

Looking Forward: 2005–2010 A Sovereign Debt Restructuring Reverie*

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In a prior article, the author asked why, if a sovereign debt restructuring treaty would be effective and easy to implement, one does not yet exist. There appeared to be at least three reasons: the very novelty of the approach; the opposition of interest groups who believe that a treaty approach would make it too easy for sovereign debtors to default; and the failure of parties to appreciate the importance of a treaty approach, coupled with concern over ceding sovereignty.¹ In this short reverie, the author hopes to show that these reasons are flawed and that, even where bond issues already include collective action clauses, a treaty approach would benefit both debtor-nations and their creditors.

The room hushed as Premier Gursky walked in. Gursky glared at his ministers, finally focusing on Yosef Steif. As Minister of Finance, Steif knew what was coming.

“Trans-Ptomaincia is rapidly exhausting its foreign reserves, and I fear we will have no choice soon but to default on our bonds,” said the Premier. “I want you, Minister Steif, to examine our options and to report back within two days. If we default, or if we restructure our debts unilaterally, our nation will suffer grave reputational costs in the world financial community.”² Steif immediately

* Copyright 2005 by Steven L. Schwarcz with apologies to Edward Bellamy, *Looking Backward: 2000-1887* (Signet Classics 1888), for the title. This article is based in part on the author’s prior articles, “Idiot’s Guide” to Sovereign Debt Restructuring, 53 *Emory L J* 1189 (2004), and Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach, 85 *Cornell L Rev* 956 (2000).

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¹ See Steven L. Schwarcz, “Idiot’s Guide” to Sovereign Debt Restructuring, 53 *Emory L J* 1189, 1213–14 (2004).

² See, for example, William W. Bratton and G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 *Vand L Rev* 1, 14–15 (2004) (recognizing that “the primary cost of default” to

set his staff to explore the sovereign debt restructuring options. The computers were temporarily down—“damn, a decade after Y2K and still there are bugs in the system”—so staff members actually had to start their research in one of their country’s few remaining libraries. Twenty-four hours later, the staff reported back with two possible approaches: one depending solely on privately negotiated agreements between their nation and its creditors (a “contractual approach”), the other based on a public international law convention, or treaty, among nations (a “treaty approach”).

Under the contractual approach, for each bond issue requiring individual bondholder approval to change essential payment terms (such as the amount of principal, the rate of interest, or the maturity schedule), Trans-Ptomaineia would offer bondholders the option of exchanging their existing bonds for new bonds having less stringent payment terms—terms that Trans-Ptomaineia could manage to pay. To induce as many bondholders as possible to agree to this exchange, exchanging bondholders would be asked to waive various protections in their bond indentures that can be waived without unanimity, such as cross default and negative pledge covenants. Bondholders not agreeing to exchange then would find these contractual protections gone if a sufficient majority of other bondholders consent.³ Years ago, Ecuador was reported as having used this strategy,⁴ although its bonds may have lost about 40 percent of their net present value as a result.⁵

On the other hand, approximately half of Trans-Ptomaineia’s existing bond issues did not require individual bondholder approval to change essential payment terms. These bond issues included “collective action clauses,”⁶ allowing even payment terms to be changed through “supermajority voting.”⁷ For these

debtor States is generally seen to be the future exclusion from the credit markets caused by reputational loss).

³ See Lee C. Buchheit and G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L Rev 59, 71 (2000) (discussing bond exchange offer with “exit consents”).

⁴ Moody’s Investors Service, Special Comment, *Sovereign Restructurings: Putting Too Much Faith in Exit Consents* (Mar 2001) (reporting on Ecuador’s use of this strategy in 2000).

⁵ Schwarcz, 53 Emory L J at 1194 n 25 (cited in note 1).

⁶ Collective action clauses are often referred to as CACs.

