Debt Defaults and Lessons from a Decade of Crises

Federico Sturzenegger and Jeromin Zettelmeyer

Debt Defaults and Lessons from a Decade of Crises

Debt Defaults and Lessons from a Decade of Crises

Federico Sturzenegger and Jeromin Zettelmeyer

The MIT Press
Cambridge, Massachusetts
London, England

MIT Press books may be purchased at special quantity discounts for business or sales promotional use. For information, please email special_sales@mitpress.mit.edu or write to Special Sales Department, The MIT Press, 55 Hayward Street, Cambridge, MA 02142.

This book was set in Palatino on 3B2 by Asco Typesetters, Hong Kong.
Printed and bound in the United States of America.

Library of Congress Cataloging-in-Publication Data

Sturzenegger, Federico.
Debt defaults and lessons from a decade of crises / Federico Sturzenegger, Jeromin Zettelmeyer.
p. cm.
Includes bibliographical references and index.
ISBN-13: 978-0-262-19553-9 (hardcover : alk. paper)
ISBN-10: 0-262-19553-4 (hardcover : alk. paper)
1. Debts, External—Developing countries. 2. Debt relief—Developing countries. 3. Developing countries—Economic policy. I. Zettelmeyer, Jeromin. II. Title.
HJ8899.S83 2007
336.3′435091724—dc22 2006027582

10 9 8 7 6 5 4 3 2 1

To the memory of Rudi Dornbusch
Our teacher and friend

Contents

3 Legal Issues in Sovereign Debt Restructuring

Sovereign lending has many characteristics and legal provisos that distinguish it from corporate debt. Most of its distinctive features have to do with the way a default situation for sovereign debt is resolved. Sovereign immunity, for example, limits the ability to sue defaulting countries or to attach their assets. The jurisdiction in which the debt instrument has been issued has implications for debt restructuring procedures. Also of relevance are bond clauses that specify remedies in case of default and define procedures for modifying the bond contract.

In what follows, we briefly review these concepts, before turning to the experience with creditor attempts to enforce sovereign bond contracts through litigation. In this context, we examine whether the possibility of uncoordinated litigation against sovereigns has impeded or delayed sovereign debt restructuring agreements, as has sometimes been argued. Finally, we ask whether some or all of the desirable characteristics of domestic bankruptcy organization could be mimicked through provisions in sovereign bond contracts, a question that has received much attention in recent years.

Legal Characteristics of Sovereign Debt

Principles Protecting Sovereign Debtors

A fundamental characteristic of sovereign debt is the lack of contractual enforcement mechanisms analogous to those that exist at the level of corporate debt. To a large extent, the reasons for this are political and practical rather than legal: it is hard to force a government to pay against its will, since most of the assets or income streams that could be used for repayment purposes (including tax revenue streams) are located inside the country. However, legal doctrine traditionally played an important role in magnifying the enforcement problem, particularly through the principle of (absolute) *sovereign immunity*, which states that sovereigns cannot be sued in foreign courts without their consent. Sovereign immunity can be derived from the equality of sovereign nations under international law: legal persons of equal standing cannot have their disputes settled in the courts of one of them (Brownlie 2003). Importantly, immunity can be waived: a sovereign can enter in a contractual relationship in which it voluntarily submits to the authority of a foreign court in the event of a dispute.

Under absolute immunity, which was the prevailing doctrine in the nineteenth century and in the first half of the twentieth century, sovereign immunity applied even to commercial transactions between foreign states and private individuals from another state. From the perspective of governments, this had the advantage that private commercial interests did not get in the way of diplomatic and political relations. As a result, unless an aggrieved creditor could persuade his own government to apply pressure, he was deprived of legal remedies to enforce repayments (except to the extent that he could successfully make a case in the *defaulting* country's courts).

In the United States, the interpretation of sovereign immunity began to change in the 1950s, in part as a consequence of the Cold War. The United States felt uneasy with granting sovereign immunity to Soviet Union state-owned companies operating in the United States. The U.S. government encouraged a more restrictive theory of sovereign immunity, under which foreign sovereigns were denied immunity for commercial activities carried on inside, or with direct effect inside, the United States. This restrictive view was embodied in the Foreign Sovereign Immunities Act (FSIA) of 1976, which allows private parties to sue a foreign government in U.S. courts if the complaint relates to commercial activity. The United Kingdom adopted similar legislation in 1978, and many other jurisdictions have followed suit (Buchheit 1986, 1995; Brownlie 2003).

As a result, sovereigns can now often be held legally accountable for breach of commercial contracts with foreign parties in the same manner as private parties. This leaves open the question of what is really a commercial transaction, and who really is a sovereign, within the terms of a foreign sovereign immunity law. With regard to the question of who is a sovereign, the U.S. FSIA, for example, defines a sovereign broadly to include agencies and instrumentalities of a sovereign.

Several court decisions have confirmed that the issuance of sovereign bonds is a commercial activity. Furthermore, a 1992 U.S. Supreme Court decision (*Republic of Argentina v. Weltover*) (Power 1996) established that suspending payments on debt contracts that call for payment in the United States entails direct effects within the United States sufficient to satisfy the U.S. nexus requirement under the FSIA. Accordingly, under U.S. law, international bond issues by a sovereign, and a subsequent default, are almost always considered commercial activities, regardless of the purpose of the issue, or the reason behind the payments interruption. Moreover, whatever protections of the sovereign remain under U.S. law can be contractually waived, and such waivers are in fact routinely included in bond covenants. As a result, under U.S. law (and that of several other major jurisdictions), sovereign immunity no longer plays an important role in shielding sovereign debtors from creditor suits.

Sovereign immunity laws may be a more effective shield against attachment proceedings, namely, creditor attempts to collect once a favorable court judgment has been obtained. Most physical assets of a sovereign located outside its borders, such as diplomatic or military property, are protected because they do not fall within the specific exceptions to sovereign immunity. Moreover, under FSIA and comparable laws, central bank assets, including international reserves, are typically immune from attachment.[1] For sovereign debt not issued by the central bank itself, this follows from the fact that although it benefits from sovereign immunity as an agency of the debtor state, it is also generally viewed as a separate legal entity that cannot be held liable for the acts of its principal. But even when the central bank itself is the debtor, most of its assets—in particular, international reserves and other assets necessary for the exercise of key central banking functions—generally enjoy immunity, unless this is explicitly waved (Lee 2003; Gramlich 1981). Moreover, as already mentioned, a sovereign or central bank can of course always attempt to limit attachable assets by locating them outside the reach of foreign courts. For example, government and central bank assets have been placed with the Bank for International Settlements (BIS) in Switzerland to take cover under the legal protections afforded to the BIS against attachment proceedings.

