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Sovereign Bonds And The
Collective Will

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SOVEREIGN BONDS AND THE COLLECTIVE WILL

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I. Overview and Summary

Multicreditor debt instruments such as bonds and syndicated bank loans are uncommon legal arrangements. In most contracts, the parties know each other's identity beforehand and they make a conscious decision to enter into a legal relationship. In a multicreditor debt instrument, the borrower's identity is of course known by each investor, but what the investors don't know -- what they often never know -- is the identity of each other. Bond investors are like the patrons in a theater audience: each one has decided to see a particular play on a particular night, but none has any idea who they will be seeing it with. If you wish to carry the analogy further, the tradable nature of bonds means that fellow patrons are constantly leaving and entering the theater throughout the performance.

Now this promiscuous grouping of investors in a bond issue is not troubling as long as you believe that the only important relationship here is that between the debtor and each separate investor. Look at a bond issue close enough, this theory contends, and you will see that it breaks down atomically into hundreds or thousands of bilateral contracts between the bond issuer and each investor; the appearance of an investor group or syndicate is just that, an appearance, with few practical or legal

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implications. This view assumes, of course, that all bondholders are the passive recipients of payments from the issuer and that the behavior of any one bondholder is a matter of indifference to the other bondholders.

And so it may be, but only until things go wrong. It is when the bond issuer runs into financial difficulties that the actions of any one bondholder can dramatically affect the interests of all the other lenders. For example, if each holder has the unfettered discretion to accelerate its bonds following an event of default, to commence a lawsuit and attach the borrower's assets, to force a foreclosure on collateral or to push the borrower into bankruptcy, the other bondholders may find their own options in dealing with the situation are dangerously curtailed. The ruthless bondholders, however large their majority, are thus at the mercy of their most ruthless colleagues. Visible financial strains on the bond issuer will thus bring out a sauve qui peut response from some bondholders. Grabbing a borrower's assets ahead of one's fellow bondholders may reveal an underdeveloped fraternal instinct, but it probably makes good business sense; there usually is little left for the hindmost creditor.

By the late nineteenth century, many bond issuers and investors had come to believe that bondholder cooperation in a distressed situation was highly desirable. In those days, bankruptcy generally meant liquidation and liquidation often meant recoveries by the creditors (particularly the unsecured creditors) of only a small portion of what they were owed. Allowing a single bondholder to force a liquidation of the debtor or, very nearly as bad, giving such a holder the leverage to compel other investors to buy him out on preferential terms in order to forestall liquidation, was therefore something that many bondholders felt should be avoided.

The problem had several interrelated aspects. How could the "grab and run" instinct of each bondholder be kept in check long enough to permit a coordinated workout to the ratable benefit of all creditors? How could the majority of bondholders ensure that their collective judgment about the terms of such a workout would be binding on all bondholders? Finally, how could the majority neutralize the ability of dissident creditors to force a preferential buyout of their claims as the price of not putting the debtor into liquidation?

Three solutions suggested themselves.

- Change the bankruptcy laws to shield a debtor from hostile legal actions while a reorganization and rehabilitation of the debtor's affairs is carried out.
- Add contractual provisions to the underlying bonds that would, in times of financial difficulties for the issuer, permit a majority or supermajority of the bondholders to direct the course of a negotiated workout and constrain any maverick elements within the bondholder group.

- Engage the equitable powers of civil courts to supervise a negotiated debt rearrangement while protecting both the borrower and the majority creditors from exploitation by dissident minorities.

At various times during the late nineteenth and early twentieth centuries, all three solutions were tried. In England, starting in the late 1870s, contractual provisions now known as “majority action clauses” began to appear in bonds and related trust deeds governed by the law of England. These clauses allowed a super-majority of bondholders to agree to reduce the amount due or to defer a payment date under a bond. Such a decision, once approved by the specified majority of holders, was binding on all bondholders, even those who did not vote in favor of the change.

For the reasons discussed below, majority action clauses were incorporated into only a small percentage of bonds issued under the law of a U.S. jurisdiction in the period 1880-1920. The preferred American solution at this time was something known as an “equity receivership.” Under this procedure, a group of creditors approached a civil court with a request that the court use its equitable powers to appoint a receiver for a financially-distressed company (usually a railroad), while the various stakeholders in the company negotiated the terms of a debt rearrangement.

By the 1920s, however, the equity receivership technique began to fall into disfavor. In 1933 (for railroads) and 1934 (for industrial companies) the U.S. Congress enacted amendments to the Bankruptcy Act that facilitated corporate reorganizations under the supervision of a bankruptcy judge. These amendments were the predecessor of the current Chapter 11.

One hundred years on, the financial community is again confronted with a remarkably similar problem. A sovereign bond issuer of the early twenty-first century is in much the same spot as the distressed corporate or railroad bond issuer of the early twentieth century. Court-supervised workouts in a bankruptcy proceeding are not possible for sovereign borrowers today, just as they were not available for most corporate issuers in the early part of the last century. Purely voluntary bond workouts then, as now, were messy, time-consuming and open to exploitation by holdout creditors. The consequences of not finding a satisfactory workout mechanism -- liquidation for the old corporate issuer and economic paralysis for the modern sovereign issuer -- are equally devastating for both debtors and creditors.

In the search for measures that will facilitate orderly sovereign debt workouts, modern commentators are coming up with proposed solutions that are strikingly similar to the ones that engaged the attention of their predecessors a hundred years ago. The merits of including majority action clauses in sovereign bonds as a method of neutralizing the holdout creditor are being touted in some circles today, just as they were in the 1920s and 1930s in the context of corporate bonds. In addition, like the reformers of a hundred years ago who began to agitate for changes to the U.S. bankruptcy law to permit large corporate bond issuers to reorganize their capital structure with the approval of most (but not necessarily all) of the creditors, some modern observers of the emerging market debt scene are suggesting the establishment

of a new international bankruptcy regime that would be applicable to sovereign debtors. Indeed, this proposal is sometimes described as a “Chapter 11 for countries”. Finally, under appropriate circumstances there may be civil procedures available in U.S. federal courts that will accommodate a creditor-led, but court-supervised, sovereign debt workout.

II. Objective

We believe that it is difficult to assess the merits of new approaches to emerging market sovereign debt problems such as the establishment of a supranational bankruptcy regime without a clear understanding of just how far sovereign debt workouts can be facilitated by the contractual provisions that already exist in most sovereign bonds or could be conducted under the auspices of existing procedures in civil courts. The history of sovereign debt restructuring over the last twenty years has, after all, been primarily a story of muddling through. Whatever the fate of the more ambitious proposals to change the system, the world will almost certainly have to muddle through for at least another few years before those changes are implemented. This means, in practical terms, using the tools we already have to promote orderly workouts. Perhaps it also means using those tools more creatively and more confidently.

Against this backdrop, this paper will focus on four questions:

- What contractual provisions now exist in sovereign bonds that could promote a voluntary restructuring of those instruments?
- How far can these provisions be pushed in order to mimic important features of a domestic bankruptcy regime such as a protection from disruptive litigation while a workout is underway?
- What legal doctrines may constrain the use of these contractual provisions for this purpose?
- What procedures may be available in U.S. federal courts to oversee and implement a restructuring of a foreign sovereign’s bond indebtedness?

The interesting issue of how documentation practices for sovereign debt instruments might change in the future to facilitate collective creditor response to a debt problem is beyond the scope of this paper.

III. Collective Decision-making Provisions

Bonds issued by both corporate and sovereign borrowers in the early nineteenth century rarely contained provisions that contemplated collective decision-making by the bondholders. Each bond was a freestanding debt instrument; its terms could not be changed without the consent of its holder and, if not paid when due, each holder was free to pursue his individual remedies against the issuer. The instruments

did not require a holder to consult with, much less to act in concert with, fellow bondholders before, during or after a default.

Although this approach ensured that each bondholder's claim against the borrower could not be deranged without that bondholder's consent, it also had the consequence of forcing financially-distressed corporate borrowers into bankruptcy (which in those days meant liquidation). The bondholders, acting as a group, lacked the legal power to agree to a temporary deferment of their claims or a partial reduction in the amounts due under the bonds in order to preserve their debtor as a going concern from whom payments, even if late or less than originally stipulated, could be expected. Of course, individual bondholders were always free to give the borrower some reprieve on their own claims, but they could not compel their fellow bondholders into similar acts of generosity. Thus, the indulgence of a few or even a majority of bondholders only enabled the more stiff-necked creditors (upon whom the cognomen "holdout" was bestowed) to be paid in full and on time. This was, is and ever shall be the holdout creditor problem in a debt workout.

A. *English Majority Action Clauses*

By the second half of the nineteenth century, this rigid legal structure for bonds came to be regarded in England as contrary to the interests of most bondholders. Corporate borrowers experiencing temporary liquidity problems were being forced into liquidation when they might have been saved by a simple deferment or a reduction of the creditors' claims. Holdout creditors could use this threat of liquidation to extract preferential settlements at the expense of the debtor and the other creditors. In response, the London market began to include in corporate bond issues or the related trust deeds a contractual provision (now often called a "*majority action clause*") that permits a super-majority of bondholders voting at a bondholders meeting to accept adjustments to the terms of the bonds, including changes to payment terms. Such adjustments, once accepted by the required supermajority of bondholders, are then binding on all holders regardless of whether an individual holder voted for the change.

The man who claimed paternity for English majority action clauses was Francis Beaufort Palmer and he announced the year of the clause's birth as 1879.¹ An English barrister practising in the last quarter of the nineteenth century, Palmer was the influential author of Company Precedents (a book of U.K. corporate form documents that went through 17 editions between 1877 and 1960). Palmer's majority action clause must have caught on quickly because, in the 1881 edition of his book, Palmer annotated his first form of majority action clause with the following explanation:

It is by no means uncommon now to insert [majority action] provisions ... in a debenture trust deed, enabling the majority to bind the minority in respect of various matters.... Now it sometimes happens that a company which has raised a large sum on debentures falls into temporary difficulties, and, though a large majority of its debenture holders may be

¹ Francis B. Palmer, Company Precedents (8th ed. 1900) at 122.

willing to give time or make some reasonable arrangement, a minority decline to concur, and, in the result, the company is forced into liquidation. The insertion of [majority action] provisions ... meets this inconvenience, and may save the majority from the tyranny of the minority.²

Majority action clauses are now a regular feature of both corporate and sovereign bonds governed by the law of England.³ Although one occasionally finds some minor drafting differences, the terms of these modern English clauses would be instantly recognized by Francis Beaufort Palmer. A description of a modern English-style majority action clause appears as Appendix A to this paper. It permits changes to the payment terms of a bond with the consent of persons representing 75% (by amount) of the bonds voting at a bondholders' meeting that meets certain quorum requirements.

B. *American Amendment Clauses*

A similar dilemma faced U.S. bond issuers of the late nineteenth century. An issuer confronting temporary liquidity problems could always seek the voluntary consent of its bondholders to defer or reduce payments, only at the risk of inviting exploitation by holdout creditors. Bankruptcy was an option, but a terminal one. Not until 1934 did U.S. bankruptcy law contain effective procedures for a "reorganization" of corporate debts that would save a company from liquidation and safeguard it against preferential demands by a few dissenting creditors.⁴ The English solution to this dilemma -- widespread use of majority action clauses in corporate bonds and indentures -- did not, however, win great support in the United States during this period.⁵

² Francis B. Palmer, *Company Precedents* (2d. 1881) at 271. By 1900, Palmer allowed himself a distinctly self-congratulatory tone. "Majority provisions have now been adopted in hundreds of cases and their usefulness is generally acknowledged," Palmer wrote, "indeed, the draftsman who omits to insert [a majority action clause] runs the risk of being accused of neglecting the best interests of the debenture or debenture stock holders." *Company Precedents* (8th ed.) at 123.

