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#### **Special Comment**

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# Proposed Frameworks for Sovereign Debt Restructuring

# I. Summary

The recent spate of sovereign bankruptcies and related crises have given rise to a heated debate about the deficiencies in the international financial architecture. The crux of the matter, it is argued, is that sovereign borrowers with unsustainable debt burdens delay restructuring efforts until the last possible moment. Although postponement is expensive due to the costs it imposes on the sovereign's economy, the fear of litigation from creditors, compounded with the uncertainty surrounding the entire process of sovereign debt restructuring is said to be so great that it causes a "restructuring paralysis". Essentially, there are two fundamental concerns with the system as it stands today:

- **Capital flight**: The tendency for foreign investors to divest themselves of a sovereign just when it needs capital the most, on the brink of default.
- **The hold-out creditor**: By refusing to go in on the restructuring the hold-out creditor can thwart negotiations and in the worst of circumstances can sue the sovereign in court and win.

If the system could somehow be reengineered to assuage these worries, countries would be willing to restructure debt sooner rather than later, and the financial system would eliminate the associated costs and burdens of sovereign crises. Although by no means the first round of such discussions, two competing initiatives on how best to restructure sovereign debt have gained foothold in the international arena. Essentially, these proposals attempt to solve sovereign debt restructuring through different legalistic machinations.

- The United States Treasury (Treasury) this proposal seeks to remove the barriers for smooth negotiations through a decentralized approach that relies heavily on the use of collective action clauses (CACs); and,
- The International Monetary Fund (IMF) this proposal aims to ease the restructuring process through a centralized manner that loosely mimics domestic bankruptcy proceedings, specifically Chapter 11 of the United States Bankruptcy Code (hereafter Chapter 11).

<sup>1.</sup> And, because of the need it creates for emergency multilateral and bilateral financing. For more detail, see, e.g., Roubini, N, "Do We Need A New International Bankruptcy Regime", April 2002. In the past, these risks were also present. But sovereign debt was held mostly in the form of syndicated long term bank loans, and therefore sovereigns were less worried about commencing a restructuring effort.

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Some caveats at the outset of this paper are necessary. First, the two positions above are not the "official positions" of either the US Treasury or the IMF. However, for ease of use they will be referred to as the IMF and Treasury reports throughout the body of this paper. Further, they are still in their formative stages. They should, thus, not be considered the last, or even, the only word of these two institutions. Second, Moody's neither professes nor assumes expertise in international law. Finally, in drafting this special comment, we have relied solely on public documents and information.

However, based on our understanding of the various parts of the proposals as they are presently formulated, it appears that both are concerned mainly with the ultimate court-access of the hold-out creditor. The hold-out creditor, although admittedly a more sensational news story, is not in our view the fundamental impediment in sovereign restructurings, but rather the fly in their ointment. As we will discuss in greater detail below, there is very little contemplation in either of these plans as to the more elemental problem presented in sovereign restructuring. Namely, the 'what if' scenario when the majority of the creditors cannot agree with one-another on the priority of their claims as the sovereign slides toward insolvency.

As has been demonstrated in the recent past, this inability of the majority to be of the same mind and thus able to reach an accord with the sovereign has been - and we suspect, will continue to remain - the largest hindrance.

## II. Overview: The Dilemma

Since the early eighties, private sector lending to emerging markets has undergone a noticeable transformation. Greater integration of international capital markets has resulted in a shift from syndicated bank loans to traded securities which has, in turn, led to an increase in efficiency of capital markets and a broadening of the financing options of sovereigns.<sup>2</sup> At the same time, the number of crises in emerging markets has also increased, and of late the flow of capital into emerging economies has diminished - a dual trend that the official sector would like reversed.<sup>3</sup> It is beyond the scope of this paper to assess the adequacy, or even the appropriateness<sup>4</sup> of the various crisis prevention methods that have been and continue to be introduced. Rather, we focus here on the situation that follows unsuccessful crisis prevention - the period during which a financial crisis is imminent.

Typically, a financial crisis is assumed to be imminent when a country's debt burden is perceived as unsustainable; that is, the net present value of its total financial obligations exceeds the present value of its assets. The problem is amplified as it becomes difficult, if not impossible, to roll over short-term debt. The country experiences capital flight as most investors become unwilling to expose themselves to heightened risk.<sup>5</sup> Further adding fuel to the fire, a sovereign on the verge of default, of late, can be vulnerable to legal attack.

