Has the Legal Threat to Sovereign Debt Restructuring Become Real?

Federico Sturzenegger
Harvard University and Universidad Torcuato Di Tella

Jeromin Zettelmeyer
International Monetary Fund
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Federico Sturzenegger
Kennedy School of Government, Harvard University
and Universidad Torcuato Di Tella

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Abstract

The existence of sovereign debt relies on the ability of creditors to impose costs on defaulting debtors. In their seminal contribution Eaton and Gersovitz (1981) began the modern literature on sovereign debt by assuming that creditors could not impose sanctions but could exclude debtor countries from international capital markets. This piece was followed by a large literature that attempted to weaken its assumptions. However, as a result of changes in the law as well as from the development of new legal strategies, during the last thirty years the possibilities for creditor actions against sovereigns have improved significantly. This survey reviews the evidence from recent litigation practice and discusses whether this requires a change in our understanding of sovereign debt markets. Our conclusion is that the original assumptions of Eaton and Gersovitz (1981) hold surprisingly well.

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I. Introduction

In the corporate world, debt contracts are enforced by the threat of liquidation, that is, by a legal mechanism for transferring the firm’s assets to the creditors in the event of default. This enforcement mechanism, however, is less reliable when it comes to sovereign debt. The reason for this is not so much “sovereign immunity”—a legal doctrine that limits the extent to which sovereign assets located in foreign jurisdictions can be attached by creditors,—but the fact that few sovereign assets (including future income streams) are in fact located outside its national borders, and that a sovereign cannot credibly commit to hand over assets within its borders in the event of a default.

If it is true that it is difficult for a creditor to obtain payment in the event of default, the question arises naturally as to why private creditors are willing to lend to sovereigns in the first place. This question has drawn substantial attention over the last two decades, starting with a seminal contribution by Eaton and Gersovitz (1981), who assumed that creditors had no direct control over debtors whatsoever, and their only means of retaliating in the event of default would be through the denial of future credit. They showed that under these assumptions it was possible to build a model with sovereign debt: If default triggers permanent exclusion from credit markets, borrowers are risk averse, and debtors have no way of insuring against output shocks other than through borrowing, the threat of losing access to credit markets is a sufficient reason for repaying, up to a certain maximum level. This level is higher the more risk averse the debtor is, and the bigger the variance of output.

Prior to World War II, it seems that this was in fact a proper description of the workings of sovereign debt markets. Individual creditors generally did not have a serious legal threat at their disposal that could have been used to extract full repayment, or a better settlement after a debt
restructuring agreement had been reached with a majority of creditors. Successful legal action was almost impossible due to full-blown sovereign immunity, and mobilizing political or economic sanctions required the joint pressure of many creditors, and was hence outside the reach of holdouts by definition. Yet capital markets did remain virtually closed for forty years following the debt crisis and defaults of the 1930s.

The possibilities for creditor actions began to change in the post-war period, and particularly after the codification of more restrictive sovereign immunity concepts in the U.S. and the U.K. in the late 1970s opened the way to litigation. At the time Eaton and Gersovitz (1981) convinced the profession to analyze debt restructuring under the assumption that litigation was fruitless in exacting payment, litigation had become a real possibility; and since a large number of creditor suits have been carried out against defaulting sovereign nations. The question analyzed in this survey is whether the evidence from the recent experience with creditor litigation warrants a change in the underlying basics of our sovereign models or whether the original tenets of the Eaton and Gersovitz framework remain valid.

The result of the survey should be of interest on several dimensions. In addition to suggesting reasonable assumptions for our sovereign debt models, it could also help explain the outcomes of recent sovereign debt restructurings. In fact, the threat of litigation may be an obvious candidate to explain the large recovery values obtained by creditors in some recent debt restructurings (see Sturzenegger and Zettelmeyer, 2005). The results should also be useful in building pricing models of sovereign debt.

The results of our survey are relatively clear cut. In spite of the legal changes that have made litigation more feasible against defaulting countries, recent experience indicates that creditors
have in general been relatively unsuccessful in devising legal strategies that have allowed them to obtain payment from defaulting nations. If anything it seems that it is defaulting countries who have substantially improved their legal tactics to avert litigation losses. At the same time, there is also evidence that it is possible to exclude countries from capital markets while the default situation lasts. This seems to have been true both during the 1980s when creditor coordination was implemented through the action of Bank Advisory Committees as well as in the 90s when litigating creditors represented a real threat to the ability of countries to obtain future lending in international markets (a situation that persisted while there were dissenting creditors).

Thus a realistic model of sovereign debt must include the fact that no sanctions are possible, but that the country may be barred from capital markets if it maintains dissenting creditors willing to litigate against the sovereign. To be clear, our evidence does not preclude a country from defaulting and later on reaccessing capital markets. It does, however, suggest that this is feasible only once the country has negotiated its restructuring with most if not all its creditors.

As was mentioned above Eaton and Gersovitz (1981) relied on two assumptions to build a model with positive sovereign debt: that creditors had no direct control over debtors, and that their only means of retaliating in the event of default would be through the denial of future credit. Notice that these are exactly the two empirical regularities that we obtain from our review of recent litigation history.

While we provide support for the original assumptions of the Eaton and Gersovitz framework, the setup has been criticized from two angles, and, as we will show, our evidence also has something to say about the alternative assumptions. First, the assumption that a default could be punished through permanent exclusion from future credit was believed to be too strong. The
problem is that in such a situation both parties—creditors and debtors—are generally worse off than in a situation in which lending were to resume. In technical parlance, a lending equilibrium sustained by the threat of a permanent embargo on future lending is not “renegotiation-proof”, in the sense that after a default both parties would potentially benefit from reaching a new agreement involving positive lending. But if such an agreement is anticipated, then this undermines the expected punishment that was sustaining positive lending in the first place (see Kletzer, 1994, for details). The reason we find the evidence not to provide support for this line of work is that it implicitly assumes a two-party framework. If there are multiple creditors and any individual creditor can expect to obtain full payment from attaching new debt issues in international capital markets, then the incentives for renegotiation actually decrease for dissenting holdouts as the number of creditors that participate in a restructuring increase. If these holdouts are effective in threatening attachment of new debt issues (as we will see below is in fact the case) the country is barred from reaccessing these markets unless it agrees with all creditors.

The second line of criticism, due to Bulow and Rogoff (1989a), focused on the implicit assumption that borrowing from international lenders is the only way in which countries can smooth consumption in response to shocks to output. What if there are other ways, including storing output, purchasing insurance, or investing a portion of one’s wealth abroad so that it can be tapped in times of need? Clearly, this would diminish the dependence on international credit for the purposes of consumption smoothing, and thus the effectiveness of exclusion from credit markets in preventing defaults. In the limit, if a country can purchase an insurance contract that

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2 There are clearly other motives for borrowing other than consumption smoothing in the face of output variability—for example, impatience to consume, or capital accumulation. However, as observed by many authors (for example, Eaton, Gersovitz and Stiglitz, 1986, pp. 491) these can generally not be exploited to enforce repayment. The reason is that they imply a point in time after which the motive for borrowing disappears (for example, because the capital stock has been
delivers payments in low output states exactly like borrowing would, then the threat of exclusion from credit loses its bite entirely. To see this, suppose sovereign debt could exist in these circumstances, and take the highest level of debt that can supposedly be sustained. Rather than repaying this debt to creditors, the country could use the repayment to collateralize an insurance contract delivering the same maximum transfer in bad states of the world as the country could have borrowed under the previous debt contract, in exchange for country payments (“premia”) in good states of the world. Thus, an insurance contract can be designed so that it exactly replicates the flows associated with international borrowing. But in addition, the country would receive interest on its collateral. Since this argument can be made for any level of debt, any borrowing is impossible. Again, the results of our survey pose doubts on the relevance of this criticism. To the extent that the country cannot insure itself on its own, payments resulting from an insurance contract in international markets may be subject to attachment by dissenting creditors, thus limiting dramatically the feasibility of insuring its income unless it has agreed with litigating creditors.

Even though we find these two criticisms not to have strong empirical support, this was not fully known at the time. So to overcome these criticisms to the original model the literature evolved in three directions. Our survey also provides some insights on the relative relevance of some of these avenues.

A first group of papers, including Sachs and Cohen (1982), Bulow and Rogoff (1989b) and Fernandez and Rosenthal (1990) focused on direct punishments as the reason for repayment.
Direct punishments are generally interpreted as interference with a country’s current transactions, i.e. trade and payments, either through seizure outside the country’s borders or through the denial of trade credit. Renegotiations are explicitly modelled in these papers. In Bulow and Rogoff (1989b), contracts can be renegotiated at any time. The amount that a country can borrow is determined by the proportion of the debtor’s output that creditors can expect to extract in this renegotiation. The fact that they can extract anything at all hinges critically on the assumption that inflicting a sanction not only harms the debtor, but also benefits the creditor directly (for example, the creditor receives a share of the debtor country’s trade payments). Thus, the threat that in the event of non-payment the creditor will actually impose the sanction is credible. This would not be the case if imposing the sanctions hurt both debtors and the creditors. Recent history finds no evidence of such costs, or that any such sanctions have been imposed in any effective way³.

A second line of research (Cole and Kehoe, 1995, Eaton, 1996, Kletzer and B. Wright, 2000, M. Wright, 2002) attempts to rescue the idea that governments repay because they are worried about the repercussions of a default in the credit market. Most of these papers tried to avoid relying on enforcement through the threat of permanent exclusion from credit markets, and some explicitly address the renegotiation problem. Some papers sidestep the Bulow-Rogoff (1989a) critique by assuming that a defaulting borrower cannot enter in deposit or insurance contracts.⁴ M. Wright

³ See Sturzenegger and Zettelmeyer (forthcoming) for a review of recent defaults. Unless one is willing to argue that the occasional withdrawal of multilateral support may be considered a sanction, there is no evidence in recent debt defaults of any specific action taken against debtors. Martinez and Sandleris (2004) and Sandleris (2005) also review the evidence and conclude that there were no sanctions.