In addition to the principle of sovereign immunity, a number of other legal principles or conventions have been invoked by sovereign debtors in resisting creditor lawsuits during the 1980s and 1990s. Two such defenses are the "act of state" doctrine and international comity (Power 1996; Brownlie 2003). The *act of state doctrine* states that courts should not judge the validity of a foreign sovereign's acts committed on its territory: "In contrast to sovereign immunity, which acts as a jurisdictional bar to suits against a sovereign, the act of state doctrine is a judicially created rule of abstention concerning the justiciability of the acts of foreign governments. In further contrast to sovereign immunity, the act of state doctrine defense cannot be waived" (Power 1996). However, the act of state doctrine has proved to be of little use to sovereigns for a similar reason as sovereign immunity, namely, that defaulting on debtors payable in international jurisdictions is not considered to be a sovereign act worthy of judicial deference (see *Allied Bank International v. Banco Credito Agricola de Cartago*, discussed later in the chapter).

Finally, *international comity*, according to an 1895 U.S. Supreme Court decision, is defined as "the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation." Comity is a "softer" principle than sovereign immunity or act of state, which Power (1996) describes as "not the rule of law, but rather one of practice, convenience, and expediency." Brownlie (2003) speaks of "neighborliness and mutual respect." Comity considerations have motivated several court decisions both against and in favor of the sovereign debtor, and continue to play a role today. In practice, comity considerations in the United States seem to have boiled down to a court assessment on whether a debtor's actions could be viewed as broadly justified in light of U.S. policies on how international debt crises ought to be resolved. As such, they have given the U.S. executive branch a lever for influencing debt-related disputes before U.S. courts. Thus, comity is an unreliable principle, as "the defense's likelihood of success is subject to reassessment with each shift in U.S. policy on sovereign debt restructuring" (Power 1996).

Governing Law

Sovereign bonds can be classified as either *international bonds* issued by a government in an international financial center (e.g., New York, London, or Tokyo) under foreign law, or *domestic bonds*, issued in the debtor country under domestic legislation. International bonds are typically not denominated in the currency of the issuer, though very recently there have been some exceptions (see chapter 12). Domestic bonds are denominated either in foreign or in local currency. *Eurobonds* refer to a specific category of international bonds, namely bonds that are issued in countries other than the one in whose currency the bond is denominated. Eurobonds are often U.S. dollar-denominated bonds issued in a European jurisdiction (e.g., England, Germany, or Luxembourg), hence the name.[2]

New York law and English law are by far the most popular governing laws for the issue of international bonds, though Luxembourg law (for Brady bonds), German law and, more recently, Japanese law and Italian law (for Argentine debt) have also played a role. Traditionally, sovereign bond contracts issued under New York and English law have differed in important respects, though this was mostly a matter of "drafting momentum" rather than statutes governing sovereign borrowing, and these differences have recently narrowed.

Bond Contracts

Sovereign bonds come with an array of contractual features, or "clauses," that have important implications for debt restructurings. These include bond *covenants*, which commit the debtor to certain actions over the lifetime of the bond and prohibit others; *remedies* in the event that contractual obligations are breached; and *procedures for modifying the contract*. A brief survey follows.

Covenants are essentially formal promises by the debtor to the creditors. They define what is expected of the debtor during the lifetime of the contract. *Positive* covenants outline things that the debtor is supposed to do: most obviously, to repay the principal, and to pay an interest coupon and related payment promises (e.g., a put option that gives the creditor the right to ask for early repayment at specified points in time). Beyond this promise to pay, positive covenants typically commit the debtor to undertaking certain actions that support the base promise, for example, sharing information with the creditors and listing the bond on a specific stock market to ensure its liquidity. Another example is a "gross-up" covenant, by which the government commits to reimbursing cash flow losses from tax measures that may affect the interest or principal.

Negative covenants refer to actions the debtor promises to refrain from, because they would undermine the base promise, and hence reduce the value of the claim. The best known negative covenants in sovereign bonds are the pari passu clause and the negative pledge clause. Both are intended to ensure that an individual creditor is not discriminated against. The *pari passu clause* prohibits the debtor from subordinating the borrower, that is, from reducing his right to repayment relative to that of other creditors (Buchheit and Pam 2003).[3] The *negative pledge clause* prohibits issuing collateralized debt unless the incumbent debt holder is given equivalent collateral. This is meant to ensure that assets that a creditor could potentially attach in the event of default, or that could help to strengthen the repayment capacity of the creditor, are not assigned to other creditors.

Bond contracts also define remedies, which are legal consequences in the event that any of these covenants is breached. These remedies are typically calibrated to the seriousness of the breach. The most serious breach, obviously, is a failure to make good on any aspect of the promise to pay. To the extent that the bond is collateralized, this could trigger seizure of collateral. It could also trigger *acceleration*, which means that all principal and any accrued interest become immediately due and payable. Acceleration clauses govern the conditions under which acceleration can occur. The typical case is that 25 percent of the bondholders can accelerate unmatured principal following a default on payment terms, while a majority (50 percent) can veto or rescind a prior acceleration, if the default event has either been "cured" or waived by the bondholders.[4] For example, following Ecuador's default in September 1999, one bond was accelerated by its holders. In August 2000, Ecuador made an exchange offer to holders of this bond which was conditional on "exiting" holders voting to rescind the original acceleration, so that holders of the bond that chose not to accept the exchange offer were left with a bond that did not constitute an immediate claim on the principal.

The contract can also trigger remedies in the event of a default of the debtor on a third party (another creditor). This is called a *cross-default*. For example, a cross-default clause could define a default on a third party as an event that triggers acceleration. In order to strengthen the creditor's legal position in the event of default, bond contracts typically contain a clause in which the debtor waives sovereign immunity in the event of future disputes, that is, he promises to submit to the courts of a specified jurisdiction (the jurisdiction whose laws govern the bond, such as New York, England, or Luxembourg). In some cases, bond clauses might restrict the assets of the sovereign that may be attached in the event of default, augmenting sovereign immunity protections or limiting the extent of a sovereign immunity waiver. For example, during the 1990s, Argentina included a clause affirming that central bank reserves backing the monetary base under its currency board arrangement were unattachable.

Finally, *amendment clauses* may govern the conditions under which the terms of the bond contract can be changed. Bonds issued under U.S. law have traditionally contained a clause permitting amendments or modifications to the contract with the consent of a simple majority of bondholders, *except* for changes in the payment terms of the bond, which required the consent of each bondholder. Hence, under such provisions, important features of the bond including the applicable law, the formal definition of default, majority thresholds needed for acceleration, the negative pledge clause, listing requirements, and so forth, could be changed against the wishes of dissenting bondholders, while changes to the bond's maturity, scheduled interest payments, or principal repayment amount required unanimity. In contrast, bonds issued under English law have traditionally included a "majority amendment clause" which permits changes in the payment terms of the bond with some supermajority (usually 75 percent). These changes bind all bondholders, including those that voted against the change.

As argued by Buchheit and Gulati (2002), these traditions are rooted in differences in domestic bankruptcy law in the two countries. Until the 1930s, majority action clauses could be found in corporate debt contracts both in the United States and in the United Kingdom, but after a 1934 amendment to the U.S. Bankruptcy Act introduced a new procedure of coordinating creditors (a precursor of the modern "Chapter 11"), majority action clauses fell out of favor in the United States and were made illegal for corporate bonds (though not for sovereign bonds) by the Trust Indenture Act of 1939.[5] Sovereign bond contracts in the United States by and large followed the template of corporate debt in not containing majority action provisions until 2003, when majority amendment clauses began to be included in New York law bonds in response to pressures from creditor countries and the IMF.

