

# Credit Derivatives and the Sovereign Debt Restructuring Process

Pierre-Hugues Verdier

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Professors Hal S. Scott and Howell E. Jackson  
Harvard Law School  
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## INTRODUCTION

Two of the most significant recent developments in the global financial system have been the rise of a large secondary market for emerging market bonds, and the rapid expansion of financial derivatives. The former took place in the wake of the 1980s Latin American debt crisis and the long series of debt restructurings that ensued. Despite the continuing economic troubles faced by these countries, much of their loan indebtedness to foreign banks was eventually converted to widely-traded bonds under the Brady Plan. This conversion catalyzed the development of a vast public market for the debt of ‘emerging markets,’ which now cover much of the developing world.

This market, however, has been beset by serious difficulties. The recent defaults of Russia and Argentina, which led to widespread economic misery and to serious social and political unrest,<sup>1</sup> highlighted the inadequacies of the multilateral bail-out approach developed in the 1990s. In addition, the increasing dispersion of sovereign private debt further complicates crisis management and debt restructuring efforts. These difficulties have been compounded, in recent years, by a series of court rulings that eliminated the principal defenses on which sovereign debtors had relied to protect their restructuring efforts against legal action by creditors.

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<sup>1</sup> See, e.g., Edward Alden, Thomas Catan & Richard Lapper, *Argentina's President Quits; At Least 14 Killed in Riots as Country Falls into Chaos; Leadership Battle Breaks Out*, FIN. TIMES, Dec. 21, 2001, at 1; Thomas Catan & Mark Mulligan, *Argentina in Dollars 155bn Debt Default; Biggest Suspension Of Payments In History; 'Third Currency' To Be Created To Kick-Start Economy*, FIN. TIMES (London ed.), Dec. 24, 2001, at 1; Thomas Catan, *Hope – and Everything Else – Is Running Out in Buenos Aires: The Economic Crisis Is Swelling the Ranks of the Poor*, FIN. TIMES (London ed.), Feb. 2, 2002, at 22; Betsy McKay, *Moscow Journal: From Worry to Worse – Revisiting a Family in Russia 7 Years Later*, WALL ST. J., Sept. 28, 1998, at A1.

The financial derivatives markets have also experienced stunning expansion. One of the fastest-growing categories of instruments have been credit derivatives.<sup>2</sup> These instruments, in their simplest form, are a promise from the seller to the buyer to make a predetermined payment when an adverse credit event affects the entity to which the derivative relates.<sup>3</sup> Virtually nonexistent as recently as ten years ago, this market has grown from an aggregate outstanding notional amount of \$893 billion at the end of 2000 to more than \$1.9 trillion at the end of 2002. This trend is expected to persist, with some estimates projecting a total of \$4.8 trillion outstanding in 2004<sup>4</sup>. Sovereign credit derivatives, traded over-the-counter in New York and London, form a significant segment of this rapidly expanding market<sup>5</sup>. Today, investors can buy credit protection on the external debt of Brazil, Mexico or the Philippines, among others.

Despite the increasing importance of the sovereign credit derivatives market, and some hints on the part of policy-makers that their use may further complicate restructuring efforts,<sup>6</sup> the possible effects of this development on global financial stability have not been explored in detail. In this paper, I will review the existing private legal regime governing credit derivatives and its interaction with the sovereign debt restructuring process. As will be seen, the standard contract terms governing credit derivatives, if properly interpreted by

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<sup>2</sup> See Charles Batchelor, *Credit Default Swaps Join Booming Derivatives Line-Up*, FIN. TIMES, Feb. 11, 2004, at 26.

<sup>3</sup> This entity is not normally a party to the transaction.

<sup>4</sup> See BRITISH BANKERS' ASSOCIATION (BBA), CREDIT DERIVATIVES REPORT 2001/02 (2002); see also INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA), MARKET SURVEY: HISTORICAL DATA (2003).

<sup>5</sup> See COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM (CGFS), CREDIT RISK TRANSFER (2003) [hereinafter CREDIT RISK TRANSFER]; Frank Packer & Chamaree Suthiphongchai, *Sovereign Credit Default Swaps*, BIS Q. REV., Dec. 2003, at 79.

<sup>6</sup> See ANNE O. KRUEGER, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 8 (2002) [hereinafter A NEW APPROACH] (“[Free-riding by creditors] may be amplified by the prevalence of complex financial instruments, such as credit derivatives, which in some cases may provide investors with incentives to hold out in the hope of forcing a default (thereby triggering a payment under the derivative contract), rather than participating in a restructuring”).

participants and the courts, adequately address many of the legal uncertainties arising from sovereign restructurings. Nevertheless, from a broader stability perspective, credit derivatives in their current form increase the likelihood of future sovereign defaults. They do this by creating incentives for protected holders of sovereign debt to prefer a default to a voluntary debt restructuring, since the former triggers payment from the protection seller while the latter does not. Even when a voluntary exchange succeeds, abstention by protected creditors and the resulting transfer of debt to protection sellers increase the likelihood of holdout litigation. In addition, the concentrated structure of the sovereign credit derivatives market may increase global systemic risk, and the availability of credit protection may encourage excessive lending in emerging markets.

Moreover, these deficiencies are not the result of faulty drafting, as the current contractual framework adequately reflects the interests of market participants. Whether the discrepancy between these legitimate interests and the need to facilitate orderly restructurings of unsustainable sovereign debt will in fact lead to undesirable consequences is ultimately an empirical matter. What this discrepancy does, however, is point to the need for an improved sovereign debt restructuring process. An analysis of the treatment of newly-adopted collective action clauses under the credit derivatives rules reveals that they may alleviate the incentives problems created by credit derivatives, assuming that the rules governing them are properly interpreted by the courts.

Part I of this paper outlines the development of the secondary market in sovereign bonds, the court decisions that have made future restructurings vulnerable to the actions of recalcitrant creditors, and recent proposals for reform of the debt restructuring process. Part II reviews the characteristics and usage of credit derivatives, the principal features of the

sovereign credit derivatives market, and the market failures potentially associated with the use of credit protection. It also introduces the standardized documentation used in credit derivatives markets, and the debate over the restructuring credit event. Part III analyzes the applicability of these standard terms to the various possible forms a sovereign debt restructuring may take, and the resulting impact on the incentives of protection sellers. It also covers the treatment of collective action clauses and a potential sovereign bankruptcy regime under current contractual terms. Finally, it explores the potential systemic risk and financial stability problems caused by the structure of the sovereign credit derivatives market.

## **I. THE SOVEREIGN DEBT RESTRUCTURING DEBATE**

### **A. General Background: Crises and Restructurings<sup>7</sup>**

#### *1. The 1980s Sovereign Debt Crisis*

Throughout the 1970s and into the early 1980s, commercial banks in New York, buoyed by large inflows of funds from oil-exporting countries, made substantial syndicated loans to sovereigns and private debtors in developing countries, notably in Latin America. These investments seemed promising, given the rising prices commanded by these countries' exports in the world markets and the weak lending opportunities in developed countries.<sup>8</sup>

The optimism, however, did not last. In an effort to counter inflationary pressures, the U.S. Federal Reserve sharply increased interest rates in 1981, thus substantially increasing the

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<sup>7</sup> The history of the 1980s sovereign debt crisis has been told many times. Accordingly, I will only provide a brief summary of the relevant background. For a concise account, see Philip J. Power, *Note, Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 *FORDHAM L. REV.* 2701 (1996); see also ROSS P. BUCKLEY, *EMERGING MARKETS DEBT: AN ANALYSIS OF THE SECONDARY MARKET* (1999); Jessica W. Miller, *Solving the Latin American Sovereign Debt Crisis*, 22 *U. PA. J. INT'L ECON. L.* 677 (2001).

<sup>8</sup> See Power, *id.* For an overview of competing explanations of the crisis, see Miles Kahler, *Politics and International Debt: Explaining the Crisis*, in *THE POLITICS OF INTERNATIONAL DEBT* 11 (Miles Kahler ed., 1986).

interest payments due by foreign debtors. A steep decline in export prices due to overproduction, along with a rise in the price of their oil imports, fragilized many developing countries' economies and depleted their foreign currency reserves. In addition, the failure of costly development strategies based on large-scale infrastructure and industrial projects further impaired their capacity to service their foreign debt.<sup>9</sup>

These difficulties culminated in the Latin American debt crisis of the 1980s. In 1982, Mexico announced that it could no longer service its foreign debt and would seek arrangements with its creditors. Several other Latin American countries, including Argentina and Brazil, soon followed suit.

The crisis placed the banks in a precarious situation. In many cases, their exposure to Latin American debtors exceeded their capital.<sup>10</sup> Thus, an outright default, which would have required them to write off the principal amount of the loans, would have threatened their solvency. Accordingly, they agreed to reschedule some of the debt and extend bridge loans to allow their creditors to meet interest payments and avoid defaulting on the original loans. The general expectation was that, in due course, the debtors' liquidity problems would subside and regular payments would resume. In the meantime, the continued interest payments allowed the banks to keep the sovereign loans on their balance sheets as performing loans.

As Latin American economies failed to recover and a cycle of reschedulings ensued, however, it became increasingly clear that they were not a long-term solution to the ongoing crisis. The 1985 Baker Plan, which involved additional loans by both commercial banks and

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<sup>9</sup> See SEBASTIAN EDWARDS, *CRISIS AND REFORM IN LATIN AMERICA: FROM DESPAIR TO HOPE* 1-6 (1995); Javier Corrales, *Market Reforms*, in *CONSTRUCTING DEMOCRATIC GOVERNANCE IN LATIN AMERICA* 74 (Jorge I. Domínguez & Michael Shifter eds., 2d ed. 2003).

<sup>10</sup> See Power, *supra* note 7, n. 40; HAL S. SCOTT, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION* (11<sup>th</sup> ed. forthcoming 2004), Draft ch. 16, at 4-5 [hereinafter *INTERNATIONAL FINANCE*].

multilateral institutions in return for the implementation of IMF-monitored austerity plans, failed to reduce the debtor countries' existing burden and the need for further loans.<sup>11</sup>

## 2. *The Secondary Market and the Brady Plan*

During that period, a secondary market in sovereign debt started to develop. Several banks sought to reduce their exposure to foreign sovereigns by selling off parts of their loans at a discount, and writing off the difference as a loss. By that time, the banks had sufficiently bolstered their capital that the gradual write-offs no longer affected their balance sheets as dramatically as they would have at the outset of the debt crisis. Secondary demand for these loans was fueled by the willingness of some sovereign debtors to negotiate debt-equity swaps, under which foreign creditors could obtain full payment of the face amount of their debt, albeit in local currency and on the condition that the proceeds be reinvested locally.<sup>12</sup> Although the banks themselves were often not in a position to benefit from such offers, they attracted many other investors who saw them as an opportunity to enter these markets at a substantial discount.<sup>13</sup> Alongside these investors, however, others also purchased for speculative purposes, with a view to profiting from later appreciation of the debt as the debtor country's economy recovered.

As a result of this development, substantial market interest arose for sovereign debt. In 1989, U.S. Secretary of the Treasury Nicholas Brady announced a new plan to reduce the indebtedness of developing countries. Under the Brady Plan, commercial banks agreed to

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<sup>11</sup> On reschedulings and the Baker Plan, see Ross P. Buckley, *Rescheduling as the Groundwork for Secondary Markets in Sovereign Debt*, 26 DENV. J. INT'L L. & POL'Y 299 (1998).

<sup>12</sup> See Steven M. Cohen, Comment, *Give Me Equity or Give Me Debt: Avoiding a Latin American Debt Revolution*, 10 U. PA. J. INT'L BUS. L. 89 (1988); Daniel H. Cole, *Debt-Equity Conversions, Debt-for-Nature Swaps, and the Continuing World Debt Crisis*, 30 COLUM. J. TRANSNAT'L L. 57 (1992); Derek Asiedu-Akrofi, *A Comparative Analysis of Debt-Equity Swap Programs in Five Major Debtor Countries*, 12 HASTINGS INT'L & COMP.L.REV. 537 (1989).

<sup>13</sup> See Power, *supra* note 7, at 2716-17.

repackage the remaining loans into bonds offered to the public and freely tradable on secondary markets. The proceeds of the bonds were then used to retire the loans, with the banks taking a write-off on the original face amounts. This securitization approach allowed the banks to exit the debt rescheduling cycle and largely eliminate their exposure to sovereign debtors, albeit at the price of recognizing substantial losses. Public investors, for their part, benefited from significant discounts, and from a new collateralization structure under which principal and interest payments were secured by zero-coupon U.S. Treasury bonds bought by the debtors with IMF support.<sup>14</sup>

The Brady Plan was widely regarded as a success, as it allowed for substantial debt reduction by engaging the private sector while improving the financial soundness of major bank lenders. Several countries, including Mexico, Costa Rica, Venezuela, Uruguay, Argentina and Brazil converted their loans to Brady bonds, some of which were retired in favor of more marketable regular eurobonds when the debtor's finances improved.

## **B. The Holdout Problem**

### *1. Origins of the Holdout Problem*

The Brady Plan, despite its merits, did not solve all the problems facing sovereign debtors. The financial situation of many remained precarious. Moreover, a consensus view developed in international policy circles that the dispersion of sovereign debt resulting from secondary trading and the issuance of Brady Bonds complicated the prospects for orderly debt restructurings in future crises.

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<sup>14</sup> For a detailed examination of the Brady Plan and the evolution of the secondary market in sovereign debt, see BUCKLEY, *supra* note 11.

During the 1980s, when syndicated bank loans were the norm, negotiations between sovereign debtors and their creditors were relatively simple. An ad hoc Bank Advisory Committee, led by the banks with the largest exposures to the particular sovereign, would be set up to negotiate with the distressed sovereign. Individual banks with smaller exposures would be discouraged from holding out on the restructuring or free riding on the bridge loans extended by others through pressure from peers, regulatory agencies and multilateral institutions.<sup>15</sup> Moreover, the legal remedies available to a creditor who decided to hold out were largely untested. Thus, over that period, holdout creditors were not a substantial concern.

The rise of the secondary market and the Brady Plan, however, led to the emergence of a sizeable category of creditors with little or no structural incentives to agree to a restructuring. These investors are largely immune from the pressures mentioned above, given their lack of ongoing relationships with either the debtors or other creditors. Even though they may have bought their debt at a substantial discount, they have little reason to settle for anything less than the face amount if they can secure it. This made the legal regime surrounding sovereign restructurings a matter of increasing concern.

## *2. Sovereign Debtors in U.S. Courts*

For a long time, the prospects for effective legal enforcement of sovereign debt in the United States were very limited. From the mid-1980s on, however, the obstacles to

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<sup>15</sup> See the United States Statement of Interest in CIBC, cited in Power, *supra* note 7, at 2751; INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 16 at 5-6.

successfully suing sovereign debtors in U.S. courts began to fall.<sup>16</sup> The groundwork for these developments had been laid decades before, by a change in the international law of sovereign immunity. In a famous letter to the Attorney General of the United States dated May 19, 1952, Jack Tate, legal adviser to the State Department, expressed the Department's adoption of the so-called restrictive theory of state immunity. Under this theory, "the immunity of the sovereign is recognized with regard to sovereign or public acts (*jure imperii*) of a state, but not with respect to private acts (*jure gestionis*)." <sup>17</sup> The restrictive theory, codified in extensive detail by the *Foreign Sovereign Immunities Act of 1976*,<sup>18</sup> was generally understood as encompassing borrowing in the United States within the "commercial activities" with respect to which foreign sovereigns are subject to the jurisdiction of U.S. courts. The Supreme Court confirmed this in the 1992 case of *Weltover v. Argentina*,<sup>19</sup> where it held that Argentina's postponement of payments on bonds payable in New York constituted a commercial act of the sovereign outside the United States, and that the act in question caused a direct effect in the United States. U.S. courts therefore had jurisdiction under Section 1605(a)(2) of the FSIA.

In any case, sovereign debt instruments normally include waivers of sovereign immunity, which also suffice to ground U.S. jurisdiction under the FSIA<sup>20</sup> and customary

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<sup>16</sup> See generally Samuel E. Goldman, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J. INT'L L. & FOREIGN AFF. 159 (2000); Ronald J. Silverman & Mark W. Deveno, *Distressed Sovereign Debt: A Creditor's Perspective*, 11 AM. BANKR. INST. L. REV. 179 (2003).

<sup>17</sup> Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to the Attorney General of the United States (May 19, 1952), in 24 DEP'T ST. BULL., 1952.

<sup>18</sup> Foreign Sovereign Immunities Act, Pub. L. No. 94-583, 90 Stat. 2891 (codified at 28 U.S.C. §§1130, 1602-11 (2000)) [hereinafter the FSIA]. The FSIA was the first in a series of modern national codifications of modern sovereign immunity law, which integrated the restrictive immunity theory. See, e.g., the State Immunity Act, 1978, 26 Eliz. II, 33 (England), 17 I.L.M. 1123.

<sup>19</sup> 504 U.S. 607 (1992).

<sup>20</sup> See FSIA, *supra* note 18, s. 1605(a)(1).

international law.<sup>21</sup> Other court decisions in the 1980s dismissed defenses based on the act of state doctrine<sup>22</sup> and Article VIII(2)(b) of the IMF Articles of Agreement.<sup>23</sup> Thus, in the 1990s, the enforceability of sovereign debt was well settled in principle, and the courts' attention turned to a series of new defenses raised by sovereign debtors in an attempt to protect the restructuring process itself.

The most important of these developments related to the holdout creditor problem. When a sovereign debtor proposes a restructuring to its private creditors (for instance, in the form of an offer to exchange their existing bonds for modified ones), each creditor has two options: she can either accept or refuse the offer. In most cases, the offer will be the result of negotiations between the sovereign and representatives of the largest creditors. Thus, these creditors will have tentatively expressed their agreement with the restructuring terms and their intention to participate in the exchange.

A smaller creditor, however, might see the situation differently. Suppose the restructuring plan embodies a fair balance between the rights of creditors and the sovereign's ability to pay, so that the creditors as a group could not obtain better terms from the debtor. Nevertheless, if the law provides an individual creditor with a remedy which allows her to hold out from the restructuring and receive full payment on the debt she holds, she will have a strong incentive to do so. Even though the debtor does not have the resources to make full payment to all its creditors, it will probably be able to do so with respect to the small amount

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<sup>21</sup> See IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 343-44 (5<sup>th</sup> ed. 1998); MALCOLM N. SHAW, *INTERNATIONAL LAW* 516-17 (4<sup>th</sup> ed. 1997).

<sup>22</sup> See, e.g., *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985), cert. dismissed, 473 U.S. 934 (1985).

<sup>23</sup> This Article renders unenforceable an "exchange contract" contrary to exchange control regulations imposed by an IMF member country. U.S. Courts, however, have interpreted this provision restrictively, holding that a loan contract which requires payment to be made in a foreign currency is not an "exchange contract." See, e.g., *Libra Bank Ltd. v. Banco Nacional de Costa Rica*, 570 F.Supp. 870 (S.D.N.Y. 1983).

held by the holdout. The problem, of course, is that other creditors will not look kindly upon this unequal treatment. To avoid the risk of receiving only partial payment while the holdout emerges unscathed, even creditors who initially agreed to the plan will be tempted to withdraw from the offer and sue for payment. In the worst scenario, the restructuring will collapse as creditors race to the courts to attach the debtor's limited assets before they run out.

Three cases from the mid-1990s provide concrete illustrations of the holdout problem and the policies elaborated by New York courts with respect to sovereign restructurings. These cases, by bringing the holdout problem to the fore of the policy debate, were also a major cause of the momentum enjoyed by the reform proposals that followed.

a. CIBC Bank & Trust Co. (Cayman) Ltd. v. Banco Central do Brasil

The first significant holdout litigation arose out of a series of Brazilian debt restructurings. In 1988, following several reschedulings, an agreement was reached between the country and a vast majority of its creditors. Under this Multi-Year Deposit Facility Agreement (MYDFA), which covered over \$60 billion of Brazil's debt, the Central Bank of Brazil became the obligor of the restructured debt. The MYDFA included provisions dealing with assignments by creditors, and made acceleration upon an event of default conditional on a vote of creditors holding at least 50% of the debt.