⁴ However, with multiple lenders, an equilibrium sustained by credit market sanctions could still unravel if a new lender refuses to participate in the sanctions. In Kletzer and B. Wright’s model, this is deterred by the original lender’s offer to “pardon” the debtor (i.e. let him return to the original lending relationship) in exchange for defaulting on any new lender. As a result, potential
(2002) shows that sovereign debt can be sustained in these circumstances if lenders collude both in the initial lending and in punishing defaults. Eaton (1996) presents a finite horizon model in which there is incomplete information about the borrower’s type: “bad” types will strategically default if this is optimal, while “good” types will always try to repay. Borrowers cannot save or buy insurance. Lenders try to distinguish between the two types by observing the borrower’s default history. If there is no uncertainty about the borrower’s ability to pay, then observing a default identifies the borrower as being a “bad” type. This leads to exclusion from credit markets.⁵ If there is extraneous uncertainty, default does not imply that a borrower is necessarily bad, but it increases the probability that he is. This leads to higher interest rates. Either way, “bad” borrowers have an incentive to build a good credit history, at least at low levels of debt.⁶

Kletzer and B. Wright (2000) M. Wright (2002) present infinite horizon models à la Eaton and Gersovitz in which default does not trigger permanent exclusion from credit markets, but rather a new financial relationship at terms that make the defaulting debtor no better off than permanent exclusion. Thus, the equilibrium in the subgame following a default is just as unpleasant for the debtor as a permanent lending embargo, but it is also efficient. The creditor appropriates all gains from trade, and would thus not want to renegotiate. Mark Wright (2002), for example, includes a model in which a country borrows from a single bank which can commit to honoring deposit and insurance contracts. The threat that enforces repayment is the replacement of the lending

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new lenders “will respect the punishment of the borrower in equilibrium”, i.e. a defaulter will not be able to find new positive surplus lending relationships.

⁵ Since this is a finite horizon game, default and exclusion from credit markets constitute the unique subgame perfect equilibrium after a borrower has been identified as belonging to the “bad” type, so renegotiation is not an issue.

⁶ However, if this goes on for sufficiently long time periods, lenders will eventually become convinced that the government is indeed “bad”. In the limit for $T \to \infty$, no borrowing can be sustained (Cole and Kehoe, 1995).
relationship with an insurance contract, in which the insurance “premium” after a default is so large as to leave the country without any surplus relative to permanent exclusion from capital markets. While these mechanisms may be at work our survey suggests that exclusion is more feasible than this literature has been willing to accept.

The survey is organized as follows. Section II describes the legal characteristics of sovereign debt a key initial step to understand the potential threat that dissenting litigants may pose. Section III, the core of this survey, reviews the legal experience on enforcing sovereign debt contracts. Section IV discusses whether domestic insolvency procedures can be mimicked through sovereign bond contracts, an issue that has received much recent attention in the context of discussions on how to improve international financial architecture. Section V reviews how investors have fared in an ex-post sense in sovereign debt markets. Section VI concludes.

Section II. Legal Characteristics of Sovereign Debt

Principles Protecting Sovereign Debtors

A fundamental characteristic of sovereign debt is the lack of contractual enforcement mechanisms analogous to those that exist at the level of corporate debt. To a large extent, the reasons for this are political and practical rather than legal: it is hard to force a government to pay against its will, since most of the assets or income streams that could be used for repayment purposes (including tax revenue streams) are located inside the country. However, legal doctrine traditionally played an important role in magnifying the enforcement problem, particularly through the principle of (absolute) sovereign immunity, which states that sovereigns cannot be

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7 Finally, a third line of research is based on the idea that a default could have much broader adverse effects on a lender’s reputation than just on his standing in credit markets. But our results have little to say on this avenue.
sued in foreign courts without their consent. Sovereign immunity can be derived from the equality of sovereign nations under international law: legal persons of equal standing cannot have their disputes settled in the courts of one of them (Brownlie, 2003). Note that, importantly, immunity can be waived: a sovereign can enter in a contractual relationship in which it voluntarily submits to the authority of a foreign court in the event of a dispute.

Under absolute immunity, which was the prevailing doctrine in the 19th century and in the first half of the 20th century, sovereign immunity applied even to commercial transactions between foreign states and private individuals from another state. From the perspective of state interests, this had the advantage that private commercial interests did not get in the way of diplomatic and political relations. As a result, unless an aggrieved creditor could persuade his own government to apply pressure, he was deprived of legal remedies to enforce repayments (except to the extent that he could successfully make a case in the defaulting country’s courts). However, a more restrictive view of sovereign immunity began to take hold after the Second World War (Brownlie, 2003, p. 325). In the United States, the interpretation of sovereign immunity began to change in the 1950s, in part as a consequence of the cold-war—the U.S. felt uneasy with granting sovereign immunity to Soviet Union state owned companies operating in the United States. The U.S. government encouraged a more restrictive theory of sovereign immunity, under which foreign sovereigns were denied immunity for commercial activities carried on inside, or with direct effect inside, the United States. This restrictive view was embodied in the Foreign Sovereign Immunities Act (FSIA) of 1976, which allows private parties to sue a foreign government in U.S. courts if the complaint relates to commercial activity. The UK adopted similar legislation in 1978, and many other jurisdictions have followed suit (Buchheit, 1986, 1995; Brownlie, 2003).
As a result, sovereigns can now often be held legally accountable for breach of commercial contracts with foreign parties in the same manner as private parties. This leaves open the question of what is really a commercial transaction, and who really is a sovereign, within the terms of a foreign sovereign immunity law. With regard to the question of who is a sovereign, the U.S. FSIA, for example, defines a sovereign broadly to include agencies and instrumentalities of a sovereign. Several court decisions have confirmed that the issuance of sovereign bonds is a commercial activity. Furthermore, a 1992 U.S. Supreme Court decision (*Republic of Argentina vs. Weltower*, see Power, 1996) established that suspending payments on debt contracts that call for payment in the United States entail direct effects within the United States sufficient to satisfy the U.S. nexus requirement under the FSIA. Accordingly, under U.S. law, international bond issues by a sovereign, and a subsequent default, are almost always considered commercial activities, regardless of the purpose of the issue, or the reason behind the payments interruption. Moreover, whatever protections of the sovereign remain under U.S. law can be contractually waived, and such waivers are in fact routinely included in bond covenants (see below). As a result, at least under U.S. law, sovereign immunity no longer plays an important role in shielding sovereign debtors from creditor suits.

This said, sovereign immunity laws may be a more effective shield against attachment proceedings, i.e. creditor attempts to collect once a favorable court judgment has been obtained. In particular, under FSIA and comparable laws, central bank assets—including international reserves—are typically immune from attachment.⁸ For sovereign debt not issued by the central bank itself, this follows from the fact that although it benefits from sovereign immunity as an agency of the debtor state, it is also generally viewed as a separate legal entity that cannot be

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⁸ The law on this matter is not entirely uniform, particularly across European countries. As a result, sovereigns have been concerned about attachment of central bank reserve assets in some European jurisdictions; see Singh (2003).
held liable for the acts of its principal. But even when the central bank itself is the debtor, most of its assets—in particular, international reserves and other assets necessary for the exercise of key central banking functions—generally enjoy immunity, unless this is explicitly waved (Lee, 2003; Gramlich, 1981). Moreover, as already mentioned, a sovereign or central bank can of course always attempt to limit attachable assets by locating them outside the reach of foreign courts. For example, government and central bank assets have been placed with the Bank for International Settlements (BIS) in Switzerland to take cover under the legal protections afforded to the BIS against attachment proceedings.

In addition to the principle of sovereign immunity, a number of other legal principles or conventions have been invoked by sovereign debtors in resisting creditor lawsuits during the 1980s and 1990s. Two such defenses are the “act of state” doctrine, and international comity (Power, 1996; Brownlie, 2003). The act of state doctrine states that courts should not judge the validity of a foreign sovereign’s acts committed on its territory. “In contrast to sovereign immunity, which acts as a jurisdictional bar to suits against a sovereign, the act of state doctrine is a judicially created rule of abstention concerning the justiciability of the acts of foreign governments. In further contrast to sovereign immunity, the act of state doctrine defense cannot be waived” (Power, 1996). However, the act of state doctrine has proved to be of little use to sovereigns for a similar reason as sovereign immunity, namely, that defaulting on debtors payable in international jurisdictions is not considered to be a sovereign act worthy of judicial deference (see Allied Bank International v. Banco Credito Agricola de Cartago, discussed below).

Finally, international comity, according to a 1895 U.S. Supreme Court decision, is defined as “the recognition which one nation allows within its territory to the legislative, executive or
judicial acts of another nation.” Although a “softer” principle than sovereign immunity or act of state—Power (1996) describes it as “not the rule of law, but rather one of practice, convenience, and expediency;” Brownlie (2003) speaks of “neighbourliness and mutual respect”—comity considerations have motivated several court decisions both against and in favor of the sovereign debtor, and continue to play a role today. In practice, comity considerations seem to have boiled down to a court assessment on whether a debtor’s actions could be viewed as broadly justified in light of U.S. policies on how international debt crises ought to be resolved. As such, they have given the U.S. executive branch a lever for influencing debt-related disputes before U.S. courts. Thus, comity is an unreliable principle, as “the defense's likelihood of success is subject to reassessment with each shift in U.S. policy on sovereign debt restructuring” (Power, 1996).

**Governing Law**

Sovereign bonds can be classified as either **international bonds** issued by a government in an international financial center (for example, New York, London, or Tokyo) under foreign law, or **domestic bonds**, issued in the debtor country under domestic legislation. International bonds are typically not denominated in the currency of the issuer, though very recently there have been some exceptions. Domestic bonds are denominated either in foreign or in local currency. “**Eurobonds**” refers to a specific category of international bonds, namely bonds that are issued in countries other than the one in whose currency the bond is denominated. Eurobonds often U.S. dollar denominated bonds issued in a European jurisdiction (e.g., England, Germany, or Luxembourg), hence the name.\(^9\)

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\(^9\) The development of the Eurobond market was influenced by tax considerations. In 1963, the United States imposed an Interest Equalization Tax (IET) on foreign securities held by U.S. investors. This forced non-U.S. corporations to pay a higher interest rate to attract U.S. investors, encouraging the development of the Eurobond market, which was not subject to the IET. The IET was repealed in 1974, but by then the market was firmly established.
New York law and English law are by far the most popular governing laws for the issue of international bonds, though Luxembourg law (for Brady bonds), German law and more recently Japanese law and Italian law (for Argentine debt) have also played a role. Traditionally, sovereign bond contracts issued under New York and English law have differed in important respects, though this was mostly a matter of “drafting momentum” rather than statutes governing sovereign borrowing. These differences have recently narrowed, as explained below.