As explained in chapter 1, the recent debt restructurings in Russia, Pakistan, Ukraine, Ecuador, Uruguay, and Argentina have not primarily relied on changes in the payment terms of the existing bond contracts but rather on exchanging the old instruments for new instruments with different payments terms. Nonetheless, majority amendment clauses played a role on three occasions. Majority amendment clauses were used directly to restructure an English law Eurobond issued by Moldova (June 2002) as well as one of Uruguay's nineteen externally issued bonds in May 2003 (a "Samurai bond" issued under Japanese law). Majority amendment clauses were also used to back up Ukraine's debt exchange offer in March 2000. By agreeing to the offer, holders of Ukraine's English law bonds delivered an "irrevocable proxy vote" in favor of an amendment that would bring the payment terms of the old bonds in line with the payment terms of the new bonds offered at the exchange. Hence, "holdouts faced the prospect of being left with an amended illiquid old bond that paid out no earlier than the very liquid new bond being offered at the exchange" (Buchheit and Gulati 2002).

In addition, the possibility of amending *nonpayment* terms to bonds has been used in three recent sovereign debt restructurings—Ecuador in 2000, Uruguay in 2003, and the Dominican Republic in 2005—to render the old instruments less attractive, hence creating an incentive for bondholders to accept the exchange offer (*exit consents/amendments*) (see Buchheit 2000; Buchheit and Gulati 2000; and IMF 2003b). In the case of Ecuador, exit amendments removed a prohibition on the further restructuring of the Brady bonds tendered in the exchange, cross-default clauses, negative pledge clauses, and the requirement to list the bonds on the Luxembourg stock exchange. In the cases of Uruguay and the Dominican Republic, the sovereign immunity waiver in the old bonds was amended to protect payments on the new bonds from attachment by holders of the old bonds; cross-default and cross-acceleration clauses were removed; and the listing requirement was also dropped (IMF 2003c).

Experience with Legal Enforcement of Sovereign Debt Contracts

As we have seen, legal protections of sovereigns from court action by creditors were significantly reduced by the 1980s. From the perspective of the sovereign debt literature in economics, this should be a good thing: if the fundamental distortion in sovereign debt—the reason why sovereign borrowing is expensive, and debt financing may be suboptimally low—is lack of contract enforcement, then improvements in creditor rights should be in the interests of both debtors and creditors. However, as the literature in both law and economics recognized early on, this is not necessarily true if individual creditors use their rights to seek an advantage relative to *other creditors*, that is, if they cease to behave cooperatively. In that case, "collective action problems" among creditors could be an obstacle to the orderly resolution of debt crises. This does not necessarily imply that creditors will be worse off relative to a situation in which they had fewer rights, but it opens the door for institutional mechanisms—from contracts that force creditors to act collectively, to formal bankruptcy-like regimes at the international level—that could improve over the status quo (see chapter 12).

In what follows, we briefly survey the experience with creditor attempts to enforce repayment through the courts following a default. We organize the discussion according to whether creditor legal action was initiated before or after a debt restructuring with a majority of the creditors was completed. Each of these litigation strategies have been linked to a particular collective action problem: pre-restructuring litigation to a possible "rush to the courthouse," in which creditors attempt to obtain a favorable settlement ahead of a possible debt restructuring, and post-restructuring litigation to the "holdout problem," in which a creditor refuses to participate in a restructuring with the hope of obtaining a better settlement later on. From an economic perspective, these collective action problems are much the same: they boil down to an attempt of individual creditors to free ride at the expense of the majority of creditors, which may scuttle a cooperative outcome. From a legal perspective, however, they involve somewhat different issues, particularly with regard to the attachment strategies that creditors might pursue.

We address two questions. First, how successful has either brand of litigation been in extracting repayment, or a favorable settlement, from the sovereign debtor? Second, has creditor litigation before or after a debt restructuring proved to be an obstacle to swift and successful debt restructurings?

Post-restructuring Litigation and the "Holdout Problem"

At the corporate debt level, creditor rights can be effectively enforced through the domestic courts, by giving creditors the right to seize collateral, liquidate, or otherwise sanction a defaulting firm. In a one-creditor world, this would generally be efficient. In a world of many creditors, however, it may give too much power to an individual creditor from the perspective of creditors collectively. In particular, liquidation is often inefficient in the sense that the liquidation value of the firm is lower than the value of the firm when it is reorganized and continues operating. Hence, creditors may have a collective interest in a debt restructuring agreement that avoids liquidation. Such an agreement could be undermined by creditors who insist on full repayment in exchange for not exercising their right to liquidate (or in exchange for not inflicting a sanction that would do the debtor more damage than full repayment to an individual creditor). If creditors know that a “holdout” can obtain full repayment conditional on a previous debt restructuring, everyone will want to be that holdout, and no one will want to restructure. This could prolong the default state, leaving a debtor without access to new capital—and creditors without any recovery of payments—for a long time. Bankruptcy legislation that imposes a court-supervised reorganization of the firm that maximizes its value as a “going concern” is often interpreted as the domestic level solution to this holdout problem.

The question is whether there is a similar holdout problem at the level of sovereign debt. Prior to World War II, this does not seem to have been the case, as individual creditors generally did not have a serious legal threat at their disposal that could have been used to extract full repayment (or a better settlement) after a debt restructuring agreement had been reached with a majority of creditors. Successful legal action was almost impossible due to full-blown sovereign immunity, and mobilizing political or economic sanctions required the joint pressure of many creditors and was hence outside the reach of holdouts by definition.

This began to change in the postwar period, and particularly after the codification of more restrictive sovereign immunity concepts in the United States and the United Kingdom in the late 1970s. Holdouts could now conceivably use the courts to extract a better deal than the settlement negotiated with the majority of creditors. The question is whether there is any evidence that creditor litigation was successful in this sense, and if so, whether it led to a systematic holdout problem. The answer is somewhat surprising: since the 1980s, there have been a large number of creditor suits (in the several hundreds), including several cases in which holdouts have in fact been able to secure better terms than average creditors. Yet holdout creditors do not so far seem to have posed a systemic obstacle to debt restructurings.

Fears that holdouts might create such an impediment go back to a well-known 1985 New York court decision, *Allied Bank International v. Banco Credito Agricola de Cartago*. In 1981, Costa Rica suspended debt payments to a thirty-nine-member bank syndicate. A restructuring agreement was subsequently reached with all creditors but one, Fidelity Union Trust of New Jersey, which sued through an agent, Allied

Bank, in U.S. courts. A lower court initially ruled in favor of Costa Rican banks that had acted on behalf of Costa Rica, accepting the defense's argument that Costa Rica's actions were protected by the act of state doctrine.