³ See Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, *Fin. Stability Rev.* (June 2000) 142, 145 ("Provisions for bondholders' meetings and majority action clauses are routinely included in bonds governed by English law ...") (hereinafter "Collective Action Problems").

⁴ For a brief description of this history, see David Skeel, *Debt's Dominion* 105-107 (2001); see also Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 *Am. Bankr. Inst. L. Rev.* 5 (1995).

⁵ On the evolution of these clauses in England and the United States, see Note, *The Rights and Remedies of the Bondholder Under Corporate Bonds and Indentures*, 27 *Col. L. Rev.* 579, 580-87 (1927) (explaining the rationale for using collective action provisions and the level of judicial scrutiny that courts gave to these clauses); Robert Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 *Col. L. Rev.* 901, 927 (1927); Charles H. Haines, Jr., *Corporations - Modification Provisions of Corporate Mortgages and Trust Indentures*, 38 *Mich. L. Rev.* 63 (1939); De Forrest Billyou, *Corporate Mortgage Bonds and Majority Clauses*, 57 *Yale L. J.* 595 (1948); Howard J. Kashner, *Majority Clauses and Non-Bankruptcy Corporate Reorganizations—Contractual and Statutory Alternatives*, 44 *Bus. Lawyer* 123 (1988).

The initial resistance to the use of majority action clauses in U.S. bonds did not reflect a concern about the validity of the clauses. Rather, it resulted from a worry that a provision permitting a post-issuance change to payment terms might impair a bond's status as a negotiable instrument under the Negotiable Instruments Law ("NIL"). A negotiable instrument, as defined in the NIL, had to contain "... an unconditional promise ... to pay a sum certain in money ... [and] be payable on demand, or at a fixed or determinable future time."⁶ With this cloud over their status as negotiable instruments, the New York Stock Exchange was reluctant to list bonds containing majority action clauses, and major bond issuers and their underwriters resisted the clauses for this reason.⁷

In light of this reluctance to employ majority action clauses, Yankee ingenuity came up with another solution to corporate debt workouts in the form of a procedure known as an equity receivership. This involved seeking the intervention of a court to appoint a receiver for a financially-distressed borrower (the technique was particularly popular for down-on-their-luck railroads, of which there were many) while the debtor and the various classes of creditors negotiated a plan of reorganization. At the end of the process, assuming agreement among most creditors could be reached, the company's assets were sold -- invariably to a new enterprise formed by the creditors of the old company -- and life would go on under a different corporate skin. Non-participating creditors could expect, at best, to receive their pro rata share of the liquidation value of the old company's assets and thus prospective hold-out creditors were strongly encouraged to join the party.⁸

By the late 1920s, however, even the proponents of the equity receivership technique began to have second thoughts about its continued utility.⁹ Negotiating such a reorganization could take a long time; dissenting creditors could and often did object to a plan, thereby causing further delays; the reorganizations were usually controlled by corporate insiders; and the lawyers and bankers involved in the process extracted large fees. Moreover, when the new Securities and Exchange

⁶ Uniform Negotiable Instruments Law 1896 § 1(2)-(3).

⁷ See Billyou, supra note 5, at 597.

⁸ One of the best descriptions of the equity receivership process can be found in the SEC Report, Part VIII, infra note 10, at 10-60. For a description of equity receiverships that sets them in the context of developments in U.S. bankruptcy law, see Skeel, supra note 4. For other materials discussing the equity receiverships of this period, see Tabb, supra note 4, at 21-24; Jeffrey Stern, Note, Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique, 90 Colum. L. Rev. 783 (1990); Douglas Baird & Thomas Jackson, Cases, Problems, and Materials on Bankruptcy 960-64 (2d ed. 1990); Arthur H. Dean, A Review of the Law of Corporate Reorganizations, 26 Cornell L. Q. 537 (1941); Silvester E. Quindry, Bonds and Bondholders: Rights and Remedies, Volume I, 451 (1934). For a contemporary judge's perspective on the development of equity receiverships, see Warner Brothers Pictures v. Lawton-Byrne-Bruner Insurance Agency Co., 79 F.2d 804, 810-812 (8th Cir. 1935).

⁹ See James N. Rosenberg, An Open Letter Containing Proposals for Amendment of the Bankruptcy Act so as to Aid in Combating the Depression, 19 Va. L. Rev. 333, 334 (an amendment to the bankruptcy law "must cut out, root and branch, the present red tape and waste of [Equity] Receiverships ...").

Commission came into existence in 1934, one of its first mandates was to examine the equity receivership process from the standpoint of fairness to the investors. The SEC did so, at extravagant length, and produced a highly critical, multi-volume report of its findings.¹⁰

Growing disenchantment with equity receiverships cast a more appealing light on the potential use of majority action clauses to effect a “reorganization by contract” of a company’s debts. Advocates of majority action clauses in U.S. bonds urged the same rationale as had their English counterparts: if the supermajority of bondholders are given the ability to adjust payment terms when the issuer ran into financial difficulties, a liquidation or an expensive equity receivership could be avoided.¹¹ Moreover, the clauses prevented a minority of bondholders from extorting a preferential settlement by threatening liquidation of the company or delaying a reorganization.

The SEC, however, did not count itself among the fans of wider use of majority action clauses to solve the holdout creditor problem. As part of its general investigation of reorganizations and bondholder protective committees in the mid-1930s, the SEC also looked at how majority action clauses had been used in the relatively small percentage of U.S. bonds that contained such clauses. Although the SEC acknowledged that the arguments in favor of using majority action clauses to facilitate corporate debt reorganizations had merit, the Commission concluded that these clauses had sometimes given rise “to abuses and problems which must be faced if the interests of security holders are not to be made subordinate to the desires and conveniences of the dominant group”.¹² The SEC seemed particularly concerned that bond majority action clauses could be abused by corporate insiders. By buying up or otherwise controlling a majority of a distressed company’s bonds, for example, the equity owners could vote to suspend or reduce payments on the bonds, thus allowing value to move down the corporate chain to the equity holders -- an inversion of the normal priorities in a corporate bankruptcy by which a company’s debt holders are paid off before the equity holders.¹³

In response, the SEC proposed, and Congress enacted in 1939, Section 316(b) of the Trust Indenture Act (“TIA”).¹⁴ This section (known as the “*voting prohibition*”) prohibits any reduction in the amount due under a publicly-issued corporate

¹⁰ Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Parts I-VIII (1937-40) (hereinafter “SEC Report”).

¹¹ Ralph A. McClelland and Frederick S. Fisher, Jr., in their book The Law of Corporate Mortgage Bond Issues (1937) at 818-822, recommended a form of majority action clause for U.S. bonds that permitted adjustments to payment terms with the consent of holders of 90% of the bonds. See also SEC Report, Part VI, supra note 10, at 145-151.

¹² SEC Report, Part VI, supra note 10, at 150.

¹³ See Mark J. Roe, The Voting Prohibition in Bond Workouts, 97 Yale L.J. 232, 250-52 (1987).

¹⁴ 15 U.S.C. § 77 ppp.

bond without the consent of each affected bondholder. Section 316(b) makes a small concession to majority action clauses by authorizing short deferments of payment dates (up to three years) with the consent of holders of at least 75% of the bonds.

The same year that the SEC was established, 1934, also saw an important amendment to the U.S. Bankruptcy Act. A new procedure, known as Section 77B (the predecessor of the modern Chapter 11), was added to the Act in order to facilitate corporate debt reorganizations under the supervision of a bankruptcy court.¹⁵ Thus, when the SEC set its cap against using majority action clauses to effect debt rearrangements with the consent of only a majority or supermajority of creditors, it did so in the sure and certain knowledge that a corporate debtor and its creditors now had another viable option -- a reorganization in bankruptcy subject to the supervision of an impartial referee in the form of the bankruptcy judge.¹⁶ This option had not been available for most corporate debtors in prior periods. The voting prohibition requirements of the TIA have, since 1939, governed the drafting of the amendment clauses in publicly-issued corporate bonds and indentures in the United States.

Although the TIA is not applicable to foreign sovereign bonds issued in the United States, the amendment clauses included in such sovereign bonds have almost invariably followed the TIA-driven approach to amendments.¹⁷ The amendment clause found in most sovereign bonds issued under the law of a U.S. jurisdiction permits amendments or modifications to the instrument with the consent of holders of 51% (or sometimes 66-²/₃%) of the bonds except that the consent of each affected bondholder is required to defer a payment date, reduce any amount of principal or interest due under the bond, change the currency of payments or take certain other enumerated actions. An example of such a clause appears as Appendix B to this paper. A minority of emerging market sovereign bonds issued under the law of a U.S. jurisdiction employ a more abbreviated amendment clause (see Appendix C) that requires the unanimous consent of affected creditors to change the “terms of payment” of the bonds.

American drafting conventions for amendment clauses in sovereign bonds may be explained by the familiarity of U.S. investors with “unanimous consent” amendment clauses in corporate issues; it may evidence a conscious preference on the part of American investors for bonds that are more difficult to restructure (on the theory that this wards off casual requests to restructure); or it may have just been the product of the drafting momentum so well known to every practicing corporate lawyer (the last

¹⁵ See Tabb, supra note 4, at 28.

¹⁶ See UPIC & Co. v. Kinder-Care Learning Centers, Inc., 793 F. Supp. 448, 453 (S.D.N.Y. 1992) (“The Securities [and] Exchange Commission was undoubtedly aware that requiring unanimity in bondholder voting – rather than mere majority action – would frustrate consensual workouts and help induce bankruptcy. And convinced that insiders or quasi-insiders would damage bondholders, the Commission welcomed this prospect.”).

¹⁷ See Albert S. Pergam, Eurobonds: Trustees, Fiscal Agents and the Treatment of Default, in Adaptation and Renegotiation of Contracts in International Trade and Finance (N. Horn ed. 1985) at 335, 338 for a discussion of the effect of the TIA on the drafting of indentures that do not need to be qualified under the TIA.

corporate bond indenture becoming the model for the next sovereign bond indenture). Significantly, however, the reasons that led to the demise of majority action clauses in U.S. corporate bonds after 1939 are not applicable to sovereign bonds issued in the United States. For a sovereign issuer, there is no bankruptcy alternative, either by way of a reorganization or a liquidation. In this sense, the position of a sovereign issuer and its creditors today is much closer to a corporate borrower before the 1934 amendments to the bankruptcy law that facilitated corporate debt reorganizations. Moreover, the SEC's concern about the possible abuse of majority action clauses to subvert the normal priorities in a bankruptcy (debt paid out first, equity last) is not relevant to a sovereign borrower that cannot go bankrupt and that, in any event, has no equity holders as such.

C. *Acceleration Clauses*

Bonds issued in the international markets by emerging market sovereigns typically require a vote of 25% of the outstanding bonds in order to accelerate unmatured principal following an event of default. This practice follows the general rule for corporate bonds issued in the United States.¹⁸ There are exceptions. In bond issues using a trust indenture (as opposed to a fiscal agency agreement), the trustee often retains the discretionary power to accelerate following the occurrence of an event of default. Also, the common practice in emerging market sovereign bond issues that are registered with the U.S. Securities and Exchange Commission (so-called "Schedule B" issues) is to give individual holders the right to accelerate their own bonds following certain events of default such as a missed payment or, in some issues, the declaration of a debt moratorium by the sovereign issuer. This right of individual acceleration is not, however, a common feature of sovereign bonds issued in the Eurobond market.

