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Legal Reform

Former US Treasury Secretary Paul O'Neill's fall 2001 call for an international bankruptcy court reinvigorated the debate on the best process for restructuring sovereign debts. O'Neill's call was surprising for many reasons: It came from an administration otherwise not noted for its warmth toward international organizations; it seemed at odds with the US Treasury's earlier warnings against official actions that might "encourage default;" and it seemed to reverse long-standing US skepticism toward the creation of an international bankruptcy court.

When the US Treasury did not follow through with a plan outlining what O'Neill had in mind, the IMF's First Deputy Managing Director Anne Krueger (2001a) filled the void. In her November 2001 speech she proposed amending the IMF's Articles of Agreement to provide a sovereign with bankruptcy-style protection from its creditors. In April 2002, in response to criticism that her initial proposal gave the IMF too large a role in granting legal protection, she proposed letting a supermajority of creditors vote to grant the debtor legal protection (Krueger 2002a). However, the US Treasury's enthusiasm for radical reform quickly waned. At the April 2002 conference where Anne Krueger laid out her revised proposals, US Treasury Undersecretary John Taylor called for immediate action to introduce new contractual provisions into sovereign debt contracts—an old idea embraced with new vigor. The IMF's proposals, according to Taylor, offered a fruitful agenda for academic research (Paul Blustein, "IMF Crisis Plan Torpedoed: Treasury Official Rejects Proposal A Day After It Is Advanced," *Washington Post*, April 3, 2002).

The implicit message in Taylor's speech was clear. As was often the case, O'Neill was at odds with the rest of the Bush administration. It was not much of a surprise when the new US treasury secretary, John Snow, signaled that the United States would not support the IMF's proposed blueprint for a sovereign bankruptcy regime. Attention shifted to calls to create a code of conduct that might make it easier for a sovereign debtor to reach agreement with its creditors. The conclusion, at least for the time being, of the political debate over the IMF's bankruptcy proposal—the sovereign debt restructuring mechanism (SDRM) in IMF acronymese—does not make it any less important to understand the issues that arise when a sovereign needs to restructure its debt. The debate over a code of conduct and the right set of contractual changes continues. Calls to create an "international bankruptcy regime" for sovereigns could come back if litigation impedes Argentina's inherently difficult restructuring.

There is a case for reform, but it is more modest than the proponents—and opponents—of either clauses or an international bankruptcy regime usually indicate. Letting a supermajority of creditors vote to change the terms of a sovereign bond—or a series of sovereign bonds—would make it somewhat easier for a sovereign to get out of default or to restructure before falling into default. However, supermajority voting will *not* make default substantially less costly to a sovereign, make a sovereign more willing to opt to restructure, or make it easy for the IMF to refuse requests for official support.

Specifically, we argue the following:

- A de facto—though not de jure—Chapter 11 debt reorganization process for sovereigns' international debt already exists.[1] Sovereigns are not firms. They cannot be liquidated. Debt does not usually become equity following default.[2] "Control" remains in the hands of the sovereign's management—its government—rather than the sovereign's creditors.[3] Litigation cannot easily or quickly shear off the country's

1. Chapter 11 is the portion of US bankruptcy law that governs the reorganization of a debtor that is worth more as an ongoing business; Chapter 7 governs the liquidation of a firm.

2. If a sovereign owns equity in local firms, it can use the "equity" it holds in a state-owned firm to retire some of its debts. Such debt-for-equity swaps were common in the 1980s, though the amounts were small. A sovereign also can issue state-contingent bonds that have "equity-like" features (e.g., GDP-linked bonds). Such bonds would have payments that vary in line with economic conditions, sharing some of the upside and the downside with bond investors. This idea was discussed in chapter 3.

3. Fortunately, or to some unfortunately, "gunboat diplomacy" to take over a deadbeat sovereign and seize its taxes and custom revenues is no longer an option for creditors, unlike in the 19th century. On the other hand, a tool some debtors used to deal with creditors in the past—beheading them—also is currently not available (see Rogoff, Reinhart, and Savastano 2003) for this latter historical curiosum). The increasing difficulty in seizing the assets of a bankrupt sovereign parallels the evolution of corporate bankruptcy regimes, which have also generally evolved over time to favor a firm's reorganization and rehabilitation rather than its immediate liquidation.

sovereign assets to the benefit of its creditors. That sounds a lot like Chapter 11. Sovereign debt restructuring even has something close to debtor-in-possession (DIP) financing—such financing comes from the international financial institutions (IFIs) rather than private creditors.

- Default is costly even though sovereigns currently enjoy substantial effective protection from litigation. It is, quite appropriately, hard to take legal action to seize a country's liquid financial assets, notably its international reserves, after a sovereign defaults on international bonds. Rather default typically leads to a sharp loss of confidence in all of the country's other financial assets—the sovereign's local debt, the local currency, and local bank deposits indirectly backed by the sovereign. These runs are far more likely to trigger a severe loss in output after a sovereign default than litigation.
- The existing process for restructuring the sovereign's external debt is not ideal. The existing stock of New York–law debt that requires unanimity to change the bond's key financial terms makes restructuring more difficult than it should be. The absence of majority-restructuring provisions in many sovereign debt contracts makes holdout strategies viable for a limited number of bondholders. Payments to holdouts are a tax on the restructuring that follows a default, not a tax on default. Of course, making it more expensive to get out of default indirectly makes it more expensive to enter into default. But the benefits of an indirect tax that *may* deter opportunistic defaults are smaller than the disadvantages of legal provisions that make it harder for a sovereign to reach agreement on a restructuring, resume payments, and escape from default.

This chapter is organized into four sections. The first discusses the problems that arise in a sovereign debt restructuring. The second examines proposals for changing the terms of sovereign debt contracts and proposals for creating a supranational bankruptcy regime for sovereigns, focusing in particular on the IMF's plan. The third section looks at calls to create a code of conduct for sovereign debt restructurings and attempts to mandate the use of creditors' committees. The final section evaluates the potential for legal reform to transform the sovereign restructuring process dramatically.

Potential Obstacles to Sovereign Debt Restructuring

As discussed in chapter 4, the absence of an international bankruptcy court has not prevented Ecuador, Ukraine, Pakistan, and Uruguay from restructuring their international sovereign bonds or prevented Russia from restructuring its Soviet-era syndicated bank debt. The absence of collective action clauses also has not been an insurmountable barrier to a restructuring: Ecuador restructured its bonds, which lacked clauses, after its default, and Uruguay even managed to preemptively restructure bonds that lacked clauses in order to avoid a default. The current process for restructuring sovereign bonds can be made to work in a range of circumstances. The case for legal reform has to be that reform can improve on the existing process—not that it is needed to do a restructuring.

Existing Debt Restructuring Process

It can be difficult to determine whether a sovereign government is truly unable to pay or is simply unwilling to make the needed adjustments. At a certain point, though, the debate over willingness to pay and ability to pay becomes moot (discussed in chapter 3). A sovereign that lacks market access will run out of the cash and be unable to pay its maturing debts. Since a sovereign in default cannot be shut down and its assets cannot be distributed among its various creditors, some form of financial reorganization is the only alternative to a prolonged default.

The need to restructure the claims that many creditors hold, in turn, creates a potential collective action problem. Every individual creditor would be better off if it got paid in full while other creditors bore the burden of the restructuring. Potential difficulties with collective action arise with the restructuring of a single bond, since each individual bondholder would prefer to be paid in full while other bondholders agreed to a restructuring. But they also arise at other levels. The holders of a specific bond issue may seek to convince the debtor to exclude their bond from its overall restructuring or may decide not to agree to a restructuring that holders of other bond issues accept and then litigate for full payment. Different groups of creditors—for example, international bondholders, domestic banks, and other governments—will seek to convince the debtor that other groups of creditors should absorb more of the necessary losses. The difficulties that a sovereign faces increase with the number of instruments and the diversity of interests holding a legal claim on the sovereign. Argentina is an extreme case: It needs to restructure 98 international bonds held by a diverse group that includes international institutional investors, domestic pension funds, and hundreds of thousands of retail investors.[4]

The documentation used in international bond contracts can make these coordination problems more difficult to solve. The law of one of four

4. Domestic residents often also buy bonds issued internationally and governed by the law of one of the world's major financial centers. They may prefer a country's international bonds to its local bonds for any of a range of reasons (the use of a foreign currency, the protection of international law, or a more liquid instrument). In countries such as Turkey, Lebanon, and Argentina before 2001, local residents are the primary market for certain international bond issues. Other countries—the United States now but also Russia before 1998—rely heavily on foreign participation in their local debt market.

places governs almost all international sovereign bonds: New York, England, Germany, and Japan. New York state and England are by far the two most important jurisdictions.[5] Japanese law is used almost exclusively for yen-denominated bonds. German law traditionally governed deutsche mark bonds, but English rather than German law increasingly governs euro-denominated bonds.

Differences between the contractual provisions used in New York–law bonds and those used in English-law bonds have been a long-standing point of concern, with many arguing that the standard "boilerplate" documentation used in New York tended to increase the risk of litigation and coordination problems. A traditional New York (and German) bond contract lacked so-called collective action clauses, while a traditional English (and Japanese) bond contract included such clauses. The contractual provisions used in New York before 2003 and England differed in two specific ways.[6] First, many, though not all, New York–law sovereign bond contracts give each individual bondholder the right to initiate litigation and allow each bondholder to keep for itself anything that it recovers from the sovereign. Such provisions increase the incentive to initiate litigation. English-law bonds, in contrast, typically require the support of bondholders who hold at least 25 percent of the bond to initiate litigation, and some English-law bonds also require that the proceeds of any litigation be distributed equally among all bondholders.[7]

Second, most traditional New York- and German-law bond contracts require the unanimous support of all creditors to change a bond's financial terms.[8] Such provisions give each individual bondholder the right to opt

5. Chapter 7 discussed the different ways of defining external debt and argued in favor of a definition based on residency. However, in the specific context of discussing the legal obstacles to a successful debt restructuring, it makes most sense to define international debt as debt governed by a foreign law.

6. The standard documentation used in New York–law bond contracts started to change in spring 2003 after Mexico's decision to introduce provisions allowing supermajority voting in New York–law bonds. Other issuers have followed Mexico's lead, but changing the composition of the existing stock of bonded debt governed by New York law will take time. For the next few years, the average New York–law bond will continue to lack clauses allowing the amendment of the bond's financial terms.

7. See IMF (June 2002b, September 2003b) for a more detailed discussion of such "majority-enforcement clauses."

8. The argument that traditional New York–law bonds lack collective action clauses is only partially correct. While payment dates and amounts can be changed only with the unanimous support of all bondholders, New York–law bonds typically contain provisions that allow the amendment of all of the bonds' terms other than the bonds' key financial terms (payment date and amount) with the support of either 50 percent or two-thirds of the outstanding holders of a debt instrument. In effect, traditional New York–law bonds contain collective action clauses but exempt the bond's key financial terms from these clauses.

out of a restructuring and then litigate to collect the bond's original payment terms in full. English- and Japanese-law bond contracts, in contrast, typically contain clauses that allow a supermajority—often 75 percent of those present at a bondholders' meeting—to amend the bond's key financial terms (Buchheit 2000b).

Difficulties of collective action, whether from a bond's legal documentation or other sources, are the primary source of the potential market failures (externalities, in economic jargon) that could hinder a successful sovereign restructuring. In some stages of the restructuring process, the existing system for sovereign debt restructuring already mitigates or limits these potential collective action problems; at other points in the process, it does not.[9] Consequently, before analyzing proposals for reform, it is worth reviewing the potential market failures that could arise in the sovereign debt restructuring process.

A Rush to Exit from the Sovereign's Own Debt. A creditor holding a claim on a sovereign government has an obvious interest in getting paid and getting out before any sovereign debt restructuring. Creditors holding debts that are about to mature are in a different position than those holding long-term debts. A debtor has a legal obligation to pay its short-term debts in full on the date the debt matures, letting its short-term creditors exit. Indeed, the maturity structure of the sovereign's debt tells creditors rather precisely where they stand in the queue to get out and makes jumping the queue impossible. A creditor holding a long-term claim can sell it only to another market participant. It thus makes sense to distinguish a rush to the exits by creditors with short-term claims from a rush to sell by creditors holding long-term claims. The former puts pressure on the debtor's reserves, the latter on asset prices.

A run on the sovereign's own debt arises when creditors lose confidence in its ability to pay because of lack of reserves, concerns about its solvency, or both. If short-term creditors believe that other creditors won't renew their claims, they have an incentive to get out if the debtor lacks sufficient reserves, even if it is solvent in the long run (Sachs 1995). Creditors with doubts about the debtor's solvency may be willing to roll over their claims if the debtor is willing to pay a high enough interest rate, but the demand for higher returns to compensate for growing perceived risks also can trigger a self-reinforcing cycle that pushes a potentially solvent sovereign into insolvency. High interest rates lead to a growing debt burden and slower growth, and the growing debt burden in turn makes creditors less willing to provide financing at the rates required for eventual solvency or makes them more inclined to get out altogether. A sovereign may find that its

9. See Buchanan (2002) for a market analyst's assessment of the existing debt restructuring process. See Krueger (2002) for the IMF's critique of the current process.

debts are growing faster than its capacity to implement additional adjustments. Moreover, even a run on an insolvent sovereign, while eminently rational from the point of view of an individual creditor, can nonetheless generate a disorderly workout that lowers creditors' collective "recovery" rate.