In 1984, an appeals court disagreed with this argument on the grounds that defaulting on foreign debt did not constitute an act of state. However, it initially upheld the lower court ruling on comity grounds, on the assumption that the U.S. executive branch was favorably disposed to Costa Rica's attempt to restructure its debts: "Costa Rica's prohibition of payments of its external debt is analogous to the reorganization of a business pursuant to Chapter 11 of our Bankruptcy Code. On that basis, Costa Rica's prohibition of payment of debt was not a repudiation of the debt but rather was merely a deferral of payments while it attempted in good faith to renegotiate its obligations" (United States Court of Appeals for the Second Circuit, 1984). Upon rehearing the case in March 1985, however, the court reversed itself after the U.S. Department of Justice argued that contrary to the court's initial assumptions, the U.S. government did not agree with "Costa Rica's attempted unilateral restructuring," concluding that "while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable" (United States Court of Appeals for the Second Circuit, 1985). According to Greenwood and Mercer (1995), this led to a settlement in which the U.S. government encouraged Fidelity Union to accept the package agreed by the rest of the bank syndicate.

The *Allied Bank* case was thus significant in several respects. It demonstrated that a holdout could be successful in the sense of obtaining a favorable judgment, and showed that two important legal principles—the act of state doctrine and international comity—did not necessarily protect sovereigns in the event of default (Power 1996). However, given the final outcome—Fidelity Union did no better than the creditors that had negotiated the earlier restructuring—the *Allied Bank* case can hardly be interpreted as illustrating the rewards of a holdout strategy. In a sense, Fidelity performed a free service for debt holders collectively, by helping to demonstrate the weakness of defenses that had been thought to protect sovereign debtors without achieving a financial advantage over creditors that had agreed to the previous restructuring. Indeed, the other creditors did not object to the litigation while it was ongoing; on the contrary, through the New York Clearing House Association, they filed a brief supporting Fidelity.

During the remainder of the 1980s, creditor litigation remained the exception, for two reasons. First, there were strong mechanisms, both contractual, and through informal institutions like the BAC process discussed in chapter 1, that encouraged collective action in resolving debt disputes and discouraged go-it-alone litigation. In particular, syndicated loan contracts, the main vehicle for private lending to developing countries during the 1970s and 1980s, typically contained "sharing clauses" that forced any member of the syndicate to share any payments extracted through litigation or settlement with the remaining members (Buchheit 1998b). Second, prior to the creation of the secondary debt market in the late 1980s, virtually all holders of distressed debt were banks, which had a regulatory incentive against declaring a creditor in default (in practice, a prerequisite for litigation), as this would have required them to write down their loans. Until the late 1980s, many creditor banks did not have sufficient reserves to do so. As observed by Power (1996), the "effect of these pressures was a de facto replication of the U.S. Bankruptcy Code's automatic stay of collection actions against a debtor. The banks were effectively unable to pursue their collection rights even though those rights were fully enforceable."

This situation began to change in the late 1980s, as creditor banks provisioned against loan losses and began writing off their loans, and the creation of a secondary market in securitized loans allowed new investors, including specialized firms that became known as "distressed debt funds" or "vulture funds," to buy defaulted debt at large discounts with a view to extracting the best possible settlement. The result was a sharp increase in holdout litigation following the Brady Plan restructurings of the early 1990s. A famous early case is *CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brazil* (Power 1996; Nolan 2001; Waibel 2003). In the early 1990s, the Dart family had accumulated $1.4 billion of Brazilian Multiyear Deposit Facility Agreement (MYDFA) debt at a large discount. The MYDFA was a 1988 debt restructuring agreement between Brazil and creditor banks that covered most of Brazil's outstanding debt. Brazil stopped servicing MYDFA debt in 1989, and eventually initiated negotiations leading to a 1993 restructuring under the Brady Plan that was accepted by all creditors except the Darts. Brazil restructured all debt except for $1.6 billion that were formally held by the Central Bank of Brazil; this prevented the Darts from becoming the majority debt holder with the right to accelerate outstanding principal and interest payments. In response, the

Darts, through CIBC as the holder of record of the debt, sued the Central Bank of Brazil in New York, claiming (1) past due interest under the MYDFA; and (2) the right to accelerate the entire principal and interest owed. In May 1995, the court ended up siding with the plaintiff on the first claim, but declined to allow the Darts to accelerate. The question of whether the Darts were entitled to recovering the full principal *at maturity* was not answered by the court since it was not the object of litigation, but in light of the *Allied Bank* case, there was a presumption that they would (Power 1996).

In March 1996, Brazil settled, paying the Darts $52 million in Eligible Interest Bonds covering past due interest until April 1994 (the settlement date of the Brady deal) and $25 million in cash covering accrued interest since April 1994. Hence, Brazil treated the remaining MYDFA as if it had been performing since April 1994, signaling that it would continue servicing the loan in the future. On that basis, the Darts managed effectively to sell their MYDFA holding by issuing $1.28 billion in Eurobonds secured by MYDFA debt in October 1996, at a modest spread over Brazilian sovereign debt with similar payment terms. Although the market value of this issue, at about $1.1 billion, fell short of the $1.4 billion that the Darts had initially demanded, this meant that the Darts came out much better than creditors that had accepted the Brady exchange.

From a legal point of view, several aspects of the *CIBC Bank* case are notable. First, Brazil did not invoke either sovereign immunity or the act of state doctrine in its defense, a recognition of the fact that these principles had lost their protective power in the context of sovereign debt litigation. Second, it tried to invoke two arguments designed specifically to fend off holdouts that had purchased distressed debt in the secondary market, namely, that assignment of the debt to CIBC was invalid under the terms of the original debt contract (in this case, the MYFDA), and that the Darts' suit violated New York's "law of Champerty," which prohibits litigating on a claim purchased exclusively for the purposes of filing a lawsuit. Both arguments were rejected by the court, establishing a precedent that was largely followed in subsequent court cases. The "Champerty defense" suffered from the problem of having to prove intent: claim holders could always argue that they had purchased the claim not with the intention to litigate but in order to get paid, and that the decision to litigate was merely a reaction to the sovereign's refusal to pay, and fully within their rights.

Finally, as in the *Allied Bank* case, the U.S. government filed a brief, but with the opposite thrust, urging the court to reject the Darts' claim for acceleration of principal on the grounds that holdouts that had purchased debt in the secondary market should not be allowed to take a free ride on debt workouts agreed by a majority of creditors: "The United States observed that its concern in *CIBC* was a 'mirror image' of its concern in *Allied* ten years earlier. In *Allied*, the United States had been concerned that a judgment for Costa Rica would encourage sovereign debtors to use the courts to extract better terms from creditors than they could obtain through negotiation. In *CIBC*, conversely, the United States was concerned that a judgment in favor of the Darts would encourage creditors to use the courts to gain unfair concessions from sovereign debtors" (Power 1996). The court ultimately agreed with the U.S. argument, so comity may have benefited the debtor in this aspect of the case.

By and large, the precedents set by the *CIBC Bank* case have been borne out in subsequent litigation. First, subsequent cases have confirmed a holdout's right to litigate on the basis of a claim acquired in the secondary market. The Champerty defense, in particular, was rejected in several instances, including by the English Court of Appeal in *Camdex International Limited v. Bank of Zambia* (1998), and on appeal by a New York court in *Elliott Associates v. Banco de la Nación* (1999). Second, courts generally paid some attention to the argument, made by the U.S. government in the *CIBC Bank* case, that holdout creditors should not be allowed to disrupt or undo debt restructuring agreements negotiated with a majority of creditors.

