SOVEREIGN DEBT RESTRUCTURING: THE JUDGE, THE VULTURES AND CREDITOR RIGHTS

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Abstract:

We analyse the role of judicial intervention in helping to achieve the Argentine debt swap of 2005 with a super-majority of 76% of creditors (by value). The courts appear to have exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement – to achieve a swap and to protect creditor rights. Our analysis shows how the courts have *de facto* carried out two of the key roles envisaged for the IMF's still-born Sovereign Debt Restructuring Mechanism (SDRM) – namely Transition and Aggregation; and it suggests how the courts can, in future, complement the market-based alternative promoted by the US Treasury - i.e. collective action clauses (CAC'S) in sovereign bond contracts.

Keywords: Sovereign debt restructuring, holdout creditors, collective action clauses

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Non technical summary (and Post-script on current developments)

The Argentine swap and the debate on SDRM versus CACs.

In 2005, Argentina successfully restructured the majority of its defaulted foreign debt by means of a swap in which three quarters of the debt was converted into new bonds[1]. It has to be said that achieving the swap owed little to recent ideas for revising the international financial architecture; nor did it make use of contract provisions designed to promote bond restructuring. Following the swap of bank-loans to bonds under the Brady Plan, the IMF had put forward a proposal for a Sovereign Debt Restructuring Mechanism (SDRM) along the lines of Chapter 11 of the US Bankruptcy code. The US Treasury, on the other hand, favoured the universal inclusion of collective action clauses (CACs) in sovereign bond contracts.

The IMF proposal was, however, effectively blocked in 2003 by a coalition of creditors, debtors and the US government, leaving the field open for the adoption of CACs. Argentine bonds involved 152 different issues in eight different jurisdictions; but they did not generally include such clauses. Nevertheless, a swap was achieved in 2005 with participation by a supermajority of 76% of creditors by value despite the substantial haircut involved. How was this done?

Judge-mediated debt restructuring

The New York Second District Court judge appears to have exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement, in particular – first to achieve a swap and then to protect creditor rights. Our analysis of the opinions and orders of Judge Griesa's court suggests four distinct judicial functions. First comes the *engagement of the debtor*: the Judge finds in favour of holdouts in order to encourage the debtor to make an offer. Second is *promoting the swap*: he refuses enforcement long enough to promote

[1] Note , however, that a quarter of the nominal value of debt (about $20b) remains in default: despite obtaining successful judgements in their favour, the holders of these defaulted bonds have received nothing from Argentina.

a successful debt swap. Third *threatening attachment*: once the swap has been accepted by a supermajority, it is time for the courts to threaten the debtor with enforcement (effectively denying it access to primary capital markets). Finally, *direct mediation*: at the same time as the judge threatens attachment, he is willing to resolve disagreements between some holdouts and the debtor to settle outstanding claims. Currently, the last two phases prevail simultaneously.

Recent academic appraisal

For Porzecanski (2005,p.331) the case of Argentina suggests that “rogue debtors, rather than rogue creditors, are the ones that pose the greatest threat to the integrity and efficiency of the international financial architecture.” Despite the waiving of sovereign immunity, he continues, “the fact remains that it is exceedingly difficult to collect from a sovereign deadbeat [and] the sad truth is that only other governments…can hope to rein in a wayward sovereign debtor and persuade it not to walk away from its lawful obligations.”

By contrast, Sturzenegger and Zettelmeyer (2005c, p. 10) commend the Argentine swap as “in most dimensions a textbook example of how to do an exchange”. Their review of the evidence from recent litigation in international debt markets Sturzenegger and Zettelmeyer (2005b pp. 7,51) has led them to conclude first that “a good model of sovereign debt should assume that creditors cannot impose any sanction on defaulting countries” ; but second that creditors “can hinder access to international capital markets”.

In their analysis of the regulatory reforms proposed for sovereign debt restructuring, Fisch and Gentile (2004) commend the judicial enforcement of sovereign obligations (through holdout litigation) over the uncertainty of market-driven, reputational sanctions.

Our conclusions

Examination of the Argentine debt swap of 2005 leads us to challenge Porzecanski's conclusion that the courts are irrelevant. Our analysis of judicial proceedings in this case leads us to conclude that, at least in the process of transition to CACs, holdout litigation may be key to preserving creditor rights in sovereign bond markets. The courts appear to play a key role and, for reasons of to do with aggregation, we expect this to continue even when CACs are in general use.

Update on current developments

In March of 2006, the Argentina government was able to issue new sovereign dollar denominated bonds which were taken up by New York bank. The bonds were issued in Buenos Aires not New York and were ranked as B- (well below investment grade); but they were placed at a yield of 8.36%, i.e. at a respectable spread of 3.7% over US Treasuries.

The New York banks are lending into a situation of serious arrears to those who did not join the swap -- which appears to contradict the requirement of Kletzer and Wright's (2002,p.635) reputational model that 'lenders will not deal with the borrower until her obligation to the initial lender has been discharged." Is this a signal of a serious breakdown in the ranks of creditors? Is this a case where a rogue debtor is raising fresh money despite the efforts of the vultures and the judge to hinder access?

We believe the answer is no to both questions, for the following reasons. Firstly, the spread charged on the new issue is not that of a rogue debtor: it is broadly in line with currently performing sovereigns elsewhere. Secondly, Argentina is not raising fresh money; it is raising cash to repay principal due i.e. it needs this money to avoid default. Thirdly, the fact that this is being done outside New York (and well below investment grade) suggests that the Court's actions are effectively denying the sovereign full-fledged return to financial markets.

Proper resolution of the swap will require some settlement with the unpaid creditors: possibly after upcoming elections. Meanwhile, what we observe is a delicate equilibrium. The act of borrowing is a signal that the sovereign does not want to go into default on issues currently being serviced. The NY banks know Argentina needs the money to avoid default (and there's a $1 billion more needed this year); but they feel safe in lending under Argentine jurisdiction, as is reflected the spread.