**Bond Contracts**

Sovereign bonds come with an array of contractual features—“clauses” —that have important implications for debt restructurings. These include bond “covenants” which commit the debtor to certain actions over the lifetime of the bond and prohibit others; remedies in the event that contractual obligations are breached, and procedures for modifying the contract. A brief survey follows.

**Covenants** are essentially formal promises by the debtor to the creditors. They define what is expected of the debtor during the lifetime of the contract. **Positive** covenants outline things that the debtor is supposed to do: most obviously, to repay the principal, to pay an interest coupon, and related payment promises (for example, a put option that gives the creditor the right to ask for early repayment at specified points in time). Beyond this promise to pay, positive covenants typically commit the debtor to undertaking certain actions that support the base promise, for example, sharing information with the creditors, and listing the bond on a specific stock market to ensure its liquidity. Another example is a “gross-up” covenant, by which the government commits to reimbursing cash flow losses from tax measures that may affect the interest or principal.
Negative covenants refer to actions the debtor promises to refrain from, because they would undermine the base promise, and hence reduce the value of the claim. The best known negative covenants in sovereign bonds are the pari passu clause and the negative pledge clause. Both are intended to ensure that an individual creditor is not discriminated against. The pari-passu clause prohibits the debtor from subordinating the borrower, i.e. from reducing his right to repayment relative to that of other creditors (Buchheit and Pam, 2003). The negative pledge clause prohibits issuing collateralized debt unless the incumbent debt holder is given equivalent collateral. This is meant to ensure that assets that a creditor could potentially attach in the event of default, or that could help to strengthen the repayment capacity of the creditor, are not assigned to other creditors.

Bond contracts also define remedies—legal consequences in the event that any of these covenants is breached. These remedies are typically calibrated to the seriousness of the breach. The most serious breach, obviously, is a failure to make good on any aspect of the promise to pay. To the extent that the bond is collateralized, this could trigger seizure of collateral. It could also trigger acceleration, which means that all principal and any accrued interest become immediately due and payable. Acceleration clauses govern the conditions under which acceleration can occur. The typical case is that 25 percent of the bondholders can accelerate unmatured principal following a default on payment terms, while a majority (50 percent) can veto or rescind a prior acceleration, if the default event has either been “cured” or waived by the creditors in the event of default must be made pro rata, has been the subject of recent controversy (see next section).
bondholders. For example, following Ecuador’s default in September of 1999, one bond was accelerated by its holders. In August of 2000, Ecuador made an exchange offer to holders of this bond which was conditional on “exiting” holders voting to rescind the original acceleration, so that holders of the bond that chose not accept the exchange offer were left with a bond that did not constitute an immediate claim on the principal.

The contract can also trigger remedies in the event of a default of the debtor on a third party (another creditor). This is called a cross-default. For example, a cross-default clause could define a default on a third party as an event that triggers acceleration. In order to strengthen the creditor’s legal position in the event of default, bond contracts typically contain a clause in which the debtor waives sovereign immunity in the event of future disputes, that is, he promises to submit to the courts of a specified jurisdiction (the jurisdiction whose laws govern the bond, e.g. New York, England, or Luxembourg). In some cases, bond clauses might restrict the assets of the sovereign that may be attached in the event of default, augmenting sovereign immunity protections or limiting the extent of a sovereign immunity waiver. For example, during the 1990s, Argentina included a clause affirming that central bank reserves backing the monetary base under its currency board arrangement were unattachable.

Finally, amendment clauses may govern the conditions under which the terms of the bond contract can be changed. Bonds issued under U.S. law have traditionally contained a clause permitting amendments or modifications to the contract with the consent of a simple majority of

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11 New York law governed emerging market bonds registered with the U.S. Securities and Exchange Commission (“Schedule B” issues), have traditionally provided each bondholder the right to accelerate and litigate his or her own bond following certain events of default such as a missed payment of principal or interest, or in some bond issues, the declaration of a debt moratorium. Starting in 2003, however, Schedule B bonds have routinely required collective action for acceleration, in line with the trend toward inclusion of collective action clauses in New York law bonds (see below).
bondholders, except for changes in the payment terms of the bond, which required the consent of each bondholder. Hence, under such provisions, important features of the bond including the applicable law, the formal definition of default, majority thresholds needed for acceleration, the negative pledge clause, listing requirements etc. could be changed against the wishes of dissenting bondholders, while changes to the bond’s maturity, scheduled interest payments, or principal repayment amount required unanimity. In contrast, bonds issued under English law have traditionally included a “majority amendment clause” which permits changes in the payment terms of the bond with some supermajority (usually 75 percent). These changes bind all bondholders, including those that voted against the change.

As argued by Buchheit and Gulati (2002), these traditions are rooted in differences in domestic bankruptcy law in the two countries. Until the 1930s, majority action clauses could be found in corporate debt contracts both in the U.S. and in the U.K, but after a 1934 amendment to the U.S. Bankruptcy Act introduced a new procedure of coordinating creditors (a precursor of the modern “Chapter 11”), majority action clauses fell out of favor in the U.S. and were made illegal for corporate bonds (though not for sovereign bonds) by the Trust Indenture Act of 1939. Sovereign bond contracts in the U.S. by and large followed the template of corporate debt in not containing majority action provisions until 2003, when majority amendment clauses began to be included in New York law bonds in response to pressures from creditor countries and the IMF (see below).

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12 The Trust Indenture Act was motivated by actions of several American companies whose equity holders began buying the companies’ bonds at heavily discounted prices after the stock market crash of 1929. Once they had achieved the necessary creditor majority, they could use this power to defer payments of the bonds, effectively inverting the priority of bondholders over equity holders. Unilateral consensus for changing the payments terms was introduced to prevent such abuse.
Recent debt restructurings in Russia, Pakistan, Ukraine, Ecuador, Uruguay, and Argentina have not primarily relied on changes in the payment terms of the existing bond contracts but rather on exchanging the old instruments for new instruments with different payments terms. Nonetheless, majority amendment clauses did play a role, on three occasions. Majority amendment clauses were used directly to restructure an English law Eurobond issued by Moldova (June 2002) as well as one of Uruguay’s 19 externally issued bonds in May of 2003 (a “Samurai bond” issued under Japanese law). Perhaps more importantly, majority amendment clauses were used to back up Ukraine’s debt exchange offer in March of 2000: by agreeing to the offer, holders of Ukraine’s English law bonds delivered an “irrevocable proxy vote” in favor of an amendment which would bring the payment terms of the old bonds in line with the payment terms of the new bonds offered at the exchange. “Holdouts faced the prospect of being left with an amended illiquid old bond that paid out no earlier than the very liquid new bond being offered at the exchange” (Buchheit and Gulati, 2002).

In addition, the possibility of amending non-payment terms to bonds has been used in three recent sovereign debt restructurings—Ecuador in 2000, Uruguay in 2003 and the Dominican Republic in 2005—to render the old instruments less attractive, hence creating an incentive for bondholders to accept the exchange offer (“exit consents/amendments”, see Buchheit, 2000; Buchheit and Gulati, 2000; and IMF, 2003b). In the case of Ecuador, exit amendments removed a prohibition on the further restructuring of the Brady bonds tendered in the exchange, cross default clauses, negative pledge clauses, and the requirement to list the bonds on the Luxembourg stock exchange. In the cases of Uruguay and the Dominican Republic, the sovereign immunity waiver in the old bonds was amended to protect payments on the new bonds from attachment by holders of the old bonds; cross-default, cross-acceleration clauses were removed; and the listing requirement was also dropped (IMF, 2003c).
III. Experience with Legal Enforcement of Sovereign Debt Contracts

As we have seen, legal protections of sovereigns from court action by creditors were significantly reduced by the 1980s. From the perspective of the sovereign debt literature in economics, this should be a good thing: if the fundamental distortion in sovereign debt—the reason why sovereign borrowing is expensive, and financing may be suboptimally low—is lack of contract enforcement, then improvements in creditor rights should be in the interests of both debtors and creditors. However, as the literature in both law and economics recognized early on, this is not necessarily true if individual creditors use their rights to seek an advantage relative to other creditors, i.e. if they cease to behave cooperatively. In that case, “collective action problems” among creditors could be an obstacle to the orderly resolution of debt crises. This does not necessarily imply that creditors will be worse off relative to a situation in which they had less rights, but it opens the door for institutional mechanisms—from contracts that force creditors to act collectively, to formal bankruptcy-like regimes at the international level—that could improve over the status quo.

In what follows, we briefly survey the experience with creditor attempts to enforce repayment through the courts following a default. We organize the discussion according to whether creditor legal action was initiated before or after a debt restructuring with a majority of the creditors was completed. Each of these litigation strategies have been linked to a particular collective action problem: pre-restructuring litigation to a possible “rush to the courthouse,” in which creditors attempt to obtain a favorable settlement ahead of a possible debt restructuring, and post-restructuring litigation to the “holdout problem,” in which a creditor refuses to participate in a restructuring with the hope of obtaining a better settlement later on. From an economic
perspective, these collective action problems are much the same: they boil down to an attempt of individual creditors to free ride at the expense of the majority of creditors, which may scuttle a cooperative outcome. From a legal perspective, however, they involve somewhat different issues, particularly with regard to the attachment strategies that creditors might pursue.

We address two questions. First, how successful has either brand of litigation been in extracting repayment, or a favorable settlement, from the sovereign debtor? Second, has creditor litigation before or after a debt restructuring proved to be an obstacle to swift and successful debt restructurings?

**Post-Restructuring Litigation and the “Holdout Problem”**

At the corporate debt level, creditor rights can be effectively enforced through the domestic courts, by giving creditors the right to seize collateral, liquidate, or otherwise sanction a defaulting firm. In a one-creditor world, this would generally be efficient. In a world of many creditors, however, it may give too much power to an individual creditor from the perspective of creditors collectively. In particular, liquidation is often inefficient in the sense that the liquidation value of the firm is lower than the value of the firm when it is reorganized and continues operating. Hence, creditors may have a collective interest in a debt restructuring agreement that avoids liquidation. Such an agreement could be undermined by creditors who insist on full repayment in exchange for not exercising their right to liquidate (or in exchange for not inflicting a sanction that would do the debtor more damage than full repayment to an individual creditor). If creditors know that a “holdout” can obtain full repayment conditional on a previous debt restructuring, everyone will want to be that holdout, and no one will want to restructure. This could prolong the default state, leaving a debtor without access to new capital—and creditors without any recovery of payments—for a long time. Bankruptcy legislation which calls for a
court-supervised reorganization of the firm that maximizes its value as a going concern is often interpreted as the domestic-level solution to this “holdout problem.”

