SOVEREIGN DEBT RESTRUCTURING: EVALUATING THE IMPACT OF THE ARGENTINA RULING

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ABSTRACT

Recent rulings in the ongoing litigation over the pari passu clause in Argentinian sovereign debt instruments have generated considerable controversy. Some public sector participants and academic articles have suggested that the rulings will disrupt or impede future sovereign debt restructurings by encouraging holdout creditors to litigate for full payment instead of participating in negotiated exchange offers. This paper critically examines this claim and argues that the incentives for holdout litigation are limited because of (1) significant constraints on creditor litigation, (2) substantial economic and reputational costs associated with such litigation, and (3) the availability of contractual provisions and negotiating strategies that mitigate the debtor's collective action problems. It also argues that the fact-specific equitable remedy in the current Argentina case was narrowly tailored to Argentina's unprecedented disregard for court opinions and for international norms of negotiating sovereign debt restructurings and is therefore unlikely to be used in future debt restructurings.

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Introduction

On August 23, 2013, the United States Court of Appeals for the Second Circuit affirmed an award of equitable relief by the District Court for the Southern District of New York that barred Argentina from paying certain creditors after refusing to pay other plaintiff-creditors that had declined an exchange offer as part of a sovereign debt restructuring.[1] In reaching this ruling, the court interpreted the bondholder-friendly *pari passu* clause that Argentina offered in its now-defaulted debt documentation.[2] Argentina immediately rejected the court's ruling and vowed to appeal to the United States Supreme Court.[3] The Argentinian government also initiated a plan to circumvent a possible adverse ruling.[4] In fact, in the country's most recent effort to avoid such rulings, the president of Argentina stated that she would try changing the payment mechanism on Argentina's international bonds to avoid the reach of U.S. courts.[5]

The ruling was not only unacceptable to the Argentinian government, but also controversial among commentators. Public sector participants were worried that it could set bad precedent for future sovereign debt restructurings by creating a free rider problem: creditors would now have an incentive to litigate for a better bargain instead of accepting a haircut as part of a consensual restructuring process. For instance, the International Monetary Fund (IMF) suggested that the ruling "could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors."[6] Similarly, France filed an amicus brief supporting Argentina's petition for certiorari on the grounds that the ruling created a "powerful

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[1] NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230, 248 (2d Cir. 2013).
[2] *Id.* at 247–48.
[3] Camila Russo, *Argentina Plans New York-Buenos Aires Bond Swap,* Bloomberg News, Aug. 27, 2013, *available at* http://www.bloomberg.com/news/2013-08-27/argentina-plans-new-york-buenos-aires-bond-swap-on-singer.html.
[4] *Id.*
[5] *Id.*
[6] IMF, Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework, 1 (Apr. 26, 2013) [hereinafter IMF, *Recent Developments 2013*], https://www.imf.org/external/np/pp/eng/2013/042613.pdf.

incentive . . . for private creditors to forgo participation in voluntary restructuring in order to enforce full payment of debt against an already distressed debtor."[7]

This Article critically examines the claim that the Second Circuit ruling will impede future sovereign debt restructurings by encouraging dissenting creditors to litigate. It argues that such incentives are, in fact, limited because there are (1) significant constraints on creditor litigation, (2) strong incentives against holding out because creditor litigation is uncertain, expensive, and risky, and (3) extensive contractual provisions and negotiating strategies available to sovereign debtors to avoid collective action problems. Furthermore, the fact-specific, narrowly tailored equitable relief in the Argentina case was predicated on Argentina's unprecedented and widely documented bad-faith negotiations with creditors; this remedy is unlikely to be available in future sovereign debt restructurings.

This Article proceeds as follows. The first part presents an overview of the scholarship on sovereign debt, with emphasis on the economic literature. The second part outlines the guidelines suggested by international organizations for negotiations between sovereign debtors and creditors. It contrasts Argentina's "uniquely recalcitrant" negotiating strategy[8] with the consensual, good faith negotiating process that most sovereign debtors use to restructure their debt. The third part looks at the critical role of effective creditor enforcement in sustaining the sovereign debt market, but concludes that recent cases of sovereign debt litigation, including the Argentinian experience, show that creditor enforcement is, at best, a weak remedy for creditors. The fourth part looks at the incentives for holdout creditors. Conventional wisdom holds that creditors have an incentive to free ride in sovereign debt restructurings. However, this view ignores the substantial costs—financial, managerial, and reputational—of litigating. The fifth part explores the various ex ante contractual provisions and ex post negotiating strategies available to sovereign debtors to avoid collective action problems. Argentina did not bargain to secure any ex ante contractual provisions that would have diluted the litigation rights of its creditors. Moreover, it deliberately chose to avoid using any ex post negotiating strategies, such as minimum participation thresholds, that would have resulted in meaningful negotiations with creditors and significantly reduced collective action problems. Finally, a short conclusion emphasizes the equitable nature of the Second Circuit ruling and the fact that it was narrowly tailored to the unique circumstances of the Argentina case. Other courts are unlikely to grant similar relief in future sovereign debt restructurings.

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[7] *See* Brief for the Republic of France as Amicus Curiae in Support of the Republic of Argentina's Petition for a Writ of Certiorari at 5, Republic of Argentina v. NML Capital, Ltd., 727 F.3d 230 (2d Cir. 2013), 2014 WL 1246725.

[8] *See, e.g.*, NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230, 248 (2d Cir. 2013).

I. Sovereign Debt: Overview of the Literature

The importance of the recurring phenomenon of debt default has prompted an abundance of theoretical and empirical literature on sovereign debt.[9] The distinguishing feature of sovereign debt relative to corporate debt is the limited mechanisms for enforcement. In contrast to private entities, sovereign nations are not subject to a legal authority. In the event of default, legal recourses are more limited than at the corporate level.[10] There are also few sovereign commercial assets located abroad to serve as collateral or repayment.

Recognizing that few direct legal sanctions can be invoked against sovereign borrowers, initial research in economics focused mainly on why countries ever chose to pay their debts—or why private creditors ever expected them to do so. In a noteworthy paper, economists Jonathan Eaton and Mark Gersovitz characterized the existence of a market for private loans to governments, paired with the lack of explicit mechanisms preventing a sovereign from repudiating its external debt, as a paradox.[11] Eaton and Gersovitz argued that sovereign countries repay their debts in order to avoid developing a reputation for defaulting and consequently losing access to international capital markets. According to the authors, countries choose to borrow from international markets in bad periods—for example, when export production is poor—and repay in good times. Countries wishing to engage in international borrowing to smooth income in this way are encouraged to repay their debts in order to avoid being shut off from borrowing and credit access the next time they need it.

However, the authors also noted that permanent exclusion from future credit would punish creditors as well as debtors and was therefore unlikely. The empirical evidence also challenged the view that exclusion from capital markets is a critical component of the enforcement of sovereign debt. As surveyed in Panizza et al., countries regain access to international capital markets following debt crises more quickly now than in previous decades.[12]

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[9] *See* Laura Alfaro & Ingrid Vogel, *International Capital Markets and Sovereign Debt: Crisis Avoidance and Resolution*, Harvard Business School Background Note 707–018 (2006), *available at* http://www.hbs.edu/faculty/Pages/item.aspx?num=33808. For surveys of the literature, see Mark Aguiar & Manuel Amador, *Sovereign Debt*, *in* Handbook of International Economics 647 (Elhanan Helpman et al. eds., 4th ed. 2014); Jonathan Eaton & Raquel Fernandez, *Sovereign Debt*, *in* Handbook of International Economics (G. Grossman & K. Rogoff, eds., 3rd ed. 1995); Ugo Panizza, Federico Sturzenegger & Jeromin Zettelmeyer, *The Law and Economics of Sovereign Debt*, 47 J. Econ. Literature 651 (2009).