Many, but not all, sovereign bonds give the holders of a majority or super-majority of the bonds the ability to reverse a prior acceleration of the issue if all events of default have either been cured or waived. Such a de-acceleration can usually be accomplished with the approval of holders of 50% of the securities, but some sovereigns have agreed to a higher level of up to 75% in their bond issues.¹⁹

The ability to rescind a prior acceleration through a collective action of the bondholders can have great tactical significance for a sovereign borrower that seeks a restructuring of the bonds. Following Ecuador's 1999 default on its Brady bonds and Eurobonds, for example, one series of the Brady bonds (the "Discount Bonds") was accelerated by holders of 25% of that series.²⁰ Eleven months later, Ecuador made an offer to exchange its outstanding Eurobonds and Brady bonds for new instruments that

¹⁸ See American Bar Foundation, Commentaries on Model Debenture Indenture Provisions, 217-19 (1971) (hereinafter "Model Debenture").

¹⁹ See, e.g., Fiscal Agency Agreement between the Republic of Argentina and Bankers Trust Company, as Fiscal Agent, dated as of October 19, 1994, at 19 (establishing a 75% threshold for rescinding an acceleration).

²⁰ See Lee C. Buchheit, How Ecuador Escaped the Brady Bond Trap, *Int'l Fin. L. Rev.*, Dec. 2000 at 17, 18.

conveyed a substantial measure of debt relief to Ecuador. This offer was conditioned upon a rescission of the acceleration of the Discount Bonds (a step that required the approval of holders of 50% of that issue) and, as part of the closing of the exchange offer, such a de-acceleration was in fact accomplished.²¹

D. *Enforcement Restrictions*

Where sovereign bonds are issued under a trust indenture (the U.S. practice) or a trust deed (the English practice), an individual holder's right to bring a legal action against the sovereign issuer will be significantly curtailed. In English trust deeds, only the trustee has the power to enforce the instrument and individual bondholders cannot act independently against the issuer unless the trustee, having been so instructed by a specified percentage of bondholders, fails to commence an enforcement action.²² Any recoveries by the trustee must be shared pro rata among the bondholders.²³

American trust indentures operate somewhat differently. As a result of an express requirement of the Trust Indenture Act (applicable to corporate issues but normally followed in sovereign issues as a matter of drafting convention) each bondholder has an unqualified right to bring an individual enforcement action to recover his share of any amounts of principal and interest not paid on their respective due dates.²⁴ Apart from this individual right to recover overdue amounts, however, only the trustee has the right to pursue other remedies, including the important right to sue for accelerated amounts.²⁵ Similar to an English trust deed, individual bondholders will not recover the ability to pursue these other remedies unless the trustee, after having been instructed by holders of at least 25% of the bonds and offered satisfactory indemnification, fails to commence an enforcement action for a specified period (usually 60 days) after notice from the bondholders.²⁶

All of this said, most foreign sovereign bonds issued in the U.S. market do not use a trust indenture or appoint a trustee to represent the economic interests of the bondholders.²⁷ The more popular approach has been to issue such bonds using a fiscal

²¹ Republic of Ecuador, Offering Circular dated July 27, 2000, Offer to Exchange U.S. Dollar Denominated Step-Up Global Bonds due 2030 and 12% U.S. Dollar Denominated Global Bonds due 2012, at pages 12-13.

²² See Andrew Yianni, Resolution of Sovereign Financial Crises – Evolution of the Private Sector Restructuring Process, *Fin. Stability Rev.* (June 1999) at 78, 81.

²³ *Id.*

²⁴ See Marcel Kahan, Rethinking Corporate Bonds: The Tradeoff Between Individual and Collective Rights, ● *NYU L. Rev.* ● (forthcoming 2002), Part I. B. 2.

²⁵ See UPIC v. Kinder-Care, *supra* note 16, at 454. See also, Jackson Nat'l Life Ins. Co. v. Ladish Co., 1993 U.S. Dist. LEXIS 1785 (suggesting, but not deciding, that only trustee can sue for accelerated amounts).

²⁶ See Model Debenture, *supra* note 18, at 232-33.

²⁷ See Collective Action Problems, *supra* note 3, at 142, 145 (“... trustees are still unusual in sovereign issues”).

agency agreement. A fiscal agent is the agent of the bond issuer itself. Accordingly, fiscal agency agreements do not concentrate enforcement rights in the fiscal agent; each bondholder retains those rights in respect of his own bonds, including the right to sue for accelerated amounts.

IV. Legal Constraints on the Use of Collective Decision-making Provisions

A. *Historical Summary*

To summarize, the historical evolution of majority decision-making provisions in corporate and sovereign bonds issued in the United States proceeded roughly as follows:

- 1880-1920 Majority action clauses were used in only a minority of bonds issued in the United States, mainly as a result of concerns about the effect of such clauses on the negotiable character of the instruments.

Chapter 11-type bankruptcy procedures that neutralize the holdout creditor problem were not yet available for most debtors.

The home-grown substitute remedy was a technique known as an equity receivership. This process, although cumbersome and expensive, permitted a negotiated workout plan to be developed under a degree of court supervision.

- 1920s-1930s Equity receiverships came under increasing criticism. Majority action clauses gained in popularity as a means of facilitating “contractual reorganizations” while avoiding the holdout creditor problem.

A bankruptcy reorganization procedure was added to the Bankruptcy Act in 1933 (for railroads) and 1934 (for industrial companies). This was the predecessor of Chapter 11.

The SEC was established in 1934 and promptly began an extensive investigation into all of the prevailing techniques for implementing debt rearrangements, including equity receiverships and the use of majority action clauses. The SEC found serious defects in each technique and recommended that corporate debt workouts be handled under the new Chapter 11-type bankruptcy

reorganization procedure, with the benefit of court supervision.

Taking this recommendation, the U.S. Congress in 1939 proscribed the use of majority action clauses in corporate bonds issued to the public in the United States, thus effectively forcing large corporate debt readjustments into the new bankruptcy reorganization process.

- 1940 - Present American-style amendment clauses (which preclude modifications to the payment terms of bonds without the consent of each affected bondholder) became a uniform feature of bonds, including sovereign bonds, governed by the law of a U.S. jurisdiction.
- 1999 - 2001 Following several sovereign bond defaults in the late 1990s, the official sector began to encourage the broader use of majority action clauses in emerging market sovereign bonds to facilitate orderly debt workouts, but neither the sovereign debtors nor the private sector investors showed much enthusiasm for the idea at the time.

In August 2000, Ecuador used its American-style amendment clauses to modify the non-payment terms of its Brady and Eurobonds in order to discourage holdout creditors in an exchange offer. Expressions of praise and outrage, depending on the source, inevitably followed.²⁸

Throughout most of this period, no one spent much time debating the merits of majority action clauses in sovereign bonds issued in the international capital markets. Until about the middle of the twentieth century, the law of most countries, including the United States and the United Kingdom, would not permit a sovereign to be sued in foreign courts without the sovereign's consent.²⁹ Thus, sovereign bonds -- despite their appearance as legally binding undertakings -- did not give bondholders effective legal remedies in national courts. Elaborate procedures for amending the bonds in the face of the sovereign issuer's liquidity difficulties must therefore have seemed a bit superfluous.

²⁸ See Felix Salmon, *The Buy Side Starts to Bite Back*, *Euromoney*, April 2001, at 46, 58-59.

²⁹ See Lee C. Buchheit, *How to Negotiate Eurocurrency Loan Agreements* 140 (2d ed. 2000).

By the time these immunity rules were formally changed to permit bondholders to sue sovereign bond issuers (1976 in the United States³⁰ and 1978 in Great Britain³¹), emerging market sovereigns were no longer borrowing to any significant extent in the bond markets; the commercial banks had, with astonishing munificence, replaced bondholders as the principal private sector creditors to these sovereigns. The debt instrument of choice during this period was the syndicated commercial bank loan agreement. The bankers famously came to regret their generosity. Starting in 1982 and lasting through the early 1990s, the syndicated bank loans to many emerging market sovereign borrowers were repeatedly rescheduled and eventually partially written off.³²

In the 1990s, bond investors flooded back into the financing vacuum for emerging market sovereigns left by the bruised retreat of the commercial banks.³³ The forms of the bonds used in this latest round of capital market borrowing by sovereign issuers were, however, a legacy of corporate issuer bond documentation as it had evolved in different countries. The bonds typically contained certain kinds of collective decision-making provisions (such as the need for holders of 25% of the bonds to approve an acceleration), but -- consistent with the drafting conventions that had evolved in the United States after 1939 -- the payment terms of sovereign bonds issued in the United States could not be amended without the unanimous consent of the bondholders. Bonds governed by the law of England, on the other hand, continued to use the majority action clauses so favored by English bond drafters and investors.

Then the defaults started ... again. Pakistan, Ukraine, Ecuador and the Ivory Coast all approached their bondholders in 1999-2001 seeking a restructuring of bonds issued in the international markets.³⁴ At the time of this writing, Argentina has embarked on the largest sovereign bond default in history. Attention has thus once again returned to the question of how orderly bond workouts, this time for sovereign issuers, can be arranged.

³⁰ Pub. L. 94-583, 90 Stat. 2891 (codified at 28 U.S.C. SS 1330, 1602-1611).

³¹ See State Immunity Act, 1978, ch. 33 (Eng.), reprinted in 17 I.L.M. 1123.

³² See John Clark, Debt Reduction and Market Reentry Under the Brady Plan, 18 Fed. Res. Bank of N.Y. Quarterly Rev. (Winter 1993-94) at 38, 41-45.

³³ See Daniel K. Tarullo, Rules, Discretion, and Authority in International Financial Reform, J. Int'l Econ. L. 613, 624 n.24 (2001) (noting the move by sovereigns to bond financing in the 1990s).

³⁴ For discussions of these defaults, see Barry Eichengreen & Christof Ruhl, The Bail-in Problem: Systematic Goals, Ad Hoc Means, NBER Working Paper 7653 (April 2000); Michael Buchanan, Emerging Markets: Bailing-Out the Nigerian Bail-In, Goldman Sachs, 17-18, September 5, 2001; International Monetary Fund: Involving the Private Sector in the Regulation of Financial Crises – Restructuring International Sovereign Bonds (2001) (<http://www.imf.org/external/pubs/ft/series/03/>) (hereinafter “Involving The Private Sector”); Institute for International Economics, The Architecture Exercise: What’s New? (http://www.iie.com/publications/files/chapters_preview/335/4iie2970.pdf); Lee C. Buchheit & G. Mitu Gulati, Exit Consents in Sovereign Bond Exchanges, 48 UCLA L. Rev. 59, n.13 & n.83 (2000) (hereinafter “Exit Consents”).

B. [Intercreditor Duties](#)

Collective decision-making provisions are intended to allow the creditors within any one bond or loan syndicate to implement their collective will in the handling of a debt workout. Stated differently, the purpose of these provisions is to protect the lenders as a group against the damage that could result from maverick creditor actions against the borrower and its assets. They also safeguard both the borrower and the other lenders against efforts by maverick creditors to extract preferential settlements as the price of their cooperation in a workout.

The provisions are thus designed to prevent the “tyranny of the minority”³⁵ in a multicreditor debt instrument. Inevitably, however, they open up the possibility of the correlative abuse -- oppression of minorities by the majority creditors. The American legal doctrines that have attempted to delineate the boundary between the permissible and impermissible use of collective decision-making provisions in multicreditor debt instruments can best be understood in the historical context described above.