The question is whether there is a similar holdout problem at the level of sovereign debt. Prior to World War II, this does not seem to have been the case, as individual creditors generally did not have a serious legal threat at their disposal that could have been used to extract full repayment (or a better settlement) after a debt restructuring agreement had been reached with a majority of creditors. Successful legal action was almost impossible due to full-blown sovereign immunity, and mobilizing political or economic sanctions required the joint pressure of many creditors and was hence outside the reach of holdouts by definition.

This began to change in the post-war period, and particularly after the codification of more restrictive sovereign immunity concepts in the U.S. and the U.K. in the late 1970s. Holdouts could now conceivably use the courts to extract a better deal than the settlement negotiated with the majority of creditors. The question is whether there is any evidence that creditor litigation was successful in this sense, and if so, whether it led to a systematic holdout problem. The answer is somewhat surprising: since the 1980s, there have been a large number of creditor suits (in the hundreds), including several cases in which holdouts have in fact been able to secure better terms than average creditors. Yet, holdout creditors do not so far seem to have posed a systemic obstacle to debt restructurings.

Fears that holdouts might create such an impediment go back to a well-known 1985 New York court decision, *Allied Bank International v. Banco Credito Agricola de Cartago*. In 1981, Costa Rica suspended debt payments to a 39-member bank syndicate. A restructuring agreement was subsequently reached with all creditors but one, Fidelity Union Trust of New Jersey, which sued
through an agent, Allied Bank, in U.S. courts. A lower court initially ruled in favor of Costa Rican banks that had acted on behalf of Costa Rica, accepting the defense’s argument that Costa Rica’s actions were protected by the “act of state” doctrine (see above).

In 1984, an appeals court disagreed with this argument on the grounds that defaulting on foreign debt did not constitute an act of state. However, it initially upheld the lower court ruling on comity grounds, on the assumption that the U.S. executive branch was favorably disposed to Costa Rica’s attempt to restructure its debts. “Costa Rica’s prohibition of payments of its external debt is analogous to the reorganization of a business pursuant to Chapter 11 of our Bankruptcy Code. On that basis, Costa Rica’s prohibition of payment of debt was not a repudiation of the debt but rather was merely a deferral of payments while it attempted in good faith to renegotiate its obligations.” Upon rehearing the case in March 1985, however, the court reversed itself after the U.S. Department of Justice argued that contrary to the court’s initial assumptions, the U.S. government did not agree with “Costa Rica’s attempted unilateral restructuring,” concluding that “while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable.” According to Greenwood and Mercer (1995), this led to a settlement in which the U.S. government encouraged Fidelity Union to accept the package agreed by the rest of the bank syndicate.

The Allied Bank case was thus significant in several respects. It demonstrated that a holdout could be successful in the sense of obtaining a favorable judgment, and showed that two important legal principles—the act of state doctrine and international comity—did not necessarily protect sovereigns in the event of defaults (Power, 1996). However, given the final outcome—Fidelity Union did no better than the creditors that had negotiated the earlier restructuring—Allied can hardly be interpreted as illustrating the rewards of a holdout strategy.
In a sense, Fidelity performed a free service for debt holders collectively, by helping to demonstrate the weakness of defenses that had been thought to protect sovereign debtors without achieving a financial advantage over those that had agreed to the previous restructuring. Indeed, the other creditors did not object to the litigation while it was ongoing, on the contrary: through the New York Clearing House Association, they filed a brief supporting Fidelity.

During the remainder of the 1980s, creditor litigation remained the exception, for two reasons. First, there were strong mechanisms, both contractually, and through informal institutions like the Bank Advisory Committee (BAC) process, that encouraged collective action in resolving debt disputes and discouraged go-it-alone litigation. In particular, syndicated loan contracts—the main vehicle for private lending to developing countries during the 1970s and 1980s—typically contained “sharing clauses” that forced any member of the syndicate to share any payments extracted through litigation or settlement with the remaining members. Second, prior to the creation of the secondary debt market in the late 1980s, virtually all holders of distressed debt were banks, which had a regulatory incentive against declaring a creditor in default (in practice, a prerequisite for litigation), as this would have required them to write down their loans. Until the late 1980s, many creditor banks did not have sufficient reserves to do so. As observed by Power (1996), the “effect of these pressures was a de facto replication of the U.S. Bankruptcy Code’s automatic stay of collection actions against a debtor. The banks were effectively unable to pursue their collection rights even though those rights were fully enforceable.”

This situation began to change in the late 1980s, as creditor banks provisioned against loan losses and began writing off their loans, and the creation of a secondary market in securitized loans allowed new investors—including specialized firms that became known as “distressed debt funds” or “vulture funds”—to buy defaulted debt at large discounts with a view to
extracting the best possible settlement. The result was a sharp increase in holdout litigation following the Brady plan restructurings of the early 1990s. A famous early case is CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brazil (Power, 1996; Nolan, 2001; Waibel, 2001). In the early 1990s, the Dart family had accumulated 1.4 billion of Brazilian Multi-Year Deposit Facility Agreement (MYDFA) debt at large discounts. The MYDFA was a 1988 debt restructuring agreement between Brazil and creditor banks that covered most of Brazil’s outstanding debt. Brazil stopped servicing MYDFA debt in 1989, and eventually initiated negotiations leading to a 1993 restructuring under the Brady plan which was accepted by all creditors except the Darts. Brazil converted all debt except for $1.6 billion that were formally held by the Central Bank of Brazil; this prevented the Darts becoming the majority debt holder with the right to accelerate outstanding principal and interest payments. In response, the Darts, through CIBC as the holder of record of the debt, sued the Central Bank of Brazil in New York, claiming (1) past due interest under the MYDFA; (2) the right to accelerate the entire principal and interest owed. In May 1995, the court ended up siding with the plaintiff on the first claim, but declined to allow the Darts to accelerate. The question of whether the Darts were entitled to recovering the full principal at maturity was not answered by the court since it was not the object of litigation, but in light of the Allied Bank case, there was a presumption that they would (Power, 1996).

In March of 1996, Brazil settled, paying the Darts $52 million in Eligible Interest Bonds covering past due interest until April 1994 (the settlement date of the Brady deal) and $25 million in cash covering accrued interest since April 1994. Hence, Brazil treated the remaining MYDFA as if it had been performing since April of 1994, signaling that it would continue servicing the loan in the future. On that basis, the Darts managed to effectively sell their MYDFA holding by issuing $1.28 bn in Eurobonds secured by MYDFA debt in October
of 1996, at a modest spread over Brazilian sovereign debt with similar payment terms. Although the market value of this issue, at about $1.1 bn, fell short of the $1.4 bn that the Darts had initially demanded, this meant that the Darts came out much better than creditors that had accepted the Brady exchange.

From a legal point of view, several aspects of the CIBC case are notable. First, Brazil did not invoke either sovereign immunity or the act of state doctrine in its defense, a recognition of the fact that these principles had lost their protective power in the context of sovereign debt litigation. Second, it tried to invoke two arguments designed specifically to fend off holdouts that had purchased distressed debt in the secondary market, namely, that assignment of the debt to CIBC was invalid under the terms of the original debt contract (in this case, the MYFDA), and that the Dart’s suit violated New York’s “Law of Champerty”, which prohibits litigating on a claim purchased exclusively for the purposes of filing a law suit. Both were rejected by the court, establishing a precedent that was largely followed in subsequent court cases. The “Champerty Defense” suffered from the problem of having to prove intent: claimholders could always argue that they had purchased the claim not with the intention to litigate but in order to get paid, and that the decision to litigate was merely a reaction to the sovereign’s refusal to pay, and fully within their rights.

Finally, as in the Allied Bank case, the U.S. government filed a brief, but with the opposite thrust, urging the court to reject the Darts’ claim for acceleration of principal on the grounds that holdouts that had purchased debt in the secondary market should not be allowed to take a free ride on debt workouts agreed by a majority of creditors. “The United States observed that its concern in CIBC was a “mirror image” of its concern in Allied ten years earlier. In Allied, the United States had been concerned that a judgment for Costa Rica would encourage sovereign
debtors to use the courts to extract better terms from creditors than they could obtain through negotiation. In CIBC, conversely, the United States was concerned that a judgment in favor of the Darts would encourage creditors to use the courts to gain unfair concessions from sovereign debtors” (Power, 1996). The court ultimately agreed with the U.S. argument, so comity may have benefited the debtor in this aspect of the case.

By and large, the precedents set by CIBC have been borne out in subsequent litigation. First, subsequent cases have confirmed a holdout’s right to litigate on the basis of a claim acquired in the secondary market. The Champerty defense, in particular, was rejected in several instances, including by the English Court of Appeal in Camdex International Limited v. Bank of Zambia (1998), and—on appeal—by a New York court in Elliott Associates v. Banco de la Nacion (1999). Second, court judgments generally paid some attention to the argument, made by the U.S. government in the CIBC case, that holdout creditors should not be allowed to disrupt or undo debt restructuring agreements negotiated with a majority of creditors.

This said, the desire to safeguard creditor rights as defined by the debt contract prevailed whenever there was a conflict between these two principles. For example, in Pravin Banker v. Banco Popular del Peru (1997), a New York court stayed Pravin’s claims for full repayment by Peru on two occasions to avoid a disruption to the ongoing Brady deal negotiations, but ultimately decided in favor of Pravin (see below for details). Similarly, in Elliott & Associates v. Republic of Panama (1997), Elliott obtained judgments covering the full claim, and subsequently settled for close to that amount, notwithstanding the fact that it had acquired the Panamanian debt at a substantial discount from Panama’s original creditors. Elliott could extract full repayment because it was able to obtain an attachment order that could have inflicted serious harm on Panama; one directed against U.S. assets of the national telecommunications company.
which Panama was about to privatize; and one which would have interfered with a large new bond issue in New York. Although Panama paid in full, the amount paid ($71 million) was an order of magnitude smaller than both the value of the privatization deal and the proceeds received from the bond issue.

