file suit against the sovereign debtor to collect the payment.

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314 Buchheit & Gulati, *supra* note 275, at 1332.

315 Macmillan, *Debt Crisis*, *supra* note 28, at 342.

316 Buchheit & Gulati, *supra* note 275, at 1332.

317 *See id*. at 1330-32 (describing acceleration clauses and enforcement restrictions in sovereign debt instruments). Acceleration of the principal amount of all the bonds typically requires the vote of holders of at least twenty-five percent of the outstanding bonds, measured in terms of the principal amount of the bonds. *Id*. at 1330.

This structure differs markedly from the rights provided to bondholders pursuant to a trust indenture.[318] Specifically, under the terms of a trust indenture, individual bondholders do not have the right to accelerate the principal amounts of their bonds. Instead, each bondholder has the right to file suit against the debtor only for payments of interest and principal that are not made on their respective due dates.[319] The trustee, as agent for the bondholders, possesses the right to accelerate the principal amount of all the bonds and to sue the debtor for the total amount.[320]

To limit the incentives of bondholders to commence disruptive litigation, sovereign debtors might modify the terms of the fiscal agency agreements pursuant to which they issue bonds to eliminate the right of individual bondholders to accelerate the principal amounts of their bonds in the event of a default. Rather than retaining the right to demand payment for the entire principal amount of its bonds, each bondholder might be limited to the right to sue the sovereign debtor only for unpaid interest and principal. This modification would reduce the attractiveness of holdout litigation by sharply limiting the size of the judgment potentially available to a bondholder while simultaneously increasing the expense of pursuing the claim. In *Elliott Associates*,[321] Elliott's ability to accelerate the principal amount of its letter agreements allowed it to obtain a judgment against Peru for over $55 million, creating a strong incentive to pursue the claim it had purchased for approximately $11 million. If, as we suggest, the claim were limited to unpaid interest (and, of course, principal at maturity), a bondholder would have relatively weak incentives to pursue holdout litigation. Moreover, the necessity of bringing multiple suits for each missed interest payment over an extended period of years would increase the burden of the litigation relative to

[318] As Mr. Buchheit and Professor Gulati note, this convention also differs from the rights provided to bondholders under trust deeds, which are commonly used in the United Kingdom. Trust deeds provide that only the trustee has the power to enforce the instrument. Individual bondholders do not have the right to file suit against the sovereign debtor unless the trustee, having been instructed by holders of a specified percentage of the outstanding bonds, fails to commence an enforcement action. Moreover, any recoveries made by the trustee must be shared pro rata among the bondholders. *Id*. at 1331.

[319] *Id*. at 1331-32; *see also* Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040, 1049-50 (2002) (noting that "[t]his right is unqualified and may thus be exercised independently by any holder regardless of whether the trustee or the other bondholders approve of such suit").

[320] Buchheit & Gulati, *supra* note 275, at 1332. Individual bondholders recover the right to sue for the total amount of the bonds in the event the trustee, having been instructed by the holders of at least twenty-five percent of the outstanding bonds and offered satisfactory indemnification, fails to commence an enforcement action within a specified period of time, typically sixty days. *Id*.

[321] This case is discussed *supra* Part II.

its expected benefits.

In addition, the ability of bondholders to act on their own might be limited by modifying the terms of the agreements to require the affirmative vote of a designated percentage of the outstanding bonds to commence any litigation on behalf of any bondholder.[322] For example, the approval of the holders of at least twenty-five percent of the outstanding bonds, measured in terms of principal amount, might be required before a bondholder would be permitted to file suit against the sovereign debtor. The required threshold for commencing litigation need not, of course, be the same as the requirement for accelerating the principal amounts of all the bonds. Thus, for instance, a vulture fund might acquire twenty-five percent of the outstanding bonds by purchasing them at deep discounts from their face values in the secondary market and thereby satisfy the requirement for acceleration. Yet, if the required threshold for commencing litigation were thirty-five percent, the fund would not be able to pursue the claim by filing suit against the sovereign debtor in court.[323]