Judge Griesa on the other hand continues to threaten Argentina with attachment and signals his willingness to resolve any disagreements that it may have with the holdouts. The increasing judicial intervention in the restructuring of Argentine debt reveals a renewed role for the courts.]

Introduction

In 2005 Argentina successfully restructured the majority of its defaulted foreign debt, converting three quarters into new bonds.[2] But, despite obtaining successful judgements in their favour, the holders of the debt remaining in default (about $20b in nominal value) have received nothing from Argentina for more than a year after the swap.

The progressive switch from bank loans to sovereign bonds in lending to emerging markets - and the Brady Plan in particular – triggered a lively debate on bond restructuring, and the potential obstacles posed by 'holdout creditors'[3]. But the IMF proposal for a new Sovereign Debt Restructuring Mechanism (Krueger, 2003) to tackle the issue found little favour with creditors or debtors; and this left the US Treasury-backed initiative for putting Collective Action Clauses into sovereign bond contracts as the preferred alternative. But the Argentine debt swap was neither mediated by the IMF, nor assisted by clauses to promote creditor coordination: it was affected by a take-it- or-leave-it offer from the debtor, accepted by a supermajority of holders despite the substantial haircut involved.

To some observers, the case of Argentina suggests that "rogue debtors, rather than rogue creditors, are the ones that pose the greatest threat to the integrity and efficiency of the international financial architecture," Porzecanski (2005, p.331). Despite the waiving of sovereign immunity, he continues, "the fact remains that it is exceedingly difficult to collect from a sovereign deadbeat [and] the sad truth is that only other governments…can hope to rein in a wayward sovereign debtor and persuade it not to walk away from its lawful obligations."

Sturzenegger and Zettelmeyer (2005c, p. 10) evidently do not share this pessimism: for them the Argentine swap was "in most dimensions a textbook example of how to do an exchange". It should be said that, in reviewing recent litigation in international debt markets, they find no evidence that sanctions on trade and payments have been imposed in an effective way. Why are they nevertheless relatively optimistic as to the

[2] With bondholders taking a haircut of about two thirds in the process
[3] These include vulture funds who buy distressed debt in default and sue for payment in full.

functioning of sovereign debt markets? Recent developments, they argue, provide support for the assumptions in the seminal paper by Eaton and Gersovitz (1981): while "creditors cannot impose any sanction on defaulting countries, they can hinder its access to international capital markets", Sturzenegger and Zettelmeyer (2005b, pp.7,51).

Examination of the Argentine debt swap of 2005 leads us to challenge both views. Porzecanski concludes that the courts are irrelevant, but we note that the judge appears to have exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement, in particular – first to achieve a swap and then to protect creditor rights. Our analysis of the opinions and orders of Judge Griesa's court suggests four distinct judicial functions. First comes the *engagement of the debtor*: the Judge finds in favour of holdouts in order to encourage the debtor to make an offer. Second is *promoting the swap*: he refuses enforcement long enough to promote a successful debt swap. Third *threatening attachment*: once the swap has been accepted by a supermajority, it is time for the courts to threaten the debtor with enforcement (effectively denying it access to primary capital markets). Finally, *direct mediation*: at the same time as the judge threatens attachment, he is willing to resolve disagreements between some holdouts and the debtor to settle outstanding claims. Currently, the last two phases prevail simultaneously.

This analysis of recent developments suggests that a simple dichotomy between sanctions and reputation is missing a key factor: that the courts can effectively ensure a successful swap. It was vultures acting through the courts that triggered the first offer from Argentina in 2003: and currently, the courts are simultaneously denying Argentina access to primary bond markets with the judicial threat of attachment and willing to directly mediate a settlement between Argentina and the holdouts that will successfully conclude the swap.

In their analysis of regulatory reforms for sovereign debt restructuring, Fisch and Gentile (2004) emphasise holdout litigation for the judicial enforcement of sovereign obligations. We see the role of the courts continuing to be important: but that of the vultures as a 'transitional' issue. In a future where CACs are widespread, it may well

be *ex ante* Creditor Committees and 'judge-mediated' debt restructuring that trigger the debtor to come up with an offer ; and Super Majority Voting that binds in the holdouts.

The paper is organised as follows: Section 1 briefly outlines salient features of the Argentine case. Section 2 offers a bargaining interpretation of the swap. Sections 3 and 4 analyse the opinions and decisions of the New York courts: encouraging the debtor to make the first offer (in Dubai September 2003); promoting the ensuing debt restructuring process (from Dubai to the final offer in March 2005); and revealing a way in which the outstanding holdout problem can be resolved. Section 5 discusses what light the Argentine case - and our interpretation of it - throws on the question of why sovereigns pay. Section 6 sets out how the widespread adoption of CAC's will reduce the role of vultures in future and sketches the role that courts and creditor committees will play. The last section concludes.

1. Key aspects of the Argentine debt - and some comparisons

Salient features of the Argentine swap are summarised in Table 1 compiled by Porzecanski (2005). Four aspects are worth highlighting.

Table 1 Comparison of Recent Sovereign Debt Restructurings

(Porzecanski, 2005)

	ARGENTINA 2005	**ECUADOR 2000**	**PAKISTAN 1999**	**RUSSIA 1998-2000**	**UKRAINE 1998- 2000**	**URUGUAY 2003**
Per Capita Income ($)*	11,586	3,363	1,826	6,592	3,841	8,280
Scope ($ Billions)	81.8	6.8	0.6	31.8	3.3	5.4
Number of Bonds	152	5	3	3	5	65
Jurisdictions Involved	8	2	1	1	3	6
Months in Default	38+	10	2	18	3	9
Principal Forgiveness	Yes	Yes	No	Yes	No	No
'Haircut' in Discount Bond (%)	66.3	40	0	37.5	0	0
Participation Rate (% of Eligible)	76	97	95	98	95	93

Note: N/A stands for not applicable

** Adjusted for purchasing power, latest (2003) data for Argentina, otherwise data corresponds to year(s) of debt restructuring as noted.*

Source: IIF IMF, World Bank, A. C. Porzecanski's Calculations.

a. Pronounced creditor heterogeneity

Argentine debt in default contained a significantly higher number of bond issues than all the other cases listed in the table: it involved many thousands of creditors in eight different legal jurisdictions. The sheer numbers posed a major obstacle to affecting a swap. Perhaps more significant however, were the conflicting incentives affecting different groups.