1. [Phase One: Acknowledgment](#)

When majority-action clauses first began to appear in a limited number of American bonds in the late nineteenth century, they were intended to give a corporate bond issuer and its majority creditors an alternative, should the need arise, to liquidation of the debtor in bankruptcy. In exercising their powers under these clauses, however, the majority creditors were assumed to have a duty -- sometimes even described as a fiduciary duty³⁶ -- to act in the best interests of all the bondholders. This was how the law was developing in England (where the clauses had first appeared) and American judges were prepared to follow that lead.³⁷

A leading case of this era, Hackettstown National Bank v. D.G. Yuengling Brewing Co.,³⁸ for example, invalidated an attempt to use a majority action clause to postpone payments due on a corporate bond in light of what the court construed as “a corrupt and unwarranted exercise of the power of the majority” bondholders. The Hackettstown decision contained strong language suggesting that lenders in a multicreditor debt instrument owe each other fiduciary duties. When challenged, the use of majority action clauses in a variety of corporate debt rearrangements during this period received careful scrutiny by U.S. courts, and actions taken pursuant to these

³⁵ Francis Palmer uses this phrase. See text accompanying note 2, supra.

³⁶ See, e.g., Haines, supra note 5, at 67.

³⁷ See Billyou, supra note 5, at 596-597 (describing the applicable law in England and Canada and noting that modifications in the United States were subject to similar restrictions in terms of court scrutiny); Note, The Rights and Remedies of the Bondholder Under Corporate Bonds and Indentures, 27 Col. L. Rev. 579, 584-586 (1927) (stating that majority bondholders were assumed to be acting in the best interests of the bond class, but suggesting that the courts were especially concerned with collusive arrangements between the debtor and the majority creditors).

³⁸ 74 F. 110 (2d Cir. 1896).

provisions were sometimes invalidated if the court found bad faith or abuse on the part of the majority creditors.

2. [Phase Two: Flowering](#)

Most corporate debt workouts during this era (about 1880 to 1920), however, were not effected through the use of majority action clauses in the underlying bonds. Rather, they were carried out through the equity receivership technique described above. The litigation and commentary of the day dealing with intercreditor duties in debt rearrangements therefore arose primarily in the equity receivership context. Significantly, intercreditor duties in these affairs were understood to run both from the majority to the minority creditors, and *vice versa*.³⁹ The contemporary literature suggests, for example, that courts would look with disfavor on speculators who purchased their bonds (presumably at a discount) while the reorganization was underway and then tried to hold up completion of a plan that enjoyed broad support among the other creditors.⁴⁰

Predictably, the lion's share of the litigation involved complaints by minority creditors that a proposed equity receivership treated them unfairly. The equity receivership process as it had evolved over this period relied heavily on the implicit cooperation of corporate insiders and friendly creditors. Courts were therefore prepared to entertain complaints by minority creditors that a resulting plan of reorganization may have been too generous to the insiders. These complaints grew in volume as the proponents of equity receiverships in the 1920s searched for more efficient methods of discouraging holdout creditors by, for example, leaving non-participating creditors with a distastefully small recovery at the end of the process. Interestingly, although the issue was hotly debated in the legal journals by some of the most prominent practitioners of

³⁹ For example, Quindry, *supra* note 8, at 452, wrote:

In announcing the disposition of courts of equity in considering reorganization plans, it has been said that the court will not allow minority bondholders to be disregarded or unfairly treated in such a plan, yet on the other hand, it will not lend its aid to a scheme by a minority bondholder of holding up a fair reorganization solely as a means of obtaining greater value or more favorable terms for his bonds than are to be given by the plan to the great majority of bondholders.

(quoting *Palmer v. Bankers' Trust Co.*, 12 F.(2d) 747 (8th Cir. 1926)).

⁴⁰ Like Quindry, Robert Swaine also quotes the language from *Palmer* on how courts will not support a minority bondholder's attempt to exploit the equity receivership process:

" . . . a court of equity . . . will not lend its aid to a scheme by a minority bondholder of holding up a fair reorganization, solely as a means for obtaining greater value or more favorable terms for his bonds that are to be given by the plan to the great majority of the bondholders. Especially is this true if it should appear that the minority bondholder has bought his bonds pending the reorganization and for the purpose of speculating thereon."

Robert Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 Col. L. Rev. 901, 927-29 (1927) (quoting *Palmer v. Bankers' Trust Co.*, 12 F.2d 747, 754 (8th Cir. 1926) and also citing *Guaranty Trust Co. v. Chicago M. & St. P. Ry.*, 15 F.2d 434, 443 (N.D. Ill. 1926) and *Jameson v. Guaranty Trust Co.*, 20 F.2d 808, 815 (7th Cir. 1927)).

the equity receivership art, no consensus was reached as to whether the equitable powers of the supervising court extended to the point of being able to force non-assenting creditors to participate in a reorganization that enjoyed broad creditor support and struck the court as inherently fair.⁴¹

3. Phase Three: Erosion

Things began to change dramatically after the amendment of the Bankruptcy Act in 1934 to add the predecessor of Chapter 11, and after the passage of the Trust Indenture Act in 1939 that prohibited the use of majority action clauses in publicly-issued corporate bonds. The availability of a bankruptcy reorganization procedure meant that minority creditors who felt themselves aggrieved by the terms of a voluntary debt rearrangement could obtain the supervision of a bankruptcy judge by forcing the process into a bankruptcy reorganization.⁴² Accordingly, there was less and less of a need to infer broad intercreditor duties in the workouts of multicreditor debt instruments as a means of countering tyrannical minorities or oppressive majorities.

Also, the abrupt discontinuance of majority action clauses in U.S. bonds after 1939 meant that courts were no longer confronted with complaints by minority bondholders that their claims against the debtor were being improperly reduced or deferred without their consent. The U.S. law of intercreditor duties as it applied to majority action clauses was thus arrested after 1939. This is not to say that American-style amendment provisions in multicreditor debt instruments were never the subject of legal scrutiny. They were, but increasingly in the syndicated bank loan context.

The modern U.S. law in this area has turned distinctly hostile to the notion of implied intercreditor duties in multicreditor debt instruments, particularly in instruments that involve sophisticated parties and carefully detailed, arms-length agreements.⁴³ Of equal importance, where the multicreditor debt instrument contains

⁴¹ The debate was between James Rosenberg and Robert Swaine and took place in the pages of the Columbia Law Review. See James N. Rosenberg, Reorganization – The Next Step, 22 Col. L. Rev. 14 (1922) and Robert Swaine, Reorganization – The Next Step: A Reply to Mr. James N. Rosenberg, 22 Col. L. Rev. 122 (1922). An Eighth Circuit decision, Phipps v. Chicago R.I. & P. Co., 284 F. 945 (1922), handed down subsequent to the Rosenberg/Swaine interchange, was in line with Rosenberg's argument (which was that courts did have the power to impose a reorganization solution on a dissenting minority), but the matter was never decided by the Supreme Court. On Phipps and the debate generally, see James N. Rosenberg, Phipps v. Chicago R.I. & P. Co., 24 Col. L. Rev. 266 (1924); James N. Rosenberg, Reorganization Yesterday Today Tomorrow, 25 Va. L. Rev. 129 (1938); Arthur H. Dean, A Review of the Law of Corporate Reorganizations, 26 Cornell L. Q. 537 (1941).

⁴² See Wilber G. Katz, The Protection of Minority Bondholders in Foreclosures and Receiverships, 3 U. Chi. L. Rev. 517 (1936) (“[T]he problem as to the type of protection, if any, to which [minority creditors] are entitled ... is worth attempting in spite of the fact that probably a large majority of current reorganizations are brought about through proceedings under Section 77B of the Bankruptcy Act.”)

⁴³ The following language from the Banque Arabe case is illustrative:

an express collective decision-making provision, U.S. courts have been reluctant to entertain a claim that the majority's use of the provision should be encumbered by vague intercreditor duties.⁴⁴

C. *Intercreditor Duties in Sovereign Debt Instruments*

If we are correct in our speculation that the availability after 1934 of a bankruptcy reorganization procedure for corporate debtors meant that U.S. courts no longer needed to rely on doctrines of implied intercreditor duties to enforce fair play among minority/majority creditors in a negotiated corporate debt workout, this raises the interesting question of whether, for sovereign debtors that still do not have a Chapter 11 safety net, the older view of intercreditor duties has some continuing vitality. The question was put squarely before a U.S. federal district court in 1995 in a case captioned CIBC Bank and Trust Company (Cayman) Limited v. Banco Central do Brasil, et al.⁴⁵ A group of related (non-bank) entities held a position in the Multiyear Deposit Facility Agreement (the "MYDFA") in which the Central Bank of Brazil was the borrower and the Federative Republic of Brazil was the guarantor. The MYDFA was in the nature of a large syndicated loan; it had been the contractual vehicle through which Brazil's public-sector debt had been restructured in 1980s. In 1992, Brazil asked all MYDFA holders to exchange their claims under that instrument for one or more series of new bonds (the choice of the type of new bond to be at the election of each creditor) issued by the Federative Republic of Brazil. The owners of this position accepted Brazil's request for the full amount of their exposure under the MYDFA. Brazil subsequently attempted to amend its offer by requiring creditors to take a minimum allocation of certain types of the new bonds. The owners declined to accept this mandatory reallocation and consequently they were excluded from participating in the bond

[I]n the case of arms length transactions between financial institutions, no fiduciary duty exists unless one was created in the agreement . . . [and] there is no automatic, status-based fiduciary duty created in the transaction.

Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank, 819 F. Supp. 1282 (S.D.N.Y. 1993). For similar language, see Banco Urquijo, S.A. v. Signet Bank, 861 F. Supp. 1220 (M.D. Pa. 1994); Banco Espanol de Credito v. Security Pacific Nat'l Bank, 763 F. Supp. 36, 45 (S.D.N.Y. 1991); First Citizens Federal Sav. & Loan Ass'n v. Worthen Bank & Trust Co. N.A., 919 F.2d 510, 514 (9th Cir. 1990); Aaron Ferer & Sons v. Chase Manhattan Bank, 731 F.2d 112, 122 (2d Cir. 1984).

⁴⁴ For example, in First National Bank Ass'n v. Canadian Imperial Bank of Commerce, 1995 U.S. Dist. LEXIS 12105 (D. Minn., June 9, 1995), where a group of banks in a syndicate entered into a standstill agreement with the borrower following a missed interest payment, the court rejected one bank's argument that the majority was obliged to declare a default. Similarly, in New Bank of New England v. Toronto-Dominion Bank, 768 F. Supp. 1017, 1021-22 (S.D.N.Y. 1991), a majority of the lenders did not vote to accelerate the debt despite the occurrence of an event of default. One lender argued, unsuccessfully, that the majority was obliged to accelerate as a result of its "implied obligation of good faith" to a fellow lender. On this point, see also Yucyco Co., Ltd v. Republic of Slovenia, 984 F. Supp. 209, 221 (S.D.N.Y. 1997) (minority creditor's claim that agent was obliged to declare an event of default and accelerate the debt – where the agreement required consent from the majority creditors to accelerate – was rejected).

⁴⁵ 886 F. Supp. 1105 (S.D.N.Y. 1995).

exchange. (The legal title to this position was subsequently transferred to CIBC Bank and Trust Company (Cayman) Limited.)

Just prior to closing the exchange, however, Brazil instructed one of its state-owned banks, Banco do Brasil (“BdB”), to withdraw from the exchange a principal amount of MYDFA debt slightly larger than that held by CIBC, thus leaving BdB with a majority position in the MYDFA. When CIBC attempted, after the exchange, to accelerate the unmatured principal due under the MYDFA (an action requiring the consent of holders of at least 50% of the outstanding amounts), BdB used its MYDFA voting power to block the acceleration. CIBC then sued in the Southern District of New York.

