

# The Sovereign Debt Restructuring Process

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*The views expressed in this paper are those of the authors in their personal capacity. In particular, they do not necessarily represent the views of the IMF, its Executive Board, or IMF management.*

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## I. Introduction

This Chapter discusses the process of restructuring a sovereign's debt once this step becomes unavoidable. All sovereign debt workouts are painful -- for the debtor country, its citizens, its creditors and its official sector sponsors. If mishandled, a sovereign debt workout can be incandescently painful. A mangled debt restructuring can perpetuate the sense of crisis for years, sometimes even for decades. A return to normal economic activity may be delayed, credit market access frozen, trade finance unavailable, capital flight endemic, financial sector instability chronic and foreign direct investment withered. Adding to this inherent difficulty, sovereign debt crises rarely come in isolation. They are often the cause of, or are caused by, or at the very least are accompanied by, political crises, banking crises, social crises and occasionally humanitarian crises.

A sovereign debt restructuring can fail in several ways. It can take too long to execute; it may not provide sufficient debt relief; it may extract debt relief that most creditors see as excessive and confiscatory; or the creditors may view the operation as unnecessarily coercive and hold a grudge that can affect future market access for the sovereign. The history of debt restructuring is littered with examples that fail to find a reasonable balance among these considerations. Long after the memory of the financial pain inflicted on creditors in a debt restructuring has faded, the capital markets will remember whether the debt workout process was conducted efficiently and fairly. The extent of the longer-term damage to the sovereign's credit reputation may well depend on the market's perception of whether the country behaved maturely and professionally during the period of its debt crisis.

This Chapter provides the first comprehensive attempt at a "playbook" of each step of the sovereign debt restructuring process, given the pitfalls outlined above. It begins with a discussion of the parties involved and proceeds to tackle the considerations at play in designing, negotiating, and concluding a restructuring. Case studies throughout illustrate innovations that have been employed over the years to facilitate the process.

## II. The players

### **The Sovereign Debtor**

The central player in a sovereign debt restructuring is, of course, the debtor. As debtors, sovereigns are unique in several ways.<sup>1</sup> First, a sovereign is uniquely exposed to hostile creditor legal actions. Unlike a corporate or individual debtor, there is no bankruptcy code that a sovereign may use to restructure its debts

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<sup>1</sup> Lee C. Buchheit, *Sovereign Debt Restructurings: The Legal Context*, in SOVEREIGN RISK: A WORLD WITHOUT RISK-FREE ASSETS? BIS Papers No. 72 107, 110 (July 2013).

under the supervision (and protection) of a court. A sovereign's debt can never be legally discharged in bankruptcy; debt relief can only be obtained with the creditors' consent. Despite efforts by some members of the international community (discussed in Chapter 9) to promote such a measure, there is no formal national or international bankruptcy mechanism for sovereigns. Sovereign debt workout procedures have therefore evolved over the last 40 years in the absence of any institutional framework. Such procedures exist, they just can't be found in a code or statute book.

Secondly, sovereigns are subject to suit in most national courts in respect of their commercial activities under the "restrictive" theory of sovereign immunity, which says that when a sovereign elects to go into the international marketplace and conduct itself as a commercial actor (such as by issuing bonds), it ought to be accountable to judicial process as though it *were* a commercial actor.<sup>2</sup> However, unlike their corporate and individual debtor counterparts, sovereign property enjoys significant protection against seizure by judgment creditors. Assets like embassies, consulates and military property abroad are typically shielded from attachment by national and international law. Only sovereign assets used for a commercial purpose will generally be in harm's way. In short, it is relatively easy for creditors to get court judgments against a defaulting sovereign but relatively difficult for creditors to enforce those judgments.

A sovereign is also unlike other debtors in that the question of *when* it has become insolvent may be subject to considerable debate. A sovereign's assets, in light of its taxing power, are theoretically congruent with all of the assets in the debtor country. Unlike a corporate or individual debtor with a fixed amount of assets (a house, bank account, etc.), a sovereign's assets may expand at will. The question then becomes at what point the theoretical power to tax is limited by the economic and political impracticalities of doing so. A sovereign's future earning capacity may be even more uncertain than that of a corporate or individual. It will depend on domestic and external economic conditions, fiscal policies, political developments and serendipitous factors such as the discovery of exportable natural resources. Conducting a sovereign debt sustainability analysis (DSA), one of the key roles of the IMF in the debt restructuring process, is therefore more of an art than a science -- albeit one in which rigorous analysis plays an important role [see Chapter [...]].