As Fisch and Gentile (2004, p. 26) note '[o]nly certain *large institutional investors*, particularly commercial banks and investment banks have ongoing relationships with the sovereign debtors… [this] may drive these institutional investors to support restructuring plans that are unlikely to be acceptable to smaller investors, notably *retail investors*, who do not expect to gain from future transactions…' In addition, there are a specialised class of *holdout litigants* popularly known as 'vulture funds' who purchase distressed debt at substantial discounts and seek capital gains either through the restructuring process or by holding out and seeking additional payments from the debtors. (The 24% creditors still holding defaulted Argentine bonds include both vultures and retail investors.)

b. Absence of creditor co-ordination

Argentina's creditors participated in the swap in the absence of either formal or informal creditor organisations. One exception was the short lived Global Committee of Argentine Bondholders (GCAB). The GCAB was set up in 2003 to pool negotiating leverage and demand a better deal claiming to represent US, European and Japanese creditors holding about $40 million. But at the time of the swap, the GCAB had lost most of its institutional constituents and a majority tendered in the exchange. This attempt at creditor organisation failed as each seemed to act in their own self-interest and took the opportunity to cut their losses and make short term gains, Gelpern (2005).

c. Significant debt write-down

On a total outstanding principal of $81.8 billion, the Argentine swap involved a 66.3% 'haircut' (column 1). The only other haircuts shown are 40% for Ecuador and 37.5% for Russia. The 76% participation rate in the swap is by far the lowest shown and implies that Argentina is still in default with 24% of its creditors by value.

d. Long Delay

It took over three years for Argentina to restructure its debt - more than twice as long as it took Russia for example. In part the reasons were political as the interim administration of President Duhalde had no mandate to negotiate a swap. Economic reasons for delay are analysed in the next section.

2. The Argentine swap: a bargaining approach

It is clear from Table 1 that lenders to emerging markets maybe exposed to substantial losses -- and to prolonged delay in restructuring in some cases. But the Argentine case challenged the idea that the IMF must play a central role in arranging sovereign debt swaps: stymied by conflict of interest and criticised by both debtor and creditors for its earlier handling of Argentina's affairs, the Fund had to withdraw to the sidelines and let creditors and the debtor sort things out themselves. "Argentina has become a test case for a vastly reduced role for the IMF and the official sector more broadly in the sovereign debt restructuring process", Roubini and Setser (2004a).

In the absence of decisive third party intervention, Dhillon et al. (2006) apply a bargaining approach to explain both the final settlement and the delay in achieving it. Because it predicts prompt settlement, the Rubinstein model of alternating offers, applied to sovereign debt negotiations by Bulow and Rogoff (1989) is not used. Instead the authors follow the approach of Merlo and Wilson (1998), where the size of

the pie is uncertain and 'efficient delay' can occur as creditor and debtor wait for economic recovery (fearing that early settlement will lock in the recession).

Based on the creditor response at Dubai in 2003 - when the Argentine government calculated the limits set by sustainability - Dhillon et al. (2006) estimate that the pie to be divided between debtor and creditors was worth almost 3% of GDP. Allowing for the "first mover" advantage for the debtor as proposer, the bargaining model implies that creditors receive a little under half the pie, a flow transfer of about $1.85bn dollars at 2004 prices. On this basis, the predicted recovery rate on debt without interest is 41 cents - a little better than the actual Buenos Aires offer (estimated to be worth about 37 cents).

As for the prolonged delay, the authors note first that political factors played a critical role until 2003 when President Duhalde - appointed earlier by congress as interim office-holder - was replaced by President Kirchner after a general election. Because the expected annual rate of economic recovery in 2003 still exceeded the time rate of discount[4], it is claimed that further postponement was economically 'efficient'.

An alternative account for delay under President Kirchner is explored by Ghosal and Miller (2006). It is noted that, where the debtor is aware of the constraints set by sustainability but the creditor is not, the debtor may have an incentive to make a low offer leading to delay to act as a *signal* to the creditor that sustainability is a serious cause for concern. While the Argentine government did not expect the creditors to accept their initial proposals at Dubai, the final settlement reached in 2005 was broadly in line with their sustainability guidelines; so, it is suggested, the delay may reflect a successful signalling strategy adopted by the President and his finance minister. [5]

Details of the final settlement (and how it compares with other cases) were provided in the previous section using calculations by Porzecanski (2005) He notes in his

[4] Estimated to be 4% for both parties

[5] Roberto Frankel, an economist who was a close observer of the swap, reckoned that the finance minister deserved a bronze statue in the Plaza de Mayo for his negotiating tactics! (Liascovich, 2005, p.257)

introduction that "A sinking currency rendered the government instantly insolvent; the net government debt, which at the one peso per dollar exchange rate was equivalent to three times tax revenues and 50% of GDP, virtually tripled once the currency sank to around three pesos per dollar, becoming unaffordable to service." He also observes that policy prior to 2002 involved the authorities in "betting the ranch" by borrowing almost exclusively in dollars and other foreign currencies to finance a string of budgetary deficits, even though their revenues were due and collected only in pesos.[6] Hence it is not the size of the write-down, nor the delay in achieving it, that could qualify Argentina as a rogue debtor. *Ipse dixit.*

3. Judge-mediated debt restructuring: from default to swap

a. Historical precedents

In 1976, the US (and soon after the UK) imposed statutory constraints on absolute sovereign immunity from suit in foreign courts without consent Buchheit (1995). In the two decades that followed, creditors developed innovative litigation strategies to maximise the benefits of restricted sovereign immunity. In the absence of statutory regulation of sovereign debt, however, the litigation strategies have had mixed results - with common law decisions influenced by the political and economic conditions in which the litigations were pursued.