Citing Hackettstown and other authorities, CIBC argued to the court that BdB was in an openly collusive arrangement with the MYDFA debtor (the Central Bank of Brazil) and guarantor (the Federative Republic of Brazil) and that BdB’s vote on the question of acceleration should therefore not be counted. Among other things, CIBC contended, BdB had breached its obligation of good faith and fair dealing to its fellow creditors. Although this was indeed the lesson of Hackettstown, the CIBC court elected to treat this case strictly as a matter of contract interpretation: the MYDFA itself did not disenfranchise a creditor who was affiliated with the debtor and the court declined to read such a disenfranchisement into the contract on the grounds of implied intercreditor duties.⁴⁶

CIBC involved a syndicated loan and the collective decision-making provision at issue in the case was majority voting for acceleration. If sovereign bonds issued under the law of a U.S. jurisdiction begin to incorporate English-style majority action clauses that permit write-downs of principal or interest claims, however, limiting judicial scrutiny to the four corners of the contract may not always make sense. Under those circumstances, we believe that a modern U.S. court would not refuse to hear a challenge to the legitimacy of a majority’s decision to reduce or defer payments due under the instrument when the facts show a collusive or corrupt oppression of the minority bondholders by the majority. Because the clauses themselves do not offer any guidance or standards for deciding when a majority may have acted improperly, courts would presumably apply olfactory tests very similar to those used by their late nineteenth century brethren. Unless courts are prepared to supervise the operation of majority action clauses in cases where non-assenting minority bondholders can show an abuse by the majority, as courts were willing to do when the clauses last appeared in American bonds seventy years ago, these clauses will not prosper as a tool for achieving creditor-led sovereign bond workouts. We are not suggesting that a decision of a supermajority of bondholders taken pursuant to a majority action clause should be overturned lightly, nor should a court substitute its own view about what might be in the bondholders’ best interest for what the holders themselves have, as a group, decided. But where a majority or supermajority cannot articulate a commercial justification for its action, a judicial inquiry into motives may be warranted.

⁴⁶ Id. at 1117.

The treatment of sovereign bonds containing American-style amendment clauses, however, is likely to be quite different. These clauses do not permit an involuntary reduction of amounts due under a bond or deferment of payment dates. Thus, the minority bondholders' complaint must be that some other, less drastic amendment or action sanctioned by the majority should be invalidated. The very limited law that has developed in the area of amendments to corporate bonds suggests that such complaints will be hard to sustain.⁴⁷ When the clauses say that any modification is permitted with the consent of only a specified majority of bondholders, apart from certain specifically enumerated amendments that require unanimous approval, American courts will examine the challenged amendment with an eye on whether -- in a real-world sense -- it is tantamount to one of the modifications requiring unanimous bondholder consent.⁴⁸ This is more in the nature of a traditional inquiry into whether the form of a party's behavior under a contract should be permitted to override the substance of its action. Courts will not, we believe, approach disputes about American-style amendment clauses from the standpoint of implied intercreditor duties. There is no reason to do so, and the modern tendency of U.S. court to respect the black letter of a financial contract is very strong.

For a sovereign debtor, of course, this prediction is both good and bad news. Good in the sense that the validity of majority-approved amendments to non-payment terms are likely to be respected. Bad in the sense that a U.S. court is unlikely to read into a bond containing an American-style amendment clause an implied duty on the part of minority bondholders to acquiesce in the wishes of the majority for a financial restructuring of the instrument.

⁴⁷ See Exit Consents, supra note 34, at 70-74 (describing cases that analyze the validity of majority amendments made to U.S. corporate bonds).

⁴⁸ See Federated Strategic Income Fund v. Mechala Group Jamaica Ltd., 1999 WL 993648 (S.D.N.Y., Nov. 2, 1999). In this unpublished decision, the court was asked to construe an American-style amendment clause in a bond indenture that listed, as changes requiring unanimous bondholder consent, any change that would reduce the principal amount of a bond or impair a bondholder's right to institute suit for enforcement of payment. The amendments at issue sought to move the corporate debtor's assets to another company (not an obligor on the bonds) and to eliminate certain guarantees for the bonds. The defendant argued that these amendments, because they did not expressly affect the payment terms of the bonds, required only majority bondholder approval. The court disagreed:

Taken together, these proposed amendments could materially impair or affect a holder's right to sue. A holder who chooses to sue for payment at the date of maturity will no longer, as a practical matter, be able to seek recourse from either the assetless defendant or from the discharged guarantors. It is beyond peradventure that when a company takes steps to preclude any recovery by noteholders for payment of principal coupled with the elimination of the guarantors for its debt, that such action does not constitute an "impairment" or "affect" the right to sue for payment.

Id. at *7.

V. Collective Decision-making Provisions in Sovereign Debt Workouts

A. *Objectives*

How far can collective decision-making provisions in sovereign bonds be used to facilitate debt workouts? Another way of asking this question is to inquire whether, and to what extent, these clauses can be used to replicate the important features of a bankruptcy code such as the “international bankruptcy regime” applicable to sovereign borrowers that has been discussed, off and on, for many years.⁴⁹ As articulated by Ms. Krueger, the principal objectives of an international bankruptcy system would be:

- to shield the sovereign debtor from disruptive litigation by individual creditors while the debt workout is underway (the “automatic stay” feature);
- to ensure that a debt restructuring plan that is acceptable to the large majority of creditors will bind any dissenting minority (the “cramdown” feature);
- to facilitate the sovereign’s ability to attract new financing from private sector sources during the workout period (the “debtor-in-possession” or “DIP financing” feature); and
- to permit a greater level of coordination among the different types of creditors (banks, bondholders, bilateral creditors, trade creditors and

⁴⁹ Most recently by Anne Krueger, First Deputy Managing Director of the IMF, in a paper entitled International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Mimeo, IMF (2002) (<http://www.imf.org/external/np/speeches/2001/112601.htm>). Ms. Krueger’s proposal was not a new idea. David Suratgar had outlined the idea in a 1984 article entitled “The International Financial System and the Management of the International Debt Crisis” in Default and Rescheduling [David Suratgar (ed.) 1984, at 151]. See Christopher G. Oechsli, Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act, 21 Va. J. Int’l L. 305 (1981); David Suratgar, The International Financial System and the Management of the International Debt Crisis, in Default and Rescheduling: Corporate and Sovereign Borrowers in Difficulty (1984); Thomas Kampffmeyer, Towards a Solution of the Debt Crisis: Applying the Concept of Corporate Compositions with Creditors (1987); Benjamin Cohen, Developing Country Debt: A Middle Way (1989); Benjamin Cohen, A Global Chapter 11, 75 Foreign Policy 109 (1989); Kunibert Raffer, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18(2), 301 (1990); Marcus Miller & Joseph Stiglitz, Bankruptcy Protection Against Macroeconomic Shocks: The Case For a “Super Chapter 11” (unpublished paper presented at the World Bank Conference on Capital Flows, Financial Crises, and Policies, 15-16 April 1999); Steven L. Schwarcz, Solving Debt Restructuring: A Bankruptcy Reorganization Approach, 85 Cornell L. Rev. 956 (2000); Jeffrey Sachs, Do We Need an International Lender of the Last Resort?, Graham Lecture at Princeton University, April 20, 1995 (<http://www.ksg.harvard.edu/ciddirector/publicat.html#Working>); Michel Camdessus, Capital Flows, Crises, and the Private Sector, Remarks to the Institute of International Bankers, March 1, 1999 (<http://www.imf.org/external/np/speeches/1999/030199>).

so forth) caught up in a sovereign debt problem (the “coordination” feature).

B. *Limitations*

The collective decision-making provisions currently used in sovereign bonds have some important limitations if one looks to them as the exclusive tool for expediting debt workouts. First, these provisions -- even the most liberal English-style majority action clauses -- operate only within the four corners of the bond containing the clauses. They therefore cannot be used to address the coordination problem. Some other method, as yet undiscovered or at least unutilized, will be needed to encourage closer coordination among the various groups of creditors such as the Paris Club, trade creditors, multilateral creditors and so forth.

Second, it is in the very nature of collective decision-making provisions that they operate by a vote of the majority or supermajority of the bondholders. One prospective holdout creditor, or a small group of similarly-minded creditors, can therefore effectively control the tactical use of these clauses by acquiring a blocking position of bonds. For example, if such a creditor controlled 25% of the bonds of one issue, it could single-handedly cause the acceleration of that bond, although perhaps at the risk of seeing the acceleration later reversed by a vote of 50% of bondholders. Similarly, a 25% holding will ensure that an English-style majority action clause could not be used to restructure the instrument without the concurrence of that 25% holder. Even amendments to the non-payment terms of a U.S. bond can be blocked if the holdout acquires 34% (in bonds that set the voting level for modifications to non-payment terms at 66-²/₃%) or 50% (in bonds that require only majority approval of such a change) of the outstanding bonds of that issue.

Third, because collective decision-making provisions operate only bond-by-bond and do not reach out to affect other bond syndicates or other types of creditors, a sovereign debtor must separately convince each bond syndicate to go along with the deal. Stated differently, in a negotiated sovereign debt restructuring (unlike a corporate reorganization under chapter 11), all similarly-situated creditors do not vote as a class and thus soliciting the “collective will” of creditors in a sovereign context really means seeking action by separate creditor groups under separate debt instruments. We discuss in Part VI of this article one idea for a procedural mechanism for homogenizing similarly-situated sovereign bondholders in order to replicate Chapter 11-style class voting.

Fourth, an active sovereign borrower will have placed its bonds in a number of jurisdictions around the world. As a matter of convention, the documentation practices in some of these markets (the German retail investor market is one example) discourage any form of collective decision-making clauses in bonds.⁵⁰

⁵⁰ Interestingly, the German Government has confirmed that, under German law, “no legal impediments exist to incorporate collective action clauses into the bonds of foreign issuers ..., provided that the debt restructuring serves to safeguard the joint interests of all bondholders.”

Finally, the unanimous consent requirement in American bonds means that a determined holdout creditor will ultimately have a claim for the principal and interest due to him under the bond. Amendments effected by the majority of the bondholders may remove the acceleration remedy or strip financial covenants out of the bond but, in the end, they cannot involuntarily reduce the amount of a holdout's claim against the issuer or postpone a scheduled payment date.

C. *The Tactical Use of Collective Decision-making Provisions*

Within these limitations, however, collective decision-making provisions can go at least part of the way toward replicating the features of a domestic corporate bankruptcy.

1. Cramdown

The best example of a provision that permits a contractual cramdown on dissenting minority bondholders is an English-style majority action clause.⁵¹ As discussed above, this is precisely what the clause was designed to do. A 75% vote of bondholders attending a meeting that satisfies quorum requirements can reduce or defer payments due under the bond containing this provision, and that decision will bind any non-assenting holders.

Two countries, Pakistan and the Ukraine, have sought a restructuring of their English law bonds in recent years. Pakistan, in an exchange offer that closed in December 1999, elected not to use the majority action clauses in its bonds to cram down holdouts, reportedly because it feared that calling meetings of bondholders might produce a less agreeable outcome such as an acceleration.⁵² The Ukraine, in an exchange offer that closed in February 2000, circumvented this problem. By accepting the Ukraine's exchange offer, each holder of an English-law bond automatically gave a proxy to the exchange agent to vote at a subsequent meeting of bondholders in favor of modifications to the old bonds that brought them into line with the payment terms of the

Bundesministerium der Finanzen, Statement by the German Federal Government on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German law", dated Feb. 14, 2000, ¶6.

⁵¹ Consistent with practice in the sovereign debt area, we loosely use the term "cramdown" to mean that a dissenting creditor is being forced to agree to a debt restructuring. Under U.S. bankruptcy law, dissenting creditors within a class can be forced to consent to a restructuring as long as there is approval from two-thirds of the class in amount and a majority of the claims in number, but this is not what is referred to as a "cramdown." Instead, a "cramdown" occurs when the plan of reorganization binds a dissenting class of creditors (which can occur under certain circumstances). For more on the subject of cramdowns under U.S. bankruptcy law, see Kenneth N. Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133, 134 (1979); Kenneth N. Klee, Cram Down II, 64 Am. Bankr. L. J. 229 (1990).