Regardless of the nature of the claim, and regardless of the particular proportion of the outstanding bonds designated as necessary to commence litigation, the requirement of securing the affirmative vote of the holders of a specified percentage of the outstanding bonds will impose delays on, and increase the expense of, suits against the sovereign debtor. These obstacles reduce the attractiveness of the litigation remedy as well as the likelihood that bondholders will undertake litigation that is disruptive to the restructuring process and harmful to other creditors. In particular, they lower the chance that nuisance litigation will be a profitable undertaking. Significantly, in addition to reducing the attractiveness of litigation, this modification may also assist the bondholders in acting as a group as collective action among the bondholders would, in almost all circumstances, be necessary to accelerate the principal amounts of the bonds and to commence litigation against the sovereign debtor. Actions taken as a group may reduce concerns regarding differential treatment of bondholders and disruption of the restructuring process. In particular, the requirement of group action would alleviate the concern that, by initiating litigation, holdout creditors were seeking to "jump the line."

[322] For a discussion of a similar proposal, see Macmillan, *Debt Work-Out System*, *supra* note 28, at 103-04.

[323] Alternatively, the agreement might provide a higher threshold for acceleration—preserving an individual bondholder's access to the courts but limiting the power of the litigation remedy.

A similar coordination of bondholder interests could be achieved by issuing sovereign bonds pursuant to trust indentures, rather than fiscal agency agreements. A trust indenture provides for a trustee to serve as the agent for the bondholders, rather than for a fiscal agent to serve as the agent of the sovereign debtor. Although the duties of a trustee are limited, they are not inconsequential,[324] and they are enhanced upon the occurrence of default on the bonds.[325] Typically, only the trustee is entitled to accelerate the principal amounts of the bonds and to file suit against the debtor. Absent a failure on the part of the trustee, the bondholders are limited in the claims they may bring against the debtor. In this way, the use of a trust indenture, and a trustee, limits the scope of the litigation option for individual bondholders while preserving the viability of litigation to enforce the obligations of the debtor.[326]

In addition, by providing for a trustee to serve as the agent for the bondholders, a trust indenture may reduce incentives to pursue holdout litigation by limiting the funds available to satisfy judgments against the debtor. Because the trustee serves the interests of the bondholders, and not the debtor, the transfer to the trustee by the debtor of funds for payment on the bonds may remove the funds from the scope of a judgment against the debtor. This result differs from the consequences of transferring funds to a fiscal agent, which may not be sufficient to avoid the reach of attachment orders. In *Elliott Associates*,[327] for example, Elliott sought to enforce its judgment against Peru in respect of its letter agreements by seeking to attach funds for the payment of interest on the Brady Bonds that Peru was to transfer to the fiscal agent for the Brady Bonds.[328] In pursuing this strategy, Elliott argued that the funds would

[324] As long as no default on the bonds has occurred, the trustee's duties are limited to the duties that are explicitly set forth in the trust indenture. As a general matter, these duties relate to the administration of the trust indenture and the bonds: maintaining a register of the bondholders and authenticating the bonds. *See* AM. BAR FOUND., COMMENTARIES ON INDENTURES 165-68, 181, 247-50 (1971) (discussing the duties of the trustee).

[325] Upon the occurrence of an event of default, the trustee's duties expand, requiring it to exercise the rights and powers granted to it under the trust indenture and to use the same degree of care and skill in their exercise as a prudent person would under the same circumstances in the conduct of his own affairs. *Id*. at 249-50 (discussing the duties of the trustee upon the occurrence of an event of default).

[326] Note that the fees paid to the trustee for its services, which are the responsibility of the debtor, are likely to be significantly less than the costs incurred as a consequence of any holdout litigation. The annual fee for a trustee is typically quite modest, while the cost of defending a suit (even a nuisance suit) brought by a recalcitrant bondholder can be substantial. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, CORPORATE FINANCE: CASES AND MATERIALS 456 (3d ed. 2001) (describing the selection criteria for trustees as including competence in ministerial tasks and low fees); *Vultures the Truly Evil Face of Capitalism*, *supra* note 302.

[327] This case is discussed *supra* Part II.