This is not to deny that creditors have significantly influenced debtor's conduct. In the case *Elliot & Associates v. Banco de La Nacion* (Peru) decided in 1999, for example, the claimants were vulture funds who threatened the debtor with enforcement and consequent delay of the imminent swap: the debtor settled their claims out of court to avoid this outcome. Similarly, in the case of *Elliot & Associates v. Panama* decided in 1997, the threat of enforcement would inter alia have interfered with a new bond issue and consequently impair Panama's ability to access capital markets. Again the case was settled out of court, in favour of the vultures.

[6] For an interesting analysis of how a government which cannot pre-commit to control spending may expose the country to recurrent crises, see Rochet (2005).

Thus even in the absence of enforcement, restricted sovereign immunity has significantly improved the leverage of creditors in the restructuring process. In the case *Pravin Banker v. Banco Popular del Peru* decided in 1997 for instance, the court went so far as to lay down the guidelines that they would follow in sovereign litigation. The first guideline was to encourage orderly debt restructuring initiatives that involved the use of Brady bonds. The second guideline was to ensure the enforcement of contracts executed between American investors and sovereign debtors. In line with U.S. foreign policy at the time, in most cases, the second guideline predominates the first. Thus in a situation where ongoing debt restructuring negotiations were at the cost of the claims of U.S. creditors, the courts were bound to concede to the latter.

b. The court's role in the Argentine swap

The Argentine swap was successfully concluded against the backdrop of over 200 law suits – (including 15 class action suits) filed in New York, Italy and Germany. How was this achieved? We believe that in large part it was due to mediation by the judge and in Table 2 we set out a description of Judge Griesa's actions to promote restructuring.

Table 2. Judge Griesa's Actions to Promote Restructuring

Event	**In favour of holdout creditors**	**In favour of restructuring**
Rush to court house	Summary judgements in favour of creditors	Stays execution
Class action to coordinate creditors	Accepts in principle	• encourages tighter definition of a 'class' • keeps *pari passu* pending
Grab race: for old bonds	Orders creditor attachment (of Argentina's right to receive old bonds)	Order to attach overturned in view of its negative impact on the ongoing swap
Grab race: for new issues	Maintains the threat of enforcement	

Column one describes the events, while columns two and three distinguish orders on the basis of whether Judge Griesa favours the holdout creditors or promotes the restructuring. In the first instance (row one), the creditors who "rushed to court" when President Kirchner was elected, successfully obtain summary judgements: Judge Griesa has no option but to allow such claims [e.g. *E.M.LTD v. The Republic of Argentina* (12 Sept 2003)] (column two) . This is only part of the story, however, as successful claimants have to enforce their judgements against the debtor by attaching its assets. This is where Judge Griesa exercises his discretion, dismissing pleas to attach specific assets of the debtor (final column).

In addition in 2003, relatively early on in the debt restructuring process, the creditors seek to certify class action suits (row two). Judge Griesa accepts certain claims encouraging creditor coordination [*H.W.Urban GMBh v. Republic of Argentina* (30 Dec. 2003)](column two). However, in his orders rejecting some class action suits,[e.g. *Alan Applestein TTEE v. The Republic of Argentina* (May 12, 2003)], he encourages tighter definition of class: he also keeps *pari passu* pending[7] (column three).

In the context of the class action suits, Judge Griesa's observations (*obiter dicta*) are instructive. At one point, he observes that

> an important channel for attempting to resolve the Argentine debt problem will undoubtedly be the effort to negotiate a debt restructuring plan.' He continues: 'judging from past national debt crises, these negotiations will be carried on largely, if not entirely by debt holders who do not choose to engage in litigation. To the extent that the other debt holders whether few or many wish to pursue litigation, the litigation should be well defined and its participants should be reasonably identifiable. One reason for this is that those involved in the debt restructuring process should have a clear idea of who has chosen litigation and thus may not be candidates for participation in a voluntary restructuring plan.

[7] With the US administration supporting Argentina's reading of the clause, see Appendix.

