Sovereign debt restructuring: the Judge, the vultures and creditor rights

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Sovereign debt restructuring: the Judge, the vultures and creditor rights*

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Abstract

What role did the US courts play in the Argentine debt swap of 2005? What implications does this have for the future of creditor rights in sovereign bond markets? The judge in the Argentine case has, it appears, deftly exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement – to promote a swap with a supermajority of creditors. Our analysis of Argentine debt litigation reveals a 'judge-mediated' sovereign debt restructuring, which resolves the key issues of Transition and Aggregation - two of the tasks envisaged for the IMF's still-born Sovereign Debt Restructuring Mechanism.

For the future, we discuss how judge-mediated sovereign debt restructuring (together with creditor committees) could complement the alternative promoted by the US Treasury, namely collective action clauses in sovereign bond contracts.

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

JEL Nos: F34; K41; K49

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Introduction

The progressive switch from bank loans to sovereign bonds in lending to emerging markets – and the Brady Plan in particular – triggered a lively debate on bond restructuring and the potential obstacles posed by 'holdout creditors'[1]. But the IMF proposal for a new Sovereign Debt Restructuring Mechanism (Krueger, 2003) to tackle the issue found little favour with creditors or debtors and this left the US Treasury-backed initiative for putting Collective Action Clauses (CACs) into sovereign bond contracts as the preferred alternative.

When in 2005 Argentina successfully restructured the majority of its defaulted foreign debt, this was neither mediated by the IMF, nor assisted by clauses to promote creditor coordination. It was effected by a take-it-or-leave-it offer from the debtor, accepted by a supermajority of bondholders despite the substantial 'haircut' involved.[2] It is our contention that the US courts played a major role in promoting the swap; and will probably continue to do so in future debt restructurings. In this paper we give an account of how the process of "judge-mediated" debt restructuring has operated in this case; and we speculate on future developments.

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

Others take a more optimistic view: for Sturzenegger and Zettelmeyer (2005c, p.10) the Argentine swap was "in most dimensions a textbook example of how to do an exchange". In reviewing recent litigation in international debt markets, however, they

[1] These include vulture funds who buy distressed debt in default and sue for payment in full, Fisch and Gentile (2004).

[2] Creditors who enter the swap suffered a loss of about two thirds in the face value of their bonds; those who did not have, so far, received nothing from Argentina in more than a year after the swap.

found no evidence that sanctions on trade and payments have been imposed in an effective way. Recent developments, they argue, provide support for the assumption made in the seminal paper by Eaton and Gersovitz (1981): that while "creditors cannot impose any sanction on defaulting countries, they can hinder its access to international capital markets", Sturzenegger and Zettelmeyer (2005b, pp.7, 51).

Careful examination of the Argentine debt swap of 2005 leads us to challenge both views. While Porzecanski concludes that the courts are irrelevant, we note that the judge appears to have exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement, in particular – first to achieve a swap and then to protect creditor rights. Likewise, the simple dichotomy between sanctions and reputation proposed by Sturzenegger and Zettelmeyer (as the only mechanisms to ensure a successful swap) misses a key factor: namely judicial intervention.

Our analysis of the opinions and orders of Judge Griesa's court suggests four distinct phases of judge-mediated debt restructuring. First comes the *engagement of the debtor*: the Judge finds in favour of holdouts in order to encourage the debtor to make an offer. Second is *promoting the swap*: he refuses enforcement long enough to promote a successful debt swap. Third *threatening attachment*: once the swap has been accepted by a supermajority, it is time for the courts to threaten the debtor with enforcement (effectively denying it access to primary capital markets). Finally, *direct mediation*: at the same time as the judge threatens attachment, he is willing to resolve disagreements between some holdouts, e.g. retail investors, and the debtor to settle outstanding claims. Currently, the last two phases prevail simultaneously.

In their discussion of sovereign debt restructuring, Fisch and Gentile (2004) emphasise the role of holdout litigation in the enforcement of sovereign obligations. We too see creditor litigation continuing to be important: but only in the period of transition to CACs do we consider that vultures play a pivotal role. In a future where CACs are widespread, it may well be litigation by an *ex ante* Creditor Committees that triggers the debtor to come up with an offer.