The solution to a rush for the exits—if no creditor is willing to step in and provide a large loan to an illiquid but potentially solvent sovereign—is simple but brutal: Seek a restructuring, and if a restructuring agreement cannot be reached quickly, then stop paying. In theory, a country should not wait until it runs out of cash to seek to restructure its debts. Waiting until the last possible moment favors a few short-term creditors but disadvantages those with long-term claims. However, a payments suspension has two potential problems:

- First, stopping sovereign payments or seeking a sovereign restructuring risks triggering a broader loss of confidence that may result in a run on the currency or the banking system. The economic distress associated with these other runs will augment the scale of the economic losses. Debtors, not surprisingly, prefer to find a source of emergency financing than to incur the cost associated with default.
- Second, stopping payments means breaching a legal contract. Creditors holding the sovereign's international debt have the right to go to a court to demand full payment. The debtor has no way to force creditors to give up their claims. It needs for its creditors to voluntarily agree to give up their old claims for new ones.

A Rush to the Courthouse (Litigation Before Restructuring). Once a payment is missed and the sovereign debtor is in default, creditors have a legal right to seek various remedies. In principle, creditors can ask the court to attach the debtor's assets. Of course, an insolvent debtor lacks enough assets to go around. This creates a potential collective action problem: The first creditor to go to court gets the asset, leaving the debtor with fewer assets to offer its remaining creditors. To limit this risk, debt contracts often contain provisions to make it possible for a wide range of creditors to initiate litigation as soon as the debtor misses payments to one of them: Cross-default provisions allow creditors to declare their claims to be in default, accelerate, and litigate for the full value of the claim, if the debtor misses a payment on *another* bond.[10] Consequently, as soon as the

10. While these provisions are common in sovereign bond contracts (which initially followed the documentation pattern of US corporate bond issues), they have proven to be a smaller problem in practice than many feared. It makes sense to rush to the courthouse only if the courthouse can seize the debtor's assets. That is typically not the case with sovereigns.

sovereign misses a payment on one bond, it runs the risk of litigation from a wide range of creditors.

In the corporate context, the risk of creditors rushing to the courts rather than working with the debtor to find a cooperative solution motivated the creation of Chapter 11 of the US bankruptcy code. Chapter 11 is designed to protect the debtor (firm) from liquidation by aggressive creditors, while it develops a restructuring plan to keep itself intact.[11]

However, the simple analogy to firms overstates a sovereign's problems. A sovereign's international creditors currently have few effective remedies to pursue in the court system:

- Creditors holding claims in default cannot ask the court to liquidate the sovereign and distribute its assets or seek to gain operational control of the sovereign debtor.
- Creditors can ask the court to seize the sovereign's international assets. But sovereigns typically don't have many assets that can be seized. (A sovereign's most important asset—its power to tax its citizens—is beyond the reach of a foreign court.) A well-advised sovereign can place its international reserves in a place where a US, UK, German, or Japanese court cannot seize them, if it takes a few relatively simple precautions. Central bank immunity remains strong.
- Creditors can ask the court to block payments on other international debts. But the debtor in default is likely to have stopped payments on all its privately held international debt anyway. No one has yet tried to challenge the payments the debtor makes to the IMF and the multilateral development banks (MDBs).

Creditors have the right to initiate litigation, but the incentive to do so is small in the absence of legal strategies that can force a sovereign to pay. A reporter recently noted, "Winning a judgment to attach the commercial assets of a deadbeat nation has been relatively easy in foreign courts, col-

11. Majority-restructuring provisions in English-law bonds also developed in response to the risk of a minority of creditors liquidating a company that the majority wanted to keep intact. Particularly with railroad companies, it rarely made sense to liquidate the company and sell off its major asset—its railway tracks. Laying tracks costs a lot of money, and the tracks were almost always worth more as railroad tracks than as scrap iron. It also did not make sense to divide the railway into parcels and sell off the parcels to different investors. Most creditors holding defaulted railroad bonds usually concluded that the value of their investment would be maximized if the railroad companies were restructured rather than liquidated. However, some creditors discovered that they could use the threat of liquidation to force the creditors who believed that the firm is worth more alive than dead to offer the creditors threatening liquidation more advantageous terms. Majority-restructuring provisions were introduced into English-law bond contracts to allow the majority to avoid having to buy off such holdouts. See Buchheit, Gulati, and Mody (2002).

lecting on such orders has been nearly impossible" (Angela Pruitt, "Nicaragua Creditor Suit Muddies Sovereign Restructurings," *Dow Jones International News*, September 29, 2003). An Argentine economist, Hernan Fardi, put it more bluntly: "Short of an invasion by troops, there's nothing plausible creditors can do to capture assets within Argentina."[12] (See box 8.1 for a more detailed discussion on Argentina.)

Free Riding (Litigation after Restructuring). If this analysis is correct, a sovereign is not likely to face a real risk of its creditors seizing its remaining reserves the day after it defaults. Yet, a sovereign that defaults on its debt still needs a good lawyer. Once it has completed a restructuring and resumed payments on its new debt, some creditors may opt out of the restructuring and seeking to use the courts to obtain full payment on their original claims. Unlike a firm, a sovereign cannot use bankruptcy law provisions that allow a supermajority of creditors to approve a restructuring agreement over the objection of a minority of similar creditors. Since every creditor has an incentive to hold out and get paid in full, in equilibrium, an exchange offer that would have otherwise been mutually beneficial to the debtor and its creditors may still fail. Too many creditors may play the holdout game (Eichengreen and Portes 1995).

The incentive to hold out and thus the scope of the potential collective action problem ultimately hinges on the creditors' ability to use the legal system to convince the debtor that it is better off paying the holdouts in full or agreeing to a favorable settlement. Since holdouts—like other creditors—have difficulty getting their hands on the sovereign's reserves, they generally have tried to get the court to stop payments on the new debt that has emerged from the restructuring. They argue that the sovereign should not be allowed to pay its new debt until all its old debt—notably that held by the holdouts, is paid in full. If the court supports the

12. Quotation from "Argentina Faces Legal Battle of Attrition Over Debt," *Reuters*, October 3, 2003. Until after World War II, most sovereigns benefited from complete immunity from litigation: A sovereign had to give its consent before it could be sued in a foreign court. In the 1950s, the United States began to adopt a more restrictive definition of sovereign immunity: Sovereigns that engaged in normal commercial transactions—those that a private firm could also do—were not immune from litigation. This practice was formalized in the 1976 US Foreign Sovereign Immunities Act and Britain's State Immunity Act of 1978. See Buchheit (2000b), and Mauro and Yafeh (2003). However, a sovereign retains considerable de facto protection. Gelpern (2004, 9–10) noted: "Importantly, even where a state may be sued and has waived immunities, collecting on a judgment is difficult. For all practical purposes, state property within its own borders is completely immune." A sovereign's external diplomatic and military assets also enjoy immunity. Moreover, the erosion of a sovereign's formal immunity has coincided with the evolution of a new norm: Sovereign default is no longer an acceptable pretext for military intervention. Creditors in the 19th century lacked legal rights, "but sometimes were able to convince their government to intervene militarily, though typically only when the bondholders' commercial interests overlapped with the government's own geostrategic interests" (Mauro and Yafeh 2003).

Box 8.1 Argentina will test the current restructuring process

Argentina is currently going through the mother of all sovereign bond restructurings. Since Argentina issued more bonds, in more jurisdictions, and in more currencies than any other emerging economy, it quite literally is likely to face just about every imaginable problem during its restructuring. Argentina is seeking to restructure 98 international bonds and 54 bonds governed by Argentine law with a reported combined face value of $87 billion.[1] Both totals dwarf the combined totals of Ecuador, Pakistan, Ukraine, and Uruguay. Moreover, Argentina is currently seeking much greater debt reduction than any of these countries sought.

The set of investors who hold Argentina's international bonds is also unusually diverse. Argentina placed a higher-than-average share of its bonds with retail investors in Europe, and domestic Argentines are estimated to hold far more of Argentina's dollar debt than US and other international investors.[2] Consequently Argentina is engaged in by far the biggest restructuring of bonds held by retail investors and is also the first sovereign to ask retail investors to agree to reduce the face value of their bonds, not just defer the repayment of the bonds' principal. The biggest surprise to date in Argentina's restructuring has been the retail investors' ability to organize themselves to participate actively in the restructuring process. Representatives of retail investors have joined institutional investors to form a single, coordinating committee. The core coordination challenge facing Argentina is developing a "menu" of restructuring terms that includes items that will appeal to retail investors (who typically want to preserve face value), domestic pension funds (who also may care about preserving face value), wealthy Argentines holding government bonds offshore, and institutional investors (who care about the bonds' current market value).

Argentina's restructuring—if it happens—undoubtedly will provide new insights into the restructuring process. So far, Argentina's experience is consistent with our core argument that a sovereign's greatest legal vulnerability comes after it completes a restructuring, not before. A number of retail creditors and one creditor that holds over 50 percent of a single bond already have initiated litigation against Argentina, but they have yet to collect much. The small investors seem to be litigating in large part out of

(box 8.1 continues next page)

holdouts, the sovereign then faces a difficult choice. It can pay the holdouts in full or stop payments on all its new debt and fall back into a broad default.

The "tax" that successful holdouts impose on a successful restructuring could fall entirely on the debtor, who has to run down its reserves or adjust more to pay the holdouts. Or the "tax" could fall on both the debtor and the majority of creditors, as a debtor who rationally anticipates the need to pay off a few holdouts has an incentive to insist that other creditors agree to a deeper restructuring. Cash used to pay off a minority in full is cash that conceivably could have been distributed to the majority without making the debtor any worse off.[13] On the other hand, the desire to

13. The question of who ends up bearing the "costs" of the holdout tax is even more complicated when the sovereign has many groups of creditors. Costs not borne by the debtor could be shared by all creditor groups or could be borne disproportionately by one group of creditors.

Box 8.1 *(continued)*

frustration. The large investor's strategy is less clear. A New York court has certified one class action lawsuit on behalf of some of Argentina's creditors, but this has yet to prompt other class action litigation. On the other hand, litigation seems likely to play a larger role in Argentina than in other cases, particularly if the restructuring drags out beyond 2004. Existing litigation already implies that Argentina will need new bonds in exchange for both its old bonds and outstanding legal judgments against it, not just for its old bonds (most other debtors have not had oustanding judgment creditors when they launched their exchange).[3] There is no shortage of small "orphan" bonds that lack collective action clauses among the 98 international bonds that Argentina is not paying, making it relatively easy for a creditor to buy a large enough position in a single bond to be able to block other investors from changing the bond's terms through exit consents. The deep debt reduction Argentina is seeking implies a low recovery value from participating in the exchange and makes litigating for the bond's full value more financially attractive. Many of Argentina's creditors are no doubt studying examples of successful litigation and considering their odds. Of course, Argentina's lawyers are also considering ways to protect the payments stream of a successful restructuring—the debtor's point of maximum legal vulnerability—from holdout litigation.

1. Data on Argentina's restructuring comes from the Government of Argentina's Secretariat of Finance, Ministry of Economy and Production (2003).

2. The pesification of the bonds held by the banking system reduced the share of Argentina's domestically held international bonds. However, after deciding to include the bonds held by the pension funds in the restructuring, the government of Argentina now estimates that domestic investors hold more than 40 percent of the $87 billion in debt that it is seeking to restructure. US investors are estimated to hold only around 10 percent of these bonds.

3. If some holders of a bond obtain a judgment before an exchange, they may be exempted from the bond's amendment provisions.

limit the number of holdouts also may lead the sovereign to propose, at the margins, a more generous restructuring than it otherwise would have (Gulati and Bratton 2003). Thus, the overall impact of holdouts on the majority of creditors is ambiguous.

The risk of holdout litigation could be costly to both the debtor and the majority of its creditors in another way: It could delay reaching an agreement that lets the sovereign resume payments. A sovereign that can get 90 percent of its international creditors to agree to a restructuring may be unwilling to go forward with that restructuring because the litigation risks from the remaining 10 percent are too great. Prolonging the period when the sovereign is in default, in turn, usually delays the country's recovery, hurting both the sovereign debtor and the majority of its creditors.