Finally, sovereign debt is remarkably adhesive. The public international law doctrine known as state succession requires governments to recognize and honor debts incurred by predecessor regimes in that country no matter how different those prior administrations may be in their political philosophy and no matter what the incumbent administration thinks about how their predecessors spent the proceeds of those prior borrowings. The exceptions to this rule of public

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<sup>2</sup> For the United States' version, see 28 USC s.1602 *et seq.*

international law are very limited, the principal one being a concept of “odious” debt. Odious debts are sometimes described as obligations incurred in the name of the state by a tyrannical regime where the proceeds do not benefit the citizenry of the country. Classic case? Money borrowed (and stolen) by a kleptomaniacal dictator.<sup>3</sup> Even in cases of territorial secession, annexation or the dissolution of a state, some apportionment of the sovereign debts of the prior political entity will probably be required.<sup>4</sup>

### **State-Owned Entities**

In the context of a sovereign debt restructuring, the debt of other state-owned or state-affiliated entities may also need to be restructured, either because those credits have been explicitly guaranteed by the sovereign or because attempting to draw a distinction between the finances of the sovereign and the related entity is essentially meaningless. Treating sub-sovereign debt may also become unavoidable as a result of the negotiating process. Creditors of the sovereign may insist that lenders to state-owned enterprises bear a proportional burden of the restructuring for reasons of inter-creditor equity. Restructuring a sovereign debtor’s contingent liabilities (*e.g.*, private sector debt with a sovereign guarantee that has not been called) presents its own challenges. A large contingent liability may undermine debt sustainability down the road if and when the guarantee is called.<sup>5</sup>

### **The Creditors**

On the other side of the table from the sovereign are its creditors. These can broadly be divided into three categories: multilateral official creditors, bilateral official creditors and commercial (private) lenders.

#### *Multilateral Official Creditors and Other “Monitors”*

Apart from the IMF, a country undergoing a debt restructuring may receive new financing from other multilateral official creditors such as the World Bank or regional development banks (*e.g.*, the African Development Bank, the Asian Development Bank, the Interamerican Development Bank). The restructuring process may also be monitored and supported by other national and international

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<sup>3</sup> For a discussion of defenses available to successor regimes sued for repayment of an “odious” loan incurred by precedent governments, see Lee C. Buchheit, G. Mitu Gulati and Robert B. Thompson, “The Dilemma of Odious Debts” (2007) 56(5) *Duke Law Journal* 1201.

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

<sup>5</sup> For a full discussion of how to deal with contingent liabilities in a sovereign debt restructuring, see Lee C. Buchheit and G. Mitu Gulati, ‘Restructuring A Sovereign Debtor’s Contingent Liabilities’ (26 December 2012) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2194099](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2194099)> last accessed 1 August 2018, reprinted in *Sovereign Financing and International Law* (C. Espósito, Y. Li, J.P. Bohoslavsky eds., 2013).

bodies. In the case of the euro area debt crisis that began in 2010, for example, the European Central Bank and the European Commission provided new financing and were actively involved in monitoring economic reform programs in the recipient countries.<sup>6</sup> In past crises, such as the 1980s global debt crisis and the Mexican debt crisis of 1994/95, the U.S. Treasury both provided new financing and played a key role in facilitating the debt restructuring process. Naturally, when the creditor universe comprises regulated financial institutions like commercial banks (which it did during the 1980s), the intervention of national regulators can be particularly effective.<sup>7</sup>

### *Bilateral Official*

Bilateral official creditor claims normally take the form of loans from one sovereign state to another, often to finance exports from the creditor country or to provide development assistance. Bilateral lenders regard their credits -- because they are not extended for profit but for public policy reasons, such as crises response, official development assistance, and trade development -- as senior to the commercial debts of the sovereign borrower. For their part, commercial lenders have sometimes contested this position, arguing that bilateral credits are extended to enhance exports from, or to further the geopolitical objectives of, the lending countries.

### *Commercial Private*

Commercial creditors may include bondholders, banks, suppliers, trade creditors, contractors and even individuals. Bondholders may range from institutional investors (investment funds, insurance companies, retirement funds) who buy sovereign bonds at or near par in the primary market and hold them to maturity, to “distress funds” who buy defaulted (or near-defaulted) debt on the secondary market at large discounts. Within the broad genus of distressed funds is a species often referred to as a “vulture” fund. Vulture investors may approach a sovereign debt restructuring with malice aforethought; they often intend from the outset to reject a negotiated settlement and to seek a preferential recovery at the sharp end of a lawsuit. Aggressive recovery strategies of this kind have sometimes caused significant disruption in the system for orderly resolution of sovereign debts, prompting debtor countries to develop techniques to counter such behavior (discussed later in this Chapter). Finally, the universe of private creditors caught up in a sovereign debt crisis may also include retail and individual creditors. This category poses its own challenges. Retail investors are often highly dispersed, less

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<sup>6</sup> Euro area member states also provided financing through the European Financial Stability Facility (ESFS) and the European Stability Mechanism (ESM). Financing was provided to a number of countries, including Greece, Ireland, Portugal, and Spain.

<sup>7</sup> Lee C. Buchheit, ‘A Change of Hat,’ (1990) 9(6) International Financial Law Review.

sophisticated than institutional investors and less able to bear significant financial losses.

### **The Role of the IMF in Sovereign Debt Restructuring**

***Because of its oversight and financing roles enshrined in its Articles of Agreement, the IMF is often central to the debt restructuring process, as described below:***

**Financing:** The IMF provides balance of payments financing “under adequate safeguards” (e.g., conditionality) to a member country implementing an economic adjustment program. The success of that program is meant to assist the member in overcoming its balance of payments problem, enable it to repay the IMF, and foster stability more generally, including by preventing or mitigating spillovers to other countries.