Then, in 1992, Brazil and its Bank Advisory Committee agreed to a further restructuring under the Brady Plan. Creditors were initially given two options. They could exchange the full face amount of their MYDFA debt for collateralized bonds with a lower, fixed interest rate, or they could instead opt for uncollateralized bonds with a rising interest rate. After many creditors committed to the offer, however, Brazil modified its terms and

requested that they convert at least 35% of their debt to collateralized, deep-discount bonds with a floating interest rate. Despite this change, the vast majority of Brazil's creditors participated in the restructuring, with one major exception. The Darts, a wealthy Florida family acting through a series of trusts, had been buying Brazilian debt in the secondary market at a large discount since 1991. They now held approximately \$1.4 billion in MYDFA debt. After the Brady deal was finalized, the Darts refused to participate and insisted that Brazil convert their entire holdings to uncollateralized bonds in accordance with the original offer.

Brazil refused, and adopted a strategy aimed at preventing the Darts from accelerating the MYDFA debt. Banco do Brasil, a state-owned bank that held a large amount of MYDFA debt, was ordered partially to withdraw from the restructuring and retain about \$1.6 billion of debt so that the Darts could not trigger acceleration by a majority vote. The Darts, through their nominee CIBC, then sued Brazil, its central bank and Banco do Brasil. They asked the Court to issue a judgment for the full principal and interest of their MYDFA debt, on the grounds that the defendants had breached the agreement and had acted in bad faith by colluding with Banco do Brasil to prevent them from accelerating the loans.

In *CIBC Bank & Trust Co. (Cayman) Ltd. v. Banco Central do Brasil*,<sup>24</sup> the Southern District of New York held that the defendants' failure to pay interest on the Darts' unconverted MYDFA debt was a breach of contract. The Darts were thus entitled to unpaid interest in an amount of close to \$60 million. The court held, however, that the Darts could not accelerate the principal amount, as they did not hold a majority of the debt. Preska J.

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<sup>24</sup> 886 F.Supp. 1105 (S.D.N.Y. 1995).

rejected the Darts' argument that an "implied covenant of good faith and fair dealing"<sup>25</sup> prohibited Brazil from using Banco do Brasil's holdings to obstruct acceleration. The clear language of the MYDFA, the plaintiffs' knowledge of the relationship between Brazil and Banco, and other provisions suggesting that the drafters would expressly have excluded Banco's share had they so wished, all militated against the Darts' claim.

*CIBC* is an important case for several reasons. First, although the defendants ultimately succeeded in preventing the Darts from recovering the full principal amount of their debt, this success was based exclusively on a contractual defense. In other words, had Banco do Brasil not been in a position to outvote the Darts, they would in all likelihood have been able to accelerate the debt and obtain judgment for the full principal amount. Whether they would have had any significant practical remedy against Brazil, however, is uncertain.

Second, the United States submitted a Statement of Interest to the Court arguing that the plaintiffs' claim should be dismissed. This was remarkable because in a previous case, *Allied Bank*,<sup>26</sup> the government had filed a brief in support of the plaintiffs' position that international comity should not be extended to protect foreign exchange controls imposed by Costa Rica. The controls prevented the defendant banks from making payments on their foreign debt.<sup>27</sup> In accordance with the Statement of Interest, the Second Circuit noted that U.S. policy on sovereign debt restructurings was "grounded in the understanding that, while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable."<sup>28</sup> By contrast, in *CIBC*, the United States pointed

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<sup>25</sup> *Id.* at 1114.

<sup>26</sup> *Supra* note 22.

<sup>27</sup> *See Power*, *supra* note 7, at 2740-41.

<sup>28</sup> 757 F.2d 516, 519; *see Power*, *id.*, at 2741.

out that the growing secondary market in sovereign debt weakened the factors that previously limited the incentives to litigate: buyers in the secondary market did not have the same long-term interests as the original lenders, and their expectations of full recovery should be informed by the fact that they acquired the debt at a substantial discount. The apparent change of policy in *CIBC* thus appeared to provide sovereign debtors with a powerful new weapon in their efforts to fend off holdout creditors.

b. *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*

The limits of this policy, however, soon became clear in *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*.<sup>29</sup> Pravin had purchased \$9 million of Banco Popular debt from Mellon Bank on the secondary market in 1990. The debt was guaranteed by the Republic of Peru. Since 1984, the debt had been in default following a national liquidity crisis and the imposition of foreign exchange restrictions. While interest payments were made between 1984 and 1992, the maturity date had long gone by without repayment of the principal. In 1989, most of Peru's external creditors, including Mellon, had filed lawsuits to prevent the statute of limitations from expiring on the outstanding debts. Shortly thereafter, however, the same creditors had agreed to stay their lawsuits and negotiate a Brady Plan restructuring of Peru's foreign debt with the new Fujimori government. The stay was conditioned upon none of the individual lawsuits being allowed to proceed on its own.

Although Pravin resold part of the debt shortly after its acquisition in 1990, it still held \$1,425,000 in 1992. At the beginning of that year, Banco Popular stopped making interest payments and Peru's central bank appointed a committee of liquidators to dissolve the failing

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<sup>29</sup> 109 F.3d. 850 (2d Cir. 1997).

bank. Pravin refused to participate in the liquidation proceedings or the Brady Plan. Instead, it filed suit against Banco Popular and Peru for the full amount of the debt. The defendants argued that the action should be dismissed on grounds of international comity. In their submission, allowing the Pravin lawsuit to proceed would allow all of Peru's other creditors to reawaken their own suits, create a race to attach Peruvian assets, and disrupt the vital structural reform efforts underway in Peru.

After initially granting several stays to allow the liquidation proceedings to continue and to resolve numerous preliminary questions, the Southern District of New York granted Pravin's motion for summary judgment. The Second Circuit upheld the District Court's decision on appeal. Calabresi J. observed that the doctrine of international comity, under which U.S. courts may recognize foreign proceedings with extraterritorial effects in the United States, does not apply when "doing so would be contrary to the policies or prejudicial to the interests of the United States."<sup>30</sup> Thus, the question was whether the U.S. policies implicated in the suit militated in favor of or against recognition of the Peruvian liquidation proceedings. Calabresi J., citing both *CIBC* and *Allied Bank*, held that:

First, the United States encourages participation in, and advocates the success of, IMF foreign debt resolution procedures under the Brady Plan... Second, the United States has a strong interest in ensuring the enforceability of valid debts under the principles of contract law, and in particular, the continuing enforceability of foreign debts owed to United States lenders... This second interest limits the first so that, although the United States advocates negotiations to effect debt reduction and continued lending to defaulting foreign sovereigns, it maintains that creditor participation in such negotiations should be on a strictly voluntary basis. It also requires that debts remain enforceable throughout the negotiations.

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<sup>30</sup> *Id.* at 854.

He accordingly held that Pravin was entitled to enforce the debt and obtain judgment for the full amount. Pravin, however, eventually abandoned its litigation strategy and participated in the Peruvian exchange offer, after failing to locate Peruvian assets abroad it could attach.<sup>31</sup>

As will be discussed below, the availability of an international comity defense is premised on U.S. policy, which may change or be reinterpreted in the future. After *Pravin*, however, it seems clear that under the current interpretation, this doctrine will not normally provide a defense against lawsuits by holdout creditors.

c. *Elliott Associates, L.P. v. Banco de la Nacion*

The rulings in *CIBC* and *Pravin* emboldened speculators, some of which began to purchase discounted sovereign debt on the secondary market for the purpose of negotiating with the debtor for full payment (or at least a substantial premium over the market price). In *Elliott Associates, L.P. v. Banco de la Nacion*,<sup>32</sup> Elliott, a hedge fund specialized in distressed debt, had purchased working capital debt of Banco de la Nacion, a Peruvian bank, of a face amount of \$20.7 million. Here, as in *Pravin*, the debt was guaranteed by the Republic of Peru and was purchased at a large discount.<sup>33</sup> There was evidence that Elliott deliberately delayed the purchase until the Second Circuit rendered its judgment in *Pravin*.<sup>34</sup> Shortly thereafter, Elliott closed the transaction and notified the debtors that it intended to negotiate repayment terms. Banco de la Nacion and Peru refused to negotiate, alleging that the assignment to

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<sup>31</sup> See Mark A. Cymrot, *Barricades at the IMF: Creating a Municipal Bankruptcy Model for Foreign States*, 36 INT'L LAW. 1103, 1110 (2002).

<sup>32</sup> 194 F.3d 363 (2d Cir. 1999).

<sup>33</sup> Elliott paid approximately \$11.4 million. *Id.*, 367.

<sup>34</sup> *Id.*

Pravin was void on grounds of champerty under s. 489 of the New York Judiciary Law.<sup>35</sup> Elliott, in turn, refused to participate in Peru's ongoing Brady Plan restructuring and filed suit against the debtors.

After a tortuous procedural history, the Second Circuit eventually decided in favor of Elliott. Essentially, Section 489 prohibits taking certain debts by assignment "with the intent and for the purpose of bringing an action or proceeding thereon." Michel J. held that Elliott's primary aim in acquiring the debt was to be paid in full, by suing if necessary. Therefore, Elliott's intent to sue was merely incidental and was not the primary purpose of the acquisition. Moreover, it was contingent, since the defendants could have avoided the suit by making payment in accordance with the terms of their contract.<sup>36</sup> This conclusion was reinforced by the policy, enunciated in *Pravin*, that sovereign debt restructurings be voluntary and that the debts remain enforceable throughout the process. Following this appeal and remand, Elliott obtained judgment for the full principal amount of the debt in July 2000.

The case, however, was not over. Elliott faced another hurdle. As in many other cases involving sovereigns, the prospects for successfully attaching assets were limited. Peruvian courts would almost certainly have refused to recognize the judgment, on public policy or similar grounds. Thus, Elliott had to find and attach Peruvian assets abroad. Most sovereign assets in foreign countries, however, are immune from attachment or seizure under

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<sup>35</sup> This Section, in relevant part, provides that "[n]o person or co-partnership, engaged directly or indirectly in the business of collection and adjustment of claims, and no corporation or association, directly or indirectly, itself or by or through its officers, agents or employees, shall solicit, buy, or take an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon."

<sup>36</sup> A champerty defense based on s. 489 had previously been raised in *CIBC*, *supra* note 24, 1110-1111. The Court, however, refused to grant the defendants' motion to dismiss on that basis, emphasizing that champerty requires a fact-specific inquiry and that the facts indicated that other, legitimate reasons existed for transferring the debt from the Darts' previous nominees to CIBC.

international law. Elliott came up with a creative solution: it would attach the payments about to be made to Peru's other creditors under the Brady Plan restructuring. Elliott first obtained a restraining order against the Chase Manhattan Bank, acting as fiscal agent for Peru in connection with the Brady bonds, but this tactic failed when Peru managed to stop the transfer of funds to Chase *in extremis*. Peru then attempted to effect payments through Euroclear, a European clearing and settlement organization based in Brussels, but Elliott obtained a restraining order from the Brussels Court of Appeals.<sup>37</sup> At this point, Peru opted to settle with Elliott for \$56.3 million rather than defaulting on the Brady bonds, whose grace period was running out.<sup>38</sup> In effect, Elliott was able to place Peru in a position where the only choices were to pay, or to see its carefully negotiated debt restructuring collapse, along with its efforts at economic reform.

### 3. *Towards the Nightmare Scenario?*

After *Elliott*, the legal techniques for preventing holdout creditors from disrupting the sovereign debt restructuring process appeared increasingly inadequate. A virtual smorgasbord of more or less creative defenses had almost invariably failed. Sovereign immunity and the act of state doctrine provide little or no protection to sovereigns who choose to raise capital in the U.S. markets.<sup>39</sup> Restrictions on assignability in loan instruments had proved ineffective to prevent a substantial secondary market from emerging.<sup>40</sup> In any case, these restrictions are increasingly uncommon in the present era of freely tradable sovereign bonds.

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<sup>37</sup> The order was granted on appeal from the Commercial Court, which had denied Elliott's claim. See Elliott Assocs., L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8<sup>th</sup> Chamber, Sept. 26, 2000).

<sup>38</sup> About this episode, see G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 635-36 (2001).

<sup>39</sup> See Weltover, *supra* note 19; Allied Bank, *supra* note 22.

<sup>40</sup> See, e.g., Elliott, *supra* note 32.

International comity<sup>41</sup> and the IMF Articles of Agreement<sup>42</sup> do not, in their current interpretation by U.S. courts, protect sovereign debtors from lawsuits during a restructuring. Although U.S. policy may change and inform a more robust approach to comity, there are little signs of such a development at this time.<sup>43</sup> The New York law of champerty, for its part, no longer poses a substantial obstacle to holdout creditors. While earlier court rulings rejecting this defense had insisted on a fact-specific inquiry, the Second Circuit holding in *Elliott* leaves little doubt that, as a matter of law, a creditor who bought its debt – even at a discount – with an intent to obtain full payment is not barred from suing the debtor under Section 489.<sup>44</sup>

As a result, sovereign debtors are now largely dependent on defenses based on the terms of the obligations themselves, as well as on any tactics that may be put in place with the cooperation of the bulk of their creditors.<sup>45</sup> One such tactic is the “exit consent,” which involves having creditors consent, as part of an exchange agreement, to amendments to the nonfinancial terms of the old debt instruments that make them unattractive to holdout creditors.<sup>46</sup> As a result, all creditors will have an incentive to take part in the exchange; otherwise, they will be stuck with largely worthless securities. Exit consents have played a

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<sup>41</sup> See Pravin, *supra* note 29.

<sup>42</sup> See Libra Bank, *supra* note 23.

<sup>43</sup> *But see* Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT’L L. 253 (2003) (advocating such a reinterpretation). One source of optimism is the United States’ recent Statement of Interest supporting Argentina’s interpretation of the *pari passu* clause against its creditors’ position that the *Elliott* interpretation should prevail. See Statement of Interest of the United States, *Macrotecnic Int’l Corp. v. Republic of Argentina*, 02 CV 5932 (TPG), January 12, 2004.

<sup>44</sup> See *Elliott*, *supra* note 32.

<sup>45</sup> See Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002).

<sup>46</sup> As will be seen below, amendments to financial terms require unanimity, but other terms may normally be amended by a majority or supermajority of creditors. See Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000); Stephen Choi & G. Mitu Gulati, *Why Lawyers Need to Take a Closer Look at Exit Consents*, INT’L FIN. L.R., Sept. 2003, at 15.

significant role in recent years, allowing sovereigns such as Ecuador and Uruguay successfully to restructure their foreign debt. Some commentators, however, argue that exit consents, while useful as a short-term solution, are insufficient to improve and stabilize the restructuring process. First, it is unclear whether a determined holdout creditor would be fazed, as nonfinancial amendments cannot at the end of the day prevent him from filing suit. Second, whether courts would enforce such seemingly oppressive amendments against minority debtholders appears questionable.<sup>47</sup> Finally, following the recent use of exit consents, creditors have become aware of the tactic and reportedly demand better protection in new bond issues against nonfinancial amendments.<sup>48</sup>

The *Elliott* Belgian restraining order caused additional consternation in financial and policy circles. Up to that point, it had been widely assumed that the potential damage holdouts could inflict was limited by the difficulty of finding attachable assets of the sovereign abroad. The Belgian decision changed this by raising the fear that holdouts would simply hold ongoing restructurings hostage in order to obtain preferential payment. The decision thus lent added urgency to the restructuring debate. Its interpretation of the *pari passu* clause has severely criticized by several scholars and practitioners, and will likely be repudiated by courts.<sup>49</sup> However, even if the *pari passu* clause were reinterpreted so as to prevent holdout creditors from obtaining restraining orders against payments to other

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<sup>47</sup> See Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103, 117 (2003) [hereinafter *Bankruptcy Procedure?*].

<sup>48</sup> See *id.*, at 117-18.

<sup>49</sup> See Gulati and Klee, *supra* note 38; Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Working Paper, Harvard Law School, Program on International Financial Systems (Draft of December 11, 2003), available at [www.law.harvard.edu/programs/pifs/pdfs/buchheitpam.pdf](http://www.law.harvard.edu/programs/pifs/pdfs/buchheitpam.pdf); Institute of International Finance, Letter from Charles Dallara, Managing Director, to Chancellor Gordon Wood, April 9, 2002; *but see* William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices* (Draft of Feb. 15, 2004) (arguing that the Elliott interpretation of the *pari passu* clause benefits all creditors, not just holdouts, by diminishing the likelihood of default, preventing discriminatory treatment of particular classes, and improving the creditors' negotiating position).

creditors, the problem might not be solved entirely. *Elliott* revealed the vulnerability of restructuring payments, but its lesson goes beyond this: all foreign assets and payments by a sovereign, including payments on other debt or for imports, or bank and security custody accounts, could conceivably be attached, regardless of whether their use had anything to do with paying foreign creditors (and thus regardless of the *pari passu* clause's interpretation).<sup>50</sup>

While such tactics have not succeeded so far, the possibility that a creative creditor might find a viable technique and open a path for others, as *Elliott* did, cannot be overlooked. In both *Pravin* and *Elliott*, the sovereigns were eventually able to settle and the restructurings went ahead. The sums at play, however substantial, were clearly not beyond their ability to pay – \$1.4 million in face amount and \$56.3 million in settlement, respectively. But what if a creditor such as the Darts, who at the time of *CIBC* were the single largest foreign holder of Brazilian debt with more than \$1.4 billion in holdings, obtained such a judgment and restraining order? And what if more and more foreign creditors faced with a restructuring choose to go down the legal path *Elliott* has obligingly cleared for them?

The sum of all these concerns, from the official sector perspective, was that even a single creditor now had considerable power to derail a restructuring – and thus considerable leverage to obtain preferential payment. According to this picture, the holdout problem has many features of the classical prisoner's dilemma:<sup>51</sup> each creditor involved would be better off if all participated in the restructuring – this is the Pareto optimal outcome. Individual creditors, however, have incentives to hold out in the hope of achieving their preferred result:

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<sup>50</sup> See *Bankruptcy Procedure?*, *supra* note 47, at 116-17.

<sup>51</sup> It is unnecessary further to elaborate this theoretical point for the purposes of this paper. See generally DOUGLAS G. BAIRD, ROBERT H. GERTNER AND RANDAL C. PICKER, *GAME THEORY AND THE LAW* (1994) for the applicability and limits of game-theoretical models to complex legal problems.

obtaining full payment while others have to cope with the restructuring terms. The actions of creditors trying to achieve this, however, lead to the worst possible outcome – the collapse of the restructuring and potential default, with adverse consequences for all creditors, the sovereign, and its people.<sup>52</sup> In other words, on that view, while the best interest of the creditors is to agree unanimously to a restructuring, this outcome is prevented by a free rider problem that can only be solved by the adoption of some form of collective action mechanism. This concern dovetailed with the questions raised by the series of financial crises that shook emerging markets from 1997 on, and led to a series of proposals to reform the sovereign debt restructuring process.

#### *4. The 1990s Currency Crises and the Role of the IMF*

In addition to the restructuring problems caused by the rise of holdout creditors, in the mid- to late 1990s a series of financial disasters shook the world's confidence in the G-7 and the IMF's crisis-handling methods. When a steep devaluation of the Mexican peso increased the cost of servicing the country's dollar-indexed notes in 1994-95, the United States and the IMF put together an enormous rescue package totaling more than \$49 billion. The package succeeded in stabilizing the peso and the loans were eventually repaid.<sup>53</sup>

The East Asian crisis of 1997 did not, for the most part, involve restructuring widely-traded sovereign debt instruments.<sup>54</sup> The foreign exposure of the largest debtor, South Korea,

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<sup>52</sup> See, e.g., Adam Thomson, *Argentine Bond Default Hits its Pensioners Hardest*, FIN. TIMES, March 13-14, 2004, at 2.

<sup>53</sup> For an account of the Mexican crisis, see John H. Chun, Note, *"Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 FORDHAM L. REV. 2647 (1996).

<sup>54</sup> For a detailed journalistic account of the East Asian crisis and its repercussions in individual countries, see PAUL BLUSTEIN, *THE CHASTENING* (2003).

consisted primarily of short-term dollar loans extended to Korean banks by foreign banks.<sup>55</sup> While these loans had previously been rolled over at maturity, the bursting of a real estate bubble in Thailand contributed to a market-wide loss of confidence in East Asian economies. By mid-1997, foreign banks were refusing to roll over their loans. Although this was not strictly speaking a sovereign debt crisis, the Korean government would not allow the banks to fail. It did not, however, have the foreign reserves to support them, and it turned to the IMF for support as its reserves dwindled and its currency came under intense devaluation pressure.