The paper is organised as follows: section 1 briefly reviews the literature on why sovereigns pay and indicates where our analysis fits in. In the next section we outline the salient features of the Argentine case (with discussion of a bargaining interpretation of the swap in an Appendix) and discuss a bargaining interpretation of the swap, section 2. The next two sections, 3 and 4, analyse the opinions and decisions of the New York courts: encouraging the debtor to make the first offer (in Dubai, September 2003); promoting the ensuing debt restructuring process (from Dubai to the final offer in March 2005); and acting to help resolve the holdout problem. Section 5 indicates how the widespread adoption of CACs will reduce the role of vultures in future and sketches the role that courts and creditor committees will play. The last section concludes.

1. Why do sovereigns pay?

How does the analysis in this paper relate to the existing literature on the incentives for sovereigns to repay debt? What role have these incentives played in the Argentine case? The academic literature has stressed the role of 'direct' sanctions, 'policy conditionality' and 'reputational' sanctions imposed by creditors, as indicated in Table 3, lines 1 to 3a. But such mechanisms played a minor role in the Argentine case: they were "the dogs that did not bark", to make an analogy with Arthur Conan Doyle's *The Hound of the Baskervilles*. Before outlining the role of the courts in helping to achieve the swap (see line 3(b) of the table), we discuss in more detail the failure of the other mechanisms.

Table 1. Why do sovereigns honour their debts?

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

Notes to Table
1. Esteves (2005)
2. Bulow and Rogoff (1989)
3. Dooley (2000), Gai et al. (2004), Irwin et al. (2006), Jeanne and Ranciere (2005)
4. Levy-Yeyati and Panizza (2005)
5. Kohlscheen and O'Connell (2003)
6. E.M.LTD v. The Republic of Argentina (12 Sept 2003)
7. Sgard (2004)
8. Kaletsky (1985)
9. Eaton and Gersovitz (1981), Kletzer and Wright (2002)
10. Fisch and Gentile (2004), Miller and Thomas (this paper)

Sanctions

The use of direct military threats to enforce debt contracts may have been relevant in the nineteenth century when 'gunboat diplomacy' was common, but not now: WTO rules prohibit trade intervention for purposes of debt collection, and seizures not authorised by a court are, by definition, illegal. But as capital markets have become increasingly globalised, the waiving of sovereign immunity – often required as a precondition for issuing debt in London or New York – has allowed for the *attachment of collateral assets* under court procedures: specialist vulture funds have developed litigation strategies to exploit these possibilities. In the case of Argentina, however, efforts by holdout creditors to attach assets have been a failure, as indicated in the last column of Table 1.

Another feature of modern capital markets is the ease with which creditors can exit; so sovereign debtors are exposed to creditor panic with associated financial and exchange rate crises, Ghosal and Miller (2002). Reducing or avoiding the *output losses* that can be triggered by capital flight is now regarded as a strong incentive for sovereigns to honour their debts, as the references in note (2) to the Table make clear.[3] In the Argentine case, severe output losses have of course occurred but – since default was widely anticipated – they ensued well before default: and, while the debt was being restructured, recovery got well under way. (A sanction that could have played a role in this case is the *denial of trade credit*, a device commonly used to put pressure on defaulting sovereigns, Kohlscheen and O'Connell, 2003).

Policy conditionality

Since the IMF policy of 'lending into arrears' initiated during the Latin American debt crises of the 1980s, the Fund has had to insist on explicit *policy conditionality* to avoid undermining debtors incentives to repay. Signing the Letter of Intent that embodies such conditions is a precondition for obtaining IMF programme assistance. In the cases of Korea in 1997 and Brazil in 2002, indeed, prospective presidents were persuaded to endorse targets for fiscal prudence before elections took place, an illustration of the loss

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

of sovereignty mentioned in the Table. Conditions for rolling over IMF lending to Argentina after default did include the requirement that steps be taken to settle with holdout creditors: but, for the IMF, Argentina was effectively "too big to fail"; and in any case it freed itself from any such policy conditionality by early repayment of all its borrowing in 2006. Kaletsky (1985) stresses the role of international pressure from G7, but this does not seem to have played an important part in the Argentine case.