**The “Trigger”:** Whether a country requires a debt restructuring will depend on a debt sustainability analysis (DSA), the feasibility of policy adjustment and the availability of financing from all available sources (including the IMF and other creditors). The IMF’s DSA hence plays a role in the decision whether a debt restructuring will take place (whether in the context of an IMF-supported adjustment program or outside).

**The Financing Envelope:** The IMF’s DSA also effectively identifies the envelope of resources available for debt service payments to official and private creditors, which is crucial to anchor deliberations between the debtor and its creditors.

**Process:** In general, the IMF encourages its members to engage in a collaborative process with their creditors when seeking a restructuring. Beyond that, the IMF leaves the specific details of the debt restructuring strategy to the debtor and its legal and financial advisors. In pre-default cases, the IMF does not insist on any particular form of dialogue between the debtor and its creditors. In post-default cases, the IMF is guided by its “Lending into Arrears” policy, which sets more specific standards for dialogue between creditors and debtors, including assessing whether the member is making a good faith effort to reach a collaborative agreement with its creditors.

**Inter-Creditor Equity:** The IMF does not intervene on issues of inter-creditor equity. Its “Lending into Arrears” Policy, however, makes a distinction between official and private claims. In some cases, creditors are likely to accept some differentiation in the treatment of their claims, as this would help limit the extent of economic dislocation, maintain market access, and preserve financial stability.

### III. The Restructuring Envelope:

Once the sovereign determines that a restructuring is necessary (or perhaps even before this determination has been made), the sovereign should hire financial and legal advisors to guide it through the process. Because those advisors are likely to be the principal interlocutors with the country’s commercial creditors, their familiarity with the market -- and the market’s familiarity with them -- is critically important.

The advisors, in conjunction with the IMF, will determine the overall quantum of needed debt relief required. Then, the question becomes what categories of debt should be included in the restructuring pool. There are some general rules of thumb. First, trade credits are generally excluded or given more lenient treatment given the economic necessity of continued trade financing. Any senior or collateralized debt obligation is also generally excluded.<sup>8</sup> Treasury bills, given the need for continued short-term financing of the government, are also generally left out of the restructured claims, with a few prominent examples to the contrary.<sup>9</sup>

## Excluded Claims

The claims of international financing institutions (IFIs) are also left out of the restructuring bucket. The IMF, for example, enjoys preferred creditor status, which means that the Fund's own claims will be excluded from the restructuring process. This is a de facto, not a legal, priority generally recognized by all stakeholders, including official bilateral as well as private creditors. IMF financing is conditioned on the member country taking steps to address its underlying economic imbalances; a process that helps to ensure that the other creditors will have their restructured claims repaid as well.<sup>10</sup> Other IFIs, such as the World Bank and the regional development banks, are also generally considered preferred creditors.<sup>11</sup>

## Domestic versus external debt

One of the biggest dilemmas facing a sovereign debtor embarking on a restructuring will be the extent to which the restructuring burden should be borne by holders of domestic-law versus foreign-law governed debt. There are several considerations at play. One issue refers to the *means* of restructuring: the sovereign can unilaterally change the terms of domestic law-governed debt by making appropriate changes in its domestic law. This gives the sovereign enormous flexibility in designing the restructuring and limiting holdout behavior (see Case Study: Greece). Moreover, if domestic-law debt is denominated in local currency, the sovereign may also choose to “inflate away” the debt problem by printing money.

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<sup>8</sup> There may be circumstances where senior or collateralized debt obligations need to be restructured. See, e.g., the case of Chad 2018

<sup>9</sup> Exceptions to this have included Russia 1998, Ukraine 1998 and Uruguay 2003. See Federico Sturzenegger and Jeromin Zettelmeyer, ‘Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998–2005’ (2008) 27(5) *Journal of International Money and Finance* 780.

<sup>10</sup> International Monetary Fund, ‘Review of Fund Facilities - Analytical Basis for Fund Lending and Reform Options’ Policy Paper (6 February 2009) <<http://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Review-of-Fund-Facilities-Analytical-Basis-for-Fund-Lending-and-Reform-Options-PP4322>> last accessed 2 August 2018.

<sup>11</sup> Alex Rieffel, *Restructuring Sovereign Debt* (Brookings Institution Press 2003).

Another set of considerations relates to the collateral effects of a debt restructuring. While restructuring local-law governed debt may be easier from a legal perspective, this debt may be disproportionately held by local institutions such as domestic banks. A restructuring of that debt may undermine the health of the banking system and worsen the prospects for restoring economic growth. Governments may also have political incentives to avoid or minimize the restructuring of domestically held debt. Those claims are often held by voters or political insiders. On the other hand, focusing a restructuring exclusively on domestic debt may help to reduce the reputational costs in the eyes of the international capital markets. Countries with a strong desire to maintain access to external borrowing may therefore have an incentive to restructure domestic debt before contemplating a restructuring of debt held mainly by external creditors. One example is Russia's 1997 default and subsequent restructuring which excluded foreign law bonds issued by the Russian Federation.<sup>12</sup>

Restructuring foreign-law governed bonds will require other tools to limit holdout behavior (see "Carrots" and "Sticks" below) because the sovereign debt cannot unilaterally change the terms of the bonds by legislative fiat, as it can with domestic-law governed bonds. An attempt to place the major weight of the restructuring on creditors with foreign-law governed debt, however, may give rise to inter-creditor equity concerns. Foreigners may refuse to agree to restructuring terms that effectively subsidize full payments to creditors holding domestic-law governed debt.