In December of 1997 and January of 1998, the IMF, along with the World Bank, the Asian Development Bank and the G-7 countries, committed enormous standby loans to South Korea. The loans, however, did not stem the outflow and, although South Korea avoided a default, at least \$8 billion in IMF funds was in effect paid out to the foreign banks that called their loans.<sup>56</sup> When the crisis spread to Russia, however, it was not able to support the outflows caused by its short-term treasury bills and defaulted on its debt in August 1998. After this default, Russia was largely free unilaterally to restructure its obligations, but at the price of effectively shutting down its access to foreign capital and causing substantial domestic economic hardship.<sup>57</sup>

With hindsight, however, the Russian default did not indicate that the IMF had become unwilling to mount large rescue packages in an effort to stem financial crises. It did so again when Turkey faced a currency crisis in 2001, as foreign investors sold their lira-denominated government securities en masse and repatriated the proceeds.<sup>58</sup> Likewise,

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<sup>55</sup> See *Bankruptcy Procedure?*, *supra* note 47, at 107.

<sup>56</sup> See *id.*

<sup>57</sup> See *id.*, at 108.

<sup>58</sup> See *id.*, at 109-110.

although Argentina eventually defaulted in December 2001 after the IMF refused to extend further loans because the government had not complied with budgetary conditions, disbursement of funds eventually resumed and the current Argentine government has negotiated increasingly favorable terms with the IMF.<sup>59</sup> Throughout 2002, the IMF also provided massive loans to allow Brazil to weather large capital outflows stemming from political and economic uncertainty.<sup>60</sup>

Throughout this period, the IMF's approach was strongly criticized. Many commentators argued that effectively bailing out foreign creditors created moral hazard by encouraging reckless lending to emerging markets. On this view, the taxpayer-funded IMF loans largely went to make whole sophisticated investors who were fully aware of the risks associated with the high returns they obtained in emerging markets. Others argued that IMF-imposed fiscal and monetary austerity was an affront to economic sovereignty and actually hindered growth instead of restoring the affected countries' solvency.<sup>61</sup> This general dissatisfaction with IMF bailouts contributed to a perceived need to reform the way in which international debt and currency crises are handled.<sup>62</sup>

The fundamental idea is that foreign creditors should be bailed in, instead of bailed out.<sup>63</sup> In other words, they should be made to share the sacrifices imposed by the country's economic difficulties by agreeing to a reduction or other concessions in connection with the

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<sup>59</sup> See *Nestor Kirchner's nimble cookery – Argentina's default, and its deal with the IMF*, *ECONOMIST*, Sept. 13, 2003.

<sup>60</sup> See *Bankruptcy Procedure?*, *supra* note 47, at 110-111.

<sup>61</sup> See, e.g., JOSEPH STIGLITZ, *GLOBALIZATION AND ITS DISCONTENTS* (2002).

<sup>62</sup> For a broad-ranging examination of this problem, see BARRY EICHENGREEN, *FINANCIAL CRISES AND WHAT TO DO ABOUT THEM* (2003) [hereinafter *FINANCIAL CRISES*].

<sup>63</sup> See Barry Eichengreen, *Bailing In the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 *FLETCHER F. WORLD AFF.* 57 (1999); Group of Seven, *Strengthening the International Financial System and the Multilateral Development Banks*, Report of G-7 Finance Ministers and Central Bank Governors, available at <http://www.g8.utoronto.ca/finance/fm010707.htm> (July 7, 2001).

debt they hold. This, of course, is but another word for debt restructuring, but with the greater sense of urgency born of the financial crises of the past decade. In this light, the increasing legal difficulties associated with voluntary restructurings appear more and more problematic. The challenge, then, is to elaborate a mechanism that would facilitate burden sharing without the adverse consequences that make countries and international financial institutions reluctant to consider outright default.<sup>64</sup>

### **C. Reform Initiatives**

Two major reform proposals emerged.<sup>65</sup> The first is the inclusion in sovereign bonds of so-called “collective action clauses” (CACs), which would allow a supermajority of creditors to amend the instrument’s payment terms and other essential provisions. The second involves the creation of an international bankruptcy mechanism, most likely under the auspices of the IMF, to oversee and coordinate the sovereign debt restructuring process while providing a legal framework for the determination of the creditors’ and debtor’s rights.

#### *1. A Market-Based Solution: Collective Action Clauses*

Contrary to sovereign bonds issued in London, those issued under New York law do not allow a majority of creditors to amend the payment terms.<sup>66</sup> While the relevant provisions normally contemplate amendments to most non-financial terms by a majority vote, amendments that would affect the debtor’s obligation to make timely payments require unanimity. This approach has been traced to the *Trust Indenture Act of 1939*, which prohibited CACs in corporate bonds on the basis that they were susceptible to abuse to the

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<sup>64</sup> These consequences include, in addition to the risk of disruptive lawsuits, that of contagion of the crisis to other countries. See FINANCIAL CRISES, *supra* note 62, at 70-71.

<sup>65</sup> For a review of these and other options not considered here, see FINANCIAL CRISES 71-98; Peter B. Kenen, *The International Financial Architecture: Old Issues and New Initiatives*, 5 INT’L FIN. 23 (2002).

<sup>66</sup> See Buchheit & Gulati, *Exit Consents*, *supra* note 46.

detriment of minority bondholders.<sup>67</sup> The Act, however, does not apply to sovereign bonds, so that there are no apparent legal obstacles to including CACs in such bonds.<sup>68</sup>

At first glance, CACs are an attractive solution to the holdout problem. If the sovereign successfully negotiates a restructuring agreement with a majority of bondholders, the terms of the agreement can be incorporated into the original bonds by amendment. As a result, the restructuring terms will bind all bondholders, including those who refused to negotiate or to agree to the restructuring. Commentators, however, have pointed out numerous difficulties inherent to CACs. Emerging market sovereigns are reluctant to adopt them, as the market may read the clauses as signaling the probability of future financial difficulties. Creditors also resist CACs with low percentage requirements, out of concern that they may be abused by the sovereign or other creditors.<sup>69</sup> CACs with higher percentage requirements, however, increase the risk that a holdout creditor might accumulate a sufficient proportion of bonds – at a substantial discount – to block a restructuring. In addition, although CACs may facilitate restructurings in respect of newly-issued bonds, they will obviously not apply to older bonds which do not include them. This is a significant issue, as many sovereign bonds are long-term ones, with maturities of at least five years, and often much longer.<sup>70</sup> Finally, even with CACs in place, simultaneous restructurings of several

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<sup>67</sup> Trust Indenture Act of 1939, 15 U.S.C. ss. 77aaa, et seq. See generally Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987). See also *Bankruptcy Procedure?*, *supra* note 47, at 110.

<sup>68</sup> See Buchheit & Gulati, *Collective Will*, *supra* note 45.

<sup>69</sup> For instance by coercing domestic holders to consent to a restructuring. See *Bankruptcy Procedure?*, *supra* note 47, at 121-22; compare *CIBC*, *supra* note 24. Creditors have also resisted sharing clauses, which would greatly reduce the benefits of holding out by forcing a creditor who succeeds in securing preferential payment to share it pro rate with the other creditors. See Buchheit & Pam, *supra* note 49 at 12.

<sup>70</sup> See, however, Anna Gelper, *How Collective Action Is Changing Sovereign Debt*, INT'L FIN. L.R., May 2003, 19 at 20 (arguing that long-term bonds are the exception, and that there is “reasonably frequent turnover” in sovereign debt stock).

categories of bonds, and across bonds and other kinds of debt, may remain difficult or impossible.<sup>71</sup>

These difficulties, however, have not discouraged some sovereigns from including CACs in recent bond issues, with some pressure from the U.S. Treasury, the IMF and the G-7.<sup>72</sup> In a speech delivered in April 2002, John B. Taylor, U.S. Undersecretary of Treasury for International Affairs, urged the inclusion of contractual restructuring terms – including collective action clauses – in future sovereign debt instruments.<sup>73</sup> Thereafter, a February 2003 Mexican notes offering included provisions by which a majority of 75% of holders can change the amounts payable on the notes or the applicable due dates, the payment currency, the governing law or jurisdiction clauses, or the amendment clause itself.<sup>74</sup> A South African offering from May 2003 also includes similar provisions.<sup>75</sup>

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<sup>71</sup> See *Bankruptcy Procedure?*, *supra* note 47; A NEW APPROACH, *supra* note 6.

<sup>72</sup> See John B. Taylor, *Sovereign Debt Restructuring: A U.S. Perspective* (Institute for International Economics, Washington, D.C.) (April 2, 2002); Group of Seven, *supra* note 63; Group of Ten, *The Resolution Of Sovereign Liquidity Crises: A report to the Ministers and Governors prepared under the auspices of the Deputies*, available at <http://www.bis.org/publ/gten03.htm> (May 1996); GROUP OF TEN, REPORT OF THE G-10 WORKING GROUP ON CONTRACTUAL CLAUSES (2002), available at [www.oecd.org/dataoecd/62/51/2501714.pdf](http://www.oecd.org/dataoecd/62/51/2501714.pdf); Michael M. Phillips, *Support Builds for Plan to Ease Debt Loads of Developing Nations*, WALL ST. J., Sept. 17, 2002, at A16. A leading economist in this area argues that CACs strike the right balance between creditor rights and the need to facilitate restructurings, whereas a more structured mechanism would overly weaken the former. See, e.g., FINANCIAL CRISES, *supra* note 62, at 10-11; Barry Eichengreen & Christof Rühl, *The Bail-In Problem: Systematic Goals, Ad Hoc Means*, NBER Working Paper 7653 (April 2000), available at <http://www.nber.org/papers/w7653>.

<sup>73</sup> See Taylor, *id.*

<sup>74</sup> See, e.g., United Mexican States, 6.625% Global Notes Due 2015, Prospectus Supplement Dated February 26, 2003. The notes also provide that other provisions may be amended by a 2/3 majority. See John Authors, *Mexico Pioneers a Plan to Ease Debt*, FIN. TIMES, Feb. 25, 2003; John Authors, *Mexico Sends Signal with Bond Clauses*, FIN. TIMES, Feb. 27, 2003, at 23.

<sup>75</sup> See, e.g., Republic of South Africa, 5.25% Notes Due May 16, 2013, Prospectus Supplement Dated May 9, 2003.

In April 2003, Uruguay launched an exchange offer for its outstanding debt instruments.<sup>76</sup> Under this complex offer, debtholders were entitled to receive new bonds denominated in various currencies and with different maturities and interest rates, depending on the nature of the bonds they agreed to exchange. Thus, the offer replaced the existing debt instruments with several series of new ones. The CAC is tailored accordingly: amendments to the payment terms of a series require a 75% majority of the holders of that series; however, if the amendments affect more than one series, they may be effected by a vote of 85% of the aggregate amount of such series and 66 2/3% of each series. This aggregation provision makes it more difficult for the holders of a small series to block a larger restructuring, and thus alleviates the difficulty noted above with respect to amendments across different instruments. Moreover, since the exchange offer covers almost all of Uruguay's existing private debt, it also avoids the transition issues that were thought to threaten the viability of collective action clauses. The Uruguay CAC is also more complete than that used in Mexico, as it includes more demanding rules for non-reserve amendments, as well as limitations on future exit consents<sup>77</sup> and on issuance of new debt to dilute the existing creditors' votes. More recently, other countries, including Canada, Turkey, Belize, Guatemala, Panama, Venezuela and South Korea have begun experiments with CACs.<sup>78</sup> However, an April 2003

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<sup>76</sup> See, e.g., República Oriental del Uruguay, Exchange Offer, Prospectus Supplement Dated April 10, 2003; see also Gelpern, *supra* note 70; Alan Beattie, *Uruguay provides test case for merits of voluntary debt exchange*, FIN. TIMES, April 23, 2003, at 3.

<sup>77</sup> See Felix Salmon, *Uruguay Closes the Loop*, EUROMONEY, May 2003.

<sup>78</sup> See William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. (forthcoming 2004) (manuscript at 29, fn. 86), available at <http://ssrn.com/abstract=387880>. For a more exhaustive progress report, see International Monetary Fund, *Progress Report to the International Monetary and Financial Committee on Crisis Resolution* (Sept. 5, 2003), available at <http://www.imf.org/external/np/pdr/cr/2003/eng/090503.pdf>; see also Sergio J. Galvis & Angel L. Saad, *Collective Action Clauses: Recent Progress and Challenges Ahead* (Draft of Feb. 20, 2004).

Brazilian bond issuance, which includes a 85% threshold for collective action, has raised concerns that market practice may already be fragmenting.<sup>79</sup>

Finally, at least one study of CACs suggests that they may already be more widespread than thought by most market participants. Gugiatti and Richards claim that many U.S. sovereign debt instruments, generally those prepared by the London offices of New York firms, contain CACs based on British models.<sup>80</sup> However that may be, it is clear that, as a result of the developments noted above, practice has now outrun the institutional and academic debate. CACs have become a reality. Whether they will ever be used successfully, however, remains to be seen.

## *2. An Institutional Solution: An International Bankruptcy Court?*

In the aftermath of the financial crises of the late 1990s, and in light of the limitations of CACs discussed above, several commentators have proposed a more ambitious solution. They would set up a mechanism, inspired by Chapter 11 of the U.S. Bankruptcy Code, which would allow an insolvent sovereign debtor and its creditors to negotiate a debt restructuring while being protected from individual legal proceedings. Although this idea has been floating

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<sup>79</sup> See, e.g., Federative Republic of Brazil, 10% Global Bonds Due 2007, Prospectus Supplement Dated April 29, 2003. See Felix Salmon, *Brazil Goes Off on a CAC Tangent*, EUROMONEY, June 2003.

<sup>80</sup> See Mark Gugiatti & Anthony Richards, *The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers* (July 11, 2003), available at: <http://ssrn.com/abstract=443840>.

for a long time,<sup>81</sup> it gained considerable momentum following an influential 1995 speech by Jeffrey Sachs<sup>82</sup> and the financial crises of the late 1990s.

So far the most credible proposal has been the one championed by Anne Krueger, the IMF's First Deputy Managing Director.<sup>83</sup> Dr. Krueger's proposed Sovereign Debt Restructuring Mechanism would be triggered by the debtor country, rather than imposed by the creditors. The debtor's choice, however, would be subject to review or approval by a third party, such as the IMF or an arbitration tribunal, or to a majority vote of the creditors.<sup>84</sup> Following initiation of the mechanism, litigation by creditors would be temporarily stayed during negotiations.<sup>85</sup> The SDRM would facilitate the provision of new funds by private creditors during the stay by granting such new financing priority over preexisting private indebtedness. This feature would be similar to debtor-in-possession financing under Chapter 11.

Once a restructuring agreement is reached, an affirmative vote of a qualified majority of creditors would bind the dissenting minority to its terms, thus circumventing the holdout problem.<sup>86</sup> Like under Chapter 11, the voting procedures and required majority would apply regardless of the contractual terms contained in the debt instruments themselves. Moreover,

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<sup>81</sup> The proposals for sovereign bankruptcy regimes made over the years are simply too numerous to list. For a review of the pre-1995 literature, see Kenneth Rogoff & Jeromin Zettelmeyer, *Early Ideas on Sovereign Bankruptcy Reorganization: A Survey*, IMF Working Paper 02/57. More recent contributions include Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000); *Bankruptcy Procedure?*, *supra* note 47; Michelle J. White, *Sovereigns in Distress: Do They Need Bankruptcy?* (2002) BROOKINGS PAPERS ECON. ACTIVITY 287.

<sup>82</sup> Sachs, Jeffrey D., *Do We Need an International Lender of Last Resort?*, Frank D. Graham Lecture, Princeton University 8 (Apr. 20, 1995), available at: [www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf](http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf).

<sup>83</sup> See A NEW APPROACH, *supra* note 6; Anne Krueger, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Address before the Institute of International Economics (April 1, 2002), available at <http://www.imf.org/external/np/speeches/2002/040102.htm>.

<sup>84</sup> A NEW APPROACH, *id.* at 23-28.

<sup>85</sup> *Id.* at 15-16.

<sup>86</sup> *Id.* at 14-15.

unlike CACs, the SDRM could cover a broad variety of claims, and provide for a vote based on the aggregate of all private debt of the sovereign.<sup>87</sup> It could also potentially cover some forms of public debt, such as bilateral debt (currently renegotiated under the Paris Club rules) and obligations to multilateral institutions such as the IMF and the World Bank.<sup>88</sup>

The Krueger proposal attracted strong opposition from creditor groups and emerging market sovereigns alike.<sup>89</sup> In addition, its implementation would be impossible without U.S. consent, but John Taylor's April 2002 speech promoting CACs as an alternative revealed the Treasury's lack of enthusiasm for a formal restructuring mechanism.<sup>90</sup> As a consequence, the SDRM project appears to have been abandoned for the time being.<sup>91</sup> Other proposals do not seem to have attracted significant interest outside academic and advocacy circles. It may be, however, that the limitations of CACs become sufficiently pressing that proposals for the IMF's SDRM or a similar multilateral mechanism are revived in the future.

### 3. *Another View: The Case for Creditors' Rights*

More recently, the consensus view of the sovereign debt restructuring problem has been challenged by commentators writing from the perspective of creditors' rights. Several observations are at the heart of this argument.

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<sup>87</sup> *Id.* at 15.

<sup>88</sup> *Id.* at 17-19.

<sup>89</sup> See, e.g., Economics Focus, *A Better Way to Go Bust*, ECONOMIST, Feb. 1, 2003, at 64 ("However most financiers, whether bankers or bondholders, loathe the SDRM ... Fearing higher interest rates and scarcer access to capital, many emerging-market governments have also criticised the plan."); Alan Beattie, *Financial Grouping Wants New Debt Rules*, FIN. TIMES, June 12, 2002; *SDRM Finds Few Friends in the Markets*, EUROMONEY, Nov. 2002; Galvis, Sergio J., *Sovereign Debt Restructurings – The Market Knows Best*, 6 INT'L FIN. 145 (2003).

<sup>90</sup> *Supra* note 72.

<sup>91</sup> Indeed, an October 2003 speech by Dr. Krueger barely mentioned the SDRM proposal, focusing instead on the inclusion of CACs in recent bond issues and the possibility of aggregating different series of claims through contractual clauses, as was done in Uruguay. See Anne O. Krueger, *Market Discipline and Public Policy: The Role of the IMF* (October 31, 2003). See also *SDRM Is Dead, and That's Official*, EUROMONEY, May 2003 – although that rumor may in time turn out to have been exaggerated.

First, while the collective action problem caused by traditional unanimous amendment clauses is real, it is not the only dynamic at play in a restructuring. The dominant theory of why sovereigns actually pay their debt in the absence of significant legal coercion holds that the main benefit of doing so is to maintain the sovereign's access to international capital.<sup>92</sup> If, at any time, the cost of continuing to pay exceeds this benefit, the sovereign will default. Conversely, a sovereign who has already defaulted and is thus barred from the markets, will negotiate a restructuring and resume payments if the benefit of renewed access exceeds the costs of doing so. In such negotiations, the relative bargaining power of the sovereign and its creditors determines how much of the surplus will be allocated to each.

On that view, the unanimous amendment clause is one of the few advantages the creditors have on an otherwise uneven playing field. In practice, because of the unanimity requirement, the debtor has to meet the reservation price of a vast majority of its creditors in order for its restructuring to succeed. Thus, creditors might rationally require such clauses, as under a majority or supermajority restructuring procedure, their bargaining power would be impaired.<sup>93</sup> Moreover, non-unanimous procedures leave minority creditors vulnerable to abuse by a majority whose interests diverge from theirs, or who collude with the debtor for side payments, further lending or other favorable terms. For this reason, Professors Gulati

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<sup>92</sup> See Bratton & Gulati, *supra* note 78, at 13-17; one of the leading papers is Herschel I. Grossman & John B. Van Huyck, *Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation and Reputation*, 78 AM. ECON. REV. 1088 (1988). Under the principal competing theory of sovereign debt, repayment cannot be supported solely by the reputation incentive, but depends on the availability of direct sanctions to creditors: see Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?*, 79 AM. ECON. REV. 43 (1989). For a historical case study evaluating the conclusions of competing sovereign debt theories, see James Conklin, *The Theory of Sovereign Debt and Spain under Philip II*, 106 J. POL. ECON. 483 (1998). As Bratton and Gulati point out, although the two theories differ considerably in the importance they attribute to legal enforcement mechanisms, both seem to support the conclusion that reducing the collective action problem among creditors reduces their share of the surplus in a restructuring.