[10] Part III looks at the role of creditor enforcement. In the United States, the 1976 Foreign Sovereign Immunities Act (FSIA) allows suing a foreign government in U.S. courts for commercial contracts. 28 U.S.C. §1602 (1976).

[11] Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 Rev. Econ. Stud. 289 (1981); *see also* Jonathan Eaton, Mark Gersovitz & Joseph Stiglitz, *The Pure Theory of Country Risk*, 30 Eur. Econ. Rev. 391 (1986).

[12] *See* Panizza et al., *supra* note 9, at 675.

Bulow and Rogoff further challenged Eaton and Gersovitz's explanation, pointing out that for reputational concerns to be strong enough to enforce contracts, a sovereign would have to be excluded from international markets that permit, for example, insurance policies to be bought against low realizations of income.[13] In addition to insurance markets, sovereigns have other ways to smooth consumption in response to bad income shocks, including self-insurance in the form of accumulating foreign currency reserves, for example, or other capital.[14] This would limit the effectiveness of exclusion from international markets as a mechanism to enforce contracts; that is, as a motivation for sovereigns to repay their debts. Anticipating this outcome, creditors would not engage in lending.

Subsequently, Cole and Kehoe showed that the ability of reputation to support debt depends on the alternatives open to a country, the country's international relationships, and assumptions made about institutions.[15] Sovereigns may worry about spillovers in other markets and relationships—for example, in foreign direct investment.[16]

Other academics identified additional incentives and punishments that could encourage countries to repay their debts, such as the debtor country's ability to interfere with trade credits and the risk of substantial economic losses following financial crises.[17] In fact, as shown by Alfaro and Kanczuk, these additional output costs are important in explaining the effects of debt crises.[18] Recent experiences with sovereign debt in the 1970s through the 2000s as well as earlier debt crises, such as those in the 1870s, 1890s, and 1930s, showed that debt crises are so difficult to manage that they can lead to economic uncertainty and stagnation.[19] Although these additional output

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[13] Jeremey Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?* 79 AM. ECON. REV. 43 (1989).

[14] *See* Laura Alfaro & Fabio Kanczuk, *Sovereign Debt as a Contingent Claim: A Quantitative Approach*, 65 J. INT'L ECON. 297 (2005). *See also* Laura Alfaro & Fabio Kanczuk, *Optimal Reserve Management and Sovereign Debt*, 77 J. INT'L ECON. 23 (2009) [hereinafter *Optimal Reserve Management*] (discussing the relationship between sovereign default and self-insurance through reserve accumulation).

[15] Harold L. Cole & Patrick J. Kehoe, *The Role of Institutions in Reputation Models of Sovereign Debt,* 35 J. MONETARY ECON. 45 (1995). *See generally* Harold L. Cole & Patrick J. Kehoe, *Models of Sovereign Debt: Partial versus General Reputations,* 39 INT'L ECON. REV. 55 (1998).

[16] *See, e.g.*, Kenneth Rogoff, *International Institutions for Reducing Global Financial Instability*, 13 J. ECON. PERSP. 21, 31 (1999).

[17] *See generally* Andrew K. Rose, *One Reason Countries Pay Their Debts: Renegotiation and International Trade*, 77 J. DEV. ECON., 189 (2005).

[18] *See Optimal Reserve Management*, *supra* note 14, at 297–314.

[19] *See* Michel Dooley, *A Retrospective on the Debt Crisis*, *in* UNDERSTANDING INTERDEPENDENCE: THE ECONOMICS OF OPEN ECONOMY (Peter B. Kenen ed., 1994); FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES (2007); Barry Eichengreen & Richard Portes, *Debt and Default in the 1930s: Causes and Consequences*, 30 EUR. ECON. REV. 599 (1986); Şule Özler, *Have Commercial Banks Ignored History?*, 83 AM. ECON. REV. 608 (1993).

losses are well documented, their micro-foundations are not yet understood.[20]

In sum, the sovereign debt literature has historically focused on the incentives to repay, particularly the loss of access to international credit markets, reputation effects, and trade and direct output costs.[21] Another critical incentive is that creditors—at least those that hold bonds governed by foreign law—have access to some legal recourse in the country in which the debt is issued. Recent work has focused on the role of legal remedies and actions, as explored in this Article. However, as there is no supranational bankruptcy court to adjudicate disputes between sovereign debtors and international creditors, resolving sovereign debt restructuring usually involves negotiation. The next part surveys the negotiation process and the Argentina case.

II. Negotiation Process

A. *Guidelines for Negotiations*

Both the IMF and the Institute of International Finance (IIF) have developed guidelines for negotiations between sovereign debtors and international creditors. The IMF policy, known as "lending into arrears" (LIA), establishes the conditions under which the IMF would be willing to lend to a sovereign debtor. The IIF Principles for Stable Capital Flows and Fair Debt Restructurings (the Principles) set forth "a voluntary approach to debtor-creditor relations, designed to promote stable capital flows to emerging-market and other debtor countries through enhanced transparency, dialogue, good faith negotiations, and equal treatment of creditors."[22]

International guidelines encourage sovereign debtors and creditors to engage in a good faith substantive negotiation over the terms of the restruc-

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[20] Dooley, for example, argues that output loss is caused by the inability of debtors and creditors to quickly renegotiate contracts and the inability to condition the loss of output ex ante by reasons of nonpayment. This creates a time interval during which residents of a country in default are unable to borrow from locals or foreigners due, for example, to the inability of new credits to be credible senior to existing credits. *See* Michael P. Dooley, *Can Output Losses Following International Financial Crises be Avoided?* (Nat'l Bureau of Econ. Research, Working Paper No. 7531, 2000). *See also* Enrique G. Mendoza & Vivian Z. Yue, *A General Equilibrium Model of Sovereign Default and Business Cycles*, 127 Q. J. Econ. 889–946 (2012).

[21] In this case, incentives to repay come from the concern that defaults may have adverse effects on domestic agents. Kenneth Rogoff argues that in the absence of better institutions, "default costs provide a punishment that in some sense substitutes for effective property rights at the international level." Kenneth Rogoff, Economic Counselor and Director, Research Department, IMF, Emerging Market Debt: What is the Problem? Speech at the Sovereign Debt Restructuring Mechanism Conference (Jan. 22, 2003), www.imf.org/external/np/speeches/2003/012203a.htm.

[22] Institute of Int'l Finance Principles Consultative Grp., *Principles for Stable Capital Flows and Fair Debt Restructuring—Report on Implementation*, at 6 (Sept. 2011) [hereinafter IIF, *Principles*].

turing. The IMF's LIA policy requires a country to make "a 'good faith effort' to reach a collaborative agreement with its private creditors" as a condition for receiving IMF funds.[23] The IIF Principles suggests that "debtors and creditors should engage in a restructuring process that is voluntary and based on good faith,"[24] adding that "timely good faith negotiations are the preferred course of action . . . , potentially limiting litigation risk."[25] Both these policy documents discourage a unilateral and coercive process because it may lead to creditor litigation and delays.

Any good faith negotiation also requires the sovereign debtor to fully and accurately disclose information that would enable creditors to make informed decisions on any restructuring offer. The IMF's LIA policy therefore requires sovereign debtors to "disclose the information needed to enable creditors to make informed decisions on the terms of a restructuring."[26] Similarly, the IIF's Principles expect "disclosure of relevant information so that creditors are in a position to make informed assessments of their economic and financial situation, including overall levels of indebtedness."[27] Thus, a key pillar of an effective negotiation process is the full and accurate disclosure of information by the sovereign debtor.