[328] *See* Eric Lindenbaum & Alicia Duran, *Debt Restructuring: Legal Considerations*, MERRILL LYNCH EMERGING MARKETS RES., Oct. 2000, at 3 (describing Elliott's efforts to enforce its judgment against Peru),

remain the property of Peru even after transfer to the fiscal agent, as the fiscal agent was Peru's agent.[329] If the Brady Bonds had been issued under a trust indenture, then the funds would have been transferred to a trustee, an agent of the bondholders, and Elliott's enforcement strategy may not have been successful.[330]

Rather than simply adopting the standard terms of trust indentures, which impose limited duties on, and grant few rights to, trustees, trust indentures for sovereign bonds might be structured to impose significant responsibilities on trustees and to grant them corresponding powers.[331] The trustee, for instance, could be charged with pursuing all claims of the bondholders against the sovereign debtor. The trustee would thus have the obligation and the authority to commence all litigation on behalf of the bondholders, including suits for unpaid interest and principal on the bonds and suits for the total principal amount of all the bonds upon acceleration. In this way, the trustee would hold the power of the litigation remedy for the benefit of all the bondholders. At the same time, the bondholders would lack the ability to engage in litigation that is disruptive to the restructuring process and harmful to other creditors.

The trustee could also be empowered to represent the bondholders in any restructuring of the bonds. One possibility would limit the trustee's authority to participating in negotiations with the sovereign debtor regarding the terms of the restructuring and then recommending proposed restructuring terms to the bondholders for their ratification. Alternatively, the trustee's authority might extend to modifying the terms of the bonds without the consent of the bondholders; that is, the trustee might be authorized to negotiate the terms of a restructuring of the bonds with the sovereign debtor and to accept those terms on behalf of the bondholders, without involving the bondholders in the restructuring process.[332] The trustee might also be designated as the

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available at http://www.emta.org/keyper/linden1.pdf.

[329] *Id*. Elliott served a restraining order on the fiscal agent, with the intent of attaching the funds upon transfer to the agent. To avoid the attachment, and a default on the Brady Bonds, Peru settled the case by making a substantial payment to Elliott and then paid the interest on the Brady Bonds. *Id*.

[330] The use of a trustee, rather than a fiscal agent, does not, however, guarantee that funds transferred in respect to the bonds will be protected from attachment. *Id*.

[331] In the context of corporate bonds, Yakov Amihud and others have proposed the creation of a "supertrustee" with substantial duties and powers, including those related to the enforcement and the renegotiation of the terms of the indenture. Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447 (1999).

[332] The trust indenture could, however, reserve to the bondholders the right to reject the restructuring terms implemented through the actions of the trustee. Any terms negotiated and accepted by the trustee might be overturned within a specified period of time, for example forty-five days, upon the vote of a supermajority

representative of the bondholders on any committee of bondholders that is formed in connection with a restructuring of the bonds.[333]

In representing the bondholders, either in court or in the restructuring process, the trustee would serve the interests of all bondholders, as the trustee would be the agent of all the bondholders, appointed through the trust indenture.[334] Thus, the trustee would not be permitted to favor the interests of one class of investors—banks and other institutional investors—over the interests of another—retail investors.

Refinements to sovereign debt instruments could also limit heterogeneity among the bondholders by limiting the class of potential holders. Prior to the implementation of the Brady Plan, debt instruments often contained provisions that were designed to limit the diversity among the class of debtholders by precluding assignment of the debt to nonfinancial institutions. Although in *Pravin*[335] the court found that the relevant provision was not sufficiently explicit to prohibit assignment to nonfinancial institutions, careful drafting could easily create an enforceable restriction on assignability. Sovereign debtors could thus sell their bonds to selected types of investors in the initial offering, and then, through restrictive assignment provisions in the agreement

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of the bondholders.

333 These committees may be appointed through the actions of the sovereign debtors, as was the case of the bank advisory committees during the 1980s, or they may be formed by the bondholders themselves, as was more typically the case during the restructurings of the 1930s. Regardless of the manner in which any particular committee is organized, the trustee could be designated, under the terms of the trust indenture, as the representative of the bondholders on all committees. This approach would minimize the costs of selecting a representative of the bondholders, as no formal action of the bondholders would be necessary. In the current crisis involving the restructuring of Argentina's debt, for example, bondholders have organized a number of committees, and they have also organized the committees into a "supercommittee," the Global Committee of Argentine Bondholders, which was formed in January of 2004 and represents over 500 institutional investors and retail investor groups. *See Argentina Creditors Unite to Speed Up Bond Talks*, ANSA ENG. MEDIA SERVICE, Jan. 12, 2004 (describing the creation of the Global Committee of Argentine Bondholders); *Don't Lie to Me, Argentina*, INSTITUTIONAL INVESTOR, Mar. 15, 2004, at 7 (same).