The desire to safeguard creditor rights as defined by the debt contract has tended to prevail whenever there has been a conflict between these two principles. For example, in *Pravin Banker v. Banco Popular del Peru* (1997), a New York court stayed Pravin's claims for full repayment by Peru on two occasions to avoid a disruption to the ongoing Brady deal negotiations, but ultimately decided in favor of Pravin. Similarly, in *Elliott & Associates v. Republic of Panama* (1997), Elliott obtained judgments covering the full claim, and subsequently settled for close to that amount, notwithstanding the fact that it had acquired the Panamanian debt at a substantial discount from Panama's original creditors. Elliott could extract full repayment because it was able to obtain an attachment order that could have inflicted serious harm on Panama, one directed against U.S. assets of the national telecommunications company which Panama was about to privatize, and one which would have interfered with a large new bond issue in New York. Although Panama paid in full, the amount paid ($71 million) was an order of magnitude smaller than both the value of the privatization deal and the proceeds received from the bond issue.

The famous 1999 case of *Elliott Associates v. Banco de la Nación* (Peru) constitutes an example of interference with future debt flows as a strategy for enforcing repayment. Following the by-now-familiar theme, Elliott Associates acquired nonperforming debt guaranteed by the Peruvian government, at a large discount, just prior to Peru's 1996 Brady deal. After Peru refused to repay in full, Elliott Associates sued in New York. A prejudgment attachment sought by Elliott Associates was initially denied on the grounds that it would have jeopardized the pending Brady restructuring, but in late 1999, Elliott obtained a prejudgment attachment order against Peruvian assets used for commercial purposes in the United States, and finally, in June 2000, a $57 million judgment against Peru. Based on this judgment, Elliott sought court orders in New York and various European countries that would either attach Peruvian assets or bar Peru from paying interest on its Brady bonds. It was eventually successful, convincing a Brussels appeals court to order the payments provider Euroclear on an emergency basis—namely, before arguments in opposition had been made—to suspend payment on Brady bond interest. Faced with an approaching payment deadline that would have brought its entire stock of Brady debt into default, Peru decided to settle with Elliott Associates for a reported sum of $56.3 million rather than continue the legal fight.

The *Elliott/Peru* case led to much consternation in policy circles because it appeared to open a powerful new channel for the enforcement of the claims of holdouts who had successfully obtained a judgment. Rather than engaging in the difficult and tedious process of attempting to attach debtor assets abroad, holdouts could ask courts to interfere with cross-border payments to mainstream creditors who had previously agreed to a debt restructuring. This seemed to be an almost foolproof enforcement channel, since it effectively gave holdouts a veto over the regularization of a country's relations with mainstream creditors, and hence over its return to international capital markets. Hence, *Elliott/Peru* appeared to catapult holdouts from their previous status of either a minor nuisance (at worst) or champions of creditor rights (at best) to a formidable obstacle to orderly sovereign debt restructurings.

However, interfering with payments to creditors that had accepted a restructuring offer did not turn out to be a very robust enforcement mechanism, for two reasons. First, its legal basis appeared questionable. Elliott Associates' motion to suspend payments to Peru's Brady bondholders rested on a broad interpretation of the pari passu clause in the debt contracts it had purchased, as giving it the right to receive a proportional share of any payments on external debt made by Peru (though arguably the Brussels court went further, effectively giving Elliott *priority* over the Brady bondholders). This contrasts with a more conventional interpretation of the pari passu clause stating that the claim in question does not have lower priority than other unsecured claims (Gulati and Klee 2001; Wood 2003; Buchheit and Pam 2004). By now, Elliott Associates' interpretation of the pari passu clause has been challenged not just by many legal commentators, but also (in the context of the Argentina case) by the U.S. government, the Federal Reserve Bank of New York, and the New York Clearing House Association.

Second, regardless of which interpretation of the pari passu clause is correct, practical and legal steps could be (and have been) undertaken to remove payments to mainstream creditors from the reach of holdouts. Most obviously, payments could be made in the debtor country, so that any cross-border transfer would involve creditor accounts only. In this case, holdouts would have to attempt to recover payments from other creditors, a legally difficult endeavor as long as explicit sharing clauses are absent from bond contracts (with such sharing clauses, however, holdouts could not hope to extract a better deal). Alternatively, international payments systems could be explicitly protected from judgment creditors through changes in national laws. Indeed, Belgium has recently adopted a law that prevents a judgment creditor from obtaining a court order that would preclude Euroclear from channeling payments from a sovereign debtor to its bondholders.

The possibility of structuring payment flows in ways that makes them difficult to attach cast doubt that Elliott Associates' strategy both in the Panama case (with respect to a new bond issue) and in the Peru case (with respect to payments to existing creditors) will continue to succeed in the future. Structuring international transactions so they are attachment-proof may, of course, impose costs; for example, if fear of attachment induces sovereigns to refrain from issuing new bonds abroad or investing reserves in international financial centers. To the extent that this is the case, it would give holdouts some leverage in settlement negotiations.

Several holdouts have attempted to mimic Elliott's legal strategy with respect to Peru, with limited success (Singh 2003; IMF 2004). In *LNC v. Nicaragua*, the Belgian Court of Appeals found that the contractual pari passu clause did not give LNC the right to attach payments channeled through Euroclear, since Euroclear was not a party to the contract in which the pari passu clause arose. In *Kensington v. Republic of Congo*, an English court also rejected enforcement based on the pari passu clause, on the grounds that reliance on this contractual clause was inconsistent with the fact that the plaintiff's claim had been reduced to a court judgment. Finally, in *Red Mountain Finance v. Democratic Republic of Congo*, the courts rejected the broad construction of the pari passu clause but issued an injunction with a similar effect, namely, preventing the debtor from making external debt payments unless proportionate payment was made to Red Mountain. The Democratic Republic of Congo (DRC) appealed the injunction, but settled with Red Mountain at about 37 percent of the value of the judgment claim before the appeal hearing, just ahead of an arrears-clearing payment to the IMF that allowed Congo to resume borrowing from official lenders after years of crisis and civil war.

In sum, changes in the legal environment since the late 1970s have made it much easier for holdout creditors to obtain judgment claims. In addition, there are several examples—most famously, *CIBC/Brazil*, *Elliott/Panama*, and *Elliott/Peru*—in which holdouts have been able to enforce those claims, or settle at substantially better terms than average creditors. These settlements seem to have occurred either because holdouts credibly threatened to attach sovereign assets or interfere with international transactions, or because of reputational concerns—debtor reluctance to defy court judgments at a time when they were regularizing their record as borrowers. This said, full repayment has remained the exception, and many holdouts have received nothing (table 3.1).