Market access

An alternative incentive to repay debts would be fear of losing *reputation*, with consequent widening of the bonds spread from normal junk bond levels[4] to what might be described as rogue-debt levels. Despite Porzecanski's characterisation, this does not appear to be the case for Argentina – where spreads are close to those of Brazil. Kletzer and Wright (2000) analyse a self-enforcing mechanism – 'cheat the cheater' – that could sustain equilibrium in debt markets with a limited number of creditors, see Table 1, line 3a.[5] Their analysis, however, is explicitly related to bank lending as in the original Eaton and Gersovitz (1981) paper: how, if at all, it might be extended to a world of anonymous bondholders is unclear.

The argument of this paper is that *the courts* have played a key role in the Argentine case: initially by threatening the debtor with attachments to prompt a credible offer, and reining in the holdouts to promote the swap. After the successful swap, the threat of attachment has effectively denied the debtor access to primary capital markets, namely London and New York. As indicated in line 3(b) of Table 1, denial of access to these markets is one way of pressuring a defaulting debtor to settle pending claims against it. By undertaking to resolve disagreements between the debtor and holdouts, the court also provides a mechanism to ensure successful settlements.

We conclude that whatever pressure there is on Argentina to finalise the swap it is not coming from self-enforcing reputation mechanisms which operate in an institutional vacuum as suggested by Kletzer and Wright. Court denial of access to New York for the issue of new bonds may not impose immediate hardship on the country or its finances:

[4] As it is prone to restructuring, corporate debt in the US is often referred to as junk bonds.

[5] It should be noted, however, that not only Venezuela but also New York banks are happily lending into serious arrears by Argentina : is this consistent with the Kletzer/ Wright equilibrium?

but it is surely not credible that a middle-income country like Argentina will wish forever to be excluded from the leading capital markets of the world.

2. Key aspects of the Argentine debt restructuring

The Argentine case is notable for being the largest-ever sovereign debt default and for being conducted without decisive intervention by international institutions. Before providing our account of role of the US courts in this case, four salient features of the Argentine swap may be discussed with the aid of Table 2: namely, the heterogeneity of creditors groups, the absence of creditor coordination, the size of the write down, and the long delay before it was accepted.

Table 2. Comparison of Recent Sovereign Debt Restructurings
(Porzecanski, 2005)

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

Note: N/A stands for not applicable
** Adjusted for purchasing power, latest (2003) data for Argentina, otherwise data corresponds to year(s) of debt restructuring as noted.*
Source: IIF IMF, World Bank, A. C. Porzecanski's calculations.

(i) Pronounced creditor heterogeneity

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

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

(ii)Absence of creditor co-ordination

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

(iii) Significant debt write-down

On a total outstanding principal of $81.8 billion, the Argentine swap involved a 66.3% 'haircut' (column 1). This is considerably larger than the other haircuts shown, namely 40% for Ecuador and 37.5% for Russia: whether it is consistent with bargaining theory we consider in the Appendix. The 76% participation rate in the swap is by far the lowest shown and implies that Argentina is still in default with 24% of its creditors by value.

(iv) Long Delay

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

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

Historical precedents

In 1976, the US (and, soon after, the UK) imposed statutory constraints on absolute sovereign immunity from suit in foreign courts, Buchheit (1995). In the two decades that followed, creditors developed innovative litigation strategies to maximise the benefits of restricted sovereign immunity. In the absence of statutory regulation of sovereign debt, however, the litigation strategies have had mixed results - with common law decisions influenced by the political and economic conditions in which the litigations were pursued.

Even in the absence of enforcement, restricted sovereign immunity has significantly improved the leverage of creditors in the restructuring process. In the case *Elliot & Associates v. Banco de La Nación* (Perú) decided in 1999, for example, the claimants were vulture funds who threatened the debtor with enforcement and consequent delay of the imminent swap: the debtor settled their claims out of court to avoid this outcome. Similarly, in the case *Elliot & Associates v. Panamá* decided in 1997, the threat of enforcement would have interfered with a new bond issue and consequently impaired Panama's ability to access capital markets. Again, the case was settled out of court, in favour of the vultures.

