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

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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 such as the International Monetary Fund and the World Bank. Moreover, countries are subject to neither liquidation nor a standardized process of debt reorganization such as that provided by U.S. bankruptcy law. 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 the claims against the sovereign debtor is balancing the interests of the majority of the creditors with the interests 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 affect current restructurings of sovereign debt.

Recent commentators have criticized holdout creditors and have proposed mechanisms designed to reduce the power of holdouts – 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 functioning of the international capital markets. Accordingly, we suggest that, prior to the implementation of broad-based regulatory reforms, the value of holdouts be tested through a market-based approach. We propose several modifications to the contractual terms of the agreements governing sovereign bonds, which can be tested in the capital markets, 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 have resulted in widespread restructurings of sovereign debt. The challenge in these restructurings is to engineer a voluntary process by which the sovereign debtor and its creditors can negotiate a workable schedule of debt payments without irreparably damaging market confidence and the ability of sovereign debtors to secure additional financing in the future. Repayment terms that appear to be unreasonably low, extended restructuring processes during which debtors suspend payments on existing debt, and unequal treatment of creditors all threaten the long-term health of the international capital markets.

Importantly, the resolution of a sovereign insolvency differs from a corporate insolvency in several key ways. These include the financial sacrifices that a country is willing to make in order to service its debt obligations, the importance of political pressure, which may affect the willingness of creditors to lend money, and the prospect of resolving liquidity crises through funds provided by international development organizations such as the International Monetary Fund (IMF) and the World Bank. At the same time, countries are not subject to either liquidation or a standardized process of debt reorganization such as that provided by U.S. bankruptcy law. Instead, negotiations between the sovereign debtor and its creditors lead to a voluntary restructuring of the debt.

The restructuring process raises several related concerns. First, the fact that sovereign defaults are not constrained by the threat of liquidation or regulatory oversight exacerbates the problem of moral hazard. The sovereign debtor may resist making internal financial sacrifices that would enable it to pay the debt and instead choose to default – an opportunistic default. Second, even when the sovereign debtor is truly experiencing financial distress, the absence of a formal proceeding for evaluating the debtor's financial condition and for determining its ability to pay creates the risk of unreasonable restructuring terms. Third, the terms of a restructuring may discriminate against minority creditors.

Given the voluntary nature of the restructuring process, creditors may refuse to participate in the restructuring, and they may instead "hold out" in hope of receiving better terms of repayment or even being paid the full value of their claims. In this way, holdout creditors provide a check on opportunism by the sovereign debtor. Similarly, the prospect of holdout by minority creditors may also limit collusive behavior among the majority creditors in connection with the restructuring. At the same time, holdouts can disrupt the restructuring process by making it more expensive and by interfering with a socially desirable outcome in hope of receiving a nuisance payoff.

The increasing use of litigation in response to defaults by sovereign debtors has heightened concerns about holdout creditors. The question whether market-based reforms, such as the use of exit consents and collective action clauses, or regulatory reforms, like a sovereign debt restructuring mechanism, should be implemented to reduce the power of holdouts has acquired new urgency in the context of Argentina's current debt crisis,[1] which is the largest sovereign default in history.[2] Moreover,

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[1] In January 2002, the Argentine government announced that it would default on $141 billion in debt. Celeste Boeri, *How to Solve Argentina's Debt Crisis: Will the IMF's Plan Work?*, 4 CHI. J. INT'L L. 245 (2003).

[2] *Id.*

Argentina's initial restructuring proposal, which contemplates paying creditors approximately 25% of the face value of the debt,[3] has spurred unprecedented levels of litigation.[4]

This Article responds to recent proposals to constrain the role of holdout creditors by advocating restraint. Although the holdout creditor may present a risk of interference with the restructuring process, the Article argues that holdouts also provide a valuable function in the restructuring process. Accordingly, the Article cautions against proposals that would eliminate the ability of holdouts to litigate against sovereign debtors. Instead, the Article proposes more narrowly tailored refinements to the litigation remedy that can be implemented through market-based changes in the terms of the agreements governing sovereign bonds. The reaction of the market to these changes offers a valuable opportunity to evaluate the role of the holdout creditor.

This Article proceeds as follows. Part I describes 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 and then considers the primary proposals for limiting holdout litigation. Part III offers an evaluation of the role of these holdout creditors and, based upon this evaluation, suggests modest alterations to the restructuring process. Specifically, we emphasize the role holdout creditors may play in maintaining the balance between the interests of the majority of creditors and the interests 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 both promoting the balance between interests and protecting the markets, while working toward a consensus regarding alterations to the international financial architecture.

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 or not 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's ability to make these assessments, however, is limited. The creditor is constrained in its ability to acquire full information about the debtor and its financial condition. Additionally, both the probability of default and the amount of recovery upon default will vary with events that occur after the making of the loan, including events resulting from the debtor's actions and events that are beyond the control of the debtor.[5]

Sovereign debt, however, differs from commercial debt in several important ways. First, 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

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[3]*See* Angela Pruitt, *Argentine Bonds May Weaken More*, WALL ST. J., Sept. 24, 2003, at C15 (describing proposed haircut).

[4]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 more than $750 million in lawsuits from disgruntled creditors).

[5]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).

make the required payments; that is, the debtor may default opportunistically.[6] Moreover, in the event a default occurs, the creditor may be subject to political pressure regarding the restructuring of the loan. International development organizations, including the IMF, may become involved in the restructuring process, providing short-term liquidity while, at the same time, mandating the macroeconomic policies to be followed by the debtor.

In many instances in which a creditor makes a loan to a sovereign debtor, all of these factors will be present, interacting with one another. This interaction complicates the creditor's analysis of the sovereign debtor's financial position, the likelihood of default as well as the likely recovery upon default, and in the event a default occurs, the expected path of the restructuring process. 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. The extent of these difficulties may be exacerbated by poor macroeconomic policies that result in stagnation.[7] In this situation, the sovereign debtor may, regardless of its ability to make payments on the loan, opportunistically default on the loan.[8] The default would make available to the sovereign debtor funds for use in ameliorating 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.[9] At the same time, the default may result in political pressure on the creditor to make additional loans to the sovereign debtor.

The risk that a sovereign debtor may opportunistically default on a loan exacerbates the problem of "debtor moral hazard"[10] in the context of sovereign debt. In the case of a loan to a sovereign debtor,

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

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

[8]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, *Sovereign Risk: Bank Deposits vs. Bonds*, MOODY'S INVESTORS SERVICE, GLOBAL CREDIT RESEARCH, 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) (unpublished manuscript, on file with the authors).

[9]*See, e.g.*, Francios P. Gianviti, *Resolution of Sovereign Liquidity Crises: Basic Concepts and Issuers*, *in* CURRENT LEGAL ISSUES AFFECTING CENTRAL BANKS 309, 312-13 (Robert C. Effors, ed., 1998) (describing negative consequences to citizens of measures taken to assure payment of amounts due on loans made to sovereign debtors). *See also* Truglia, *supra* note 8, at 5 (noting that "the real question is – what level of resource mobilization are [sovereign debtors] willing to undertake to repay their debts?").

[10]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 AND JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 165, 189-90 (1992). In the parlance of Professor Fischel, these conditions give rise to debtor misbehavior. Fischel, *supra* note 5, 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 6, at 4.

the creditor has a paucity of remedies in the event the sovereign debtor defaults on the loan. The creditor may not seek a liquidation of the sovereign debtor in order to distribute the proceeds of sales of the sovereign debtor's assets in satisfaction of the amounts due under the loan;[11] instead, the creditor must pursue a restructuring of the loan.[12]

In the event creditors are not able to protect themselves from opportunistic defaults, and so limit the losses associated with debtor moral hazard, access to loans will be restricted and borrowing costs will be higher.[13] Both creditors and sovereign debtors, then, have interests in developing mechanisms for limiting the possibility of opportunistic defaults.[14] As a general matter, these efforts, together with the other terms of the bargains between the creditor and the debtor, are reflected in the terms of the agreement governing the loan.[15] In particular, a loan agreement provides the creditor with the right to enforce its claim against the debtor under specified circumstances, and the agreement contemplates that enforcement will involving filing suit in court.[16] Litigation, then, may be seen as a check on the possibility of

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[11]William W. Bratton & G. Mitu Gulati, *Sovereign Debt Restructuring and the Best Interests of Creditors*, [ ] VAND. L. REV. (forthcoming [Mar.] 2003) (manuscript at 12, on file with the authors).

[12]As a general matter, litigation remedies are of limited value because of the difficulties in enforcing a judgement against the sovereign debtor. As a general matter, obligations of a sovereign debtor can not successfully be directly enforced in the courts of the sovereign debtor itself. Rather, the creditor must pursue the action in the courts of the jurisdiction designated in the agreement governing the loan, typically located in the United States or the United Kingdom. Moreover, the creditor must rely on the assets of the sovereign debtor located in that same jurisdiction to satisfy any judgement against the sovereign debtor. In the typical case, however, the sovereign debtor will not have substantial assets in the designated jurisdiction. *See* Bratton & Gulati, *supra* note 11, at 11-12 (describing inadequacies of litigation remedies).

[13]See Roubini & Setser, *supra* note 6, at 4 (observing that creditors will refuse to make loans to some creditworthy debtors because of their inability to assess the likelihood of default).

[14]A costly restructuring process will also deter opportunistic defaults by raising the cost to creditors of defaulting. *See, e.g.*, Michael Dooley & Sujata Verma, Rescue Packages and Output Losses Following Crises (June 2001) (unpublished manuscript, on file with the authors) (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); 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). 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 8, 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").

[15]*See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982) (describing a loan agreement as "the sum of the rules or agreements defining the relationship of certain participants in the business to other participants (and among themselves) and, as such, a reflection of the trade-offs among the elements").

[16] Specific elements of the loan agreement explicitly contemplate enforcement litigation, including the debtor's waiver of sovereign immunity, choice-of-law provisions in 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 initiation of litigation.

opportunistic defaults on sovereign debt, which, in turn facilitates the functioning of the international capital markets.

For debt securities issued in the capital markets by sovereign nations, the impact of all these factors – the difficulty in obtaining information regarding the financial policies and position of the issuer, the likelihood of default and the likely recovery on default, the potential for opportunistic default, the possibility of political pressure, and the probability of involvement by the IMF – is reflected in the prices of the securities.[17] Participants in the markets collect information, and, taking into account the nature of the data, they consider all of these factors in estimating the value of the debt securities in the markets. Based on these estimations, participants buy and sell the securities, which, in turn, allows the prices of the debt securities to reflect the aggregate impact of these considerations on the values of the securities.[18]

B. Background to Litigation - The Sovereign Debt Markets

Concerns regarding opportunistic defaults, and the role of the restructuring process in limiting these defaults, have long been part of the fabric of the sovereign credit markets. These concerns have been prudent as the history of 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, of course, the current crisis. A review of the past crises provides a framework for analyzing the role of holdout litigation today.[19] In particular, a historical perspective highlights the importance of developments in both the capital markets and in the courts to the emergence of holdout litigation.

As the capital markets have developed, diverse creditors have come to hold sovereign debt, particularly sovereign bonds. The differing interests of these creditors hinder the ability of participants in the restructuring process to secure universal agreement to proposed terms. At the same time, creditors have gained access to the judiciary. As a result, rather than simply rejecting restructuring plans, dissenting creditors may pursue their claims against sovereign debtors in court. The combination of these two developments may be viewed as providing the platform for the holdout litigation present in the current crisis.

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[17]For all securities issued in the capital markets, the efficient capital markets hypothesis predicts that market prices reflect available information. *See* STEWART C. MYERS & RICHARD A. BREALEY, PRINCIPLES OF CORPORATE FINANCE 347-51 (2003). As James Tobin first noted, additional information, including information that is not relevant to the fundamental values of the securities, may also be reflected in the prices of the securities. James Tobin, *On the Efficiency of the Financial System*, 153 LLOYDS BANK REV. 1 (1984). This insight formed the basis of noise theory. *See, e.g.*, Schleifer & Summers, *The Noise Trader Approach to Finance*, 4 J. ECON. PERSP. 19 (1990); J. Bradford DeLong et al., *Noise Trader Risk in Financial Markets*, 98 J. Pol. Econ. 703 (1990).

[18]*See* Ronald J. Gilson & Renier Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984) (describing the role of trading in efficient capital markets).

[19]*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, *supra* note 8, at 6 (describing study of past sovereign defaults as a useful tool in providing insights into possible future developments).

1. The Crisis of the 1930s

Following World War I, foreign governments began to issue large amounts of bonds in New York City.[20] In the early 1920s, the principal issuers of sovereign bonds were Argentina, Brazil, Chile, and Cuba.[21] 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."[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 then 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 protective committees to negotiate with sovereign debtors.[28] Initially, in the United States, these committees were *ad hoc* committees formed by

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[20]Truglia, *supra* note 8, at 7. As a general matter, banks arranged loans that were then floated as tradeable securities in the market. *Id.* In addition, the banks provided trade finance and other short-term credit. *Id.*

[21]Erika Jorgensen & Jeffrey Sachs, *Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period*, *in* THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE 53 (Barry Eichengreen & Peter H. Lindert eds., 1989).

[22]*Id.* at 56. According to analyses conducted during the time of the crisis, between 1920 and 1929, sovereign debtors in Latin America issued bonds totaling $2.2 billion in value. JOHN MADDEN ET AL., AMERICA'S EXPERIENCE AS A CREDITOR NATION 74 (1937). The proceeds of these bond issuances, as a general matter, were used to bolster reserves, balance government deficits, and finance current expenditures. Albert Fishlow, *Lessons from the Past: Capital Markets during the 19th Century and the Interwar Period*, 39 INT'L ORG. 383, 419-20 (1985).

[23]For a description of these difficulties, see Jorgensen & Sachs, *supra* note 6, at 57 (noting 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 as import duties constituted the principal source of governmental revenue) and Vinod K. Aggarwal, *The Evolution of Debt Crises: Origins, Management and Policy Lessons*, *in* SOVEREIGN DEBT: ORIGINS, CRISES AND RESTRUCTURING 13 (Vinod K. Aggarwal & Brigitte Granville eds., 2003) (noting that the depression "crushed the debt servicing prospects of . . . Latin American debtors").

[24]Jorgensen & Sachs, *supra* note 21, at 58.

[25]*Id.*

[26]Aggarwal, *supra* note 23, 38, 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, however, pursued redress through the banks that participated in the issuance of the bonds. The banks, having served as the underwriters for the bonds, had relationships with the sovereign debtors as well as the ability to contact all the bondholders. Upon receiving complaints from bondholders, the banks either

bondholders to negotiate with each sovereign debtor in default on its bonds. 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 among committees in negotiations with sovereign debtors.[30] In response to these problems, the State Department sponsored the formation of a working party to develop plans for the creation of a permanent organization to represent bondholders, and, in 1933, the Foreign Bondholders Protective Council was organized.[31] The Council derived authority from its status as a statutorily-created institution, but the Council lacked the power to bind bondholders.[32] Instead, the Council recommended settlements to bondholders, and the bondholders accepted or rejected the settlements.[33] Further concessions from sovereign debtors, however, were rare once the Council recommended a settlement to the bondholders as the Council then ceased negotiations on behalf of the bondholders.[34]

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.[35] As a consequence of these protracted negotiations, the market for sovereign bonds evaporated. 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.[36]

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established a means of acting directly for the bondholders or financed a protective committee to act in the interests of the bondholders. Yet, the banks lacked incentives to seek meaningful compensation for the bondholders as the banks were the fiscal agents for the bonds and they desired to maintain favorable relationships with sovereign debtors as a means of securing additional financing opportunities. As a result, the claims of the bondholders remained unsatisfied. *See, e.g.*, SEC REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Pt. V, 512-31 (1937) (critiquing the pursuit of claims through the banks); Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 338, 305 (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 16 (Barry Eichengreen & Peter H. Lindert eds., 1989) [hereinafter Eichengreen & Portes (Deluge)].