# A. Situation Summary - Fly In The Ointment

As we have explained in a series of previous special comments, broadly speaking sovereign debt is issued under two types of governing laws, English Law and New York law. Debt instruments issued under both types of legal systems include various collective action clauses (CACs). Such clauses, when invoked by the majority of the bondholders, can bind the minority to a particular change. Moreover, in a restructuring, prior to tendering their old bonds, the majority of investors can utilize an "exit consent" to enforce all changes made to the old instrument on those creditors who refuse to enter the exchange. These changes will likely have a detrimental impact, rendering the old bond instrument less hospitable thereby "persuading" all creditors to participate in the tender offer.

However, under New York law the terms of payments can only change through *unanimous* agreement of all creditors. Under English law, there are no clauses that require unanimous consent. This distinction in

<sup>2.</sup> Since 1980, emerging bond market issues have grown four times as quickly as syndicated bank loans, 'International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring', November 26 2001 address by Anne Kreuger to the National Economists' Club Annual Members' Dinner, Washington D.C.

<sup>3.</sup> The term official sector will be used to denote multilateral financial institutions, the G-7 finance ministries and other individual finance ministries. The G-7 is composed of the US, Canada, Japan, UK, France, Germany and Italy.

<sup>4.</sup> Indeed, the International Monetary Fund (IMF) considers the prevention of financial crises to be a priority and has: improved surveillance of both debtor country policies and international financial markets; improved communication between the IMF, member countries and private capital markets; and, created a Contingent Credit Line (CCL) facility.

<sup>5.</sup> The situation may be exacerbated by a refusal by the official sector to provide financial support.

<sup>6.</sup> See Moody's special comments: "Sovereign Debt: What Happens If A Sovereign Defaults?", July 2000; "Sovereign Restructurings: Putting Too Much Faith in Exit Consents" March 2001; for more details.

the legal paradigm is important, as it provides a powerful negotiating tool to New York law bond investors that is unavailable to English law bond investors. If the holder of a bond governed by New York law, for whatever reason, does not enter the exchange, he will retain his legal rights under the terms of the old bond.<sup>7</sup> Thus, if the sovereign fails to meet its obligation, the investor has a claim in court.

Some have argued that unless creditors' rights under the old terms of the bond can be fully and completely stripped there is great incentive for one or two disobliging creditors to refrain from tendering their old instruments for newly structured ones. That indeed, these hold-out creditors will be the cause of a rapid disintegration of the process to the point where no restructuring will occur. Creditors will assume that a sovereign will pay the hold-out creditor the full amount under the old terms either to avoid or settle a legal suit, leaving those who would have accepted the offer hoodwinked. In such circumstances, the argument continues, it is virtually impossible to arrive at any sort of a consensus because investors do not trust one another, resulting in the type of disorderly workouts evidenced of late. In crafting the proposals on augmenting the international financial architecture, the drafters have thus focused on de-clawing the rogue investor, who at times is derogatorily referred to as the vulture investor.

## B. For Whom Is A New Financial Architecture Necessary?

It seems interesting that the focus of the international financial architecture debate has shifted to the hold-out creditors. We suggest that one important aspect - that may have not received adequate attention - for consideration is the investor base of the sovereign. If the investor base is small, discrete and identifiable - such as was the case for Pakistan - restructuring efforts rarely focus on the rogue creditor. The incentives of the few investors are similarly aligned and a restructuring agreement is more easily struck. If on the other hand, the investor base is large, disparate and unidentifiable - as is the case in Argentina - then cooperation amongst the majority becomes a cumbersome and tedious process. It will be difficult to ensure that a majority of investors see eye-to-eye on the terms of the new instrument, because there will likely be disagreement between the different classes of debt holders on issues of parity and priority.

Orderly restructuring rules, it seems to us, are primarily necessary in instances where the emerging market sovereign has a substantial capital market presence, and thus has a large and divergent investor base. The hold-out creditor, although a fascinating side-show for many, including the media and legal academics, may likely be a distraction from the main and fundamental event.