⁵² See *Involving the Private Sector*, supra note 34, at 5, 30-31 (describing the Pakistan restructuring).

new bonds being offered in the exchange.⁵³ The result? 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 in the exchange. The Ukraine could compel this outcome as long as it achieved at least a 75% acceptance of its exchange offer for each old bond.

For sovereign bonds with American-style amendment clauses, an involuntary reduction or deferment of claims will not be possible as a result of the unanimity requirement in the amendment clauses. Nevertheless, prospective holdouts can be encouraged to participate in a deal that enjoys the support of most other bondholders by the prospect of holding old bonds that have been amended by the majority holders in a variety of disagreeable ways (short of changing the amount or due date of a payment due under the old bond) just prior to the closing of the exchange offer. We have discussed this technique of seeking “exit consents” in a prior article and we will not repeat that discussion here.⁵⁴ The technique can be useful in convincing the fence-sitting bondholder to come along with the majority. Only one sovereign bond issuer, Ecuador in August 2000, has made a tactical use of exit consents in a restructuring of bonds containing American-style amendment clauses.⁵⁵ Whether U.S. courts will find some exit amendments to be impermissibly severe on the holdouts remains an open issue: there are no reported cases in the United States that discuss the validity of the technique in the sovereign context, and only a few in the area of corporate bond exchanges.⁵⁶

2. [Automatic Stay](#)

The automatic stay protection in a U.S. corporate bankruptcy is intended to stop individual creditors from taking actions, such as lawsuits or set-offs, that could prejudice the eventual reorganization of the debtor’s affairs. Of course, the legal ability to cram down a plan of reorganization on dissenting creditors in a corporate bankruptcy means that the automatic stay protection is needed only during the period before the reorganization becomes effective.

The situation is different in a sovereign debt workout. The threat of disruptive legal actions while a restructuring is underway is certainly present in the sovereign context, although holdout creditors have traditionally waited for a sovereign to complete its restructuring with other creditors before launching a legal attack. But without a sure ability to cram down a deal on holdout bondholders, the sovereign debtor must worry about maverick creditor litigation both before and after completion of a restructuring with the other bondholders.⁵⁷

⁵³ Id., at 6, 31-33 (describing the restructuring for Ukraine).

⁵⁴ See Exit Consents, supra note 34.

⁵⁵ See Buchheit, supra note 20, at 20.

⁵⁶ See Exit Consents, supra note 34, at 78-82.

⁵⁷ Some commentators have suggested that the threat of litigation by holdouts is being exaggerated. See Comments of Michael Chamberlin, EMTA Executive Director, The IMF’s Sovereign Bankruptcy Proposal and the Quest for More Orderly Workouts (January 29, 2002)

Collective decision-making provisions can provide a significant protection against maverick lawsuits while the workout is in progress. The customary requirement that holders of 25% of the bondholders in a particular issue consent to an acceleration of the unmatured principal gives a measure of protection because most bondholders will not wish to sue just for their share of one or two missed payments. Of equal importance, however, is the ability of a simple majority (in most bonds) to rescind any prior acceleration as part of a final workout. The discontented bondholder who is thinking of pursuing independent legal remedies must therefore face the possibility that, after months of expensive litigation, the sovereign debtor will reach an agreement with the majority of its bondholders, the acceleration will be reversed and the litigant creditor will be left with a claim only for its share of any payments that remain unpaid after the settlement. This can be a powerful disincentive to the commencement of lawsuits before a restructuring has been concluded.

Finally, in the case of sovereign bonds issued pursuant to a trust deed (in England) or a trust indenture (in the United States), the restrictions contained in those instruments on enforcement actions by individual bondholders can provide a significant degree of protection against maverick lawsuits while a restructuring is in progress. In effect, holders of 25% of the bonds must instruct the trustee to begin an enforcement action for accelerated principal and, even then, any recovery by the trustee will be shared pro rata among all the holders. This is not a regime conducive to maverick lawsuits. As noted above, however, only a minority of foreign sovereign bonds issued in the United States have employed a trust indenture structure.

3. [DIP Financing](#)

We propose to consider in somewhat more detail the question of whether existing collective decision-making provisions in sovereign bonds can be used to replicate the debtor-in-possession financings that are a regular feature of Chapter 11 reorganizations for corporate borrowers in the United States. DIP financings are credits extended to a company (with bankruptcy court approval) after it has entered into the Chapter 11 process in order to allow the company to continue its business operations while the plan of reorganization is being worked out.⁵⁸ In order to encourage lenders to extend new credit, the law treats these loans as an administrative expense of the bankruptcy and they enjoy a legal priority over other claims against the debtor.⁵⁹

Now consider the position of a sovereign borrower, the Republic of Ruritania, that encounters temporary difficulties in servicing its existing external debts. Ruritania does not have a Chapter 11 option. Thus, its choices boil down to two: seek

(<http://www.emta.org/ndevelop/rider7.pdf>); Institute for International Finance, Summary Report on the Work of the Steering Committee on Emerging Markets Finance, p.12 (1999). Other observers believe that holdouts pose a serious threat to the sovereign debt workout process. See Gabrielle Lipsworth & Jens Nystedt, Crisis Resolution and Private Sector Adaptation, 47 IMF Staff Papers 188, 211 (2001).

⁵⁸ 11 U.S.C. § 364(b).

⁵⁹ See David L. Buchbinder, Fundamentals of Bankruptcy, A Lawyer's Guide 342 (1991).

emergency financial help exclusively from official sector institutions such as the International Monetary Fund or approach its private creditors for a restructuring of their outstanding credits to the country.

Each alternative has drawbacks. Official sector lenders are increasingly reluctant to pour fresh money into a country only to see those funds flush out again to repay, in full and on time, private sector creditors. On the other hand, a full restructuring of private sector credits, quite apart from the damage that this may do to the country's long-term credit standing and financing prospects, may in fact be too drastic a remedy for a liquidity-driven problem. A restructuring would involve permanent deferments or reductions in amounts owed to private creditors. If the liquidity problem can be resolved quickly, a restructuring will have unnecessarily imposed permanent damage on private creditors.

(a) [Technique](#)

As an alternative to a permanent restructuring of private sector claims, could Ruritania obtain the equivalent of a DIP financing from a group of private lenders in order to tide the country over until its liquidity problems are resolved? This money would presumably come in together with fresh funds from the official sector institutions.

Such a financing would naturally be very difficult to arrange, and even if arranged would be prohibitively expensive, unless the new lenders could be assured of a legally-enforceable priority over existing Ruritanian debts owed to private sector creditors. The question, then, is whether Ruritania could convince a critical mass of its existing creditors (and we will assume that these are bondholders holding bonds with American-style amendment clauses of the kind set out in Appendix A) voluntarily to subordinate themselves to a specific new financing (let's call it the "*New Loan*") that would be used to continue payments on Ruritania's existing bonds during an interim period, thereby avoiding the need for a restructuring of those debts.

(b) [Legal Analysis](#)

From a legal perspective, such a request from Ruritania would amount to a proposal that the pari passu clause in Ruritania's existing bonds (the clause ensuring that the bonds will not be subordinated to any new creditors) be amended to permit a subordination of each existing bond syndicate to the New Loan. The terms of a subordination would confirm the agreement of the existing bondholders that the New Loan creditors will enjoy a senior status. The subordination would not release or discharge the sovereign's obligation to make payments on its existing bonds; it would merely evidence an intercreditor arrangement giving the New Loan seniority over the old bonds (or any instruments that may be exchanged for those bonds).⁶⁰ The agent or trustee for the New Loan would be given the power to enforce the terms of this subordination.

⁶⁰ For a discussion of the various types of subordinations, see Dee Martin Calligar, *Subordination Agreements*, 70 *Yale L. J.* 376 (1960).

Could an amendment providing for such a targeted subordination be accepted by the majority of bondholders in each existing bond syndicate with the effect that any non-assenting holders in that syndicate will also be bound by the terms of the subordination? As noted above, most amendment clauses in emerging market sovereign bonds issued under the law of a U.S. jurisdiction have an Edenic character: one may eat from any tree in the garden, or modify any provision of the bond, with the approval of only a majority (sometimes 66-²/₃%) of the holders except that certain specifically enumerated amendments require the consent of each affected bondholder. So the analysis first looks to see whether a targeted subordination falls within the list of unanimous consent amendments. Does it change a payment date on the old bonds? No. Does it reduce the amount of principal or interest due under the old bonds? No. Does it change the currency in which the old bonds are payable? No. Does it alter the voting percentages of the old bonds? No.

What a targeted subordination *may* do is make it less likely that Ruritania will in fact be able to make the payments due on its existing bonds because it will now be obligated to pay the New Loan as a matter of legal priority. But the amendment clauses in Ruritania's bonds do not make modifications of this kind the subject of unanimous consent. The best analogy may be to amendments to financial covenants such as negative pledge clauses. By amending a negative pledge restriction to permit Ruritania to pledge an asset to secure another creditor, the bondholders may have impaired their own ability to be paid because the proceeds from any sale of that asset will naturally go first to the secured creditor. The bondholders would presumably not consent to such a modification unless they believed that giving this flexibility to Ruritania (i.e., the ability to raise fresh money on a secured basis) was a risk worth taking. Most American-style amendment clauses leave this kind of judgment in the discretion of the majority of the bondholders.⁶¹

(c) Commercial Analysis

The commercial justifications for Ruritania's bondholders to accept a targeted subordination to the New Loan may be compelling. The New Loan (together, perhaps, with new official sector funds) would be intended to avoid a default on Ruritania's outstanding obligations while the country's liquidity problems are being addressed. The worst case scenario for the existing creditors is therefore one in which Ruritania's financial difficulties persist and a restructuring becomes inevitable down the road, notwithstanding the New Loan. But in analyzing whether to accept the targeted subordination, the choice for existing creditors is the possibility of a restructuring tomorrow versus the certitude of a restructuring today.

Assuming that the proceeds of the New Loan are committed to the continued servicing of Ruritania's outstanding debts, the existing bondholders will receive payments that they might otherwise have been asked to forgo or defer in a

⁶¹ The version of the American-style amendment clause contained in Appendix C to this paper, however, arguably precludes an amendment involving a voluntary subordination because it refers generally to changes in "terms of payment".

restructuring. The risk for the existing bondholders, of course, is that should a restructuring eventually become necessary, the financial terms of that restructuring will to some degree be harsher as a result of the addition of a legally senior claim (the New Loan) to Ruritania's debt stock. One aspect of the financial question is whether the benefit of receiving continued debt service payments while the New Loan is being disbursed outweighs the incremental severity of restructuring terms should a restructuring prove unavoidable.

Finally, in the absence of a targeted subordination and a New Loan from private sector sources, Ruritania, if it is to avoid a compulsory restructuring, would look to borrow from international financial institutions such as the World Bank and the IMF. Even if those lenders were prepared to be the sole providers of new funding (and there is reason to doubt whether, in light of the well-publicized reluctance of official lenders to perpetuate the practice of financial bail-outs, they would be), those institutions claim for themselves a de facto senior creditor status. Thus, either way, the bondholders would be faced by a larger component of senior debt should a restructuring become necessary down the road.

VI. [Procedural Options for Achieving Majority Control of a Sovereign Debt Workout](#)

The equity receivership technique of the late nineteenth and early twentieth centuries evolved over time to meet what the debtors and bondholders of the day saw as a pressing need. Debt rearrangements for corporate and railroad borrowers were occasionally necessary. There was no bankruptcy procedure in place at the time that would accommodate such a workout (short of liquidation) and prevent exploitation by dissident creditors. The equity receivership solution engaged the equity powers of a U.S. court to shield the debtor from piecemeal asset foreclosures while the stakeholders negotiated and implemented the terms of a rearrangement.