<sup>93</sup> See Bratton & Gulati, *id.*

and Bratton argue that the inclusion of CACs should at least be accompanied by the recognition of a duty of good faith in intercreditor relations.<sup>94</sup>

Second, the implications of the holdout cases outlined above, including *Elliott*, may have been exaggerated. No recent sovereign restructuring has collapsed because of the actions of holdout creditors.<sup>95</sup> On the contrary, countries such as Ecuador, the Ukraine, Pakistan and Uruguay have successfully conducted exchange offers in recent years by using exit consents. Some of these restructurings involved significant sacrifices on the part of their creditors, and had considerable coercive elements.

Third, the high profile gained by so-called ‘vulture funds’ such as Elliott, who specialize in the holdout tactics outlined above, obscures the fact that sovereign bondholders also include large numbers of pensioners and other retail investors.<sup>96</sup> From an equity perspective, such creditors should not be deprived of their limited bargaining power against sovereigns in return from uncertain improvements in financial stability, especially since experience reveals that the current arrangements are quite sufficient to allow orderly restructurings.

Given the vulnerability of the current sovereign debt restructuring process to legal action by holdout creditors, as well as the legal uncertainties surrounding the future of the international financial architecture, the effects of the growing market for sovereign credit

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<sup>94</sup> See *id.* at 47; see also Andrei Schleifer, *Will the Sovereign Debt Market Survive?*, Harvard University, Department of Economics Working Paper (March 2003) (arguing that a collective action mechanism can only work if counterbalanced by features such as the presence of a court bound to find solutions in the best interests of creditors).

<sup>95</sup> See Robert B. Gray, Chairman, International Primary Market Association, *Remarks*, 2003 AM. SOC’Y INT’L L. PROC. 223, at 226.

<sup>96</sup> See *id.*, at 20 (referring to “cookie jar” offerings of Argentine bonds in Germany and Japan in the 1990s); see also Richard Lapper, *Creditors Unite to Seek Better Deal on Argentine Debt*, FIN. TIMES, Dec. 9, 2003 (some 500,000 small investors in Europe hold defaulted Argentine bonds).

derivatives on the incentives faced by creditors may have a crucial impact on financial stability. This appraisal, however, need be informed by the realization that some of the stability concerns may have been overplayed, and that the interests of creditors ought to remain a central consideration. I now turn to an examination of credit derivatives.

## II. CREDIT DERIVATIVES

### A. Credit Default Swaps

The past two decades have seen another extremely significant innovation in international finance: the rise of derivative instruments as a major financial market. Derivatives, as their name suggests, are financial instruments whose value and other characteristics derive from those of an underlying instrument, index, or other variable.<sup>97</sup> The most basic derivatives are options, forwards and swaps – the so-called “building blocks” of the derivatives markets.<sup>98</sup>

A stock option, for instance, is a right (but not an obligation) to buy or sell stock at a predetermined price – the “strike price” – at a certain point in the future – the “strike date.” The value of the option depends on fluctuations in the market price of the underlying stock. For example, suppose A owns stock in XYZ Company, but is worried that the current market price of the stock (\$100) may go down in the future. A, however, does not wish to sell the

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<sup>97</sup> See, e.g. ALASTAIR HUDSON, *THE LAW ON FINANCIAL DERIVATIVES* 12 (3<sup>rd</sup> ed. 2002) (“A derivative product is a financial product the value of which is *derived* from another financial product.”) [emphasis in original]; INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 14, p. 1 (“Derivatives are financial instruments whose value is based on or derived from other assets or variables”).

<sup>98</sup> See Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677 at 691 (“[A]n option is the right to buy or sell something in the future, a forward is the obligation to buy or sell something in the future, and a swap is an exchange of periodic payment obligations in the future.”) On derivatives generally, the reference work is SCHUYLER K. HENDERSON, *HENDERSON ON DERIVATIVES* (2003).

stock outright.<sup>99</sup> Instead, she buys a put option from B – a promise from B to buy the stock on the maturity date if A so requests – at a strike price of \$90. In exchange for that promise, A must pay a premium up front.<sup>100</sup>

On the strike date, two things can happen. On the one hand, if the market price of the stock is above the strike price of \$90, A will choose not to exercise the put option, since she can get a better price for her stock by selling it in the market. Thus, the option will expire worthless, and B will keep the premium. On the other hand, if the stock price has fallen below \$90 – say, to \$80 – A will exercise the put option and require B to buy the stock at the strike price of \$90. Thus, B will suffer a loss of \$10. In this example, the option is physically-settled, which means that the underlying stock is actually delivered by A to B upon exercise. A could also buy a cash-settled option, which means that the underlying instrument will not be delivered. Rather, B will make a payment to A for the difference between the market value of the stock on the strike date and the strike price – here, \$10. Cash-settled options and other derivatives are common, and allow derivatives to be traded regardless of whether one of the parties actually owns the underlying instrument.

The simple example of A's option illustrates the main purpose for which derivatives are used: to reallocate risk. Before buying the put option, A bore the full risk of fluctuations in the price of her stock. If the price fell to \$30, she would lose \$70. After buying the option, however, A's downside risk is limited. The least she can get for her stock on the strike date is \$90, since this is the price for which B promised to buy the stock at A's request. Therefore, A

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<sup>99</sup> There are countless possible reasons for this. A may not want to forfeit the possibility of a profit from a future increase in the stock price. Alternatively, A may be unable to sell the stock for regulatory or tax reasons, for instance because the stock is restricted and may not legally be resold until a certain period expires.

<sup>100</sup> For a more exhaustive description of option types and possible combinations, see Feder, *supra* note 98 at 692-98; INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 14, at 3-7.

has transferred the risk that the price of XYZ stock may fall below \$90 to B. B has accepted that risk, in exchange for a premium. A has retained both the risk that the price may fall by less than \$10, and the potential benefit of a price increase.

While options are relatively simple derivatives, they can be combined among themselves and with other basic derivatives in very complex ways. Derivatives available in the market can protect buyers from risk arising from interest rate and currency exchange rate fluctuations, variations in the prices of securities, commodities or indexes thereof, even against bad weather – the possibilities are virtually endless.<sup>101</sup> While many standardized derivatives are now traded on specialized exchanges, more complex derivatives tend to be individually negotiated between sophisticated parties. The latter type are referred to as “over-the-counter” (OTC) derivatives.<sup>102</sup>

The option described above was used to transfer a specific risk from A to B: the risk of a decrease in the price of XYZ stock. This is a type of market risk, which may more generally be defined as “the exposure to the possibility of market movements.”<sup>103</sup> Another type of risk typically faced by holders of debt instruments is credit risk – the risk that a debtor will default on its obligations by reason of a deterioration in its creditworthiness.<sup>104</sup> Credit derivatives are designed to transfer credit risk between counterparties without transferring ownership of the underlying asset. The simplest example of a credit derivative is the single-name credit default swap (CDS).

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<sup>101</sup> See ROBERT J. SCHILLER, *THE NEW FINANCIAL ORDER: RISK IN THE TWENTY-FIRST CENTURY* (2003).

<sup>102</sup> See Feder, *supra* note 98, at 678.

<sup>103</sup> *Id.* at 688.

<sup>104</sup> Cf. *Id.* at 706 (“Credit risk is the possibility that an obligor will fail, and, thus, be unable to meet its obligation to make a payment.”)

Under a CDS, a party – the “protection seller” – promises, upon the occurrence of a “credit event” affecting the reference entity, to make a payment to the other party – the “protection buyer.”<sup>105</sup> The applicable credit events are negotiated between the parties and, as will be seen below, vary from swap to swap, but they typically include events such as a failure by the reference entity to make a payment on its obligations, and bankruptcy. Like other derivatives, CDS can be physically-settled or cash-settled. Upon a credit event under a physically-settled swap, the protection buyer will deliver the covered obligations of the reference entity it owns to the protection seller, who will pay a pre-agreed amount – the “par value” of the obligations. By contrast, under a cash-settled CDS, no delivery will take place. Instead, the protection seller will pay the difference between the par value of the obligations and their market value following the credit event. In return for this protection, the protection buyer will pay a regular premium to the protection seller over the life of the swap.

For instance, suppose that A holds a \$100 bond issued by JKL Company, and is worried that JKL might go bankrupt and default on the bond in the future. To protect herself against that risk, A buys a CDS from B, with JKL as the reference entity, bankruptcy as a credit event, and a par value of \$100 for the bond. A makes regular premium payments to B. Later, but still during the life of the swap, JKL goes bankrupt and the value of the bond plummets to \$10. As a result of this credit event, A is entitled to a payment from B. The nature of this payment depends on whether the CDS provides for physical settlement or cash settlement. In the former case, A is entitled to deliver the bond to B, who will pay A the bond’s agreed par value of \$100. In the latter case, A will keep the bond, and B will make a

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<sup>105</sup> Cf. Packer & Suthiphongchai, *supra* note 5, at 80 (“Credit default swaps are credit protection contracts whereby one party agrees, in exchange for a periodic premium, to make a contingent payment in the case of a defined credit event.”)

net payment of \$90 to A – the difference between the par value of \$100 and the fair market value of the bond after JKL’s bankruptcy. Note that, under a cash-settled CDS, there is no requirement that A actually own the bond.

As can be seen, the CDS isolates credit risk from market risk. If the market price of the bond merely decreases – for instance because interest rates have increased, or because the market considers that JKL has become a riskier issuer – no credit event will occur and the B will not have to compensate A under the swap. Only if a credit event occurs with respect to JKL is the CDS triggered. Credit events are generally meant to reflect significant deteriorations in the creditworthiness of the reference entity rather than market fluctuations, in accordance with the general definition of credit risk mentioned above.

Although credit default swaps share important characteristics with insurance contracts, they are not the same. First, unlike insurance contracts, which require that the beneficiary have a material insurable interest which will be affected by the event insured against, no such requirement applies to CDSs.<sup>106</sup> As explained above, a party could buy protection under a cash-settled CDS and receive a net payment upon the occurrence of a credit event, without having to prove that she had any interest in the reference entity’s creditworthiness before entering the swap. Even under a physically-settled CDS, the protection buyer can simply acquire the underlying obligations after the swap has been triggered but prior to delivery. Second, payments under insurance contracts are normally limited to the extent of the insured’s financial loss arising from the event. Under a CDS, however, the amount of the payment is determined exclusively by the previously agreed par value of the reference

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<sup>106</sup> See Don Bendernagel, James Hill & Brian Rance, *Credit Derivatives: Usage, Practice and Issues, in SWAPS AND OTHER DERIVATIVES IN 2001* 755 (Edward J. Rosen ed., 2001).

obligation, as well as by its market value in the case of a cash-settled CDS. This simplicity allows claims under CDSs to be processed quickly and with a minimal probability of disputes, unlike insurance claims, which depend on the insurer's evaluation of the loss and often lead to lengthy disputes and litigation. As a result of these differences, credit derivatives dealers are not subject to insurance regulation or to common law insurance rules.<sup>107</sup>

## **B. The Market for Credit Derivatives**

### *1. Usage of Credit Derivatives*

The initial impetus for the development of credit risk transfer activities was the desire of banks better to manage their risk exposures. From the 1970s on, banks began to use techniques such as syndication and securitization to fund residential mortgage portfolios. The attractiveness of such techniques increased following the 1982 sovereign debt crisis, as the capital of several large international banks dwindled. The adoption of the Basle Capital Accord in 1988 also spurred the growth of securitization activities. By sharing the risk of loans, or by taking them off their books, the banks could use the regulatory capital that would normally have been tied down to cover these loans for other purposes.<sup>108</sup> Thus, credit risk transfer allowed them to diversify their overall portfolios, as well as to transcend their own capital limitations and tap the broader capital markets to fund their lending activities. As these techniques extended beyond mortgages to other categories of assets, they gradually gave

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<sup>107</sup> See *Id.* at 814ff; Emily R. Pollack, *Assessing the Usage and Effect of Credit Derivatives* 21ff (April 2003) (Unpublished Paper, Program on International Financial Systems, Harvard Law School); Schuyler K. Henderson, *Credit Derivatives*, in *CREDIT DERIVATIVES: LAW, REGULATION AND ACCOUNTING ISSUES* 1, 35-36 (Alastair Hudson ed., 2000) A recent study by the United Kingdom's Financial Services Authority pointed to the residual risk that some credit derivatives may be recharacterized as insurance: see FINANCIAL SERVICES AUTHORITY, *CROSS-SECTOR RISK TRANSFERS*, Annex B (2002).

<sup>108</sup> See Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 *DUKE J. COMP. & INT'L L.* 541, 3 (2002) ("The sovereign debt crisis and the Basle accords marked the beginning of a transformation of world banking. From then on, the management of the capital base became one of the key management tasks of major banks.")

rise to the idea that credit exposures, which had traditionally been held until maturity, could be seen as tradable commodities.<sup>109</sup>

Credit derivatives, when they grew in importance in the 1990s, added powerful new tools to the banks' arsenal of sophisticated risk management practices. Initially seen as a complement to loan securitization techniques, credit derivatives rapidly started developing independently.<sup>110</sup> A major advantage of credit default swaps is that they can be purchased to hedge the risk exposure to a loan without selling the loan itself and potentially jeopardizing the bank's ongoing business relationship with the debtor. Thus, a bank with a profitable relationship with a large debtor can continue to benefit from its business, without creating a concentrated portfolio that would make the bank excessively vulnerable to changes in that particular debtors' creditworthiness.<sup>111</sup> In addition, the bank can continue to service the loans without the additional legal and administrative costs involved by serving as agent under a securitization structure.<sup>112</sup> Finally, while partial loan sales are complex and cumbersome, credit default swaps can easily be structured so as to transfer only part of the credit risk on a given loan.<sup>113</sup>

The benefits of such credit transfers can be further leveraged through more sophisticated structures, such as synthetic CDOs – a securitization technique under which the credit risk associated with the securitized asset is transferred to the securitization vehicle through a credit default swap, rather than by transferring the asset itself. Various tranches of

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<sup>109</sup> CREDIT RISK TRANSFER, *supra* note 5 at 4.

<sup>110</sup> See Romain Ranciere, *Credit Derivatives in Emerging Markets*, IMF Policy Discussion Paper (September 2001) at 4.

<sup>111</sup> See Bell & Dawson, *supra* note 108, at 549.

<sup>112</sup> *Id.*, at 550.

<sup>113</sup> *Id.*

debt in the securitization vehicle, corresponding to various degrees of risk, are then sold to third-party investors.

Another widespread technique is the sale of credit-linked notes (CLNs). Under this structure, the protection seller under a cash-settled CDS turns around and sells CLNs to investors. Both the original CDS and the CLNs are referenced to the same entity. The CLN buyers pay an up-front principal amount and earn interest from the seller, just as they would from regular notes. The payments under the CLNs, however, will be reduced if a credit event occurs with respect to the reference entity. The protection seller under the CDS has thus passed the credit risk along to the CLN investors. A significant advantage of CLNs is that, since they are funded upfront, they eliminate the counterparty risk inherent in regular CDSs – i.e., the risk that the protection seller may be unable to settle the swap when a credit event occurs.<sup>114</sup> Moreover, since CLNs can be to many investors in relatively small denominations, their existence improves the liquidity of the credit risk transfer market. Finally, CLNs can be structured so as to replicate the characteristics of the underlying obligations held by the original protection buyer, thus providing the market with investment opportunities that would otherwise be unavailable.<sup>115</sup> It will be noticed that both synthetic CDOs and CLNs involve use of an underlying cash-settled credit default swap, and are normally based on the same credit event definitions.<sup>116</sup> Therefore, the rest of this paper will focus on the characteristics and documentation of credit default swaps.

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<sup>114</sup> See Gunter Dufey & Florian Rehm, *An Introduction to Credit Derivatives*, University of Michigan Business School, Working Paper 00-013 (August 1, 2000), at 6.

<sup>115</sup> See Bell & Dawson, *supra* note 108, at 554.

<sup>116</sup> See Jeffrey Tolk, Moody's Investor Services, *Understanding the Risks in Credit Default Swaps* (March 16, 2001) at 3-4.

On the demand side, investors such as insurance companies have a substantial interest in diversifying their own portfolios by acquiring exposure to bank loans and other assets.<sup>117</sup> This demand was compounded in the 1990s by a long period of low interest rates. As a result of these powerful demand and supply forces, a substantial market in credit risk transfer has developed. Markets participants now include, in addition to banks and insurance companies, securities dealers (acting either as intermediaries or for their own account), investments funds (such as pension funds, mutual funds and hedge funds), and government agencies.<sup>118</sup> Hedge funds, in particular, now utilize increasingly elaborate investment techniques based on credit derivatives to acquire and customize various synthetic exposures.

Finally, CDSs also provide valuable information to the market, by creating a mechanism through which the credit risk of an asset is priced separately from its other features.<sup>119</sup> For this reason, increases in the spread for CDSs referenced to a particular entity may foretell future financial difficulties or default.<sup>120</sup> This market-based source of information can be of use, not only to investors, but also to domestic and international policymakers.

## 2. *Sovereign Credit Derivatives*

Sovereign credit derivatives, consisting primarily of credit default swaps referenced on sovereign obligations,<sup>121</sup> constitute an important segment of the market. A recent study

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<sup>117</sup> See generally INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, IAIS PAPER ON CREDIT RISK TRANSFER BETWEEN INSURANCE, BANKING AND OTHER FINANCIAL SECTORS PRESENTED TO THE FINANCIAL STABILITY FORUM (2003) (hereinafter IAIS PAPER). The IAIS report estimates that insurance companies globally may be accepting around \$667 billion in credit derivatives (*Id.* at 3).

<sup>118</sup> CREDIT RISK TRANSFER, *supra* note 5, at 6-9; Pollack, *supra* note 107, at 4.

<sup>119</sup> See Feder, *supra* note 98 at 707.

<sup>120</sup> See, e.g., Jorge A. Chan-Lau, *Anticipating Credit Events Using Credit Default Swaps, with an Application to Sovereign Debt Crises* (IMF Working Paper, May 2003); Ranciere, *supra* note 110 at 9-14; but see Fitch Ratings, *Credit Derivatives: A Case of Mixed Signals?* (December 4, 2003) on the limitations of this approach.

<sup>121</sup> See Ranciere, *id.*, at 5-6 (“[T]he default swap is the cornerstone product in the credit derivatives emerging markets, accounting for 85% of outstanding notional according to Deutsche Bank”). Other instruments, such as

conducted by the Bank for International Settlements on the database maintained by CreditTrade, a major credit derivatives broker, found that sovereign CDSs accounted for 7.4% of all quotes in 2002 and 2003.<sup>122</sup> While sovereign CDSs were not the fastest-growing segment, their general movement in volume reflected those of the market, with rapid growth between 1997 and 1999, a marked slowdown in 2000 and a resumption of growth between 2001 and 2003.<sup>123</sup> Unlike CDSs traded on corporates and banks, however, sovereign CDSs suffered a temporary setback in 2002, as trading in one of the major names, Argentina, ground to a halt following its late 2001 default.<sup>124</sup>

The mean number of quotes per name was higher for sovereigns than for other categories, given the relatively small number of actively traded names. The market is highly concentrated in a small number of debtors. Brazil, Mexico, Japan, the Philippines and South Africa accounted for more than 40% of all sovereign quotes between 2000 and 2003.<sup>125</sup> More generally, the market is overwhelmingly concentrated on emerging market debtors, with 90.5% of all quotes.<sup>126</sup> This, of course, is unsurprising, given that these debtors generally present significantly higher credit risk than developed countries. It does, however, raise the question as to how credit protection can interact – and possibly interfere – with sovereign debt restructurings in emerging markets.

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credit-linked notes, basket CDSs, synthetic CDOs, and CDSs on large emerging market corporate debtors (mostly state-owned enterprises, particularly in the oil sector), also exist. *See id.* at 6-7; Jane Herring, *Credit Derivatives in Emerging Markets: A Product Analysis*, in CREDIT DERIVATIVES: APPLICATIONS FOR RISK MANAGEMENT 11 (1998).