# III. Decentralized Approach - The US Treasury Department Proposal

"In our view, the most practical and broadly acceptable reform [to the international financial architecture] would be to have sovereign borrowers and their creditors put a package of new clauses into their debt contracts. The clauses would describe as precisely as possible what happens when a country decides that it has to restructure its debt. ...What should these new clauses look like? In decentralized fashion, many of the details would be determined by the borrowers and lenders as new bonds are issued, but the legal templates should conform to several essential guidelines."

Although the US Department of Treasury has not issued an official policy statement or an official document outlining a proposal, through various speeches it appears that the Treasury is suggesting that the problems around sovereign restructuring can be addressed through a decentralized, market-oriented approach relying heavily on the use of CACs. The particulars are not addressed, as the debtor and the creditors remain responsible for ensuring that the details are taken care of, but broadly the bonds should follow a legal template that contains the following features:

## • Majority Action CACs - to hold even for Terms of Payment

The Treasury recommends that all bonds issued by a sovereign contain majority action clauses, where creditors holding 75% of the principal could agree to a restructuring that would be binding on the minority. <sup>9</sup> The single most significant aspect of this recommendation is that the binding nature of these CACs would hold for terms of payment clauses as well. This suggestion is tantamount to "no New York Law bonds for sovereigns." <sup>10</sup>

<sup>7.</sup> This statement must be taken in conjunction with all that we have said about the effects of exit consents.

<sup>8.</sup> Taken from "Sovereign Debt Restructuring: A US Perspective", John B. Taylor, Under Secretary of Treasury for International Affair's speech at the conference

<sup>9.</sup> The 75% figure was a offered as an example rather than a precise recommendation.

## • Restructuring process to be clearly delineated in the bond instrument.

The US Treasury proposes that clauses be added to specify:

1. Creditor representation in the event of a default;

A representative would negotiate with sovereigns on behalf of bondholders, and would be responsible for accounting for and distributing payments. The representative, rather than individual bondholders, would have the power to initiate litigation, but only if a predetermined, but unspecified, proportion of bondholders agreed that this was the appropriate course of action.

2. Required data to be provided by the debtor;

The US Treasury has not yet specified the precise nature of the data that is to be provided. Presumably, this is yet another detail that debtors and creditors must work out for themselves.

3. The period of time within which this data should be made available.

#### • Moratorium

The Treasury also suggests that debt contracts include clauses that would describe precisely how a sovereign would initiate the restructuring. That is, contracts should state a period of time, <sup>11</sup> between the time that the sovereign declares that it wants to restructure and the time that the restructuring negotiations can begin. During this time, the contract should specify that the sovereign is allowed a temporary suspension of payments, preventing a bondholder representative from initiating litigation.

#### • Additional features of the plan are:

- 1. The inclusion of CACs in syndicated bank loans as well as other debt contracts to eliminate the problem of asset diversity.
- 2. Arbitration process to settle creditor disputes. <sup>12</sup>

Apart from the fact that many important details of the restructuring - such as how long a standstill would remain effective or how a representative would be chosen - remain unresolved, under US law at any rate, the Treasury proposal may be untenable. As a result of the Trust Indenture Act of 1934, and US customary practice since, issuers can alter any or all clauses and terms to the bond with the approval of the majority, **except for** clauses that discuss the principal, coupon or maturity of a bond. These "terms of payment" clauses require the **unanimous** approval of bondholders.

Notwithstanding that the Treasury proposal is not yet official and not yet fully developed, it appears that the proposal as it stands today calls for a consensus among sovereign issuers, investors and financial intermediaries to make CACs applicable to *the entire spectrum* of bond and loan agreements. If this proposal gains favor, in future, sovereigns would likely not be able to issue bonds governed by US Law.

# IV. Centralized Approach - The IMF's Sovereign Debt Restructuring Mechanism (SDRM)

"The bottom line is that far-reaching developments in capital markets over the last two or three decades have not been matched by the development of an orderly, predictable framework for creditor coordination, in which the roles of the debtor, the creditors and the international community are clearly spelt out...[This] imposes significant costs on all parties involved.... Our goal therefore should be the creation of better incentives to encourage the orderly and timely restructuring of unsustainable sovereign debts, while protecting asset values and creditors' rights."