Moreover, in the case *Pravin Banker v. Banco Popular del Perú* decided in 1997, the court went as far as to lay down the guidelines that they would follow in sovereign litigation. The first guideline was to encourage orderly debt restructuring initiatives that involved the use of Brady bonds. The second guideline was to ensure the enforcement of contracts executed between American investors and sovereign debtors. In line with U.S. foreign policy at the time, in most cases the second guideline dominates the first: thus in a situation where ongoing debt- restructuring negotiations were at the cost of the claims of U.S. creditors, the courts were bound to concede to the latter.

The court's role in the Argentine swap

The Argentine swap was successfully concluded against the backdrop of over 200 law suits – (including 15 class action suits) filed in New York, Italy and Germany. How was this achieved? We believe that in large part it was due to mediation by the judge; and in Table 3 we summarise the actions taken by Judge Griesa to promote restructuring.

Table 3. Judge Griesa's Actions to Promote Restructurings

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

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

In addition in 2003, relatively early on in the debt restructuring process, the creditors seek to certify class action suits (row two). Judge Griesa accepts certain claims encouraging creditor coordination [*H.W.Urban GMBh v. Republic of Argentina* (30 Dec. 2003)] (column two). However, in his orders rejecting some class action suits, [e.g. *Alan Applestein TTEE v. The Republic of Argentina* (May 12, 2003)], he encourages tighter definition of class: he also keeps *pari passu* pending[6] (column three).

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

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

In early 2005, just before completion, the vultures attempt to stymie the swap. In the first instance, they succeed in their bid to obtain an order to attach the contractual right of the debtor to receive old bonds [*NML Capital Ltd. v. The Republic of Argentina* (13 Mar. 2005)]. In response to Argentina's submission that this would make it abort the swap, Judge Griesa overturns his own judgement. In contrast with precedent, the Judge is motivated by a concern to promote restructuring and not only to enforce the claims of

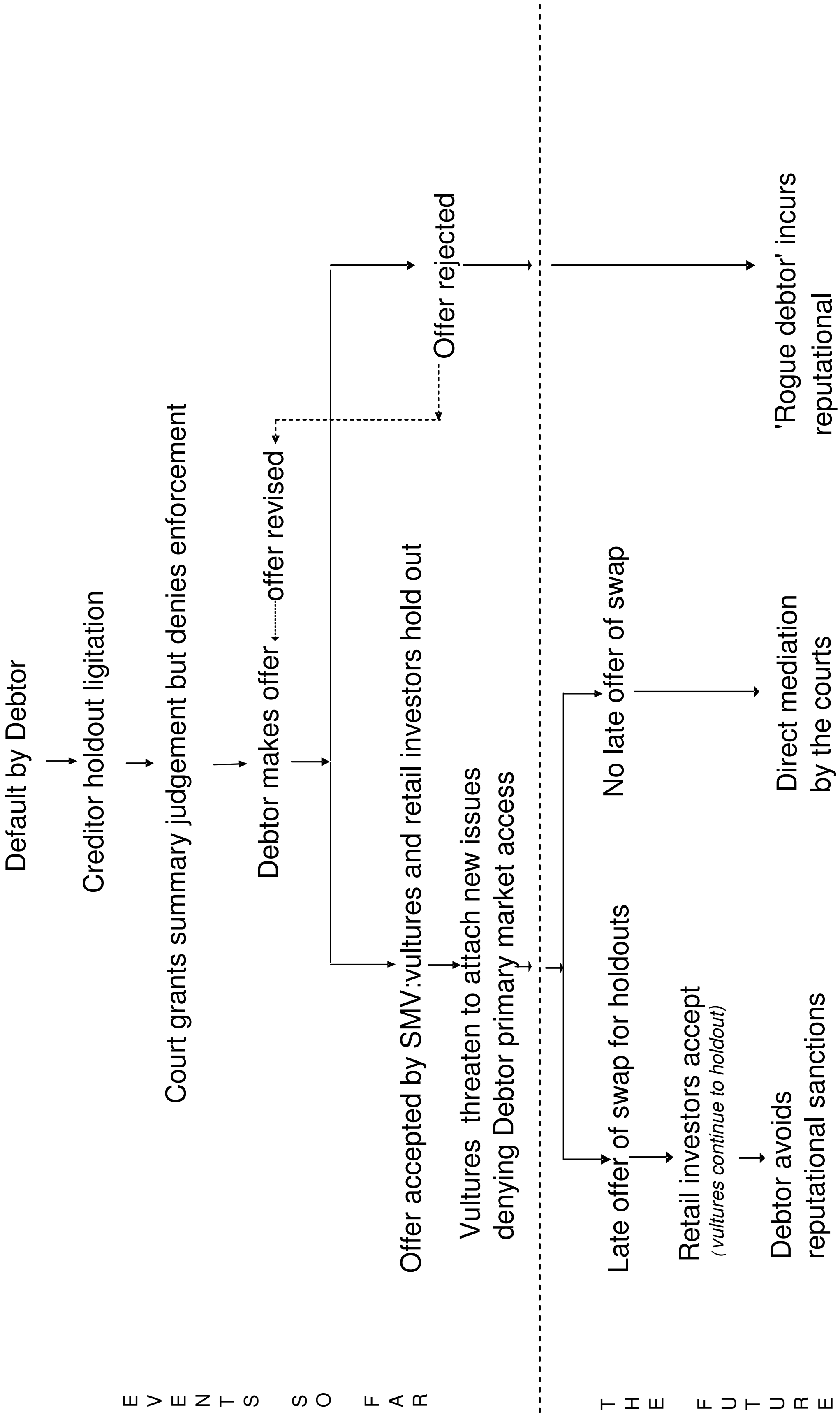
[6] With the US administration supporting Argentina's reading of the clause, see Miller and Thomas (2006, Appendix).