B. Argentina's Negotiations with International Creditors

After a prolonged period of economic crisis and political chaos, Argentina defaulted on its external sovereign debt in December 2001.[28] Argentina then approached the IMF to renew its financial assistance package.[29] As part of those negotiations, Argentina agreed to "engage in constructive negotiations with all representative creditor groups" and to make an offer that "would attain broad support from creditors."[30] It also agreed to include a minimum participation threshold in its debt restructuring offer,[31] meaning that a certain percentage of creditors would have to agree to the proposed debt exchange offer before it would go into effect. This would give the coun-

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[23] IMF, *Recent Developments 2013*, *supra* note 6, at 11.

[24] IIF, *Principles*, *supra* note 22, at 33.

[25] *Id.*

[26] IMF, *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework* 26 (Aug. 1, 2003), [hereinafter IMF, *Reviewing the Process*], https://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf.

[27] IIF, *Principles*, *supra* note 22, at 32.

[28] *See* Carmen M. Reinhart, *This Time is Different Chartbook: Country Histories on Debt, Default, and Financial Crises* 16 (Nat'l Bureau of Econ. Research, Working Paper No. 15815, 2010), *available at* http://www.nber.org/papers/w15815; *see also Argentine President Resigns*, BBC NEWS, Dec. 21, 2001, *available at* http://news.bbc.co.uk/2/hi/americas/1722584.stm.

[29] Memorandum from the Acting Secretary to the Members of the Int'l Monetary Fund Executive Board, *Argentina—Selected Issues*, 69–70 (June 6, 2005) (on file with the Int'l Monetary Fund) [hereinafter IMF, *Argentina—Selected Issues*].

[30] *See id.* at 71.

[31] *Argentina—Letter of Intent and Addendum to the Technical Memorandum of Understanding,* 5 (Mar. 10, 2004), http://www.imf.org/external/np/loi/2004/arg/02/.

try a strong incentive to negotiate with creditors and to avoid a piecemeal approach to restructuring.

Although Argentina met repeatedly with creditors, it had become clear by mid-2004 that these meetings were "largely procedural" and that Argentina did not intend to engage in substantive negotiations with creditors regarding the terms of the potential debt exchange offer.[32] Instead, Argentina presented its offer as final and not subject to negotiation.[33] Creditors were not satisfied with the offer because they did not think it reflected the country's ability to repay its debt.[34] Furthermore, the exclusion of past-due interest from the offer was "a major departure from past sovereign restructurings."[35]

Despite these objections, Argentina proceeded with its unilateral offer, threatening not to pay creditors anything if they rejected it. Argentina also failed to keep its agreement with the IMF "to establish a minimum participation threshold for the debt restructuring."[36] Moody's Credit Research, for example, stated that "the case of Argentina was and remains unique in its unilateral and coercive approach to the debt restructuring."[37] The London Club, a group representing bank creditors, categorically stated that it did not want a "non[-]negotiated process and a unilateral offer as the one launched by Argentina" in future sovereign debt restructurings.[38] The IMF concurred that "no constructive dialogue was observed and the authorities presented a non-negotiated offer,"[39] also noting that there was "a consensus among [IMF] staff, management and major shareholders that the authorities had not lived up to their commitment . . . to engage in constructive negotiations with all representative creditor groups."[40]

In addition, Argentina failed to accurately disclose information to creditors. For instance, in an assessment of the Argentinian debt restructuring process, the IMF stated that Argentina may have deliberately understated its economic forecasts in order to enhance its leverage with creditors:

> The low official 2004 growth projection may, however, in part have reflected a strategic decision by the authorities to understate growth prospects to strengthen their bargaining position in debt

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[32] IMF, *Argentina—Selected Issues*, *supra* note 29, at 72.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] IMF, *Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access Sovereign,* 16 (July 12, 2006) [hereinafter IMF, *Ex Post Assessment*].

[37] Elena Duggar et al., *The Role of Holdout Creditors and CACs in Sovereign Debt Restructurings*, Moody's Investor Service, (Apr. 10, 2013), at 10, *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_150162.

[38] London Club Coordinating Group, Presentation to Paris Club Creditors (June 15, 2005), *available at* http://www.clubdeparis.org/sections/communication/archives-2005/rencontre-du-club-de/downloadFile/attachment3_file/LCCGtoParisClubwebsitev2.pdf.

[39] IMF, *Recent Developments 2013*, *supra* note 6, at 36.

[40] IMF, *Ex Post Assessment*, *supra* note 36, at 16.

> exchange negotiations. Throughout late 2003 and 2004 there were pressures on the Fund from the authorities to underestimate growth prospects for this same reason.[41]

In the end, 76% of the creditors accepted the offer.[42] However, this acceptance rate was driven by the acquiescence of domestic investors; the participation rate for bonds held in Argentina was 98%, with 100% participation among banks and pension funds.[43] These figures may not indicate genuine approval of the offer given that government authorities had considerable leverage with domestic actors, especially with regulated financial institutions like banks and pension funds. In contrast, the participation rate for bonds held by foreigners was a significantly lower 63%.[44] The IMF cautions that even this participation rate should be viewed with some skepticism:

> After all, a high participation rate could be as much an indication of a debtor's bad faith—with creditors finding a "take-it-or-leave-it" threat credible—as of good faith. The law passed by the [Argentinian] congress prohibiting the executive from reopening the debt restructuring or agreeing to a settlement with nonparticipating creditors may have enhanced the credibility of what many creditors indeed perceived as a "take-it-or-leave it" offer.[45]

Participation rates would likely have been even lower if creditors had not been coerced into accepting an unfair offer.

After the exchange offer, there were still significant arrears on defaulted debt.[46] In contrast, other sovereign debt restructurings had "achieved participation in the range of 93–99% and, as a result, residual arrears were modest."[47]

Even after the debt exchange was over, the IMF encouraged Argentina "to formulate a forward-looking strategy to resolve the remaining arrears outstanding to private creditors consistent with the IMF's lending into arrears policy."[48] The IMF noted that the only other country that had a significant

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[41] *Id.* at 17 n.5.

[42] IMF, *Argentina—Selected Issues*, *supra* note 29, at 78.

[43] *Id.*

[44] *Id.*

[45] IMF, *Ex Post Assessment*, *supra* note 36, at 43.

[46] IMF, *Argentina—Selected Issues, supra* note 29, at 78.

[47] *Id.* Shleifer and Roubini note that the "rogue creditor[ ]" problem "has been vastly overstated," pointing to restructuring experiences such as those of Ecuador, Pakistan, Russia, and Ukraine. Andrei Shleifer, *Will Sovereign Debt Market Survive?*, 93 AM. ECON. REV. 85, 85–90 (2003); Nouriel Roubini, *Do We Need a New Bankruptcy Regime?,* 1 BROOKINGS PAPERS ON ECON. ACTIVITY 321, 321–33 (2002). *See also* ELENA DUGGAR, MOODY'S INVESTOR SERVICE, US COURT RULING ON ARGENTINA'S DEBT COULD HAVE LIMITED IMPLICATIONS FOR SOVEREIGN DEBT RESTRUCTURINGS 3 (2012).