[30]BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 21 (1995) [hereinafter EICHENGREEN & PORTES (WHAT CRISIS)].

[31]Eichengreen & Portes (Deluge), *supra* note 29, at 16. Similar associations of bondholders existed in the United Kingdom and France, as well as in other creditor countries. *Id.* at 15-16.

[32]Macmillan, *Debt Work-out System*, *supra* note 28, at 84.

[33]*Id.*

[34]Jorgensen & Sachs, *supra* note 21, at 70.

[35]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 finally reached in 1958. EICHENGREEN & PORTES (CRISIS), *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, 38, at 13.

[36]Aggarwal, *supra* note 23, 38, at 14; EICHENGREEN & PORTES (CRISIS), *supra* note 30, at 22-23.

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, Western Europe, and Japan became the principal source of loans to sovereign debtors in Latin America.[37] In August 1982, however, Mexico declared that the country could no longer service its debts to foreign creditors,[38] notably commercial banks.[39] In the following months, Brazil, Argentina, Bolivia, and Venezuela made similar announcements.[40] And, in the following years, many sovereign debtors fell into arrears on their debts, and several sovereign debtors suspended debt service altogether.[41]

In response to this crisis, the commercial banks formed bank advisory committees to negotiate with sovereign debtors.[42] While the official role of a bank advisory committee was to serve as a conduit of information between the sovereign debtor and the commercial banks that had made loans to the debtor,

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[37]Following the dramatic increase in oil prices in 1973, many Latin American countries began to rely on loans from commercial banks to finance their imports of oil. The increase in oil prices provided both the funds and the incentives for commercial banks to make loans to these sovereign debtors. The oil-exporting countries, unable to spend the revenues they received from their exports on imports, deposited surplus "petrodollars" in commercial banks located in the United States, Western Europe, and Japan. The commercial banks, seeking high rates of return on investments of the deposited petrodollars, faced limited demand for loans among the industrialized countries as economic recessions in these countries reduced the need for capital. These banks, then, sought alternative borrowers, recycling the petrodollars into loans to sovereign debtors, especially the governments of emerging market economies of Latin America. *See* LEX RIEFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 154 (2003); Stephen Bainbridge, *Comity and Sovereign Debt Litigation: A Bankruptcy Analogy*, 10 MD. J. INT'L L. & TRADE 1, 5 (1986).

[38]The difficulties in servicing debts to foreign creditors stemmed from a combination of factors. The oil crisis in 1979 resulted in additional increases in oil prices, Mexico, as well as other Latin American countries, relied on additional loans from commercial banks to finance their imports of oil. The recession of the early 1980s was accompanied by a fall in raw material prices, which reduced the export revenues on which these countries relied to service their loans. In addition, in 1981 the Board of Governors of the Federal Reserve raised interest rates, which increased borrowing costs. *See* RIEFFEL, *supra* note 37; Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructurings*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159 (2000).

[39]At the end of 1982, the total value of Mexico's external borrowing was $78 billion, of which more than $32 billion was owed to commercial banks. RIEFFEL, *supra* note 37, at 157 (citing WORLD BANK, GLOBAL DEVELOPMENT FINANCE (2002)).

[40]*See* Philip J. Power, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2708 (1995) (describing defaults among sovereign debtors in Latin America).

[41]*See* Truglia, *supra* note 8, at 10 (stating that "[a]ll told, approximately [fifty] countries have defaulted on their sovereign and commercial obligations since August 1982.").

[42]As a formal matter, the sovereign debtors appointed the committees. Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. ILL. L. REV. 493, 506 n.40. In many ways, the bank advisory committees were successor committees to the bondholder protection committees. 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." *See* Daniel McGovern, *Different Market Windows on Sovereign Debt: Private-sector Credit from the 1980s to the Present*, *in* SOVEREIGN DEBT: ORIGINS, CRISES AND RESTRUCTURING 82-83 (Vinod K. Aggarwal & Brigitte Granville eds., 2003).

as a practical matter the committees negotiated the terms of restructurings of loans directly with sovereign debtors.[43] The committees, however, lacked the authority to bind the commercial banks to the agreements reached with sovereign debtors.[44] Rather, the committees advised the banks of the terms of the agreements, and then the committees sought ratification of the agreements.[45]

Typically, bank advisory committees were comprised of between ten and fifteen members.[46] The commercial bank holding the largest claim against the sovereign debtor served as the chair of the committee, and the commercial banks with significant claims, based on the geographic concentration of the loans, served as the other members of the committee.[47]

The bank advisory committees, in negotiating restructurings of sovereign loans, adhered to a principal of treating all commercial banks equally.[48] More specifically, the committees sought to ensure

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[43]*See* Power, *supra* note 40, at 2712 (describing the role of bank advisory committees). At the time Mexico declared that the country could no longer service its debts to foreign creditors, more than five hundred commercial banks were listed as creditors of record. Buchheit & Reisner, *supra* note 42, at 505. In addition, "Mexico probably had many additional commercial bank creditors that had acquired Mexican credit exposure by purchasing sub-participations in loans arranged by other banks." *Id.*, n. 36. Thus, negotiations between a sovereign debtor and each of the creditors extending loans to the debtor were not feasible.

[44]The committees were neither chosen nor formally designated by the banks as their representatives. Buchheit & Reisner, *supra* note 42, at 506. Moreover, upon the declaration of a *moratorium* on the servicing of obligations, including commercial loans, each commercial bank had the right to pursue legal remedies against the debtor. *Id.* at 504.

[45]*See* Charles Lipson, *Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, *in* COOPERATION UNDER ANARCHY 207, 218 (Kenneth A. Oye ed., 1986) (describing the process by which bank advisory committee developed restructuring plans).

[46]Robert K. MacCallum, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks* Inter Sese, 1987 COLUM. BUS. L. REV. 425, 437.

[47]The members of the committees were typically international commercial banks based in the United States, the United Kingdom, Germany, Japan, Switzerland, France, and Canada. As a general matter, each member of the committee bore responsibility for securing the ratification by a specific group of smaller banks of the agreement reached with the sovereign debtor. *See* MacCallum, *supra* note 46, at 437-38 (describing the membership of the bank advisory committees); Lipson, *supra* note 45, at 60 (describing the tasks of the bank advisory committees).

[48]Sovereign debtors also followed the principle of equal treatment of creditors. Buchheit & Reisner, *supra* note 42, at 505-06. In announcing that a restructuring had commenced, a sovereign debtor included assurances that all commercial banks would be treated equally. Id. at 505. 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 bank creditors to the [debtor] confirming their wiliness to forebear from exercising their legal rights *if* the international banking community as a whole evidences a similar restraint.

Id. (emphasis in original).

the uniform treatment of assets – like assets were to be treated alike,[49] and they also sought uniformity in "the important areas of pricing, fees, tenor, amortization, and legal documentation."[50] In this way, the bank advisory committees sought to minimize the costs associated with the restructuring process. By following a basic principle of uniformity, the bank advisory committees minimized the period of time needed to complete the negotiations with sovereign debtors.[51] 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.[52]

Although the members of the bank advisory committees and the other commercial banks supported the principal of treating all banks equally as a means of reducing the transactions costs of the restructuring process, 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 point of agreement. The principal reasons for disagreements among the banks were differences in the sizes of the loans the banks had made relative to their total assets and differences in the regulations to which the banks were subject.

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 assets.[53] 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 "non-performing" in the event interest accrued on the loan was not paid within ninety days after its due date.[54] Regulations also required that all banks set aside adequate reserves for non-performing

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[49]Lipson, *supra* note 45, at 211. Some loans were treated differently from those made by commercial banks. Very short-term obligations such as suppliers' credits and trade-related credits were generally not included within the restructuring process. Buchheit & Reisner, *supra* note 42, at 515. Officially guaranteed loans were generally the subject of negotiations with the creditor governments, working informally through the Paris Club. Lipson, *supra* note 45, at 212. Publicly issued bonds were "good candidates for exemption from a restructuring," Buchheit & Reisner, *supra* note 42, at 515, "because they [were] widely dispersed, and because each holder [had] legal rights to petition for default if payments [were] not made on schedule." Lipson, *supra* note 45, at 212. The commercial banks "usually agreed to let [sovereign debtors] stay current on their obligations to bondholders." RIEFFEL, *supra* note 37, at 110.

[50]Buchheit & Reisner, *supra* note 42, at 506. 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.*

[51]Charles Lipson explains the norm of uniformity has "the great advantage of speeding negotiations. . . not only minimizes negotiating time in the first rescheduling, but also makes subsequent reschedulings much easier," and "by creating a clear standard, it also "eases negotiations with other [sovereign debtors]." Lipson, *supra* note 45, at 212.

[52]Id.

[53]*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 KELESTSKY, THE COSTS OF DEFAULt 112, tbl. 6.3 (1985)).

[54]*See* Power, *supra* note 40, at 2710 (describing applicable regulations).

loans, called "loan-loss reserves."[55] Since the total value of the loans made by large commercial banks in the United States exceeded the total values 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, in negotiating restructurings with sovereign debtors, worked diligently to avoid defaults.[56] Specifically, the bank advisory committees devised a plan for the restructurings in which sovereign debtors continued to pay interest on the loans as it came due.[57] This plan, however, required the commercial banks to make additional loans to the sovereign debtors because the sovereign 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] proportionate to the bank's aggregate credit exposure to the country on that date."[58]

Large commercial banks located in the United States, with portfolios of loans to sovereign debtors in excess of the value of their assets, readily supported the plan, including the making of new loans, as the plan provided a means for these banks to avoid insolvency.[59] These banks had two additional reasons for supporting the plan. 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.[60] These services, however, were only the starting point for the businesses the banks hoped to develop. As Lex Rieffel describes:

> [s]ome banks were especially interested in trade credit for private sector importers and exporters and other short-term lending activities (such as interbank credit and deposits). Others were more interested in establishing branches or subsidiaries abroad to provide financial services (such as traveler's checks, credit cards, and foreign exchange trading) in which they had a comparative advantage

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[55]*Id.*

[56]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 all [commercial banks] to build up their capital sufficiently to absorb the shocks.").

[57]The plan also included rescheduling of the principal amounts of the loans. *See* Power, *supra* note 40, at 2709 (describing the restructuring process). In rescheduling a loan, a creditor permits payments due (or to become due) on the loan to be paid at times later than those specified in the loan agreement. MacCallum, *supra* note 28, at 430.

[58]Buchheit &Reisner, *supra* note 42, at 508.

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

[60]Lipson, *supra* note 45, at 212.

over local banks. Still others sought mandates to manage or hold foreign currency reserves.[61]

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,"[62] and so they expected to participate with one another in many negotiations regarding the restructuring of sovereign loans. In addition, these banks participated together in many loan syndications,[63] and they were linked to one another through a network of financial operations necessary to allow funds to flow through the international capital markets.[64]

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 plan. 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.'"[65] Declaring the loans made to sovereign debtors to be non-performing loans would not have threatened the solvency of these banks as they had adequate loan-loss reserves. In addition, for some of these banks, the sizes of their portfolios of loans to sovereign debtors were so small that the assets of the sovereign debtors located in the United States, and subject to attachment, were sufficient to have satisfied any judgements the banks may have won against the sovereign debtors.[66] Finally, the smaller banks did not have business relationships with sovereign debtors nor were they regular participants in the international capital markets. Accordingly, the smaller banks were not concerned about jeopardizing the development of future international business.[67]

The smaller commercial banks were particularly opposed to making new loans to troubled sovereign debtors, a practice they viewed as "throwing good money after bad."[68] In addition, these banks

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[61]RIEFFEL, *supra* note 37, at 106-07. Professor 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.

[62]RIEFFEL, *supra* note 37, at 111.

[63]*See* Lipson, *supra* note 45, at 211 (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. As a general matter, the lead manager of the syndicate negotiates the terms of the loan agreement with the debtor, and an agent bank, appointed pursuant to the terms of the agreement, administers the agreement. *See* Buchheit and Reisner, *supra* note 42, at 500 (describing nature of loan syndication process); MacMillan, *Debt Crisis*, *supra* note 28, n. 95 (describing the nature of syndicated loans).

[64]*See* Lipson, *supra* note 45, at 211 (describing the relationships among commercial banks).

[65]MacMillan, *Debt Crisis*, *supra* note 28, at 324.

[66]*See* Bainbridge, *supra* note 37, at 18 (describing the availability of litigation remedies to smaller commercial banks).

[67]Lipson, *supra* note 45, at 214 (describing the role of smaller commercial banks).

[68]Power, *supra* note 40, at 2711 The sovereign debtors, after all, were "self-declared insolvent debtors." MacMillan, *Debt Crisis*, *supra* note 28, at 324. *See also* 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

recognized that the larger commercial banks were facing a threat of insolvency, and so they had very strong incentives not only to make new loans as specified in the restructuring plan but also to commit additional funds to cover any shortfall in the value of the total loan package arising from the refusal of the smaller banks to make new loans.[69]

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. Yet, the bank advisory committees could not bind these banks to the terms of the agreements reached with sovereign debtors nor could they force the banks to assent to the plans. The bank advisory committees, then, sought the voluntary cooperation of the smaller banks in both ratifying the agreements and implementing the plans.

The members of the bank advisory committees themselves sought the cooperation of recalcitrant smaller commercial 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.[70] 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.[71] If necessary, officials of the large bank would warn the smaller bank that failure to cooperate might create difficulties for the smaller bank in purchasing participations in new syndicated loans, including loans to domestic borrowers. Finally, the officials might identify the risk that the smaller bank would develop a reputation as an "unreliable partner in difficult situations."[72]

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writing off their existing loan portfolios.").

[69]WILLIAM R. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE 75 (1984). *See also* MacCallum, *supra* note 46, at 435 (noting that the smaller banks, many of whom acquired portfolios of loan 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); MacMillan, *Debt Crisis*, *supra* note 28, at 324 (describing this situation as "the 'free-rider' problem in bank relations").

[70]In determining to serve as a member of the bank advisory committee, the large commercial banks generally recognized that this service included working to secure the cooperation of the smaller commercial banks. *See* Lipson, *supra* note 45, at 215 -18 (describing the calculus of the large commercial banks in determining to serve as members of bank advisory committees).