⁷ Collective action clauses are clauses in individual loan agreements and bond indentures that enable, typically, a “supermajority” of creditors (that is, some percentage of creditors higher than a simple “greater-than-50-percent” majority) who are parties to any such contract, to modify essential payment terms, such as the amount of principal owed, the interest rate thereon, and maturities. Steven L. Schwarcz, 85 Cornell L Rev 956, 1014 (2000). Some commentators advocate including collective action clauses in all sovereign debt loan agreements and bond indentures. See, for example, Barry Eichengreen, *Toward a New International Financial Architecture* 65–70 (Inst for Intl Econ 1999); Christopher Greenwood and Hugh Mercer, *Considerations of International Law*, in Barry Eichengreen and Richard Portes, eds, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* 103,

issues, it would be easier to agree on debt restructuring terms with creditors because, if and when the relevant supermajority of bondholders agreed to terms, their agreement would bind any objecting bondholders.

The treaty approach to sovereign debt restructuring, Steif learned, would rely on a newly-opened treaty among States, based on a model developed in 2000⁸ and later proposed by the International Monetary Fund (IMF).⁹ A debtor State taking advantage of this treaty would agree to conduct its economic policies so as to put itself back on the road to viable growth, in exchange for which the treaty would give priority to repayment of new private moneys loaned to the debtor State. The treaty also would empower the debtor State and a supermajority of its creditors to approve a restructuring plan, which would bind all creditors, notwithstanding the objections of holdouts against whom the plan did not discriminate.¹⁰

Steif pondered: Which approach, the public law treaty or the private law contract negotiation, would be more effective and pragmatic for his nation? And should he recommend using a combination of these approaches? To answer that, Steif first had to understand better the problems associated with sovereign debt restructuring. His staff reported that there are three: the holdout or collective action problem; the moral hazard problem; and the taxpayer-funding problem.

109–10 (Center for Econ Poly Res 1995); *Diminishing Returns: There Are Scores of New Designs for the International Financial Architecture*, Economist 98 (Oct 9, 1999) (advocating collective action clauses for all sovereign bond contracts, in accordance with recommendations by the Council on Foreign Relations); John B. Taylor, *Sovereign Debt Restructuring: A U.S. Perspective*, Remarks at the Institute for International Economics Conference on Sovereign Debt Workouts: Hopes and Hazards (Apr 2, 2002), transcript available online at <<http://www.treas.gov/press/releases/po2056.htm>> (visited Feb 10, 2005). Since mid-2003, collective action clauses increasingly are being included in new sovereign debt bond agreements. Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 Emory L.J. 691, 694 (2004).

⁸ Although the concept of a sovereign debt restructuring treaty was first conceived as early as 1995, see Jeffrey D. Sachs, *Do We Need an International Lender of Last Resort* 2–3, 8 (Apr 20, 1995) (Frank D. Graham Lecture, Princeton University), unpublished manuscript available online at <www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf> (visited Feb 10, 2005), it was not modeled and substantively developed until 2000, see Schwarz, 85 Cornell L. Rev. 956 (cited in note 7).

⁹ See, for example, Anne Krueger, IMF First Deputy Managing Director, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Remarks at the Institute for International Economics Conference on Sovereign Debt Workouts: Hopes and Hazards (Apr 1, 2002), transcript available online at <<http://www.imf.org/external/np/speeches/2002/040102.htm>> (visited Feb 10, 2005).

¹⁰ Under the treaty, a “supermajority” would require the affirmative vote of creditors holding at least two-thirds in amount and more than one-half in number of creditors voting on the restructuring plan. Schwarz, 53 Emory L.J. at 1216–17 (cited in note 1).

The collective action problem, Steif learned, arises because the conflicting interests of a debtor State and its creditors make it difficult to reach complete agreement on a restructuring plan, a difficulty exacerbated, and sometimes made impossible, by the task of attempting to reach agreement *among* the State's many creditors.¹¹ Except for the bond issues (about half, Steif recalled) governed by collective action clauses, the staff found, not unexpectedly, that most of the remaining bond indentures require individual bondholder consent in order to alter essential payment terms. Therefore, one or more bondholders may hold out, hoping that the overall desire to reach an agreement will induce Trans-Ptomaineia, or even other creditors, to buy out their claims or pay them a premium. In practice, though, holdouts discourage all creditors, even those who otherwise wish to reach an agreement, from agreeing to a debt restructuring plan.