The famous 1999 case of Elliott Associates v. Banco de la Nacion (Peru) constitutes an example of interference with future debt flows as a strategy for enforcing repayment. Following the by now familiar theme, Elliott acquired non-performing debt guaranteed by the Peruvian government, at a large discount, just prior to Peru’s 1996 Brady deal. After Peru refused to repay in full, Elliott sued in New York. A pre-judgment attachment sought by Elliott was initially denied on the grounds that it would have jeopardized the pending Brady restructuring, but in late 1999, Elliott obtained a pre-judgment attachment order against Peruvian assets used for commercial purposes in the U.S., and finally, in June 2000, a US$57 million judgment against Peru. Based on this judgment, Elliott sought court orders in New York and various European countries that would either attach Peruvian assets or bar Peru from paying interest on its Brady bonds. It was eventually successful, convincing a Brussels appeals court to order the payments provider Euroclear on an emergency basis—i.e. before arguments in opposition had been made—to suspend payments on Brady bond interest payments. Faced with an approaching payments deadline that would have brought the whole stock of Brady debt into default, Peru decided to settle with Elliott for a reported sum of US$56.3 million rather than continue the legal fight.

The Elliott/Peru case led to much consternation in policy circles because it appeared to open a powerful new channel for the enforcement of the claims of holdouts who had successfully obtained a judgment. Rather than engaging in the difficult and tedious process of attempting to
attach debtor assets abroad, holdouts could ask courts to interfere with cross-border payments to mainstream creditors that had previously agreed to a debt restructuring. This seemed to be an almost foolproof enforcement channel, since it effectively gave holdouts a veto over the regularization of a country’s relations with mainstream creditors, and hence over its return to international capital markets. Hence, *Elliott/Peru* appeared to catapult holdouts from their previous status of either a minor nuisance (at worst) or champions of creditor rights (at best) to a formidable obstacle to orderly sovereign debt restructurings.

However, interfering with payments to creditors that had accepted a restructuring offer did not turn out to be a very robust enforcement mechanism, for two reasons. First, its legal basis appeared questionable. Elliott’s motion to suspend payments to Peru’s Brady bond holders rested on a broad interpretation of the *pari passu* clause in the debt contracts it had purchased, as giving it the right to receive a proportional share of any payments on external debt made by Peru (though arguably the Brussels court went further, effectively giving Elliott *priority* over the Brady bond holders). This contrasts with a more conventional interpretation of the *pari passu* clause stating that the claim in question does not have lower priority than other unsecured claims (Gulati and Klee, 2001; Wood, 2003; Buchheit and Pam, 2004). By now, Elliott’s interpretation of the pari passu clause has been challenged not just by many legal commentators, but also (in the context of the Argentina case, see below) by the U.S. government, the Federal Reserve Bank of New York and the New York Clearing House Association.

Second, regardless of which interpretation of the pari passu clause is correct, practical and legal steps could be (and have been) undertaken to remove payments to mainstream creditors from the reach of holdouts. Most obviously, payments could be made in the debtor country, so that any cross-border transfer would involve creditor accounts only. In this case, holdouts would have to
attempt to recover payments from other creditors, a legally difficult endeavour as long as explicit sharing clauses are absent from bond contracts (with such sharing clauses, however, holdouts could not hope to extract a better deal). Alternatively, international payments systems could be explicitly protected from judgment creditors through changes in national laws. Indeed, Belgium has recently adopted a law that prevents a judgment creditor from obtaining a court order that would preclude Euroclear from channelling payments from a sovereign debtor to its bondholders.

The possibility of structuring payment flows in ways that makes them difficult to attach casts doubts that Elliott’s strategy both in the Panama case (with respect to a new bond issue) and in the Peru case (with respect to payments to existing creditors) will continue to succeed in the future. This said, structuring international transactions so they are attachment-proof may, of course, impose costs; for example, if fear of attachment induces sovereigns to refrain from issuing new bonds abroad, or investing reserves in international financial centers. To the extent that this is the case, it would give holdouts some leverage in settlement negotiations.

Several holdouts have attempted to mimic Elliott’s legal strategy with respect to Peru, with limited success (Singh, 2003; IMF, 2004). In LNC vs. Nicaragua; the Belgian Court of Appeals found that the contractual pari passu clause did not give LNC the right to attach payments channeled through Euroclear, since Euroclear was not a party to the contract in which the pari passu clause arose. In Kensington vs. Republic of Congo, an English court also rejected enforcement based on the pari passu clause, on the grounds that reliance on this contractual clause was inconsistent with the fact that the plaintiff’s claim had been reduced to a court judgment. Finally, in Red Mountain Finance vs. Democratic Republic of Congo, the courts rejected the broad construction of the pari passu clause but issued an injunction with a similar
effect, i.e. preventing the debtor from making external debt payments unless proportionate payment was made to Red Mountain. The DRC appealed the injunction, but settled with Red Mountain at about 37 percent of the value of the judgment claim before the appeal hearing, just ahead of an arrears-clearing payment to the International Monetary Fund which re-established Congo’s access to multilateral financial support after years of crisis and civil war. Notice that Congo settles for the same reason that Panama settled: to avoid interference with new flow of funds obtained in international financial markets. Thus, while the Elliot case against Peru is the one that has received most of the attention in the literature, it is its case against Panama the one that is really relevant for the workings of sovereign debt markets.

In sum, changes in the legal environment since the late 1970s have made it much easier for holdout creditors to obtain judgment claims. In addition, there are several examples—most famously, CIBC/Brazil, Elliott/Panama, and Elliott/Peru—in which holdouts have been able to enforce those claims, or settle at substantially better terms than average creditors. These settlements seem to have occurred either because holdouts credibly threatened to attach sovereign assets or interfere with international transactions, or because of reputational concerns—debtor reluctance to defy court judgments at a time when they were regularizing their record as borrowers. In fact, the relatively large restructurings of sovereign debt of recent years that took place in Russia, Ukraine, Pakistan, Ecuador, Moldova and Uruguay, have been finalized without any dissenting creditors, either because collective action clauses were used to entice full participation or sufficiently attractive deals were offered to achieve high participation rates and then fully pay the small share of dissenting creditors. Among this group only Argentina has remaining litigation. Thus it is not farfetched to argue that the leverage of holdouts has been sufficiently strong to induce relatively favourable settlements for the creditors, particularly for countries that were expecting to resort to international capital markets in the short run. It comes
then as no surprise that having the Argentine government stated explicitly their reluctance to tap again international markets, it is this country the one that is not concerned about potential holdout retaliation.13

One important caveat should be pointed out. While the evidence points to the fact that countries cannot access commercial lending until they have cleared their slate with dissenting creditors, this has not curtailed their possibilities of obtaining aid, multilateral or bilateral finance. I.e. official credit has remained available even for those counties that were in open default to commercial creditors. Thus, creditors have leverage, to the extent that countries are eager to access international capital markets with commercial creditors, something that is more likely at times when cost of funding in international markets is low, or when the country finds itself restricted to the availability of official funds, or if the country is sufficiently big that official sources are not sufficient given the financing needs of the country. As a result full repayment has remained the exception, as the detailed revision of the many legal cases in Table 1 shows, and market exclusion has been the norm.

To conclude, holdouts currently enjoy some leverage—more than in previous decades and perhaps more than at any time in history. Nonetheless, this leverage is basically restricted to the possibility of attaching new flows the country may obtain in international markets.14 However

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13 See Sturzenegger and Zettelmeyer (2005) for a description of these cases.

14 As a result holdout strategies may make sense only for highly specialized firms such as Elliott Associates. This may explain why actual or expected litigation from holdouts does not so far seem to have derailed any debt restructuring agreement. Holdout strategies may not be attractive for either retail bondholders or large investors with a broader commercial interest in the debtor countries. Agreeing to a reasonable debt restructuring offer—one that reflects the country’s capacity to pay—may be the best option available to mainstream creditors, even if there is an expectation that there could be some successful holdouts. This is true, of course, only to the extent that payments to successful holdouts are expected to remain relatively small—otherwise, the country’s capacity to honor its commitments to the majority could be undermined.
small, this leverage seems to have been sufficient to tilt the countries in favor of settling with
holdouts.

**Pre-Restructuring Litigation and the “Rush to the Courthouse”**\(^\text{15}\)

In both law and economics, the possibility of destructive “creditor runs” began to attract
attention in the early 1980s. Among the first to raise the issue in the legal literature on sovereign
debt appear to have been Barnett, Galvis and Gouraige (1984). The context of the article was the
debt rescheduling agreements between commercial bank creditors and distressed debtors that had
taken place since 1982, and had so far avoided open defaults. Barnett et al. argued that this was a
fragile state of affairs. If an individual creditor decided not to participate in such an agreement
and declared a default as the first step towards litigation, this would trigger cross-default clauses,
resulting in a “race to the courthouse.” This would result in avalanche of creditor claims that
could not possibly be met by the debtor. Moreover, the state of open default would further
magnify the debtor’s economic problems.

As it turned out, “races to the courthouse” did not happen during the 1980s. Based on the
discussion in the previous section, this is not surprising: a free rider problem may not, in fact,
have existed. The rules of syndicated lending ensured that everyone who participated in a “race
to the courthouse” arrived there at about the same time. And even if litigating creditors managed
to attach payments ahead of others, they might have had to share these payments with other
members of the syndicate. Barnett et al. may have been right that “racing to the courthouse”
would have triggered pandemonium. But under the rules of the 1980s, a creditor initiating the
race stood to gain little, and might have suffered the same costs—in the form of an aggravation

\(^{15}\) On this see also Roubini and Setser (2004).
in the debtor’s repayment capacity—as subsequent participants in the race. Hence, stability prevailed.

After the advent of secondary debt markets, these contractual restrictions began to lose their bite, either because new bond issues no longer had sharing provisions, or because distressed debt funds could acquire an entire loan (or a majority stake) at a discount, rendering sharing clauses irrelevant. Yet, there were relatively few cases of pre-restructuring litigation. The best known is the *Pravin Banker v. Banco Popular del Peru*, which was mentioned in the previous section. The argument that Pravin’s suit might set off a race to the courthouse and disrupt Peru’s ongoing restructuring negotiations was, in fact, made by the debtor, and the court initially accepted it, granting two stays of litigation. In the end, however, the court sided with Pravin, and no creditor stampede occurred. The reasons for this might be related to those discussed at the end of the previous section: for most creditors, a litigation strategy is not very attractive unless holdouts undermine the viability of a reasonable debt restructuring agreement. Pravin owned only $1.4 million of Peruvian debt: “although irksome to both the country and its other creditors, it was not about to bankrupt the Peruvian treasury or scuttle the country’s contemplated Brady deal” (Power, 1996).

The only debt crisis of the post-war period (and perhaps in history) that has, in fact, witnessed massive pre-restructuring litigation is the most recent crisis in Argentina. By late 2004, almost 140 law suits—including 15 class action suits, a novel vehicle in the context of sovereign debt litigation—had been filed against Argentina in New York, Italy, and Germany, both by distressed debt funds holding Argentine claims and “retail investors.”  