[71]These banking relationships were vital to the businesses of the smaller commercial banks as they provided access both to particpations 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, as the smaller banks generally lacked access to information regarding the financial positions of the debtors and, in restructurings, the repayment intentions of the debtors. In effect, the lack of information required smaller commercial banks to evaluate restructuring plans without conducting detailed analyses of the financial positions of the sovereign debtors or the terms of the agreements with the debtors. In addition, recalcitrant smaller commercial banks might be "blacklisted in international banking," but this sanction generally had limited effect as the smaller banks "rarely participated in international lending anyway." Lipson, *supra* note 45, at 220. For a description of the banking relationships on which the smaller banks relied, see Lipson, *supra* note 45, at 220 (describing, in general terms, the nature of the banking relationships); Power, *supra* note 40, at 2712 (describing the difficulties of the smaller commercial banks in gaining access to information regarding sovereign debtors); MacCallum, *supra* note 46, at 438 (describing the limitations on the depth of the analyses performed by the smaller banks).

[72]*See* Lipson, *supra* note 45, at 220 (describing the tactics used by large commercial banks in pressuring smaller commercial banks to support restructuring plans negotiated by bank advisory committees).

This pressure was often sufficient to cause reluctant smaller banks to ratify the agreements with the sovereign debtors and to the support restructuring plans.[73] In the event that it was not, additional pressure could be exerted by federal banking regulators.[74] 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 payment on their external indebtedness."[75] As the statute gave regulators broad discretion to determine whether or not a bank was required to maintain greater reserves, regulators were able to pressure reluctant banks to support restructurings.[76]

Finally, the IMF also exerted pressure, albeit indirectly, on recalcitrant smaller banks to ratify agreements with sovereign debtors and to support restructuring plans. In 1982, the IMF initiated the practice of conditioning any new loans to be made by the IMF to a troubled sovereign debtor on a commitment from all the commercial banks that had made loans to the debtor to make new loans.[77] 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 to receiving IMF loans.[78] The commercial banks, as a means of influencing the future macroeconomic policies of sovereign debtors, required each debtor to adopt the austerity program proposed by the IMF and to submit to monitoring by the IMF as a condition

[73]"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).

[74]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, *Relational Contract Theory and Sovereign Debt*, 8 NW. L. J. INT'L L. & BUS. 727, 742 n.82. *See* Power, *supra* note 40, at 2713 (describing regulators as being "able to cajole reluctant banks into rescheduling their outstanding loans and extending new loans when requested"); MacCallum, *supra* note 46, at 435 n.36 (noting that "the mere intimation of the possibility of enacting legislation or the taking of other action would ordinarily be sufficient to obtain adhesion to national policy").

[75]12 U.S.C. § 3904(a)(1)(A). *See also* 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 and Supervision Act.).

[76]Power, *supra* note 40, at 2713. *See also* Palzer, *supra* note 74, 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").

[77]*See* Lipson, *supra* note 45, at 23 (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 exposure).

[78]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.

to receiving new loans.[79] This structure of interrelated conditions among the IMF and the commercial banks served as a means of exerting pressure on recalcitrant smaller banks.[80]

In addition to the smaller commercial banks, commercial banks located outside the United States were also not inclined to support the restructuring plans negotiated by the bank advisory committees. As was the case with the smaller commercial banks, the primary basis for opposition was the requirement of making new loans to troubled sovereign debtors.[81] The bank advisory committees, of course, viewed this opposition as a threat both to the principle of treating all commercial banks equally and to the success of the restructuring plans. And, as was the case with recalcitrant smaller banks, the bank advisory committees themselves sought the cooperation of reluctant banks located in Western Europe.

In many ways, the process for securing the cooperation of reluctant foreign commercial banks was similar to the process for securing the cooperation of the recalcitrant smaller commercial banks. For large foreign banks, appeals were made to the interests of the banks in maintaining and developing relationships with sovereign debtors and in playing a significant role in the international capital markets. For smaller foreign banks, pressure was exerted through the immediate banking relationships on which the banks relied.

As a general matter, for commercial banks located in Western Europe, the ratio of the total value of the loans made to the governments of emerging market economies in Latin America to the total value of their assets was much lower than the same ratio for the large commercial banks located in the United States. Thus, the exposure resulting from the crisis in the Latin American sovereign debt markets was significantly lower for the Western European banks than for the large U.S. banks.[82] 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 interest accrued on the loan was not paid within ninety days after its due date.[83] The banks in Western Europe, as a result, preferred to capitalize accrued but unpaid interest – to add the interest (or at least a portion of it) to the principal amount of the loans, rather than to make additional loans to provide sovereign debtors with the cash needed to make interest payments on existing loans in a timely manner. But, of course, capitalized the interest would also threaten the solvency of the large commercial banks located in the United States.

This tension was resolved in favor of the large commercial banks in the United States, rather than the commercial banks in Western Europe, simply because the U.S. banks were able to commit credibly to

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[79] *See* Lipson, *supra* note 45, at 21 (noting that "[t]he difficult issue of the [sovereign debtor's] future policies [was] removed from the negotiations [regarding the restructuring of the loans made by commercial banks]. The [commercial banks] simply insist[ed] on I.M.F. conditional lending and supervision").

[80] *See, e.g.*, MacMillan, *Debt Crisis*, *supra* note 28, at 319 (noting that "the IMF effectively created a *quid pro quo* system in which the participation of the commercial banks, [sovereign debtors], and the IMF itself was conditioned on the cooperation of all the participants."); McGovern, *supra* note 42, 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.").

[81] *See* Lipson, *supra* note 45, at 212 (describing the objections of foreign commercial banks to the restructuring plans negotiated by bank advisory committees).

[82] *See, e.g.*, Lipson, *supra* note 45, at 210-13 (describing the greater vulnerability of U.S. commercial banks as compared to Western European commercial banks).

[83] *Id.*

supporting only restructuring plans that provided for new loans to sovereign debtors as any other plan would have led to their insolvency. The Western European banks, on the other hand, could not credibly refuse to support restructuring plans that provided for new loans because, while these plans were not the most preferred plans, they would not result in tremendous losses to the banks. At the same time, the large commercial banks in the United States urged the large commercial banks in Western Europe to support the restructuring plans favored by them (and, because of their credible commitment to the plans, the only viable plans) as a means of enhancing their relationships with sovereign debtors and their roles in the international capital markets.[84] Once the large commercial banks in Western Europe agreed to the restructuring plans, they, like the large commercial banks in the United States, used their relationships with smaller commercial banks, the immediate banking relationships on which the smaller banks relied, to pressure the smaller banks ratify the agreements negotiated with the sovereign debtors and to support the restructuring plans.[85]

Utilizing the various forms of pressure available to them – from the bank advisory committees, from federal banking regulators, and from the IMF – the commercial banks concluded forty-two debt restructurings with the governments of thirty-two countries during the period from 1982 to 1984.[86] Some of the restructurings were completed within a few months, while other restructurings were completed only after a period of several years.[87]

These restructurings, however, were followed by more restructurings. The restructuring of the debt owed by Mexico 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, so the country entered into a new series of negotiations that resulted in rescheduling loans in excess of $97 billion.[88] 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.[89]

The repeated restructurings caused strains among the commercial banks that participated in them. As Lee Buchheit notes:

> [t]he 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 [sic] banks; banks in North America versus banks in Europe, Japan and the

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[84]*Id*. at 209-19 (describing 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).

[85]Of course, once the large commercial banks in Western Europe agreed to support the restructuring plans favored by the large U.S. commercial banks, the banks had strong incentives to induce the smaller commercial banks in Western Europe to support the plans as the support of the smaller banks would reduce the size of the new loans the large banks were required to make.

[86]RIEFFEL, *supra* note 37, at 159.

[87]*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.

[88]*See* MacCallum, *Debt Crisis*, *supra* note 28, at 427 (describing the restructuring of Mexican debt).

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

> Gulf; banks with large loan loss reserve provisions versus banks without such provisions.[90]

These strains, and the resulting fissures, however, did not result in significant litigation.[91] 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."[92]

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[90]Lee C. Buchheit, *Majority Action Clauses May Help Resolve Debt Crises*, INT'L FIN. L. REV., Aug. 13, 1998, at [ ]

The bank advisory committees worked to minimize these strains and to limit the impact of the fissures. For example, commercial banks were, upon their request, occasionally granted permission to allocate their new loans to debtors of their choice within the country. In this way, the banks were permitted to select assets with limited risk and to maintain relationships with existing clients. In addition, restructuring plans were modified to provide a cushion in the event smaller banks refused to make new loans. Rather than providing for new loans in precisely the amount required to complete the rescheduling of all the loans, the restructuring plans provided for a small amount of additional loans so that if all the commercial banks were to make new loans as required by the plans, a small amount of excess financing would be provided (the loans would be slightly oversubscribed). *See* Lipson, *supra* note 45, at 219 (describing efforts of bank advisory committees to minimize the strains among commercial banks). 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 the sovereign debtor. RIEFFEL, *supra* note 37, at 122.

The bank advisory committees did not, though, "buy out' recalcitrant commercial banks as a means of minimizing the strains among the commercial banks. That is, they did directly not purchase the loans made by the recalcitrant banks. As Professor Lipson reports the views of a syndications manager in London, "no banks have ever 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 45, at 219.

[91]*See, e.g.*, RIEFFEL, *supra* note 37, at 159 n.17 (noting that none of the restructurings led by the bank advisory committees in the 1980s were disrupted by litigation); Cleary Gottlieb Steen & Hamilton, New York & Clifford Chance , London, *Avoiding the Nightmare Scenario*, INT'L FIN. L. REV., Aug. 1992, at 19 (noting that "[w]hen one considers that the debt crisis has offered more than U.S.$550 [billion] of provocation to potential plaintiffs, the number of lawsuits actually filed . . . over the last decade has been astonishingly small."); Bainbridge, *supra* note 37, at 3 (noting that the debt crisis of the 1980s "produced remarkably little litigation").

[92]Rieffel, *supra* note 37, at 159 n.17. The large commercial banks located in the United States did not pursue any claims in the courts, and they discouraged other commercial banks from seeking redress in the courts. *See* Buchheit & Reisner, *supra* note 42, at 504-05 (describing the situation among banks as "a kind of balance of terror").

In addition, 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 chances of actually recovering such amounts from the attachment and sale of limited sovereign assets in the United States was close to nil." Power, *supra* note 40,at 2744. *See also* James B. Hurlock, *The Way Ahead for Sovereign Debt*, Int'l Fin. L. Rev., July 1995, at 10-11 (noting that "it [was] much more difficult than often supposed to seize sovereign assets of any significance. Usually only limited assets exist outside the debtor country and much of that is legally immune from attachment.").

Finally, 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 supermajorty vote, to declare an event of default. Buchheit & Reisner, *supra* note 42, at 496. The syndicated loan agreements also contained several provisions that limited the recovery that any bank might receive through litigation. Sharing clauses, for example, required that in the event any member of a bank syndicate received any payment from the debtor, including in respect of litigation settlements or judgements, that exceeded the member's proportionate share of the syndicated

The strains among commercial banks and the fissures in 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 inter-bank swaps.[93] As the debt crisis deepened, many commercial banks became eager to sell, in the secondary market, the loans they had made to sovereign debtors.[94] Importantly, these banks were willing to sell their sovereign loans to purchasers for cash, even if the sales required the banks to sell the loans at prices reflecting substantial discounts from the face values of the loans.[95] By selling loans made to a particular sovereign debtor, a bank was able to reduce the proportion of the total loans made to that debtor held by the bank, thereby reducing the amount of new loans the bank would be required to make in future restructurings of the loans made to the sovereign debtor.

Initially, the loans were purchased by corporations seeking to make equity investments in the emerging market economies located in Latin America. The loans, together with debt-for-equity swaps with the sovereign debtors, provided an attractive means of obtaining the local currencies needed to make

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loan, the member must pay share the payment ratably with the other members of the syndicate. *See, e.g., id.*, at 497 n.9 (describing sharing clauses). Consequently, any member electing to sue the debtor would be required to share any payment received from the debtor in connection with the suit with the other members of the syndicate. In addition, cross default clauses provided that a default under other loan agreements to which the debtor is a party constituted a default under the loan agreement in which the clause is contained. *See, e.g., id.*, at 496 (describing cross default clauses). Consequently, a declaration of a default under one loan agreement would provide banks that had made loans to the debtor under other loan agreements containing cross default provisions with the right to pursue default remedies under their loan agreements.

[93]*See* Michael M. Chamberlain & Thomas E. Winsdale, *Regulating the LDC Debt Market*, INT'L FIN. L. REV., Aug. 1992, at 16 (describing the development of the market for inter-bank swaps).

The commercial banks participating in the market swapped loans to sovereign debtors in which they had relatively little confidence for loans to sovereign debtors in whom they had relatively more confidence. A commercial bank, for instance, may prefer to hold loans made to one sovereign debtor over loans made to another sovereign debtor if the bank has a better relationship with, and so perhaps a better chance of receiving payments from, the favored sovereign debtor. In addition, differences in applicable regulations may create differences among banks regarding the desirability of holding loans made to different sovereign debtors. *See* Lee C. Buchheit, *Legal Issues in Trading Sovereign Debt*, INT'L FIN. L. REV., Feb. 1986, at 18, 18 (noting that "as long as each side regards the credits it would acquire as marginally less impaired than those it would give up, then an asset trade deal is possible.").

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 in Debt Restructuring Techniques*, INT'L FIN. L. REV., Aug. 1992, at 10 (describing the mechanics of the secondary market).

[94]The secondary market provided a means for smaller commercial banks to exit from the business of making loans to sovereign debtors. *See* Macmillan, *Debt Crisis*, *supra* note 28, at 328 (noting the means by which commercial banks exited the international lending market).

[95]*See* Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401, 492. Upon such a sale, the banks were required to record on their balance sheets losses in amounts equal to the discounts. *See* MacMillan, *Debt Crisis*, *supra* note 28, at 328.

the investments – that is, the currencies needed to purchase plants and equipment.[96] Then, over the course of the next several years, more commercial banks sold the loans they had made to sovereign debtors in the secondary market at increasingly greater discounts. The resulting increase in supply and decrease in price attracted a large pool of investors.[97] These investors, rather than seeking to make equity investments in the Latin American emerging market economies, sought speculative gains.[98] Finally, sovereign debtors began purchasing their own loans in the secondary market. These debtors not only benefitted from purchasing their loans at steep discounts from their face values, but they also benefitted from reducing the total amount of loans outstanding, which, in turn reduced the amount of interest accruing on the loans.[99]

Despite the efforts of the bank advisory committees, and of the other commercial banks, in restructuring the loans made to the emerging market economies in Latin America, and despite the completion of dozens of restructurings, the emerging market economies in Latin America continued to

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[96]A corporation first purchased, in the secondary market, sovereign loans made to the country in which the corporation desired to make an investment. The corporation then sold the loans to the sovereign debtor for an equivalent amount of local currency. As a result, the corporation obtained the needed currency. At the same time, the sovereign debtor reduced the total amount of loans outstanding, and so also reduced the amount of interest accruing on the loans. *See* Power, *supra* note 40, at 2716 (describing the role of debt-for-equity swaps in development of the secondary market for commercial loans); Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401, 411 (describing the impact of the debt-for-equity swaps).