Worse, the staff reported, the collective action problem in Trans-Ptomaineia's case is even more intractable because its bonds, like those of many other nations, are held by hundreds, if not thousands, of investors, located in dozens of countries.¹² Furthermore, in many cases the bonds are held in nominee name, so it is difficult and costly to ascertain the actual identity of the bondholder.¹³ And, because the bonds are actively traded, the identity of bondholders constantly changes.¹⁴

Steif also learned that sovereign debt restructuring potentially creates a second problem: moral hazard, or the greater tendency of people who are protected from the consequences of risky behavior to engage in that behavior. Moral hazard typically results where multilateral governmental entities such as the IMF act as lender of last resort to financially troubled States, enabling them to avoid default and its consequences. From the standpoint of a debtor State, the moral hazard problem means that countries anticipating an IMF bailout might have less reason to take a prudent economic course.¹⁵ From the standpoint of creditors, the moral hazard problem is that lenders that anticipate being protected from default might have a greater tendency to take unwarranted financial risk.

Steif laughed! If the IMF is prepared to bail his country out without needing to take a prudent economic course, fine with him and his countrymen.

¹¹ For a detailed discussion of the collective action problem, see Schwarcz, 85 Cornell L Rev at 959–61, 1003–06 (cited in note 7) and Schwarcz, 53 Emory L J at 1192–94 (cited in note 1).

¹² See Schwarcz, 85 Cornell L Rev at 1004 (cited in note 7).

¹³ *Id.*

¹⁴ *Id.* at 1005.

¹⁵ For a detailed discussion of the moral hazard problem, see Schwarcz, 85 Cornell L Rev at 961–63 (cited in note 7) and Schwarcz, 53 Emory L J at 1194–95 (cited in note 1).

But fat chance: as early as 1999 the IMF refused to act as a lender of last resort when Ecuador defaulted on Eurobond payments, and it again refused in 2001 to bail out Argentina.¹⁶ Recent events have only confirmed that refusal.¹⁷

The third problem of sovereign debt restructuring, however, resonated more clearly with Steif: where to obtain the funding so critical to ensuring that essential governmental functions do not collapse during the restructuring period? In the distant past, much of this money was provided by the IMF in the form of loans. These loans, though, became politically controversial when the taxpayers of IMF member States realized that they themselves were funding them,¹⁸ thereby indirectly subsidizing not only defaulting States but also the defaulting States' creditors. Where could Trans-Ptomaineia obtain this funding?

Having identified the problems—effectively the collective action problem of binding holdout creditors to a reasonable debt restructuring plan, and the problem of finding funding to maintain his nation's essential governmental functions—Steif turned to finding possible solutions. Although it was already nightfall, he was scheduled to present his findings to the Premier and other Ministers the next day, and he would not fail. The way to vet this out, he decided, was to bring his staff together, notwithstanding the late hour, to intelligently debate the solutions.

By 9 PM, his staff had assembled—some grumbling—in Steif's large office. "Which approach," he asked, "private law contract negotiation or the new public law treaty, would be more effective and pragmatic for Trans-Ptomaineia?"

Tulani, the senior staffer, stood up and spoke on behalf of the others. "Both approaches address the collective action problem," she said, "but the treaty would solve it much more effectively. Under the treaty, supermajority voting, requiring an affirmative vote in favor of a restructuring plan by Trans-Ptomaineia's creditors holding merely two-thirds in amount of the outstanding debt, would bind all of Trans-Ptomaineia's objecting creditors, even those who vote negatively or fail to vote."¹⁹ "Without supermajority voting imposed by treaty," Tulani continued, "any attempt by our nation to change the essential terms of its bargain with creditors would often require unanimous approval.

¹⁶ But the IMF did agree to reschedule existing Argentine loans. Schwarcz, 53 *Emory L.J.* at 1194–95 n 25 (cited in note 1).

¹⁷ For a detailed discussion of IMF practices in various sovereign debt crises, at least through 2002, see Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 *Intl Law* 103, 108–12 (2003).

¹⁸ To understand why, see Schwarcz, 85 *Cornell L Rev* at 963–66 (cited in note 7).