Nonetheless, the impact of holdouts—for good or for ill—on the current restructuring process should not be exaggerated. Sovereigns typically put forward attractive restructuring proposals because they need to attract the support of the majority of their creditors, not because they want to avoid a small number of holdouts. A sovereign that gets most of its creditors to accept its restructuring proposal has a number of defenses against the risk of holdout litigation:

- First, holding out means giving up "liquidity"—the ability to trade out of a position easily. The risk of being stuck with a small, illiquid, and difficult-to-sell instrument may deter potential holdouts.
- Second, litigation is costly, takes time, and may not succeed. No legal strategy assures full payment to a holdout that is willing to incur the legal costs required to make itself a real nuisance. The most successful recent holdout, Elliot Associates, was able to collect on its litigation against Peru only after spending four years in the courts (Moody's Investor Service 2000).
- Third, the tactic that allowed Elliot to collect against Peru—its ability to convince a Belgian court that key provisions in New York–law bank loans and sovereign bond contracts, the *pari passu* clause, prevented Peru from paying the bonds that emerged from its restructuring while its old bank loans remained in default (Buchheit and Pam 2004)—may not be available in the future. The US Treasury and the Federal Reserve Bank of New York recently filed *amicus curiae* briefs that argue that the Belgian court's order to Peru was based on a faulty interpretation of the meaning of the *pari passu* clause.[14] The US courts have yet to rule on the correct interpretation of this key provision, but creditors planning to initiate litigation on the basis of the Belgian court's decision should be aware that other courts may adopt their own interpretation of the key clause.
- Fourth, debtors that have issued New York–law bonds can take a number of steps to inhibit holdout litigation. Most New York–law bonds have provisions that allow a majority to amend the bonds' nonfinancial terms. The holders of the old bonds who are willing to participate in the exchange can, as their last act as holders of the old bonds, vote to amend the bonds' nonfinancial terms in ways that make litigation much more difficult (exit consents).[15] Felix Salmon of *Euromoney* noted,

14. See Buchheit and Pam (2003). The United States (2004), Federal Reserve Bank of New York (2004), and Clearinghouse Association LLC (2004) all filed *amicus curiae* briefs arguing against the Belgian court's interpretation of the pari passu clause.

15. Ecuador, for example, amended its bonds to eliminate the Luxembourg listing requirement and the requirements that it cancel bonds acquired by the debtor. Because Ecuador also reversed the acceleration of one of its bonds (the other bonds had not been accelerated), these changes effectively meant that the remaining bonds lacked the votes to accelerate their bonds in the event of a missed coupon payment. Since the bonds had a long maturity, any litigious creditor would have to wait a long time for the bond to generate enough arrears to make litigation worthwhile. See Buchheit and Gulati (2000) and Buchheit (2000a).

"If bondholders can be persuaded to swap into a new instrument, they can be asked as they exit the old bonds to vote to strip them of many of their key protections. Anybody remaining behind is left with an illiquid and unattractive instrument in default which will almost certainly be worth less than the new bonds that everyone else swapped into" (Salmon 2003).

- Fifth, even if the courts rule in favor of those seeking to copy Elliot's strategy, sovereign debtors will take additional steps to limit their potential vulnerability. Notably, debtors, with the support of creditors who participate in the restructuring, are likely to amend the old bonds in ways that make it harder for holders of the "old," unrestructured debt to block the payments stream on the "new" debt that emerges from the restructuring.[16] After all, neither the creditors who participate in the restructuring nor the debtor has an interest in letting holdout creditors push the debtor back into default.

Holdouts have proved, at least to date, to be a much less severe impediment to successful restructurings than the official sector feared in 1996, when the G-10 published a report that called for the adoption of collective action clauses. The number of holdouts in recent bond restructurings has been manageable. Yet, the risk of successful holdouts imposing a higher tax on future restructurings cannot be discounted entirely:

- The attractive returns some investors have obtained by holding out could inspire copycat litigation (Singh 2003). Until the courts rule otherwise, Elliot's successful strategy against Peru provides a roadmap other holdouts can follow. Nicaragua is appealing the decision of a lower Belgian court, which used the logic of the Peru-Elliot decision to rule against Nicaragua.[17] The Democratic Republic of the Congo recently settled rather than face a protracted legal battle.
- The more debt reduction the debtor needs and the lower the market value of defaulted debt, the larger the potential gains from a "hold out

16. Uruguay, for example, convinced its creditors to amend the "old bonds" waiver of sovereign immunity so that the payments streams on the new bonds were exempt from the standard waiver.

17. Nicaragua v. LNC LLP. The Belgian court that initially ruled against Elliot ruled in favor of LNC, since its original ruling in Elliot had been reversed by the Belgian Court of Appeals. Both Elliot and LNC argued that payments on the new debt could be seized to pay the old debt, since the new and old debts were "pari passu." Nicaragua is appealing. In both cases, the Belgian courts ruled on the meaning of a key phrase in New York–law bonds and used this ruling to block payments through Euroclear—a payments clearinghouse based in Belgium. Buchheit and Pam (2003, 8) noted in the context of the original ruling on Elliot that "the Belgian Court of Appeals was being asked to interpret New York law as it applied to a boilerplate provision in an unsecured New York loan agreement in the absence of any controlling (or for that matter, any) New York judicial precedents on the point."

and litigate" strategy. Litigation is more attractive if the alternative is to accept a restructuring worth 20 cents (the potential return from litigation that recovers the full value of the principal and any past due interest exceeding 500 percent) than if the restructuring is worth 50 cents (the potential return is closer to 100 percent). Unless the probability of successful litigation falls alongside the prospective returns, the risk of litigation should go up alongside the amount of debt relief the debtor is seeking. However, creditors participating in an exchange that returns only 20 cents on the dollar also have more reason to worry that the large cash payments to holdouts are cutting into their own returns and therefore have a stronger incentive to help the debtor limit its exposure to litigation.

- Sovereigns often pay a small number of holdouts in full rather than fight their claims for full repayment.[18] This is often quite rational: If the bonds have not been accelerated (or have been deaccelerated), the sovereign only has to make small coupon payments to avoid the costs of protracted litigation. However, if creditors come to expect that a small number of holdouts will be paid on relatively favorable terms, the credibility of future debtors' threats to treat holdouts roughly is undermined.
- The legal strategies of both holdout creditors and debtors will continue to evolve. Argentina is sure to attempt to protect the payments streams on its eventual restructuring from Elliot-style litigation. Potential holdout creditors similarly will attempt to protect themselves from the risk that exit consents will undermine their post-restructuring leverage. For example, a large player noted for its aggressive behavior has bought up more than 50 percent of one of Argentina's smaller New York–law bonds—enough to prevent Argentina from being able to amend the bonds' nonfinancial terms through exit consents.

In sum, ad hoc ways can limit the risk of holdouts posing substantial problems. To date these approaches have worked, but none of them is ideal.

Absence of an Agreed Priority Structure: Negotiating the Relative Treatment of Different Creditor Classes. A bankruptcy regime typically lets creditors know ex ante how they will be treated in relation to other credi-

18. Ecuador was able to deaccelerate its bonds and avoid litigation risk by clearing arrears and then continuing to pay a relatively small coupon. Indeed, paying creditors London Interbank Offered Rate (LIBOR) coupons at current interest rates could be considered a form of punishment. Holdouts would have preferred that Ecuador remained in default so that they could initiate litigation. Uruguay never defaulted, so it too needs to make coupon payments only for the time being. Debtors certainly have not always paid holdout creditors the full principal value of the creditors' claim—mitigating any expectation that a small number of holdouts will receive a generous payoff even without having to go to court.

tors holding similar types of claims (Gelpern 2004). Bankruptcy law sets out a priority structure that outlines how different types of debts will be treated, and a court makes sure that high-priority claims get more than low-priority ones. The result: Holders of different types of debt generally know how their class of claims will be treated relative to other classes, even if they do not know exactly how well they will do.

As discussed in chapter 7, however, no court or law can force a sovereign to respect a priority structure. The absence of any agreed, enforceable rules of priority is both good and bad. It certainly can make it more difficult to reach agreement. The debtor and its creditors have to agree in broad terms on how different creditor groups should be treated before they can get down to negotiating financial terms. However, the debtor's ability to favor some creditors also provides some of the lubrication that helps a sovereign function without formal bankruptcy protection. Paying some debts while in default can help limit the impact of sovereign default on the banking system and let the sovereign obtain limited new financing.

Provision of Senior New Money. Creditors have good reason not to want a sovereign to be able to raise substantial new funds after a default: Losing access to international markets after a default is a prime incentive for payment.[19] On the other hand, it may not be in the interest of the bankrupt sovereign's creditors for the sovereign to be completely unable to access any new financing. Most domestic bankruptcy laws have provisions that allow a bankrupt firm undergoing reorganization to retain access to some new credit, on the theory that access to new money ultimately leads the firm's existing creditors to recover more of their initial investment.

The difficulties in providing new money to a sovereign are arguably another type of collective action problem in a restructuring. All creditors might be better off if the debtor obtained access to limited amounts of new money to finance its ongoing operations. However, each individual creditor would prefer that the new money be used to pay down its debt rather than to increase the value of the firm (or sovereign) for all creditors. Even if the new money can only be used for the benefit of all creditors, each individual creditor would rather that another creditor put up the funds. Bankruptcy law solves this collective action problem by assuring the providers of new financing (or DIP financing) that they will be repaid before most existing debt and by preventing any individual creditor from claiming the "new money" for its exclusive benefit.

19. One of the early insights of the analytical sovereign debt literature was that a defaulted debtor may be a decent credit and could even be able to borrow again relatively rapidly. The debtor will have a reputation for not paying but may also have less debt than countries that are trying to pay all their debt. Some creditors may be willing to take a chance and lend to the country that defaulted; the loss of market access following default is not a given.

However, the current absence of private DIP financing for a sovereign may be a smaller problem than proponents of an international bankruptcy regime think:

- Bankrupt sovereigns already have access to new money. Preferred creditors—the IMF and MDBs—can provide net new financing to a sovereign that is in default on its private international creditors. This financing is functionally analogous to DIP financing, and the debtor's self-interest in maintaining access to this source of financing provides a strong incentive for it to sustain payments to preferred creditors even absent legal priority. Moreover, a sovereign that defaults on its international debt may still be able to borrow domestically.[20]
- A bankrupt sovereign may have less need to access new financing than a private firm. Firms need to carry inventory, buy parts, and otherwise borrow at least from suppliers in order to remain viable. Sovereigns can—and do—operate by matching cash receipts and cash expenditures, particularly when they are not making payments—principal and interest—on their existing debt. Arrears to government suppliers in effect may allow the government to borrow for short periods even after default.
- In some emerging economies, a sovereign guarantee is needed for private firms to access trade credit. For example, export financing agencies often require a sovereign guarantee and can be a major source of trade financing. In other economies, private banks provide trade financing without any involvement from the sovereign. So long as trade credits are exempted from capital controls, private firms may be willing to provide other private firms with trade credits—and even longer-term credit—while the sovereign is in default. If a sovereign guarantee is needed for private firms to access trade finance, an informal commitment by the sovereign to give priority to trade financing may be all that is needed.[21]
- The absence of new financing often compels the debtor to make needed policy adjustments. Given the typical fall in a government's revenue

20. The government of Argentina has incurred substantial new debts subsequent to its default, largely by issuing compensation bonds to banks and bank depositors. This is not exactly new money, since the government is not selling new debt for cash. But it certainly has resulted in new future obligations for the government. The Central Bank of Argentina did not default on the debt it issued, and it has developed a market for peso-denominated central bank paper subsequent to default.

21. Kletzer and Wright (2000) note that the postulated cost of default from a loss in access to trade financing has not been observed in practice. Argentina, for example, has sustained access to trade financing by allowing local banks to take in dollar deposits and make dollar loans only if they can demonstrate the dollar loans are being used for trade financing.

following a default—even after taking into account the interest savings—the need to match revenues and expenditures often demands real adjustment. Being forced to make sudden and procyclical adjustments in the face of a downturn may hurt the crisis country, but it is not obvious that it hurts the sovereign's creditors.

Policy Conditionality. Creditors who agree to provide a debtor with relief from its debts will want it to agree to take steps to increase its ability to pay. This requires collective action: Different creditors are likely to have different conceptions of the steps the debtor needs to take. The current system for sovereign debt restructuring generally relies on the IMF to solve this coordination problem. The debtor negotiates a set of policy reforms that often set out the broad parameters for the subsequent debt restructuring with the IMF in return for new loans or the refinancing of the IMF's existing exposure. A single entity like the IMF can reach agreement with the debtor more easily than a group of creditors with different and at times competing interests. The IMF also is far better positioned to link its financing to monitored policy commitments than private creditors.

Private creditors point out—correctly—that creditors play a larger role in commercial debt reorganizations. In part, this is because IMF conditionality is a partial substitute for private conditionality. But nothing forces private creditors to rely on IMF conditionality: External private creditors, for example, could refuse to restructure their own claims unless the debtor agrees to additional policy changes. In practice this has rarely happened, largely because of the difficulties a sovereign's disparate creditors face in coordinating their actions (it is far easier for creditors to coordinate their rhetorical demands). Coordination gets more difficult as the number of creditors go up. Plus, many creditors value the ability to trade in and out of a bond, and are unwilling to give up the ability to trade in order to make a credible commitment to link their willingness to agree to a restructuring to the debtor's ongoing compliance with its policy promises.

Rush to Default. Most potential market failures in a restructuring arise from collective action problems among creditors. However, the risk of opportunistic default stems from a different kind of market failure: the difficulty in writing an enforceable debt contract with a sovereign borrower. Just as sovereign borrowers worry that their creditors will rush to the exits at the first hint of trouble, precipitating an avoidable default, private creditors worry that a sovereign will prefer an opportunistic default to necessary policy adjustments (Dooley and Verma 2001).

As discussed in chapter 3, theoreticians of sovereign borrowing have paid great attention to this risk. Some academic models suggest that the threat of losing market access and a sovereign's desire to preserve its reputation for creditworthiness might not be enough to eliminate incentives *not* to pay. In practice, these models often paint too narrow a picture of the "reputational" costs of defaulting on international debt. An international default usually not only damages the sovereign's reputation with international investors but also hurts its domestic credibility. Opportunistic default has been rare.