16 In addition, a large number of suits has been filed in Argentine courts. By May of 2005, 9 of the 15 class action suits filed in the United States had been certified.
resulted in judgments in favor of the creditors, including a $725 million judgment in favor of one creditor (EML, a subsidiary of Dart Capital). In terms of sheer numbers, this looks very much like the “race to the courthouse” predicted by Barnett et al (1985).

The question is whether it also had any of the predicted effects. Barnett et al.’s main concern—that a race to the courthouse would trigger a default—is, of course, moot in this case, since Argentina had already declared default in December of 2001. Moreover, in spite of the judgments obtained by EML and others, the avalanche of lawsuits has not, so far, weakened Argentina economically. Attempts to actually attach assets have so far turned out to be fruitless.\(^{17}\)

The greatest harm that these lawsuits could have done to Argentina would have been to interfere with its debt exchange offer, by creating legal obstacles to the debt exchange or its settlement, or discouraging creditors from participating in the exchange. As far as creditor participation is concerned, this was, in fact, lower than in preceding exchanges (76 percent), but much higher than anticipated, given widespread creditor misgiving about both the substance of the offer and the preceding negotiation process. Regarding legal obstacles, two class action litigants did, in fact, attempt to block the exchange offer, but a New York court ruled against them in November of 2004, and the offer went ahead in January.

This was followed by a further legal challenge in March 2005, shortly before the exchange was to settle. NML Capital (an offshore fund with ties to Elliott Associates) asked a New York court

\(^{17}\) In May 2002, in *Applestein vs. Republic of Argentina and Province of Buenos Aires*, plaintiffs sought to attach the representation office of the province in New York. Investors have also requested the attachment of diplomatic facilities, as well U.S. accounts of Correo Argentino S.A. (the re-nationalized postal service). All these requests have been denied.
to attach a portion ($7 bn) of Argentina’s defaulted bonds that had been turned in by consenting bondholders to the Bank of New York, in charge of carrying out the exchange, arguing that they had market value and hence could be sold to satisfy a future judgment. The court rejected this argument, on the grounds that until settlement, the bonds belonged to the creditors that had accepted the exchange, and that attaching them would jeopardize the exchange; however, it agreed to maintain a freeze pending appeal. In late May, an appeals court upheld this decision, arguing that the lower court “acted within its discretionary authority to vacate the remedies in order to avoid a substantial risk to the successful conclusion of the debt restructuring. That restructuring is obviously of critical importance to the economic health of a nation.” While the court refused to rule on the legal issues disputed by the parties and hence did not set a precedent, one has to agree with Gelpern’s (2005) observation that “if future judges use similar reasoning, pre-closing challenges look increasingly remote.”

IV. Can Domestic Insolvency Procedures be Mimicked Through Sovereign Bond Contracts?

An important theme of the discussion so far has been the tension between enforcing creditor rights, which is desirable from the perspective of efficient debt markets, and avoiding a hold-out creditor problem, which is desirable from the perspective of an efficient resolution of debt crises. At the domestic level, this tension is resolved by bankruptcy legislation, which attempts to safeguard creditors rights—by giving creditors priority over equity holders and ensuring that the firm is restructured in a way that maximizes its capacity to repay—while protecting majority creditors from holdouts (for example, by imposing a stay of litigation pending the outcome of a reorganization, and making the outcome of a reorganization binding on all creditors). The question is whether the same objectives can be achieved by appropriately designing sovereign debt contracts, and relying on courts in the major issuing jurisdictions to enforce them. The
consensus from a growing literature on that topic (Eichengreen and Portes, 1995; Eichengreen, 2000, 2002; Schwarcz, 2000; Buchheit and Gulati 2002; Taylor, 2002; Bolton, 2002; Bolton and Skeel, 2004; IMF, 2002b, 2003b,d,e,f) appears to be: to some extent, but not completely.

Domestic bankruptcy procedures are often interpreted as serving three practical purposes: (1) eliminating free-rider problems during and after the restructuring negotiations, particularly the holdout creditor problem; (2) ensuring that the firm has access to financing while it is being restructured (“debtor in possession”, or “DIP” financing); (3) enforcing a predetermined priority structure. Bond covenants currently deal with only the first of these, and do so to only a limited extent. Contractual innovations that could address the first purpose more completely and begin to address the second and third are not inconceivable, but complicated and perhaps impracticable.

Consider first free-rider problems. As argued in the last section, these can be divided into two groups: pre-restructuring litigation and problems caused by holdouts that litigate after a debt restructuring. As we have seen, most newly issued international bonds already contain some protections against these problems. With regard to pre-restructuring litigation, acceleration clauses ensure that a critical mass of creditors is necessary in order to accelerate repayment and that a majority of creditors can veto this decision. With regard to holdouts, majority amendment clauses can impose a restructuring agreed to by a supermajority of bondholders on a dissenting minority. However, the extent to which these clauses solve the free rider problem is limited. Even if the debtor had just one bond issue outstanding, a minority bondholder could obviously still block an agreement if he controlled a sufficiently large share of the issue. With multiple bond issues, this problem is aggravated by the need to coordinate creditors across these issues: many majority decisions are required, rather than just one, to amend bonds in a consistent way. Moreover, with public debt fractured into many issues, each of which may trade at large
discounts in crisis times, it may be easy for distressed debt funds to acquire a controlling majority of one issue on the secondary market.

To deal with these problems, additional collective action clauses could be added to the standard acceleration, enforcement, and majority amendment clauses (Buchheit, 1998a,b; Taylor, 2002; IMF, 2003e). Bond-by-bond majority action clauses could be supplemented with “aggregation clauses” that would, in effect, allow a supermajority of bond holders across bond issues to amend the payments terms of all bonds even if the usual supermajority required for issue-by-issue amendments is not present. Moreover, proposals have been made to coordinate bondholder representation and discourage litigation by holdouts. These include adding sharing clauses to bond contracts that state that if any bondholder receives a payment disproportionate to that received by other bondholders, this must be shared with the remaining bondholders, and “collective representation clauses” which would delegate the authority to represent the bondholders in debt restructuring negotiations to an agent (though bondholder voting on a proposed restructuring would still be required). For example, bonds could be issued under a “trust indenture” (in U.S. law) or a trust deed (in English law); these give a trustee a limited monopoly over litigation and require it to share any proceeds among all holders of the same bond issue (Buchheit and Gulati, 2002). Additional language in the bond contract would be required, however, to give the trustee the power to negotiate.

Bonds issued in recent debt restructurings have taken limited steps in these directions. In Uruguay’s May 2003 exchange, all new external bonds were issued under a trust indenture, and included an aggregation clause to the effect that, if 85 percent of holders of bonds issued under the same indenture agreed to an amendment of the payment terms, then the supermajority level required for the amendment at the level of each individual bond was reduced from 75 percent to
66⅔ percent. Argentina’s proposed December 2004 exchange contains a similar clause, with the novel feature that aggregated voting would apply across bonds governed by different governing laws. These aggregation features are still very limited compared with a situation where all bondholders would make a supermajority decision “across” bonds, in the sense that they would still give a 34 percent minority of holders of each individual bond issue the power to hold out, even if more than 85 percent of all bondholders desire a change. But in principle, they could be extended further.

Next, consider “DIP financing.” Bank Advisory Committee process in the 1980s served this purpose, providing “new money” in the context of debt rescheduling agreements. In contrast, in the post-Brady era of debt exchanges, distressed borrowers have never been able to obtain new private financing either just before or at the time of a debt restructuring agreement. Instead, the role of the provision of “DIP financing” to countries has been assumed entirely by the official sector, particularly the International Monetary Fund (though attempts were made, some of which were successful, in persuading private creditors to maintain or roll over their exposures in several crises that did not lead to a restructuring; see Roubini and Setser, 2004). The question is whether legal innovations in bond contracts could make it easier for private sector DIP financing to come forward. A proposal in this direction has been made by Buchheit and Gulati (2002), who suggest that this could be achieved through an amendment in the pari passu clause in each bond that would legally subordinate the bond holders to new creditors that are willing to lend to the country during a pre-set period. In the event that the attempt to “rescue” the country through the infusion of new private funds fails, the new creditors would be paid off before the old creditors received any payments. However, the new infusion may also stave off a restructuring altogether, and hence be in the interests of the existing creditors. According to Buchheit and Gulati, an amendment of the pari passu clause would not affect the payment terms of the bond and could
hence could generally go forward with a simple majority of bondholder for bonds with U.S.-style amendment clauses.

Finally, consider the problem of enforcing a pre-set priority structure across claim-holders. In sovereign bonds there generally is no such structure, arguably because it could not currently be enforced. However, as argued in a number of recent papers (Bolton and Skeel, 2004; Bolton and Jeanne, 2005; and Borensztein et al, 2005; see also Gelpern, 2004) a pre-set priority structure based on the time of first issuance—in other words, giving seniority to holders of earlier issues—could reduce incentives to overborrow and lower the cost of borrowing at low debt levels by removing the possibility of debt dilution (the reduction of the claims of earlier creditors on the recovery value of the debt through subsequent debt issuance). Senior creditors could, of course, still decide to give up their seniority in a crisis situation through an amendment as described by Buchheit and Gulati. Borensztein et al. discuss some options for contractual enforcement of such a structure; these might be legally feasible, but are complicated. The complication arises from the fact that existing creditors, rather than subordinating themselves, must somehow commit the debtor to negotiate future bond contracts such that future creditors are contractually subordinated to present creditors. This could possibly be achieved by defining the failure to do so as a default event, and giving creditors the power to accelerate their bonds in that event. In other words, current creditors could accelerate if they observed new bond issues that are not explicitly subordinated to currently outstanding issues. Whether this is a sufficiently strong incentive to induce debtors to negotiate a consistent priority structure based on time of issuance with successive generations of creditors is open to question.