<sup>122</sup> *See* Packer & Suthiphongchai, *supra* note 5, 79 at 81.

<sup>123</sup> *Id.*

<sup>124</sup> *Id.* at 82.

<sup>125</sup> *Id.*

<sup>126</sup> *Id.* at 83. *See also* Ranciere, *supra* note 110, at 5, who cites August 2001 Deutsche Bank estimates of the total size of the emerging markets credit derivatives market at \$200-300 million, with 50-60% on Latin America, 23-30% on Eastern Europe, and 10-20% on other regions.

The principal market participants are hedge funds, who use sovereign CDSs to gain leveraged returns through unfunded synthetic exposures, as well as through various arbitrage techniques. Mutual funds and pension funds are also protection sellers, gaining exposure to sovereign credits through credit-linked notes and CDOs. They also occasionally buy protection on their long bond positions. Banks, as indicated above, generally buy protection to hedge their existing loan or bond exposures. Finally, broker-dealers act as intermediaries, notably by repackaging synthetic credit exposures as credit-linked notes sold to investors, as well as between protection buyers and sellers under regular CDSs. They also retain some risk as part of their own trading books.<sup>127</sup>

### 3. *Potential Market Failures*

Despite the benefits that make them attractive to market participants, credit risk transfer techniques – including credit default swaps – are not without drawbacks. In a recent study, the Committee on the Global Financial System reviewed several market failures that may be associated with credit risk transfer.<sup>128</sup> Although these risks were principally discussed in connection with securitization techniques such as CDOs, they also apply to credit defaults swaps. Unsurprisingly, they also are very similar to the kinds of market distortions that can arise under insurance contracts.

First, several potential problems arise out of the asymmetry of information between the protection buyer and the protection seller. For instance, the bank that has originated a loan will normally monitor its debtor's creditworthiness on a continuous basis, and may have advance warning of impending financial difficulties. Thus, the bank will have an incentive to

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<sup>127</sup> See Ranciere, *id.*, at 7-8.

<sup>128</sup> See CREDIT RISK TRANSFER, *supra* note 5, at 16ff.

select its lowest quality exposures for credit risk transfer – an *adverse selection* problem. In turn, this practice could potentially close the credit risk transfer market to high quality exposures, through the following mechanism. Since protection sellers have cannot tell the quality of the credit risk being transferred, they will discount all credit risks accordingly – in other words, they will charge a higher spread for taking them on. Protection buyers, however, who can tell which of their credit risks are of high quality, will refuse to transfer them under these conditions, as the protection will be too expensive in relation to the risk. Therefore, only low quality risks will be offered, and the protection sellers will further discount accordingly. As a result, only low quality risks will be traded, at a discounted price, i.e., for high spreads. This is known as a “market-for-lemons” problem, after George Akerlof’s Nobel Prize-winning 1970 article.<sup>129</sup>

The credit risk transfer market has developed several techniques to alleviate this problem. In the context of CDOs, for instance, this is sometimes accomplished by requiring the originating institution to randomly select the obligations from its existing portfolio. More frequently, the institution retains some proportion of the securitization vehicle’s equity (which absorbs the first losses on the transferred portfolio). Both these techniques tend to align the protection buyer’s selection incentives with the protection seller’s.

In general terms, asymmetric information is less of a problem for single-name instruments such as regular credit default swaps, because they are limited to widely-traded reference entities about which plentiful public information is available. This is particularly true with respect to CDSs on sovereign obligations, since events affecting sovereign debtors

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<sup>129</sup> See George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

are reported and analyzed by multiple media and official sources, so that existing creditors are unlikely to possess material nonpublic information about the debtor. Therefore, adverse selection is not likely to be a significant problem in the sovereign CDS market.

Second, the credit risk transfer may affect the behavior of the protection buyer in its ongoing relationship with the borrower. For instance, the protection buyer will have reduced incentives to continue monitoring the borrower's creditworthiness or to take action against breaches by the borrower of obligations imposed by the original contract.<sup>130</sup> This is known as *moral hazard*. Once again, this problem can largely be solved by using the techniques mentioned above.<sup>131</sup> In other situations, however, the interests of the protection buyer can be completely at odds with those of the protection seller. The protection buyer may refuse to extend further loans to the borrower, whereas it would have done so were it exposed to the full risk associated with a default.<sup>132</sup> Here too, the problem is less acute in the sovereign market, since most debt is now held in freely tradable bond form and most holders no longer have ongoing lending or other business relationships with the debtor.

Third, and most importantly, the protection buyer may exploit unanticipated situations by taking advantage of the credit transfer contract's failure to provide for all possible eventualities. This *incomplete contracting* problem can arise in situations where an event occurs which, although technically constituting a credit event under a CDS, does not reflect a decline in the reference entity's creditworthiness. Issues of this nature have arisen repeatedly with respect to the "Restructuring" credit event included in many CDSs, as will be discussed

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<sup>130</sup> See CREDIT RISK TRANSFER, *supra* note 5 at 18, 21.

<sup>131</sup> See *id.* at 18.

<sup>132</sup> However, this effect is not free from ambiguity. See CREDIT RISK TRANSFER, *supra* note 5, at 22: "[Government-owned companies in emerging markets] had in some cases perceived a change in their relationship with those banks that were active users of CRT, with expanded credit lines apparently being made available to them."

in Part III. This problem, of course, will be compounded if the protection buyer actually possesses the capacity to provoke, or increase the likelihood of, a default on the part of the reference entity. Thus, one of the fundamental questions raised by the use of sovereign credit derivatives is whether the legal framework that governs them provides adequate legal certainty.

### **C. The Documentation of Credit Derivatives**

#### *1. ISDA Documentation*

Although parties to OTC derivative transactions are free to document these instruments as they wish, the International Swaps and Derivatives Association (ISDA) – an industry group based in New York – has developed a widely-used set of standard documentation. ISDA-led standardization has been a major factor in the rapid development of OTC derivatives markets,<sup>133</sup> and ISDA has become an important de facto regulator of OTC derivatives.<sup>134</sup>

Parties to OTC derivatives typically enter into an ISDA Master Agreement, which provides a framework for their legal relationship. This standardized contract includes many boilerplate provisions, such as the representations and covenants of each party, the netting and calculation of payments, procedures applicable upon default or early termination, as well as provisions concerning notices, transfer, contractual currency, governing law and jurisdiction, and tax arrangements.<sup>135</sup> The parties can also customize the Master Agreement by choosing

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<sup>133</sup> *See id.* at 4.

<sup>134</sup> *See* Frank Partnoy, *ISDA, NASD, CFMA and SDNY: The Four Horsemen of Derivatives Regulation* (USD School of Law, Public Law and Legal Theory Working Paper 39).

<sup>135</sup> *See* ISDA, 1992 ISDA MASTER AGREEMENT (1992) and ISDA, USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENT (1992). ISDA published a revised Master Agreement in 2002, which retains the same basic structure. The 1992 Master Agreement remains widely used in the industry.

various options in an attached Schedule, or by amending the Agreement itself. Within this framework, the terms of individual trades are documented by Confirmations. In case of inconsistency, the Confirmation overrides the Master Agreement and the Schedule with respect to that trade. This two-tiered structure has many advantages, including allowing parties to net the payments due under various trades, and providing an orderly mechanism for unwinding transactions upon the default or bankruptcy of one of the parties.<sup>136</sup>

Confirmations describe the essential economic terms of the individual trade through the use of definitions published by ISDA with respect to major types of OTC derivatives transactions. Thus, credit default swaps are typically documented by reference to the 1999 or 2003 ISDA Credit Derivatives Definitions.<sup>137</sup> The 2003 Definitions preserve the structure adopted by ISDA in 1999, with some modifications. Both sets of definitions allow the parties to set out the basic terms of their trades by choosing among a menu of options. Once again, in case of inconsistency, the Confirmation overrides the standardized Definitions. As a result, the parties are free to customize the standard ISDA documentation as they see fit, although such an exercise can be somewhat perilous for inexperienced practitioners.

The principal terms covered are as follows. The parties must choose an Effective Date and a Scheduled Termination Date, which will determine the life of the swap. They also designate the Reference Entity – the entity with respect to which a Credit Event will trigger payment under the swap. Crucially, they also designate the acceptable Categories and Characteristics of two sets of obligations. The first set – defined simply as Obligations – are

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<sup>136</sup> Section 2(c) of the 1992 Master provides for netting of amounts due under the same transaction, and allows the parties to designate groups of transactions for netting.

<sup>137</sup> See 1999 ISDA CREDIT DERIVATIVES DEFINITIONS (1999) [hereinafter the 1999 DEFINITIONS]; 2003 ISDA CREDIT DERIVATIVES DEFINITIONS (2003) [hereinafter the 2003 DEFINITIONS].

the ones with respect to which a credit event will trigger the swap. For instance, suppose A purchases a CDS from B, with Brazil as a Reference Entity, Bond or Loan as the applicable Obligation Category, and Not Domestic Currency as one of the applicable Obligation Characteristics. Under this swap, B will have to pay A if a credit event occurs with respect to bonds or loans issued by Brazil. However, B will not have to pay if the credit event relates to bonds or loans denominated in Brazilian reals. Thus, by carefully choosing the applicable Category and Characteristics, the parties can tailor their swap to the kinds of risk they deem relevant.<sup>138</sup>

The second set – defined as Deliverable Obligations – are the obligations that the protection buyer will be entitled to deliver for payment under a physically-settled CDS. Thus, this choice does not apply to a cash-settled CDS. Deliverable Obligations are also determined by the choice of a Category and of one or many Characteristics. Suppose, under the example above, that the swap is a physically-settled one, and that the parties have chosen the same Category and Characteristics for Deliverable Obligations as they did for Obligations. A default by Brazil on its foreign currency-denominated bonds will trigger the swap, since the bonds are within the applicable Category and are not denominated in reals. If A, however, happens to own real-denominated bonds, she will not be allowed to deliver them to B for payment under the swap, since they do not fit the chosen Deliverable Obligations Characteristics. This is true whether or not the real-denominated bonds have also been defaulted on by Brazil.

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<sup>138</sup> Under the 1999 and 2003 Definitions, the parties must choose one Obligation Category among Payment, Borrowed Money, Reference Obligations Only, Bond, Loan or Bond or Loan. They may also choose one or more of the following Characteristics: Pari Passu Ranking (which became “Not Subordinated” in 2003), Specified Currency, Not Sovereign Lender, Not Domestic Currency, Not Domestic Law, Listed and Not Domestic Issuance.

Emerging market CDSs typically have a broader set of Deliverable Obligations than Obligations, so as to avoid failures to deliver.<sup>139</sup> As a result, the protection buyer often benefits from a “cheapest-to-deliver” option upon default: she can maximize the economic benefit of the swap by delivering the cheapest available Deliverable Obligations.<sup>140</sup> Thus, the restrictions on Deliverable Obligations have a crucial impact on the potential payoff from the swap.

In addition to defining the relevant obligations, the parties must also select the applicable Credit Events. Under the Definitions, the choices are: Bankruptcy,<sup>141</sup> Obligation Default,<sup>142</sup> Obligation Acceleration,<sup>143</sup> Failure to Pay,<sup>144</sup> Repudiation/Moratorium<sup>145</sup> and

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<sup>139</sup> See Ranciere, *supra* note 110, at 15.

<sup>140</sup> *Id.*

<sup>141</sup> Bankruptcy occurs when the Reference Entity: (a) is dissolved; (b) becomes insolvent or admits it in writing; (c) makes a general assignment, arrangement or composition for the benefit of its creditors; (d) institutes or has instituted against it a proceeding seeking a judgment of insolvency, bankruptcy or another similar law affecting the rights of creditors, and such proceeding (i) results in such a judgment; or (ii) is not dismissed within 30 days; (e) has a resolution passed for its winding-up, official management or liquidation; (f) seeks or become subject to the appointment of a receiver or a similar officer; (g) has substantially all of its assets taken possession of by a secured creditor; (h) causes or is subject to any similar event; or (i) takes any action in furtherance, or consents to, any of the foregoing acts. This overview omits many of the details in the actual definition: see 1999 DEFINITIONS, s. 4.2; 2003 DEFINITIONS, s. 4.3.

<sup>142</sup> Obligation Default occurs when “one or more Obligations have become capable of being declared due and payable...as a result of...the occurrence of a default [or] event of default...*other than a failure to make any required payment.*” [emphasis added]. 1999 DEFINITIONS, s.4.4; 2003 DEFINITIONS, s. 4.4. This credit event encompasses many technical defaults that do not reflect upon the Reference Entity’s creditworthiness and is rarely used.

<sup>143</sup> Obligation Acceleration covers the same type of event as Obligation Default, with the difference that, in addition to the Obligations being capable of being declared due and payable, they have actually been so declared. 1999 DEFINITIONS, s. 4.3; 2003 DEFINITIONS, s. 4.3.

<sup>144</sup> Failure to Pay means “after the expiration of any applicable (or deemed) Grace Period..., the failure by a Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment Requirement under one or more Obligations.” 1999 DEFINITIONS, s. 4.5. The 2003 DEFINITIONS add: “in accordance with the terms of such Obligations at the time of such failure.” 2003 DEFINITIONS, s. 4.5. The Payment Requirement is specified by the parties in their confirmation; the default amount is USD 1,000,000. 1999 DEFINITIONS, s. 4.8(d); 2003 DEFINITIONS, s. 4.8(d).

<sup>145</sup> Repudiation/Moratorium occurs when “a Reference Entity or Governmental Authority (a) disaffirms, disclaims, repudiates or rejects, in whole or in part, or challenges the validity of, one or more Obligations in an aggregate amount of not less than the Default Requirement or (b) declares or imposes a moratorium, standstill or deferral, whether de facto or de jure, with respect to one or more Obligations in an aggregate amount of not less than the Default Requirement.” 1999 DEFINITIONS, s. 4.6. The Default Requirement is set by the parties, with a default amount of USD 10,000,000. 1999 DEFINITIONS, s. 4.8(a). It is unclear what clause (b) adds that

Restructuring.<sup>146</sup> Upon the occurrence of one of the selected events, the protection buyer must deliver to the protection seller a notice containing “a description in reasonable detail of the facts relevant to the determination that a Credit Event has occurred.”<sup>147</sup> If the confirmation so provides, the protection buyer must also deliver a notice citing publicly available information confirming such facts.<sup>148</sup> Once these requirements are met, the protection seller must make payment according to the chosen settlement method. Finally, the Confirmation also provides for the amount of the premium paid by the protection buyer, dispute resolution mechanisms, and various technical details.

## 2. *Credit Events and the Restructuring Debate*

The main problem affecting the documentation of sovereign credit derivatives has been defining the applicable credit events. This problem also affects other credit derivatives. It does so, however, to a lesser degree, because the failure of corporate entities is subject to well-defined legal regimes such as bankruptcy and restructuring laws.<sup>149</sup> Even in the corporate context, however, difficulties remain.<sup>150</sup> In recent years, the principal example of

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wouldn't be covered by the Failure to Pay credit event. Clause (a), however, might cover anticipatory repudiations, although no Failure to Pay has yet occurred. The Repudiation/Moratorium definition has undergone considerable clarification in the 2003 DEFINITIONS (s. 4.6). The new definition only applies when the repudiation or moratorium is actually followed within 60 days (or on the next payment date for bonds) by a Failure to Pay or Restructuring (regardless of the amount). 2003 DEFINITIONS, s. 4.6.

<sup>146</sup> The Restructuring clauses of both the 1999 DEFINITIONS and the 2003 DEFINITIONS are reproduced in Appendix 1 and discussed in detail, *infra*.

<sup>147</sup> 1999 DEFINITIONS, s. 3.3. The parties may also allow the protection seller to originate the Credit Event Notice by designating “Buyer and Seller” as the Notifying Parties. *See* s. 3.2(b)(ii).

<sup>148</sup> This is called a Notice of Publicly Available Information. “Publicly Available Information” is in turn defined as information published in a previously agreed number of internationally recognized news sources, information received from the Reference Entity or its agent or trustee, and information filed in certain legal proceedings or stated in a judgment or other court or regulatory order. *See* 1999 DEFINITIONS, s. 3.5, for details.

<sup>149</sup> In the United States, both regimes are embodied in the United States Bankruptcy Code, 11 U.S.C. 101ff. In some foreign jurisdictions, corporate restructurings are dealt with under a legal regime distinct from bankruptcy.

<sup>150</sup> CREDIT RISK TRANSFER, *supra* note 5 at 19.

the uncertainties associated with the ISDA Credit Events has been the debate surrounding the Restructuring definition.

As mentioned earlier, credit risk is the risk that a debtor will default on an obligation due to a deterioration in its creditworthiness. Market participants who trade in credit derivatives expect these instruments to transfer credit risk separately from market risk. There arise, however, many cases where distinguishing one from the other is a challenge. Nevertheless, market participants attempt to do so by isolating events that genuinely reflect a deterioration in the reference entity's creditworthiness from mere market movements. Despite the important distinctions between credit derivatives and insurance, an important indicator of credit risk is whether holders of the obligation actually suffer a loss as a result of the event. For this reason, Obligation Default is almost never included by parties as a Credit Event, because many technical defaults on debt obligations – for instance, a failure to deliver financial reports on time, or a minor deviation from a restrictive covenant – do not result in any loss on the part of the creditors, and their occurrence is not a materialization of credit risk.<sup>151</sup> Of course, separating credit risk from market risk cannot be achieved with perfect accuracy, but the exercise is useful insofar as it makes credit protection activities more reliable and less costly.

From this perspective, determining which restructurings should constitute credit events raises thorny issues. For instance, many debt renegotiations resulting in change to the terms of the underlying obligation do not mean that the debtor is encountering financial difficulties. On the contrary, an agreement on more favorable lending terms may be the result of an improvement in the debtor's credit, and thus in its negotiating position. Moreover, the

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<sup>151</sup> See Bendernagel, *supra* note 106, at 280; see also Tolk, *supra* note 116, at 9.

variety of possible debt renegotiation scenarios – from informal negotiations with individual creditors to full-fledged restructuring under Chapter 11 or analogous foreign laws – makes precise definition of the underlying event itself problematic.<sup>152</sup>

Since the 1999 Definitions were adopted, ISDA’s approach to Restructuring has been as follows. First, the definition requires that the change in the obligation fall within a list of adverse changes: a reduction in interest or principal, a postponement of their accrual or payment, a change in ranking or priority of the obligation, or a change in the currency or composition of any payment.<sup>153</sup> The 1999 Restructuring clause expressly encompasses the occurrence of such changes as a result of an Obligation Exchange, defined as the mandatory transfer of any securities, obligations or assets to holders of Obligations in exchange for such Obligations. As will be seen, this requirement played a crucial role in the litigation surrounding Argentina’s 2001 pre-default exchange, and was dropped from the 2003 Definitions. Second, the event must affect the Obligations in an aggregate amount no less than a Default Requirement amount predetermined by the parties.<sup>154</sup> Third, the event must not be provided for under the terms of the Obligation.<sup>155</sup> Finally, the definition excludes certain technical adjustments, as well as events that do not “directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.”<sup>156</sup>

Limiting the Restructuring definition and other credit events in this way, of course, is primarily of interest to protection sellers. Definitions that encompass events that do not truly cast aspersions on the reference entity’s creditworthiness would allow protection buyers to

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<sup>152</sup> See Tolk, *id.*, at 8.

<sup>153</sup> See 1999 DEFINITIONS, s. 4.7(a).

<sup>154</sup> See *id.* If the parties do not specify an amount, the Default Requirement is deemed to be USD 10,000,000.