The IMF proposal has been put forward in several stages. The first is known simply as SDRM-I. The second is known as SDRM-II. There is, however, a third proposal that has been introduced which modifies SDRM-II by incorporating the CAC approach of the Treasury. For purposes of this special comment, we will refer to this latest proposal as SDRM-II (b).

<sup>10.</sup> The proposal seems to recognize that bonds issued under New York law do not include majority action clauses for terms of payment but Undersecretary Taylor stated in his speech that "there is no legal reason why such clauses could not be included [going forward]"

<sup>11. 60</sup> days was suggested.

<sup>12.</sup> This would address the problem of aggregation across creditor classes. There have been various private sector proposals on the solution to aggregation problems, but these would have to be described in a separate document.

<sup>13.</sup> Anne Kreuger, First Deputy Managing Director, IMF in her speech entitled, "New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking" at the conference "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, April 1, 2002.

All three proposals leverage off a number of earlier sovereign debt restructuring plans that had encouraged the establishment of an international debt workout procedure, loosely modeled on Chapter 11 of the US Bankruptcy Code. <sup>14</sup> Any of the SDRM plans may become enforceable through treaty law. It is suggested that the most likely means of achieving enforcement would be through appropriately modifying the IMF Charter. Such modification would require approval by all member states. The main difference between SDRM-I and SDRM-II is that the extent of the IMF's involvement is greatly reduced in the latter. It is no longer the main decision-maker; rather, it turns over this power to the creditors.

In general the SDRM plans rest on four main principles.

#### • Prevent a "grab race"

Establishing a moratorium during which creditors cannot enforce their claims against the sovereign, in advance of others. The sovereign is protected from any legal action taken by one or all of its creditors could accomplish this.

#### · Motivate creditors to finance the debt restructuring

Reduced ability to litigate will increase debtors' incentive to restructure debt, which will make countries less vulnerable to financial crises. This reduction of risk will accordingly increase the value of bonds thus providing creditors with an incentive to participate in the process.

#### • Limit confusion around the process

if the actors in a restructuring know the rules of the game, the process will be orderly.

#### Restraining the hold-out creditors

these creditors are perceived as having the ability to overturn the entire restructuring process.

#### A. SDRM-I

Under the provisions of SDRM-I, the IMF plays the significant role of arbiter of first and last resort. The process begins when the debtor nation formally requests the IMF to impose an automatic stay on all of the country's outstanding debt obligations. If the request is accepted and endorsed by the IMF, a moratorium is put into effect for a short, but unstipulated, time period.

During the moratorium, creditors are strictly prohibited from threatening the sovereign with any form of litigation. The IMF suggests that, much like a domestic bankruptcy court, it would oversee the process of restructuring debt, but the actual terms of the agreement are to be negotiated by the creditors and the debtor. Further, once a supermajority of the creditors has agreed to the terms of the restructuring with the sovereign, the terms would be made enforceable on all creditors. That is to say, similar to the procedures for gaining acceptance of a reorganization plan under the US Bankruptcy Code, the super-majority would have the ability and the right to 'cram-down' the new terms on all creditors. The hold-out creditors would have no option to contest the terms.

For a variety of reasons, SDRM-I met with intense opposition from market participants, which then led to SDRM-II.

#### B. SDRM-II

Under SDRM-II the IMF's role as the overarching umpire is reduced.

- A supermajority of creditors, rather than the IMF, decides on the duration of the stay on payments.
- Solely preferred creditors finance the reorganization. The conditions of the reorganization will be decided by a supermajority of creditors. The original SDRM called for IMF support.
- Negotiations for restructuring the debt are supervised by a neutral agency rather than the IMF. The proposals do not mention any more specifics.
- Hold-out creditors are kept under control by supermajority voting across all classes of debt.

This plan briefly touches on the use of CACs but dismisses the idea on the grounds that they would be awkward to implement. <sup>15</sup>

<sup>14.</sup>Among the people who have supported this idea in the past are Jeffery Sachs, "Do We Need An International Lender Of The Last resort?" Frank D. Graham Lecture, Princeton University, 1995, and Steven Schwarcz, "Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach," Cornell Law Review 85, no. 4, 2000.