[48] Staff Representative for the 2005 Consultation with Argentina, *Argentina: 2005 Article IV Consultation*, 32 (May 31, 2005) [hereinafter Staff Representative, *Argentina: 2005 Article IV Consultation*], http://www.imf.org/external/pubs/ft/scr/2005/cr05236.pdf.

problem with holdout creditors, Dominica, worked constructively with individual creditors to convince them to accept its exchange offer.[49]

Argentina, in contrast, refused to pay or even negotiate with holdout creditors. The Argentinian "authorities reiterated that they would not reopen the offer to accommodate non-participating creditors."[50] They also passed the "Lock Law", which "limited the power of the executive to effect judicial or nonjudicial settlements with nonparticipating creditors or to reopen the debt exchange."[51] This new law prompted a warning that "[the Lock Law] might increase on the margins the government's vulnerability to legal challenge . . . [since the] holdouts will surely argue that the law amounts to a legal act formally subordinating the old debt to the new in violation of the *pari passu* undertakings in the old bonds."[52] Argentina ignored this warning and refused to deal with holdouts. Instead, "freezing out the holdouts" had become "a domestic political strategy" for Argentina's politicians.[53]

Nonetheless, Argentina reopened the exchange offer in 2010. Although the second exchange offer was *less* attractive than the 2005 exchange,[54] several creditors exchanged their defaulted bonds, raising participation to 91%.[55] There were two reasons why creditors chose to participate in the 2010 exchange. First, defaulted Argentinian debt was trading at very low prices, driven down by Argentina's refusal to negotiate with dissenting creditors.[56] Thus, it was attractive for arbitrageurs to purchase the defaulted bonds and exchange them for performing Argentinian debt instruments.[57] Second, some of the holdout creditors had lost faith in the litigation process and no longer expected a better outcome.[58] The relatively high cumulative participation rate, which was highlighted by the Argentinian authorities, should therefore not be understood as a proxy for broad creditor satisfaction with the offer.

Private sector creditors were not alone in dealing with Argentina's bad faith negotiating style. The IMF's acting managing director felt that the institution was "blackmailed" during its negotiations with the Argentinian gov-

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[49] IMF Monetary and Capital Markets Department, *A Survey of Experiences with Emerging Market Sovereign Debt Restructurings*, 13 (June 5, 2012) [hereinafter IMF, *Survey of Experiences*], http://www.imf.org/external/np/pp/eng/2012/060512.pdf.

[50] IMF, *Argentina—Selected Issues*, *supra* note 29, at 78.

[51] Staff Representative, *Argentina: 2005 Article IV Consultation*, *supra* note 48, at 32.

[52] Anna Gelpern, *What Bond Markets Can Learn from Argentina*, Int'l Fin. L. Rev. 19, 22 (2005).

[53] Anna Gelpern, *Sovereign Damage Control*, Peterson Institute for International Economics, Policy Brief Number PB13–12, 2 (May 2013).

[54] *See* J. F. Hornbeck, Cong. Research Serv., R41029, Argentina's Defaulted Sovereign Debt: Dealing With the Holdouts 16 (2013).

[55] *Id.* at 8.

[56] Drew Benson & Eliana Raszewski, *Argentina Offers 66% Haircut on Defaulted Bonds*, Bloomberg News, (Apr. 15, 2010), http://www.bloomberg.com/news/2010-04-15/argentina-offers-new-bonds-to-holders-of-20-billion-debt-to-end-default.html.

[57] *See id.*

[58] *See id.*

ernment over the terms of its loan package.[59] Similarly, the Paris Club, an informal group of sovereign creditors, believed that Argentina's settlement with public sector creditors was "dependent on Argentina's political agenda" rather than on its ability to pay.[60]

III. Creditor Enforcement

In some cases, a country may face circumstances such as wars and revolutions that make it genuinely difficult to service sovereign debt.[61] Sovereign debtors also have a strong economic incentive to renege "whenever the expectation of further loans no longer exceeds in amount the interest payable on old ones."[62] Moreover, even when a sovereign debtor has the capacity and ability to pay its debts, "domestic political opposition" can force political actors to renege on external commitments.[63] Thus, some sovereign debtors have chosen to "default with some regularity, and when they do, often pay back a fraction of what they have borrowed."[64] Argentina is a prominent example, having defaulted seven times on its external debt—in 1827, 1890, 1951, 1956, 1982, 1989, and 2001.[65] It has spent a remarkable 33% of the years between 1816 and 2009 in default on its external debt.[66] Argentina has also defaulted on its domestic debt five times.[67]

Given such a strong economic incentive to renege, why do countries ever negotiate in good faith with their creditors? One reason, already mentioned, may be that a country values its reputation for keeping promises.[68] This need not be just a moral commitment. The economic value of a good reputation in the sovereign debt markets can have important spillover effects in other areas, such as attracting foreign investment.[69] A sovereign debtor that keeps its word in one arena is likely to do so in others. Conversely, a sovereign debtor that regularly breaks its promises to external creditors seems likely to violate the rights of other international investors.[70] The nationalization of Yacimientos Petrolíferos Fiscales (YPF), an Argentinian en-

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[59] Ana Baron, *El FMI quiereque la Argentina aumente los pagos de la deuda,* Clarín (Mar. 16, 2004), http://edant.clarin.com/diario/2004/03/16/p-00315.htm.

[60] Paris Club Presentation, Meeting with Private Sector Representatives (Sept. 11, 2012).

[61] *See* Jonathan Eaton, *Debt Relief and the International Enforcement of Loan Contracts*, 4 J. Econ. Persp., 43, 48 (1990).

[62] *Id.*

[63] *Id.* at 49.

[64] Shleifer, *supra* note 47, at 87.

[65] Reinhart, *supra* note 28, at 16.

[66] *Id.*

[67] *Id.*

[68] *See* Rogoff, *supra* note 16, at 31.

[69] *See* Cole & Kehoe, *supra* note 15, at 69.

[70] *See id.*

ergy company, should therefore come as no surprise;[71] this is a country with a history of violating investor rights.

In addition to reputational concerns, sovereigns are incentivized to repay debt governed by foreign law because creditors holding such debt have legal recourse through litigation.[72] The IMF has recognized that this threat of litigation is an important underpinning of the sovereign debt market: "Effective creditor enforcement supports a credit culture and increases the availability of credit to sovereigns. Litigation may also cause a recalcitrant sovereign debtor to acknowledge the extent of its financial difficulties and bring it to the negotiating table."[73] When bonds are issued under foreign law, creditors can sue a defaulting debtor in a foreign court and typically obtain a favorable judgment if the sovereign debtor is in breach of contractual obligations. However, the value of this judgment can be limited for two reasons. First, the creditors generally cannot recover a sovereign debtor's local assets since these are typically protected by domestic law.[74] Second, sovereign debtors benefit from foreign governments' sovereign immunity laws, limiting creditors' ability to seize sovereign assets held abroad. According to the IMF, "[a]lthough sovereign debtors typically irrevocably waive sovereign immunity in their bond documents, this only constitutes a partial waiver of sovereign immunity."[75] As a general rule, sovereign governments may waive sovereign immunity only with respect to assets of a commercial nature.[76] Assets held in a sovereign capacity often continue to be immune from attachment by sovereign debt creditors. For example, foreign assets held in a diplomatic capacity, such as military assets or an ambassador's residence, are always protected in the United States.[77]

These significant restrictions on creditor litigation have meant that the "experience with holdout creditors in bond restructurings has been very limited so far."[78] As a result, the IMF acknowledged in 2012 that "creditor coordination and holdouts have not generally been a major problem."[79] IMF directors have emphasized that the impact of anecdotal successes in creditor litigation should not be overstated.[80]

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[71] *See Argentina to Expropriate Repsol Oil Subsidiary YPF,* BBC (Apr. 16, 2012), http://www.bbc.co.uk/news/business-17732910.

[72] *See* Shleifer, *supra* note 47, at 87.

[73] IMF, *Recent Developments in Sovereign Debt Litigation and Implications for Debt Restructuring and Debt Relief Processes*, 2 (Mar. 22, 2004) [hereinafter IMF, *Recent Developments 2004*].

[74] *See* IMF, *Legal Aspects of Standstills and Moratoria on Sovereign Debt Payments and Their Effect on Actions by Creditors*, 21 (Feb. 20, 1996) [hereinafter *Standstills*].

[75] *See id.* at 17.

[76] *See id.* at 22.

[77] *Id*. at 21–22.