Of course, any change in the existing regime for sovereign debt restructuring risks reducing a sovereign's incentive to pay, making opportunistic default more likely, and reducing capital flows to emerging markets. However, it is important not to exaggerate the role that the threat of litigation currently plays in sustaining incentives for sovereign payment. The market for sovereign bonds functions even though a creditor buying a New York–law sovereign debt contract has only limited ability to enforce the contract through the courts. Sovereign debtors already enjoy substantial effective protection from legal action following a default. It is hard to believe that the threat of holdout litigation provides much of a deterrent to default: Such litigation comes with a long lag and usually hurts the government that is trying to resume payments, which may not be the government that stopped payments.[22]

No Rush to Get Out of Default. In some ways, the real risk is not that a sovereign will rush to default—default itself remains extremely costly, despite the absence of a strong legal sanction. Rather, it is that a sovereign that has already incurred the large costs and reputational damage associated with a default will be in no particular hurry to restructure. Once the initial economic and financial shock of the default wears off, the cost of continuing to remain in default may be comparatively small. Creditors have little to fall back on but the threat of litigation, and that is not much of a threat since it is next to impossible to seize a sovereign's assets. Indeed, the sovereign's vulnerability increases, perversely, when the sovereign reaches a settlement with a majority of its creditors. A holdout then can attach the new external payments stream.

The basic incentives to get out default parallel the basic incentives not to default. Settlement with existing creditors is a prerequisite for the eventual resumption of international market access. More intangibly, resuming payments on a sovereign's external debt often contributes to the ability of a country's private firms to raise money externally. A restructuring agreement also can increase the confidence of a country's domestic residents, making domestic residents more willing to keep their savings at home. Finally, persistent default poses a problem for a country's capacity

22. It is possible that emerging-market sovereign debtors systematically overestimate their vulnerability to litigation, and, therefore, their perceived vulnerability creates a significant incentive for payment even in the absence of strong evidence that a sovereign's external creditors can take effective legal action following a default. See Sachs (2002) for an argument along these lines.

to continue to borrow from the IMF and the other IFIs. A country in default on its international sovereign bonds can continue to receive financing from the IMF for some time, but not indefinitely.

Other Runs. Stopping payments on the sovereign's own debt eliminates a direct source of pressure on its reserves. Investors can no longer "run" out of the sovereign's own debt.

However, default may trigger other runs—a run on the domestic banking system, a run on the currency, and a withdrawal of cross-border interbank credit. When a sovereign breaks its promise to pay its debts, it calls into question its ability to deliver on its other common promises, including the promises to provide a currency that offers a stable source of value and to backstop the banking system. These promises are easy to fulfill if everyone believes in the sovereign. But once confidence is gone, a sovereign is in the same position as a bank with more demand deposits than reserves. If everyone wants out, no one can get out. Markets break down, reserves are exhausted, and bank deposits and currency markets are often frozen.

Such bank runs are not simply the product of an irrational loss of confidence by depositors.[23] Most highly indebted sovereigns owe a lot of money to the local banking system: Such interlinkages can cause a sovereign crisis to spread quickly—a sovereign crisis often becomes a banking crisis, and a banking crisis often becomes a currency crisis.

Don't Forget about Politics. A default is a fairly visible signal of failed policy. A sovereign default usually results in domestic fiscal adjustment, cuts in spending and increases in income and value-added taxes, and a fall in domestic financial wealth. A domestic as well as external debt restructuring is often necessary in severe crises. Chapter 7 emphasized that a domestic debt restructuring is a capital levy—a tax on domestic savings. Not surprisingly, default often leads to political change.

The difficulty in finding a durable new government and developing political consensus around a new approach to economic policy can severely impede reaching rapid agreement on a restructuring. Indeed, the political costs of default—and the impact default has on the personal and professional reputation of policymakers—is one reason why governments delay seeking a restructuring until well after it is clear that they have no other choice.

23. Argentina is a case in point. Argentina ultimately was able to stop the run on its banks, in part because its central bank was willing to rediscount performing pesified bonds to supply emergency liquidity to the banks even as the government was in default on its international debt. But this improvised guarantee was clearly partial: Deposits were repaid in devalued pesos. Depositors had every reason to run. Argentina, in fact, imposed a deposit freeze (the *Corralito* and *Corralon*) before it defaulted on its international debt.

Approaches to Legal Reform

There are two dominant approaches to legal reform—contractual and statutory.[24] The contractual approach aims to change the restructuring process by changing the provisions in existing debt contracts. The statutory approach would create a body of international law to govern the restructuring of at least the sovereign's external debts—in some proposals, all of the sovereign's debt. The restructuring process outlined in the international treaty would override the provisions found in the debt contract.

Both approaches seek to address the rush to the courthouse and the free rider or holdout problem. The rush to the courthouse is either stopped through an outright stay on litigation or slowed by provisions that make it more difficult for an individual creditor to initiate and collect on litigation. The free-rider problem is addressed either through the introduction of provisions that allow a supermajority of the holders of an individual bond to make the restructuring binding on all holders of that bond or through the creation of legal capacity to hold a broader "aggregated" vote of the holders of all instruments participating in the restructuring. Many proposals also are motivated by a desire to use legal change to strengthen incentives for sovereigns with unsustainable debts to move more quickly to address their problems. Majority voting might encourage sovereigns to initiate a preemptive restructuring, and greater protection from the risk of litigation might lead sovereigns to suspend payments more quickly, stopping a rush to the exits.

While it is important to compare and contrast the statutory and contractual approaches, it would be a mistake to assume that all statutory or all contractual proposals are the same. Some contractual proposals attempt to increase the debtor's ability to address holdouts by amending the bond's financial terms; others aim to increase the creditors' leverage by imposing new reporting requirements on the debtor and by limiting the debtor's ability to amend the bond's nonfinancial terms. Some statutory proposals assign a large role to a third party—either the IMF or a new international court; others try to minimize the role of a third party and leave most decisions in the hands of the debtor and its creditors. Some would make the restructuring process more friendly to the debtor, while others would tilt the balance of power toward creditors.

Contractual Proposals

Two broad options for contractual change have been put forward: broadening the use of majority-restructuring provisions similar to those used in

24. Some have also proposed a "code of conduct" for sovereign debtors and their creditors (both before and during a debt restructuring) as a complement, not necessarily as an alternative, to a contractual or statutory approach. The code is discussed later in this chapter.

traditional English-law documentation or adopting the new clauses similar to those proposed by a group of creditor representatives. Of course, keeping traditional New York–law documentation is also an option.

Broadening the Use of Majority-Amendment Clauses. Imitating English-law practice would require, at a minimum, changing the provisions used in New York–law bonds to allow the amendment of the bond's key financial terms with a 75 percent majority vote. A broader reform would also introduce a requirement that litigation could only be initiated with the support of 25 percent of all holders of the bond, and that any proceeds from such litigation would need to be shared among all the holders of the bond.

However, adopting the key provisions used in English-law bonds does not require adopting all English-law conventions lock, stock, and barrel. Some standard English-law provisions could be modified to match New York–law conventions and reflect legitimate creditor concerns without watering down the core change. For example, to amend a bond, the bond's voting provisions could require the support of 75 percent of the outstanding principal value of the bond to change its key terms rather than the support of 75 percent of bondholders present at a meeting that meets quorum requirements. (See box 8.2 for a more detailed discussion of various types of collective action clauses).

It is also possible to give a set of key nonfinancial terms the same protection that is provided to a bond's financial terms. The ability to amend a bond's financial terms directly through a transparent vote reduces the need to rely on provisions allowing the amendment of a bond's nonfinancial terms to avoid holdouts (so-called exit consents).

Litigation-Friendly Clauses. A number of organizations representing private creditors joined together at the end of 2002 to lay out their own proposals for changing bond documentation.[25] They suggested the intro-

25. The Institute for International Finance (IIF), the Emerging Markets Traders Association (EMTA), the Emerging Markets Creditors Association (EMCA), the Securities Industry Association (SIA), The Bond Market Association (TBMA), the International Primary Markets Association (IPMA), and the International Securities Market Association (ISMA) all joined together to propose new clauses. These industry groups were motivated by a sense that the official sector's proposals, which focused on addressing the collective action problem created by holdout creditors, failed to address what creditors believed were more important problems in the restructuring process. Creditors worried that debtors would abuse exit consents, particularly if domestic creditors held a large share of a country's international bonds and argued that the creditors had difficulties establishing a satisfactory dialogue with the debtor. The decision to propose a high threshold for amending financial terms reportedly reflected both the difficulties of reaching consensus among the creditor organizations and an expectation that any "consensus" clauses would emerge from additional negotiation with the official sector. The creditors' proposals, however, may have backfired. The risk of the creditors' proposals defining New York-law documentation convention seems to have contributed to Mexico's decision to introduce its own preferred set of clauses into its New York–law bonds.

Box 8.2 More on bond documentation

Even before Mexico's 2003 decision to introduce collective action clauses into its New York-law bonds, bonds with clauses that allow a supermajority to amend the bond's key financial terms already constituted well over 20 percent of the market for dollar-denominated international sovereign bonds and around 50 percent of the smaller market for euro-denominated international sovereign bonds. A number of issuers used English law for their dollar-denominated debt, just as some issuers used New York law for their euro-denominated debt. Russia, Lithuania, Latvia, Ukraine, Pakistan, and Kazakhstan all have issued dollar-denominated bonds governed by English law that contain clauses. Argentina, Brazil, and Turkey traditionally used English law in their euro-denominated issues even as they used New York law in their dollar bonds. Colombia, Chile, Lebanon, and Mexico, in contrast, have traditionally used New York law for both their dollar- and euro-denominated debt.

Mexico's decision to introduce clauses into its New York–law documentation, however, has eroded the identification of New York governing law with the absence of collective action clauses.[1] Right now a number of "flavors" of collective action clauses are floating around. Eventually, however, the market is likely to settle on a single standard for voting provisions or perhaps on a range of accepted formulas:

- Traditional English-law documentation allows for the bond's payments terms to be amended with the support of 75 percent of those present at a bondholders' meeting that meets quorum requirements. If the quorum requirement is low and not many bondholders show up at a meeting, such provisions could allow the bond's terms to be amended with the support of less than 20 percent of the holders of the bond's outstanding principal value.
- Mexico partly followed the English-law convention of allowing 75 percent of the holders of a bond to amend its key financial terms when it introduced majority-amendment provisions into its international bonds in spring 2003. However, the 75 percent is calculated on a different basis—holders of the entire principal amount outstanding—rather than those represented at a meeting that meets quorum requirements. Bonds held directly by the debtor and bonds held by institutions where the debtor exercised equity control would be excluded from the vote. Mexico also broadened the definition of a bond's key financial terms to go beyond payment terms and dates. Any change in voting rules, governing law, jurisdiction, the pari passu provision, and the waiver of sovereign immunity also required the support of 75 percent of the holders of bond's outstanding principal value. Other terms could be amended by a two-thirds vote. Mexico did not make use of a trustee structure.[2]

(box 8.2 continues next page)

duction of provisions that would allow a supermajority to amend a bond's financial terms. However, they wanted the thresholds for the supermajority vote to be set higher than is the norm in the English-law market. The private creditor organizations proposed allowing 85 percent of the holders of a bond's outstanding principal value to amend the bond's financial terms, but only so long as no more than 10 percent of the holders of that bond objected. The support of 90 percent of the bondholders would be needed to overcome the opposition of the 10 percent. Provisions that related to the ability of creditors to sue to collect on their bonds could

Box 8.2 *(continued)*

- A few issuers have used documentation that resembles Mexico's, but increased the voting thresholds to 85 percent for key terms. Brazil initially used such documentation, but it recently reduced the voting threshold in its bonds to 75 percent.
- Uruguay's bonds have Mexican-style clauses that allow the bond's key terms to be amended with the support of 75 percent of the holders of the bond's outstanding principal value. But they also have provisions that allow for "aggregation." In the "aggregated vote," the votes of all Uruguay's outstanding external bonds are pooled and the threshold for amending the financial terms of any individual bond issue is lowered to two-thirds *so long as* 85 percent of all the holders of Uruguay's external bonds support the restructuring. The ability of one-third of the holders of a single bond issue to opt out of the "aggregated" vote protects against the risk that all of Uruguay's bondholders might gang up to impose large losses on a specific bond. Uruguay made use of a trustee structure, which makes the decision to litigate a collective rather than an individual one and assures that any proceeds from litigation are shared. The trustee is also responsible for excluding bonds directly or indirectly under the debtor's control from any vote. Uruguay's documentation also requires that Uruguay disclose the details of its economic plan and debt restructuring proposal to the trustee for distribution to all bondholders in the event of a restructuring.[3]

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1. This identification was never perfect. Richards and Gugiatti (2003) looked closely at the terms of all New York–law bond issues to assess the impact of clauses on spreads. They found—to their surprise—that a few bonds issued prior to Mexico's seminal bond issue contained collective action clauses, apparently because these particular bond contracts had been drafted by the English offices of New York law firms. The New York–law bond issues of Egypt, Lebanon, Qatar, and Kazakhstan all contained collective action clauses (as did a small Bulgarian issue), so, nearly $12 billion in New York law–bonds contained collective action clause, even before Mexico put clauses into its own bonds. Market participants were not aware of the use of clauses in these bonds—reinforcing Richards and Gugiatti's overall argument that clauses have no impact on pricing.