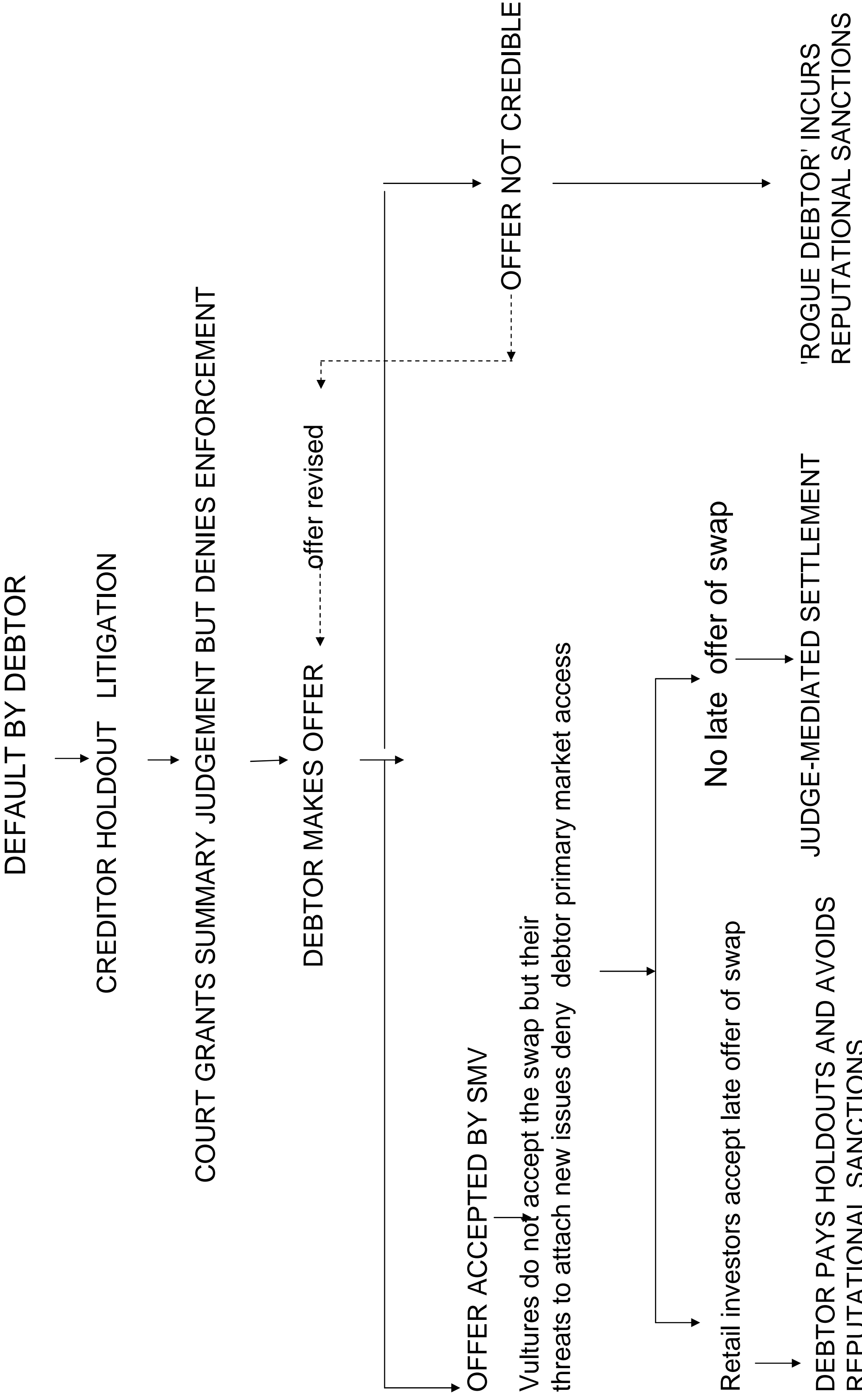
In early 2005, just before completion, the vultures attempt to stymie the swap. In the first instance, they succeed in their bid to obtain an order to attach the contractual right of the debtor to receive old bonds [*NML Capital Ltd. v. The Republic of Argentina* (13 Mar. 2005)]. In response to Argentina's submission that this would make the sovereign abort the swap, Judge Griesa overturns his own judgement. In contrast with precedent, the Judge is motivated by a concern to promote restructuring and not only to enforce the claims of holdout litigants. Judge Griesa's decision is affirmed by the Second Circuit who find '[t]hat restructuring is obviously of critical importance to the economic health of the nation.' The findings (in the decisions to vacate the attachment orders) assure the creditors who may wish to participate in the swap that the court will ensure its successful conclusion.

c. Judge-mediated debt restructuring

Chart 1 provides a summary of the sequence of events described above - and where they may lead. As a preliminary we note that, in his decisions, Judge Griesa views the debt as a consolidated whole and continuously keeps the claims of the holdouts distinct from the ongoing swap.[8]

[8] Thereby avoiding the problems that 'potential multiple issuance holdouts' pose to the successful completion of swaps (IMF, 2003c).

Chart 1 Judge-mediated debt restructuring



Following default by the debtor, the court grants summary judgements in favour of holdout creditors as a means to prompt the debtor to make an offer. Then, in marked contrast to precedent, Judge Griesa reins the holdout creditors in so as to promote a settlement. Judge Griesa is concerned with the reasonableness of the swap and the percentage of creditors who consent to the amendment. He may well have elicited a degree of support above the 75% level associated with collective action clauses. But as the chart indicates, this is not the whole story: 24% of creditors are outside the swap and there are no collective action clauses to ensure their compliance. This brings us to the current phase, i.e. the post-swap outcomes analysed in the next section.

4. Judge-mediated debt restructuring: a speculative analysis of post-swap outcomes

So far, the post-swap phase of Argentine bond litigation has consisted of unsuccessful attempts by professional holdouts to attach the assets of the sovereign, the initiation of judge mediated debt settlements and forthright denials by the debtor to compensate creditors outside the swap. For Porzecanski (2005) the latter constitutes the actions of a 'rogue debtor'- defined as a sovereign who can pick and choose the claims it wishes to satisfy and ignore the rest.

This pessimistic assessment of the situation is not borne out by low post-swap, sovereign spreads paid by the debtor in secondary markets for its existing debt, however, i.e. the market does not appear to share Porzecanski's dire predictions (Sturzenegger and Zettelmeyer, 2005c, p.10). Additionally, Judge Griesa has recently warned Argentina of the danger that its assets are still open to attachment. A similar decision was also made in favour of the holdouts by the German courts. Fisch and Gentile (2004) suggest a relationship between the availability of judicial enforcement and the functioning of sovereign debt markets: this is because holdouts, especially vultures, impose costs on defaulting debtors and such costs are essential for the maintenance of sovereign debt itself. Finally, in Judge Griesa's recent summary

judgements [*Vanina Andrea EXPOSITO v. The Republic of Argentina* (17 Feb. 2006)] he directs that

> Judgement will be entered for the principal amount of the bonds plus accrued interest. The parties shall consult with one another concerning the form of the judgement and the amounts of interest that should be awarded in the judgement. If the parties are unable to reach an agreement on those subjects, they shall jointly submit an agreed proposed judgement to the court. If the parties are unable to reach agreement on those subjects, plaintiff shall submit a proposed judgement to the court, and the Republic shall submit any objections to plaintiff's proposed judgement within five business days thereafter. The court will then resolve any remaining disagreements.