[78] IMF, *Involving the Private Sector in the Resolution of Financial Crises—Complementing the Catalytic Approach, and the Restructuring of International Sovereign Bonds—Further Considerations*, 4 (Feb. 13, 2002) [hereinafter IMF, *Remarks*].

[79] IMF, *Survey of Experiences*, *supra* note 49, at 1.

[80] IMF, *Remarks, supra* note 78, at 4.

These obstacles and restrictions were illustrated by Argentina's default in 2001. Argentina's non-exchanging creditors failed to recover any meaningful assets through litigation in foreign courts, despite the fact that Argentina failed to negotiate with them in good faith prior to its unilateral and coercive exchange offer. In 2012, the IMF stated that the case of the Argentinian holdouts was a cautionary tale for creditors litigating against sovereigns: "The long-running quest for assets by Argentina's 'vulture' creditors demonstrates the practical limits on litigating against sovereigns even where one has an enforceable judgment in hand."[81] Similarly, Lee Buchheit of Cleary Gottlieb Steen & Hamilton LLP stated that "in light of the [Argentinian] experience, the markets now seem to believe that legal remedies alone are unlikely to be a satisfactory recourse for private sector debt holders, at least if the sovereign default is large enough or persists long enough."[82] Creditor litigation, by itself, has not "created a credible debt-enforcement regime."[83] Rather, the inability of investors to collect against a uniquely intransigent and problematic debtor such as Argentina suggests that "the troubles afflicting sovereign-debt markets result from creditor rights being *too weak*, not too strong."[84]

In contrast, bilateral sovereign creditors have generally fared better in sovereign debt restructurings. These creditors have additional leverage in negotiations with sovereign debtors because they can draw upon "political rights which enable them to threaten the debtor's interests outside the borrowing relationships."[85] The IMF agreed with this assessment:

> Official creditors through the Paris Club are in the strongest bargaining position because they are able to bring to bear, in a bilateral or multilateral context, political and diplomatic approaches to the resolution of sovereign liquidity problems. Their negotiations have also been facilitated by the [International Monetary] Fund's policy not to extend financial assistance to any member country that remains in arrears to official creditors. Private creditors, on the other hand, do not have as much clout with sovereign borrowers who negotiate with them as adversaries, and the satisfactory conclusion of their negotiations is not a pre-condition for [International Monetary] Fund assistance.[86]

In theory, the Paris Club requires a "comparability of treatment" whereby private sector creditors are expected to agree to "comparable" treatment to

[81] IMF, *Survey of Experiences, supra* note 49, at 13.

[82] Lee C. Buchheit, *Role of the Official Sector in Sovereign Debt Workouts*, 6 Chi. J. Int'l L. 333, 340 (2005).

[83] Laura Alfaro, Noel Maurer & Faisal Ahmed, Gunboats and Vultures: Market Reaction to the "Enforcement" of Sovereign Debt 7 (Apr. 2010) (unpublished manuscript).

[84] Andrei Shleifer, *Will the Sovereign Debt Market Survive?*, 93 Am. Econ. Rev. 85, 85 (2003) (emphasis added).

[85] Bulow & Rogoff, *supra* note 13, at 43.

[86] *Standstills*, *supra* note 74, at 39.

Paris Club creditors in any sovereign debt restructuring.[87] In practice, this clause has only limited the ability of private creditors to negotiate a better deal than the Paris Club, not the other way around.[88] Thus, comparability of treatment has proven to be a "highly discretionary, one-way street."[89]

IV. Holdout Incentives

Conventional wisdom holds that investors have the incentive to free ride in sovereign debt restructurings. The argument is that a holdout creditor has the incentive to wait for the successful conclusion of a restructuring agreement.[90] After the restructuring is completed, the holdout creditor either waits for the sovereign debtor to spontaneously continue servicing the old debt or else litigates to pressure the sovereign debtor to settle.[91] By doing so, the holdout creditor receives a higher recovery and bears none of the costs of the sovereign debt restructuring. From this perspective, it is surprising that anyone voluntarily accepts a severe write-down instead of holding out and enjoying a free lunch at the expense of other creditors. Yet restructurings have been successfully completed, and the problem of holdout creditors has been limited.[92]

The first reason for this is that investors that buy defaulted debt in the secondary market may have greater flexibility to agree to a sovereign debt exchange offer since the offer price may be set at or above the price that they initially paid for the debt in the market.[93] This is especially true for investors that account for their investments at market price—a speedy and successful debt exchange offer is likely to boost the value of their claims.[94] Thus, secondary market buyers may be strongly motivated to agree to an exchange offer and to pocket the short-term price appreciation from a successful debt restructuring.

The second reason is that litigation is expensive, risky, and difficult to execute. Although the success of previous sovereign debt litigation can set a favorable judicial precedent, the value of such a precedent is quickly eroded by the fact that sovereign debtors can avoid a given precedent by changing the contractual language that gave rise to that particular court ruling. Fur-

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[87] *See* Alon Seveg, *When Countries Go Bust: Proposals for Debtor and Creditor Resolution*, 3 Asper Rev. Int'l Bus. & Trade L. 25, 40–41 (2003).

[88] *See* Arturo C. Porzecanski, *Debt Relief by Private and Official Creditors: The Record Speaks*, 10 Int'l Fin. 191, 201–04 (2007).

[89] *Id.* at 204.

[90] IMF, *Reviewing the Process*, *supra* note 26, at 22.

[91] *Id.*

[92] IMF, *Remarks*, *supra* note 78, at 4.

[93] IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises: The Role of Creditors' Committees—Preliminary Considerations*, 7 (Aug. 11, 1999) [hereinafter IMF, *Creditors' Committee*s].

[94] IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises—Collective Action Provisions in International Sovereign Bonds*, 2 (Aug. 11, 1999) [hereinafter IMF, *Collective Action Provisions*].

thermore, as Part V will outline, sovereign debtors have other tools to limit the litigation rights of creditors. The decision to litigate is therefore a "high-risk, high-return strategy."[95]

A. Litigation Expense and Specialized Knowledge

Converting a favorable court judgment into an actual cash recovery is expensive and time-consuming due to the considerable restrictions on sovereign debt enforcement. Investors must weigh the substantial upfront costs of litigation against an uncertain future recovery.[96] Furthermore, such litigation requires specialized knowledge that few investors have.[97] This is especially true of creditors with small holdings, which "will generally not have the resources or the sophistication to pursue the litigation option."[98] Lastly, even for a creditor that would otherwise be able to litigate, there are strong reasons not to do so because such litigation inevitably "[diverts] time and attention from the investment fund manager's primary task of managing the fund's assets."[99] For all of these reasons, the "number of successful litigations by creditors remains very small," and litigation is not a strategy likely to be widely adopted.[100]

B. Investor Constraints and Illiquidity

Many potential sovereign debt investors, such as pension funds, insurance companies, and banks, face different regulatory restrictions regarding holding non-investment grade bonds.[101] In addition, many have incentives to invest in performing sovereign debt since their performance is usually measured against emerging market bond indices and holding defaulted debt is likely to lower their performance relative to the benchmark.[102] Many sover-

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[95] Julian Schumacher, Christoph Trebesch, Henrik Enderlein, *Sovereign Defaults in Courts*, 12 (University of Munich Working Paper, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189997.

[96] IMF, *Fund Policy on Sovereign Arrears to Private Creditors*, 23 (Jan. 9, 1998) [hereinafter IMF, *Fund Policy*]. *See also* Felix Salmon, *Stop Selling Bonds to Retail Investors*, 35 GEO. J. INT'L L., 837, 838 (2004) (noting that lawyers in sovereign debt litigation "can be extremely expensive").