To conclude, holdouts currently enjoy some leverage—more than in previous decades and perhaps more than at any time in history. Nonetheless, this leverage remains limited, and attempts to exploit it are risky because of high legal costs and foregone debt service. Hence, holdout strategies may make sense only for highly specialized firms such as Elliott Associates. This may explain why actual or expected litigation from holdouts does not so far seem to have derailed any debt restructuring agreement. Holdout strategies may not be attractive for either retail bondholders or large investors with a broader commercial

Table 3.1
Sovereign litigation: Selected cases

Creditor	Domicile of creditor	Debtor	Original claim	Status	Year	Judgment for creditor (in millions of U.S. dollars)	Received (in percent)
Litigation with collective action problems[a]							
Dart and others[b]	US	Argentina	[c]	JTP	2002/2004	. . .[d]	—
Dart	US	Brazil	1400	JTP	1994	. . .[d]	100
Elliot Assoc.	US	Cote D'Ivoire	8	OCS	1994	. . .[d]	. . .[d]
Elliot Assoc.	US	Ecuador	6	OCS	1995	. . .[d]	100
LNC Investments	US	Nicaragua	26.3	JTP	1999	87.1	—
GP Hemisphere Assoc.		Nicaragua	30.9	JTP		126	—
Van Eck Emerg. Markets	US	Nicaragua	13	JTP		62.5	—
Elliot Assoc.	US	Panama	48	OCS	1998	78	100
Elliot Assoc.	US	Peru	64	OCS	1999	. . .[d]	100
Pravin Bankers Assoc.[e]	US	Peru	1.4	OCS	1996	. . .[d]	. . .[d]
Elliot Assoc.	US	Poland	SF 5	OCS	1995	. . .[d]	. . .[d]
Elliot Assoc.	US	Turkmenistan	3.8	OCS		. . .[d]	100
Litigation without collective action problems[a]							
Winslow Bank	Bahamas	Cameroon	8.9	JTP	1997	51.5	—
Del Favaro Spa	Italy	Cameroon	2.9	JTP	1998	4.9	<10[f]
EnergoInvest	Form. Yug.	Congo D.R.	55.8	JTP	1998	74.9	—
ITOH Middle East	Bahrain	Congo D.R.		JTP		. . .[d]	—
Equator Bank	UK	Congo	6.7	OCS	1994	. . .[d]	. . .[d]
Red Mountain	US	Congo	27	OCS	2001/2002	. . .[d]	30
Kintex	Bulgaria	Ethiopia	8.7	In arbitration		. . .[d]	—
Booker Plc.	UK	Guyana	6	Dropped case	2003	. . .[d]	—
Laboratorio Bago	Argentina	Honduras	1.45	Pending		. . .[d]	—
Yugoimport	Form. Yug.	Mozambique	10.9	Pending		. . .[d]	—

Table 3.1
(continued)

Creditor	Domicile of creditor	Debtor	Original claim	Status	Year	Judgment for creditor (in millions of U.S. dollars)	Received (in percent)
Export-Import Bank	Taiwan	Niger	60	JTP		72.3	—
J&S Franklin Ltd.	UK	Sierra Leone	1.2	JTP		2.7	74
UMARCO	France	Sierra Leone	0.6	Pending		. . .[d]	. . .[g]
Exec. Outcomes	US	Sierra Leone	19.5	Pending		. . .[d]	. . .[h]
Chatelet Inv. Ltd.	Sierra Leone	Sierra Leone	0.4	Pending		. . .[d]	—
Sancem Int.	Norway	Sierra Leone	3.7	OCS		. . .[d]	24
Banco Arabe Español	Spain	Uganda	1	JTP[i]		2.4	. . .[d]
Transroad Ltd.	UK	Uganda	3.9	JTP[i]	2003	8.3	30[j]
Ind. of Construction	Form. Yug.	Uganda	7	JTP[i]		8.9	—
Sours Fab. Famous	Form. Yug.	Uganda	0.3	JTP[i]		1.4	. . .[d]
Iraq Fund for Ext. Dev.	Iraq	Uganda	6	JTP[i]		6.4	—
Shelter Afrique	Kenya	Uganda	0.9	OCS		. . .[d]	11
Cardinal	Bahamas	Yemen	8.2	OCS	2001	. . .[d]	33
Camdex Int.	Bahamas	Zambia	40–45	JTP	1997	100	100

Source: Singh (2003), IMF (2004), and news reports. Original claim in millions of U.S. dollars unless otherwise stated.
Note: JTP denotes Judgment to Pay; OCS denotes Out of Court Settlement (including in cases when there was a JTP).
[a] Litigation with collective action problems refers to instances in which the plaintiff was one of many holders of the same instrument (or a similar debt instrument that was also defaulted).
[b] Others include Old Castle, Urban, Macrotechnic, NML, and so forth. Substantial litigation has also taken place in Germany and Italy, sometimes involving retail bondholders.
[c] Approximately US$1 billion in the United States, EUR64 million in Italy, EUR42.2 million in Germany. See 18-K filing presented to the SEC commission by the Argentine government.
[d] Indicates payments ongoing or settlement for an undisclosed amount.
[e] See Nolan (2001).
[f] Singh (2003) reports that GBP150,000 were attached in London.
[g] US$1 million paid so far.
[h] US$1.1 million paid so far.
[i] Ruling obtained in local courts.
[j] US$2.79 in legal fees were paid out. See http://fr.allafrica.com/stories/200412200466.html.

interest in the debtor countries. Agreeing to a reasonable debt restructuring offer—one that reflects the country's capacity to pay—may be the best option available to mainstream creditors, even if there is an expectation that there could be some successful holdouts. This is true, of course, only to the extent that payments to successful holdouts are expected to remain relatively small; otherwise, the country's capacity to honor its commitments to the majority could be undermined. However, the limited leverage of the holdouts should generally ensure that this is the case: holdouts will not be able to extract payments beyond their limited capacity to inflict direct or reputational damage to a country.

Pre-restructuring Litigation and the "Rush to the Courthouse"

In both law and economics, the possibility of destructive "creditor runs" began to attract attention in the early 1980s.[6] Among the first to raise the issue in the legal literature on sovereign debt were Barnett, Galvis, and Gouraige (1984), in the context of debt rescheduling agreements between commercial bank creditors and distressed sovereigns that had taken place since 1982, and had thus far stopped short of open defaults. Barnett, Galvis, and Gouraige argued that this was a fragile state of affairs. If an individual creditor decided not to participate in such an agreement and declared a default as the first step toward litigation, this would trigger cross-default clauses, resulting in a "race to the courthouse." This would result in an avalanche of creditor claims that could not possibly be met by the debtor. Moreover, the state of open default would further magnify the debtor's economic problems.

As it turned out, "races to the courthouse" did not happen during the 1980s. Based on the previous discussion, this is not surprising: a free rider problem may not, in fact, have existed. The rules of syndicated lending ensured that everyone who participated in a "race to the courthouse" arrived there at about the same time. And even if litigating creditors managed to attach payments ahead of others, they might have had to share these payments with other members of the syndicate. Barnett, Galvis, and Gouraige may have been right that "racing to the courthouse" would have triggered pandemonium. But under the rules of the 1980s, a creditor initiating the race stood to gain little, and might expect to suffer the same costs—in the form of an aggravation in the debtor's repayment capacity—as subsequent participants in the race. Hence, stability prevailed.