In the post swap phase, Judge Griesa shows the courts willingness to mediate a settlement and successfully complete the swap. The 24% of Argentina's creditors who did not participate in the swap are a heterogeneous group, comprising vultures and retail investors *inter alios*. Holdouts now have the option of submitting their claims to the court and possibly obtain what the other participants obtained in the swap: and this may be the way for retail investors to settle their claims, Porzecanski (2005).

In the interests of their reputation, vultures may not be inclined to accept a haircut of two thirds; they have the patience and skill to holdout for years and the continuing legal threat suggests that their strategy will be to prevent Argentina from accessing primary capital markets. It is acknowledged in the literature that holdouts in the post-swap phase of a sovereign debt crises can interfere with a sovereigns' future access to international financial markets by attaching new bonds, Sturzenegger and Zettelmeyer (2005a)[9]; and the precedent for the possibility of attaching the proceeds of new bond issues is the case of *Elliot & Associates v. Panama* (see above). However, the courts willingness to mediate a settlement for some holdouts can prompt Argentina to use this option to resolve its present stand off with the vultures

[9] 'Holdouts currently enjoy some leverage …this leverage is basically restricted to the possibility of attaching new flows the country may obtain in international markets.' p 14

Chart 1 above sketches two possible outcomes. First, on the left , is a court-mediated debt restructuring . The outstanding court orders require that holdout creditor claims (for something much closer to the face value of the debt) need to be satisfied. Ironically, judicial enforcement -- with its lack of voluntariness-- may free Argentina from its 'most favoured creditor' commitment to those in the swap[10]: the debtor can be seen to have had no choice but to accede to holdout (especially vulture) claims.

Of course, if the current impasse were to continue indefinitely with Argentina making no effort to compensate the retail investors outside the swap and running the gauntlet of the holdouts in all its international financial transactions, it would surely come to be treated as a rogue debtor and suffer whatever reputational sanctions that implies. This is the second outcome indicated on the right hand side of Chart1.

5. Why sovereigns pay?

How does the analysis in this paper relate to the existing literature on the incentives for sovereigns to repay debt? What role have these incentives played in the Argentine case? The academic literature has stressed the role of 'direct' sanctions, 'reputational' sanctions, and of 'policy conditionality' rather than judicial interventions that effectively denies a debtor access to primary markets and provides the possibility of judge-mediated debt settlements. This is indicated in Table 3.

[10] The 'most favoured creditor' clause (MFC) clause … sought to assure participating creditors that holdout would not get a better deal. (Gelpern, 2005, p 5)

Table 3. Why do sovereigns pay?

	Loss of	Comment	Agent/ Institution	Mechanism	Argentina(2005)
Sanctions	Exports	Transfer	'Gunboat'(1)		Illegal under WTO
	Output	Transfer	'Gunboat'(2)		Illegal under international law
		Deadweight	Crisis(3),	Creditor panic	Yes (including anticipatory crisis (4))
	Trade credit		Banks(5)	Deny rollovers to business	Yes, short term
	Collateral Assets	Transfer	Court as enforcer(6)	Attachment	Unsuccessful
Policy Conditionality	Sovereignty over policy	Explicit	IMF as enforcer(7)	Program conditions	Yes, but IMF repaid in Dec 2005
	International Goodwill	Implicit	G7(8)		
Market access	Access to primary capital markets	By sovereign	Court as gatekeeper(9) Court as mediator (9)	Threat of attachment pending Willingness to resolve disagreements between holdouts and debtor	
	Reputation with leading banks		"Anarchy"(10)	"Cheat the cheater"	Not evident from sovereign spreads

Notes to Table

1. Esteves(2005)

2. Bulow and Rogoff(1989)

3. Dooley (2000), Gai et al.(2004), Irwin et al (2006), Jeanne and Ranciere (2005)

4. Levy-Yeyati and Panizza (2005)

5. Kohlscheen and O'Connell(2003)

6. E.M.LTD v. The Republic of Argentina (12 Sept 2003)

7. Sgard (2004)

8. Kaletsky (1985)

9, Fisch and Gentile(2004), Miller and Thomas(this paper)

10. Eaton and Gersovitz (1981), Kletzer and Wright (2002)

The use of direct military threats to enforce debt contracts may have been relevant in the nineteenth century when 'gunboat diplomacy' was common, but not now: WTO rules prohibit trade intervention for purposes of debt collection; and seizures not authorised by a court are, by definition, illegal. But as capital markets have become increasingly globalised, the waiving of sovereign immunity – often required as a precondition for issuing debt in London or New York – has allowed for the *attachment of collateral assets* under court procedures: and specialist vulture funds have developed litigation strategies to exploit these possibilities. In the case of Argentina, however, efforts by holdout creditors to attach assets have been a failure, as indicated in the last column of the Table.

Another feature of modern capital markets is the ease with which creditors can exit; so sovereign debtors are exposed to creditor panic with associated financial and exchange rate crises, Ghosal and Miller (2002). Reducing or avoiding the *output losses* that can be triggered by capital flight is now regarded as a strong incentive for sovereigns to honour their debts, as the references in note (2) to the Table make clear.[11] In the Argentine case severe output losses have of course occurred and – since default was widely anticipated – they ensued well before default occurred. Another sanction that has played a role in this case is the *denial of trade credit*, a device commonly used to put pressure on defaulting sovereigns, Kohlscheen and O'Connell (2003).