As a category, "domestic debt" is becoming more difficult to define. Traditionally, domestic debt was governed by domestic law, denominated in local currency, and locally held, while "external debt" was foreign-law governed, held abroad, and denominated in foreign currency. These lines have blurred in recent years, with non-resident creditors holding domestic-law governed debt (denominated in either local or foreign currency), and with resident creditors holding foreign-currency denominated, foreign-law governed debt.<sup>13</sup>

#### IV. Preparing the restructuring proposals

The sovereign debtor, as the party seeking to modify the terms of its existing debt contracts, will be responsible for preparing proposals -- often captioned "Indicative Restructuring Scenarios" -- that lay out both the overall quantum of debt relief the sovereign will be seeking from private creditors as well as the methods (haircuts, maturity extensions, coupon adjustments etc.) by which that relief will be

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<sup>12</sup> Sturzenegger and Zettelmeyer (n11) and Carmen M. Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, (Princeton University Press 2009).

<sup>13</sup> For a discussion of this, see Anna Gelpern and Brad Setser, 'Domestic and External Debt: The Doomed Quest for Equal Treatment' (2004) 35 *Georgetown Journal of International Law* 795.



conveyed. Behind the curtain, these proposals will have already been vetted by the IMF team working on the country's fiscal adjustment program to ensure consistency with the terms of that program. The release of Indicative Restructuring Scenarios is intended to serve several purposes:

- The Scenarios will psychologically prepare the creditors for the level of debt relief the sovereign will be seeking – helping to reduce “sticker shock” once a specific debt exchange offer is made.
- Having run the Scenarios up the proverbial flagpole, the sovereign will proceed to count the number of equally proverbial bullet holes that the documents display when they are taken down and analyzed.
- Release of the Scenarios marks the beginning of a formal negotiation process with the creditors. In the parlance of the investment bankers, the Scenarios represent the debtor's “ask” in the coming negotiations.

A sovereign will have a choice in how to release its Indicative Restructuring Scenarios. If the Scenarios describe the proposed treatment of bonds or other securities, the Scenarios will constitute material non-public information (“MNPI”) within the meaning of the securities laws (because they signal the maximum amount of debt relief the sovereign will be requesting). Sharing the Scenarios with selected creditors or with a creditors' committee will therefore require the sovereign to obtain non-disclosure/stop trading agreements from the institutions receiving the MNPI. The other alternative, putting the Scenarios on a public website, avoids the need for non-disclosure agreements but comes with its own risk. Once in the public domain, the Scenarios will later permit the government's critics to compare the government's opening position (as revealed in the Scenarios) with the terms of the final deal; the difference will represent the nature and extent of the government's negotiating concessions.

#### V. The negotiation process

Once a sovereign debtor concludes that a restructuring is inevitable, the challenge becomes reaching a deal with creditors. This can sometimes be relatively easy if the sovereign has a simple debt profile and a relatively homogenous creditor base (*e.g.*, Moldova, 2003, Seychelles, 2009). In the context of a complex debt structure and widely diverse creditors (with banks, bondholders, hedge funds, suppliers, trade creditors, contractors, etc.) (*e.g.*, Iraq, 2005), however, arriving at an agreement on restructuring terms palatable to all creditors may be extraordinarily challenging.

## Engagement with Official Sector Creditors

The principal international forum for restructuring official bilateral claims is the Paris Club<sup>14</sup>, an informal group of 22 creditor countries that have worked together since the 1950s to find coordinated and sustainable solutions to countries' debt problems. (See Box).

The Paris Club has six main principles that underlie and guide its work. These include *solidarity* (that members shall act as a group); *consensus* (that decisions are taken by consensus); *information sharing* (that members share views and information); *case-by-case approach* (that decisions will be tailored to each individual debtor); *conditionality* (in particular, that the country must have an appropriate IMF-supported program), and *comparability of treatment*.<sup>15</sup> The latter principle states that a debtor country that signs an agreement with its Paris Club creditors should not accept from its private - and non-Paris Club creditors terms of treatment of its debt less favorable to the debtor than those agreed with the Paris Club. This means, in essence, that these creditors must use the Paris Club terms as the baseline for their own negotiations.<sup>1617</sup>

A significant portion of new official bilateral lending now comes from non-Paris Club countries such as China and India. Unless the non-Paris Club creditors agree to restructure their credits within the Paris Club on an ad hoc basis, the sovereign borrower will need to negotiate bilaterally with each lending country. This uncoordinated process for restructuring bilateral debts is both painful and costly.