After the advent of secondary debt markets, these contractual restrictions began to lose their bite, either because new bond issues no longer had sharing provisions, or because distressed debt funds could acquire an entire loan (or a majority stake) at a discount, rendering sharing clauses irrelevant. Yet, there were relatively few cases of pre-restructuring litigation. The best known is *Pravin Banker v. Banco Popular del Peru*, which was mentioned previously. The argument that Pravin's suit might set off a race to the courthouse and disrupt Peru's ongoing restructuring negotiations was, in fact, made by the debtor, and the court initially accepted it, granting two stays of litigation. In the end, however, the court sided with Pravin, and no creditor stampede occurred. The reasons for this might be related to those discussed at the end of the previous section: for most creditors, a litigation strategy is not very attractive unless holdouts undermine the viability of a reasonable debt restructuring agreement. Pravin owned only $1.4 million of Peruvian debt: "Although irksome to both the country and its other creditors, it was not about to bankrupt the Peruvian treasury or scuttle the country's contemplated Brady deal" (Power 1996).

The only debt crisis of the postwar period (and perhaps in history) that has, in fact, witnessed massive pre-restructuring litigation is the most recent crisis in Argentina. By late 2004, almost 140 lawsuits, including 15 class action suits, a novel vehicle in the context of sovereign debt litigation, had been filed against Argentina in New York, Italy, and Germany, both by distressed debt funds holding Argentine claims and "retail investors."[7] Many of these suits have resulted in judgments in favor of the creditors, including a $725 million judgment in favor of one creditor (EML, a subsidiary of Dart Capital). In terms of sheer numbers, this looks very much like the "race to the courthouse" predicted by Barnett, Galvis, and Gouraige (1984).

The question is whether it also had any of the predicted effects. Barnett, Galvis, and Gouraige's main concern that a race to the courthouse would trigger a default is, of course, moot in this case, since Argentina had already declared default in December 2001. Moreover, in spite of the judgments obtained by EML and others, the avalanche of lawsuits has not, so far, weakened Argentina economically. Attempts actually to attach assets have so far turned out to be largely fruitless.[8]

The greatest harm that these lawsuits could have done to Argentina would have been to interfere with its debt exchange offer by creating legal obstacles to the debt exchange or its settlement, or by discouraging creditors from participating in the exchange. As far as creditor participation is concerned, this was, in fact, lower than in preceding exchanges (76 percent), but much higher than anticipated (chapter 8). Regarding legal obstacles, two class action litigants did, in fact, attempt to block the exchange offer, but a New York court ruled against them in November 2004, and the offer went ahead in January 2005.

This was followed by a further legal challenge in March 2005, shortly before the exchange was to settle. NML Capital (an offshore fund with ties to Elliott Associates) asked a New York court to attach a portion ($7 billion) of Argentina's defaulted bonds that had been turned in by consenting bondholders to the Bank of New York, in charge of carrying out the exchange, arguing that they had market value and hence could be sold to satisfy a future judgment. The court rejected this argument, on the grounds that until settlement, the bonds belonged to the creditors that had accepted the exchange, and that attaching them would jeopardize the exchange; however, it agreed to maintain a freeze pending appeal. In late May, an appeals court upheld this decision, arguing that the lower court "acted within its discretionary authority to vacate the remedies in order to avoid a substantial risk to the successful conclusion of the debt restructuring. That restructuring is obviously of critical importance to the economic health of a nation" (United States Court of Appeals for the Second Circuit 2005). While the court refused to rule on the legal issues disputed by the parties and hence did not set a precedent, one has to agree with Gelpern's (2005) observation that "if future judges use similar reasoning, preclosing challenges look increasingly remote."

Can Domestic Insolvency Procedures Be Mimicked Through Sovereign Bond Contracts?

A central theme of the discussion so far has been the tension between enforcing creditor rights, which is desirable from the perspective of efficient debt markets, and avoiding a holdout creditor problem, which is desirable from the perspective of an efficient resolution of debt crises. At the domestic level, this tension is resolved by bankruptcy legislation, which attempts to safeguard creditors' rights by giving creditors priority over equity holders and ensuring that the firm is restructured in a way that maximizes its capacity to repay while protecting majority creditors from holdouts (e.g., by imposing a stay of litigation pending the outcome of a reorganization, and making the outcome of a reorganization binding on all creditors). The question is whether the same objectives can be achieved by appropriately designing sovereign debt contracts, and relying on courts in the major issuing jurisdictions to enforce them. The consensus from a growing literature on that topic (Eichengreen and Portes 1995; Eichengreen 2000, 2002; Schwarcz 2000; Buchheit and Gulati 2002; Taylor 2002; Bolton 2003; Bolton and Skeel 2004; IMF 2002b, 2003b, d, e, f) appears to be, to some extent, but not completely.

Domestic bankruptcy procedures are often interpreted as serving three practical purposes: (1) eliminating free rider problems during and after the restructuring negotiations, particularly the holdout creditor problem; (2) ensuring that the firm has access to financing while it is being restructured ("debtor in possession" or "DIP" financing); and (3) enforcing a predetermined priority structure. Bond covenants currently deal with only the first of these, and do so to only a limited extent. Contractual innovations that could address the first purpose more completely and begin to address the second and third are not inconceivable, but are complicated and perhaps impracticable.

Consider first *free rider problems*. As argued in the last section, these can be divided into two groups: pre-restructuring litigation and problems caused by holdouts that litigate after a debt restructuring. As we have seen, most newly issued international bonds already contain some protections against these problems. With regard to pre-restructuring litigation, acceleration clauses ensure that a critical mass of creditors is necessary in order to accelerate repayment and that a majority of creditors can veto this decision. With regard to holdouts, majority amendment clauses can impose a restructuring agreed to by a supermajority of bondholders on a dissenting minority. However, the extent to which these clauses solve the free rider problem is limited. Even if the debtor had just one bond issue outstanding, a minority bondholder could obviously still block an agreement if he controlled a sufficiently large share of the issue. With multiple bond issues, this problem is aggravated by the need to coordinate creditors across these issues: many majority decisions are required, rather than just one, to amend bonds in a consistent way. Moreover, with public debt fractured into many issues, each of which may trade at large discounts in crisis times, it may be easy for distressed debt funds to acquire a controlling majority of one issue on the secondary market.

To deal with these problems, additional collective action clauses could be added to the standard acceleration, enforcement, and majority amendment clauses (Buchheit 1998a, b; Taylor 2002; IMF 2003e).

Bond-by-bond majority action clauses could be supplemented with "aggregation clauses" that would, in effect, allow a supermajority of bond holders *across* bond issues to amend the payments terms of all bonds even if the usual supermajority required for issue-by-issue amendments is not present. Moreover, proposals have been made to coordinate bondholder representation and discourage litigation by holdouts. These include adding sharing clauses to bond contracts that state that if any bondholder receives a payment disproportionate to that received by other bondholders, this must be shared with the remaining bondholders, and "collective representation clauses," which would delegate the authority to represent the bondholders in debt restructuring negotiations to an agent (though bondholder voting on a proposed restructuring would still be required). For example, bonds could be issued under a "trust indenture" (in U.S. law) or a "trust deed" (in English law); these give a trustee a limited monopoly over litigation and require it to share any proceeds among all holders of the same bond issue (Buchheit and Gulati 2002). Additional language in the bond contract would be required, however, to give the trustee the power to negotiate.