334 Absent the imposition of fiduciary duties to serve the interests of bondholders, the trustee may not provide an entirely robust check on low restructuring terms, because the trustee, while the agent of the bondholders, is chosen by the debtor. Like the banks that sold sovereign bonds to investors in the 1920s, the trustee may have incentives to serve the interests of the debtor over the interests of the bondholders. Similarly, the trustee may not completely eliminate discriminatory restructuring terms. Trustees are typically banks, and so they may, for the sake of business relationships, be inclined to favor the interests of banks over the interests of other investors. As a result, the terms of the restructurings, like the terms of the restructurings in the 1980s, may favor the interests of banks and other institutional investors. Nonetheless, trustees may seek to develop reputations for acting in the interests of all the bondholders, and investors may be able to use the market to pressure sovereign debtors to select these trustees. *See* Amihud et al., *supra* note 331, at 471-72, 484-85 (discussing similar issues in the context of supertrustees for corporate bonds).

335 This case is discussed *supra* in Part II.

governing the bonds, limit the types of investors to whom the bonds could be resold in the secondary market. In addition to the general category of nonfinancial institutions, vulture funds or retail investors[336] could be specifically precluded from holding the bonds. Although limitations on assignability would reduce the liquidity of the bonds, the limitations would also reduce the range of interests that would be implicated in a restructuring, facilitating creditor coordination and limiting the likelihood of disruptive and harmful litigation.

Finally, the terms of fiscal agency agreements might be modified to provide specific enforcement rights for bondholders that have been discriminated against in the context of a default or restructuring.[337] For example, in the case in which a sovereign debtor fails to make a required payment to a portion of the bondholders, the agreement might provide that the vote of holders of twenty-five percent of only those bonds experiencing the default is necessary to accelerate the principal of those bonds, rather than requiring the vote of holders of twenty-five percent of the outstanding bonds to accelerate the principal on all the bonds.[338] By adjusting the threshold required for accelerating the unmatured principal on bonds in this way, this proposed change would provide a means for aggrieved bondholders to enforce their rights when the rights of other bondholders have not been infringed. At the same time, the modification would also provide incentives for these

[336] Some commentators have expressed particular concern regarding the use of class action lawsuits in the restructuring process. The class action mechanism is a procedural tool to facilitate the litigation of claims in which the interests of individual class members are small. *See, e.g.*, Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, LAW & CONTEMP. PROBS., Spring/Summer 2001, at 53, 55-56 (describing the role of class actions in facilitating the litigation of small claims). Limiting the participation of small investors, particularly retail investors, in the sovereign debt market is virtually guaranteed to eliminate the potential for class action litigation.

[337] Marcel Kahan has proposed a similar modification to the trust indentures governing corporate bonds. *See* Kahan, *supra* note 319, at 1074. These rights may provide a means for minority bondholders to protect themselves from a tyranny of the majority, and this protection may be particularly important in the absence of judicial enforcement of an implied covenant of good faith and fair dealing among bondholders in sovereign debt restructurings. Specifically, these rights may provide some explicit protections for minority creditors, obviating the need to rely on the courts to recognize and enforce intercreditor duties. For a discussion of the problems associated with the reliance on contract terms, as well as the significance of duties among holders of sovereign debt, see Bratton & Gulati, *supra* note 14.

[338] As Professor Kahan notes, if

> only a subset of holders is affected directly by the [debtor's] action, the threshold requirement becomes harder to meet. If the threshold—say, holders of 25% of the outstanding bonds—was reasonable assuming that the rights of all bondholders were affected, it can become oppressive if the affected subset holds only 40% or 20% of the outstanding bonds.

Kahan, *supra* note 319, at 1075.

bondholders to take action, by commencing litigation, to limit the strategic actions of the sovereign debtor and the majority of the bondholders.

These modest refinements to sovereign debt instruments, particularly fiscal agency agreements, are likely to provide an effective means of reducing the costs engendered by holdout litigation while facilitating the restructuring process and promoting the functioning of the international capital markets. Rather than requiring extensive changes throughout the market for sovereign debt, these reforms can be tailored to the circumstances of individual sovereign debtors.