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<sup>14</sup> See G20 Hangzhou Leaders' Summit Communiqué, September 4-5, 2016 and G20 Finance Ministers and Central Bank Governors' Meeting Communiqué, March 19-20, 2018

<sup>15</sup> <http://www.clubdeparis.org/en/communications/page/the-six-principles>

<sup>16</sup> The Paris Club Agreed Minute will include the following clause: "In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Republic of Ruritania commits to seek promptly from all its external creditors debt reduction and reorganization arrangements on terms comparable to those set forth in these Agreed Minutes, while trying to avoid discrimination among different categories of creditors. Consequently, the Government of the Republic of Ruritania commits to accord all categories of creditors -- and in particular creditor countries not participating in these Agreed Minutes, and private creditors -- a treatment not more favorable than that accorded to the Participating [Paris Club] Creditor Countries."

<sup>17</sup> <http://www.clubdeparis.org/en/communications/page/what-does-comparability-of-treatment-mean>

### The Paris Club: Evolution in Debt Treatment

The Paris Club has concluded 433 successful negotiations with 90 countries over the last sixty years.

From its first debt treatment in 1956 to the late 1980s, the Paris Club mostly dealt with countries that were facing liquidity crises. Therefore, until 1987, all agreements were reached under the “**Classic terms**”: non-concessional reschedulings with a repayment profile negotiated on a case-by-case basis, but with no nominal debt relief. These reschedulings supported countries with IMF adjustment programs.

With the 1980’s debt crisis, lower and middle-income countries started to face deeper debt sustainability challenges. The Paris Club thus softened its terms by creating the **Venice<sup>1</sup> terms** in 1987, which lengthened repayment and grace periods. **Toronto terms** were created in 1988 for the most heavily indebted and poorest countries and enabled concessional treatments by providing debt cancellation for the first time (33% cancellation of non-ODA (Official Development Assistance) credits and very concessional rescheduling of ODA claims)). In 1990, Paris Club creditors created the **Houston terms**, designed for lower-middle-income countries, which lengthened repayment periods (non-ODA repayment periods lengthened to 15 years and ODA repayment periods lengthened up to 20 years with a maximum of 10-year grace), allowed ODA credits to be rescheduled at a concessional rate and enabled debt swaps on a bilateral and voluntary basis for ODA claims. Considering that debt vulnerabilities were still high in 1991 for low income countries, the Paris Club replaced its Toronto terms by the **London terms** which raised debt cancellation rate from 33% to 50%.

With the adoption of increasingly concessional terms, the Paris Club recognized that the external debt situation of low-income countries, mostly in Africa, had become extremely difficult and deterred future economic growth. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction -- together with continued provision of concessional financing and pursuit of sound economic policies -- were deemed not sufficient to reach sustainable external debt levels within a reasonable period of time and without additional external support.

Thus, in 1994, the Paris Club decided to treat the debt stocks of some countries by creating the **Naples terms**, which replaced London terms. For the poorest and most indebted countries, the level of cancellation was at least 50% and could be raised to 67% of eligible non-ODA credits. The rescheduling of ODA claims was further lengthened up to 40 years. The level of cancellation was again raised (up to 80%) for non-ODA claims with **Lyon terms** in 1996. Under these terms, stock treatments were implemented for the very first time for countries having established a satisfactory track record with both the Paris Club and IMF and for which there was sufficient confidence in their ability to respect the debt agreement.

In 1996, the international financial community realized that the external debt of a number of mostly African low income countries had become unsustainable and launched the **Initiative for Heavily Indebted Poor Countries (HIPC)**, which aimed to place the debt of the poorest and most indebted countries on a sustainable path, notably by including in debt treatments multilateral claims which never had been restructured before. In 1999, Paris Club creditors decided to reinforce the HIPC initiative to provide faster and broader debt cancellation to a large number of countries. Consequently, the Paris Club replaced its Lyon terms by **Cologne terms** which raised debt cancellation rate of non ODA claims, for countries declared eligible to the enhanced HIPC initiative, from 80 to up to 90% or more on a case-by-case basis. On top of that, all Paris Club creditors agreed to provide additional efforts to the HIPC Initiative assistance, on a bilateral basis.

Meanwhile, in 2003, Paris Club creditors agreed on a new approach, the **Evian Approach**, to deal with non-HIPC countries, providing them with more tailor-made (phased) and concessional treatments. Under this approach, a debt treatment may take various forms depending on the results of the IMF’s debt sustainability analysis: flow treatment, stock reprofiling, and stock reduction (in exceptional cases). Treatments would be phased to ensure that countries would only fully benefit from concessional treatment if they maintained a sound track record on its IMF-supported programs over time.

## Engagement with Commercial Creditors

The sovereign must decide whether, and how, to engage with committees of representative creditors that may have been formed to negotiate with the sovereign on the creditors' behalf.<sup>18</sup> Creditors' committees play a central role in corporate debt workouts and are mandated under certain insolvency laws such as Chapter 11 in the United States.<sup>19</sup> Their use in sovereign debt restructurings, however, has varied. Creditor committees with a negotiation mandate were standard in the 19<sup>th</sup> and early 20<sup>th</sup> centuries and in the commercial bank-led debt restructurings between the late 1970s and mid-1990s. When sovereign bond restructurings began in the late 1990s, however, creditor committees generally fell into disuse. Debtor countries usually opted for informal consultations with individual creditors or groups of creditors. Creditor committees have reappeared more recently in sovereign bond restructurings (e.g., in Greece 2012 and Ukraine 2015).