¹⁹ See Schwarcz, 85 *Cornell L Rev* at 1003–06 (cited in note 7) and Schwarcz, 53 *Emory L.J.* at 1192–94 (cited in note 1) (discussing supermajority voting). See also Schwarcz, 85 *Cornell L Rev* at 1012–13 (cited in note 7) (proposing that any sovereign debt restructuring treaty be retroactive, binding all existing creditors, and explaining why such retroactivity would be respected under international law).

And, although we theoretically could attempt to settle with creditors individually notwithstanding their contractual protection of unanimity, the *Allied Bank* case²⁰ holds that this settlement would not bind other creditors, who could then sue Trans-Ptomaineia on the original claims.”

“Fascinating,” Steif said. “But in all fairness, why should nations and international organizations respect a treaty that potentially can discriminate against those objecting creditors?”

Tulani replied, “Discrimination is impossible because, under the treaty, the supermajority voting is done by classes of claims that are substantially similar to the other claims of their class.²¹ Therefore, a vote by holders of the requisite supermajority that benefits their claims will also benefit holders of substantially similar claims. And, if a sufficient minority of creditors of any class does not like the restructuring plan, they can veto it.”²²

“In contrast,” Tulani continued, “private law contract negotiation cannot completely solve our collective action problem. Half of our nation’s bond issues lack collective action clauses. For those bonds, we would have to try using exchange offers in order to coerce agreement to the terms of a restructuring plan. Experience shows, however, that their utility is limited. Ecuador, for example, tried using an exchange offering under which the new bonds had both a buyback provision and a principal reinstatement provision that were considered favorable to accepting creditors. At the same time, creditors accepting the exchange would be bound by exit consents²³ that significantly altered the nonfinancial terms of remaining outstanding bonds to the detriment of holdout creditors. Even with this aggressive approach, 3 percent of Ecuador’s creditors continued to hold out and later sued Ecuador directly on their uncompromised claims,²⁴ thereby jeopardizing the success of any future exchange offering that fails to obtain 100 percent participation.”²⁵

²⁰ *Allied Bank Intl v Banco Credito Agricola de Cartago*, 757 F2d 516, 521–23, (2d Cir 1985).

²¹ See Schwarcz, 53 Emory L J at 1198 (cited in note 1). For a discussion of how a sovereign debt restructuring treaty might divide claims into classes for supermajority voting purposes, see Schwarcz, 85 Cornell L Rev at 1006 (cited in note 7).

²² All it would take to veto a restructuring plan is opposition by creditors holding *either* more than one-third in amount, or at least one-half in number, of the claims represented by the class. See Schwarcz, 53 Emory L J at 1216–17 (cited in note 1).

²³ See Moody’s Investors Service, *Sovereign Restructurings* (cited in note 4).

²⁴ See *Elliott Assocs v Banco de la Nacion*, 194 F3d 363, 380–81 (2d Cir 1999) (allowing a holdout creditor in a bond exchange offer to sue the debtor State, Peru, directly for the holdout’s full claim).

²⁵ Compare Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 Emory L J 1115, 1139 (2004) (observing that “[p]ayments to holdouts in Ecuador and Uruguay, a potential windfall for Argentina’s litigants, and recent settlements benefiting holdouts under loan instruments may

“Furthermore,” Tulani noted, “bond exchange offers are extremely costly. For example, Ecuador’s bonds lost about 40 percent of their net present value due, at least in part, to that nation’s exchange offer.²⁶ That does not even take into account the transaction costs of effectuating the exchange offer! And coercive exchange offers themselves may create legal problems.”²⁷