[97]*See* MacMillan, *Debt Crisis*, *supra* note 28, at 328 n.120 (noting that "[i]n 1986 the average price of the regional debt had already sunk to 65% of its nominal value, and it continued on a constant downward course until it hit 28% in 1989.") (citing Inter-American Development Bank, Economic and Social Progress Report in Latin America: 1990 Report 18 (1990)).

[98]The investors purchased loans made to a particular sovereign debtor in the expectation that, upon improvements in the country's financial position, the price of the sovereign loans would rise, allowing for a sale of the loans at a profit. *See* Tracy Corrigan, *Picking Up the Pieces of an Emerging Market*, FIN. TIMES, Apr. 5, 1994, at 17. The steep discounts from the face values of the sovereign loans would have allowed these investors to profit substantially in the event the sovereign debtors repaid even a small proportion of their outstanding loans. *See* MacMillan, *Debt Crisis*, supra note 28, at 328. Because interest on the sovereign loans accrued based upon the face value of the loans, interest payments made on loans purchased at discounts from their face values yielded a rate of return in excess of the market rate. James R. Kraus, *Trading in Third World Debt Soars as Investors Rush In*, AM. BANKER, Sept. 17, 1991, at 10.

[99]*See, e.g.*, Alberto G. Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 77-78 n. 88 (1991) (noting that in 1988, Bolivia repurchased its commercial bank loans with a face value of $240 million at a price of 11% and Chile repurchased its commercial bank loans with a face vale of $300 million at a price of 56% of its face value) (citing J.P. Morgan & Co., *LDC Debt Reduction: A Critical Appraisal*, WORLD FIN. MKTS., Dec. 30, 1988, at 6).

The commercial banks strongly objected to this practice, preferring that sovereign debtors use available dollar reserves to make payments due on their loans instead. Banks were particularly concerned that the proceeds from the new loans made to the sovereign debtors in the restructuring process might be used to purchase loans in the secondary market rather than paying the interest on the rescheduled loans. In light of these objections, sovereign debtors sought to purchase their loans without the knowledge of the commercial banks, particularly the bank advisory committees. *See* Power, *supra* note 40, at 2718 (describing the principal objections of the commercial banks to this practice).

falter.[100] In an effort to improve both the restructuring process and the outcomes of the restructurings, commercial banks, operating through bank advisory committees, introduced multi-year rescheduling agreements.[101] Yet, the debt crisis continued. In October of 1985, Secretary James Baker announced a new program for alleviating the debt crisis, a program entitled the "Program for Sustained Economic Growth" (Baker Plan).[102]

Although several restructurings were completed under the Baker Plan, during 1987 "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."[103] The need for these new techniques became apparent in the early part of the year, when Jose Sarney, the President of Brazil, declared a moratorium on payments to external creditors.[104] Then, in April of 1987, Citibank announced that the bank would record a loss of $2.5 billion in order to increase its loan-loss reserves from $2 billion to $5

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[100]While growth remained relatively weak, consumer price inflation rose substantially. Over the same period, the total value of loans made to the governments of these countries declined dramatically. *See* Inter-American Development Bank, Economic and Social Progress Report in Latin America: 1990 Report 15 (1990) (describing the difficulties confronting the emerging market economies in Latin America).

At least one commentator has suggested that this decline in commercial bank loans, particularly during the period from 1984 to 1986, resulted not so much from concerns regarding the financial positions of the sovereign debtors (and the macroeconomic difficulties they faced) as from increases in the number of recalcitrant commercial banks. To the extent the sovereign debtors adhered to their austerity programs and their economies improved, demand for commercial bank loans declined so that continued lending at the same volume of loans was not necessary. *See* Paul Krugman, *Private Capital Flows to Problem Debtors*, *in* DEVELOPING COUNTRY DEBT AND ECONOMIC PERFORMANCE (Jeffrey D. Sachs ed., 1989).

[101]The agreements were designed to reduce the time and expense of annual restructurings as well as to form a basis for the banks to exit the market. 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 rate 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 multi-year 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 multi-year rescheduling agreements. *See* RIEFFEL, *supra* note 37, at 162-63 (describing the experiences with multi-year rescheduling agreements).

[102]Christine A. Bogdanowicz-Bindert, *World Debt: The United States Reconsiders* 64 FOREIGN AFF. 259, 267 (1985). The Baker Plan sought to provide additional loans to sovereign debtors, from both official sources and private sources. *See* Rieffel, *supra* note 37, at 163 (describing the Baker Plan). The availability of these additional loans, however, was subject to the commitment, by each sovereign debtor receiving the loans, to implement reforms in three areas – import barriers, restrictions on foreign investment, and money-losing state enterprises – all of which were deemed to be important for achieving long-term growth. The IMF was to supervise each debtor in its efforts to implement these policies. Id.

[103]A restructuring of the loans made to Mexico was completed in March of 1987, a restructuring of the loans made to Argentina was completed in August of 1987, and a restructuring of the loans made to Brazil was completed in November of 1988. RIEFFEL, *supra* note 37, at 164. The success of the Baker Plan, as a general matter, is difficult to determine. Experts disagree as to whether or not the additional loans made to sovereign debtors under the Plan were sufficient to meet the targeted amounts set forth in the Plan. *Id. But see* MacMillan, *Debt Crisis*, *supra* note 28, at 327 (arguing that the Brady Plan "failed to maintain bank lending").

[104]RIEFFEL, *supra* note 37, at 165.

billion, an amount equal to 25% of the bank's exposure to loans made to sovereign debtors in the emerging market economies.[105] Other large commercial banks in the United States soon made similar adjustments, and a second round of adjustments was announced later in the year.[106] In the next year, 1988, commercial banks located in Western Europe and Japan followed the lead of the U.S. commercial banks in increasing provisions for loans made to sovereign debtors in emerging market economies.[107]

On March 10, 1989, in a speech at the Brookings Institution, Secretary of the Treasury Nicholas Brady articulated a series of new principles for resolving debt crises, which became known as the "Brady Plan."[108] These principles included a reduction in the total amount of debt owed by sovereign debtors in

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[105]*See* MacMillan, *Debt Crisis*, *supra* note 28, at 327 (describing changes in provisionings for loans to sovereign debtors in Latin America); RIEFFEL, *supra* note 37, at 165 (same).

[106]RIEFFEL, *supra* note 37, at 164.

[107]*Id.* The increases in loan-loss reserves, and the consequent decreases in loan exposure, eliminated, for the large commercial banks located in the United States, the threat of insolvency. 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. PAP. & PROC. 165, 165-70 (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, Economic and Social Progress Report in Latin America: 1990 Report 14 (1990). In 1989, reserves represented 30% of the value of loans to these sovereign debtors. *Id.*

The elimination of the threat of insolvency dramatically reduced the incentives of these banks, in serving as members of bank advisory committees and in negotiating the restructuring of loans made to sovereign debtors, to work diligently to avoid defaults on the loans. More importantly, the elimination of the threat of insolvency deprived these banks of their basis for credibly committing to support only their most preferred agreements with the sovereign debtors and, consequentially, their most preferred restructuring plans. The result, of course, was to weaken an important force for imposing cohesiveness among the commercial banks that had made loans to sovereign debtors.

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 declines in the prices of the loans in the secondary market. At the beginning of 1987, the average price for sovereign loans in the secondary market was sixty-seven cents on the dollar. By the middle of the year, the price had fallen to forty-five cents on the dollar. The lowest price, thirty-two cents on the dollar (based on a weighted average), was observed in 1989. *See* RIEFFEL, *supra* note 37, 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 the commercial banks.

[108]*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 69-83 (Edward R. Fried & Philip H. Trezise eds., 1989) (outlining principles for resolving debt crises). As Professor Rieffel notes, "[i]n one sense, the Brady Plan contained nothing new. Virtually all of the elements could be found in one or more f the rescheduling deals completed in the 1987-88 period." RIEFFEL, *supra* note 37, at 170.

The first restructuring under the Brady Plan involved the debt Mexico owed to foreign creditors. The negotiations regarding the restructuring, despite the new plan, were difficult. As starting points, the bank advisory committee proposed that the bonds be issued in an aggregate principal amount representing a 15% discount from the total principal amount of the loans, while Mexico proposed a discount of 55%. When the negotiations stalled, Secretary Brady invited the members of the bank advisory committee and the governmental officials from Mexico to Washington, D.C. to discuss the status of the restructuring. The negotiations then resumed in a conference room at

exchange not only for a commitment on the part of the debtors to adopt macroeconomic reforms and structural reforms (notably the privatization of state-owned entities) designed to achieve sustainable growth, but also for greater assurances of the collectability of the debt. In addition, these principles included the use of a variety of options for the debt to increase liquidity in the international capital markets. Finally, these 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.[109]

To implement these policies, the loans made by the commercial banks to each sovereign debtor participating in the Brady Plan were securitized. Specifically, the loans were pooled together, and then the loans were exchanged for bonds, called Brady bonds.[110] The bonds were sold publicly through the international capital markets to investors, and the proceeds from the sale of the bonds were used to repay the loans to the commercial banks. As a result of these transactions, the debtor's debt to the commercial banks was extinguished, and the commercial banks were able to "exit" the market for loans to sovereign debtors.[111] The bonds, representing the debt of the sovereign debtor, were held by investors.

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the Treasury Department, with Undersecretary David Mulford working with the parties to help refine the amount of official support required to complete the restructuring. The restructuring, which was completed in March of 1990, included a par bond and a discount bond reflecting a 35% discount from the principal amount of the loans, both of which were collateralized with thirty-year, zero coupon Treasury bonds and further enhanced with additional collateral in respect of the total interest accruing over a period of eighteen months. For a description of the debt owed by Mexico under the Brady Plan, see RIEFFEL, *supra* note 37, at 174.

[109]*See*, Rieffel, *supra* note 37, 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. Previously, the IMF required sovereign debtors to eliminate arrears to both official creditors and commercial banks (and other private creditors) before the IMF would provide additional loans. In this way, the IMF sought to reinforce incentives to satisfy contractual obligations. During the restructurings under the Brady Plan, however, the IMF would provide 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). *Id*.

[110]*See* Power, *supra* note 40, at 2720 (describing the securitization process used in connection with the issuance of Brady bonds).

[111]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, to the loans from which they were converted. 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." RIEFFEL, *supra* note 37, at 170. 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 interest 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 prevailing rate in the market. 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, as a general matter, had a maturity of thirty years, which was substantially longer than the maturity of the loans. *See*, RIEFFEL, *supra* note 37, at 172 (describing the menu of options offered under the Brady Plan); Power, *supra* note 40, at 2721-22 (describing the characteristics of the Brady Bonds).

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, the principal amount of the bonds was collateralized with thirty-year, zero-coupon U.S. Treasury bonds that were purchased with a combination of credit from the IMF and loans from the World Bank and the Inter-American

The Brady Plan effectively resolved the debt crisis of the 1980s.[112] Although regulators initially viewed Brady bonds as "appropriate only for a limited audience of speculative investors," the high rate of return provided by the bonds attracted many investors.[113] As the market for sovereign bonds grew, the governments of the emerging market economies, particularly in Latin America, both realized that they could access the bond markets for a significant portion of their financing needs and implemented strategies to access these markets. One of the most important advantages of bonds was 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 inter-company comparisons of the risks associated with the bonds, which, in turn, facilitate daily market pricing and buying and selling in the market, all of which serves 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 main form of private capital flows to emerging market economies.[114]

Development Bank, as well as with reserves of the debtor. 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 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, U.S. 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*, RIEFFEL, *supra* note 37, at 172 (describing the enhancements used to support the Brady Bonds); Power, *supra* note 40, at 2721-22 (describing the characteristics of the Brady Bonds).

[112]*See* RIEFFEL, *supra* note 37, at 176 (describing the impact of the Brady Plan). 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 Scott, A Bankruptcy Procedure for Sovereign Debtors? (Feb. 2003) (unpublished manuscript, on file with the authors). William Cline, studying the restructurings undertaken by thirteen countries between 1988 and 1995, notes that these restructurings involved a total of $190 billion of loans made by commercial banks, and a reduction in the principal amount of this debt by $60 billion. William Cline, International Debt Reexamined 220-21 (Institute for Economics) 1995. Including amounts owed to creditors other than the banks, this reduction reflected 15% of the total value of the debt owed to foreign creditors. *Id.*

[113]McGovern, *supra* note 42, at 75. The total value of the market for Brady bonds reached $170 billion in 1999. Jane Brauer & Douglas Chen, Brady Bonds: A Decade of Volatility 2 (Merrill Lynch Emerging Markets Research).

[114]*See* RIEFFEL, *supra* note 37, at 190-92 (describing recent trends in financing in the emerging market economies). In addition to Brady bonds issued in connection with the restructuring of commercial loans, sovereign debtors also issued a new bonds, particularly eurobonds. *See* McGovern, *supra* note 42, at 78 (describing the components of the markets for sovereign bonds).

3. *The Current Crisis*

By 1994, new debt crises, crises involving sovereign bonds, began to erupt.[115] Most recently, the crises have involved a series of restructurings of sovereign bonds – issued by Ecuador, Pakistan, the Ukraine, Argentina, and Uruguay – and they comprise the current crisis in sovereign debt. These restructurings, and so the current crisis, however, differ significantly from the previous crises in that, as the eurobond market has developed, and sovereign debtors have issued a variety of bonds to meet their financing needs, the investors holding the bonds have diverse of interests, which complicates the restructuring process. These restructurings, as compared to the restructurings of the 1930s in which sovereign bonds were held by relatively few investors, and to the restructurings of the 1980s in which sovereign debt consisted of loans made by commercial banks, involve many different types of investors, differing in the level of exposure to the risks of the bonds, in the regulatory environment, and in the level of involvement in the international capital markets. Moreover, these restructurings, unlike the restructurings of the 1930s and, to a lesser extent, the restructurings of the 1980s, are taking place in the context of a liquid market in which investors may readily sell their interests.

C. Creditor Heterogeneity and the Growing Divergence of Interests

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, non-financial companies, and retail investors.[116] This diversity in investors is reflected in the recent restructurings. For example, in the case of Ecuador, the bonds subject to the exchange offer were widely held by institutional investors in New York and London, many of whom had substantial holdings of bonds issued by the governments of emerging market economies.[117] For Pakistan, approximately one-third of the bonds subject to the exchange offer were held by domestic residents and the remaining bonds were held by financial institutions and retail investors in the Middle East.[118] In the case of the Ukraine, three of the bonds subject to the exchange offer were held by a small number of investment banks and

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[115]The first of these crises, the Mexican Peso Crisis, the Asian Crisis of 1997, and the Russian Crisis of 1998, arose from financial crises in which the values of local currencies declined significantly 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 of 1998, the restructuring of loans made by commercial banks. For a description of the Mexican Peso Crisis and the Russian Crisis of 1998, see Scott, *supra* note 24, at 7-10. See RIEFFEL, *supra* note 8, at 198-208 (describing these crises).

[116]*See* McGovern, *supra* note 42, at 77 (describing the various types of holders of sovereign bonds). The diversity of the investors in the eurobond markets 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 constraints imposed on investors by regulations. In addition, derivative instruments are used to allow banks and hedge funds to enhance returns while dispersing risk. *Id.* at 78-9 (describing the variety of instruments traded in the markets).