<sup>155</sup> See *id.*

<sup>156</sup> See *id.*, 4.7(b)(iii)

trigger the swaps opportunistically and obtain full payment of the reference amount – which may be higher than the market value of the obligations at that time. Thus, broad credit events may amount to free protection against market risk for the protection buyer.<sup>157</sup> Consec's 2000 restructuring illustrated this problem. The troubled insurer reached an agreement with its lender banks to restructure its credit facilities. The agreement technically constituted a Restructuring under the 1999 Definitions, because the maturity for one short-term loan had been extended. Accordingly, many protection buyers triggered their swaps.<sup>158</sup> In addition, they exercised their “cheapest-to-deliver” option by delivering long-term Consec securities, whose value had declined precipitously following the restructuring, to a level well below that of the bank debt that was actually restructured.<sup>159</sup>

Although the Consec swaps appear to have been settled without litigation, many protection sellers considered the result inappropriate.<sup>160</sup> ISDA subsequently adopted an optional Modified Restructuring Definition that excluded restructurings affecting Obligations held by less than three holders, or adopted by consent of less than two-thirds of holders.<sup>161</sup> With respect to physically-settled derivatives, the modified definition also prohibited protection buyers from delivering obligations with a maturity date more than thirty months

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<sup>157</sup> This is a crucial concern for credit rating agencies hired to rate CLNs or synthetic CDOs: *see* Tolk, *supra* note 116 at 5. For instance, if the credit event definitions are broader than the rating agency's definition of a default, then the risk associated with the CLN or CDO will in fact be greater than indicated by the rating calculated on the basis of the probability of a “real” default by the reference entity. The rating agencies' desire to capture only substantive (as opposed to formal or technical) defaults, however, can clash with the certainty and rapidity of execution sought by protection buyers (*Id.* at 8). For instance, Moody's definition of default, instead of focusing on specific aspects of a restructuring, involves an evaluation of whether the process results in a “diminished financial obligation,” or “has the apparent purpose of helping the borrower avoid default” (*Id.* at 5). The substantial subjective aspects of such an evaluation have prevented its adoption in ISDA forms.

<sup>158</sup> *See* Pollack, *supra* note 107, at 28.

<sup>159</sup> *See* Ranciere, *supra* note 110, at 18.

<sup>160</sup> *See* HENDERSON ON DERIVATIVES, *supra* note 98, at 149; Pollack, *supra* note 107, at 28-30.

<sup>161</sup> *See* ISDA, RESTRUCTURING SUPPLEMENT TO THE 1999 CREDIT DERIVATIVES DEFINITIONS, s. 4.10 (2001); 2003 DEFINITIONS, s. 4.9; The idea here is that widely-held obligations are less likely to be restructured for non-credit reasons: *see* Tolk, *supra* note 116, at 8. The Supplement does not seem to have been widely adopted in the sovereign CDS market; *see* Packer and Suthiphongchai, *supra* note 5, at 83.

after that of the restructured obligation or the termination date of the swap, whichever is earlier.<sup>162</sup> Despite these amendments, the Conseco experience, along with a similar one following Xerox's restructuring of its bank loans,<sup>163</sup> led several protection sellers to argue for the outright elimination of the Restructuring definition from ISDA documentation.

In addition to accurately separating credit risk from market risk, another goal of the definition-setting exercise, from the protection sellers' perspective, is to reduce moral hazard by avoiding situations where the buyer will have the incentive and capacity to precipitate a credit event. This objective generally coincides with a broader systemic interest in encouraging debtors to participate in restructurings. The modified Restructuring definition took a step in that direction by excluding modifications to smaller classes of Obligations, which are more vulnerable to manipulation by protection buyers.

The interests of protection sellers in avoiding moral hazard, however, are not the only ones at play. Protection buyers who use credit derivatives to hedge their exposures to credit risk need these instruments to deliver adequate protection. Courts have recognized this legitimate interest. In *Ursa Minor Limited v. Aon Financial Products*,<sup>164</sup> the Second Circuit held that the broad waiver of defenses in a credit default swap prevented protection sellers from asserting defenses based on the alleged invalidity of the government-backed security bond whose default had triggered the swap. In another case, however, a technical interpretation prevailed and resulted in a windfall to protection buyers. In *Deutsche Bank AG v. ANZ Banking Group Ltd.*,<sup>165</sup> the Commercial Division of the Queen's Bench held that,

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<sup>162</sup> See RESTRUCTURING SUPPLEMENT, *id.*, s. 2.29; 2003 DEFINITIONS, *id.*, s. 2.32-2.33.

<sup>163</sup> See CREDIT RISK TRANSFER, *supra* note 5 at 20.

<sup>164</sup> 7 Fed. Appx. 129 (2<sup>d</sup> Cir. 2001), *aff'g* 2000 WL 1010278 (S.D.N.Y.); *see* Pollack, *supra* note 107, at 7.

<sup>165</sup> 2000 WL 1151384 (QBC (Comm. Ct.))

since the obligations of the City of Moscow did not provide for a grace period, a default that lasted only one day had triggered a credit event.<sup>166</sup> As a result, Deutsche Bank, the protection seller, had to accept the obligations and settle the swap, effectively providing ANZ with market risk protection it had not bargained for.

Despite such occasional excesses, the need of protection buyers for adequate protection is particularly acute when banking regulators allow banks to use credit derivatives as risk mitigation techniques and correspondingly to reduce their capital requirements.<sup>167</sup> Credit event definitions so narrow that they exclude events that cause genuine loss to protection buyers might destabilize the banking system. This is why, for instance, many banking regulators insist that credit derivatives used by banks to hedge credit risk include Restructuring as a Credit Event. European banking authorities have been adamant on this point,<sup>168</sup> and the current Basel proposals do not contemplate capital relief for hedges that exclude Restructuring as a credit event.<sup>169</sup>

Notably, despite its increasing disrepute among market participants, the Restructuring credit event has remained an essential feature of virtually all *sovereign* credit derivatives.<sup>170</sup> It is easy to see why. Under the current sovereign debt regime (or absence thereof), countries

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<sup>166</sup> In the aftermath of this dispute, ISDA adopted a three business days minimum grace period requirement, which applies even when the underlying obligation does not provide for a grace period. See 1999 DEFINITIONS, s. 1.11. “The purpose of the concept is to reduce the likelihood that, with respect to Obligations having no grace period or a very short grace period, a Failure to Pay Credit Event will be triggered by a failure to make a relevant payment for administrative reasons or other reasons that do not reflect upon the creditworthiness or financial condition of the Reference Entity.” (*Id.* at vii). This provision has been maintained in the 2003 DEFINITIONS, s. 1.12.

<sup>167</sup> See CREDIT RISK TRANSFER, *supra* note 5, at 20; HENDERSON ON DERIVATIVES, *supra* note 98, at 150.

<sup>168</sup> See Pollack, *supra* note 107, at 31.

<sup>169</sup> See CREDIT RISK TRANSFER, *supra* note 5 at 20; Pollack, *id.*, at 37-42; INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 15, at 20-21.

<sup>170</sup> Ranciere, *supra* note 110, at 16: “Restructuring is very often excluded from corporate credit derivatives but is always included as a credit event in sovereign credit derivatives”. See also Packer & Suthiphongchai, *supra* note 5, at 83.

do not go bankrupt. They also very rarely fail to pay: outright sovereign debt defaults like Russia's or Argentina's are the exception, not the rule. Nevertheless, sovereigns frequently encounter severe economic difficulties that make it impossible to continue servicing their current debt level. The normal outcome of such difficulties is the negotiation of a "voluntary" debt restructuring with the countries' external creditors.<sup>171</sup> Such restructurings often reflect a substantial deterioration of the sovereign's creditworthiness and, as such, are a manifestation of credit risk. Thus, absent the Restructuring definitions, the protection offered by sovereign credit derivatives would likely be inadequate.

In spite of the importance of the Restructuring definition to the sovereign swap market, this clause, like the other standard credit events, was developed in the corporate context and does not consistently reflect sovereign market concerns.<sup>172</sup> In addition, while parties may adapt the definitions, and doubtlessly do so in highly customized transactions, the available evidence shows that most sovereign CDSs still incorporate the unmodified 1999 Restructuring definition.<sup>173</sup> Thus, more recent amendments to that provision may not be particularly relevant to the current sovereign credit default swap market. This raises questions as to whether the current credit event definitions can handle sovereign debt restructurings adequately, and whether the results coincide with broader systemic interests in preventing holdout litigation and, ultimately, promoting successful restructurings as a debt reduction technique for indebted countries.

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<sup>171</sup> See Martin Hughes, *Areas of Legal Risk in Sovereign-Linked Credit Derivatives*, in CREDIT DERIVATIVES: LAW, REGULATION AND ACCOUNTING ISSUES, *supra* note 107, 64 at 65-66.

<sup>172</sup> See *Id.*, at 65.

<sup>173</sup> See Packer & Suthiphongchai, *supra* note 5, at 83 ("Unlike CDSs written on bank and corporate obligations, the vast majority of outstanding sovereign CDSs remain governed by the old restructuring clause of the 1999 ISDA Credit Derivatives Definitions.") The proportion appears to be in excess of 95%.

### III. CREDIT DERIVATIVES AND THE RESTRUCTURING PROCESS

Under the current restructuring process, distressed sovereigns and their creditors conduct negotiations on a case-by-case, voluntary basis. Restructurings typically fall within one of two categories, depending on whether they occur before or after a formal default on the affected debt.<sup>174</sup>

#### A. Post-Default Restructurings

Post-default restructurings were the norm in sovereign finance during the 1980s and early 1990s. The sovereign would first suspend payments on its debt, usually in the midst of a serious economic crisis. There ensued a period during which the creditors received reduced payments of principal or interest, or no payments at all. As a result of the suspension, a majority of creditors could accelerate the debt, but they had very limited enforcement options beyond this. Instead, they often chose to avoid formally declaring a default. The sovereign, for its part, was barred from further access to the international financial markets, which hindered economic growth and government activities.

Eventually, the parties would agree to initiate negotiations towards a debt restructuring. From the sovereign's perspective, the principal benefit of a composition was renewed access to international capital. Provided that future growth prospects were such that the return from new capital inflows would exceed the cost of resuming payments on a reduced schedule, the sovereign had an incentive to split that surplus with the creditors in return for bringing the default to an end. The creditors, for their part, would accept the restructuring

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<sup>174</sup> See Bratton & Gulati, *supra* note 78, at 18-19 (observing that, although "liquidity crises often move more quickly than the adjustment processes and default proves unavoidable," several countries, including Pakistan, Ecuador, Ukraine, Argentina and Turkey negotiated pre-default restructurings in recent years).

terms to the extent that they were better than what they could obtain through any available enforcement techniques. Beyond this, the legal provisions governing the debt – particularly unanimous voting procedures – along with various extraneous factors (such as official sector involvement) would determine the strength of the creditors’ negotiating position, and thus, how much of the surplus they could extract from the debtor.

Once an agreement was reached, the renegotiated terms would either be incorporated in the existing obligations through a creditor vote, or embodied in new obligations distributed through an exchange offer. This is how Brady restructurings were typically structured. Following the exchange, holdout creditors – if any – held a majority of the remaining debt. They could thus accelerate future payments and sue the debtor. Their enforcement options, however, were still deficient. Thus, the quasi-totality of creditors typically participated in these restructurings.

Post-default restructurings do not pose particular difficulties with respect to sovereign credit derivatives. The initial suspension or default clearly constitutes a Repudiation/Moratorium or Failure to Pay credit event, so that any swaps referenced to the affected debt will be triggered at the outset. The sovereign’s deliverable obligations will thus be transferred to the protection sellers. As a result, the restructuring negotiations will not suffer from the dislocation of incentives and moral hazard problems associated with credit protection.

## **B. Pre-Default Restructurings**

### *1. The Exchange Offer Framework*

While post-default restructurings of this sort still occur – as the current negotiations involving Argentine bonds demonstrate – they no longer dominate sovereign finance. In

recent years, a series of successful pre-default restructurings have considerably changed the landscape. Countries such as Ecuador, Uruguay and Pakistan have restructured their debts through voluntary exchange offers without having to resort to formal suspension or default. Distressed sovereign debtors now frequently engage in negotiations with their creditors when their obligations become unsustainable, but well before a true crisis occurs.

There are several reasons for this. First, when a sovereign's debt becomes unsustainable, both the sovereign and its creditors have an interest in avoiding the consequences associated with a default followed by a protracted suspension of payments. Second, the official sector undoubtedly prefers an orderly exchange offer to the disruption caused by a default. Although large official aid packages have accompanied recent pre-default restructurings, this pattern reduces the need for these packages to be negotiated in crisis circumstances. It also arguably reduces their size, in comparison with the amounts that would be needed to reverse a widespread loss of market confidence and a potential currency crisis. Third, the development of exit consents has provided debtors with a powerful tool to coax recalcitrant creditors into accepting an exchange offer.

The contemporary pre-default restructuring process, although it is also conducted on a case-by-case basis, is based on the following pattern. During negotiations, the creditors cannot accelerate or sue the debtor, since it is still making payments. All parties, however, know that the sovereign is financially distressed. From the sovereign's perspective, a default would have one principal cost: closing its access to international capital. However, it would also have a benefit: allowing the sovereign to halt payments on its existing debt (except to the limited extent that creditor enforcement techniques can create additional costs). The benefit must be higher than the cost, otherwise the sovereign would not be contemplating default.

Thus, the sovereign will rationally want to make an offer that is between what the creditors expect to receive after default, and the full value of continued access to international markets. Where exactly the line will be drawn depends, once again, on the respective negotiating strength of the parties and on extraneous factors, such as official sector intervention.

In practice, the restructuring is implemented through an exchange offer. The sovereign makes a public offer to exchange the old bonds for new bonds with less favorable terms, such as a lower interest rate or a longer maturity. In many cases, the debtor also uses two additional techniques to provide additional incentives for the bondholders to participate. First, holders who subscribe to the offer are asked to provide exit consents to allow amendments that will make the old bonds unattractive. Second, the debtor represents (or at least strongly intimates) that it will cease payments on untendered old bonds and will not offer any better terms to non-participating holders. Both these features of exchange offers, of course, make them quite coercive and weaken the creditors' position. In some recent cases, there have been little or no negotiations – the sovereign simply made a 'take it or leave it' offer.

Market experience with recent exchange offers indicate that the threshold participation rate for success is about 90%. In recent restructurings in Ukraine and Ecuador, the participation rate was over 95%.<sup>175</sup> Following a successful exchange, the debtor has to decide whether to continue servicing any untendered bonds. If it chooses to default, holdout

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<sup>175</sup> See Gray, *supra* note 95, at 225. While there is no formal participation threshold, the debtor normally insists on a high participation rate, principally because (i) of the possibility of legal action by holdouts, whatever the chances of success; and (ii) it wants to retain the option to keep servicing the untendered debt while successfully reducing its debt burden. Of course, while the debtor wants to keep the latter option, it will nevertheless attempt to convince creditors that servicing the old debt will not be a priority, so as to encourage them to participate.

creditors are entitled to accelerate and sue. Once again, however, their enforcement clout is limited by the lack of attachable assets and the costs associated with litigation.

## 2. *Exchange Offers under the 1999 ISDA Definitions*

How is a voluntary exchange treated under the 1999 ISDA Definitions? The new financial terms implemented by an exchange clearly fall within the listed events in Section 4.7 (reduction in the rate or amount of interest or principal, or postponement of payments of principal or interest). Assuming that the changes affect securities that qualify as Obligations, the question thus becomes whether such event occurs in the way described in the definition. First, the paragraph expressly includes events that occur “as a result of an Obligation Exchange.” Section 4.9 goes on to define an Obligation Exchange as a “*mandatory transfer ... of any securities, obligations or assets to holders of Obligations in exchange for such Obligations.*” Second, as an alternative to an Obligation Exchange, the paragraph also includes events which simply “occur” or are “agreed between the Reference Entity ... and the holders.”<sup>176</sup>

In the only published case on point, *Eternity Global Master Fund v. Morgan Guaranty Trust Co.*, the Southern District of New York held that a voluntary debt exchange did not trigger the Restructuring credit event. Eternity, which had invested in Argentine debt, entered into three credit default swaps for hedging purposes. The protection seller was Morgan, the Reference Entity was the Republic of Argentina, and the swaps included both Repudiation/Moratorium and Restructuring among the applicable Credit Events.

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<sup>176</sup> See Appendix 1 for the full definition.

On November 1, 2001, the President of Argentina issued a decree instructing the Minister of the Economy to offer a voluntary exchange to holders of Argentine government debt. On November 19, Argentina officially announced the exchange. Under its terms, any tendered debt would be held in trust for the holders, who would be issued new secured debt obligations with lower yields and longer maturities. This effort, however, proved insufficient to resolve the crisis. On December 24, 2001, Argentina suspended payments on its debt obligations.

Starting on November 1<sup>st</sup>, Eternity repeatedly requested that Morgan settle the swaps. In response, Morgan took the position that the debt exchange did not constitute a credit event. Only on December 27, following Argentina's suspension of payments, did Morgan declare that a "Repudiation/Moratorium" credit event had occurred. Eternity subsequently sued Morgan for breach of contract, fraud and misrepresentation. The breach of contract claim alleged that Argentina's voluntary debt exchange constituted a Restructuring credit event, so that Morgan should have settled the swaps in November.

Morgan argued that since the definition of "Obligation Exchange" requires that the exchange be mandatory, Argentina's voluntary exchange did not qualify and thus could not result in a Restructuring. Although the court denied Morgan's first motion to dismiss,<sup>177</sup> it eventually accepted this argument on a subsequent motion to dismiss Eternity's amended complaint.<sup>178</sup> First, the court held, since the exchange was not mandatory, it could not be an Obligation Exchange. Second, even though Eternity had in fact tendered its debt in exchange for lower-interest, longer-maturity Argentine bonds, this did not mean that a change in the

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<sup>177</sup> 2002 WL 31426310 (S.D.N.Y.)

<sup>178</sup> 2003 WL 21305355 (S.D.N.Y.)

obligations had been agreed between Argentina and the holder. Under the terms of the exchange, the obligations held in trust for the holders remained unchanged, so there was no postponement, deferral or delay in payments or reduction in interest on them.

While the second part of McKenna J.'s reasoning might strain the reader's credulity, it is easy to see why he accepted Morgan's argument. Argentina's exchange was (at least conspicuously) voluntary. Surely, it would have seemed odd to allow a holder who voluntarily agreed to accommodate its creditor, to then turn to its insurer and claim payment under the swap. Since the holder would not have to live with the restructured obligations, it might be willing to accept a unfavorable exchange offer. Moreover, allowing a voluntary exchange to trigger the swap would bypass the clear requirement in the Obligation Exchange definition that the exchange be mandatory.

### 3. *Effect on Incentives*

The reasoning in *Eternity* is based on the existence of the trust, an uncommon restructuring technique that was used for reasons peculiar to the Argentine exchange.<sup>179</sup> The result reached in *Eternity*, however, will likely be followed in future cases involving voluntary restructurings, regardless of whether the debtor uses the trust device. As a matter of contractual interpretation, allowing a voluntary exchange to trigger the swap would circumvent the express requirement that an Obligation Exchange be 'mandatory.' To avoid this result, a court faced with an exchange offer without a trust could argue that the changes in payments or maturity did not occur "with respect to" the old bonds: the old bonds still have

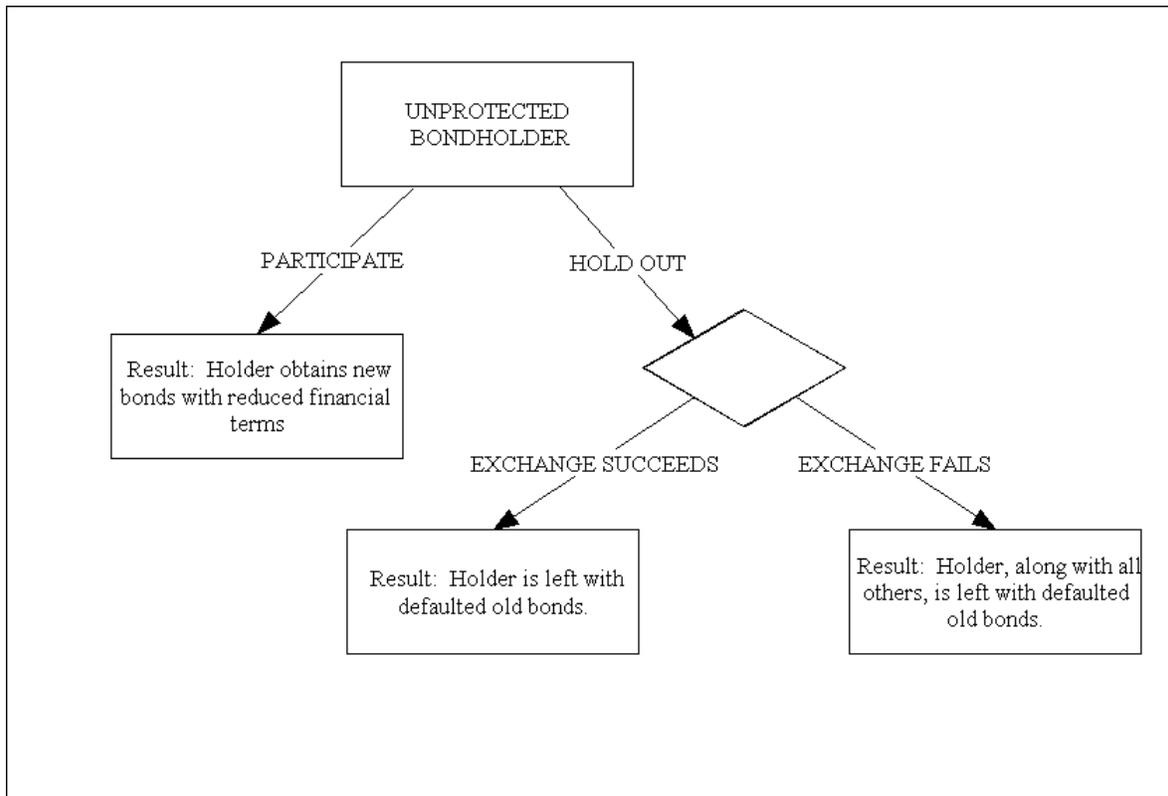
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<sup>179</sup> The failed 2001 exchange targeted Argentina's domestic currency debt (whether held by domestic creditors or foreigners), and was meant to be followed in early 2002 by an exchange offer for Argentina's foreign currency bonds. Argentina adopted the trust structure in order to avoid concentrating the domestic currency debt in the hands of foreign holdouts from the first exchange, at least until the second exchange could be completed. See e-mail from Jeremiah Pam, on file with the author.

the same payment terms. The new bonds, for their part, have different payment terms, but those have never been changed. All that has happened is that old bonds have been voluntarily exchanged for new bonds. Thus, neither the definition of Obligation Exchange nor the general language of Section 4.7(a) apply. As will be described below, such an interpretation would be buttressed by the market's general acquiescence to the *Eternity* ruling, whose reasoning was not repudiated by ISDA when it adopted the 2003 Definitions.