The use of creditor committees in sovereign debt workouts can be a surprisingly contentious issue. By "recognizing" a creditor's committee, the sovereign is implicitly agreeing that it will negotiate the terms of the debt restructuring with that body. The connotation of the word "negotiate" in this context is that the sovereign will not make a formal offer to its creditors without the prior approval of the committee. If discussions bog down, or if members of the committee insist on features that the authorities simply cannot accept (e.g., a requirement that the sovereign also restructure its multilateral debts), then the sovereign's ability to complete its debt restructuring will be blocked, possibly for a long time.

The alternative to a formal negotiation with a creditors' committee is for the sovereign debtor and its advisors to consult with individual creditors or small groups of creditors to determine what financial terms are likely to be supported by a broad majority of the creditor universe. Without a formal endorsement of terms by a creditor committee, of course, the sovereign runs the risk that its market soundings in these consultations may prove inaccurate and the restructuring offer will fail. One school of thought therefore holds that a sovereign will be under pressure to be *more* generous (to the creditors) in the terms offered following an informal consultation process than it would have been after a formal negotiation process with a committee.

Creditors are generally in favor of committees. The Institute for International Finance (the "IIF") has endorsed the use of committees and published

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<sup>18</sup> See Lee C. Buchheit, 'Use of Creditor Committees in Sovereign Debt Workouts' (2009) 10(3) *Business Law International* 205 and Timothy B. DeSieno, 'Creditor Committees in Sovereign Debt Restructurings: Understanding the Benefits and Addressing Concerns' in Martin Guzman, José Antonio Ocampo and Joseph E. Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press 2016).

<sup>19</sup> 11 USC § 1102.

best practices for their formation and operation.<sup>20</sup> Creditors have also advocated the incorporation of so-called “engagement clauses” in sovereign bond contracts. These are contractual commitments to recognize the formation of a creditors’ committee upon sovereign default or other signs of difficulty. Such clauses may also require the issuer to negotiate in good faith with the committee and to pay the costs of incurred by the committee.<sup>21</sup> For various reasons, few sovereign issuers have included such clauses in their bond contracts.<sup>22</sup> If the IMF is providing financing to the sovereign, then the negotiation process between a sovereign and its creditors will implicate the IMF’s arrears policies. These include both the Lending into Arrears (LIA) policy and the Lending into Official Arrears (LIOA) Policies, which establish norms for a sovereign’s engagement with its commercial private and official bilateral creditors, respectively, in a post-default scenario. The policies are designed to encourage a sovereign to engage constructively with its creditors to reach agreement on a debt restructuring, and discourage creditors from holding out of a fairly negotiated deal. (See Box).

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<sup>20</sup> The IIF, according to its website, is the global association of the financial industry, with close to 450 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks. For the Principles, see Institute of International Finance, ‘Principles for Stable Capital Flows and Fair Debt Restructuring’ Report on Implementation by the Principles Consultative Group (October 2016), Annex I < <https://www.iif.com/publication/regulatory-report/2016-report-implementation-principles-consultative-group>> last accessed 1 August 2018.

<sup>21</sup> See International Capital Market Association, ‘Standard Aggregated Collective Action Clauses (“CACs”) For the Terms and Conditions of Sovereign Notes’ (August 2014) <<https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/primary-market-topics/collective-action-clauses/>> last accessed 1 August 2018. (hereinafter ICMA CACs)..

<sup>22</sup> See Deborah Zandstra, ‘Creditor Engagement in Sovereign Debt Restructuring (April 2016), Clifford Chance Client Briefing, [https://www.cliffordchance.com/briefings/2016/04/creditor\\_engagementinsovereigndeb.html](https://www.cliffordchance.com/briefings/2016/04/creditor_engagementinsovereigndeb.html).

### The IMF's Arrears Policies

**Lending Into Arrears Policy:** The LIA policy allows the IMF to lend to a sovereign with arrears to external private creditors, only if the member is making a “good faith effort” to reach a collaborative agreement with its private creditors. While the policy does not outline exactly what type of behavior constitutes “good faith,” it does implicitly set expectations about the extent of the dialogue between the debtor and its creditors.

**Lending Into Official Arrears Policy:** The negotiations between a debtor and its official bilateral creditors take place in the shadow of the IMF's lending into *official* arrears policy (the “LIOA” policy). The IMF traditionally had a strict policy of non-toleration of unresolved arrears to official bilateral creditors. In light of changes in the official creditor landscape -- whereby the majority of official sector financing to low income countries is now provided by non-Paris Club creditors -- the policy was amended in 2015 to allow the IMF to lend into unresolved official arrears when *any* of the following criteria are met: (i) the creditors consent; (ii) there is a representative Paris Club agreed minute; (iii) if there is no representative Paris Club agreed minute, the debtor is negotiating in good faith with the creditor to resolve the arrears and the IMF's decision to provide financing despite the arrears would not have an undue negative effect on its ability to provide financing in the future.