holdout litigants. Judge Griesa's decision is affirmed by the Second Circuit who find '[t]hat restructuring is obviously of critical importance to the economic health of the nation.' The findings (in the decisions to vacate the attachment orders) assure the creditors who may wish to participate in the swap that the court will ensure its successful conclusion.

Chart 1 illustrates this process of Judge-mediated debt-restructuring, with the events described above summarised in the upper part of the Chart. Following default by the debtor, the court grants summary judgements in favour of holdout creditors as a means to prompt the debtor to make an offer. Then, in marked contrast to precedent, Judge Griesa reins the holdout creditors in so as to promote a settlement. The Judge is concerned with the reasonableness of the swap and the percentage of creditors who consent to the amendment. Finally the offer is accepted by a Super Majority Vote (SMV) but this leaves a fraction of creditors outside the swap -- and there are no CACs to ensure their compliance. (This leads to the next phase, the post-swap outcomes analysed in the next section.)

Two particular aspects of this process are worth highlighting. First, that Judge Griesa effectively aggregates across creditors in the swap by treating the debt as a consolidated whole; second, he keeps the claims of the holdouts distinct from those of creditors involved in the ongoing swap.

Chart 1 Judge-mediated debt restructuring



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

So far, the post-swap phase of Argentine bond litigation has involved unsuccessful attempts by professional holdouts to attach the assets of the sovereign and forthright denials by the debtor of any compensation for creditors outside the swap. For Porzecanski (2005), the latter constitutes the actions of a 'rogue debtor' – defined as a sovereign who can pick and choose the claims it wishes to satisfy and ignore the rest. This pessimistic assessment of the situation is not borne out by low post-swap, sovereign spreads paid by the debtor in secondary markets for its existing debt i.e. the market does not appear to share Porzecanski's dire predictions (Sturzenegger and Zettelmeyer, 2005c, p.10). Our view of post-swap developments is more nuanced: what we observe are judge-mediated efforts to complete the swap in the absence of CACs.

The lower part of Chart 1 indicates future developments, sketching two possible outcomes - other than the 'rogue-debtor' scenario. First on the far left, the debtor makes a late offer of a swap (consistent with the "most-favoured-creditor" commitment made to those who accepted the swap). We reckon that this is highly likely to be accepted by retail investors since the bonds involved in the swap have increased substantially in value. In the interests of their reputation, however, vultures may *not* be inclined to accept a haircut of two thirds; and they have the patience and skill to holdout for years trying to prevent Argentina from accessing primary capital markets. But once a late offer is accepted by other holdouts, it is doubtful that vultures alone can continue to deny a debtor access to primary capital markets (for historical evidence see Esteves, 2005).