[117]*See* International Monetary Fund, Reviewing the Process of Sovereign Debt Restructuring within the Existing Legal Framework, tbl. 1 (Aug. 2003) (unpublished manuscript on file with the authors) (describing the principle elements of recent restructurings of sovereign bonds).

[118]Institutional investors in the Unite States and Europe held only a small fraction of the bonds. *See* id .tbl. 1 (describing the principle elements of recent restructurings of sovereign bonds).

hedge funds, while the remaining bond was widely held by retail investors in Europe.[119] For Argentina, of the approximately $100 billion principal amount of debt subject to the (current) restructuring, approximately $50 billion is estimated to be held by domestic financial institutions,[120] approximately $20 billion is estimated to be held by retail investors in Europe, approximately $3 billion is estimated to be held by retail investors in Japan, and the remaining $27 billion is estimated to be held by institutional investors in the United States.[121] Finally, in the case of Uruguay, more than one-half of the bonds subject to the exchange offer was held by domestic investors, many of whom were retail investors.[122] In addition, other bonds were widely held by retail investors in Europe and in Japan, and dollar-denominated bonds were largely held by institutional investors in the United States.[123]

These differing types of investors differ in their level of exposure to the risks of the bonds, in the regulatory environment they confront, and in their level of involvement in the international capital markets. These differences make reaching an agreement regarding the best approach to a restructuring of the bonds difficult. As in the case of the restructurings of the loans made by the commercial banks, although the bondholders may agree that all bondholders should be treated equally, and so they may support a uniform agreement, they are unlikely to prefer the same point of agreement.

Individual bondholders differ significantly in the level of their exposure to the risk of default on sovereign bonds; that is, the total value of bonds held in their portfolios as compared to the total value of their assets differs markedly both across the various types of bondholders and within the various classes of bondholders. While individual bondholders may face a threat of insolvency upon a default on a particular issue of sovereign bonds, defaults on the bonds do not give rise to any systemic risk. So, unlike the restructurings of the 1980s, the current restructurings do not threaten the solvency of the commercial banks, or the investment banks, or the insurance companies and pension funds, or many of the mutual funds, retail funds, or hedge funds, nor do they jeopardize the stability of the international capital markets.

This absence of a widespread threat of insolvency, while avoiding a global crisis in the international capital markets, also removes a focal point for reaching agreement among bondholders as to the terms of a restructuring of bonds. During the restructurings of the 1980s, the large commercial banks, threatened with insolvency upon a default on the loans made to sovereign debtors, an outcome that would have jeopardized the stability of the international capital markets, were able to commit credibly to supporting only restructuring agreements that provided for new loans to sovereign debtors. They were also able to use this commitment to pressure recalcitrant banks both to ratify the agreements with the sovereign debtors providing for new loans and to support the restructuring plans that involved new loans to troubled sovereign debtors. Moreover, the threat to bank solvency also increased the incentive for governmental regulators and multilateral institutions, including the IMF, to become involved in the

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[119] *See* id .tbl. 1(unpublished manuscript on file with the authors) (describing the principle elements of recent restructurings of sovereign bonds).

[120] These institutions are primarily banks and pension companies. *See* id .tbl. 1(describing the principle elements of recent restructurings of sovereign bonds).

[121] *See* International Monetary Fund, Reviewing the Process of Sovereign Debt Restructuring within the Existing Legal Framework, tbl. 1 (Aug. 2003) (unpublished manuscript on file with the authors) (describing the principle elements of recent restructurings of sovereign bonds).

[122] *See* id. (describing the principle elements of recent restructurings of sovereign bonds).

[123] *Id.*

restructuring process. These officials, however, may be less likely to become involved in a restructuring if the stability of the international capital markets is not in jeopardy.

Bondholders also face significantly different regulatory environments. Banks, including commercial banks and investment banks, as well as other institutional investors, record the values of their portfolios of sovereign bonds at market prices, often daily and certainly monthly or quarterly. Retail investors, however, typically do not perform this exercise. By "marking to market" their portfolios, banks and other institutional investors record their gains and losses almost as they occur. Retail investors typically record gains and losses only upon sales of bonds. In a restructuring of sovereign bonds, then, banks and other institutional investors may elect to exit the restructuring process by selling their bonds in the market – further depressing the price and creating losses for other holders, including retail investors – rather than holding the bonds and working to complete the restructuring process. As various bondholders, particularly banks and other institutional investors, adjust their portfolios of bonds in this manner, efforts to reach consensus among the bondholders may be hindered.

Importantly, only certain large institutional investors, particularly commercial banks and investment banks, have ongoing relationships with the sovereign debtors that they are eager to broaden to include additional business. These institutional investors are also the only bondholders likely to be permanent participants in the international capital markets, with expectations that they will work with one another in a variety of settings. These interests, in developing relationships with sovereign debtors and with other participants in the international capital markets, may drive these institutional investors to support restructuring plans that are unlikely to be acceptable to smaller investors, notably retail investors, who do not expect to gain from future transactions. The institutional investors may be willing to suffer a greater loss in a particular restructuring as a means of solidifying a relationship with the sovereign debtor and as establishing a reputation for success in restructuring bonds, both of which are likely to lead to future business opportunities and future revenues. Retail investors, on the other hand, receiving all payments in respect of the troubled bonds only in the restructuring, may seek a higher immediate return.

Investors purchase bonds in the market at differing prices. Unlike the restructurings of the 1930s in which investors typically purchased bonds from banks at equivalent prices, and unlike the restructurings of the 1980s in which all of the commercial banks had made loans to the sovereign debtors equal to the principal amount of the loans, investors in the bond markets may purchase sovereign bonds at substantial discounts from the face amounts. While these prices, of course, reflect estimates of the likelihood that the entire principal amount of the bonds will be repaid, they do create substantial disparities among bondholders. For example, retail investors who purchase bonds at the time of their issuance, at prices near the face amount of the bonds, are likely to be reluctant to accept significant discounts from the principal amounts in the restructurings. Other investors, notably "vulture funds,"[124] who purchase the bonds once the sovereign debtor begins to experience distress, pay a much lower price for the bonds and so may be willing to accept a significant discounts from principal amounts in restructurings. In between these two extremes, banks and other institutional investors, in marking their

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[124]The term "vulture" refers to the fact that these hedge funds typically purchase the debt of countries, or companies, that are in financial distress. As a result, the debt may be purchased at a substantial discount from the principal amount. In making these purchases, these funds typically seek short-term gains, either through the restructuring process or by holding out and seeking additional payments from debtors, either through negotiated transactions or as a result of litigation. *See* Bratton & Gulati, *supra* note 11, at 22, 22 n.62. For a general description of the strategies used by vulture funds, see HILLARY ROSENBERG, VULTURE INVESTORS 25-36 (2000). For a more detailed description of the role of vulture funds in the restructuring of sovereign debt, see Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J INT'L. 253 (2003).

portfolios to market, may be willing to accept some discounts from principal amounts in restructurings, depending upon the magnitude of the losses or gains they have recorded.

In addition to creating differences in the discounts from principal amounts that differing investors may be willing to accept in restructurings, the purchase of bonds in the market at differing prices also engenders disagreements as to the appropriate measure of the discounts to be included in a restructuring agreement. Specifically, in the event bondholders are able to reach an agreement regarding the appropriate discount, or "haircut," to be suffered in a restructuring of bonds, they typically 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 discount, or haircut, should be applied with respect to the prices at which investors purchased their bonds.

These many differences among these investors create many opportunities for disagreements, particularly over the terms of restructurings. Moreover, the absence of a focal point for an agreement, as well as a method of credibly committing to supporting only that point of agreement, exacerbates the difficulties investors face in overcoming the divergence in their interests. Furthermore, the ability to sell bonds, and to purchase bonds, readily in the markets augments the problems bondholders face in coordinating their actions. As a result of these differences, difficulties, and problems, the recent restructurings have involved recalcitrant bondholders, and many of these holdouts have pursued their claims against sovereign debtors in court.

II. The Role of the Courts

A. Developments in Creditor Litigation and the Holdout Problem

At the same time that the market for sovereign debt has become an international market with diverse investors, increasingly the likelihood of holdouts, the ability of those holdouts to pursue litigation remedies has increased. Courts have rejected the various defenses sovereign debtors have raised in suits brought by creditors, providing creditors with unprecedented access to litigation.

In the 1930s, during the restructurings that begin our historical overview, litigation was not a viable option for holdout creditors. The contracts governing the bonds on which these sovereign debtors defaulted generally provided protections for the holders of the bonds in the event of a default, such as pledges of the good faith and credit of the issuing government,[125] and security clauses assigning specific sources of governmental revenues or specific governmental properties to fulfill servicing requirements.[126] 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, were unable to be sued without their consent.[127]

The power of the sovereign immunity defense to block creditor litigation was subsequently significantly reduced. In 1952, the Executive Branch adopted a restrictive theory of sovereign immunity,

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[125]Jorgensen & Sachs, *supra* note 21, at 61.

[126]EDWIN BORCHARD, STATE INSOLVENCY AND FOREIGN BONDHOLDERS 83-89 (1951).

[127]*See* 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."); 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.")

which was announced in the Tate Letter.[128] The restrictive theory provided that sovereigns retained immunity for their public or sovereign acts, but could be sued in U.S. courts for their commercial or public acts.[129]

The Executive Branch's theory was subsequently codified in the Foreign Sovereign Immunities Act of 1976 (FSIA).[130] Thereafter, the Supreme Court held that issuing sovereign bonds constituted commercial activity within the meaning of the FSIA.[131] The Court further held that Argentina's rescheduling of the 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.[132]

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.[133] At the same time, sovereign debtors increasingly waived their sovereign immunity and explicitly consented to jurisdiction of the U.S. courts.[134] The predictable consequence of these developments was an effort by creditors to enforce the obligations of 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 confronted a crippling balance of payments deficit as a result of external economic shocks and ill-fated domestic policy responses. This balance of payments deficit caused Costa Rica to experience a shortage of foreign currency with which to pay its external debt,"[135] including debt owed to commercial banks. In an effort to alleviate this crisis, in July of 1981,

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[128] Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman (May 19, 1952), reprinted in 26 Dept. of State Bull. 984-985 (1952), and in Alfred Dunhill of London, Inc. v. Cuba, 425 U.S. 682, 712-13 (1976). See Turkmani, 193 F.Supp.2d at 170-171 (describing Tate Letter).

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

[130] *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, 613 (1992), citing Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682, 698-705 (1976).

[131] Id. at 613-14.

[132] Id. at 618-19.

[133] 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 jurisdiction did not amount to waiver of sovereign immunity in the United States).

[134] See, e.g., Libra Bank, Ltd. v. Banco Nacional de Costa Rica S.A., 676 F.2d 47, 49 (2nd 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 Indus. 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 the Congo, 729 F.Supp. 936, 940 (S.D.N.Y. 1989) (same).

[135] Bainbridge, *supra* note 37, at 29.

the Board of Directors of the Central Bank of Costa Rica passed a resolution prohibiting all state-owned entities from paying interest or principal owing on debts to foreign creditors and denominated in foreign currency.[136]

The inability of a syndicate of commercial bank debtors to obtain repayment of a $40 million dollar-denominated loan owed to it by Banco Nacional de Costa Rica led the syndicate to seek an order of attachment in New York state court.[137] Banco Nacional first defaulted in the state court proceeding and then, after the syndicate had obtained an order of attachment for Banco Nacional's property in New York and successfully attached $800,000 in assets, entered an appearance, removed the action to federal court, and moved to vacate the order of attachment on the grounds of sovereign immunity.[138] The Second Circuit held that the foreign state had explicitly waived all sovereign immunity in writing and upheld the attachment.[139]

When the plaintiffs moved for summary judgment, Banco National then tried an alternative approach, arguing that the events in Costa Rica constituted a defense to repayment under the act of state doctrine.[140] 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.'"[141] 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 within 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."[142] 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.[143]

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 the International Monetary Fund, Bretton Woods Agreement, art. VIII, § 2(b)[144] prohibited the enforcement of the loan agreement. Banco Nacional argued that Costa Rica's moratorium on payments on external debt denominated in foreign currency constituted an unenforceable exchange agreement.[145] The Bretton Woods Agreement provides that "[e]xchange

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[136] *See* Bainbridge, *supra* note 37, at 29 (describing the response to the debt crisis in Costa Rica); Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1442 (S.D.N.Y. 1983) (describing the moratorium). *See also* Truglia, *supra* note 8, at 11 (describing events surrounding the debt crisis in Costa Rica).

[137] Libra Bank, Ltd. v. Banco Nacional de Costa Rica S.A., 676 F.2d 47, 48 (2d Cir. 1982).

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

[139] Libra Bank Ltd. v. Banco Nacional de Costa Rica, 676 F.2d 47, 50 (2d Cir. 1982)

[140] Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F.Supp. at 876.

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

[142] 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.

[143] Id. at 896.

[144] Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39 (as amended).

[145] Libra Bank, 570 F.Supp. at 896.

contracts which involve the currency of any member and which are contrary to exchange control regulations of that member maintained or imposed consistently with [the IMF Articles of] Agreement shall be unenforceable in the territories of any other member."[146]

The court rejected this third defense as well. The court considered two competing interpretations of the term "exchange contract", a broad interpretation and a narrow one.[147] Reasoning that a definition of the term "exchange contract" sufficiently expansive to include loan agreements would "[do] violence to the text of the section," the court opted for the narrow definition.[148] 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.[149]

The Libra Bank litigation illustrates both the growing potential of creditor litigation as a remedy against a defaulting sovereign debtor and the limitations of such litigation. The judicial decisions recognized the validity of the syndicate's contractual claim and rejected a variety of attempted defenses. Thus the decisions made it clear that enforcement litigation was a viable option for creditors. At the same time, the litigation illustrated the potential futility of such litigation. 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.[150]

A second case also arising out of the Costa Rica default and restructuring, *Allied Bank Int'l v. Banco Credito Agricola de Cartago*,[151] , introduces the prospect of holdout litigation. Suit was originally filed by Allied Bank International (Allied Bank) as agent for a syndicate of thirty-nine commercial banks, all of which had participated in a loan to three banks wholly owned by Costa Rica. The suit was a breach of contract claim based on the failure of the debtors to make payments on the loan owed to the syndicate.[152] 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.[153] The District Court, basing its decision on the act of state doctrine, dismissed the complaint.[154]

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[146]*Id.*

[147] See id. at 897 (describing broad and narrow interpretations).

[148]*Id.* at 898 (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..

[149] Id. at 900.

[150] 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).

[151]Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440 (S.D.N.Y. 1983) [hereinafter *Allied Bank*], *aff'd,* 733 F.2d 23, 1984 U.S. App. LEXIS 23237 (2d Cir. Apr. 23, 1984) (per curiam) [hereinafter *Allied Bank I*], *rev'd on rehearing* 757 F.2d 516 (2d Cir. 1985) [hereinafter *Allied Bank II*].

[152]*Allied Bank*, 566 F. Supp. at 1442.

[153]*Id.*

[154]*Id.* at 1440.