2. Mexico's clauses generally followed the provisions recommended by the G-10. However, Mexico initially did not adopt the G-10's recommendation to use a trustee rather than a fiscal agent structure. Under the G-10 model, only the trustee, not the individual bondholders, would be able to initiate litigation. The trustee also would assure that the proceeds of litigation would be shared among all bondholders (Group of Ten 2002).

3. See Gelpern (2003) for a comprehensive comparison of the G-10's proposals, the proposals of industry groups, and the documentation used by Mexico and Uruguay.

not be amended at all. The voting thresholds for modifying a bond's nonfinancial terms would be raised from 67 to 75 percent, and more important, the definition of "financial terms" would be broadened. Bonds controlled directly or indirectly by the debtor would be excluded from the vote (control would be defined broadly and could include regulated financial institutions that the debtor did not directly control). In practice, provisions for amending financial terms would be tighter than those now found in English-law bonds, and provisions for amending nonfinancial terms would be tighter than those now found in New York–law bonds.

Creditor groups also proposed introducing two additional sets of contractual provisions into bond documentation. First, the documentation would require additional financial disclosure from the debtor, with the disclosure requirements increasing should the debtor fall into default. Second, the documentation would include a set of provisions that would require that the debtor pay the expenses of a committee formed to represent creditors' interest during a restructuring.

Assessment of Competing Contractual Proposals

Some proposed changes could make it easier for a debtor to avoid holdout litigation; others could make a restructuring harder—and give the creditors more leverage. The devil is really in the details: The thresholds for amending the bond's financial and nonfinancial terms, the definition of financial and nonfinancial terms,[26] and the definition of who is eligible to vote all matter.

It is possible to create bonds with collective action clauses that are harder to restructure than current New York–law bonds that lack collective action clauses. For example, the creditor groups proposed contractual changes that would make it harder to amend a bond's nonfinancial terms to encourage participation in a restructuring. However, those changes would not be balanced with provisions that would make it significantly easier to avoid holdouts by amending the bond's financial terms. A potential holdout could obtain the 10 percent needed to block a restructuring amendment without much difficulty. If the debt trades at 20 cents on the dollar, it takes only $10 million to buy a blocking $50 million position in a $500 million bond with 90 percent majority-amendment provisions and $20 million to buy a blocking $100 million face position in a $1 billion bond. Sophisticated creditors who hold less than this are not likely to initiate litigation anyway. Elliot spent $11.8 million to buy its position in Peru's sovereign debt in 1995 and ended up collecting nearly $56 million. Those interested in imitating Elliot's strategy are likely to be willing to commit similar—if not larger—sums.[27] Litigation is expensive and makes sense only if the creditor is angling for a substantial payoff.

The need to assure that any consensual restructuring has the support of the overwhelming majority of the country's creditors has to be balanced against the need to offer the debtor—and its cooperating creditors—pro-

26. Technically, bonds that grant other terms the same protection they give the bond's key financial terms often define a set of "reserve matters" (which include both the bond's financial terms and a set of key nonfinancial terms) that have a higher level of protection than all other provisions in the bond contract.

27. Indeed, the litigation currently being pursued by one large creditor, the Darts, against Argentina is based on this mode. The Darts bought a controlling stake in a single bond issue to protect against exit consents and have a large enough claim to make litigation potentially attractive.

tection against the risk of holdout litigation. A voting threshold that lets 50 percent of the holders of a bond amend the bond's financial terms probably fails to offer creditors enough protection. Conversely, the proposed voting threshold of 90 percent fails to offer the debtor sufficient protection against holdouts. Such provisions risk pushing the debtor to find less transparent means of carrying out a necessary restructuring.

In our view, provisions that allow the amendment of a bond's key terms—financial terms as well as the key nonfinancial terms—by a vote of 75 percent of the bond's outstanding principal get the balance basically right. Amending such a bond's financial terms is much easier than is now the case in a typical New York–law bond. Yet such clauses also provide creditors with more protection than current English-law documentation.

There is no evidence that introducing this kind of collective action clauses into sovereign debt contracts would reduce a sovereign's incentives to pay. Clauses that allow a bond's financial terms to be amended do not make default per se less costly. They only make it easier for the sovereign to avoid holdouts when it can put forward a restructuring proposal that the vast majority of its creditors accept. The evidence that the threat of holdouts is needed to motivate a sovereign to pay is thin. It is hard to see how English-law bonds would survive in the market if typical English-law provisions made default an attractive option for sovereigns.[28]

Marketing Bonds with Clauses

Until recently, sovereign debtors have been reluctant to change the documentation used in their New York–law bonds (or start issuing their dollar bonds governed by English law), despite repeated calls for reform from the official sector. Their reluctance has stemmed from concerns—perhaps misplaced—that the market would penalize debtors who issued with clauses and that the first debtor to initiate change would bear a disproportionate share of the costs.

This is why the early 2003 decision of Mexico—a traditional market leader—to change the documentation that it used in its New York–law bonds was crucial. The US Treasury certainly encouraged Mexico to take the lead in introducing clauses. But Mexico's decision seems to have been motivated at least as much by a desire to bring the debate on the IMF's proposed bankruptcy regime to a close and by fear that if it did not act, it would leave the field open and allow creditor groups to rewrite the standard documentation used in New York–law bonds. Mexico realized that it would be better off if it decided the type of restructuring provisions that it wanted in its bonds and made these provisions the market standard rather than taking the risk of others setting the market standard. If Mex-

28. The use of both English- and New York-law documentation in both the dollar-denominated and euro-denominated debt markets has long suggested the absence of a significant price penalty for either governing law.

ico paid any premium on its path-breaking bond, it was very small. In fact, most analysts find no evidence of *any* price penalty on the initial bond. Mexico's use of clauses in subsequent bond issuance has been described as a "nonevent" (IMF September 2003a).

Most subsequent issuers followed Mexico's example and issued bonds that allow key terms to be amended with a 75 percent vote, though a few raised the threshold for amending key terms to 85 percent. Uruguay, however, went further than Mexico and introduced truly innovative "superclauses" in the bonds that emerged from its debt exchange (Salmon 2004b). Uruguay's new clauses allow aggregated voting across several bond issues (box 8.2). These provisions are probably too innovative to become the new market standard. Nonetheless, Uruguay's clauses do demonstrate how certain innovations could both provide the debtor with more protection against holdouts and offer creditors more protection against debtor abuse.[29] Broadening the voting base helps the debtor, since it takes a lot more money and commitment for a holdout to obtain 15 percent of $5 billion in bonds than to obtain 25 percent of $500 million or even $1 billion in bonds, while the higher 85 percent voting threshold for the aggregated vote offers the creditors an added level of protection.

The use of clauses that allow the amendment of a bond's financial terms now seems likely to emerge as the market standard. One of the "big three" emerging-market sovereign debtors in the world—Russia—has long used English law for its international bonds and thus issued debt with clauses. The other two members of the big three—Mexico and Brazil—are now using majority-amendment clauses in their new New York–law bonds as well.[30] Argentina will dramatically increase the stock of bonds with clauses should it complete an exchange to end its default. Chile, Colombia, Costa Rica, Guatemala, Korea, Poland, Peru, South Africa, and Venezuela have all started using clauses in their new New York–law bond issues (Taylor 2004b).

However, changing the contractual provisions used in new sovereign debt issues will not change the terms of the roughly $200 billion stock of existing international bonds that lack majority-restructuring provisions.[31]

29. See Batholomew, Stern, and Liuzza (2002) for an innovative JP Morgan Chase proposal to introduce "aggregating" clauses after a default through a two-step exchange offer.

30. Russia traditionally used English law for its dollar-denominated international bonds but did on occasion use German law for bonds denominated in deutsche marks. Brazil traditionally used New York law for its dollar-denominated bonds and English law for its euro-denominated bonds. When it first introduced clauses into its New York law bonds in 2003, Brazil used a 85 percent voting threshold. However, it has subsequently started to issue bonds with 75 percent voting threshold.

31. IMF data (September 2003a) indicate that there are $163 billion in outstanding New York–law bonds (at least $9.1 billion of which now make use of collective action clauses) and $33 billion in outstanding German-law bonds. This estimate, however, excludes the outstanding stock of Brady bonds and therefore understates the stock of existing bonds that

IMF projections suggest that if all new sovereign debt contracts included new contractual provisions allowing a supermajority to amend the bond's key financial terms, it would take a little under 10 years for 80 percent of the entire stock of external-law debt to include collective action clauses. If debt exchanges or buybacks lead the stock to turn over before it matures, the process would be more rapid.[32] The process of changing sovereign debt contracts has only just begun.[33] Most sovereign international bonds will lack provisions allowing the amendment of key financial terms for some time: This limits the ability of contractual reform to change the restructuring process immediately—for better or for worse.

Statutory Proposals

While contractual proposals seek to change the terms of individual contracts that could interfere with an orderly restructuring, statutory proposals seek to create a set of rules that would replace existing contractual provisions. Statutory proposals therefore necessarily do two things:

- establish the legal basis needed to override existing sovereign debt contracts. Since a sovereign can issue debt in a number of jurisdictions, a treaty is required to create a body of international law that would trump conflicting national law; and
- empower an existing institution (typically the IMF) or create an institution to act as a referee between the debtor and its creditors and give the referee's decisions the force of law. Some provisions in any bankruptcy regime almost certainly will require authoritative interpretation even if every effort is made to minimize the authority given to a third party.

Statutory proposals typically aim to address the same set of problems as contractual proposals—notably the free-rider problem and the rush to the courthouse. Some, however, are more ambitious and target other

lack collective action clauses. On the other hand, it also likely fails to take into account the roughly $12 billion in outstanding New York-law bonds that Richards and Gugiatti (2003) found that included collective action clauses even before Mexico's pioneering issue.

32. Because there is a long tail of very long-term bonds, it would take another nine years to increase the percentage from 80 to 90 percent, absent liability management operations or sovereign restructurings that result in more rapid turnover of long-term bonds (IMF June 2002a).

33. If the trend toward introducing sensible restructuring provisions into new debt contracts is reversed, the official sector could take a number of steps to strengthen incentives for the use of clauses or even to require their use. See Roubini and Setser (2003).

problems.[34] Patrick Bolton and David Skeel (2003) would use a statutory regime to enforce a "first issued, first paid" priority structure. Andrei Shleifer (2003) has suggested that a statutory regime should be designed to increase creditors' leverage in a sovereign restructuring. Rather than examining all proposals for sovereign bankruptcy regimes, it makes sense to focus on the IMF's SDRM proposal. This proposal both is representative of proposals that focus on protecting a sovereign debtor from holdout litigation and is more developed than most other proposals. Consequently, it is likely to continue to frame the debate. One caution: The IMF's proposal evolved over time, so in many cases, our discussion will include options that the IMF initially considered but then discarded.[35]

Stay on Litigation to Stop Creditors from Rushing to the Courthouse?

Most corporate bankruptcy regimes insist that the debtor stop payments on all its debts when it files for bankruptcy and, in turn, be provided with automatic protection from litigation (a stay on litigation). Automatic or close to automatic protection from litigation is balanced by court supervision of the debtor while it prepares its restructuring proposal. If the debtor does not reach agreement with its creditors on a restructuring proposal, the court moves to liquidate the debtor.

The IMF's initial thinking, along with most other proposals for a sovereign bankruptcy regime, loosely followed the corporate model. Anne Krueger suggested in November 2001 that the IMF be given the ability to determine whether a debtor should be given temporary legal protection. However, relying on the IMF to determine whether a debtor deserves protection raises a host of problems. Many debtors are reluctant to expand the IMF's role in the restructuring process, while creditors argue that the IMF's financial exposure makes it an interested party. They also fear that the IMF's governance structure gives it an intrinsic bias toward protecting one of its members. The obvious alternative—setting up a new international institution just to supervise sovereign restructurings—requires an extraordinary amount of effort without eliminating the IMF's broader role in the restructuring process: The two institutions would either need to coordinate with each other or risk working at cross-purposes. It would be strange, for example, for the court to deny legal protection to a debtor that the IMF believed deserved financial support.

34. See Rogoff and Zettelmeyer (2002b) for an excellent survey of proposals to create an international bankruptcy regime for sovereigns.

35. For the final version of the IMF's proposal, see IMF (April 2003). Earlier versions include IMF (November 2002 and February 2003) and Krueger (2001a, 2002a, and 2002b).

The IMF eventually concluded that an automatic stay on creditor litigation was not desirable, largely because the IMF was not planning to require that a sovereign debtor stop payment on all its debts—or even those owed to external private creditors.[36]

The IMF's final proposal focuses on creating the legal machinery for supermajority voting on the debtor's final restructuring proposal. It assumes that most debtors would not need a stay: The possibility that the debtors proposal would be approved before an individual creditor could collect through the courts would deter most litigation.[37] However, the IMF also outlines two ways a debtor could obtain additional protection from creditors immediately after default, should such protection prove necessary. First, the debtor has the option of putting a proposal for a temporary stay to a vote of its creditors. A supermajority of creditors then would determine whether to give the debtor legal protection, just as a supermajority of creditors would vote to approve the debtor's final restructuring proposal. Second, the debtor and a committee of its creditors could petition the judicial panel set up to administer the "bankruptcy" process to block disruptive litigation if such litigation threatened to disrupt the restructuring process before a creditor vote could be organized (IMF March 2003).