Since the IMF policy of 'lending into arrears' initiated during the Latin American debt crises of the 1980s, the Fund has had to insist on explicit *policy conditionality* to avoid undermining debtors incentives to repay. Signing the Letter of Intent that embodies such conditions is a precondition for obtaining IMF programme assistance. In the cases of Korea in 1997 and Brazil in 2002, indeed, prospective presidents were persuaded to endorse targets for fiscal prudence before elections took place, an illustration of the loss of sovereignty mentioned in the Table. Conditions for rolling over IMF lending to Argentina did include the requirement steps be taken to settle with holdout creditors: but by repaying all its IMF borrowing in 2006, Argentina –

[11] As with bank-runs there is a risk of self-fulfilling crisis occurring: schemes to reduce this risk include Cohen and Portes (2004) and Cordella and Levy-Yeyati(2005).

like Brazil – freed itself from any such policy conditionality. Kaletsky (1985) stresses the role of international pressure from G7, but this does not seem to have played a key role in this case.

We argue in this paper that the courts have in fact played a key role: by threatening the debtor with attachments to prompt a credible offer, then reining the holdouts in to promote the swap. After the successful swap, the threat of attachment has effectively denied the debtor access to primary capital markets, namely London and New York. As indicated in the second line from the bottom of Table 3, denial of access to these markets is one way of pressuring a defaulting debtor to settle pending claims against it. By undertaking to resolve disagreements between the debtor and holdouts, the court also provides a mechanism to ensure successful settlements.

An alternative incentive would be fear of losing reputation, with consequent widening of the bonds spread from normal junk-bond levels[12] to what might be described as rogue-debt levels. Despite Porzecanski's characterisation, this does not appear to be the case for Argentina - where spreads are close to those of Brazil. Kletzer and Wright (2000) analyse a self-enforcing mechanism -'cheat the cheater' - that could sustain equilibrium in debt markets with a limited number of banks[13], see bottom line of Table 3.

Their analysis, however, as in the original Eaton and Gersovitz (1981) paper, is explicitly related to bank lending. How, if at all, it might be extended to a world of anonymous bondholders is unclear.

Whatever pressure there is on Argentina to finalise the swap does not seem to be coming from self-enforcing market mechanisms which can operate in a state of institutional anarchy. The pressure comes from actions taken in the courts as part of an evolving process of judicial influence and intervention. Denying Argentina access to New York for the issue of new bonds may not impose immediate hardship on the country or its finances: but it is surely not credible that a middle income country like

[12] As it is prone to restructuring, corporate debt in the US is often referred to as junk bonds.
[13] It should be noted, however, that not only Venezuela but also New York banks are happily lending into serious arrears by Argentina (see Postscript): is this consistent with the Kletzer/Wright equilibrium?

Argentina will wish forever to be excluded from the leading capital markets of the world.

6. CAC's, courts and creditor committees

The preceding analysis has emphasised the role that courts (prompted by holdout litigation) have played, and are still playing, in the orderly resolution of a major sovereign debt crisis. Study of the opinions and orders of Judge Griesa's court suggests three distinct judicial functions - encouraging the debtor to make an offer; promoting a successful debt swap and finally dealing with holdouts – which together protect creditor rights. But the new bonds include CAC's, as is now common with new issues of sovereign debt. The future, it seems, belongs to CACs. How will this affect the role of holdouts and of the courts?

Promoting the swap and handling holdouts

Given that these clauses are designed to reduce the profit opportunities available to holdouts, it should make it easier for creditors to organise a swap, with a SMV requirement of 75% as the industry standard. As the IMF has warned, however, aggregation will remain a problem: the clauses only operate within a single bond issue, Krueger (2002). The judge in the Argentine cases viewed the debt as a consolidated whole thereby effectively aggregating a majority of the creditors (76%) that participated in the swap. Despite the requirement for unanimity in the bond contracts, the courts promote a swap influenced by economic, political and financial factors at the time. Similar action may be called for in future.

With CAC's, however, the issue of recalcitrant holdouts should disappear. Subject to the necessary majority for a swap, the holdouts will be impelled to accept the same terms. They cannot hold out for better. While CAC's and courts may well solve aggregation and resolve the holdout problem, this will not necessarily prompt the debtor into making an offer. Vultures may not have the incentive to initiate debtor engagement but existing creditors will, as we explain in the next section.

Esteves (2005) suggests that enhanced creditor organisation will substantially increase creditor payoffs. In the Argentine case, this would surely be true for those creditors who sold out to institutional investors at prices of less than 30 cents. But, because institutional investors acted to coordinate creditors and to negotiate with the debtor, the payoff to creditors as a whole would probably not have risen much -- as the economic analysis of the swap in this paper confirms. If aggregation can be solved by CAC's and the courts, there will be less need for New York banks to buy distressed debt and bargain with the sovereign.

Debtor engagement: Class action suits and bondholder organisation

The historical record provides evidence of the effectiveness of formal and permanent bondholder committee's like the British Corporation of Foreign Bondholders in the early part of the 20th century, Esteves (2005). Even without such corporations there is still hope: class action suits.

Buchheit and Gulati (2002) argue that class action suits could be used to involve courts in sovereign debt restructuring. According to them creditors have a basic "class" interest[14] which is distinguishable from the interest of an individual creditor. With CAC's including SMV the class interest are better defined[15]. Class action procedures would engender the formation of ex-post, ad hoc creditor committees that would prompt the debtor into making an offer. In the latest judgement in the existing (and only) certified class action, Judge Griesa granted the motion of the class for summary judgement [*H.W.URBAN GMBH, Individually and on behalf of all others similarly situated v. The Republic of Argentina* (9 March, 2006)]. This favourable judgment increases the effectiveness of this option in the future.