Should Argentina chooses not to make a late offer, it maybe forced to accept direct mediation by the courts (as shown in the centre of Chart 1): in an unprecedented development, Judge Griesa has indicated the court's willingness to mediate a settlement *directly* should this prove necessary to complete the swap. Specifically, in one of many similar summary judgements [*Vanina Andrea EXPOSITO v. The Republic of Argentina* (17 Feb. 2006)] he directs that

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

As indicated above, the holdouts are a heterogeneous group with vultures and retail investors motivated by different incentives. With direct mediation by the courts, holdouts now have the option of submitting their claims to the court and possibly obtaining what the other participants obtained in the swap: this may be the way for retail investors to settle their claims, Porzecanski (2005). Ironically, judicial enforcement – with its lack of voluntariness – might free Argentina from its 'most favoured creditor' commitment to those in the swap[7]: the debtor can be seen to have had no choice but to accede to holdout (especially vulture) claims. But these sequences of events will be time consuming and uncertain: it may be designed as a threat to persuade the debtor voluntarily to make a late offer as discussed above.

5. CACs, courts and creditor committees

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

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

Promoting the swap and handling holdouts

Given that CACs are designed to reduce the profit opportunities available to holdouts, it should make it easier for creditors to organise a swap, with a SMV requirement of 75% as the industry standard. As the IMF has warned, however, aggregation will remain a problem: the clauses only operate within a single bond issue, Krueger (2002). The judge in the Argentine case viewed the debt as a consolidated whole thereby effectively aggregating a majority of the creditors (76%) that participated in the swap. Despite the requirement for unanimity in the bond contracts, the courts promoted a swap influenced by economic, political and financial factors at the time. Similar action may be called for in future. With CACs, however, the issue of recalcitrant holdouts should disappear. Subject to the necessary majority for a swap, the holdouts will be impelled to accept the same terms. They cannot hold out for better.

While CACs and courts may well solve aggregation and resolve the holdout problem, this will not necessarily prompt the debtor into making an offer. Vultures may not have the incentive to initiate debtor engagement but existing creditors will, as we explain in the next section.

Debtor engagement: Class action suits and bondholder organisation

The historical record provides evidence of the effectiveness of formal and permanent bondholder committees like the British Corporation of Foreign Bondholders in the early part of the 20th century (Eichengreen and Portes, 1995; Esteves, 2005). Mauro and Yafeh (2003, p.26) point out that, "… one of the roles of the Corporation of Foreign Bondholders (CFB) [was] to protect small bondholders from large bondholders who might otherwise arrange for a separate, advantageous deal for themselves in exchange for the promise to provide the country with new lending."

This is relevant to the Argentine case where many small creditors sold out to institutional investors at prices of less than 30 cents. Esteves (2005) suggests that enhanced creditor organisation will substantially increase creditor payoffs: but, because institutional investors acted to coordinate creditors and to negotiate with the debtor, the payoff to creditors as a whole would probably not have risen much – as the economic analysis of the swap in this paper confirms.

Even without bondholder committees, there is still hope: class action suits. Buchheit and Gulati (2002) argue that class action suits could be used to involve courts in sovereign debt restructuring. According to them creditors have a basic "class" interest[8] which is distinguishable from the interest of an individual creditor. With CACs including SMV this class interest is better defined[9]. Class action procedures would engender the formation of ex-post, ad hoc creditor committees that would prompt the debtor into making an offer. In the latest judgement in the existing (and only) certified class action, Judge Griesa granted the motion of the class for summary judgement [*H.W.URBAN GMBH, Individually and on behalf of all others similarly situated v. The Republic of Argentina* (9 March 2006)]. This favourable judgment increases the effectiveness of this option in the future.

To conclude, we see the vulture-initiated strategies for debt resolution as important principally in the period of transition to CACs. Unlike Fisch and Gentile (2004), who emphasise the continuing role of the vultures, we assume that SMV under CACs will reduce the threat of holdout litigation as we know it, but will nonetheless leave an important role for judicial intervention in debt restructuring.[10]

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

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[8] A class interest is one in which creditors as a class can achieve a settlement more effectively than individual creditors.

[9] While Sturzenegger and Zettelmeyer (2005) may dismiss class action procedures as ineffective for solving holdout problem, with CACs this is no longer an issue.