[97] *See* IMF, *The Restructuring of Sovereign Debt—Assessing the Benefits, Risks, and Feasibility of Aggregating Claims*, 7–8 (Sept. 3, 2003) [hereinafter IMF, *Restructuring of Sovereign Debt*], https://www.imf.org/external/np/pdr/sdrm/2003/090303.pdf. *See also* Gelpern, *Sovereign Damage Control, supra* note 53, at 2 ("enforcement requires skill, commitment, and resources beyond the reach of all but a few specialists").

[98] Lee Buccheit, *Changing Bond Documentation: The Sharing Clause,* 17 INT'L FIN. L. REV., 17, 18 (1998).

[99] IMF, *Recent Developments 2004*, *supra* note 73, at 25.

[100] IMF, *Survey of Experiences*, *supra* note 49, at 11.

[101] *See* Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 213–14 (2010).

[102] *See* IMF International Capital Markets and Legal Departments, *Involving the Private Sector in the Resolution of Financial Crises-Complementing the Catalytic Approach*, 8 (Jan. 8,

eign debt investors are therefore anxious to sell defaulted bonds at the earliest sign of distress because they do not want to hold "a depreciating and illiquid asset."[103] Such investors are also eager to participate in an exchange offer because, after the exchange is complete, the defaulted bonds are likely to be illiquid and infrequently traded.[104] Sovereign debtors also threaten to delist the defaulted bonds, further raising the costs of holding and trading them.[105] Lastly, funding litigation expenses inevitably sets up a conflict between current investors that will have to pay the costs of litigation and future investors that will benefit from any recovery.[106] For all these reasons, the vast majority of investors are unable or unwilling to hold defaulted, illiquid sovereign debt in their portfolios.

C. Business Relationships

Many sovereign debt investors are also anxious not to undermine their longstanding business relationships with the sovereign debtor and domestic residents.[107] Furthermore, institutional creditors may be promised future business with the sovereign government in exchange for agreeing to a restructuring.[108] Such business can include "fees and commission from ongoing and future underwriting of the country's bonds and the franchise value of their commercial banking operations in the debtor country."[109] Thus, the motives and incentives of large financial institutions are not necessarily aligned with those of minority investors and such institutions may have good reason to agree to a restructuring even when the sovereign debtor is not offering a fair deal.[110]

D. Reputation and Regulatory Pressure

Institutional investors can be subject to substantial regulatory pressure from the public sector and national regulators in their own country to agree to a deal with a sovereign debtor.[111] This pressure is particularly acute when the investor is a financial institution of the defaulting sovereign or has sub-

2002) [hereinafter IMF, *Catalytic Approach*], http://adlib.imf.org/digital_assets/wwwopac.ashx?command=getcontent&server=webdocs&value=EB/2002/EBS/140479.pdf.

[103] IMF, *Recent Developments 2004*, *supra* note 73, at 24.

[104] *See* IMF, *Catalytic Approach*, *supra* note 102, at 8.

[105] *See e.g.*, IMF, *Argentina—Selected Issues*, 73 (Jun. 3, 2005) (Argentina threatened to delist its bonds following the 2005 exchange offer).

[106] *See* IMF, *Recent Developments 2004*, *supra* note 73, at 25.

[107] *See id.* at 4.

[108] *See* IMF, *Creditors' Committees*, *supra* note 93, at 6–7.

[109] Nouriel Roubini & Brad Setser, Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies 169 n.56 (2004).

[110] *See* IMF, *The Design and Effectiveness of Collective Action Clauses*, 6 (Jun. 6, 2002) [hereinafter IMF, *Collective Action Design*], https://www.imf.org/external/np/psi/2002/eng/060602.pdf.

[111] IMF, *Creditors' Committees*, *supra* note 93, at 6–7.

stantial commercial presence in that country.[112] Even in the absence of regulatory pressure, investors are concerned about the reputational consequences of pursuing litigation, which is subject to considerable criticism.[113] They are often referred to as "vulture investors." Most investors are unable to hold out against such strong regulatory and reputational pressures.

E. Summary

Between 1976 and 2010, only 30 of the 180 cases of sovereign debt restructuring with private creditors resulted in litigation.[114] The IMF agrees that "[c]reditor litigation in the context of bond restructurings has been rare, with the exception of Argentina (2005)[,] with more than 50 litigation cases filed in the U.S. and the U.K.[,] as well as Greece."[115] Most sovereign debt restructurings were, instead, characterized by "high participation rates and speedy completion" because "the underlying offers were seen by participating creditors as reasonable, in that they reflected governments' capacity to pay and offered adequate burden sharing."[116] Creditor litigation has primarily been pursued in cases where the sovereign debtor did not offer a fair deal.

This should come as no surprise since litigation is not a realistic option for most retail and institutional investors. However, it raises the question of why most investors are sanguine about the presence of those investors that are willing to litigate. There are three reasons for this. First, demand from such investors for "distressed debt supports the functioning of the secondary market, with some benefits to creditors and the debtor."[117] Without such investors, the market for distressed debt might cease to function, especially when faced with a debtor that is intent on offering a nonnegotiated and coercive offer. Thus, post-default, the "threat of litigation only serves to increase the value of the bonds."[118] Second, holdout litigation can aid intercreditor equity by offering "a mechanism by which minority shareholders can challenge restructurings designed principally for the benefit of the majority of the creditors."[119] Third, investors participating in the exchange may see "payments to the holdouts as a modest tax on the restructuring that [keeps] the threat of enforcement real, perhaps deterring the debtor from defaulting on the margins."[120] Holdout creditors thus "serve as a check on opportunistic

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[112] *See* IMF, *Catalytic Approach*, *supra* note 102, at 21–22.

[113] IMF, *Recent Developments 2004*, *supra* note 73, at 25.

[114] Schumacher et al*.*, *supra* note 95, at 8, 11.

[115] IMF, *Recent Developments 2013*, *supra* note 6, at 28.

[116] IMF, *Survey of Experiences*, *supra* note 49, at 10.

[117] IMF, *Recent Developments 2004*, *supra* note 73, at 6.

[118] Felix Salmon, *Collective Indecision*, EUROMONEY (Nov. 1, 2002), http://www.euromoney.com/Article/1002887/BackIssue/50041/Collective-indecision.html.

[119] Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring,* 53 EMORY L. J. 1043, 1098 (2004).

[120] Gelpern, *supra* note 52, at 21.

defaults and onerous restructuring terms."[121] Without the presence of such investors, the threat of creditor enforcement ceases to be credible, and bond prices would likely collapse after a sovereign default.

V. Dealing with Holdout Creditors

Even if creditors have individual incentives to hold out, sovereign debtors can overcome collective action problems in restructurings by (1) including ex ante contractual provisions in bond documentation that make it more difficult for dissenting creditors to hold out and litigate their claims and (2) using ex post negotiating strategies that encourage collective action among creditors.

A. Ex Ante Contractual Provisions

Several types of ex ante contractual provisions can minimize the risk of holdout creditors in sovereign debt restructurings. Some of these provisions have been championed by international organizations, including the IMF, as effective mechanisms for dealing with holdout creditors.

1. Collective Action Clauses

The most widespread contractual mechanism for dealing with collective action problems is the collective action clause (CAC). Typically, these clauses empower a qualified majority of creditors to bind dissenting creditors and thereby "limit the potential threat of litigation from 'holdout' creditors."[122] The public sector has long "encouraged the use of collective action clauses in international sovereign bond issues,"[123] demonstrating a strong belief that CACs can make a "significant contribution to the restructuring process."[124]

Collective action clauses come in several flavors. The first type, the majority restructuring clause, allows a supermajority of creditors *within* a bond issue to bind all remaining creditors to the financial terms of a debt restructuring.[125] Once this supermajority threshold, typically set at 75%, is met, dissenting creditors have no recourse and must accept the financial terms on offer.[126] This type of CAC has gained widespread acceptance in contracts governed by New York law. Ninety-nine percent of the aggregate

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[121] Fisch & Gentile, *supra* note 119, at 1047.