“You’ve got me thinking,” responded Steif. “There’s an important additional reason why the treaty is much better than using exchange offers. Even if we *otherwise* could persuade the requisite supermajority of bondholders in each bond issue with collective action clauses, and 100 percent of bondholders in every other bond issue, to agree to the terms of a restructuring plan, we’d still face a potential collective action problem. Collective action clauses only operate *within* a given bond issue, not across multiple bond issues. Therefore, investors in one or more of our bond issues could hold out in order to get better terms! In fact, now that I think of it, we also have some nonbonded indebtedness in the form of bank loans, and it’s not inconceivable that individual banks also could hold out. Under the treaty, though, that type of holdout behavior is impossible. Creditors having the same priority of claims would vote as a *single class*, even if they lack contractual affiliation with other creditors in the class.²⁸ Because the claims of all of our bondholders and bank creditors are, in fact, *pari passu*,²⁹ we could classify all of them together and bind them, voting as single group, by one supermajority vote. This is a powerful solution because it gives individual holdouts much less ability to stymie the will of the vast majority of our nation’s creditors.”³⁰

“Excellent point!” exclaimed Tulani. “From the standpoint of solving the collective action problem, there’s no question the treaty approach is much more effective than the contractual approach. *But there’s an additional, and equally important, reason why Trans-Ptomaineia should go with the treaty approach:* the contractual approach simply doesn’t address our need for funding to run essential

yet trigger an epidemic of holdout behavior under . . . bonds [not containing collective action clauses]”).

²⁶ Scott, 37 Intl Law at 108–09 (cited in note 17).

²⁷ See, for example, A. Mechele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 Emory L.J 997, 1015–16 (2004).

²⁸ See Schwarcz, 53 Emory L.J at 1205 (cited in note 1).

²⁹ Creditors of a debtor State generally have *pari passu*, or equal and ratable, claims. Schwarcz, 85 Cornell L Rev at 1006 (cited in note 7).

³⁰ See for additional support, Dickerson, 53 Emory L.J at 1016 (cited in note 27); Scott, 37 Intl Law at 122 (cited in note 17).

governmental services during the restructuring period.³¹ We no longer can rely on the IMF to provide this funding, so we'll have to borrow from commercial sources, such as banks or capital-market investors. But without giving new investors a priority over our existing indebtedness, there's no damn way they'll lend to us. New investors simply won't want to be taxed by the claims of existing creditors!³² The treaty, however, concretely solves this problem by granting first priority to the claims of investors that provide the restructuring financing.”³³

Steif frowned. “Why can't we simply issue new bonds that have priority, under Trans-Ptomaineian law, to all existing creditor claims?”

“The reason,” Tulani replied, “is two-fold. First, new investors would worry that we simply could change Trans-Ptomaineian law in the future to take away their priority.³⁴ The second reason is that giving priority to new investors under our nation's internal law might offend our existing creditors, and thereby impair our access to future commercial credit.”³⁵

“Similarly,” continued Tulani, “it would be impractical to give the new bonds priority by trying to negotiate with our existing creditors to subordinate their claims. Even though, in theory, they should agree to the subordination in order to accommodate the restructuring financing,³⁶ the reality is that we'd again face an insurmountable collective action problem in trying to get all creditors on board.”³⁷

“It's clear, then,” exclaimed Steif. “I will recommend to Premier Gursky tomorrow that we go with the treaty approach. He may ask me, though, about the mechanics of implementing that approach. For example, are we a party yet to the treaty? What do we need to do to become a party to the treaty? And what costs would we incur by choosing this approach?”

“Well, we're not yet a party to the treaty,” responded Tulani, “but it's fairly easy to become a party. All we need to do is to have the Parliament enact legislation making the treaty effective under our internal law.”³⁸ Then, under our

³¹ See Patrick Bolton and David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 Emory L J 763, 775 (2004) (arguing that “[a] final shortcoming of [a contractual approach] is that it does not address the sovereign's need for new financing”).

³² Schwarcz, 85 Cornell L Rev at 986 (cited in note 7).

³³ See *id* at 986–97, 1033–34.

³⁴ See *id* at 992.

³⁵ See *id* at 993.

³⁶ See, for example, *id* at 988 (arguing that permitting a debtor State to grant priority in order to obtain restructuring financing should increase the expected value of existing nonpriority claims).

³⁷ See, for example, Bolton and Skeel, 53 Emory L J at 775 (cited in note 31).

³⁸ See Schwarcz, 85 Cornell L Rev at 1034 (cited in note 7).