Official bilateral creditors covered by the anticipated terms of the Club's “Agreed Minute” are deemed resolved for Fund program purposes. Relying on the Paris Club's comparability of treatment principle, the Fund deems that non-Paris Club official bilateral creditors will restructure the member's debt on similar terms as the Paris Club creditors.

## VI. Creditor objectives and constraints

Commercial creditors typically approach a sovereign debt workout with the following objectives and constraints:

- (i) If a class of creditors (like trade creditors or Treasury bill holders) can talk their way out of participating in a debt restructuring that is, for them, the best option, but it will be proportionally bad for all the other creditors. A debt restructuring is a zero-sum game. The sovereign will need a certain level of debt relief. If one creditor or class of creditors is exempted from the process, the other creditors will have to make additional contributions to cover the shortfall. Accordingly, the basic rule for a creditor is this -- if you can jolly your way out of a debt restructuring, great; but if you can't, then do all in your power to ensure that as many other creditors as possible are also roped into the process.

- (ii) The basic logic of a debt restructuring for the creditors is simple -- accept some degree of debt relief in order to enhance the collectability of the balance of the exposure. That logic, however, requires a judgment about how much debt relief will be required, in combination with fiscal adjustment and official sector support, to return the sovereign to a sustainable position. This is usually where the IMF comes in. The creditors will look to the Fund to vouchsafe (implicitly) that the amount of debt relief being requested from them is sufficient to achieve sustainability but not more than is necessary to reach that point.
- (iii) Creditors watch each other warily. No creditor wants to be embarrassed by giving more debt relief than other similarly-situated creditors. This instinct inexorably leads to calls for measures designed to assure parity of treatment among different types of creditors.<sup>23</sup> (See below, “Parity of treatment undertakings”.)
- (iv) Finally, once debt relief has been given, the creditors will want to do everything they can to prevent backsliding by the sovereign debtor. An IMF program may help to enforce fiscal discipline, but only for a while. Over the longer term the creditors will need to look to contractual protections (such as financial covenants and events of default) to impose behavioral discipline on their sovereign borrowers. In truth, however, these are crude and frequently ineffective tools.

## VII. Methods and techniques

Open the toolbox of a sovereign debt restructurer and you are likely to find three main tools:

- change the maturity dates for amounts of principal or interest falling due under the affected debts and introduce grace periods,

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<sup>23</sup> Lee C. Buchheit, ‘The Search for Intercreditor Parity’ (2002) 8 Law and Business Review of the Americas 73.

- reduce the principal amount of the debt (in the jargon, a principal “*haircut*”), and
- reduce the interest rate on the debt (in the case of bond indebtedness, a “*coupon adjustment*”).<sup>24</sup>

It is possible, of course, to mix and match these techniques (for example, a maturity extension with a coupon adjustment) and this is indeed the norm in most sovereign debt restructuring packages.

For their part, creditors can be expected to express strong views about the method chosen to address a sovereign’s debt problem. Principal haircuts are particularly disfavored by commercial creditors. When the restructuring involves only a maturity extension and/or a coupon adjustment, a post-closing improvement in the sovereign’s financial prospects and credit rating will directly benefit creditors because the secondary market value of the *entire* principal amount of their claims against the country will increase. Principal haircuts, however, involve a forfeiture by the creditor of portion of that claim. A subsequent improvement in the credit rating of the country can therefore lift the value of only the residual principal amount of the claim. This explains why transactions calling for principal haircuts are more likely to involve the issuance of some form of “value recovery instrument” (see Part \_\_\_ below) that will permit creditors to recoup a portion of their loss if the economic fortunes of the sovereign debtor improve in the future.

One restructuring technique that has received recent attention involves a “*reprofiling*” of maturities (that is, a relatively short extension of the maturity dates of affected debt instruments), often with interest rates left untouched during the extension period. The classic example is Uruguay’s debt restructuring of 2003. Uruguay extended the maturity date of each of its 18 bonds issued in the international markets by a uniform five years, while leaving the coupon rates during this extension period the same as those on the bonds as originally issued.<sup>25</sup> In 2016, the IMF endorsed the use of a reprofiling technique in situations where the Fund is providing exceptional access to its financing, and cannot determine with high probability whether the sovereign’s debt is sustainable.<sup>26</sup> The reprofiling shifts the

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<sup>24</sup> Other techniques for achieving debt relief are sometimes possible. For example, when the sovereign’s debt obligations are trading at a significant discount to face value in the market, the sovereign borrower -- if it has a funding source -- may attempt to repurchase the instruments and thus benefit from that discount. This was the method employed by a number of HIPC countries to reduce their commercial debts. Funding for those HIPC buybacks came from official sector grants.

<sup>25</sup> Lee C. Buchheit and Jeremiah S. Pam, ‘Uruguay’s Innovations’ (2004) 19 *Journal of International Banking and Regulation* 28. (hereinafter Buchheit and Pam, ‘Uruguay’s Innovations’).