Supermajority Voting to Solve the Free-Rider Problem?

A statutory regime allows a single aggregated vote of the holders of all participating instruments—for the sake of simplicity, say the holders of all external sovereign bonds—to determine the success of the restructuring plan. In principle, a single "aggregated" vote would have three advantages over the bond-by-bond voting process of standard collective action clauses:

- An aggregated vote avoids the risk of a holdout obtaining a large enough position in an individual instrument to block any amendment of the bond's terms. It is a lot harder to buy up a blocking position in the debtor's entire debt stock than to buy a blocking position in a single bond issue.

36. The IMF's Sean Hagan has emphasized this point. For an extensive discussion, see IMF (February 2003).

At one point, the IMF floated a proposal that would not have provided the debtor with any formal legal protection, while it was developing its restructuring plan—implicitly recognizing that a sovereign's core assets already enjoy substantial legal protection.

37. The IMF did suggest implementing the sovereign's legal defenses with certain provisions designed to reduce creditors' incentive to initiate litigation (so-called litigation retardants).

- The capacity to override existing sovereign debt contracts would eliminate the need to wait for the existing stock of roughly $250 billion German- and New York–law sovereign debt to be retired.[38]
- The SDRM could override contractual provisions that inhibit supermajority voting in bank loans as well as bonds. It eliminates the risk that new kinds of financial instruments with difficult-to-restructure contractual terms might emerge.[39]

However, these advantages have to be weighed against the practical difficulties associated with setting up a single aggregated vote. These difficulties are worth exploring in detail.

Which Instruments Should Participate in the Aggregated Vote? Restructuring experts often note that it is far better to hold an instrument that is not part of the restructuring than to haggle for more of the debtor's limited cash flow. Not surprisingly, the key to any proposal for an "aggregated" vote is the process used to select the precise instruments that will participate in that vote.

A comparison with Uruguay's "aggregation" clauses is instructive. Uruguay's clauses allow two possible forms of voting. Each bond can be restructured though an individual vote, or all the bonds in the series *specified in the contract* can be restructured through a single aggregated vote. A statutory regime, however, needs to find another way to define the set of creditors that would participate in the aggregated vote.

There are two broad options. One is for the statute, in broad terms, to define the set of instruments that have to participate in the vote if the debtor wants to take advantage of the bankruptcy regime. The treaty that created the bankruptcy regime would set out a series of criteria to determine whether an instrument should be part of the vote, and the debtor would be required to include all instruments that meet these criteria in its restructuring proposal. Since there would inevitably be disputes, a third party would have to determine whether a given instrument had to be part of the proposal. The other option is to let the debtor select which instruments to include in the restructuring from the set of debts that meet the basic eligibility criteria. The debtor, in effect, would get to define the "series" of instruments that would participate in the aggregated vote. The first option restricts the debtor's choices if it wants to take advantage of the bankruptcy regime. The second gives the debtor substantial flexibility to craft a restructuring proposal that suits its interest. It could, for example, opt to exclude international bonds held heavily by either domestic banks or domestic pension funds from its overall restructuring.

38. To some, this is also a key disadvantage of the proposal, since investors who bought one kind of contract lose the key protections of that contract. See Galvis (2003).

39. We are indebted to Lewis Alexander for this point.

The IMF proposed letting the debtor determine which instruments would participate in the aggregated vote. The debtor was required to set out three lists of instruments that would be

- restructured through the SDRM's single aggregated vote;[40]
- restructured outside (Paris Club debt, for example, likely would be restructured in a separate process. Some domestic debts might be as well); and
- excluded from the restructuring altogether.

One Vote or Many? In most domestic bankruptcy regimes, creditors are organized into voting classes. All creditors holding claims with the same priority are put into the same class, and the bankruptcy judge assures that the restructuring terms respect these priorities. Each class votes separately on the restructuring proposal, and approval of the overall deal generally requires the approval of all creditor classes.[41] Separating creditors into classes is a way of protecting a minority of creditors with distinct interests from being abused by the majority. For example, a supermajority of unsecured creditors cannot vote in favor of a plan that strips secured creditors of their collateral and distributes the collateral among unsecured creditors.

A bankruptcy-style restructuring process for sovereigns either could set up a single vote of all participating unsecured creditors or divide creditors into different voting classes. This is a technical issue but one with immense consequences. Almost all sovereign debt is unsecured, so following the bankruptcy principle that debt with the same legal priority should be part of the same class would imply that all of the sovereign's unsecured debt should be organized into a single aggregated vote. This change to the current sovereign debt restructuring process would truly be radical. The holders of a sovereign's domestic debt, its Paris Club creditors, and holders of its international bonds and syndicated bank loans would all be part of the same vote.

Such a change poses a host of obvious problems. If Paris Club creditors held a small part of the sovereign's overall debt, a supermajority composed of private creditors alone could impose restructuring terms on them—including restructuring terms that require budgetary authoriza-

40. These instruments would have to meet certain criteria in order to be eligible to participate in the SDRM's aggregated vote: For example, they could not be governed by the crisis country's law, and they would have to be the product of a commercial contact that creates a right to payment. Secured debt and debts owed to the IFIs also would be excluded from the vote.

41. In some rare instances, a class of creditors can be forced to accept a restructuring against its will. In Chapter 11 of the US bankruptcy code, this process is referred to as cramdown. In the sovereign context, the term cramdown is often used loosely to describe any majority voting process that allows supermajority voting.

tions. For example, Argentina's private creditors might be able to cast a vote that forces the US Congress to spend money forgiving Argentina's debt. Conversely, Paris Club creditors might outvote private creditors in some instances. In the unlikely event that domestic debt was included in the bankruptcy regime, holders of domestic debt might be able to impose restructuring terms on both the Paris Club and external private creditors.

Dividing unsecured creditors into different classes offers one potential solution to these problems. Each class would vote separately, and approval of the overall deal—and presumably the resumption of payments—would require the approval of all creditor classes. However, this requires an agreed-upon process for setting up creditor classes, and it creates a risk of one class of creditors refusing the restructuring terms and blocking the overall restructuring.[42]

Another option is to limit the scope of the SDRM's aggregated vote. This assures that only relatively similar creditors participate in the vote and avoids the need to set up lots of special classes of creditors. The IMF in the end moved in this direction.[43] Domestic debt is excluded from the IMF's final SDRM proposal. The proposed treatment of the Paris Club was a bit more ambiguous, but the cleanest version of the IMF's proposal would also leave the Paris Club entirely out of the process.[44]

This makes the SDRM easier to design and operate but also limits its potential to solve many of the most vexing problems that arise in a sovereign restructuring. In many cases, more sovereign debt would need to be restructured "outside" than "inside" the IMF's proposed SDRM.

Domestic Debt

The trade-off between a narrow international bankruptcy regime that is easy to operate and a broad, complicated, intrusive and potentially more powerful international bankruptcy regime is most obvious with domestic debt. A bankruptcy regime that excludes domestic debt would not address those cases where domestic debt accounted for most short-term pressure. It also would not determine the relative priority that should be granted to domestic and external debt, let alone to different domestic claims.

42. Singh (2003) notes that in corporate bankruptcy, an entire creditor class sometimes has held out for a better deal. Approval of the overall deal requires the support of all classes in the United States, and it is sometimes more trouble than it is worth to cram down the overall deal on a holdout class.

43. The IMF's final proposal gave the debtor the option of dividing its unsecured external creditors into classes, if classification would facilitate reaching agreement on a restructuring. However, the debtor was under no obligation to classify its creditors. This differs fundamentally from domestic bankruptcy.

44. The IMF staff and management suggested that the Paris Club could be part of the SDRM if Paris Club creditors always received the protection of voting as a separate creditor class. However, the IMF's Executive Board generally was less inclined than IMF staff to include Paris Club debt in the SDRM.

The legal problems associated with the restructuring of domestic debt are also fundamentally different from those associated with the restructuring of international debt. Domestic debt often can be restructured by a unilateral decree that changes the debt's payment terms.[45] Legal problems arise if the constitutionality of such decrees, or other laws mandating a debt restructuring, is challenged—not from holdouts. Even if the sovereign concludes it needs its domestic creditors to accept an exchange offer, it often has substantial powers of moral suasion, particularly over domestic banks. Consequently, a new internationally supervised process for restructuring domestic debts would introduce new constraints on a sovereign's current ability to restructure domestic debt unilaterally—a much larger loss of national sovereignty than in a bankruptcy regime limited to external debts.

Including domestic debt also would unavoidably draw the IMF, a new court, or a dispute resolution body more deeply into a range of domestic political disputes. There are many more potential kinds of domestic claims on the sovereign than international claims—a point emphasized in chapter 7. Are wage arrears debt? Should arrears to pensioners be treated differently than those to the police and teachers? If the banking system collapses, are bank deposits guaranteed by the government part of the overall restructuring process? Or should they be addressed separately (and more quickly)? The bankruptcy regime's rules could well shape the terms all these groups received in the restructuring. The difficulties in deciding what constitutes domestic debt could be reduced by limiting the bankruptcy regime to domestic debts incurred as a result of the formal extension of credit to the sovereign. But no matter how "narrow" the definition of domestic debt, a regime that included domestic debt would be exponentially more complex than one limited to external debt.[46]

Mechanism to Provide New Senior Money?

Most bankruptcy regimes grant absolute priority to new financing. Creditors providing new money are among the first in line for payments if the reorganization fails and the debtor has to be liquidated. New financing is

45. Most domestic debt contracts lack provisions analogous to the collective action clauses found in English-law international bonds. Some legal analysts have even argued that introducing a contractual procedure for domestic debt restructurings might make domestic debt restructuring more difficult, since it would lay the basis for challenging the legality of a decree that superseded the contractually defined restructuring process.

46. Including domestic debt would almost certainly require dividing domestic and external debt into different classes (so-called mandatory classification). Moreover, the interests of holders of fixed-rate debt denominated in domestic currency, debt denominated in the domestic currency but indexed to inflation, debt payable in the domestic currency but indexed to a foreign currency, and domestic debts denominated in a foreign currency differ, making aggregation of all domestic debts difficult. See IMF (August 2002) for a more detailed discussion.

often called DIP financing after a provision in Chapter 11 of the US bankruptcy code.

No sovereign bankruptcy regime could grant private creditors providing new money to the sovereign the same level of protection as domestic bankruptcy regimes. Most proposals do not even try to provide new money with "absolute" priority in payments—a nebulous concept for a debtor that cannot be liquidated. Rather they just try to provide the new money with relative priority over some other external debt payments, though presumably not over payments to the IFIs.

Priority to new money can be provided in two ways. One is through explicit subordination agreements. Existing creditors legally subordinate themselves to the new money, so the creditors providing the senior funds have a legal claim on any payments made to the now-subordinated and formally junior creditors. The other way is by making the repayment of new money a requirement for a valid vote on the debtor's restructuring proposal. This is all the IMF proposed (IMF April 2003).[47] Neither option would provide external new money with priority over domestic debt payments or would prevent a debtor from falling into default on its "new money" financing if it also were not paying its other external debts. Realistically, this would not provide sufficient comfort to generate large private flows at reasonable rates.

Moreover, the IMF's existing ability to provide new money to a sovereign going through a debt restructuring weakens the case for an elaborate mechanism for the provision of private new money. Providing new money exclusively through the IMF makes it easier to link access to new financing to policy changes on the part of the debtor, helping to offset the absence of a court that can oversee a sovereign debtor's operations. Advocates of senior new private lending often are motivated more by the desire to reduce the IMF's role in the sovereign debt restructuring process rather than to fill an obvious gap in the system.[48]

Fundamental Tensions in the Design of Any Statutory Regime

The bankruptcy analogy is in many ways misleading, because the creation of a sovereign bankruptcy regime would almost certainly create a restructuring process that differs substantially from the corporate debt restructuring process. For example, the powers the judges (or their functional equivalent) sitting on an international bankruptcy court (or its equivalent)

47. In either case, the priority provided in the sovereign context is much weaker than that provided in domestic bankruptcy. Priority in domestic bankruptcy includes a priority claim on the debtor's assets if the debtor is shut down. A sovereign cannot be shut down, so a similar protection cannot be provided. Moreover, most mechanisms to provide priority do not provide effective legal remedies, should the debtor stop paying its "priority" financing.

48. For example, Steven Schwartz's (2000) proposal for private DIP financing was motivated by the need to get the IMF out of the business of lending to countries.

could exercise over a sovereign would likely be far more limited than the powers a bankruptcy court can exercise over an insolvent firm. No court is likely to ever be given the power to assume operational control of a sovereign debtor—or to transfer operational control to creditors.

The debtor's sovereignty creates a series of additional tensions that complicate the design of any new restructuring regime.