Assuming that the *Eternity* ruling is generally applicable to voluntary restructurings, how does it affect the incentives of the protected creditor faced with an exchange offer? Consider first the incentives of the unprotected bondholder (i.e., the bondholder who has not purchased a credit default swap), as represented by Figure 1. If he participates in the exchange, he will receive new bonds with a value lesser than that of his old bonds. If he refuses to subscribe to the offer, however, two outcomes are possible. First, if enough bondholders similarly hold out, the exchange will fail to attract enough subscriptions (about 90%) and the restructuring will collapse. As a result of the restructuring's failure, the debtor will likely default at some point in the future. The bondholders, individually or collectively, may then try to enforce their claims against the debtor, but the prospects for significant recovery in such circumstances are uncertain. They may also resume negotiations in order to achieve a post-default restructuring, but the suspension period will involve serious losses both to the bondholders – as payments on the bonds will have been suspended – and to the debtor – whose access to the international financial markets will be shut. Second, the exchange might reach the 90% threshold despite the non-participation of our individual bondholder. In this case, he will be left with old bonds after most other creditors have switched to new bonds.

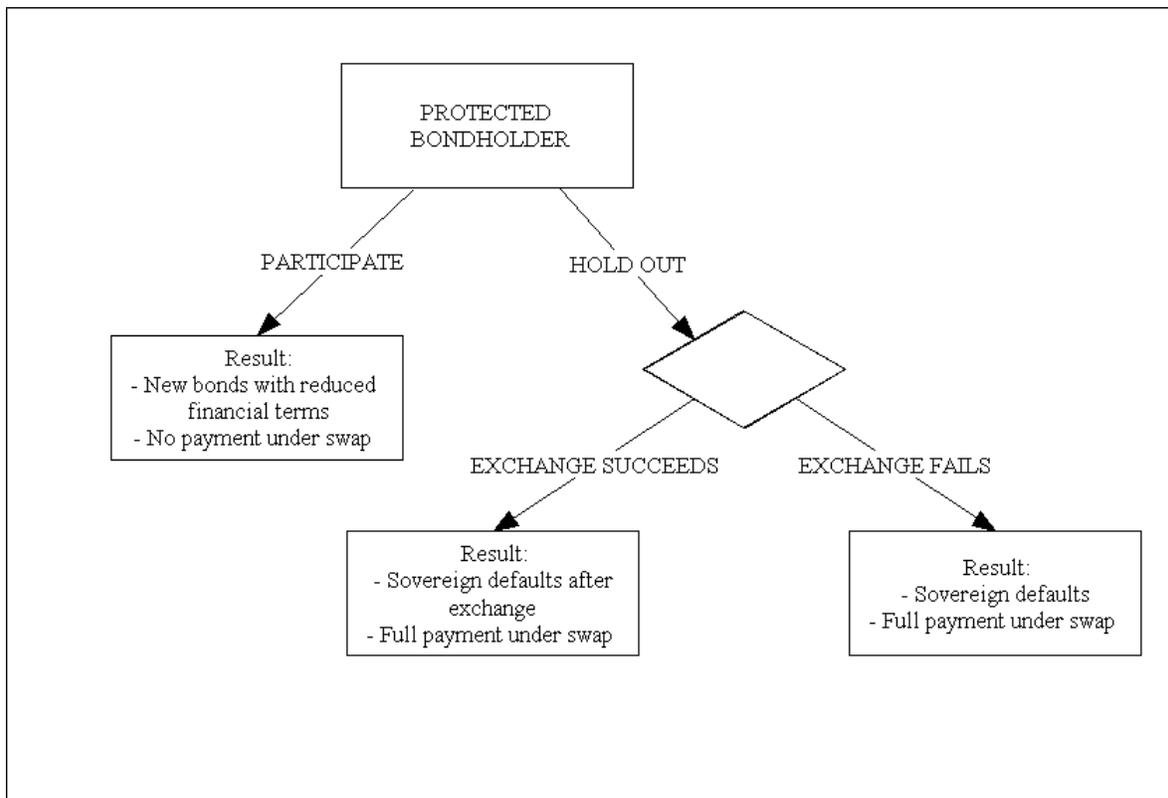
After the debtor defaults on the old bonds, the bondholder will have some remedies, but their effectiveness will likely be limited, and they will come at substantial transaction costs.



**FIGURE 1**

Under these circumstances, the bondholder will choose to participate if the present value of the new bonds is greater than the expected payoff from any available enforcement methods against the debtor. As mentioned above, the sovereign debtor will calibrate its offer accordingly. The available enforcement methods, along with other factors affecting the bondholders' bargaining power, will determine the proportion of the surplus that they can extract from the debtor. Once the debtor meets the reservation price of 90% or more of the debtors, however, the exchange succeeds.

The holder who has bought a credit default swap on his bonds, for his part, faces very different incentives. As shown by Figure 2, if he refuses to tender his bonds in the exchange offer, two outcomes are possible. First, it may be that, despite his non-participation, the exchange will attract enough bondholders to ensure its success. In this case, the non-participating holder retains the old bonds, on which the debtor subsequently defaults. The default triggers the credit default swap (as a Failure to Pay or Repudiation), and the holder is entitled to deliver the old bonds for their face amount to the protection seller. The protection seller, for his part, obtains highly devalued bonds.



**FIGURE 2**

Second, if enough bondholders refuse to subscribe to the offer, the exchange fails. Assuming that the offer was motivated by the debtor's impending inability to service its debt,

the debtor will eventually default. Once again, upon default, the CDS is triggered and the protected holder can deliver the bonds for their full face amount. The protection seller obtains highly devalued, recently-defaulted bonds. On the other hand, if the debtor does not default, then the protected holder again escapes any sacrifice and keeps receiving payments on the bonds' original terms.

Thus, in all cases, the protected bondholder who refuses to subscribe to the exchange offer retains the full value of the old bonds. If he participates in the exchange offer, however, he receives new bonds with terms inferior to those of the old bonds.<sup>180</sup> Since a voluntary exchange does not trigger the CDS, he receives no compensating payment from the protection seller and thus loses the benefit of the swap.<sup>181</sup> Moreover, participating in restructuring negotiations will involve certain costs, while standing aside and waiting for the exchange to fail costs nothing. Under these conditions, the protected holder will rationally choose to refuse the offer and pass the costs imposed by the restructuring (or its failure) along to the protection seller.

Thus, all protected holders should rationally refuse to participate. Their non-participation increases the likelihood that the exchange offer will not reach the 90% threshold

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<sup>180</sup> Unless, of course, the exchange fails despite his participation. In that case, he is entitled to full payment under the swap. However, if he holds out, payment under the swap is virtually certain. Therefore, credit protection still provides him with an incentive to hold out.

<sup>181</sup> One possibility, however, is that the sovereign's default on any post-restructuring residual debt might trigger the swap. However, this possibility is insufficient to convince the protected holder to participate, for at least two reasons. First, there is no guarantee that there will be any residual debt, or that the debtor will default on it. The only means the protected holder possesses to ensure that a post-restructuring default will occur (or that she will retain the full benefit of the old bonds) is to hold out and keep the old bonds herself. Second, even if a post-restructuring default occurs, the amount of the residual debt might not be sufficient for the default to meet the Payment Requirement and trigger the swap.

Of course, there is always the possibility that the voluntary exchange might fail sufficiently to improve the country's financial position to avoid default on its entire debt. This is what happened in Argentina, as explained above. Thus, most swaps were eventually triggered on December 21. The issue settled in *Eternity* arose with respect to credit default swaps which matured between November 1<sup>st</sup> and December 21<sup>st</sup>.

and will fail, thus preventing the sovereign from successfully restructuring its bonds and reducing its debt load. Notably, this is the case regardless of how generous the exchange offer is to bondholders, since any reduction in the bond's value will suffice to provide protected holders with an incentive to hold out. This argument also assumes that the returns on the various enforcement techniques available to creditors are low. Therefore, it would survive a rectification of the *Elliott* interpretation of the *pari passu* clause. As a result, the existence of credit protection increases the likelihood of failure for voluntary exchange offers.

Moreover, even if the exchange succeeds despite the non-participation of protected bondholders, their actions still increase the likelihood of post-restructuring holdout litigation. This is because, after the exchange offer is consummated and followed by a default on the residual debt, the protection sellers end up with the defaulted obligations. While participating in the exchange offer would have been the rational decision *ex ante*, they no longer have that option. Instead, they will likely choose to take their chances in court, or to cut their losses by selling the obligations at a discount to vulture funds who will attempt to sue the debtor. In both cases, the chances of recovery are uncertain, but the creditors might at the very least succeed in disrupting the debtor's international trade and financial operations. Thus, in addition to increasing the risk of failure for voluntary exchange offers, the presence of protected holders also aggravates the risk that a successful exchange will be followed by disruptive holdout litigation.

#### 4. *Amendments to the ISDA Definitions*

As most sovereign credit derivatives are still documented under the 1999 Definitions,<sup>182</sup> the incentives problem they cause can be expected to persist for some time. Nevertheless, although the fragility of the current restructuring process itself is at the heart of the problem, changes in documentation and market practices could alleviate its effects.

As mentioned above, the Restructuring clause was modified after Conseco to exclude renegotiations of small classes of obligations and restructurings effected with low majorities, as well as to impose a maturity limitation date for deliverable obligations. The modified clause, however, is not usually included in sovereign CDSs.<sup>183</sup> In addition, even if it were so included, it would not in itself solve the problem, as all it does is further narrow the Restructuring definition. If the main Restructuring definition did encompass voluntary sovereign restructurings effected through exchanges, then the modifications could be appropriate to exclude certain types of opportunistic restructurings. In their present form, however, the post-Conseco amendments have little impact on sovereign finance.

The 2003 Restructuring definition, for its part, eliminates both the concept of Obligation Exchange and the requirement that an exchange be ‘mandatory.’ Instead, Restructuring only applies when one of the enumerated events (i) occurs “in a form that binds all holders of such obligations,” (ii) “is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation to bind all holders of the Obligation,” or (iii) “is announced (or otherwise decreed) by a Reference Entity

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<sup>182</sup> See Packer and Suthiphongchaim, *supra* note 5, at 83.

<sup>183</sup> See *Id.*

or a Governmental Authority in a form that binds all holders of such Obligations.”<sup>184</sup> However, since without a collective action clause, the changes that trigger a Restructuring cannot be imposed on an unwilling minority of creditors, none of the alternatives applies to “voluntary” sovereign debt restructurings.

On one possible interpretation, alternative (i) or (ii) would be met if all the holders *in fact* consented to the restructuring by tendering their obligations in response to an exchange offer. Thus, a voluntary debt exchange would not trigger a Restructuring Credit Event unless and until all holders tendered their obligations. This interpretation of clause (i), however, is unlikely to prevail. First, as a practical matter, some holders of sovereign bonds virtually always omit to participate in exchanges for a variety of reasons, so that even under a *de facto* test, clause (i) would usually not be satisfied. Second, the definition seems on its face to contemplate *de jure*, rather than *de facto*, bindingness. Indeed, if all creditors individually agreed to a restructuring, it could be argued that it does not have any of the coercive elements that normally accompany a credit event.

For these reasons, the 2003 Restructuring clause will likely be interpreted along the same lines as the 1999 one, with the result that voluntary exchanges will not trigger swaps documented under the new definitions. The exclusion of voluntary exchanges from the Restructuring definition reflects market practice, and many participants are satisfied with *Eternity*'s treatment of the Argentine exchange. One possible reason is the difficulty of distinguishing between truly distressed exchanges and non-coercive, routine liability management operations which include an exchange offer. Of course, even if all voluntary restructurings were *prima facie* caught by paragraph (a) of the definition, the benign sort

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<sup>184</sup> See Appendix 1 for the full definition.

would be excluded by paragraph (b)(iii), as they do not reflect a deterioration of the sovereign's creditworthiness. That clause, however, is fundamentally subjective. Frequent resort to it would significantly increase legal uncertainty and slow down settlement. Another reason for the market's preference for excluding voluntary restructurings is that if they were credit events, protection buyers might have reduced incentives to negotiate the best possible arrangement. After the restructuring, protection sellers would be left with excessively devalued obligations. On the other hand, as restructuring negotiations are usually conducted by large, unprotected creditors, this problem might not arise in practice as small protected creditors would free-ride on institutions-led restructuring negotiations.<sup>185</sup>

As a result, even as the sovereign credit derivatives market gradually migrates to the 2003 ISDA Definitions, the distortion in restructuring incentives created by these instruments will endure.

### **C. Collective Action Clauses**

Would the use of CACs to effect a sovereign debt restructuring trigger credit default swaps referenced to the sovereign? Once again, the issue only arises with respect to pre-default restructurings, since the swaps would already have been triggered by a prior default.

#### *1. Collective Action Clauses and the ISDA Definitions*

As mentioned above, the changes in financial terms adopted as part of a restructuring normally fit one or more of the events listed in the Restructuring definition. The 1999 Definition covers such events when they are "agreed between the Reference Entity ... and the

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<sup>185</sup> Another possible solution to this problem would be to give protection sellers a greater role in negotiations with distressed debtors: *see* Pollack, *supra* note 107, at 47ff. However, Ms. Pollack also indicates that this would go against the prevailing market sentiment that credit default swaps should remain "separate and independent" products. *Id.* at 51.

holder or holders of such Obligation.”<sup>186</sup> The 2003 Definition contemplates CACs even more clearly, by providing that changes to the listed financial terms constitute a Restructuring if they “are agreed between the Reference Entity ... and a sufficient number of holders of such Obligation to bind all holders of the Obligation.”<sup>187</sup> Thus, in both cases, restructurings effected through CACs are *prima facie* caught by the Restructuring definition.

Both definitions, however, go on to exclude such events if they are “provided for under the terms of [the] Obligation in effect as of the later of the Trade Date and the date as of which such Obligation is issued or incurred.”<sup>188</sup> Clearly, the CAC is part of the debt instrument itself, so that implementation of a restructuring through its use might appear to be “provided for” under the terms of the Obligation. On this interpretation, no Restructuring credit event would be triggered. There are, however, multiple reasons why such an interpretation ought to be rejected.

First, the drafters of the ISDA definition clearly did not intend the “provided for” clause to exclude CACs. To be sure, the 1999 Restructuring clause does not expressly describe CACs, and one might argue that the original drafters did not turn their minds to this problem and had no specific intention to cover or exclude CACs. After all, the inclusion of CACs in corporate bonds is prohibited by the *Trust Indenture Act*.<sup>189</sup> Likewise, until very recently, sovereign bonds issued in the United States did not include CACs.<sup>190</sup> This argument, however, overlooks the fact that the Definitions are meant to be used to document transactions under either New York or English law. Bonds issued in London, both corporate

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<sup>186</sup> 1999 DEFINITIONS, s. 4.7(a) (*see* Appendix 1).

<sup>187</sup> 2003 DEFINITIONS, s. 4.7(a) (*see* Appendix 1).

<sup>188</sup> 1999 DEFINITIONS, s. 4.7(a); the 2003 Definitions contain a substantially identical clause, but use the expression “expressly provided.”

<sup>189</sup> *Supra* note 67 .

<sup>190</sup> *See supra*, Part I.

and sovereign, routinely include CACs, and these provisions are frequently used to implement restructurings. In light of the drafters' knowledge of this fact, their failure clearly to exclude CACs can only be read as intention that their use trigger the Restructuring clause.

This result is even clearer under the 2003 Definitions. Clause (ii) of the 2003 Definition so clearly covers CACs that it is almost inconceivable that the drafters nevertheless wanted to exclude them. Another indication of this intent is that, in addition to modifying the Restructuring clause to cover CACs, the 2003 drafters also added provisions that make restructured sovereign obligations deliverable despite changes in their characteristics caused by the restructuring.<sup>191</sup> This clearly indicates that they contemplated that, at least in certain circumstances, sovereign debt restructurings could trigger the Restructuring event. As seen above, voluntary exchanges do not trigger the clause, so the drafters must have been contemplating the use of CACs.

Second, any interpretation that would exclude CACs from the Restructuring definition would clearly be at odds with the policy pursued by the adoption of CACs. These clauses allow a supermajority of holders to bind the minority to the financial terms of a restructuring. At least with respect to this feature, they are intended to solve the collective action problem that otherwise makes restructurings difficult or impossible, and to eliminate the holdout creditor problem. Their adoption is seen as a market-based alternative to a more elaborate international bankruptcy regime.<sup>192</sup> Thus, their use, as contemplated by supporters, can be expected to reflect a substantial deterioration in the sovereign's creditworthiness. This is

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<sup>191</sup> Section 2.16 of the 2003 Definitions defines "Sovereign Restructured Deliverable Obligation" as any sovereign obligation that has all the Deliverable Obligation Characteristics (and is thus deliverable) immediately prior to a restructuring, regardless of whether it still has all these characteristics after the restructuring. Section 2.15(c) provides that a Sovereign Restructured Deliverable Obligation is deliverable in a sovereign restructuring, subject to certain conditions.

<sup>192</sup> See, e.g., Taylor, *supra* note 72.

admittedly equally true of voluntary restructurings under the current system, which do not trigger credit events. However, when a CAC is used, the protection buyer's argument that the exchange is in fact involuntary is stronger, because the restructuring can be enforced against him even if he votes against it. Indeed, even if a protection buyer votes for a restructuring, some coercion still occurs, as the negotiations are conducted under the shadow of the CAC's potential utilization.

Finally, excluding collective action clauses from the definition would perpetuate the incentives problem created by credit derivatives in the restructuring process. CAC have not yet been used in actual restructurings and, as noted above, several commentators doubt their usefulness. An interpretation of the definition that would exclude CACs would further dilute their effect. Like protected holders faced with a voluntary exchange offer, protected holder faced with a CAC restructuring will prefer to hold out in hope that the restructuring will fail and that the debtor will default, thus triggering the swaps. While the problem would be somewhat alleviated by the lower voting threshold under CACs – 75% or 85%, compared to the *de facto* 90% threshold for a voluntary exchange – a small number of protected creditors could still tip the scales.