While the case was pending before the District Court, the parties entered into negotiations to restructure the loan.[155] 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 bank syndicate, Fidelity Union Trust Company of New Jersey, refused to ratify the agreement or to participate in the restructuring plan.[156] Allied Bank subsequently appealed the district court decision on behalf of Fidelity, the sole holdout creditor.[157] The Second Circuit initially agreed with the district court that the suit should not be heard, dismissing it on grounds of comity.[158] Apparently the New York financial community reacted adversely to the Second Circuit's 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.[159]

In any event, the Second Circuit subsequently agreed to rehear the case. Upon rehearing, the Justice Department submitted an amicus brief explaining that although its position was to encourage the cooperative renegotiation of debt, this position was "grounded in the understanding that, while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable."[160] The Justice Department explained that the imposition of unilateral exchange controls by Costa Rica was therefore inconsistent with U.S. policy.[161]

Importantly, Fidelity's position was also supported by the New York Clearing House Association (Clearing House), which filed an amicus brief.[162] Clearing House's position was seemingly motivated by a desire to establish clear legal precedent for enforcing the rights of commercial banks and other creditors against sovereign debtors.[163] A judicial decision favorable to the claim, although detrimental to the restructuring plan, would provide the bank advisory committees (and the other commercial banks) with additional leverage in negotiating other agreements with sovereign debtors and in developing restructuring plans in future crises.[164]

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[155]*Allied Bank II*, 757 F.2d at 519.

[156]*Id.*

[157]*Id.*

[158] Allied Bank I, 733 F.2d 23 (2nd Cir. 1984)

[159] William W. Park, Legal Policy Conflicts in International Banking, 50 Ohio St. L.J. 1067, 1075-76 (1989).

[160] Allied Bank II, 757 F.2d at 519.

[161]Brief for the United States as Amicus Curiae, July 1984, at 6-7, 18, Allied Bank v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985).

[162]Bainbridge, *supra* note 37, 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 very diligently to avoid defaults on the loans. *See* id. (describing the New York Clearing House Association).

[163]*See* id. at 30-31 (discussing the likely motivations of the members of the New York Clearing House Association in filing an *amicus curiae* brief in favor of Allied Bank).

[164]*Id.*

Upon rehearing, the Second Circuit concluded that 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 within its own territory, did not bar the lawsuit. The court concluded that the situs of the debts 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, 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 in accordance with recognized principles of contract law.[165]

The court went on to reject the argument that principles of comity should bar the suit, reasoning that "The 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."[166] Accordingly, the court granted the plaintiff summary judgment.

The two Costa Rica cases thus open 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, suggest a clear relationship between the availability of judicial enforcement of loan agreements against defaulting sovereigns and the functioning of the sovereign debt markets. 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.

Following the Costa Rica cases, sovereign debt litigation continued. Courts adhered to the approach in the Costa Rica cases. In particular, the courts found that neither international political considerations nor the plaintiff's unwillingness to participate in a voluntary restructuring operated to bar recovery. Instead, the court evidenced a repeated willingness both to take jurisdiction and to resolve the cases promptly upon motions for summary judgment. *A.I. Credit Corp. v. Jamaica* is a typical such case.[167] Following three reschedulings of its debt in 1978, 1979, and 1981, Jamaica entered into a fourth rescheduling in 1984.[168] 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 agreement.[169] A.I. Credit Corp. 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

[165] Allied Bank II, 757 F.2d 521-22.

[166] Id. at 522.

[167] A.I. Credit Corp. v. Jamaica, 666 F. Supp. 629, 630 (S.D.N.Y. 1987).

[168] Id.

[169] Id.

sued for payment based on the terms of the fourth rescheduling.[170] The court observed that although the reschedulings affected debts owed to some 113 financial institutions, AICO was the only party to bring suit.[171] The court found that the terms of the 1984 agreement explicitly provided AICO with an individual right to bring suit to enforce the agreement.[172] The court then concluded that there was no outstanding issue of material fact, and granted summary judgment in favor of the plaintiff.[173]

Defendants have not been entirely powerless in these lawsuits. In particular, carefully drafted loan agreements have enabled defendants to block holdout litigation. An example can be found in the litigation by CIBC Bank, on behalf of the Dart family, against Banco Central de Brasil.[174] Brazil negotiated the Multi-Year Deposit Facility Agreement (the "MYDFA") as part of the restructuring of its debt in the 1980s.[175] The MYDFA provided, among its terms, that MYDFA debt could be accelerated, upon the event of a default, only if more than 50% of the creditors, calculated by amount of debt holdings, voted to accelerate.[176] Just a year after the MYDFA was consummated, Brazil became 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 entire the principal.[177]

CIBC Bank's effort to accelerate was blocked by Brazil's careful approach to the new restructuring. In connection with the 1992 restructuring, Brazilian officials ordered Banco do Brasil, a Brazilian commercial bank 51% owned by the Brazilian Treasury, to retain $1.6 billion of MYDFA debt rather than converting all of its holdings pursuant to the restructuring. By retaining a majority of the outstanding MYDFA debt, Banco do Brasil was able to prevent CIBC from obtaining a majority vote in favor of accelerating the debt.[178]

In the litigation that followed, although the court rejected Banco Central's attempts to raise defenses of improper assignment and champerty, it upheld Brazil's move to block acceleration of the debt. The court observed that the plain terms of the contract required a majority vote to accelerate, and that CIBC did not hold a majority of the outstanding debt.[179] 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

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[170] Id.

[171] Id.

[172] Id. at 631-32.

[173] Id. at 633.

[174] CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995).

[175] Id. at 1107.

[176] Id.

[177] Id.

[178] Id.

[179] Id. at 1113.

acceleration.[180] Significantly, the court observed that the implied covenants sought by CIBC would have the effect of significantly altering the rights of the parties, and would impair the ability of debtors and creditors "to order their relationships through contractual debt agreements."[181] 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.[182] 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's claimed damages from more than $1.4 billion to only $60 million.

Defendants 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. In Pravin Banker Assocs., Ltd. v. Banco Popular del Peru,[183] a bank association filed suit on debt originally borrowed by Banco Popular from the Mellon Bank of Pittsburgh under the terms of two letter agreements. The debt was guaranteed by the government of Peru and subsequently sold to the plaintiff in the secondary market at a deep discount. In addition to arguing that the case should be dismissed based on principles of comity, the defendants argued that the assignment of the debt to the plaintiff was invalid, barring the plaintiff's claim. The district court and the Second Circuit rejected these arguments and awarded summary judgment to the plaintiff in the amount of $2,161,539.78.

On the issue of comity, the Pravin court expanded on the Second Circuit's analysis in *Allied Bank.* The court identified two competing U.S. policies implicated by sovereign debt litigation. On the one hand, the United States encourages the resolution of foreign debt restructurings through Brady Plan negotiations. On the other hand, the United States has a strong interest in ensuring the continued enforceability of foreign debts owed to US lenders. The Pravin court concluded that the second interest limited the first, so as to require that creditor participation in restructuring negotiations be voluntary, supported by the backdrop of the creditor's continued right to enforce the debt. Accordingly, the court found that principles of comity did not preclude a grant of summary judgment.

The Pravin court also considered Peru's argument that Mellon's assignment of the debt to Pravin was improper. The terms of many of the letter agreements for sovereign debt authorize the creditor to assign its interest in the letter agreement "to any financial institution." Peru argued that this language should be interested to preclude an assignment to Pravin, which was not a bank. The court rejected this argument, explaining that, under New York law, only express limitations on assignability are enforceable. 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. Accordingly, it concluded that the assignment was valid whether or not Pravin was properly characterized as a financial institution.

Perhaps the best known instance of creditor litigation is the successful litigation by Elliott Associates, a vulture fund, against Peru.[184] Elliott purchased over $20 million worth of debt in the secondary market for slightly over 55% of its face value. The debt was in the form of Letter Agreements

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[180] Id. at 1115 (calling CIBC's argument "quite creative, [but] wholly unpersuasive").

[181] Id. at 1116.

[182] Id.

[183] 109 F.3d 850 (2d Cir. 1997).

[184] Elliott Assocs. v. Banco de la Nacion, 194 F.3d 363 (2d Cir. 1999).

of Banco de la Nacion, which had been guaranteed by Peru shortly after Peru announced a Brady deal.[185] Elliott subsequently refused to participate in the restructuring of the debt and demanded full payment. When Peru refused to pay, Elliott sued in New York district court. Although the district court originally dismissed the suit, holding that it violated New York's prohibition on champerty, N.Y. Judicial Law § 489, the decision was overturned by the Second Circuit, which granted summary judgment in favor of Elliott. After several unsuccessful attempts to collect its judgment in New York, Elliott then sued in a Belgian court to obtain an order of attachment on funds transferred by Peru in an attempt to pay interest on its Brady bonds. When the Belgian court ordered the attachment, Peru settled, paying Elliott approximately $56 million.

As in Pravin, Peru argued that the assignment of debt to Elliott was invalid. The court rejected this argument, relying on the Pravin decision. In Elliott Associates, however, Peru also argued that Elliott had purchased the Peruvian debt "with the intent and for the purpose of bringing" litigation, thereby rendering the purchase a violation of the prohibition of champerty imposed by New York Judiciary Law § 489. The district court dismissed the suit, finding that Elliott had, indeed, violated the statute. The Second Circuit, however, reversed. 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."[186] 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."

Recent decisions reflect both the outcome and the policy considerations of the earlier precedents. For example, in Turkmani v. Republic of Bolivia,[187] the District of Columbia district court relied on the Second Circuit's interpretation of the New York champerty statute in Elliott Associates. 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 non-payment risk associated with an investment in sovereign debt. After also rejecting the defendant's sovereign immunity defense, the court awarded summary judgment to the plaintiff.[188]

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.[189] These lawsuits have been fueled, in part, by Argentina's proposed 75% 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 already

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[185] Interestingly, Elliott purchased its debt shortly after the favorable Second Circuit decision in Pravin.

[186] 194 F.3d at 379.

[187] 193 F. Supp. 2d 165 (D.D.C. 2002).

[188] 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 33% 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. Turkmani opted out of the litigation class and pursued a separate lawsuit, seeking to recover approximately $266,000 in principal and accrued interest.

[189] See Pamela Druckerman, Frustrated Argentine Bondholders Try Suing, Wall Street Journal, August 23, 2002.

granted summary judgment to various individual plaintiff bondholders.[190] The court's analysis was straightforward:

> The obligations of the Republic on the bonds involved in these lawsuits are unconditional. Sovereign immunity has been waived. The Republic defaulted on the bonds when it ceased to pay the interest. This would seem to meant hat the Republic now owes the three plaintiffs principal and accrued interest.[191]

In particular, the court explicitly rejected Argentina's defenses, including the act of state doctrine, considerations of comity and N.Y. Judiciary Law § 489.[192] In granting summary judgment in favor of various individual plaintiffs, the court has temporarily stayed its judgment to permit Argentina to propose a restructuring plan.[193] In one of the most recent decisions, H.W. URBAN GmbH v. Republic of Argentina,[194] a court granted a motion for certification of a class of holders of two series of Argentinean bonds. The court's decision was the first to certify a class action in connection with a major sovereign debt restructuring.[195]

B. Responses to Holdout Litigation

These recent cases of holdout litigation have heightened the urgency of the ongoing debate regarding the best means of dealing with recalcitrant creditors. There are three main approaches to addressing the holdout problem in sovereign debt restructuring. The first is a market based approach in which the sovereign restructures the debt through an exchange offer coupled with amendments to the original debt contracts effected through exit consents. The second is a contractual mechanism, the use of collective action clauses (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 contract over the objections of the holdouts. The third is an international bankruptcy procedure, the sovereign debt restructuring mechanism (SDRM).

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

[191]Lightwater Corp., 2003 U.S. Dist. LEXIS 6156, *10-11 (S.D.N.Y., Apr. 14, 2003).

[192]Id. at *11-*13.

[193]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).

[194] 2003 U.S. Dist. LEXIS 23363 (S.D.N.Y. 2003).

[195] Angela Pruitt, U.S. Ruling a Setback for Argentina, Wall St. J., Jan. 2, 2004, at B4

1. Exchange Offers and Exit Consents

Exchange offers enable a sovereign to restructure its debt through a market process without the involvement of any legal tribunal and without any modifications to existing law.[196] Essentially an exchange offer involves an offer by the sovereign to exchange new debt for old.[197] Because a creditor's decision to accept an exchange offer is voluntary, sovereigns that conduct exchange offers face a potential holdout problem. Creditors may refuse the offer in hopes of obtaining better terms as a holdout, either by forcing the sovereign to buy them out at a higher price in order to enable the restructuring to proceed or by continuing to receive payments in accordance with the original terms of the debt.

Exit consents are designed to mitigate the holdout problem. As a condition of the exchange offer, creditors accepting the exchange are required to consent to various modifications in the terms of the original debt agreement that are designed to make it unattractive to continue to hold the original debt. Although amendments to the payment terms of the bonds by fewer than 100% of the creditors are not permissible if the bond has a uniform action clause, other terms can typically be modified by a majority or supermajority of creditors. Examples of these modifications include waivers of sovereign immunity, submission to jurisdiction, financial covenants and listing obligations.[198] The amendments are designed to make the continued retention of the original bonds less attractive, thereby pressuring creditors to accept the exchange offer rather than holding out.

The use of exit consents was pioneered in the restructuring of US corporate junk bonds in the 1980s.[199] U.S. Courts generally accepted their use. In the leading case of Katz v. Oak Industries, Oak made an exchange offer to debt holders that offered them a premium over the existing market price of their debt in exchange for their vote to remove all financial covenants of the existing agreements, which would dramatically reduce the financial protection available to remaining bondholders. Although the offer was challenged as violating the contractual obligation of good faith and fair dealing, the Delaware Chancery court upheld the offer.

Ecuador successfully used exit consents to obtain a 97% acceptance of its restructuring exchange offer in 2000. In order to accept the exchange, the "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."[200] Commentators report that the presence of the exist amendments played a "significant" role in the decision of some bondholders to accept the exchange offer.[201]

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[196] *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 61 (2000) [hereinafter Buchheit & Gulati, *Exit Consents*] (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").

[197] The extent of the resemblance to the proposed exchange in Aladdin of "new lamps for old" is, of course, a key question.

[198] Buchheit & Gulati, *Exit Consents*, *supra* note 196 at 81-82.

[199] Id. at 67. [and note two empirical studies of impact on bond prices]

[200] Bucheit & Gulati, *Exit Consents*, *supra* note 196, at 84.

[201] Id.

Despite the successful use of exit consents in Ecuador, it is unlikely that exit consents will provide a viable approach in every case. In some cases the size of the haircut necessary to relieve the debtor's financial crisis may prevent a voluntary exchange from being economically feasible. In other cases, the decrease caused by the amendments in the value of the debt held by holdouts will be less than the anticipated increase in the value resulting from the holdout.[202] Moreover, it is possible that a court would find the nature of the exit amendments to be too substantial and refuse to enforce those amendments against the holdouts.[203]

2. *Collective Action Clauses*

CACs enable a majority or supermajority of debtors to change the payment terms of an issue of debt. CACs have long been a standard contractual term for sovereign debt issued under UK law. Sovereign debt contracts governed by US law have, however, traditionally contained unanimous action clauses or UACs, which require all creditors to consent to an amendment of significant terms in the contact, such as changes to the interest rate or repayment schedule. Because the majority of creditors cannot force minority creditors to accept a restructuring, even a restructuring that is in the best interests of the creditors, the minority creditors have an option to hold out – refusing to go along with the restructuring in hopes that they will be bought out at a price higher than the restructuring price. Hold out is facilitated by the creditors' option, in some circumstances, to reject the restructuring proposal and use litigation to attempt to obtain payment of the debt in full. CACs constrain this "tyranny of the minority,"[204] by enabling the minority's holdout to be overridden by a majority or supermajority vote. In addition to addressing the collective action problem, CACs address the growing coordination problem caused by the fact that an increasing percentage of sovereign debt is held by dispersed public creditors.