Constitution, the Premier and Minister of State can sign, and thereby ratify, the treaty. The treaty binds creditors from ratifying countries because, as mentioned, each country must also enact the legislation needed to make the treaty's provisions part of that country's internal law.³⁹ Although that alone would be insufficient to bind creditors from nonratifying countries—and, because only a dozen countries have so far signed the treaty, it's almost certain that some of our bondholders are from nonratifying countries—we still should be okay because the Minister of Law believes the treaty should also bind creditors whose debt instruments are governed by the law of a ratifying country.⁴⁰ All of Trans-Ptomaineia's debt is evidenced by bond indentures or loan agreements governed by either New York or United Kingdom law⁴¹ and, happily, both the United States and the UK have already ratified the treaty.”

“But I thought the US Government has been opposing the treaty!” exclaimed Steif.

“For years they had,” Tulani explained.⁴² “Until they realized that simple contracting can't be the full answer. Then they bowed to international pressure to sign.” “The costs of using the treaty also should be minimal,” Tulani continued. “The treaty is largely self-administering. We would simply negotiate with our creditors to determine mutually acceptable terms on which to restructure our debt. The treaty itself provides powerful aids to induce this negotiation.⁴³ We can't, for example, cram an unreasonable restructuring plan down the throats of our creditors; if we tried that, creditors damn well wouldn't approve it.⁴⁴ On the other hand, creditors won't want to veto a reasonable plan because, until a plan's approved, they won't begin to be paid under it.”

“Out-of-pocket costs likewise should be minimal. The IMF would perform the treaty's few administrative tasks.⁴⁵ Disputes should rarely arise because the treaty's rules are narrowly crafted to minimize adjudicatory discretion.⁴⁶ Any

³⁹ See *id.*

⁴⁰ See *id.* at 1017.

⁴¹ This is the norm for sovereign debt generally. See Schwarcz, 53 *Emory L.J.* at 1208 (cited in note 1).

⁴² See Daniel K. Tarullo, *Neither Order nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 *Emory L.J.* 657, 658 (2004) (referring to US Treasury Department preference for the “market-oriented” contractual approach).

⁴³ Schwarcz, 85 *Cornell L.Rev.* at 1020–22 (cited in note 7).

⁴⁴ Recall that opposition by creditors holding *either* more than one-third in amount, or at least one-half in number, of the claims represented by the class will veto a restructuring plan. See text accompanying note 22.

⁴⁵ Schwarcz, 85 *Cornell L.Rev.* at 1022 (cited in note 7).

⁴⁶ See *id.* at 1028 (arguing also that “[t]he only interpretative disputes that might arise would concern either the good faith requirement for filing or the right of creditors to object to an excessive

disputes that do arise probably would be limited to disagreement with existing creditors over the amount of restructuring financing that we request.⁴⁷ I don't anticipate we'd have that disagreement, but if we do it would be quickly resolved through arbitration supervised by the International Centre for Settlement of Investment Disputes, or ICSID.⁴⁸ This is an arm of the World Bank that we've relied on many times before for arbitrating investment disputes between our nation and foreign nationals. The only cost is nominal: ICSID charges for use of its arbitration facilities."⁴⁹

Steif sighed with relief, both for himself and his nation: "What good fortune for the people of Trans-Ptomaineia, and indeed for all of Trans-Ptomaineia's honest creditors, that this sovereign debt restructuring treaty now exists. A year earlier, and it would have been a very different story!"

amount of restructuring financing [but] disputes over whether bankruptcy filings are made in good faith are extremely unusual even in a corporate context, [and] corporate creditors 'very rarely' object to an amount of [restructuring] financing as excessive, and in a sovereign debt restructuring, the need to object should be equally rare because of the public scrutiny involved").

⁴⁷ *Id.*

⁴⁸ See *id.* at 1024–28 (discussing ICSID arbitration, and proposing that a tribunal based on the ICSID model be used for adjudicating sovereign debt restructuring disputes). See also Convention on the Settlement of Investment Disputes between States and Nationals of Other States (1965), art 1, 17 UST 1270 (1966).

⁴⁹ Schwarcz, 85 *Cornell L. Rev.* at 1025 (cited in note 7).