What, then, is one to make of the “provided for” clause? As a starting point, one should note that the clause only applies when the relevant “*event*” is not provided for under the terms of the obligation. The term “event” refers to the list that follows the first paragraph of Section 4.7(a): reduction in interest or principal, extension of maturity, change in currency, etc. CACs in and of themselves, however, provide for no such “event;” all they do is create an amendment procedure that allows a majority of holders to amend the obligations. Interestingly, while the “provided for” clause predated by several years the Restructuring

definition debate outlined above, as well as ISDA’s effort to address sovereign restructurings in the 2003 Definitions, it survived these changes. The 2003 drafters, however, qualified it by adding the word “expressly,” which reinforces the conclusion that they intended the clause to cover express provisions rather than amendments later made to the obligations. An example of an express provision would be a clause that automatically adjusts the interest rate on the basis of some exogenous event, such as a credit rating improvement. While this adjustment is clearly excluded by the “provided for” clause, use of CACs to restructure the obligations is not.

## 2. *Do Collective Action Clauses Make the Obligations Contingent?*

In addition to the “provided for” clause, another difficulty arises with respect to CACs. One of the Deliverable Obligations Characteristics often specified by parties to sovereign CDSs is “Not Contingent.”<sup>193</sup> This means, as the term suggests, that in order for the protection buyer to be entitled to deliver an obligation under a physically-settled swap, that obligation must not be subject to “any contingency.”<sup>194</sup> This clause was litigated in British courts in 2003, in the aftermath of Railtrack’s bankruptcy. Nomura International plc had purchased credit default swaps referenced on Railtrack from Credit Suisse First Boston. When the credit event occurred, Nomura attempted to deliver Railtrack exchangeable bonds to Credit Suisse. These bonds could, under certain circumstances, be exchanged for Railtrack

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<sup>193</sup> As Ranciere, *supra* note 110, indicates at 17, “[i]n emerging markets, physical settlement tends to be the dominant procedure,” for several reasons: (i) accurate quotes are difficult to obtain for distressed sovereign bonds during a financial crisis, as the market is highly illiquid; (ii) in such circumstances, the recovery value of bonds is often underestimated, so that cash settlement would expose the protection seller to greater risk; and (iii) protection buyers often use sovereign CDSs to hedge actual positions. Although there is no market data on the use of the “Non Contingent” characteristic, it appears to be a standard term. For instance, the 2003 ISDA Sovereign Master Credit Derivatives Confirmation Agreement, a model published to facilitate the documentation of sovereign credit derivatives under the 2003 Definitions, recommends the inclusion of “Non Contingent” for all such derivatives.

<sup>194</sup> 1999 DEFINITIONS, 2.18(b)(vii)

shares upon demand by the holder or the Trustee acting for the benefit of holders. Railtrack did not have the option to demand that the bonds be exchanged. Despite this, Credit Suisse refused to settle the swap and argued that the exchange feature made the bonds “contingent” and thus non-deliverable.

In *Nomura International plc v. Credit Suisse First Boston International*,<sup>195</sup> Justice Langley, of the Commercial Division, held that Nomura was entitled to deliver the bonds. In his view, a provision that operates in favor of a bondholder and in his favor could not be described as a contingency. Despite the exchangeability feature, the holder can choose to claim repayment and is entitled to it, as the exchange is within his control and is unaffected by external events or by the debtor’s actions. Langley J. summarized his position as follows:

The purpose of requiring that the Deliverable Obligation be “Not Contingent” is, I think, plainly to secure a right to payment of the principal amount as such which *cannot be affected in amount by extraneous factors over which the seller of credit, as holder, has no control.* [emphasis added]

This language raises an issue with respect to bonds containing CACs. On a literal reading of Justice Langley’s decision, since other holders of the bonds can agree with the debtor to change the bonds’ financial terms and impose the new terms on a dissenting minority, an individual holder’s right to payment can be affected by “extraneous factors” over which he has no control. Therefore, the bonds are “contingent” and therefore non-deliverable under the terms of most sovereign CDSs currently on the market. Notably, under this literal interpretation, clauses permitting majority amendments to non-payment terms would not make obligations contingent, since they do not affect their “amount.” Likewise, clauses permitting unanimous amendments to payment terms would not be affected: since every

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<sup>195</sup> 2003 WL 933569 (QBD (Comm. Ct.)). On this dispute, *see* Pollack, *supra* note 107 at 12-15.

individual holder has a veto, the amendments are never beyond his “control.” Only collective action clauses, which allow majority amendments to payment terms, would make bonds contingent.

This interpretation, of course, would be highly problematic. CDSs written on sovereigns that have converted their existing bonds to new ones containing CACs would be useless. Even more strikingly, all English law bonds containing CACs would be non-deliverable. This result would clearly defeat the legitimate expectations of protection buyers. Of course, this problem could be avoided by omitting to list “Not Contingent” as a Deliverable Obligation Characteristic in CDSs on sovereigns who include CACs in their bonds. This, however, might jeopardize the protection sellers’ interest in excluding “genuinely” contingent obligations. ISDA recognized this in 2003, as it amended the Definitions to clarify that exchangeable and convertible obligations are not contingent. The new language, however, does not clearly address the potential argument that CACs make obligations contingent.

The better view is that voting provisions such as CACs are simply not the kinds of contingency that should make bonds non-deliverable. As explained above, they are intended as a substitute for a statutory restructuring process that is absent from sovereign finance. The possibility that such procedures of general application might be brought to bear on a debtor and lead to a reduction of its creditor’s claims is a normal background expectation in all financial markets. In other words, just as the possibility that a corporate debtor may go bankrupt does not make its obligations “contingent,” neither does the possibility that a sovereign debtor may invoke voting procedures that have been put in place to facilitate the restructuring of distressed debt. One should not, however, overlook the potential for majority

abuse that comes with CACs. In a figurative sense, one might say that an individual creditor's claim is always "contingent" on the other creditors' not colluding with the debtor to reduce its value. It may be that the solution to this problem should come from the courts' imposing some duty of fair dealing on the majority, as advocated by Professors Bratton and Gulati.<sup>196</sup>

#### **D. The SDRM**

None of the more ambitious sovereign bankruptcy proposals is currently attracting significant support in policy circles. It is, however, worthwhile to examine the interaction of a potential Sovereign Debt Restructuring Mechanism (SDRM) with credit derivatives, as the reform project may be revived if CACs prove insufficient to facilitate debt restructurings in the future.

Should such a far-reaching reform of sovereign debt restructuring be adopted, one expects that ISDA would change its definitions, perhaps in substantial ways, to reflect the new environment. Even under the current definitions, however, a sovereign debtor's decision to invoke the SDRM would constitute a credit event and trigger CDSs written on that sovereign. First, use of the SDRM would undoubtedly trigger the Bankruptcy definition. This credit event is not usually included in sovereign CDSs, but market practice would likely evolve in that direction following the adoption of the SDRM. Second, the Failure to Pay and Repudiation/Moratorium credit events would also apply to the payments standstill following the debtor's filing. Finally, physical settlement of the swaps would not be subject to any

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<sup>196</sup> See Bratton & Gulati, *supra* note 78.

contingency problem created by CACs, since the SDRM would be provided for by statute or by international treaty rather than in the obligations themselves.

This result is consistent with the parties' expectations, since use of the SDRM is clearly meant to be a last resort for sovereigns with unsustainable debt. Under the Krueger proposal, the IMF or an independent body would have to confirm that the sovereign's financial position justifies invoking the SDRM, thus providing some protection against unjustified restructurings.<sup>197</sup> Therefore, use of the SDRM would in virtually all cases reflect a significant deterioration in the sovereign's creditworthiness, and thus a materialization of the sort of credit risk the swaps are intended to cover. The standstill and the subsequent reduction or rescheduling of payments on the sovereign's debt would also have coercive features strongly analogous with those of domestic bankruptcy regimes.

Once again, however, one might wonder whether the incentives created by the mechanism are truly optimal. Dr. Krueger, for instance, argues that the SDRM would provide a legal background for voluntary restructuring negotiations. On that view, future restructurings, like arrangements with creditors in the domestic context, would be negotiated "in the shadow of the law," in the sense that all involved parties would know that the likely alternative to an agreement is for the sovereign to invoke the SDRM. In Dr. Krueger's words, "the intention is that the existence of a predictable legal mechanism will in itself help debtors and creditors to reach agreement without the need for formal activation."<sup>198</sup> This benefit of a SDRM, however, would be undermined by the fact that while a voluntary restructuring does not trigger CDSs, use of the SDRM does. Therefore, protected holders would have incentives

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<sup>197</sup> See A NEW APPROACH, *supra* note 6, at 23-28.

<sup>198</sup> *Id.* at 4.

to refuse a negotiated settlement and force the debtor to use the SDRM. While this result is preferable to an outright default, it nevertheless mitigates the expected benefits of the SDRM. As a result, even if the SDRM were to be adopted, the exclusion of voluntary exchanges from the Restructuring definition would hinder the resolution of sovereign debt problems.

## **E. Sovereign Debt and Global Financial Stability**

In addition to the legal interpretation issues and incentives problems discussed above, the potential effects of the rise of sovereign credit derivatives on financial stability deserve mention.

### *1. Market Concentration and Systemic Risk*

The structure of the credit derivatives market raises systemic risk concerns. Intermediation activities with respect to credit derivatives are highly concentrated,<sup>199</sup> often in unregulated or lightly regulated subsidiaries of large securities firms. A small number of dealers routinely buy and sell credit derivatives, either on their own account or as intermediaries. Among other activities, they maintain a substantial inventory of such derivatives for the purpose of future business with parties wishing to take opposite positions.

Although these dealers are thought to maintain a balanced book, verifying this is difficult under the current regulatory regime.<sup>200</sup> Moreover, the considerable legal uncertainty surrounding credit derivatives means that even an apparently balanced book may turn out to be questionable under pressure.<sup>201</sup> For instance, dealers who acted as intermediaries between

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<sup>199</sup> See CREDIT RISK TRANSFER, *supra* note 5, at 27.

<sup>200</sup> See *id.* at 25-26; see also Garry J. Schinasi et al., *Modern Banking and OTC Derivatives Markets: The Transformation of Global Finance and its Implications for Systemic Risk*, IMF Occasional Paper 203 (2000), at 49ff. For an examination of the credit requirements and other regulations applicable to derivatives dealers, see INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 15, at 22-45.

<sup>201</sup> See *id.* at 27.

parties to Argentine swaps have been known to take contrary positions in litigation arising under each branch of the transaction.<sup>202</sup> Inconsistent court rulings and the resulting imbalances in payments could threaten the liquidity of some dealers. Likewise, the difficulty of hedging the exposures created by CDSs by purchasing identical instruments can also lead to mismatches between the losses on credit derivatives and the payments received under other, less accurate hedging techniques, such as shorting the underlying obligations themselves.<sup>203</sup>

These systemic risk concerns are compounded by the fact that, in addition to dealer concentration, the sovereign derivatives market is also highly concentrated on some reference entities. As seen above, a small number of major emerging debtors, including Brazil, Mexico, Japan, the Philippines and South Africa, account for a vast proportion of the market.<sup>204</sup> While the concept and mechanics of financial crisis ‘contagion’ in emerging markets are still a matter of debate among economists, there is no doubt that series such crises have happened in quick succession in the past. One needs only think of the Latin American crisis of 1982 and the East Asian crisis, Russian default and Brazilian scare of 1997-98. A similar series of closely correlated crises and the resulting credit events could severely strain the credit derivatives market.<sup>205</sup> The execution of all requested settlements would require that the system operate without a glitch, and a failure by a dealer or another party to many transactions could easily spread to others.

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<sup>202</sup> See Pollack, *supra* note 107, at p. 19-20.

<sup>203</sup> On this point, see Ranciere, *supra* note 110, at 19.

<sup>204</sup> See Packer and Suthiphongchai, *supra* note 5, at 81-83; Ranciere, *supra* note 110, at 5.

<sup>205</sup> On the financial stability problems associated with credit derivatives exposures to correlated credit risks, see generally David Rule, *The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability*, FIN. STABILITY REV., June 2001, at 117.

Evaluating the probability of such a series of events, and whether it would suffice to trigger a series of failures in the international financial system, is beyond the scope of this paper. It is certainly encouraging that, so far, credit derivatives have performed satisfactorily in periods of financial stress. Protection buyers have been able to recover substantial amounts from their investments in the Industrial Finance Corporation of Thailand and the Korean Development Bank.<sup>206</sup> Likewise, despite the initial confusion caused by Argentina's ill-fated November 2001 voluntary exchange, credit default swaps were orderly settled when the country actually defaulted.<sup>207</sup> In Russia, however, the 1998 default led to a number of legal challenges relating to credit derivatives, including the *ANZ Banking* case. As the market keeps expanding, the possibility of a chain reaction remains worrisome.

Finally, credit derivatives also reduce systemic risk by spreading exposures among financial institutions and investors and by facilitating diversification. Moreover, the many technical amendments to the 2003 Definitions are likely to improve legal certainty in the credit derivatives market. Therefore, it may be that, given a sufficiently robust legal regime, sovereign credit derivatives actually result in a net decrease in overall systemic risk.

## 2. *Excessive Lending in Emerging Markets*

The availability of credit protection may contribute to continued excessive lending in emerging markets. For instance, large financial institutions may be induced to make riskier loans and increase their sovereign debt holdings by the confidence that the credit risk can be passed on to other institutions such as smaller banks or insurance companies. Sophistication about the characteristics and risks associated with derivatives is spreading rapidly through the

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<sup>206</sup> See André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 152-53 (2000).

<sup>207</sup> See Ranciere, *supra* note 110, at 22-23.

financial system. In many cases, these instruments offer smaller institutions opportunities for diversification that would otherwise be unavailable. Nevertheless, allegations intermittently surface that complex derivatives sold by large dealers have caused substantial losses to relatively unsophisticated buyers who failed fully to appreciate their risks.<sup>208</sup> While this element of information asymmetry may subside over time, many commentators believe that financial markets as a whole have repeatedly shown excessive enthusiasm for emerging markets,<sup>209</sup> which could be further fueled by the multiplication and greater accessibility of synthetic exposures created by credit derivatives.

## CONCLUSION

This examination of the contractual framework for sovereign credit derivatives invites three general conclusions. First, the 2003 Definitions evidence a conscious effort by ISDA to respond systematically to the legal issues raised by sovereign restructurings. This is a welcome change from the Association's previous approach of responding to discrete market events by *ad hoc* amendments to the Definitions. As a result, the 2003 Definitions, when interpreted correctly, provide clear guidance with respect to the various forms a sovereign restructuring may take, including the utilization of the newly-adopted CACs in New York sovereign bonds. As the credit derivatives market moves to the new definitions, legal uncertainty will be reduced.

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<sup>208</sup> In the mid-1990s, considerable litigation arose in the United States alleging improprieties by dealers in marketing derivatives to end-users. See INTERNATIONAL FINANCE, *supra* note 10, Draft ch. 15, at 46-58. The IAIS PAPER, *supra* note 117, at 5-6, notes that credit risk transfer activities pose particular challenges for insurance companies' risk management programs, and that regulators should take measures to ensure that the firms under their supervision have the requisite skills and knowledge to evaluate and manage the risks involved.

<sup>209</sup> See, e.g., STIGLITZ, *supra* note 61.

As a more general matter, however, the tension between the market's apparent satisfaction with the *Eternity* ruling, on the one hand, and its undesirable consequences on the feasibility of sovereign debt restructurings, on the other, points to the externalities associated with private rulemaking with respect to derivatives. In other words, even assuming that ISDA, taking into account the interests of both protection buyers and sellers, can elaborate definitions that optimally facilitate private risk management, the danger remains that such definitions may be suboptimal from the perspective of global financial stability.

The extent to which this tension is real remains unclear. As explained above, the exclusion of voluntary exchanges from the Restructuring definition was a deliberate choice on the part of the drafters, especially in 2003, when sovereign restructuring issues were clearly considered. It might be that the fall of regulatory obstacles will lead ISDA to comply with market demands and abandon the Restructuring definition. ISDA would then have to articulate an alternative definition to address sovereign debt restructurings. In view of the fact that many of the techniques used to reduce moral hazard in corporate credit derivatives are not available with respect to sovereigns, protection sellers focusing on the problem might demand that voluntary restructurings be included in one form or another. One possible option would be to defer to the judgment of some third party, such as a credit rating agency, as to whether the exchange is 'distressed' or not. This would bring ISDA documentation in line with financial stability imperatives. They would also make sense because, as indicated above, the absence of a bankruptcy regime for countries creates substantial differences between the

sovereign and domestic restructuring processes, with the result that what is truly “voluntary” in one case should not be treated the same in the other.<sup>210</sup>

This solution, however, seems improbable given ISDA’s choice to retain the 1999 definitional approach to Restructuring in its 2003 definitions, despite the objections of some market participants. Moreover, changes to the definitions cannot in and of themselves address the fundamental issue at hand. The real threat to stability does not come from credit derivatives themselves, but from the fragility of the current restructuring process. Progress in avoiding financial crises can only be achieved by improvements to this process. For instance, as the sovereign debt market migrates to CACs, the incentives problems created by credit protection are likely to decrease.

Second, while the 2003 ISDA drafters were clearly aware of the restructuring debate, international financial policymakers do not appear to have given much thought to the impact of credit derivatives on their reform plans. This is unsurprising under the normal expectation, which is that financial markets will spontaneously adapt to major structural changes. This expectation, however, can become rather perilous when the interests of the private parties drafting the clauses may be at odds with the stability objectives pursued by the reforms. More generally, the lesson is that, given the growing importance of financial derivatives, their interaction with any proposed innovation ought to be closely scrutinized in order to avoid unintended consequences. This point, of course, applies not only to sovereign restructuring reform but to almost any serious financial reform effort.

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<sup>210</sup> For instance, Moody’s makes the point that “[c]redit risk is risk imposed on the lenders by an obligor. It does not include, and a Moody’s rating does not address, risks that lenders impose on themselves – i.e., the possibility that lenders will voluntarily take losses that are not forced on them by obligors.” (Tolk, *supra* note 116, at 8). It is unclear, however, whether “voluntary” sovereign restructurings truly fit this description.

Finally, at the intersection of sovereign debt and credit derivatives, the problems one observes are the same as in these individual markets, but they compound each other to a considerable degree. The brittleness of the current restructuring process makes it vulnerable to the destabilizing effect of credit derivatives. In turn, the legal uncertainties associated with credit risk transfer activities may amplify the systemic risk created by the flow of capital to emerging markets. In order for this rapidly expanding market to confer all its benefits without endangering global financial stability, these issues will need to be explored empirically.

## APPENDIX: ISDA RESTRUCTURING DEFINITIONS

### 1999 ISDA Definitions:

#### **Section 4.7. Restructuring.**

(a) “Restructuring” means that, with respect to one or more Obligations, including as a result of an Obligation Exchange, and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs, is agreed between the Reference Entity or a Governmental Authority and the holder or holders of such Obligation or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that is binding upon a Reference Entity, and such event is not provided for under the terms of such Obligation in effect as of the later of the Trade Date and the date as of which such obligation is issued or incurred:

(i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals;

(ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;

(iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium;

(iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation; or

(v) any change in the currency or composition of any payment of interest or principal.  
[...]

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring: [...]

(iii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.

(c) If an Obligation Exchange has occurred, the determination as to whether one of the events described under Section 4.7(a)(i) to (v) has occurred will be based on a comparison of the terms of the Obligation immediately before such Obligation Exchange and the terms of the resulting Obligation immediately following such Obligation Exchange. [...]

**Section 4.9. Obligation Exchange.** “Obligation Exchange” means the mandatory transfer (other than in accordance with the terms in effect as of the later of the Trade Date or date of

issuance of the relevant Obligation) of any securities, obligations or assets to holders of Obligations in exchange for such Obligations. When so transferred, such securities, obligations or assets will be deemed to be Obligations.

**2003 ISDA Definitions:**

**Section 4.7. Restructuring.** (a) “Restructuring” means that, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs in a form that binds all holders of such Obligation, is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation to bind all holders of the Obligation or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that binds all holders of such Obligations, and such event is not expressly provided for under the terms of such Obligation in effect as of the later of the Trade Date and the date as of which such Obligation is issued or incurred:

(i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals;

(ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;

(iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium;

(iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation; or

(v) any change in the currency or composition of any payment of interest or principal to any currency which is not a permitted currency. [...]

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring: [...]

(iii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.

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