<sup>15.</sup> This criticism is particularly interesting in light of the fact that the IMF proposals - a new international bankruptcy system put into place through treaty law - would likely prove difficult to put into practic

## C. SDRM-II (b)

The IMF provided an update to SDRM-II at its Spring 2002 Meetings. This latest approach to sovereign debt restructuring and dispute resolution, which for lack of title we will refer to in this paper as SDRM-II (b), appears to combine a greater use of CACs with the existing structure of SDRM-II.

The proposal has two parts: (1) the extensive use of CACs in sovereign debt contracts, in conjunction with, (2) the establishment of what the IMF calls a "complementary statutory mechanism" designed to facilitate the orderly and timely restructuring of unsustainable emerging market debt. Additionally, a somewhat complicated apparatus for dispute resolution amongst creditors is discussed.

#### 1)The use of CACs

The IMF states that the inclusion of CACs for terms of payment - which are typical of bonds issued under English Law - is one way to facilitate sovereign debt restructuring. However, implementation would pose a problem as: a) the domestic laws of certain countries actually prevent the modification of the rights of minority bondholders without their consent - e.g. the United States; and b) there would be a large discrepancy in treatment between the bonds issued under these new provisions and the bonds that are currently in circulation. Due to these drawbacks, the IMF reiterates the need to construct what it refers to as "statutory" support for the restructuring mechanism . <sup>16</sup>

#### 2)Statutory Mechanism - Dispute Resolution Forum

The mechanism would take the form of a treaty obligation - most likely achieved through an amendment of the IMF Articles of Agreement. <sup>17</sup> While the recommendations of SDRM II remain in place, the IMF has added a dispute resolution forum. The IMF contends that for the new approach to sovereign debt restructuring to be taken seriously, it will need to have the capacity to resolve disputes among creditors justly and efficiently. Thus, the forum would operate under four basic pillars: independence, competence, diversity and impartiality. <sup>18</sup>

Notwithstanding the feasibility of establishing an impartial international adjudicative body, <sup>19</sup> the remainder of the SDRM recommendations could be implemented by amending the IMF Articles of Agreement. This factor alone, makes the IMF proposals highly contentious and thus questionable.

# V. As An Aside: US Bankruptcy System - In Short

The US bankruptcy system is a complicated web of statutory provisions and common law opinions that offers protection for both investors and the issuing entity. As such, its mere existence and the various provisions within the US Code offer both investors and corporate entities equally potent strategic artillery that, in the end, keep both sides honest. Admittedly, bankruptcy is not the best of all possible outcomes for either issuers or creditors. It is a time-consuming and expensive process, which more often than not leaves the creditors with less than that they had bargained for while at the same time may cause the dismissal of incumbent managers. <sup>20</sup>

The premise of the system is to offer a debtor a second chance, allowing it to rehabilitate itself - with some outside assistance at times - thereby giving investors a second chance at recouping their investment. On a very basic level, it is divided into two broad steps: 1) reorganization and rehabilitation; and if that fails, 2) liquidation. Thus, a corporate entity in crisis is given the chance to re-organize, but if it fails, the creditors have the ability and the right to liquidate the corporate enterprise and divvy up the remains before everything is lost.

<sup>16.</sup>On June 27, 2002, The Executive Board of the IMF met to discuss the design and effectiveness of CACs, and ways to encourage their use in sovereign debt contracts. One option that may be considered in the future is to make IMF funding conditional on the inclusion of CACs in sovereign debt contracts. However, many IMF Directors are presently strongly opposed to this conditionality. 17. Since the IMF articles of agreement can only be amended by a 2/3 majority of voting members comprising 85% of the vote, implementation of this approach would be a daunting task.

<sup>18.</sup> It is suggested that this forum would consist of about 21 members who would be chosen by an independent electoral committee established by the Executive Board from among a pool of 183 candidates nominated by the 183 member countries of the IMF. The appointment of the forum would be subject to the approval of the Board of Governors and the Managing Director, and each member would be appointed for a renewable term of four or five years.

<sup>19.</sup> Since the electoral committee is appointed, and the competence of its members judged by the Executive Board of the IMF, it is not clear to us how the dispute forum would be independent of the IMF. While the pool of 183 members certainly provides for diversity, it will surely be difficult to assess each nominee

<sup>20.</sup> On the high costs of bankruptcy for managers, see, e.g., Stuart C. Gilson & Michael R. Vetsuypens, CEO Compensation in Financially Distressed Firms: An Empirical Analysis, 48 J. FIN. 425-58 (1993); Lynn M. LoPucki & William C. Whitford, Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. PA. L.REV. 125, 150 (1990).