Importantly, these reforms can be tested in the market. Once the modified terms are incorporated in agreements governing bonds issued by different sovereign debtors, we will be able to observe their effect on the incidence of holdout litigation. In particular, we will be able to observe whether the modified terms appear to limit disruptive litigation in sovereign bond restructurings. Moreover, we will be able to observe the effect of the modified terms on the prices of sovereign bonds. The resulting prices will indicate the value investors attribute to the modified terms and, indirectly, to the role of holdout litigation. If including terms that reduce the availability of litigation in a sovereign debt instrument results in the bonds bearing a higher interest rate than similar bonds that are not subject to the terms, the difference in interest rates would support the argument that holdout litigation provides value to investors. This evidence that the possibility of investors enforcing their rights through litigation adds value to sovereign bonds would suggest that enforcement rights should not be eliminated without careful analysis. In contrast, the failure of investors to demand a premium to purchase bonds subject to terms limiting the ability of holders to accelerate the principal amounts of the bonds or to initiate litigation against the sovereign debtor would suggest that investors view these actions as strategic behavior by holdout creditors and not as enhancing the value of the bonds.[339]

Despite the benefits of these modest reforms, sovereign debtors may adopt the modified terms we suggest only over an extended period of time, if they adopt them at all. Participants in the sovereign debt market may view the possibility of holdout litigation under existing debt instruments as valuable for both the restructuring process and the market itself, and so they may perceive reforms designed to limit this possibility as unnecessary or inappropriate.

[339] This result would be similar to the evidence indicating that bonds subject to CACs do not appear to trade at substantial discounts to similar bonds containing UACs. These studies are identified *supra* note 281.

Moreover, frictions in the market may delay the modification of existing terms in sovereign debt instruments. For example, participants in the sovereign debt market may have a strong preference for standard terms, not only across sovereign bonds issued by the same sovereign debtor but also across all sovereign bonds.[340] To the extent a sovereign debtor elects to include a new term, including one of the modifications we propose, in an agreement governing an issue of bonds, the debtor will incur costs in both drafting the term and in marketing the bonds with the new term to investors.[341] These costs may be sufficiently large to deter the introduction of new terms, particularly in cases in which the benefits of the new term are uncertain. Moreover, attorneys who represent sovereign debtors and attorneys who represent underwriters, play a mediating role in determining the terms to be included in an agreement governing an issue of bonds.[342] The attorneys may, despite the interests of their clients, be reluctant to negotiate, prepare, and implement new terms in the agreement as the costs to the attorneys are likely to be significantly greater than the benefits to the attorneys.[343] In fact, while limited, the available

[340] Some commentators, particularly legal scholars, have analyzed the preference for standard terms within the context of a bias in favor of the status quo. *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 359-62 (1996) [hereinafter Kahan & Klausner, *Path Dependence*] (analyzing the relevance of behavioral biases, including the status quo bias, for the persistence of standard contract terms); Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998) (analyzing the role of standard terms in form contracts in creating a bias among contracting parties for the status quo). Legal scholars have also analyzed this preference within the framework of network effects among terms in agreements, particularly agreements governing bonds. *See* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 587-90 (1995) (describing the role of standardization in facilitating the evaluation of complex terms in bonds); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997) [hereinafter Kahan & Klausner, *Standardization and Innovation*] (analyzing the role of learning externalities and network externalities in contributing to the standardization of terms in corporate contracts); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995) (analyzing the role of network externalities in determining terms in corporate contracts).

[341] *See* Klausner, *supra* note 340, at 782-86 (analyzing the importance of legal services network effects and marketing network effects in determining corporate contract terms). Robert Ahdieh has argued that legal services network effects may be particularly significant in the context of sovereign debt instruments and that marketing network effects may be the most important factor in influencing the preference for standard terms in sovereign debt instruments. Ahdieh, *supra* note 287, at 718-21.

[342] *See* Choi & Gulati, *supra* note 287, at 948, 974-80 (analyzing the role of attorneys in determining the terms contained in sovereign debt instruments, particularly standard terms); Kahan & Klausner, *Path Dependence*, *supra* note 340, at 353-58 (analyzing the importance of attorneys in determining the terms contained in corporate contracts, particularly standard terms).