Bonds issued in recent debt restructurings have taken limited steps in these directions. In Uruguay's May 2003 exchange, all new external bonds were issued under a trust indenture, and included an aggregation clause to the effect that, if 85 percent of holders of bonds issued under the same indenture agreed to an amendment of the payment terms, then the supermajority level required for the amendment at the level of each individual bond was reduced from 75 percent to 66.66 percent. Argentina's 2005 exchange contains a similar clause, with the novel feature that aggregated voting would apply across bonds governed by different governing laws. These aggregation features are still very limited compared with a situation where all bondholders would make a supermajority decision "across" bonds, in the sense that they still give a 34 percent minority of holders of each individual bond issue the power to hold out, even if more than 85 percent of *all* bondholders desire a change. But in principle, they could be extended further.

Next, consider *DIP financing*. As we saw in chapter 1, the BAC process in the 1980s served this purpose, providing "new money" in the context of debt rescheduling agreements. In contrast, in the post–Brady era of debt exchanges, distressed borrowers have never been able to obtain new private financing either just before or at the time of a debt restructuring agreement. Instead, the role of the provision of "DIP financing" to countries has been assumed entirely by the official sector, particularly the IMF, although attempts were made, some of which were successful, in persuading private creditors to maintain or roll over their exposures in several crises that did not lead to a restructuring (see Roubini and Setser 2004, chap. 4). The question is whether legal innovations in bond contracts could make it easier for private sector DIP financing to come forward. A proposal in this direction has been made by Buchheit and Gulati (2002), who suggest that this could be achieved through an amendment in the pari passu clause in each bond that would legally subordinate the bond holders to new creditors that are willing to lend to the country during a preset period. In the event that the attempt to "rescue" the country through the infusion of new private funds fails, the new creditors would be paid off before the old creditors received any payments. However, the new infusion may also stave off a restructuring altogether and hence be in the interests of the existing creditors. As Buchheit and Gulati emphasize, an amendment of the pari passu clause would not affect the payment terms of the bond and hence could generally go forward with a simple majority of bondholder for bonds with U.S.-style amendment clauses.

Finally, consider the problem of *enforcing a preset priority structure* across claim holders. In sovereign bonds there generally is no such structure, arguably because it could not currently be enforced. However, as argued in a number of recent papers (Bolton and Skeel 2004; Bolton and Jeanne 2005; Borensztein et al. 2005; Gelpern 2004) a preset priority structure based on the time of first issuance—in other words, giving seniority to holders of earlier issues—could reduce incentives to overborrow and lower the cost of borrowing at low debt levels by removing the possibility of debt dilution (the reduction of the claims of earlier creditors on the recovery value of the debt through subsequent debt issuance). Senior creditors could, of course, still decide to give up their seniority in a crisis situation through an amendment as described by Buchheit and Gulati (2002). Borensztein et al. (2005) discuss some options for contractual enforcement of such a structure; these might be legally feasible, but they are complicated. The complication arises from the fact that existing creditors, rather than subordinating themselves, must somehow commit the debtor to negotiate future bond contracts such that *future* creditors are contractually subordinated to *present* creditors. This could possibly be achieved by defining the failure to do so as a default event, and giving creditors the power to accelerate their bonds in that event. In other words, current creditors could accelerate if they observed new bond issues that are not explicitly subordinated to currently outstanding issues. Whether this is a sufficiently strong incentive to induce debtors to negotiate a consistent priority structure based on time of issuance with successive generations of creditors is open to question.

The sense of the discussion so far is that introducing bankruptcy reorganization-like features in sovereign debt through bond contracts alone may be at best complicated and, at worst, impossible. This view has led several authors to propose mechanisms beyond contract law which might improve the debt restructuring process. A number of proposals since the 1980s have envisaged creating a formal legal regime for sovereign bankruptcy, through international treaty and/or amendments in national statutes (see Rogoff and Zettelmeyer 2002 for a survey). The best-known and most detailed of these is the IMF's recent proposal for a "Sovereign Debt Restructuring Mechanism" (Krueger 2002; IMF 2002b, 2003d; Hagan 2005), which was discussed by the IMF's Executive Board in 2002 and 2003, but ultimately failed to attract support from the requisite supermajority of the IMF's shareholders. In its final version, the IMF's proposal envisaged a majority action provision making a debt restructuring agreement binding on dissenting debt holders (including nonbond creditors, which cannot easily be dealt with through aggregation clauses), limited protection from prerestructuring litigation, and a mechanism for DIP financing. A subsequent proposal by Bolton and Skeel (2004) went a step further in additionally proposing a mechanism for enforcing first-in-time seniority (see chapter 12).

A more limited alternative to a statutory sovereign bankruptcy regime, which would mainly address any remaining free rider problem, could be to use U.S. federal class action procedures as a basis for court-supervised restructurings involving sovereign debtors. According to Buchheit and Gulati (2002), sovereign debt restructurings satisfy the basic condition for initiating class action suit under federal procedures because creditors have a basic common ("class") interest, and separate legal actions by individual members of a class could harm that interest. In their strongest form ("mandatory class actions"), any eventual settlement reached in a class action will bind all members of the class, at least to the extent that the court has jurisdiction over the class members, hence essentially removing the holdout problem. A weaker form allows class members to opt out of the litigation proceedings. In either case, the proposed settlement must be approved by the court.

The mechanics of class action suits would be for one or several individual bondholders to bring a suit before a U.S. court asking the court to "certify" the creditors as a class (either mandatory or with an opt out). So far, there are ten cases on record in which U.S. courts have agreed to certify creditors of a sovereign as a class (*Hirshon v. Bolivia* in 1995, and nine cases involving Argentina, which were certified in 2004 and 2005). All have failed to meet the standard that would be required to deal effectively with holdout problems, as none of them constituted a mandatory class action. Moreover, in the cases involving Argentina, the classes were defined narrowly to comprise only the holders of one or two Argentine bond series issued under New York law, and the U.S. courts have denied certification requests involving broader class definitions.

In sum, for the foreseeable future, the prospects for applying domestic bankruptcy-like procedures to sovereigns are fairly dim. The application and coverage of collective action clauses has steadily grown in the last few years, but still falls far short of fully dealing with free rider problems. No attempt has been made to use bond clauses to subordinate existing creditors to new lenders in a crisis, or to create a systematic priority structure based on the time of issue. Mandatory class action suits have not been used as a vehicle to deal with the holdout problem, and court decisions in Argentina suggest that U.S. courts are unlikely to regard all bondholders (or even all creditors) as a "class," preferring much narrower class definitions that leave plenty of opportunities for independent litigation. Finally, the IMF's proposal to create a new body of sovereign bankruptcy law at the international level is on hold owing to lack of support from major creditor and debtor country governments. In the meantime, however, debt exchanges seem to have worked fairly well, and holdouts have not proven to be a significant obstacle to carrying out these exchanges. It remains to be seen whether this will continue to be the case in the future.