## An Example

If a small group of dissident investors believe that the borrower-issuer has, for whatever reason, not offered the best exchange feasible, they can force the distressed issuer into bankruptcy. The company will generally attempt to keep all of its investors as content as reasonably possible throughout the work-out process prior to bankruptcy. Most companies, however, file voluntarily for bankruptcy protection in order to control the process.

Once the company is in bankruptcy, Chapter 11 of the US Code provides protection to creditors and the borrower alike. Provisions that govern reorganization plans ensure that a single "hold-out" investor or other creditors cannot prevent a plan from being approved. Distributions or new debt that do not make a particular class "whole" (termed "impaired"), if accepted by two thirds of that class of creditors, can be "crammed down," and applied to all creditors within that class. Dissident minority holders will, as a consequence, be reluctant to have their legal claim stripped and be placed in this alternative-less situation. They, in turn, will try their very best to avoid bankruptcy proceedings. Negotiations proceed with each side having recourse to the bankruptcy system as both a safe harbor and a potent weapon. Ultimately, however, if the reorganization plan does not work, the corporate entity is liquidated and the remaining assets - little as they may be - will be divvied up amongst the creditors on a priority of claims basis.

In addition to the bankruptcy code, a restructuring in the US via debt exchanges involves the hold-out problem. The Trust Indenture Act (1934) could prevent issuers from altering the principal, coupon or maturity of a bond without the unanimous approval of bondholders.<sup>23</sup> Therefore, a group of bondholders can refuse to agree to a mutually beneficial debt exchange, and hold out, unless a specific set of demands is met. Obviously, the end game in the hold-out paradigm is to pay off the maturing claims of those "holding-out" with any savings which otherwise would be realized by a proposed recapitalization. In response, issuers can use the threat of bankruptcy or adverse indenture amendments to induce creditors to accept an unfavorable restructuring of liabilities, which would preserve value for equity holders even though the firm has not met its obligations to its creditors.

In situations wherein the issuer is in a crisis, bondholders should theoretically want to scale down their claims in order to avoid the high costs and uncertainty of bankruptcy. Yet, interestingly, out-of-court consensual restructurings are difficult to achieve, and exchange offers made by distressed issuers to their bondholders regularly fail.<sup>24</sup> Part of the problem is a direct consequence of the difficulty involved in apportioning losses in accordance with priority of creditors' positions in the capital structure. Creditors often assume that the Absolute Priority Rule (APR) will bind in a bankruptcy court, and so are unwilling to accept out of court restructuring terms that appear to deviate from it.<sup>25</sup> This issue arises when the offer involves more than one class of creditor, or more than one specific debt issue.

Similar to the hold-out problem is a phenomenon known as the "big-player" or "cram-down" in debt exchange. In these cases, a large group of bondholders may also be stakeholders in the issuing enterprise through stock ownership or through other business relationships. As such, the big-player may have a stronger interest in maintaining the issuer as a going concern than does the smaller bondholder. When such relationships exist, exchanges which clearly hurt the smaller bondholder may be "crammed-down" if the tender minimum can be met, mostly or entirely by the vote of the big player. <sup>26</sup>

<sup>21.</sup>Chapter 11, § 303,

<sup>&</sup>quot;(b) An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under Chapter 7 or 11 of this title

<sup>(1)</sup> by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder, if such claims aggregate at least \$10,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

<sup>(2)</sup> if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least \$10,000 of such claims;..."

<sup>22.</sup> Dissident bondholders within a class can be forced to consent as long as there is approval from two-thirds of the class in amount and a majority of the claims in number. See 11 U.S.C. §§ 1126 (c) & 1129(a)(8). In some circumstances, the plan can also bind a dissenting class of creditors (this is referred to as a "cram down"). See 11 U.S.C. §1129(b); Kenneth N. Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 AM. Bankruptcy L. J. 133 (1976); Cram Down II, 64 AM. Bankruptcy L. 1229 (1989)

<sup>23.</sup> Unless otherwise specified in the terms of the bond agreement. Generally referred to as "collective action clauses" (CACs), when explicitly stated in the terms of the bond instrument, it is possible to have a supermajority of claims-holders accept the new terms whereby they become mandatory on all claim holders. As a matter of practice, bonds issued in New York (New York Law bonds) do not have such super-majority clauses; bonds issued in London (English Law bonds) do. For a better description of the differences in US and English practices, see Yianni, " Resolution of Sovereign financial Crises - Evolution of the Private Sector Restructuring Process", in Bank of England, Financial Stability Rev. 78, 80-81 (June 1995). Also, see supra note 10.