A variety of commentators have endorsed the CAC approach, including the Treasury Department. Commentators defend CACs first, as a contractual approach which avoids the shortcomings of a more intrusive regulatory solution. Indeed, supporters argue that, by solving the collective action problem and reducing the risk of disruptive holdouts, CACs should raise the value of debt. Although some have argued that CACs may create a moral hazard problem for debtors by reducing the difficulty of restructuring, recent empirical evidence indicates that the market does not view CACs as less attractive than UACs. This suggests that creditors do not anticipate the use of CACs to increase bad faith or strategic defaults by sovereign debtors.

The advantages of CACs are straightforward. As long as the sovereign reaches agreement with a majority or supermajority of its creditors, the restructuring can proceed despite the objections or simple nonparticipation of the minority creditors. The negotiated terms subsequently bind all the holders. Thus CACs lessen the problem of creditor coordination by allowing the sovereign to negotiate with representatives of a majority of the creditors. In addition, they reduce the holdout problem by enabling the majority of creditors to force a restructuring upon a recalcitrant minority.

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[202] Christopher C. Wheeler and Amir Attaran term this a "buoying up" effect. *See* Wheeler & Attaran, *supra* note 124, at 265. 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).

[203] See, e.g., Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1346 (2002) [hereinafter Buchheit & Gulati, *Collective Will*] (identifying this possibility).

[204] *See* Buchheit & Gulati, *Collective Will*, *supra* note 203, at 1335.

Attempting to reform the restructuring process through the universal use of CACs has several disadvantages. First, because CACs are a contractual term, their inclusion must be acceptable to creditors. The IMF and others have argued for the inclusion of CACs in all new debt contracts, reasoning that CACs do not impair the marketability of bonds issued under UK law. Nonetheless, the IMF has not explained the failure of the market to reach this solution independently. Although commentators rely heavily on a story of path dependence to explain the continued use of UACs in bonds issued under New York law, they cannot explain why, despite official encouragement, only a small percentage of sovereign debt, particularly emerging market debt, contains UACs.[205]

Second, even where they are included, CACs only apply to a single issue of debt and do not enable holders of one issue to force holders of another to accept a restructuring. They neither require that all issues be restructured nor deal with potential problems of unfairness between creditors holding different issues. Thus, while CACs may work effectively to change the terms of a single class of debt or within a country that has a limited number of debt issues,[206] 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 currency and the governing laws of eight different countries.[207] Finally, although CACs may eliminate the tyranny of the minority, they do so at the expense of potentially creating a tyranny of the majority. In particular, CACs offer a risk that majority creditors 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,[208] it is not clear what content this doctrine has in limiting the right of a particular creditor to base its voting decision exclusively on its own financial interests. Notably, in a recent U.K. decision evaluating the duties of majority creditors negotiating in accordance with a CAC, the Court specifically found that majority creditors had no obligation to negotiate on behalf of all creditors rather than in their own self interest.[209] The court explained: "By signing up at the outset, each lender submits to the decision of hte majority lenders at important forks in the road."[210] The problem of heterogenous creditor interest then exacerbates the risk of unfairness to some creditors.

Third, the insertion of CACs into newly issued debt would not address concerns about restructuring the existing stock of debt that contains UACs. Because of the long term nature of much sovereign debt, the full utility of CACs would be delayed considerably into the future.

Finally, CACs do not wholly eliminate strategic use of litigation. Indeed, unless and until courts have developed a jurisprudence clarifying the rights and responsibilities of creditor groups in connection with the amendment process, there is a substantial risk that holdouts will use litigation in an effort to interfere with the restructuring process and in an attempt to be paid off. Indeed, the uncertainty associated

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[205] Yan Liu, Collective Action Clauses in International Sovereign Bonds, Working Paper at 23, August 30, 2002 (http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/liu.pdf).

[206] See David A. Skeel, Jr., Can Majority Voting Provisions do it All?, 52 Emory L.J. 417, 422 (2003) (observing that value of CACs is limited to their ability to change the terms of a single class of debt).

[207] Speech of Dr. Guillermo Nielsen, Argentine Secretary of Finance, Dubai, Sept. 22, 2003 at 14 (http://www.argentinedebtinfo.gov.ar/documentos/discurso_gn_dubai_con_diap_english.pdf).

[208] Bratton & Gulati, *supra* note 11.

[209] Redwood Master Fund, Ltd v. TD Bank Europe Limited, [2002] EWHC 2703 (Ch), 30 (High Court of Justice, Chancery Div. 2002).

[210] Id. at 27

with judicial review of such creditor claims may offer a partial explanation for the failure of the market to attribute greater value to debt contracts containing CACs.

3. The Sovereign Debt Restructuring Mechanism

There have been various proposals for some form of sovereign bankruptcy procedure, but the one that has attracted the most attention, and the one on which this article will focus, is the proposal by Anne Kreuger, deputy managing director of the IMF. In its most recent form, the sovereign debt restructuring mechanism (SDRM) would create a process by which a majority of creditors could negotiate a restructuring that would then be binding upon all creditors. The advantages of the SDRM over the universal use of CACs include the fact that the SDRM could be applied to existing debt, even debt issued with UACs, and the ability of the SDRM to deal with multiple issues of debt.

The IMF's proposed SDRM is still under development. In its current form (Jan. 2003), the SDRM would place primary responsibility for negotiating the restructuring in the hands of the creditors. Practically speaking, the SDRM is more of a workout mechanism than an international bankruptcy court. The SDRM proposes grouping creditors into a single class which would have the power to restructure all debt subject to the SDRM (domestic debt is currently not included) by supermajority vote. A judge or some type of official would resolve disputes among creditors but, unlike the US bankruptcy process, the judge would not evaluate the substantive terms of the restructuring for fairness. A restructuring negotiated by the supermajority of creditors would be binding on all creditors subject to the restructuring.

Importantly, the current proposal does not include a standstill or a stay on creditor enforcement of claims through litigation.[211] 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. 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.[212]

Under this proposal, the majority creditors are the ones who have a seat at the negotiating table. The SDRM mechanism offers no formal procedure by which to involve small or retail investors in the negotiations and, instead, offers a legal mechanism designed to reduce their power vis a vis the majority. Moreover, to the extent that banks are the majority creditors, there are reasons to question their ability act as effective agents for the minority. Indeed, there are likely to be substantial differences in creditor interests.

III. The Role of Holdout Litigation

A. The Benefits and Costs of Holdout Litigation

Holdout litigation, we have seen, may be viewed as arising from developments in two distinct, but related, spheres – the capital markets and the courts. As the market for sovereign debt developed to include diverse investors with differing interests, the judiciary developed a set of legal doctrines that substantially limited the defenses sovereign debtors may fruitfully assert in suits brought by creditors.

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[211] Anne Krueger, Sovereign Debt Restructuring: Messy or Messier, at 4

[212] See Kunibert Raffer, To Stay or Not to Stay - A Short Note on Differing Versions of the SDRM, Working Paper, Jan. 31, 2003 (http://www.jubileeplus.org/latest/raffer310103.htm) (demonstrating the effect of the Hotchpot rule through numerical examples).

Thus, as the likelihood of recalcitrant creditors increased, the likely success of these creditors in pursuing claims against sovereign debtors in court also increased. Moreover, we have also seen that holdout litigation may provide important benefits that facilitate the restructuring of sovereign debt as well as promote the functioning of the international capital markets.

In the restructurings of the 1930s, recall, the bondholder protective committees, including the 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 sovereign 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 among both sovereign bondholders and bondholders and, ultimately, leading to the collapse of the market for sovereign bonds. In the restructurings of the 1980s, the bank advisory committees, although lacking the authority to bind commercial banks to agreements with sovereign debtors, were (with considerable effort) able to pressure recalcitrant banks to accept restructuring plans that had been negotiated with sovereign debtors (and to forego pursuing claims against sovereign debtors in court). These pressures, however, created strains among the commercial banks participating in the restructurings. And, these strains led to the development of a secondary market for loans to sovereign debtors, engendering even greater strains among the banks that were resolved only with the implementation of the Brady Plan through which the loans were securitized and exchanged for sovereign bonds.

Holdout litigation, then, may facilitate the restructuring process by providing a mechanism for striking the necessary balance between the interests of the majority of creditors with those of minority creditors. By providing an effective means for minority creditors to pursue their claims against sovereign debtors in courts, and so to have the merits of their claims adjudicated, holdout litigation may prevent restructurings from becoming mired in negotiations lasting years. At the same time, the holdout litigation may prevent (or at least limit) restructurings designed principally for the benefit of the majority of the creditors from being completed over the objections of the minority creditors.

Holdout litigation may also promote the operation of the international capital markets. Specifically, holdout litigation may serve as a potential check on opportunistic defaults by sovereign debtors. By limiting the possibility of opportunistic defaults, holdout litigation curtails the extent to which creditors may be inclined to restrict financings available to (creditworthy) sovereign debtors, thereby increasing capital flows (as compared to situations in which the possibility of opportunistic defaults is not limited). This check is particularly valuable in circumstances in which other market-type constraints operate poorly, as may be the case in the context of sovereign debt. For example, although the empirical evidence is mixed, studies indicate that a sovereign debtor's reputation for repayment has little effect on its subsequent ability to borrow.[213] If a concern for reputation is not important, other constraints may be necessary.

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[213]For example, upon completing their study of the experiences with sovereign debt over a period exceeding 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." [Lindert & Morton 40 (1989). *See also* [Cardoso & Dornbush (1989) (finding an absence of reputation effects in the market for sovereign debt); Jorgensen & Sachs, *supra* note 21 (noting an absence of reputation effects in the market for sovereign debt); [Eichengreen (1991) (concluding that reputation effects have limited impact in the market for sovereign debt). *But see* [Ozler (1993)] (finding evidence of reputation effects in the sovereign debt market); Michael Robert Tomz, Sovereign Debt in International Cooperation: Reputational Reasons for Lending and Repayment (Oct. 2001) (unpublished manuscript, on file with the authors) (finding evidence of reputation effects in the sovereign debt market).

In addition, to serving as a potential check on opportunistic defaults by sovereign debtors, holdout litigation may enhance the liquidity of the market for sovereign debt. By permitting creditors to reject the terms of a restructuring plan, including a plan supported by a majority of the other creditors, and to pursue the full value of their claims against a sovereign debtor in court, the potential for holdout litigation may entice vulture funds to enter the sovereign debt market. Once in the market, these funds create liquidity for other investors by offering them a means of exiting the market for a fixed sum of money (as opposed to remaining in the market until the restructuring process is complete).[214] This liquidity may be particularly beneficial to banks and other institutional investors that mark their portfolios to the market as it provides a means of limiting losses by selling the sovereign debt in their portfolios. Similarly, retail investors, notably those with fixed incomes, may benefit from the ability to monetize their claims. Moreover, the option value of holdout litigation may further enhance the liquidity of the sovereign debt market. That is, even if original creditors such as banks and other institutional investors do not wish to litigate their claims against sovereign debtors, they may obtain value from the right, and the ability, to sell their claims to other investors, such as vulture funds, that are more inclined toward litigation.

To the extent vulture funds purchase significant blocks of claims, they may reduce the administrative burden associated with the restructuring process. By aggregating claims, vulture funds may serve as a forum for coordinating the actions of creditors (at least the creditors who sold their claims to the funds) and as a mechanism through which communications (and, perhaps, negotiating) costs may be reduced.[215] Any reduction in the administrative burden resulting from the consolidation of the claims of many creditors, of course, is likely to be overshadowed by the costs incurred as a result of any litigation that the vulture funds pursue in respect of the purchased claims.

These benefits that holdout litigation confers on the restructuring process and on the international capital markets, however, are not without concomitant costs. Indeed, efforts by individual creditors, particularly vulture funds, to enforce their rights through litigation (and so to refuse to participate in the restructuring process) have long been characterized as disruptive to the restructuring process and abusive to other creditors.[216] Vulture funds, in particular, have been criticized for purchasing claims as a means of

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[214]*See, e.g.*, Suniati Yap, *Investing in Chapter 11 Companies: Vultures or Whiteknights?*, 2 SW. J. L. & TRADE AM. 153 (1995) (describing the role of vulture funds in providing liquidity in the market for distressed corporate debt); 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 (arguing that vulture funds provide liquidity in the market for distressed sovereign debt).

[215]*See, e.g.*, Yap, *supra* note 214 at 153 (describing the role of vulture funds in reducing the administrative burden associated with corporate restructurings); ROSENBERG, *supra* note 124 (describing the role of vulture funds in reducing the administrative burden associated with corporate restructurings). 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.

[216]*See, e.g.* 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 (1994) (describing criticisms of holdout creditors in general and vulture funds in particular); Buchheit & Gulati, *Exit Consents*, *supra* note 196 (describing criticisms of holdout creditors in general and vulture funds in particular in the context of sovereign bond restructurings); Bratton & Gulati, *supra* note 11 (describing criticisms of holdout creditors in general and vulture funds in particular in the context of sovereign bond restructurings)

disrupting a restructuring that is acceptable to the (vast majority of) creditors.[217] As a result of this disruption, vulture funds simultaneously increase the length of time needed to complete the restructuring and decrease the funds available to pay creditors.[218] In addition, to the extent the strategy of purchasing distressed debt at relatively low prices and holding out for substantial payments on the claims in the restructuring, or, perhaps, payment of the full value of the claims upon successful litigation, yields significant returns to vulture funds while other creditors suffer losses, the actions of the vulture fund have been strongly criticized as abusive.[219] Indeed, the actions of Elliott Associates in gaining, through litigation, access to the payments to be made in accordance with the restructuring plan have been widely condemned as grossly disruptive and abusive.[220]

The weighing of the benefits and costs of holdout litigation is a complex process, and the outcome of the process is highly uncertain. Moreover, the complexity and uncertainty are exacerbated by the difficulties inherent in determining the extent of the "holdout problem." Some commentators have argued that the problems created by holdout creditors, particularly vulture funds, are sufficient not only to impact the restructuring process negatively but also to require a new approach to sovereign debt restructuring. For example, Anne Krueger, the First Deputy Managing Director of the IMF, in first proposing the development of the SDRM, stated that:

> [t]he more recent success of an aggressive legal strategy employed against Peru by a vulture company called Elliott Associates underlines the power that holdout creditors retain. . . . This case – and the possibility that rogue creditors will open other legal avenues – shines a spotlight on what is a missing element of the international community's current approach to the roles of the public and private sectors in debt restructuring.[221]

Other commentator, have argued that the holdout problem "has not been as severe as initially thought."[222] For example, Nouriel Roubini argues that vulture funds may be "part of the solution rather than part of the problem" as "[l]ow risk aversion vultures tend to buy low, when default has occurred and debt prices have collapsed and get large mark to market gains from a successful deal; thus, they may

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[217]*See, e.g.*, Yap, *supra* note 214, at 160 (describing the impact of vulture funds on the restructuring process); ROSENBERG, *supra* note 124 (describing criticisms of vulture funds as disrupting the restructuring process). Note that, while vulture funds may purchase claims as a means of securing a higher payment by disrupting the restructuring process, they may also purchase claims as a means of securing a nuisance payment. That is, rather than seeking a substantial payment on the claims, or even payment in full, vulture funds may seek to coerce the sovereign debtor into making a payment simply to remove the nuisance cost associated with the holdout litigation.