[343] *See* Choi & Gulati, *supra* note 287, at 995-96 (describing the incentives of attorneys to favor standard terms in sovereign debt instruments); Kahan & Klausner, *Path Dependence*, *supra* note 340, at 353-58 (describing the reasons attorneys may favor standard terms in corporate contracts despite the interests of their

empirical evidence indicates that the preference for standardized terms retards the adoption of new terms in sovereign debt instruments and that attorneys play an important role in preserving the status quo in sovereign debt instruments.[344]

Finally, even if sovereign debtors were to modify their debt instruments in the manner we suggest, our approach is not without limitations. First, the utility of our approach depends upon the capacity of the sovereign debt market to price a variety of closely-related contractual terms. To the extent the market is not able to price these terms accurately—through the interest rate borne by the bonds or the discounts from principal amounts reflected in trading prices—our approach is of limited use. Yet, we expect that the market for sovereign debt is reasonably efficient. In addition, our proposal limits the ability of sovereign debtors to rely on contractual uncertainty in an effort to prevent the market from fully pricing the risks associated with clarification of the scope of litigation rights. Our proposal thus serves to enhance the efficiency of the sovereign debt market.

Second, the reforms we suggest are designed to balance the power of bondholders relative to sovereign debtors and the power of minority bondholders relative to the majority of the bondholders. The modifications we propose may not strike the appropriate balance. We may observe too little litigation—so that the check on opportunistic defaults is removed—or too much litigation—so that restructurings are disrupted by lawsuits that serve only the interests of the bondholders pursuing the litigation. Importantly, the incremental nature of our proposal, which allows the scope of litigation to be adjusted through modifications to the terms of subsequent issues of bonds, provides a process for responding to any problems that arise.[345]

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clients in customized terms); Korobkin, *supra* note 340, at 1594-95 (describing the benefits to attorneys of standardized terms).

[344] *See* Choi & Gulati, *supra* note 287, at 995-97 (drawing these conclusions from an empirical analysis of changes in the terms of sovereign debt instruments from 1995 to early 2004). *But see* Kahan & Klausner, *Standardization and Innovation*, *supra* note 340, at 742, 753-56 (detecting no evidence that attorneys assisted in the diffusion of learning benefits regarding new terms or that they promoted standardization by maintaining the consistency of new terms in trust indentures for corporate bonds issued between November 1988 and August 1993).

[345] The relationship of the litigation remedy to the restructuring process is likely to provide the impetus for continuing modifications. We have seen that the absence of litigation during the restructurings of the 1930s and the 1980s resulted in dramatic changes in the sovereign debt market. We can expect that not only too little but also too much litigation will impact the current restructuring process. Moreover, because the reforms we suggest will result in relatively minor modifications to the terms of sovereign debt instruments, we can expect that any changes in the market for sovereign bonds will be modest.

Third, the modifications we propose relate only to individual issues of bonds, and so they do not provide a means of making adjustments through the restructuring process to different issues of bonds. The modifications do, however, provide a means of gathering information regarding more fundamental changes in the terms of sovereign debt instruments and also the international financial architecture. At the same time, the modifications may serve as "small changes [that] may help lead to even larger, later changes"[346] that Professor Choi and Professor Gulati identify as an important factor facilitating changes in the sovereign debt market.

CONCLUSION

Proposals to reform the process of sovereign debt restructuring have proliferated, largely in response to a concern that disruptive and harmful litigation by holdout creditors threatens the viability of voluntary restructurings. We argue, however, that holdout litigation has emerged as a natural response to developments in the sovereign debt market, including concerns regarding opportunistic defaults by sovereign debtors and an increase in the heterogeneity among creditors. Judicial enforcement of sovereign debt obligations enhances the operation of the sovereign debt market by lowering the cost of financing to sovereign debtors and increasing the value of the obligations to creditors.

Broad reforms that rely on majority-driven decisionmaking or an international bankruptcy regime are premature. At the same time, they pay insufficient attention to important differences in creditor interests. Any reform demands a conception of intercreditor fairness that exceeds the scope of current reform proposals. A claim of unfairness to minority creditors will present the same threat of disrupting a proposed restructuring whether it is presented in a court in the United States or the United Kingdom, in an international bankruptcy court, or to an international development organization like the IMF. More importantly, regardless of the forum, creditors will have ample opportunity to pursue claims for strategic purposes in the hope of obtaining a superior payment.

[346] Choi & Gulati, *supra* note 287, at 934.