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

Conclusions

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

Our conclusions differ from those of Sturzenegger and Zettelmeyer (2005) who are inclined to dismiss the role of holdout litigation in favour of reputational models. Our interpretation can also be contrasted with the view that holdout litigation represents a lasting solution to sovereign debt crises, Fisch and Gentile (2004). We agree with them that holdout litigation is 'part of the solution and not the problem' (Roubini, 2002), but believe that to be true *only in the period of transition to CACs*. Our description of judge-mediated debt restructuring emphasises the role of the common law judges in the orderly resolution of sovereign debt crises, currently and in the future.

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APPENDIX

The size of the write-down and the long delay: a bargaining approach

It is clear from Table 2 that lenders to emerging markets may be exposed to substantial losses and to prolonged delay in restructuring in some cases. In addition, the Argentine case challenged the idea that the IMF must play a central role in arranging sovereign debt swaps: stymied by conflict of interest and criticised by both debtor and creditors for its earlier handling of Argentina's affairs, the Fund had to withdraw to the sidelines and let creditors and the debtor sort things out themselves.[11]

With the IMF *hors de combat*, the New York Court had perforce to play a greater role. But the court does not carry the same big stick as the Fund: its role is to promote negotiations between sovereign and the creditors to achieve a fair outcome, and to preserve the sovereign debt market. In this spirit, Dhillon et al. 2006 apply a bargaining approach to explain both the final settlement and the delay in achieving it, assuming implicitly that the court is holding the ring. The authors follow the approach of Merlo and Wilson (1998) where the size of the pie is uncertain and 'efficient delay' can occur as creditor and debtor wait for economic recovery - fearing that early settlement will lock in the recession. (The Rubinstein model of alternating offers, applied to sovereign debt negotiations by Bulow and Rogoff (1989), is not used because it predicts prompt settlement.)

Based on the creditor response to the initial Argentine offer at Dubai in 2003 Dhillon et al. (2006) estimate that the "pie" to be divided between debtor and creditors was worth almost 3% of GDP. Allowing for the "first mover" advantage for the debtor as proposer, the bargaining model implies that creditors receive a little under half the pie. On this basis, the predicted recovery rate on debt without interest is 41 cents – a little better than the final settlement (estimated to be worth about 34 cents in Table 2).

As for the prolonged delay, the authors note that political factors played a critical role until 2003 when President Duhalde – appointed earlier by Congress as interim office-holder – was replaced by President Kirchner after a general election. Because the expected annual rate of economic recovery in 2003 exceeded the time rate of discount[12], it is claimed that further postponement was economically 'efficient'. An alternative

[11] "Argentina has become a test case for a vastly reduced role for the IMF and the official sector more broadly in the sovereign debt restructuring process", Roubini and Setser (2004a).

[12] Estimated to be 4% for both parties

account for delay under President Kirchner is explored by Ghosal and Miller (2006). There it is noted that, if the debtor is aware of the constraints impose by sustainability while the creditor is not, the former may have an incentive to make a low offer leading to delay in order to act as a *signal* to the creditor (that sustainability is a serious cause for concern). On this reasoning, the Argentine government would *not* have expected creditors to accept the offer made at Dubai in 2003; but the final settlement reached in 2005 - broadly in line with Argentina's sustainability guidelines - would reflect a successful signalling strategy by the President and his finance minister.[13]

The observed delay and the write down are, it seems, broadly consistent with a bargaining approach. Moreover, according to Porzecanski (2005), the fall of the currency rendered the government insolvent because of the large debts contracted by previous administrations. He notes in his introduction that "[a] sinking currency rendered the government instantly insolvent; the net government debt, which at the one peso per dollar exchange rate was equivalent to three times tax revenues and 50% of GDP, virtually tripled once the currency sank to around three pesos per dollar, becoming unaffordable to service": and he also observes that policy prior to 2002 involved the authorities then in power "betting the ranch" by borrowing almost exclusively in dollars and other foreign currencies to finance a string of budgetary deficits, even though their revenues were due and collected only in pesos.[14] (Porzecanski, 2005).

If Argentina was insolvent for reasons to do with previous administrations, why should it be treated as a rogue debtor? In our view, it all depends on how creditors outside the swap are dealt with. The bargaining model assumes that all creditors get parity of treatment (as they might with under CACs). So far, however, those outside the swap have received nothing. How the sovereign might deal with the holdouts so as to avoid been treated as rogue debtor is discussed in section 4 of the paper.

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

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