[218]*See, e.g.*, Yap, *supra* note 214, at 160 (describing criticisms of vulture funds as disrupting the restructuring process); Wheeler & Attaran, *supra* note 124, at 259-60 (describing the role of holdout creditors, particularly vulture funds, in giving rise to the "classic collective action problem").

[219]*See, e.g.*, Yap, *supra* note 214, at 162 (describing criticisms of the "inherent unfairness" of payments to vulture funds while other creditors suffer losses); John Nolan, Emerging Market Debt and Vulture Hedge Funds: Free-Ridership, Legal and Market Remedies 7-8 (Sept. 2001) (unpublished manuscript on file with the authors) (describing abuses on the part of vulture funds).

[220]*See, e.g.* IMF, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring* (Nov. 2001) (unpublished manuscript, on file with the authors).

[221]IMF, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring* (Nov. 2001) (unpublished manuscript, on file with the authors).

[222]Roubini, *supra* note 8, at 7.

accept an exchange offer rather than litigate."[223] In addition, Professor Roubini notes that "[l]itigation is costly (especially for small creditors); some creditors (the retail ones) are more risk averse than others and the outcome of litigation is uncertain; some have a high rate of time preference and may not want to wait for the delay costs of protracted litigation. Thus, a majority of creditors are [sic] likely to accept an offer that is mark-to-market neutral of slightly positive, rather than holdout and incur the costs and risks of litigation."[224] Professor Roubini also posits that "large financial institutions that have ongoing business relations with a sovereign debtor . . . are unlikely to hold out and fight."[225] Finally, Professor Roubini notes that "the holdout problem can be minimized through side payments ("bribes") offered by creditors who have a lot to gain from a successful deal; or by the debtor (that "ex post" buys out a limited number of holdouts); or official creditors (via extra amounts of official finance that provide enhancements and/or sweeteners to a deal)."[226]

B. Tools for Limiting Disruptive and Abusive Litigation

The difficulties in weighing the benefits and costs of holdout litigation, coupled with the difficulties in determining the extent of the holdout problem, counsel for modest reforms that are designed to reduce the likelihood of litigation that is disruptive to the restructuring process and abusive to other creditors without precluding litigation that facilitates the restructuring of sovereign debt and promotes the functioning of the international capital markets. In particular, these reforms relate to the terms commonly contained in agreements governing sovereign bonds that define the rights of bondholders to file suit against sovereign debtors (the issuers of the bonds), focusing on the terms contained in agreements that are subject to the laws of the State of New York.

Most sovereign bonds issued in the United States are issued pursuant to a fiscal agency agreement.[227] 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.[228] The fiscal agent is the agent of the sovereign debtor, as issuer of the bonds.[229] The agreement, in this way, also governs the terms of the bonds.

With respect to enforcement of the terms of the fiscal agency agreement, the acceleration clause typically provides that, following an event of default, a vote of twenty-five percent of the outstanding bonds is necessary to accelerate the unmatured principal of the bonds.[230] In addition, in many, but not all,

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[223] *Id.*

[224] *Id.*

[225] *Id.*

[226] *Id.*

[227] Buchheit & Gulati, *Collective Will*, *supra* note 203, at 1332.

[228] MacMillan, *Debt Crisis*, *supra* note 28, at 342.

[229] Buchheit & Gulati, *Collective Will*, *supra* note 203, at 1332.

[230] *Id.* at 1331. Mr. Buchheit and Professor Gulati also note two exceptions to this rule. First, for bonds issued pursuant to a trust indenture (as opposed to a fiscal agency agreement), the trustee often retains discretionary power to accelerate the unmatured principal amount of the bonds following an event of default. Second, for bonds that are registered with the Securities and Exchange Commission, individual bondholders have the right to accelerate

agreements, the holders of a majority of the outstanding bonds, or a supermajority of the outstanding bonds, have the right to reverse an acceleration of unmatured principal so long as all events of default have been cured or waived.[231]

Importantly, under the terms of the fiscal agency agreement, individual bondholders retain all rights themselves.[232] Each bondholder, then, retains the right not only to accelerate the unmatured principal on its bonds but also to file suit against the sovereign debtor for the full amount represented by the accelerated principal on the bonds.[233] This convention differs markedly from the rights provided to bondholders pursuant to a trust indenture.[234] Specifically, under the terms of a trust indenture, individual bondholders retain the right to file suit against the sovereign debtor only for payments of principal and interest that were not paid on their respective due dates.[235] The trustee, rather than bondholders, possesses the right to sue for unmatured amounts.[236]

To limit the incentives of bondholders to commence litigation that is disruptive to the restructuring process and abusive to other creditors, issuers and underwriters, together with their attorneys, might propose that the terms of fiscal agency agreements be modified to limit the ability of bondholders to file

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the unmatured principal of their own bonds following specified events of default, such as a missed payment, or, in some cases, the declaration of a moratorium by the sovereign debtor.

Note that, subsequent to a restructuring, holdout creditors may possess sufficient voting power in the remaining debt to meet this threshold requirement. As Mr. Buchheit notes, "[p]rior to an exchange offer, the presence of sympathetic creditors in the bondholder group may dilute the voting power of an obstreperous minority below 25 % threshold. By removing the indulgent majority through an exchange offer, however, the sovereign [debtor] may unintentionally give the hold-out creditors the voting power they need to accelerate the old bond and commence legal actions." Lee C. Buchheit, *Sovereign Debtors and Their Bondholders*, UNITAR TRAINING PROGRAMME ON FOREIGN ECON. REL. (2000). To avoid this problem, the agreement may be crafted to designate the threshold as a percentage of the originally issued bonds, rather than of the outstanding bonds.

[231]*Id.* at 1330-31. Most agreements provide for a reversal of an acceleration upon the vote of fifty percent of the outstanding bonds, although some agreements require the vote of up to seventy-five percent of the outstanding bonds.

[232]This result follows from the fact that the fiscal agent is the agent of the sovereign debtor, as issuer of the bonds, rather than bondholders.

[233]*Id.*

[234]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 Great Britain. 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 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.

[235]*Id. 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) [hereinafter, Kahan, *Rethinking Bonds*] (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.").

[236]Buchheit & Gulati, *Collective Will*, *supra* note 203, at 1333. Mr. Buchheit and Professor Gulati further note that individual bondholders recover the right to sue for unmatured amounts in the event the trustee, having been instructed by the holders of 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.

suit against sovereign borrowers for the full amount represented by the accelerated principal on their bonds. Fiscal agency agreements might be modified to reflect the approach of trust indentures, in which the right of individual bondholders to sue sovereign debtors is limited to unpaid interest and principal. Holdout litigation is attractive under circumstances in which the cost of litigation, including the cost of executing on a judgment, are low relative to the amount of the judgment. By providing that, in the event of a default, the entire amount of the debt is immediately due, the acceleration clauses currently contained in fiscal agency agreements enable individual bondholders to obtain immediate judgments for the full face amounts of the bonds plus any missed interest payments. Indeed, the presence of this type of acceleration clause permitted Elliott Associates to obtain a judgment against Peru for $55 million. Absent the right to accelerate amounts owed on the bonds, a bondholder can only sue for missed interest payments (and, of course, principal at maturity), and the bondholder may be forced to bring multiple suits extended over a period of years. Obviously, the lengthy delay and increased cost associated with this repeat process reduce the attraction of litigation, and so reduce the likelihood that holdout creditors will pursue litigation that is disruptive or abusive.

Alternatively, the terms of fiscal agency agreements might be modified to limit directly the ability of bondholders to file suit against sovereign borrowers. Regardless of whether a suit involves the full amount of the unmatured principal (upon acceleration following a vote of twenty-five percent of the outstanding bonds) or for unpaid amounts of interest and principal, the terms of the agreements might be changed to require the affirmative vote of a designated percentage of the outstanding bonds to commence any litigation.[237] While a threshold of twenty-five percent would be consistent with the threshold required to accelerate payments due on the bonds, the threshold in respect of suing the sovereign borrower may be less than twenty-five percent (implying that, while the affirmative vote of twenty-five percent of the outstanding bonds is necessary to accelerate unmatured amounts, only the affirmative vote of a smaller portion of the outstanding bonds is needed to commence litigation). Again, the delay in pursuing the suit and the increased cost of the suit may lower the attractiveness of the litigation, and so reduce the likelihood that holdout creditors will pursue litigation that is disruptive and abusive.

Conversely, to provide incentives for bondholders to commence litigation that facilitates the restructuring process and promotes the functioning of the capital markets, issuers and underwriters, together with their attorneys, might propose that the terms of fiscal agency agreements be modified to ensure that, in circumstances in which the interests of fewer than all of the bondholders have been adversely affected, the impacted bondholders have the right to enforce the terms of the agreements.[238] 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 twenty-five percent of those bonds is necessary to accelerate the unmatured principal on those bonds (rather than requiring the vote of twenty-five percent of the outstanding bonds to accelerate the unmatured principal on the bonds).[239] By adjusting the threshold required for accelerating the unmatured principal on bonds in this way, the 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

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[237]For a discussion of a similar proposal, see MacMillan, *Work-out System*, *supra* note 28, at 103-04.

[238]Marcel Kahan has proposed a similar modification to the trust indentures governing corporate bonds. *See* Kahan, *Rethinking Bonds*, *supra* note 235, at 1074.

[239]As Professor Kahn 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, 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." *Id.*

bondholders to take action, by commencing litigation, to limit the strategic actions of the sovereign borrower.

These modest reforms to the enforcement provisions commonly contained in agreements governing sovereign bonds that are subject to New York law 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 capital markets. Importantly, these modifications of contractual terms can be tested in the market. Once the modified terms are incorporated in fiscal agency agreements, we will be able to observe their effect on the incidence of holdout litigation; that is, we will be able to observe whether suits filed in connection with the restructuring of an issuance of bonds subject to these terms appears to be designed to secure fair payment or to disrupt the process and abuse other creditors.

The market will also reflect the significance of these modifications through the extent to which bond prices and the cost of borrowing adjust. Numerous studies, for example, have argued creditors do not view the introduction of CACs as costly because bonds containing CACs do not appear to trade at a substantial discount relative to bonds containing UACs.[240] If the capital markets reacted similarly to contractual provisions that limited the opportunity for individual creditors to accelerate debt or to initiate litigation, we would have powerful evidence that the market views these actions as strategic behavior by holdout creditors, rather than a meaningful check on the restructuring process, and values terms that reduce the incidence of creditor litigation. In contrast, evidence that bonds with these provisions were less attractive to market participants would suggest that the possibility of creditors enforcing their rights through litigation adds meaningful value to the bonds that should not be eliminated without careful analysis.[241]

Note, however, that the approach we suggest is not without limitations. First, we seek a balancing of the interests of the majority of the creditors and the interests of the minority creditors. The modifications we propose may not strike the appropriate balance; that is, we may observe too much litigation (litigation that is disruptive and abusive) or we may observe too little litigation (so that a

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[240]*See, e.g.* Anthony Richards & Mark Bugiatti, *Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets*, 6 INT'L FIN. 415 (2003); 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 an Collective Action Clauses*, 8 BANK ENG. FIN. STAB. REV. 142 (2000); Kostas Tsararonis, *The Effect of Collective Action Clauses on Sovereign Bond Yields*, BIS Q. Rev.: Int'l Banking & Fin. Dev. 22 (1999).

[241]Although, as several commentators have noted, the capital markets may not be entirely efficient, and so may not be able to price all terms in agreements governing bonds immediately, over time we expect that any frictions may be overcome, so the capital markets are (at least) reasonably efficient. For a discussion of possible frictions in the capital markets, particularly the markets for bonds, see Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565 (1995); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L. Q. 347 (1996). *See also* Russell B. Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998); Russell B. Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998).

In addition, courts, when resolving disputes between parties arising from terms contained in contracts governed by the laws of the State of New York, generally seek to determine, as a matter of law, the meaning of common (or "boilerplate") terms. In seeking to interpret these terms, the courts generally seek to determine the "market understanding" of these terms and to incorporate the terms in light of this understanding. As a consequence, judicial decisions regarding the meaning (and the implication) of common terms help to clarify the meanings and so assist the market in pricing the terms. *See* Sharon Steel v. Chase Manhattan Bank, 691 F.2e 1039 (2d Cir. 1982). *See also* G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy,* BUS. LAW. (2002); Issam Hallak, Courts and Sovereign Eurobonds: Credibility of the Judicial Enforcement of Repayment (Oct. 2003) (unpublished manuscript, on file with the authors).

limitation on opportunistic default is removed). The contracting process provides an ongoing mechanism for adjusting this balance with respect to subsequent issues. Second, the modifications we propose relate to only individual issuances of bonds, they do not provide a means for making adjustments through the restructuring process among many different issues of bonds. The modifications we propose, then, provide a means for gathering information regarding more fundamental changes to the international financial architecture.

Conclusion

Proposals to reform the process of sovereign debt restructuring have proliferated, largely in response to a concern that disruptive and abusive litigation by holdout creditors threatens the viability of voluntary restructurings. In this Article we argue that litigation by holdout creditors has emerged as a natural response to developments in the sovereign debt markets, including the need for creditor empowerment to constrain opportunism by defaulting sovereign debtors and an increasing heterogeneity in creditor identities and interests. Because we argue that judicial enforcement of sovereign debt obligations increases their investment value, we argue that broad-based regulatory reforms are premature.

At the same time, the existing literature pays insufficient attention to genuine differences in creditor interests. Reform proposals rely unduly on majority-driven decisionmaking that may be unfair to minority creditors. Thus, any reform demands a conception of intra-creditor fairness that is beyond the scope of the existing literature and current reform proposals. Regardless of whether the decisionmaker called upon to evaluate a claim of unfairness to minority interests is an international bankruptcy court, a court in the United States or the United Kingdom, or a public official such as an officer of the IMF, the pursuit of such claims is likely to provide analogous threats to the restructuring process to litigation by holdout creditors, particularly vulture funds. More importantly, creditors will have ample opportunity to pursue claims for strategic purposes in the hope of obtaining a superior payment.

In short, if creditor heterogeneity and broader ownership of sovereign debt has caused an increased holdout problem, litigation similar to that seen in *Elliott Associates* is merely a symptom of the problem, and not the problem itself. Longer term solutions to the problem are likely to require steps such as formal prioritization of claims through a seniority system of debt issues, as well as increased transparency about the financial condition, and extent of indebtedness of the sovereign debtor.