To conclude, we see the vulture-initiated debt resolution strategies as important principally in the period of transition to CAC's. Unlike Fisch and Gentile (2004), who emphasise the continuing role of the vultures, we assume that SMV (supermajority voting) under CAC's will actually minimise the threat of holdout

[14] A class interest is one in which creditors as a class can achieve a settlement more effectively than individual creditors.
[15] While Sturzenegger and Zettelemeyer (2005) may dismiss class action procedures as ineffective for solving holdout problem, with CACs this is no longer an issue.

litigation as we know it but nonetheless increase judicial intervention in debt restructuring.[16]

Thus instead of the threat of attachment by specialist creditors, it will hopefully be the formation of *ex ante* Creditor Committees, class actions suits and the possibility of judge-mediated resolution of disagreements between the debtor and holdouts that will prompt the debtor into making an offer to successfully restructure its debt, Eichengreen and Portes (1995), Esteves (2005).

Conclusions

Our interpretation of the Argentine litigation is that Judge Griesa has used creditor heterogeneity to promote the swap - encouraging holdouts to bring the debtor to the negotiating table but restraining them when they threaten the swap itself. Following this interpretation, we believe that the Judge will encourage the holdouts to threaten Argentina's access to primary credit markets unless and until it deals satisfactorily with creditors outside the swap. The latter made possible by his willingness to resolve disagreements that may arise between the holdouts and Argentina. If this happens, Argentina should regain access to these markets.

Our conclusions differ from those of Sturzenegger and Zettelmeyer (2005) who are inclined to dismiss the role of holdout litigation in favour of reputational models. Our interpretation can also be contrasted with the view that holdout litigation represents a lasting solution to sovereign debt crises, Fisch and Gentile (2004): we agree that holdout litigation is 'part of the solution and not the problem'[17] *but only in the period of transition.* Our description of a judge-mediated debt restructuring emphasises the role of the common law judges in the orderly resolution of sovereign debt crises.

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[16] The incentives for vultures to litigate will arise from issues in which they have a SMV. They will use the courts to enforce hundred percent claims against the debtor. In the absence of unanimity however, these claims will be isolated at the margins and will not affect the entire debt.

[17] Roubini (2002)

Clarification of the judicial role in the functioning of the sovereign debt crises should allow us to extend the analysis to examine the role of creditor committees in the context of the increased use of CAC's, whether this involves the re-creation of *ex ante* bondholder committees, Eichengreen and Portes (1995) or the evolution of *ex post* bondholder organisation through the mechanism of class action procedures or the role of the judge as mediator.

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Appendix

Argentine bond contracts - amendments and legal remedies

Most of the international bonds issued by Argentina are governed by US law. A sovereign debtor formally undertakes to repay the principal or pay interest and perform all acts that further such fundamental purposes of a debt contract. These represent its positive obligations to its creditors. A sovereign also undertakes to refrain from performing any act that undermines the fundamental purpose of a debt contract or its primary contractual obligations e.g. to repay the principal. The *pari passu* clause is a well known example of a negative obligation and was used successfully by holdouts against Peru in 1999. This clause proscribes the debtor from subordinating one creditor to another by paying one while denying another, Buchheit et al (2003).

Bond contracts also set out the legal remedies or consequences in the event any of the clauses are breached by either the creditor or debtor. The consequences depend on the nature of the breach. In the event a debtor fails to pay the creditor interest, this breach could trigger acceleration, imposing on the debtor an obligation to immediately pay the entire principal and the all accrued interest.

In the absence of an supranational statute or authority governing sovereign borrowing, the Southern District Court of New York (SDNY), the lowest court in the hierarchy of courts in the state of New York, is vested with jurisdiction to deal with all legal matters that arise between Argentina and its creditors. Thus sovereign debt litigation governed by US law is judge made or common law. However, unlike the common law of contract law in domestic jurisdictions which is geared for situations in which the parties know each other, sovereign bond contracts involve a debtor and potentially hundreds of thousands of bondholders. This makes collective decision-making provisions an important feature of sovereign bond contracts. Under certain conditions, sovereign bond contracts give the creditors and the debtor the right to amend their primary contractual obligations.

The collective decision-making provisions in the Argentine debt instruments vary according to the contractual terms, Buchheit et al (2002). Variations in the payment terms and the date of payment can, for instance, require the unanimous consent of all the bondholders in the series ('unanimity'). The non-financial terms in the debt instruments such as provisions setting out what the applicable law is, the definition of default, thresholds needed for acceleration etc. can be varied by a supermajority vote (SMV). Once there is a SMV, the modifications voted on bind all bondholders regardless of whether an individual bondholder voted for the change.

Prior to March 2005, Argentine debt instruments issued under US law required unanimity. This requirement distinguished Argentine bonds from those with collective action clauses (CAC's). CAC's characterise corporate and sovereign bonds governed by English law. These clauses allow for changes to the payment terms of a bond with the consent of persons representing 75% (by amount) of the bonds voting at a bondholder's meeting provided that certain quorum requirements are met (SMV). Dixon et al (2000). The required supermajority varies with different issues.

CAC's are not typically found in debt instruments governed by U.S. law. According to some views creditors using bonds issued under U.S. law have traditionally been wary of CAC's and consistent with corporate bankruptcy law, have preferred unanimity to vary the financial terms of debt instruments, Buchheit et al (2002). In 2003, however, under pressure from creditor countries and the IMF, sovereign debt issued under U.S. law now contains SMV. The increased use of SMV has characterised new debt issued in recent restructurings in Ecuador, Uruguay, Argentina, Russia and Pakistan.

In addition to this change in bond documentation, Ecuador used 'exit consents' to render their old bonds less attractive to creditors as an incentive for them to participate in the proposed swap, Buchheit et al (2000); IMF, (2003 b). Exit consents (amendments) used in case of Uruguay, for instance, amended the sovereign immunity waiver in the old bonds to protect payments on the new bonds from attachment by holders of the old bonds IMF (2003c).

In 2003, after the Argentine default, there have been market driven changes in the amendment clauses contained in sovereign bonds issued under U.S. law: unanimity was gradually being replaced by SMV. More specifically, the financial terms of bond contracts could now be amended by SMV. This is the context in which Judge Griesa, the SDNY Judge is called upon to decide the suits brought against Argentina by its creditors.

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