The sense of the discussion so far is that introducing bankruptcy reorganization-like features in sovereign debt through bond contracts alone may be at best complicated and, at worst,
impossible. This view has led several authors to propose mechanisms beyond contract law which might improve the debt restructuring process. A number of proposals since the 1980s have envisaged creating a formal legal regime for sovereign bankruptcy, through international treaty and/or amendments in national statutes (see Rogoff and Zettelmeyer, 2002, for a survey). The best known and most detailed of these is the IMF’s recent proposal for a “Sovereign Debt Restructuring Mechanism” (Krueger, 2002; IMF, 2002b, 2003d; Hagan, 2005), which was discussed by the IMF’s Executive Board in 2002 and 2003, but ultimately failed to attract support from the requisite supermajority of the IMF’s shareholders. In its final version, the IMF’s proposal envisaged a majority action provision making a debt restructuring agreement binding on dissenting debt holders (including non-bond creditors, which cannot easily be dealt with through aggregation clauses), limited protection from pre-restructuring litigation, and a mechanism for DIP financing. A subsequent proposal by Bolton and Skeel (2003) went a step further in additionally proposing a mechanism for enforcing first-in-time seniority.

A more limited alternative to a statutory sovereign bankruptcy regime, which would mainly address any remaining free rider problem, could be to revive the “equity receivership” technique, used in the United States for corporate debt restructurings prior to the arrival of Chapter 11-like bankruptcy reorganization statutes, in restructuring sovereign debt (Buchheit and Gulati, 2002). Under this procedure, courts, acting upon the request of creditors, appointed “receivers” which managed companies while the restructuring agreement was negotiated, and limited the benefits that holdouts could expect to receive. Buchheit and Gulati argue that federal class-action procedures could be used as a basis for analogous, court-supervised restructurings involving sovereign debtors. According to these authors, sovereign debt restructurings satisfy the basic condition for initiating class-action suit under federal procedures because creditors have a basic common (“class”) interest, and separate legal actions by individual members of a class could
harm that interest. In their strongest form ("mandatory class actions"), any eventual settlement reached in a class action will bind all members of the class, at least to the extent that the court has jurisdiction over the class members, hence essentially removing the holdout problem; a weaker form allows class members to opt out of the litigation proceedings. In either case, the proposed settlement must be approved by the court.

The mechanics of class action suits would be for one or several individual bondholders to bring a suit before a U.S. court asking the court to "certify" the creditors as a class (either mandatory or with an opt-out). So far, there are 10 cases on record in which U.S. courts have agreed to certify creditors of a sovereign as a class (Hirshon vs Bolivia in 1995, and nine cases involving Argentina, which were certified in 2004 and 2005). All have fallen below the standard that would be required to effectively deal with holdout problems, as none of them constituted a mandatory class action. Moreover, in the cases involving Argentina, the classes were defined narrowly to comprise only the holders of one or two Argentine bond series issued under New York law, and the U.S. courts have denied certification requests involving broader class definitions.

In sum, for the foreseeable future, the prospects for applying domestic bankruptcy-like procedures to sovereigns are fairly dim. The application and coverage of collective action clauses has steadily grown in the last few years, but still falls far short of fully dealing with free rider problems. No attempt has been made to use bond clauses to subordinate existing creditors to new lenders in a crisis, or to create a systematic priority structure based on the time of issue. Mandatory class action suits have not been used as a vehicle to deal with the holdout problem, and court decisions in Argentina suggest that U.S. courts are unlikely to regard all bondholders (or even all creditors) as a "class", preferring much narrower class definitions that leave plenty
of opportunities for independent litigation. Finally, the IMF’s proposal to create a new body of sovereign bankruptcy law at the international level is on hold owing to lack of support from major creditor and debtor country governments. In the meantime, however, debt exchanges seem to have worked fairly well, and holdouts have not proven to be a significant obstacle to carrying out these exchanges. It remains to be seen whether this will continue to be the case in the future.

V. How Investors Fared

A central question—perhaps the question—in the study of sovereign defaults is how defaults and the subsequent settlement affect the parties involved. The economic literature on sovereign debt generally assumes that defaults have benefits and costs for the debtor, and that the decision to default is based on a comparison of these costs and benefits. In contrast, a default always harms the creditor, but for sovereign debt to exist, this harm must be made up by positive returns in normal times. In the following we briefly summarize the evidence on the losses that defaults have inflicted on the debtors, as well as the overall average returns earned by investors holding risky sovereign debt.

To summarize the losses suffered by creditors as a result of specific debt restructurings, one would ideally like to compare the value of the (remaining) payment stream that was originally promised to investors and that associated with the restructured instruments, both discounted at a common interest rate (see Sturzenegger and Zettelmeyer, 2005). Unfortunately, there is no study that compares all debt settlements since the 1820s using such a summary measure. Instead, several authors have compared debt restructurings in various aspects—such as the face value reductions suffered, the average reduction in interest payments, etc.—that contribute to the overall reduction in the investors’ claim.
In an extensive historical study of debt and defaults since the 1820s, Suter (1992) compares debt restructurings in three periods—1820-1870, 1871-1925, and 1926-1975—in terms of (1) the extent to which interest arrears were repaid; (2) reduction in interest rates, and; (3) reduction in face value. He finds that, by these measures, debt settlements seem to have become tougher for investors over time. In the first period, there were hardly any face value reductions, interest rates were typically reduced by about 15 percent, and 81 percent of the outstanding arrears were capitalized into new bonds (this ignores compound interest on arrears). In the second period, the rate of capitalization of arrears was only 72 percent, interest rates were reduced by about 16 percent, and face value by 23 percent. However, the latter is in part a reflection of the increasing use of land and railway concessions to “repay” investors in this period. Finally, the interwar defaults led to much larger investors losses: only 35 percent of interest arrears were recognized on average; interest payments suffered an average haircut of 34 percent, and face value was reduced by 23 percent, but without any offsetting assignment of non-debt assets.

Jorgenson and Sachs (1989) compute investor losses for four major Latin American default cases in the 1930s—Bolivia, Chile, Colombia, and Peru—by comparing the present value of the principal outstanding at default to the present value of actual repayment after default, both discounted back to the default year using a risk-free international interest rate. Using this methodology, Jorgenson and Sachs show that the 1930s defaults and restructurings resulted in very large present value losses: 37 percent for Colombia, 61 percent for Peru, 69 percent for Chile, and a staggering 92 percent for Bolivia.

Rieffel (2003, p. 171, based on World Bank data) summarizes the terms of the Brady deals by averaging the face value reduction suffered by investors choosing discount bonds (i.e. bonds with the same coupon as outstanding bank loans, but smaller face value) and the discounts
reflected in the buyback component (the difference between the face value and the market price at which bonds were bought back). The average discounts range from about 35 percent for Mexico (1990) to 76 percent for Côte d’Ivoire. Importantly, these discounts significantly understate the present value discount suffered by investors, because they do not take into account the much longer maturity (30 years) of the new Brady bonds relative to the previous bank loans, which for the most part had already come due and were being rolled over.\(^\text{18}\)

Finally, Sturzenegger and Zettelmeyer (2005) calculate the present value losses attributable to the bond exchanges and restructurings of 1998-2005. To do so, they compare the present value of the originally promised payment stream—including both remaining interest payments and principal outstanding—to the \textit{expected} present value of payments promised at the time of a debt restructuring; as this is unobservable, the post-restructuring interest rate (which prices in any expected future losses) is used to discount both streams. Out of the six major debt restructurings of externally issued debt in this period, investors suffered face value reductions in four cases (the Russia 2000 Prins and IANs exchange, Ukraine 2000 and Ecuador 2000, Argentina 2005), while the remainder (Pakistan, 1999; and Uruguay 2003) involved mainly extensions in maturity and to a lesser extent interest rate reductions.\(^\text{19}\) But there is not much of a relationship between the extent of face value reductions and the present value “haircuts,” which ranged from just 5-20

\(^{18}\) For example, Beim and Calomiris (2001) report that the “fair market value” of Mexico’s discount bond was about 51 cents on for each dollar of face value of the new debt, while the corresponding value of the par bond was about 37 cents. Hence, the value offered to investors for each dollar of old debt was about 33 cents (0.65 times 0.51) and 37 cents, respectively. Assuming that the present value of the old claim was 1 dollar on the dollar (this loan had already come due), this means that the present value loss suffered by the banks was about 65 percent—much higher than the 35 percent discount in face value.

\(^{19}\) This was also the case in Argentina’s 2001 “Phase I” restructuring of international bonds aimed mostly at domestic bondholders.
percent for Uruguay (2003) to over 50 percent for Russia (2000) and over 70 percent for Argentina (2005), with the remaining exchanges falling mostly in the 20-40 percent range.

One interesting implication of these results is that with the exception of Argentina (2005), investors suffered smaller losses as a consequence of the supposedly creditor-unfriendly unilateral exchange offers than the negotiated settlement with Russia, which was conducted by a Bank Advisory Committee. Based on Rieffel’s computations, it also seems that most Brady deal restructurings negotiated between banks and debtor countries involved significantly larger present value losses. Of course, it is possible that these different outcomes reflect different initial conditions (including a bigger debt overhang in the 1980s). In the absence of a systematic study that controls for initial conditions, what can be said at this point is only that unilateral debt exchanges, perhaps surprisingly, do not appear to have been associated with larger investor losses than negotiated debt restructurings.

The main limitation of “haircut” calculations of this kind is that they say nothing about how investors fared in the longer run, i.e. whether defaults—as well as capital losses in crisis times in countries that did not end up defaulting—were ultimately offset by high returns in good times. To answer this question, one needs to compute investor returns over longer horizons. Several papers tackle this issue: Eichengreen and Portes (1986, 1989) track a large sample of bonds issued on behalf of overseas borrowers in the U.S. and the U.K. in the 1920s; Lindert and Morton (1989) track over 1500 bonds issued by 10 borrowing countries between 1850 and 1983 (including bonds outstanding in 1850); and Klingen, Weder and Zettelmeyer (2004) compute returns on public and publicly guaranteed bank loans and bond flows to about two dozen emerging markets in the 1970-2000 period, using aggregate data at the debtor country level compiled by the World Bank.
The results are remarkably consistent across time periods and methodologies. The upshot of the three studies is that while investors both incurred significant losses and made large profits in specific episodes and for specific countries, the long run average premium of emerging market debt relative to sovereign debt in the traditional creditor countries, such as the U.K. and the U.S., has generally been positive, but small (150 basis points or less). According to Lindert and Morton, the portfolio of 1522 bonds issued by overseas borrowers over the course of 150 years would have narrowly “beaten” a portfolio of creditor country sovereign bonds absorbing the same flows, by 42 basis points on average per annum. For bonds issued prior to 1914, they find a virtual tie (-14 basis points) while bonds issued between 1914 and 1945—the “generation” that suffered from the defaults of the 1930s—did slightly better (113 basis points). Eichengreen and Portes find that foreign government bonds issued in the U.S. in the 1920s did slightly worse than their domestic U.S. counterparts, while Sterling bonds did slightly better (on the order of 100 basis points). For the 1970-2000 period and a sample of both bank and bond lending to 22 emerging markets countries, Klingen, Weder, and Zettelmeyer find a long-run premium of -17 to 46 basis points, depending on the methodology applied. This reflects the combined effect of negative spreads during the boom-bust cycle from 1970 to the late 1980s (reflecting the debt crisis of the 1980s) and sharply positive spreads, on average, since then.