Those equity powers still exist in U.S. courts. Indeed, the Federal Rules of Civil Procedure ("FRCP") contain a provision, Rule 66, allowing for the appointment of receivers "in accordance with the practice heretofore followed in the courts of the United States".⁶²

The true successor to the old equity receivership technique, however, may lie in the federal class action procedures. FRCP 23 contains the rules for the commencement, certification and settlement of class actions in U.S. federal courts. The prerequisites to a class action in a federal district court are set out in FRCP 23(a):

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class,

⁶² FRCP 66.

and (4) the representative parties will fairly and adequately protect the interests of the class.⁶³

In addition, pursuant to FRCP 23(b), an action may be maintained as a class action if any of the following criteria are satisfied:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.⁶⁴

In class actions based on FRCP 23(b)(3) above, individual members of the class may “opt out” of the class and pursue their individual remedies.⁶⁵ If the class is certified under FRCP 23(b)(1) or (b)(2), however, the action -- and any eventual settlement -- will bind all members of the class.⁶⁶ These are sometimes referred to as mandatory class actions.

The supervising court has very broad powers to issue orders to ensure the procedural fairness of the action to all members of the class.⁶⁷ In addition, a class

⁶³ FRCP 23(a). The analogy between class actions and bankruptcy has been drawn by a number of prominent commentators. See, e.g., Stephen Yeazell, *Collective Litigation as Collective Action*, 1989 U. Ill. L. Rev. 43.

⁶⁴ FRCP 23(b).

⁶⁵ See Bryant B. Edwards, Jeffrey A. Herbst & Selina K. Hewitt, *Mandatory Class Action Lawsuits as a Restructuring Technique*, 19 Pepp. L. Rev. 875, 905 (1992) (hereinafter “Mandatory Class Action”).

⁶⁶ Id. 898-904.

⁶⁷ FRCP 23(d).

action cannot be dismissed or compromised without the approval of the court, and notice of any such dismissal or compromise must be given to all members of the class.⁶⁸

If it is to avoid the holdout creditor problem, a class action commenced for the purpose of restructuring sovereign bond indebtedness would need to be certified as a mandatory class action under FRCP 23(b)1 or (b)2. One rationale for certifying mandatory class actions under Rule 23(b)1(B) is that claimants would otherwise be competing for a “limited fund” of assets.⁶⁹ Unless treated as a class, the first litigants may deplete the fund and substantially impair the interests of the less agile litigants. This rationale may apply to a sovereign borrower whose “limited fund” is the pool of scarce foreign exchange resources from which all future external debt service payments will need to be made. In the absence of mandatory class certification, some litigious creditors may succeed in grabbing these assets or compelling a preferential settlement of their claims by the sovereign. Either way, the pool is diminished to the detriment of all other creditors. In addition, because sovereign borrowers are unlikely to have on hand resources sufficient to pay in cash the full amount of even compromised claims, these cases may seek declaratory or injunctive relief requiring the borrower to issue new securities in exchange for existing bonds, rather than just monetary damages.⁷⁰

To date, a limited number of class actions have been brought by indenture trustees under corporate bonds to obtain court approval of a proposed settlement with bondholders, even when the indenture contained a provision (as required by Section 316(b) of the TIA) that prohibited the bondholders themselves from voting to impair the right of non-assenting fellow bondholders to receive full and timely payments.⁷¹ The theory of these cases has been that Section 316(b) does not promise that a bondholder’s claim will never be impaired; it only promises that any such impairment will be subject to judicial scrutiny and supervision.⁷² Such scrutiny and supervision is

⁶⁸ FRCP 23(e).

⁶⁹ See James Wm. Moore, Moore’s Federal Practice (3d ed.), Vol. 5, § 23.2[2] for a description of the “limited fund” basis for certification as a non-opt out class under Rule 23(b)(1)(B).

⁷⁰ See id., § 23.43 for a general discussion of injunctive or declaratory relief under Rule 23(b)(2). See also Mandatory Class Action, supra note 65, at 907-908.

⁷¹ See, e.g., Centerre Trust Co. v. Jackson Saw Mill Co., 736 S.W. 2d 486 (Mo. App. E.D. 1987) (declaratory judgment action brought by trustee under Missouri class action rules; court affirmed a judgment approving a settlement and making the settlement binding on all bondholders).

⁷² See MBank Dallas v. LaBarge, Inc., No. 86 C 9583 (N.D. Ill. Dec. 29, 1986) (unpublished Findings of Fact, Conclusions of Law and Order). The trustee under a defaulted debenture issue brought a mandatory class action for a declaratory judgment to approve a settlement of the claims. The court found that the settlement did not deprive debentureholders of their right to sue for payment within the meaning of Section 316(b) of the TIA, saying:

This lawsuit is a suit, .. for enforcement of the right to receive payment of principal and interest The Proposed Settlement will constitute the best available payment of such principal and interest, and the Court has subjected the Proposed Settlement to judicial scrutiny. Individual lawsuits by Debentureholders at this time would circumvent the best

available in the context of the class action itself.⁷³

Class actions have also been commenced by one or more holders of corporate bonds, as class representatives, in order to ensure that a negotiated settlement with the issuer will bind all other bondholders.⁷⁴

To our knowledge, this technique has never been used to effect a general debt rearrangement for a foreign sovereign bond issuer.⁷⁵ We are aware of one case, however, Hirshon v. The Republic of Bolivia,⁷⁶ in which two holders of bonds issued by the Republic of Bolivia brought a class action in the U.S. District Court for the District of Columbia for recovery of the amounts due under the bonds following a prolonged default. The plaintiffs sought certification of the class under FRCP 23(b)(3) (which permits class members to opt out). Approximately one year after the action was filed, the plaintiffs reached a settlement with Bolivia calling for the bonds to be redeemed at 33% of outstanding principal. The plaintiffs argued that the settlement terms were reasonable in light the risk that the plaintiffs might be unable to collect on a judgment, even if they were successful at trial.⁷⁷ Class members were given one month after notice of the proposed settlement to opt out of the class. The court then conducted a fairness hearing and approved the settlement.⁷⁸

interest of the Debentureholders as a whole and interfere with the rights of all holders and would lead to a race to judgment and quite possibly, to a reduced recovery for all Debentureholders.

Id. at 19-20. But see Continental Assurance Co. v. Macleod-Stedman, Inc., 694 F. Supp 449, 456 (N.D. Ill. 1988) (court indicated that non-opt out class action could not be used to avoid the TIA's requirement of unanimous noteholder consent to changes in payment terms, but plaintiff subsequently withdrew its request for class certification).

⁷³ This theory has its critics. See Richard L. Epling, *Are Rule 23 Actions a Viable Alternative to the Bankruptcy Code?*, 23 Seton Hall L. Rev. 1555, 1567 (arguing that Rule 23 is a procedural rule that cannot override Section 316(b) of the TIA, a federal substantive law).

⁷⁴ See, e.g., Kemper Investors Life Ins. Co. v. Las Colinas Corp., No. 88C 9162 (N.D. Ill.) (unpublished Findings of Fact, Conclusions of Law and Order) (investor brought suit individually and as class representative of defaulted secured notes; court certified the case as mandatory class action and approved a negotiated settlement binding on all noteholders); The Harry and Jeanette Weinberg Foundation Inc. v. Alleco Inc., No. 91-2641 (8th Cir. 1991), appeal dismissed sub nom., Croyden Associates v. Alleco Inc., Bankr. L. Rep. (CCH) ¶ 74,710 (1992) (dismissing appeal of district court's order to certify debentureholders as a class and approve a class settlement).

⁷⁵ In Carl Marks Co. v. Union of Soviet Socialist Republics, 665 F. Supp. 323 (S.D.N.Y. 1987), plaintiff holders of Imperial Russian Government bonds brought an action as class representatives of holders of different series of the bonds. A default judgment against the USSR was entered but later vacated for want of subject matter jurisdiction.

⁷⁶ C.A. No. 1.95CV1957 (D.D.C. 1995); post-settlement challenge dismissed, 979 F. Supp. 908 (D.D.C. 1997).

⁷⁷ C.A. No. 1.95CV01957 (D.D.C. 1995) (Plaintiffs' Memorandum in Support of Final Approval of the Proposed Class Action Settlement, dated April 3, 1997, at pg 7.)

⁷⁸ 979 F. Supp. 908, 910.

Restructuring sovereign bond debt through a mandatory federal class action could achieve these objectives:

- the class action would displace individual lawsuits against the debtor (at least in the United States);
- all similarly-situated bondholders would be treated as a single class, thus allowing them to express a view on any proposed settlement as an homogenized class, rather than bond syndicate-by-bond syndicate; and
- any debt rearrangement that is worked out between the sovereign and the bondholders may be submitted to the court for approval and, if approved, would bind all bondholders.

Conducting a sovereign bond workout under the auspices of a U.S. federal class action would inevitably raise a number of novel legal and practical issues. For example, would the foreign sovereign borrower consent to the process? Who would be appointed as representatives of the bondholder class? A class action would only be feasible for a sovereign debtor that had issued a significant percentage of its bonds in the United States or where the bonds contained a choice of U.S. law and submission to U.S. court jurisdiction. To the extent that the natural geographical focus of a sovereign debt workout is in some other country, class action litigation in the United States may be in no one's interest.

Could a sovereign's non-U.S. law bonds be brought within the class action and made subject to a settlement? Would the G-7 governments encourage their local courts to refrain, on grounds of comity or otherwise, from entertaining separate lawsuits or giving inconsistent judgments if lawsuits are brought outside the United States by holders of non-U.S. law bonds? Even if non-U.S. law bonds are included, should the chosen foreign law applicable to those bonds guide the U.S. court or could one confidently predict that the law applicable to claims for money due but not paid is sufficiently similar across most jurisdictions so as to justify the U.S. court applying its own law?⁷⁹

How would a court deal with other categories of creditors such as the Paris Club, the multilateral lenders or trade creditors that could not easily be included in a class action? Perhaps the court would decide that it could not approve any settlement of a bondholder class action as "fair, adequate and reasonable"⁸⁰ until it had received confirmation that other creditor groups had also agreed to moderate their own claims on

⁷⁹ See Arthur R. Miller & David Crump, *Jurisdiction and Choice of Law in Multistate Class Actions After Phillips Petroleum Co. v. Shutts*, 96 Yale L. J. 1, 57-67 (1986).

⁸⁰ See *Mandatory Class Action*, *supra* note 65, at 911 (stating that commentators agree that this is the test for court approval of a settlement).

the sovereign's foreign exchange reserves going forward or, in the case of the multilateral creditors, agreed to augment those reserves through new lending.

Apart from jurisdictional issues, any use of the class action mechanism to facilitate a sovereign debt workout will have to take into account the mandates of the Supreme Court's recent pronouncements in *Ortiz v. Fibreboard Corp.*⁸¹ and *Amchem Products, Inc. v. Windsor*.⁸² In each of these cases, the Court expressed concern that lawyers and lower courts had pushed the class action mechanism in mass tort cases far beyond its original purpose. Among other things, the Court said that lower courts, in deciding whether to certify a class, should be especially wary where the class action was either "non opt-out" or "settlement only."⁸³ Underlying the Court's decisions in both cases was a concern about the potential for collusion in class actions.⁸⁴ More specifically, the concern was with opportunistic class counsel who might put their own interests in fees above those of the class members.