- First, no one can force a sovereign to make use of a bankruptcy regime's provisions. A sovereign always will have the option of reaching agreement with its creditors on its own, without any "court" supervision. Any bankruptcy regime has to include features that make it attractive to sovereign debtors—or risk the fate of the IMF's contingent credit line, which was discontinued after no IMF member applied to use it. The IMF's SDRM, for example, let the sovereign pick the set of instruments that would participate in the aggregated voting process without imposing substantial new constraints on a sovereign. We don't think this alone is a large enough change to upset the fundamental balance between a debtor and its creditors, which is needed for the sovereign debt market to work. However, the risk of more ambitious proposals that provide the debtor with substantially more protection altering the balance is real.

- Second, the penalties that can be imposed on a sovereign that fails to live up to bankruptcy regime's standards are limited as long as effective litigation against a sovereign debtor remains difficult. The main penalty available to the "referee" would be to lift formal bankruptcy protection—which might not be that strong a penalty. Another potential punishment for poor behavior is losing the ability to restructure through an aggregated vote. This, however, penalizes both the debtor and its creditors just when the debtor is getting its act together. Skeptics of the SDRM like Andrei Shleifer were right to note that the SDRM did not give creditors any new rights against the sovereign.[49] Giving creditors new powers and strengthening the incentive for a sovereign to seek bankruptcy protection likely would require lifting many of the de facto protections a sovereign now enjoys.

49. Shleifer (2003) argues that the US municipal bond market works—municipalities borrow at low rates, and default is rare—because the US bankruptcy regime for municipalities requires the judge decide on the basis of the best interest of the municipalities' creditors. This argument, though, puts too much emphasis on the "best interest of creditors" clause—a provision that generally has been interpreted only to require negotiations. More important, in practice, is the ability of a state government to prevent a municipality from even filing for Chapter 9. Most state governments intervene before a municipality goes belly up: States usually bail out a troubled municipality in return for significant changes in municipal administration. Municipalities, at the end of the day, are not sovereign. See McConnell and Picker (1993).

- Third, the limited power any bankruptcy court would have over a sovereign debtor would likely mean that losing access to IMF financing would remain the strongest penalty for poor debtor behavior. A country's IMF program—the primary surplus assumption and the projected real exchange rate path—almost certainly would continue to set the broad parameters for negotiations between the debtor and its creditors (unless the IMF is unable to reach agreement with the debtor on a primary surplus path, as in Argentina). Negotiations between a debtor and the majority of its creditors would continue to be shaped far more by the country's IMF program than by the presence of a sovereign bankruptcy regime able to force a minority of creditors to accept a restructuring proposal. (See IMF January 2003a.)
- Fourth, the different balance between debtor and creditor interests in national bankruptcy regimes complicates reaching agreement on any major changes. An ambitious sovereign bankruptcy regime would not necessarily emulate many features of corporate bankruptcy, but it would require consensus on the right way to apportion bargaining power between a sovereign debtor and its creditors.
- Finally, the "architects" of any new statutory regime have to strike a difficult balance between proposing an approach that seems too close to the current restructuring process to be worth the enormous effort required to ratify a new international treaty, and an approach that engenders opposition because it would radically change the current restructuring process. SDRM-lite proposals that do little more than create the legal authority to allow an aggregated supermajority vote hardly seem worth the trouble, now that Uruguay has demonstrated that clauses can do much the same thing if all the country's bonds are issued in the same jurisdiction. On the other hand, the enormous investment in new institutions, rules, and procedures required to replicate something close to Chapter 11 of the US bankruptcy code at the international level is hard to justify so long as sovereigns do not experience more severe legal problems than they have in recent restructurings.

Would a Statutory Regime Radically Change the Behavior of Either Sovereign Debtors or the IMF?

Proponents and opponents of a statutory regime often argue that granting the debtor greater legal protection, whether from litigation immediately after default or from holdout litigation following a successful deal, will transform the incentives of all players in the sovereign restructuring process. Anne Krueger argued that the SDRM would encourage sovereign debtors with truly unsustainable debts to move more quickly to stop the rush for the exits, to the gain of the debtor and the vast majority of its creditors. Creditors, in contrast, worry that a statutory proposal will strengthen the incentives of all debtors to suspend payments rather than tighten their fiscal policy belts and cut spending/raise taxes.[50] Many proponents of an international bankruptcy regime argue that its main advantage would be that it would change the IMF's own incentives, not those of debtors or private creditors. A bankruptcy regime would make the IMF—and its major shareholders—less willing to lend to countries with unsustainable debts.

All these claims should be taken with a grain of salt. The creation of a sovereign bankruptcy regime along the lines proposed by the IMF would likely have a far smaller impact than anyone would care to admit. Sovereigns already enjoy substantial protection from litigation. Aggregated voting among the sovereign's external bondholders won't eliminate the difficulties in coordinating the restructuring of external bonds and Paris Club and domestic debts. Nor will it eliminate the complexities created when domestic banks hold a large share of the sovereign's external debt. The risk of a restructuring triggering a run on the banks, a run on the local currency, or both will remain. The collapse of the domestic banking system—particularly when combined with the widespread insolvency in the corporate sector after a collapse in the exchange rate—assure that the sovereign crisis will lead to a severe fall in output, even if the sovereign has additional legal protection. Sovereign restructurings—particularly the complex restructurings requiring deep debt reduction and real concessions from many sets of creditors—won't suddenly become fast, painless, and easy.[51]

Would the SDRM, in its final form, have made a substantial difference in Argentina? The likely answer is no. Litigation by domestic bank depositors who resisted pesification and sought to obtain full payment in dollars from the domestic courts has been a far larger problem than litigation by external creditors.[52] The severe recession that followed default was the outcome of the run on the banks that led to a bank holiday, the run on the currency that led to capital and exchange controls, and the balance sheet impact of the devaluation on an economy with pervasive cur-

50. Of course, making it easier to default would also make it harder for sovereigns to obtain access to new credit. Some academics who believe that emerging markets have an intrinsic bias toward overborrowing argued that this was a reason to create a bankruptcy regime. The SDRM would make it harder for emerging-market governments with less-than-pristine reputations to overborrow. See Bulow (2002).

51. The IMF was aware that a standstill on sovereign payments would likely have been insufficient to avoid a generalized run out of the crisis country. Anne Krueger argued that capital and exchange controls and other nonmarket actions would still be needed. The IMF (February 2003) includes a sophisticated discussion of the risk of a sovereign debt restructuring triggering a domestic banking crisis. However, the SDRM proposal itself did little to address these risks.

52. Argentina's Economy Minister Roberto Lavagna has incentives to bluff, but he declared in November 2003 that investor litigation would have no effect on Argentina's restructuring proposal.

rency mismatches—not litigation from external creditors. The ability to restructure Argentina's 98 external bond instruments in a single aggregated vote would make it easier to avoid holdouts, but it would not magically produce restructuring terms acceptable to retail bondholders, domestic Argentine pension funds, and international investors. Aggregated voting won't eliminate a gulf between the maximum offer a debtor is willing to make and the minimum offer a majority of creditors say they are willing to consider.[53]

The argument that the SDRM would have led the IMF to pull the plug on Argentina earlier is no more convincing. The SDRM does not make it any easier to distinguish between temporary liquidity problems and deep problems of insolvency, or eliminate the risk of initiating a sovereign restructuring triggering a series of runs. Political pressures to avoid the financial and economic disruption that follows a default and steep falls in output would not disappear.

Codes and Committees

Codes of Conduct

Both the Banque de France (2003) and the Institute of International Finance (IIF 2003) have proposed creating a code of conduct to guide a sovereign debt restructuring. Proposals for legal reform tend to focus on ways to limit the risk of "rogue" or "holdout" creditors disrupting a restructuring, while proposals for codes tend to focus on improving the behavior of a sovereign during the restructuring. A code of conduct could be combined with contractual change, be embedded in a statutory regime, or complement the current exchange offer–based process for sovereign debt restructurings.

A code could aim to do many things. One option is a code that lays out broad general principles—transparency, good faith, fair burden-sharing, and comparability of treatment—for a sovereign restructuring. Focusing on general principles limits the risk of the code being applicable to a specific crisis but runs the risk of not being of much use either. Principles that everyone can agree on tend to be open to multiple interpretations. Attempts to provide more precise definitions of terms like "good faith" typically result in sharp disagreements.[54] Another option is a code that clari-

53. Argentina initially sought to reduce the face value of its outstanding international bonds by 75 percent, which would imply a larger haircut in net present value (NPV) terms (the discount rate the market assigns to these bonds will exceed their coupon). Argentina subsequently indicated it would improve its offer by recognizing past due interest, but as of July 2004, it is not clear whether creditors will accept this proposal.

54. Banque de France (2003) has suggested developing a code that would set out both general principles and best practices for meeting these general principles.

fies how the key parties in the restructuring—the sovereign, its private creditors, the Paris Club, the IMF, and other IFIs—should interact. This might strengthen informal norms that shape the behavior of various parties in the restructuring. However, no player now seems very keen to constrain in advance its options in a restructuring. An ambitious code might even create a neutral third party to arbitrate the disputes that arise between the debtor and its creditors. But it is hard to see how a third party could force a sovereign debtor or a dispersed group of creditors to accept its decisions; an arbitrator most likely would only make voluntary suggestions.

However, no code could

- prevent a creditor run, stop a rush to the courts by giving the sovereign formal protection against litigation, or create the ability to restructure with a majority vote. While a code could be made semibinding on a sovereign debtor, it can do no more than suggest, but not require, that creditors roll over positions. No matter how much a code might improve debtor behavior if a restructuring is needed, creditors are still likely to prefer to get out before the restructuring if they can. Similarly, a code can only suggest that creditors reward a debtor's good faith behavior by restraining from litigation. In the absence of clauses allowing restructuring through a majority vote, a code cannot bind a minority of holdouts to a restructuring deal. The classic critique of weapons nonproliferation treaties also applies to a code of creditor conduct; they bind only those that don't want to proliferate. A debtor that works cooperatively with most of its creditors may still experience difficulty from rogue creditors who are intent on using their legal leverage to extract a more favorable settlement.
- change the core preferences of different groups of creditors or the debtor. It will not remove differences between the restructuring terms amenable to institutional investors that mark to market, those amenable to retail investors, and those amenable to the Paris Club. A code similarly will not change a debtor's incentive to protect the banking system from the fallout of its decision to seek a restructuring, even if this means treating domestic and external debt differently.

Need for Balance

Proposals for a code can be broken down into codes of "good debtor conduct" and codes of "good creditor conduct." In practice, though, it is hard to trade "good conduct" by the debtor for "good conduct" by the creditors. Most proposed codes do not create a means of sanctioning bad behavior by creditors, but link the debtor's compliance with the code to access new

IMF lending.[55] Such codes therefore are often long on requirements for the debtor and short on credible commitments by creditors.[56] This, plus the inability of a code to make a commitment by most creditors binding on all creditors—creates a significant asymmetry between the demands the code makes on a debtor and the demands it places on creditors.[57] Since creditors are pushing for a code where their obligations are very limited and their ability to pursue legal action or to hold out is unhampered, there is little chance that debtors will accept their proposals.

A less ambitious, voluntary code could prove to be more useful. Debtors often do stop communicating with creditors when they stop paying. There is a sense—we think exaggerated—that there is no obvious process for going about a sovereign restructuring. Consequently, a code that tried to lay out the minimal requirements for a cooperative restructuring might improve the sovereign workout process, in part by setting out some basic expectations that even a government in the middle of an economic and political crisis should be able to follow. Such a code might even be self-enforcing since all parties have an interest in a successful restructuring. However, a code should not be expected to settle the difficult questions of how to "fairly" allocate the pain inherent in a debt restructuring across all creditors or how to strike the right balance between restructuring external debt and policy adjustments that affect the country's citizens.

A useful code could

- *emphasize disclosure*. The debtor should be expected to provide full and accurate information about its debt profile and restructuring plans to its creditors shortly after it falls into arrears. This should include publishing a full accounting (detailed and disaggregated) of

55. In theory, adherence to the code during the restructuring could be a condition for creditors' final agreement on restructuring terms. However, this raises obvious problems of time consistency. If the debtor dithers for a few years before finally getting its act together and then puts forward an acceptable proposal, creditors are unlikely to turn the proposal down just to punish the debtor for failing to live up to a code in the past.

56. The IIF (2003) code calls for disclosure of macroeconomic and financial information by the debtor, continuous consultation before a crisis, enhanced consultations with creditors during a crisis, a standing committee of creditors, a group of "wise men" to advise debtors in trouble on appropriate policies, and extended negotiations on the terms of a debt restructuring. Debtors also agree not to discriminate between domestic and external debt or between private and Paris Club claims. Yet while the IIF wants to be involved in the design of both a program's macroeconomic conditionality and the country's debt restructuring, it, unlike the IMF, is not willing to offer new money—nor are its members willing to commit to roll over their positions.