[122] IMF, *Survey of Experiences*, *supra* note 49, at 14.

[123] IMF, *Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use*, 3 (June 6, 2002) [hereinafter IMF, *Collective Action Clauses*], https://www.imf.org/external/np/psi/2002/eng/060602a.pdf.

[124] IMF, *Restructuring of Sovereign Debt*, *supra* note 97, at 8.

[125] *See* IMF, *Collective Action Design*, *supra* note 110, at 2.

[126] *See* IMF, *Recent Developments 2013*, *supra* note 6, at 14.

value of such bonds issued since 2005 have included majority restructuring clauses.[127] Only one issuer, Jamaica, has chosen not to include such a clause in its bond offerings.[128]

One potential problem with majority restructuring clauses is that they apply only to the bond issue at hand.[129] A second type of CAC, the aggregation clause, applies a supermajority threshold clause *across* a predefined set of debt instruments.[130] However, there is significant concern that this type of CAC could be abused if the instruments covered by the clause have different contractual claims or maturities and the debtor tries to manipulate the voting process by offering terms that are attractive for some debt instruments but not others.[131]

The third type of CAC, the majority enforcement clause, allows "a qualified majority of [creditors] to limit the ability of minority [creditors] to accelerate their claims after a default."[132] Alternatively, if the acceleration of debt claims has already happened, the clause allows a majority or supermajority of creditors to reverse the acceleration.[133]

The fourth type, an enforcement provision found in trust deeds, vests the right to litigate in the hands of a bond trustee.[134] The bond trustee is required to litigate only upon receiving both a request to do so from a minimum percentage of bondholders—typically 20% to 25%—and "adequate indemnification."[135] Any proceeds received from the litigation are typically shared among all bondholders, not just the creditors that chose to litigate.[136] The combination of these provisions makes it very difficult for dissenting creditors to litigate against the sovereign debtor.

2. Pari Passu *Clauses*

Pari passu clauses limit the ability of debtors to privilege one group of creditors over another. Although *pari passu* clauses are sometimes seen as a single category, there are three different types.[137] The narrowest version simply provides that "the bonds rank *pari passu* with all External Indebtedness."[138] This formulation provides for equal rank only and makes no mention of debt service payments by the debtor. Almost half of all sovereign bonds issued in the 2000s contain this narrow version of the *pari passu*

[127] NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 264 (2d Cir. 2012).
[128] *Id*.
[129] IMF, *Collective Action Design*, *supra* note 110, at 18.
[130] *See id.*
[131] IMF, *Restructuring of Sovereign Debt*, *supra* note 97, at 5.
[132] IMF, *Collective Action Clauses*, *supra* note 123, at 14.
[133] *Id.*
[134] *Id.*
[135] IMF, *Collective Action Provisions*, *supra* note 94, at 12–13.
[136] IMF, *Collective Action Design*, *supra* note 110, at 2.
[137] Duggar, *supra* note 47, at 2.
[138] *Id*.

clause.[139] A more bondholder-friendly version states that the "bonds will rank *pari passu* in priority of payment *and* in rank of security."[140] Finally, the broadest, most bondholder-friendly version separately provides for both equal priority and equal payment of similarly situated creditors.[141] For instance, Argentina's bond offering featured the broadest version of the *pari passu* clause:

> The Securities will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness.[142]

The scope of the two broader versions of the *pari passu* clause has, however, been subject to various interpretations.[143] Under a narrow interpretation, the clause is violated only if the sovereign debtor legislatively subordinates the claims of one group of creditors relative to another group of similarly situated creditors.[144] Under a more expansive interpretation, "the covenant would preclude the borrower from making payment to one class of creditors in circumstances where other creditors that are also owed payment have received nothing."[145] In 2012, the United States Court of Appeals for the Second Circuit clarified the meaning of the *pari passu* clause in Argentina's bond offerings, holding that clauses that separately provided for both equal priority and equal payment prohibited Argentina from paying one class of creditors while refusing to pay others.[146]

In future bond offerings, sovereign debtors can avoid this now-settled interpretation by changing the wording of the clause or by adopting a less bondholder-friendly version of the clause, such as deleting language that provides for equal payment. Italy has already changed the *pari passu* clauses in its most recent bond offerings to accomplish this.[147]

In 2000, a Brussels court adopted a similar interpretation when faced with a clause providing that the debt "will rank at least *pari passu* in priority of payment" with other external debt.[148] Several commentators bemoaned the "nightmarish situation" that the ruling would create, saying that it "put a

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[139] *Id.*
[140] *Id.* (emphasis added).
[141] *See id.*
[142] NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 251 (2d Cir. 2012).
[143] IMF, *Catalytic Approach*, *supra* note 102, at 14.
[144] *Id.*
[145] *Id.*
[146] *NML Capital Ltd.*, 699 F.3d at 259.
[147] IMF, *Recent Developments 2013*, *supra* note 6, at 31.
[148] G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 Bus. Law. 635, 636 (2001) (noting that the *pari passu* clause in that case said that "[t]he obligations . . . will rank at least *pari passu* in priority of payment with all other" external debt of the issuer).

large hammer in the hands of holdout creditors, thereby enabling them to cause even more disruption in restructurings."[149] These predictions have not come true, and sovereign restructurings have proceeded largely unimpeded since the Brussels ruling. The Second Circuit ruling, which only interprets the broadest version of the *pari passu* clause, is also unlikely to have a significant impact on future restructurings, especially because sovereign debt issuers can change the wording of the clause in their future bond offerings.

3. Sharing Clauses

Loan agreements typically include sharing clauses, which require a creditor to share with all remaining creditors the proceeds of any recovery through litigation against the debtor.[150] The inclusion of sharing clauses therefore makes bond instruments significantly less attractive for creditors that would have otherwise chosen to litigate against a sovereign debtor.[151] This is because sharing clauses distribute any potential gains from litigation across all creditors, while the costs of such litigation are borne exclusively by the litigating creditors.

4. Choice of Law

Sovereign debtors have the option of issuing bonds under their own law. In such cases, creditors have limited litigation recourse because sovereigns may be able to retroactively amend their laws to insert additional contractual provisions into the bond documents or can otherwise limit the rights of creditors to pursue litigation.[152] For instance, in 2012, the Greek authorities retroactively inserted aggregation clauses into their local law debt, allowing a majority of creditors to bind minority creditors to the terms of the financial exchange.[153] Furthermore, bonds issued under local law typically limit the ability of creditors to litigate in foreign courts. Thus, "in the absence of legal remedies, creditors would have little choice other than to accept the terms of a restructuring."[154]

5. Summary

Sovereign debtors have the contractual technology to severely limit the ability of creditors to dissent from any sovereign debt restructuring, which can increase the risk of opportunistic default by sovereign debtors. One recent example is Ecuador. The combination of two defaults in 1995 and 2000

[149] *Id.* at 638.
[150] *See* Buchheit, *supra* note 98, at 1–2.
[151] *See* IMF, *Fund Policy*, *supra* note 96, at 36.
[152] *See* IMF, *Collective Action Design*, *supra* note 110, at 19.
[153] IMF, *Recent Developments 2013*, *supra* note 6, at 29.
[154] IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises*, 61 (Aug. 10, 1998).

with record oil prices had left Ecuador with "an enviably manageable external debt profile."[155] Nevertheless, the country defaulted on its international bonds in late 2008 to opportunistically redirect funds allocated for debt service into social programs.[156] Even though Ecuador had the money to continue making debt payments, individual creditors could not seek legal remedies, such as acceleration, because Ecuador refused to disclose the bonds that it owned or controlled.[157] Without this information, the trustee empowered to protect creditor interests could not determine whether the required 25% of bondholders had consented to enforce acceleration.[158] As a result of their inability to pursue acceleration, "bondholders felt they had little choice but to accept Ecuador's [offer to repurchase the bonds at a 65% discount]."[159] Put another way, "the system designed to protect bondholders against such [an opportunistic] default [had] failed."[160]

This part raises the question of why a sovereign debtor would ever choose *not* to insert such contractual provisions into its bond documents. One hypothesis is that sovereign debtors have an ex ante incentive to credibly commit to greater creditor enforcement rights in order to attract more favorable financing terms.[161] Less creditworthy countries must therefore decide whether the premium for including contractual terms that limit creditor litigation rights is worth paying.[162] The important point, however, is that this is an ex ante bargain between the sovereign debtor and the creditor that is priced into the financial terms of the transaction. Once the bargain is set, the sovereign debtor has an incentive to dilute the provisions to which it had originally committed.[163]

B. Ex Post Negotiating Strategies

Sovereign debtors retain several tools to aid a restructuring process even in the absence of the contractual terms discussed above.