<sup>24.</sup>Anne Schwimmer, "Hard Truths about the Restructuring Business", Investment Dealers' Digest 18 at 20 (Nov. 26, 1990).

<sup>25.</sup> Eberhart & Sweeney (1992) and Eberhart & Weiss (1998) document deviations from APR even in Chapter 11 cases.

It is interesting to note that New York law has, over the decades, stubbornly maintained its unanimous consent clauses for terms of payment, and refused to import the CACs of English Law. This can, perhaps, be traced to the history of the New York drafting conventions, and the imbalance that they sought to correct. <sup>27</sup>

## A. But Sovereigns Are Different

"Sovereignty - The power to do everything in a state without accountability, - to make laws, to execute and to apply them, to impose and collect taxes and levy contributions, to make war or peace, to form treaties of alliance or of commerce with foreign nations, and the like."  $^{28}$ 

Ultimately, however, it should not be forgotten that the issuer under consideration here is a sovereign. And sovereign immunity law is a secure doctrine in international law with universal jurisdiction that lends authoritative shelter to many of the sovereign's assets. Thus, currently, if a sovereign in financial crisis cannot bring a tenable proposal to the restructuring table, and its creditors have New York style bonds, then they can bring a suit in court. However, in general, a sovereign's vulnerability to legal attack is limited as it is directly linked to three factors:

- 1) The viability of legal action:
  - Does the governing law under which the debt instrument was drafted offer access to the courts?
- 2) The availability of monetary recourse:
  - Will the creditor be satisfactorily compensated at the end of the legal process?
- 3) The characteristic of those who hold the outstanding bonds:
  - Is the up-side great enough for the creditor to pursue the costly and time-consuming litigation route?

If the answers to all three questions is a resounding "yes" chances are the sovereign is at risk for legal action in the event of a restructuring or default. If however, any one of these questions is answered in the negative, then lawsuits are unlikely. They are, quite simply, not worth the time or the effort. This leaves the sovereign in an interesting position. In instances where it has little or no assets in the jurisdiction of the suit, the creditors have no reason to sue. The sovereign can thus renegotiate the terms of the exchange in any way it deems fit, provided it does not plan to issue any more bonds in the jurisdiction the suit was brought.<sup>29</sup> The investor's most powerful retaliation is, perhaps, to not invest again.

# VI. Back To The Proposals - Their Impact

Both the suggested IMF and Treasury approaches turn on the premise that the hold-out creditor has gained significant power over the past two decades and has in effect thwarted and possibly deterred the negotiation efforts of sovereigns in times of extreme distress. Rather than risk being taken to court, presumably the sovereign would rather put off the inevitable restructuring until a crisis erupts, and multilateral institutions step in to bail them out. Regardless of the cause of the breakdown in process, the result has been a drop in foreign portfolio investment to emerging markets, affecting investors and debtors alike.

The mechanism used to restrain this rogue investor is different in the two proposals: the IMF's SDRMs impose a moratorium and explicitly, through treaty law, deny legal recourse to the investors; while the Trea-

26. An example might be an exchange that amounts to a debt-for-equity swap allowing the issuer to avoid bankruptcy. The minority of former bondholders that voted against the tender offer experience an uncompensated loss when the majority that accepted the tender offer are able to take actions that impair the interests of the minority, who are still debt holders, such as modifications to the indenture that effectively strip protective covenants. The end result may be that the minority bondholders stand to recovery much less in a subsequent bankruptcy than if the firm had filed for bankruptcy immediately. Moody's may consider an exchange to have been involuntary and to have caused a monetary loss, even if only a small proportion of bondholders appeared to have been coerced.