Table 2 shows some results for specific countries, based on Lindert and Morton (1989) and Klingen et al. (2004). For the long pre-World War I period, one important result is that investors earned positive average spreads in most debtor countries—including Argentina, Brazil, and Chile, which all defaulted at least once in this period. Thus, the defaults of these countries were more than offset by debt service in normal times. This was not the case for Russia, Turkey, and particularly Mexico. In all three of these cases, what made the difference was political upheaval,
war, or revolution. Mexico repudiated completely on two occasions: after deposing the Emperor Maximilian in 1867, who had been installed by France three years earlier; and after the 1911 revolution. Russia did the same after the 1917 revolution, and Turkey did so after World War I, when the new nationalist government refused to repay pre-war Ottoman debts. At the other extreme, Egypt’s creditors earned exceptionally high returns because of the combination of a risky ex-ante spread with full repayment after the attempted default of 1876 led to the 1882 British invasion and loss of sovereignty. In short, both the negative spreads for Mexico, Russia, and Turkey and the high positive spread for Egypt reflect forecast errors, while the moderate positive spreads for the remainder reflect repayment performance that was in line with expectations. In the case of Argentina, Brazil, and Chile, ex ante spreads were comparatively high (Lindert and Morton, Table 2.2), which was validated by a default some time in the late 19th century. In the cases of Australia, Canada and Japan, ex ante spreads were lower, validated by full repayment.

It is also interesting to interpret Lindert and Morton’s post-World War I returns. First, note the missing values for Mexico (1915-45) and Russia (1915-83); this reflects extended absences of these countries following their revolutions and repudiations in the early 20th century. The worst return in the interwar period was that of Chile, consistent with the exceptionally large write-down associated with its interwar default (69 percent, according to Jorgenson and Sachs’ methodology). High returns—both for bonds issued in the interwar period, and after the Second World War prior to the 1980s debt crisis—are associated with Argentina, the only major Latin American borrower to avoid default in the interwar period. The same was true for Japan, which repaid faithfully until the attack on Pearl Harbor and again after the war.
The right columns of the table, which are based on data and calculations by Klingens, Weder, and Zettelmeyer (2004), consider the post-war experience for the Latin American countries and Turkey. In contrast with its good repayment performance during the first half of the century, the main defaulter is now the Republic of Argentina. It was the only major borrower to undergo large debt write-offs both after the 1980s debt crisis and after the boom-bust cycle of the 1990s, hence its large negative spread. Like Argentina, Brazil, Mexico, and Chile went through two major boom-bust cycles, but, unlike Argentina, only the first of these cycles ended in a default. As a result, the overall realized spread from 1970-2001 is about zero, reflecting the offsetting effects of poor returns until the resolution of the 1980s debt crisis, and high returns since then.

Finally, Turkey’s post-war experience was unusual. It is the only country in the group that does not exhibit negative spreads for the 1970-92 period. This reflects the absence of a large debt write-off during or after the 1980s debt crisis. After devaluing in 1979, Turkey restructured “convertible Turkish lira deposits”—foreign commercial bank deposits in Turkish banks with an exchange rate guarantee from the central bank—but left medium term sovereign loans untouched (Rieffel, p. 307-311), and managed to avoid further debt restructuring during the 1980s or 1990s. But neither does Turkey exhibit large realized spreads between the early 1990s and 2001—unlike Brazil, Chile, or Mexico. This is a result of the 2000-2001 financial crisis, which led to a limited commercial bank debt restructuring in early 2001 and depressed sovereign bond prices, which enter in the calculations underlying the returns for the period ending at end-2001. Thus, while the Turkey’s average result for the entire 1970-2001 period is very similar to that of Mexico, its composition is very different.

The unusually high returns during the 1990s provide clues for evaluating the behavior of international financial markets during the last decade. They signal both unusually high ex-ante
creditor demands, possibly due to the negative returns obtained during the eighties, and better-than-expected outcomes.

VI. Conclusions

This survey has discussed how the evidence from recent litigation in international debt markets may shape our view on the reasons for the existence of sovereign debt. The evidence suggests that a good model of sovereign debt should assume that creditors cannot impose any sanction on defaulting countries, but that they can hinder its access to international capital markets. We also discussed whether a contractual approach may resolve the coordination problems in sovereign debt markets and concluded that this is unlikely. Finally we also showed that the evidence suggests that while defaults occur recurrently, investors do obtain a positive extra return ex-post, although this premia changes over time.

While our set of facts provides support for the assumptions in the seminal Eaton and Gersovitz (1981) piece, the literature has since attempted to build models of sovereign debt that either allowed for sanctions or did not rely on exclusion.

Does this mean we should go back to the original specification? The answer is: not necessarily. In fact there are good reasons not to dismiss the literature that has tried to build models while avoiding the need to assume permanent exclusion from credit markets. While we find that sanctions are not feasible and that the threat of exclusion is, there are two main reasons for thinking that the threat of exclusion may be less relevant for some countries or to all countries in the future. On the one hand official credit has been continuously available to most countries, even under a situation of overt default. Thus, the threat of exclusion refers only to commercial creditors. A direct conclusion of this fact is that the costs of default are less serious for small
countries for which official debt may be large enough to substitute for commercial debt, something that would not be feasible for larger countries. Not surprisingly these countries exhibit large amounts of official debt and very little amount of commercial debt.

Secondly, as was shown in this survey, legal tactics are updated all the time, and new ways are discovered both to extract payment from a defaulting sovereign as well as to avoid attachments. If countries find ways to issue sovereign debt that is free from attachments, then the threat of exclusion becomes, once again irrelevant. While this has not happened yet, using financial havens, or some protected markets such as Euroclear, may become the next testing ground on how sovereign markets will work in the future. At any rate, the current boom in emerging markets seems to suggest that neither of these developments appears likely in the short run.
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## Table 1. Recent Litigation Results

<table>
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<th>Creditor</th>
<th>Domicile of Creditor</th>
<th>Debtor</th>
<th>Original Claim</th>
<th>Status</th>
<th>Year</th>
<th>Judgement for Creditor (in US$ million)</th>
<th>Received (in percent)</th>
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<td>3.9</td>
<td>JTP 9/</td>
<td>2003</td>
<td>8.3</td>
<td>30/10/</td>
</tr>
<tr>
<td>Ind. Of Construction</td>
<td>Form. Yug.</td>
<td>Uganda</td>
<td>7</td>
<td>JTP 9/</td>
<td></td>
<td>8.9</td>
<td>--</td>
</tr>
<tr>
<td>Sours Fab. Famous</td>
<td>Form. Yug.</td>
<td>Uganda</td>
<td>0.3</td>
<td>JTP 9/</td>
<td></td>
<td>1.4</td>
<td>... 4/</td>
</tr>
<tr>
<td>Iraq Fund for Ext. Dev.</td>
<td>Iraq</td>
<td>Uganda</td>
<td>6</td>
<td>JTP 9/</td>
<td></td>
<td>6.4</td>
<td>--</td>
</tr>
<tr>
<td>Shelter Afrique</td>
<td>Kenya</td>
<td>Uganda</td>
<td>0.9</td>
<td>OCS</td>
<td></td>
<td>... 4/</td>
<td>11</td>
</tr>
<tr>
<td>Cardinal</td>
<td>Bahamas</td>
<td>Yemen</td>
<td>8.2</td>
<td>OCS</td>
<td>2001</td>
<td>4.1</td>
<td>33</td>
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<tr>
<td>Camxed Int.</td>
<td>Bahamas</td>
<td>Zambia</td>
<td>40-45</td>
<td>JTP</td>
<td>1997</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Singh (2003), IMF and IDA (2004), and news reports.

Notes: "JTP" denotes Judgement to Pay; OCS denotes "Out of Court Settlement" (including in cases when there was a JTP).

1/ Litigation with collective action problems refers to instances in which the plaintiff was one of many holders of the same instrument (or a similar debt instrument that was also defaulted).

2/ Others include Old Castle, Urban, Macrotechnic, NML etc. Substantial litigation has also taken place in Germany and Italy, sometimes involving retail bondholders.

3/ Approximately US$1 billion in the US, EUR46 million in Italy, EUR42.2 million in Germany. See 18-K filing presented to SEC commission by Argentine government.

4/ Indicates payments ongoing or settlement for an undisclosed amount.


6/ Singh (2003) reports that GBP150,000 were attached in London.

7/ US$1 million paid so far

8/ USD1.1 million paid so far

9/ Ruling obtained in local courts.

10/ US$2.79 of legal fees were paid out. See http://fr.allafrica.com/stories/200412200466.html.
Table 2. Emerging Market Realized Spreads on Sovereign Debt 1850-2000
(in percentage points)

<table>
<thead>
<tr>
<th></th>
<th>Bonds 2/</th>
<th>Bonds and long-term bank loans 3/</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1.71</td>
<td>1.95</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.89</td>
<td>0.7</td>
</tr>
<tr>
<td>Chile</td>
<td>1.48</td>
<td>-1.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>-2.72</td>
<td>...</td>
</tr>
<tr>
<td>Australia</td>
<td>1.01</td>
<td>1.21</td>
</tr>
<tr>
<td>Canada</td>
<td>1.27</td>
<td>0.65</td>
</tr>
<tr>
<td>Egypt</td>
<td>2.92</td>
<td>-0.73</td>
</tr>
<tr>
<td>Japan</td>
<td>1.25</td>
<td>2.26</td>
</tr>
<tr>
<td>Russia</td>
<td>-1.63</td>
<td>...</td>
</tr>
<tr>
<td>Turkey</td>
<td>-1.56</td>
<td>-0.88</td>
</tr>
</tbody>
</table>

1/ Difference between the realized return on sovereign debt of the respective periphery country and the return on sovereign debt of the investor’s home country (for bond returns 1850-1983) or the U.S (for all private external lending, 1970-2001).
3/ Source: adapted from Kingen, Weder and Zettelmeyer, 2004; uses their “indirect approach.”