1. Minimum Participation Thresholds

A sovereign debtor can reduce collective action problems by conditioning any debt exchange offer on the participation of a minimum percentage of

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[155] Lee C. Buchheit & G. Mitu Gulati, *Ecuador's Sovereign Bond Default—The Coroner's Inquest*, 28 INT'L FIN. L. REV. 22 (2009).

[156] *Id.* at 22–23.

[157] *Id.* at 24.

[158] *Id.*

[159] *Id.* at 25.

[160] *See id.* at 22.

[161] *See* Eaton & Fernandez, *supra* note 9, at 2057.

[162] IMF International Capital Markets, Legal and Policy Developments and Review Departments, *Collective Action Clauses: Recent Developments and Issues*, 26 (Mar. 25, 2003) [hereinafter IMF, *Collective Action Recent Developments*], https://www.imf.org/external/np/psi/2003/032503.pdf.

[163] *See* Eaton & Fernandez, *supra* note 9, at 2058.

creditors, typically set at 75% to 90%.[164] High participation thresholds reduce the incentive to hold out because if enough creditors choose not to participate in the exchange offer, then the sovereign debt restructuring would fail and holdout creditors would not benefit from the concessions of other creditors.[165] Thus, conditioning any restructuring on a high participation threshold minimizes the pool of dissenting minority creditors and thereby reduces the risk of creditor litigation.[166] Several countries, including Jamaica and Uruguay, have used this "explicit announcement of minimum participation thresholds" as a "mechanism to resolve coordination problems."[167]

2. *Exit Consents*

Exit consents are another way to encourage full creditor participation in sovereign bonds issued under New York law.[168] Creditors participating in the exchange are asked, as part of the offer, to agree to change the nonpayment contractual provisions of all bonds under the same issue. The goal is to make the bonds held by the dissenting, nonexchanging creditors less attractive through the deletion or modification of contractual provisions that provide for robust creditor protection.[169] The IMF has recognized that exit consents, "when appropriately designed, may play a useful role in facilitating a debt restructuring in circumstances where the bonds do not contain majority restructuring provisions."[170]

3. *Full Payout*

Sovereign debtors can always choose to pay the nonexchanging creditors in full. Although there are holdouts in almost every restructuring, sovereign debtors can pay the holdouts in full to avoid legal challenges.[171] Holdouts have generally been "paid in full after a preemptive restructuring."[172]

4. *Summary*

The judicious use of these ex post mechanisms has allowed debtors to restructure their sovereign debt without significant holdout problems, even

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[164] IMF, *Recent Developments 2013*, *supra* note 6, at 28.
[165] *See id.* at 31.
[166] *See* IMF, *Involving the Private Sector in the Resolution of Financial Crises: The Restructuring of International Sovereign Bonds—Further Considerations,* 6 (Jan. 30, 2002).
[167] IMF, *Survey of Experiences*, *supra* note 49, at 14.
[168] IMF, *Involving the Private Sector in the Resolution of Financial Crises—Restructuring International Sovereign Bonds*, 11 (Jan. 11, 2001), http://www.imf.org/external/pubs/ft/series/03/ips.pdf.
[169] *See id.*
[170] IMF, *Collective Action Recent Developments*, *supra* note 162, at 12–13.
[171] IMF, *Recent Developments 2013*, *supra* note 6, at 12.
[172] *Id.*

in the absence of ex ante contractual terms. Argentina, however, chose not to use exit consents or minimum participation thresholds.[173] Such mechanisms—even somewhat coercive techniques such as exit consents—still require an "element of consent" by the creditors, but Argentina was not interested in obtaining such consent through a negotiated outcome.[174]

VI. Conclusion

In *NML Capital v. Republic of Argentina*, the Second Circuit faced a unique set of facts. The case involved a bondholder-friendly debt contract that included an unconditional waiver of sovereign immunity and the most creditor-friendly version of the *pari passu* clause.[175] The contract excluded collective action clauses that can facilitate sovereign debt restructurings and eliminate the right of dissenting creditors to pursue litigation remedies.[176] The sovereign debtor adopted a "uniquely recalcitrant" negotiating strategy and failed to abide by international norms governing restructuring negotiations between sovereign debtors and creditors.[177] Argentina legislatively subordinated the claims of dissenting creditors by passing a law prohibiting any payment or settlement with non-exchanging creditors.[178] In short, the Argentina case highlighted "the potential dangers of uncooperative debtors to the international financial system" and the limited leverage that creditors have for dealing with them.[179] Given this unprecedented set of facts, the Second Circuit affirmed the district court's narrowly tailored, fact-specific equitable remedy. In ruling for the plaintiff-creditors, the Second Circuit emphasized that "New York's status as one of the foremost commercial centers is advanced by requiring debtors, including foreign debtors, to pay their debts."[180]

Due to the exceptional nature of the Argentina case, the Second Circuit's ruling is unlikely to set a broad precedent. For example, in a recent case in the Southern District of New York, *Export-Import Bank of the Republic of China v. Grenada*, the creditor—Taiwan's export-import bank—alleged that Grenada had violated the *pari passu* clause in its debt agreement by continuing to pay some creditors while not paying debt held by the plaintiff.[181] The creditor sought summary judgment for equitable relief, relying on

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[173] *See* Gelpern, *What Bond Markets Can Learn from Argentina*, *supra* note 52, at 22 (describing Argentina's non-use of exit consents).

[174] *See id.* at 22.

[175] *See* NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230, 237, 248 (2d Cir. 2013). *See also* NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246, 251 (2d Cir. 2012) (quoting the *pari passu* clause in Argentina's debt contract).

[176] *See NML Capital, Ltd.*, 727 F.3d. at 247.

[177] *See id.* at 247 n.13.

[178] *See id.* at 237, 241.

[179] IIF Staff Note on Argentina, Meeting with Paris Club Creditors, at 3 (Jun. 15, 2005).

[180] *NML Capital, Ltd.*, 727 F.3d at 248.

[181] Export-Import Bank of the Republic of China v. Grenada, No. 13 Civ. 1450 (HB), 2013 WL 4414875, at *1 (S.D.N.Y. Aug. 19, 2013).

the Second Circuit's decision in the Argentina case.[182] However, the district court refused to grant such relief, noting that the Argentina case did not answer the broader question of whether "any non-payment that is coupled with payment on other debt" or "legislative enactment alone" would constitute a breach of the *pari passu* clause.[183] It clarified that the inquiry is fact-specific and that the Second Circuit ruling was predicated on the conduct of Argentina's legislative and executive branches in dealing with dissenting creditors.[184] As such, the Grenada case suggests that courts will not automatically apply the Argentina precedent to future sovereign debt restructurings.

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[182] *Id.* at *4.
[183] *Id.* (internal quotations omitted).
[184] *Id.*