27.See e.g., Altman, Edward I., (1986), "Bankruptcy and Reorganization", in Edward I. Altman Ed.: Handbook of Corporate Finance.

27.See *e.g.*, Altman, Edward I., (1986), "Bankruptcy and Reorganization", in Edward I. Altman Ed.: Handbook of Corporate Finance, Wiley & Sons, New York; Jaffe, Mark M., "Chapter 11 Strategies and Techniques - Creditors Committees, Effective Use of Plan Provisions, Objections to Confirmation, Financing a Chapter 11 Case, "Cramdown" and How It Works", 59 *Tulane Law Review* 1298 (1985).

Reier, Sharon, "Bankruptcy Boondoggle", Financial World 36, 38, (October 16 1990). See also, Coffee, John C. Jr., and Klein, William A., "Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations," 58 University of Chicago Law Review 1207 (1991). ("We believe that bankruptcy costs are substantial, particularly for those issuers whose bondholders have accepted coercive exchange offers. In these cases, high bankruptcy costs do arm the issuer with substantial leverage, by which the issuer can negotiate a pre-bankruptcy reduction in its indebtedness that still leaves the shareholders owning substantial equity in the corporation. We appreciate that the academic literature has long debated the size and significance of bankruptcy costs.")

28. Black's Law Dictionary, Sixth Edition, page 1396 (1990).

29. As was a sovereign sued in court cannot issue new debt in or borrow out of any jurisdiction that would accept the court's order of attachment. Specifically, the stream of funds can be attached by the litigious creditor. The threat of such a sanction has proven to be significant in a recent.

sury also suggests a moratorium of sorts, and recommends that all sovereigns issue bonds with majority consensus rules that extend to terms of payment clauses. In this instance, the bondholder does not lose his right to litigate *per se*, but must access the courts through a representative that the majority chooses to negotiate on its behalf during a restructuring.

The worst possible scenario for a sovereign bond investor is when the sovereign declares itself in crisis, proposes a restructuring plan, and that plan is untenable to the investor. In such instances, there is very little the unlucky investor in possession of the illiquid bond can do. The one available recourse, which has in fact developed in response to this blatant imbalance of power, is to take the sovereign to court and sue for restitution. Even under this circumstance, due to sovereign immunity laws and to jurisdictional restrictions, the litigious investor is likely to lay claim on very little. In addition to the limited assets available for attachment and seizure, the actual costs associated with legal action are sufficiently staggering to deter all but the most incensed investors.

However, the simple threat of legal action is a powerful tool. The investor base that has the courts available to it has a bargaining chip in the negotiations with a sovereign planning a debt restructuring. To avoid the associated stigma of a suit or a settlement, the sovereign may be motivated to offer the best exchange it possibly can.

#### 1)Inter-creditor Disputes - Parity of Claim

Although both suggested approaches recognize that creditors will disagree amongst one another in the restructuring process, neither approach presents a clear means of incenting or ensuring that the majority does in fact arrive at an agreement on parity or priority of claims. The issue of majority consensus is especially important in instances where the investor base is large and disparate. In both instances, this essential dilemma has been left to the creditor and the issuer to decide.

Put simply, the situation as it stands today will not been remedied through either of these recommendations. The dispute amongst the creditors and the issuers as to "who gets what and when" is one of the driving forces behind the issuer's trepidation toward offering an exchange. When the investor base is large and dissimilar, it is too difficult to make sure that the majority of the creditors will be happy.

#### 2)Legal Recourse is Valuable - Yield May Increase

It is possible that if rules were implemented which effectively took away legal recourse from individual bondholders, some investors would demand a higher coupon. Arguably, a device that takes away the individual bondholder's right to seek legal action and enforce his claim in court renders the relevant investment instrument more, not less, risky. The one negotiating tool that had been available to the investor, in the worst possible case scenarios, has been taken away.

Under both of the proposals currently under discussion, while the sovereign is being provided with incentive to declare bankruptcy or a moratorium of sorts, it is not being given any incentive to come up with a tenable solution to its crisis. Neither are creditors given any incentive to reach an accord sooner than they would otherwise have. However, with their right to legal recourse removed, creditors may be deprived of a powerful tool to use at the restructuring table with the sovereign and with one another.

Therefore, it is difficult for us to see how either of these proposals, in their present form, would address the concerns of the international financial community.