VII. Conclusion

This paper has four principal objectives. First, we have tried to demonstrate that considerations of collective decision-making have been present in the design of most bond contracts or implicit in the legal system since the late nineteenth century, although the manner in which the collective action has been implemented has changed over time. Second, the relatively diluted version of collective decision-making provisions in U.S. bonds does not reflect a public policy prejudice against majoritarian debt rearrangements; it is rather the result of historical developments that effectively forced such workouts into the bankruptcy courts (where, in fact, supermajority creditor control is now enshrined). Third, even existing collective decision-making provisions in sovereign bonds may give considerably more scope for majority creditor influence in a sovereign debt workout than some may suppose. If used confidently and creatively, these clauses can be used to mimic, to varying degrees, features of a corporate bankruptcy such as automatic stays, cramdowns and debtor-in-possession (DIP) financings. Finally, it may be feasible to engage the equity powers of U.S. federal courts in the oversight of some sovereign bond workouts with the result that the bondholders can be homogenized into a single voting class, and any court-approved compromise of the action will bind all members of that class.

⁸¹ 527 U.S. 815 (1999).

⁸² 521 U.S. 591 (1997).

⁸³ See *Ortiz*, 527 U.S. at 846-47.

⁸⁴ See John C. Coffee, *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 Colum. L. Rev. 370, 37-72 (2000) (discussing the Court's concerns in *Ortiz* and *Amchem* about the possibility of collusion); William B. Rubenstein, *A Transactional Model of Adjudication*, 89 Geo. L. J. 371, 380 (noting the Court's repeated expressions of concern in both *Ortiz* and *Amchem* about the adequacy of class counsel's representation).

This raises the question, however, of how to explain the market's ambivalent reaction to prior suggestions that contractual provisions such as majority action clauses become a standard feature in sovereign bonds. The official sector, starting in 1998 after the Mexican and Asian devaluation crises, strongly urged emerging market sovereign borrowers to consider including these provisions in their international bonds⁸⁵ but neither the sovereign issuers nor their institutional investor creditors showed much interest in the idea at the time.⁸⁶

We believe that there are a number of reasons for this resistance to the inclusion of majority action clauses in sovereign bonds.

- For so long as sovereign borrowers and their creditors nurtured the expectation of receiving an official sector bailout, they saw no advantage in embracing debt instruments that could permit a consensual restructuring without the need for a bailout. The ready availability of bailouts, despite repeated verbal warnings from the official sector that bailouts were no longer on offer, virtually guaranteed that sovereign debtors and their creditors would not give the official sector an easy way out.

⁸⁵ See Group of Seven, Strengthening the International Financial System and the Multilateral Development Bank (<http://www.g7-2001.org>); International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, "Communique" (April 29, 2001) (<http://www.imf.org/external/np/cm2001/010429b.htm>); Group of Seven, Declaration of G-7 Finance Ministers and Finance Ministers and Central Bank Governors (1998); (<http://www.imf.org/external/np/g7103098dc.htm>); Group of Ten, The Resolution of Sovereign Liquidity Crises (1996) (<http://www.bis.org/publ/gten03.htm>). Among the discussions of the need for collective action provisions are, Tarullo, *supra* note 33, at 667-672; Barry Eichengreen, *Toward a New International Financial Architecture* (1999); Tobjorn Becker, *et al.*, *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?* (IMF Working Paper WP/01/92, 2001) (<http://www.imf.org/external/pubs/ft/wp0192.pdf>); Barry Eichengreen & Christof Ruhl, *supra* note 34; *Collective Action Problems*, *supra* note 3; Barry Eichengreen & Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?* (NBER Working Paper No. 7458, 2000); Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (1995); Lee C. Buchheit, *A Lawyer's Perspective on the New Financial Architecture*, 14 *J. Int'l Banking L.* 225 (1999) (reprinted in Rosa Lastra (ed.), *The Reform of the International Finance Architecture* 237 (2001)); Lee C. Buchheit, *The Collective Representation Clause*, *Int'l Fin. L. Rev.*, September 1998, at 9; Lee C. Buchheit, *Majority Action Clauses May Help Resolve Debt Crises*, *Int'l Fin. L. Rev.*, August 1998, at 13; Lee C. Buchheit, *Changing Bond Documentation: The Sharing Clause*, *Int'l Fin. L. Rev.*, July 1998 at 17.

⁸⁶ See International Monetary Fund, *Resolving and Preventing Financial Crises: The Role of the Private Sector* (2001) (observing the failure of the markets to adopt collective action clauses in New York law bonds) (<http://www.imf.org/external/np/ext/1b/2001/032601.htm>); Richard Portes, *The Role of Institutions for Collective Action*, in Charles Adams, Robert E. Litan & Michael Pomerleano (eds), *Managing Financial and Corporate Distress, Lessons from Asia* 47, 48 (2001) ("[M]arket participants ... appear to reject any effective action by the official community to promote collective action clauses").

- Some sovereign borrowers worried that including these provisions in their bonds would raise the cost of the borrowings. This was, at best, a speculative concern, as empirical research later showed.⁸⁷
- Bond issuers and underwriters are in the business of selling bonds, not preparing for future restructurings. Majority action clauses are thus viewed in the same light as prenuptial agreements: extraordinarily useful at the end, but distinctly unromantic at the beginning. Bond underwriters, who (they hope) will not be there when the end comes, are natural proponents of this view.
- Some sovereign borrowers may have gone so far as deliberately to dilute the protections offered by even the conventional forms of collective decision-making provisions as a visible demonstration to the market that the bridge to a future restructuring had been burnt. This bit of bravado will be regretted, of course, if it becomes necessary to start crawling back over the charred timbers of that bridge.
- A concern was occasionally expressed that contractual provisions facilitating an orderly restructuring of the debt would only invite casual requests to restructure.⁸⁸ Dilute the horror of a sovereign debt restructuring, this theory contends, and you will have more frequent restructurings.

We believe that the market's bashfulness about securing and employing mechanisms that will ensure majority creditor control of future sovereign debt workouts is misguided. The presence or absence of majority decision-making provisions in bonds does not influence a sovereign's decision to embark on a restructuring. The cost and the consequences -- political, social and financial -- of a generalized debt restructuring are typically so high that no sovereign takes this step lightly. Indeed, if history teaches any lesson, it is that sovereigns often delay taking necessary debt management measures until a point when the severity of those measures is needlessly aggravated. In today's world, the institutional (mark-to-market) investors in sovereign bonds share

⁸⁷ One study suggested that majority action clauses raise spreads for low credit quality borrowers and lower them for high quality borrowers. See Barry Eichengreen & Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, supra note 81. Several other studies, however, concluded that the choice of U.S. or English governing law in sovereign bonds (used as a proxy for the presence of majority action clauses) showed no statistically significant differences in pricing. See *Collective Action Problems*, supra note 3, at 146-49.

⁸⁸ But see Andy Haldane, *Private Sector Involvement in Financial Crisis: Analytics and Public Policy Approaches*, *Fin. Stability Rev.* (Nov. 1999) 184, 196 (suggesting that collective action clauses could – if they were perceived as insuring against a disorderly grab for assets – actually lower the cost of sovereign bond finance). Investors who hold this view would presumably be distressed to learn that in 1937 the SEC recommended that a stated percentage of the fees paid to the underwriters of sovereign bond issues be deducted and held to defray the costs of future sovereign bond restructurings. See SEC Report, Part V, supra note 10, at 746.

fully in the horror of a sovereign debt meltdown. The greater risk to these investors does not lie in the threat of casual defaults, it lies in the prospect of messy and ill-defined workout procedures that leave assets languishing on the lenders' books at default levels for long periods of time and that invite exploitation by opportunistic creditors.

Description of English-Style Majority Action Clause*

12. *Meetings of Noteholders, Modification and Waiver*

(a) *Meetings of Noteholders*

The Agency Agreement contains provisions for convening meetings of Noteholders to consider matters relating to the Notes, including the modification of any provision of these Conditions or the Deed of Covenant. Any such modification may be made if sanctioned by an Extraordinary Resolution (as defined below).

The quorum at any such meeting for passing an Extraordinary Resolution shall be two or more persons holding or representing a clear majority of the principal amount of the Notes for the time being outstanding, or at any adjourned meeting two or more persons being or representing Noteholders whatever the principal amount of the Notes for the time being outstanding so held or represented, except that at any meeting the business of which includes consideration of proposals, *inter alia*, (i) to modify the maturity of the Notes or the dates on which interest is payable in respect of the Notes, (ii) to reduce or cancel the principal amount of, or interest on, the Notes, (iii) to change the currency of payment of the Notes, or (iv) to modify the provisions concerning the quorum required at any meeting of Noteholders or the majority required to pass an Extraordinary Resolution, the necessary quorum for passing an Extraordinary Resolution shall be two or more persons holding or representing not less than 75 per cent., or at any adjourned such meeting not less than 25 per cent., of the principal amount of the Notes for the time being outstanding.

As used in this Condition 12, “Extraordinary Resolution” means a resolution passed at a meeting of the Noteholders duly convened and held in accordance with the provisions contained in these Conditions and the Agency Agreement by a majority consisting of not less than 75 per cent. of the persons voting thereat upon a show of hands or if a poll shall be duly demanded then by a majority consisting of not less than 75 per cent. of the votes given on the poll. An Extraordinary Resolution passed at any meeting of Noteholders will be binding on all Noteholders, whether or not they are present at the meeting.

* From Republic of Moldova, 9.875% Notes due 2002, U.S. \$75,000,000.

Description of U.S.-Style Amendment Clause: Version One*

Modifications, Amendments and Waivers

With (i) the affirmative vote, in person or by proxy thereunto duly authorized in writing, of the holders of not less than 66% in aggregate principal amount of the Notes then Outstanding represented at a meeting duly called and held as specified above, or (ii) the written consent of the owners of 66% in aggregate principal amount of the Outstanding Notes, the Republic and the Fiscal Agent may, upon agreement between themselves, modify, amend or supplement the terms of the Notes or, insofar as affects the Notes, the Fiscal Agency Agreement, in any way, and such holders may make, take or give any request, demand, authorization, direction, notice, consent, waiver or other action provided by the Fiscal Agency Agreement or the Notes to be made, given or taken by holders of Notes: provided, however, that no such action may, without the consent or affirmative vote of the holder of each Note affected thereby: (A) change the due date for the payment of the principal of, or any installment of interest on, any Note, (B) reduce the principal amount of any Note, or the portion of such principal amount which is payable upon acceleration of the maturity of such Note, or the interest rate thereon, (C) change the currency in which any payment in respect of any Note is payable, (D) reduce the proportion of the principal amount of the Notes the vote or consent of the holders of which is necessary to modify, amend or supplement the Fiscal Agency Agreement or the terms and conditions of the Notes or to make, take or give any request, demand, authorization, direction, notice, consent, waiver or other action provided thereby to be made, taken or given, or (E) change the obligation of the Republic to pay Additional Amounts (as defined below). Any such modification, amendment or supplement shall be binding on the holders of Notes.

* From Republic of Guatemala, 8 1/2 % Notes due 2007, U.S. \$150,000,000.

Description of U.S.-Style Amendment Clause: Version Two*

Modification

The Republic may modify any of the terms or provisions contained in the Bonds in any way with the written consent of the holders of not less than 51% in principal amount of the Bonds at the time outstanding, provided that (i) if any such modification would change the terms or currency of payment of the principal amount of or interest on any Bond or the amounts thereof or affect the rights of holders of less than all the Bonds at the time outstanding, the consent of the holders of all the Bonds affected thereby is required and (ii) if any such modification would reduce the aforesaid percentage needed for authorization of such modification, the consent of the holders of all outstanding Bonds is required.

* From Republic of Indonesia, 7 3/4 % Bonds due 2006, U.S. \$400,000,000.