57. In the IIF's (2003) proposed code, bondholders would agree only to evaluate whether to continue to hold a bond on its own merits. Banks commit to "consider" rolling over their exposure, but recent experience suggests a bank can consider the pros and cons of rolling over its exposure and then decide to reduce it.

its outstanding debts soon after defaulting and informing creditors of any subsequent new issuance that increases its debt stock. When the debtor is ready to put forward its initial restructuring proposal, it should also provide a list of claims that would be restructured through the exchange or the initial restructuring proposal, those that would be restructured through other processes, and those that would not be restructured. It should also indicate how its overall restructuring proposal would apportion available near-term cash flow across different creditor groups, as well as how each creditor group would contribute to the creation of a viable medium-term debt profile.[58]

- *outline how to move from imminent default to a successful restructuring*. Creditors should organize themselves to provide constructive input into the restructuring process; standing committees are likely to be unrepresentative of the debtor's current creditors and therefore unlikely to help.[59] Debtors should have an obligation to consult with creditor representatives as they develop their restructuring proposal. Creditors will have the legal right to initiate litigation while the debtor is developing its restructuring proposal, though hopefully most creditors will refrain from litigating. Debtors are within their rights to seek to use their existing contractual powers—the ability to amend the financial terms of English-law bonds and to amend through exit consents the nonfinancial terms of New York–law bonds—to limit the risks holdouts pose when the exchange offer is made.
- *set realistic expectations for intercreditor equity*. No ex ante consensus on a "fair" allocation of the burden between domestic and external creditors exists. Perfect equity may not even be in the interest of external creditors: A domestic debt restructuring that triggers a bank run could ultimately result in lower recovery levels for external creditors. Private creditors are unlikely to be willing to embrace a common understanding on how to apply the Paris Club's principle of comparability. Little is gained from promising too much.
- *call for clauses in new bonds*. Bonds that emerge from the restructuring should contain clauses that allow the amendment of the bond's financial terms.

A minimal code that sets out principles that apply to all cases should not prevent a debtor from making commitments that go beyond its relatively modest requirements in return for more concrete and specific commit-

58. Uruguay's bond documentation formally requires a similar level of disclosure.

59. In relatively simple cases (e.g., limited number of instruments, rescheduling rather than debt reduction), the debtor may be able to rely on informal market soundings. In more complex cases, the debtor may need to work with different committees representing different groups of creditors.

ments from creditors. If a given creditor group is willing to roll over its claims, to put up new money, to agree not to take legal action to collect on its claims, or even to agree amongst themselves that they will take all decisions by a supermajority vote. (For example, the two-step restructuring process laid out by Bartholomew, Stern, and Luizza [2002] would commit creditors to take decisions by supermajority voting in stage one.) Then the debtor might want to match these additional creditor commitments with additional commitments of its own. On a more modest scale, a debtor might be willing to agree to pay the fees of advisors selected by a representative committee of cooperative creditors.

If the IMF determined that a modest code's disclosure requirements made sense, then the IMF could decide to link its lending to the debtor's efforts to live up to these requirements. But it would be a mistake to orient the IMF's lending during a restructuring solely toward forcing a reluctant debtor to abide by an ambitious, creditor-friendly code of conduct. The IMF has a number of goals following a default other than enforcing a code of good conduct.[60] Financing to support macroeconomic stabilization and to mitigate the loss of output immediately after a default may be a more important goal than quick agreement on an external debt restructuring. The IMF has enough difficulty securing sound macroeconomic policies from debtors in default–-particularly if the crisis country already owes substantial sums to it and may default on it absent new IMF lending.[61] Consequently, the IMF is unlikely to be willing to make adherence to a code of conduct the sole criterion to determine whether it will lend to a debtor running arrears to its private creditors.

Ambitious plans to create a binding code of conduct are neither realistic nor desirable. However, a more modest code that tries only to force debtors to lay out their overall restructuring plan in a clear and transparent way could make a positive contribution to the resolution of sovereign debt crises. Such a code would try to map out more clearly the existing sovereign debt restructuring process—one based on consultation with creditors leading to an exchange offer, combined with the use of various amendment provisions to limit the risk of holdouts.

60. The IMF's current policy (IMF September 2002b) for lending into arrears requires a sovereign debtor make a "good faith effort to reach a collaborative agreement with its creditors." Formal IMF policy papers have hinted that good faith efforts often imply good faith negotiations (IMF July 2002b). In practice, though, the IMF generally has defined good faith very broadly, to the chagrin of private creditors. The IMF would be better served if it did not make promises that exceed what it is able (or willing) to deliver. The IMF should focus on encouraging a debtor to disclose both its macroeconomic program and its restructuring plans to private creditors.

61. The IMF board indicated (IMF September 2002b) that the IMF should continue to lend if negotiations broke down because creditors' demands implied greater macroeconomic adjustment than in the country's IMF program. This, of course, assumes that the country's IMF program set out an agreed, fully defined adjustment path—something that Argentina's 2003 program failed to do.

Committees

Sovereign debtors generally have not negotiated the precise financial terms of a general exchange with a creditors' committee. Instead, sovereigns have hired financial and legal advisors who have helped the debtor assess the terms that a significant fraction of creditors would accept. The country and its advisers then launch a "take-it-or-leave-it" exchange offer (Buchheit 2000a). The debtor usually indicated that it would go ahead with the exchange only if the exchange offer attracted sufficient participation (usually at least 80 or 85 percent of claims).[62]

There is no guarantee that engaging in protracted bargaining with a creditors committee will result in a more effective restructuring process. The current process lets a debtor introduce an offer that it believes will meet creditors' bottom line, and the need to attract widespread participation creates an incentive for the debtor to put forward a fair proposal. A process based on negotiations, in contrast, implies formal bargaining with a select group of creditors to gain the committee's endorsement of the debtor's proposal before launching an exchange. Given the difficulties creditors with disparate interests face taking a collective decision, formal bargaining might result in more strategic behavior, not more rapid agreement. Moreover, agreement with a committee neither guarantees that other bondholders will accept the exchange nor reduces the risk of holdouts. Changes in the market (and law) make historical comparisons difficult, but the historical record of committees is mixed. The bondholder committees in the 1930s did settle some defaults until the 1950s (Eichengreen and Portes 1995). Bank advisory committees did not necessarily produce rapid agreement in the 1980s, in part because the most reluctant bank on the advisory committee could hold up any deal.[63]

Many private creditors believe the IMF should deny financing to any debtor that refuses to negotiate exchange terms directly with a committee. This asks too much of the IMF. Exchange offers based on informal consultation and market soundings have worked: Bondholder committees have yet to prove their value. Until they do so, there is no need for the IMF to use its leverage to empower those creditors who sit on a committee. Of course, if enough bondholders give their proxy to members of a repre-

62. Russia is a partial exception. It negotiated the restructuring of its London Club debt with a bank advisory committee. "Investors" who bought the London Club debt in the secondary market were not directly represented, but the committee did include banks that had been active in the securitization of Russia's London Club debt. However, the general applicability of Russia's process remains open to question: Russia was formally restructuring syndicated bank loans, and, as discussed in chapter 4, it held an usually strong legal hand.

63. On the other hand, once agreement was reached with the bank advisory committee, the committee could help bring other banks into the restructuring. Smaller banks looked to the lead banks for cues about whether to agree to a restructuring, and lead banks put pressure on other banks to participate.

sentative creditors committee, the debtor will have to consult closely—though not necessarily formally negotiate—with the committee to be able to launch an effective exchange.

Assessing Reform Proposals

The discussion of contractual reforms highlighted the differences between various contractual proposals and endorsed collective action clauses that allow the amendment of a bond's key terms with the support of 75 percent of the holders of the bond (clauses like those Mexico used). The discussion of statutory proposals focused on the core questions that would have to be addressed in the design of a statutory regime, including the practical difficulties associated with laying the basis for an aggregated vote. We are more sympathetic to "light" statutory proposals that focus on creating the legal basis for aggregated voting rather than proposals that try to replicate all the features of Chapter 11 of the US bankruptcy law. However, until now, we have deferred explicitly evaluating the relative merits of the contractual and statutory approaches.

Any discussion of proposals to create a statutory international bankruptcy regime should acknowledge that many of the basic problems national bankruptcy regimes are designed to solve are simply not a problem in the sovereign context, at least not right now. The difficulty in seizing a sovereign's assets deters a rush to the courthouse and provides most sovereigns de facto protection from litigation while they develop their restructuring proposals. A sovereign, unlike a corporation, does not need protection from a minority of creditors who would rather liquidate than restructure. Argentina's creditors point out—not incorrectly—that Argentina has enjoyed two years of protection from its creditors even though it has not tried very hard to develop a restructuring plan. A few nuisance lawsuits by creditors who collect almost nothing won't have a major impact on the restructuring. A sovereign in default on its international debt often does have access to new money from domestic creditors and the IFIs even in the absence of a bankruptcy regime.

Conversely, most proposals to create an international bankruptcy regime would not solve some of the problems that do arise in the international context. The absence of rules laying out the relative priority of different sovereign claims does complicate reaching agreement on a sovereign restructuring. However, as discussed in chapter 7, the scale and diversity of claims on the sovereign makes designing a sensible—let alone an enforceable—set of sovereign priorities extremely difficult. The absence of a priority structure is an argument for a different kind of reform of the sovereign debt restructuring process, not an argument for clauses or the IMF's proposed bankruptcy regime.

Ultimately, the case for moving beyond collective action clauses and adopting an international bankruptcy regime hinges on the ability—or inability—of contractual change to offer an effective solution to the holdout problem. A sovereign's greatest legal vulnerability currently comes after it has reached agreement with most of its creditors and starts to resume payments, not when it is in default.

The statutory approach clearly offers a more elegant solution to the holdout problem than collective action clauses. Holdouts have not blocked recent restructurings, but the returns some recent holdouts have achieved risk inspiring additional litigation. Holdouts were a much bigger problem at the end of the series of debt restructurings that marked the 1980s than at the beginning. The gradual introduction of collective action clauses will help. But a creditor could still buy a controlling stake in an orphan bond and then keep that bond out of a restructuring that the holders of other bonds are willing to accept. An international bankruptcy regime that created a single, aggregated vote of all unsecured external bondholders would free a sovereign that gains the support of a supermajority of its external bondholders from the risk of litigation, even if it did not gain the support of a majority of the holders of each and every bond.

On the other hand, the practical difficulties in designing even a modest statutory bankruptcy regime are real. There is no easy way to determine who will be part of the aggregated vote or to define the role that the referee that oversees the vote should play in the restructuring process. The political difficulties in gaining support for a new treaty that overrides national law are at least as daunting (see "A Global Chapter 11?" *Wall Street Journal*, April 22, 2002). A modest proposal commensurate with the nature of the problems that have been observed in sovereign debt restructurings seems to offer too few gains to be worth the costs. A more ambitious proposal requires deeper and more invasive intrusions into national sovereignty than most countries are likely to find acceptable.

Signs that collective action clauses like those used by Mexico are emerging as the market norm therefore provide a strong argument against seeking statutory reform. Uruguay's new bonds demonstrate that contractual provisions even can allow an aggregated vote across a series of its New York–law bonds.[64] However, until these more innovative provisions show signs of entering a substantial share of the stock of outstanding sovereign debt, the case for contractual reform has to rest largely on the expanded use of more standard collective action clauses. Fortunately, most sovereigns—even large emerging economies like Russia and Brazil—have not issued nearly as many international bonds as Argentina. With a smaller number of

64. Many bonds are issued as part of a series—such as a medium-term note program. Rather than registering each bond in the series, a major issuer often obtains a single shelf registration and then issues a series of bonds that meet the shelf registration's basic regulatory requirements. This already "links" together the different bonds and helps to provide the basis for "aggregation." It would be more difficult to aggregate bonds that were part of different series or to write a contract aggregating New York-law, English-law, German-law, and Japanese-law bonds.

bonds, the practical difference between a single aggregated vote and an instrument-by-instrument vote starts to shrink—so long as *all* the debtor's bonds have majority-restructuring provisions.

Nonetheless, clauses will not transform the restructuring process overnight. In the next few years, relying on contractual reforms means making the existing system work. Argentina, and no doubt others, will need to rely on provisions that allow the amendment of bonds' nonfinancial terms in order to make holding out unattractive.

Conclusion

Contractual change—or a treaty creating a sovereign bankruptcy regime along the lines of the IMF proposal—would address only one of the current market failures that complicate a sovereign restructuring: the risk of holdout litigation. Letting more restructuring decisions be taken by a supermajority vote could allow debtors to spend more time finding a deal acceptable to most of its creditors and less time working with their lawyers to minimize their vulnerability to holdout litigation. However, legal reform is not well suited to addressing the host of other difficulties facing a sovereign that needs to restructure its debts. Protection from the risk of holdout litigation won't minimize the risk of a sovereign restructuring leading to costly spillovers into the rest of the economy. It won't make it any easier to prevent a sovereign debt restructuring from triggering a collapse in the banking system, particularly when local banks are the sovereign's major creditors. The diversity of claims on the sovereign will still complicate reaching rapid agreement on restructuring terms, especially when deep debt reduction is needed. Addressing the market failures created by the secondary runs that follow a sovereign default requires creative thinking—and tools other than clauses or bankruptcy-style legal protection.

The case for taking steps to limit the risk of holdouts should rest on the ability of these steps to make the restructuring process more transparent and make the outcome of the restructuring somewhat easier to predict ex ante—not on their ability to radically reform the international financial system. Efforts to provide a sovereign with more protection from litigation—either through protection immediately after a default or through protection from the risk of holdout litigation after a restructuring agreement—are unlikely to transform the incentives of the major players in the sovereign restructuring process radically. Litigation simply is not the biggest problem a bankrupt sovereign currently faces. Contractual reform is worthwhile because it would improve on the existing restructuring process at a low cost, not because it would make the sovereign restructuring process smooth and trouble-free.