<sup>26</sup> See International Monetary Fund, ‘The Fund’s Lending Framework and Sovereign Debt—Further Considerations’ (9 April 2015), <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/The-Fund-s-Lending-Framework-and-Sovereign-Debt-Further->



maturities of existing debts out of the IMF's program period, thus obviating the need to fund those maturities with official sector resources.<sup>27</sup>

## VIII. The Holdout Creditor

For the vast majority of private sector creditors affected by a sovereign's financial distress, accepting a restructuring of their claims is the only practicable solution. The sovereign debtor will lack the resources to pay all of its debts on their original terms; that's pretty much the definition of financial distress. Turning all or any significant part of those claims into court judgments does not alter this hard fact. The sovereign will not have the money to pay all claims in full regardless of whether the claimants transform themselves from simple creditors into judgment creditors.

But what is inescapable for the broad majority of creditors (a negotiated, consensual workout) can be an attractive business opportunity for the few or the one lender that is prepared to break ranks with fellow creditors. The theory is simple. If the sovereign debtor receives debt relief from most of its lenders, this will increase the likelihood that the sovereign will have the money to pay off an importunate maverick creditor that declines to join the restructuring and threatens to pursue legal remedies. In the jargon of sovereign debt restructuring, these maverick creditors are "holdouts" from the main restructuring exercise.

There is a popular belief that holdout creditors attempt to delay or derail sovereign debt restructurings. They don't. Indeed, the holdout creditor prospers only if all or most of its fellow creditors agree to provide debt relief to the sovereign; the more debt relief the better from the standpoint of the holdout. If the holdout population in a sovereign debt restructuring is of any significant size, the financial predicates behind the entire exercise are undermined and the holdout's prospects of extracting a preferential recovery diminish. By their very nature holdouts are individualistic and do not regulate themselves as a group. Even if holdouts will not derail a debt restructuring, they can cause considerable mischief after it closes. The sovereign debtor's job is therefore to employ some combination of carrots and sticks (discussed below) in order to reduce the size of any holdout population in a debt restructuring and to neutralize, to the extent possible, the extent of any post-closing mischief.

The relationship of holdouts to those creditors who elect to join a sovereign debt restructuring has altered over the years. Once upon a time the

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[Considerations-PP5015](#), and 'The Fund's Lending Framework and Sovereign Debt - Preliminary Considerations' Policy Paper (23 May 2014), <http://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/The-Funds-Lending-Framework-and-Sovereign-Debt-Preliminary-Considerations-PP4871> last accessed 2 August 2018.

<sup>27</sup> *Id.*

investor community welcomed, or at least tolerated, the threat of holdout creditors in a sovereign debt workout. The prospect of litigious holdouts, the argument went, would induce the sovereign debtor to offer more generous financial terms to all of its creditors in an attempt to narrow or eliminate the holdout class. Choose your idiom. Holdouts, although perhaps insufficiently infused with fraternal creditor spirit, were none the less the pebble in the shoe, the burr in the saddle, the bee in the bonnet that kept sovereign debtors from demanding excessive amounts of debt relief from the creditor class as a whole.

Those days are over. The perception of holdouts as benign spurs to sovereign debtor restraint ended in 2012 in the context of the Argentine saga. In that year, some of the holdouts from the Argentine debt restructuring of 2005 sought and obtained an injunction from a US federal court effectively preventing Argentina from making payments on the new bonds it had issued in that restructuring to participating creditors unless it was prepared to pay in full the litigious holdouts. The holdouts had thus turned on their fellow lenders. Not only were the holdouts demanding a preferential recovery indirectly funded by the generosity of their quondam fellow creditors, they were now forcing the debtor to default on those indulgent creditors unless the holdouts were paid off in full. Post-Argentina, the suppression of holdout creditor behavior has therefore become an imperative not only for sovereign debtors but also for the vast majority of their other lenders.

## IX. Encouraging creditor participation

Sovereign debtors sometimes attempt to cajole their lenders into granting debt relief, sometimes they bludgeon them into doing so, and occasionally they try to do both at the same time.<sup>28</sup>

### **Carrots**

Cajoling usually involves adding sweeteners to the restructuring package to entice widespread creditor participation. Naturally, these sweeteners can operate only at the margin. By its very nature a sovereign debt restructuring will be distasteful for the lenders caught up in the exercise.

#### *Cash (or cash equivalents)*

The transaction sweetener with the highest saccharine content will be cash or a cash equivalent like high-quality short-term debt obligations of a third party. Cash can be used to pay down outstanding principal, to reimburse accrued but unpaid

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<sup>28</sup> See generally, Lee C. Buchheit & Elena L. Daly, *Minimizing Holdout Creditors: Carrots and Minimizing Holdout Creditors: Sticks* in *Sovereign Debt Management* (Rosa M. Lastra, Lee C. Buchheit eds. 2014).

interest or to pay “participation fees” to the creditors joining the restructuring. The problem, of course, will be funding. The one commodity that will be in short supply for a country embarking on a restructuring of its external debt is foreign currency. There have been cases (Greece in 2012 is the most recent example) where official sector sources have been prepared to lend a sovereign debtor the cash (or cash equivalent) needed to sweeten its offer to commercial creditors.<sup>29</sup>

#### *Value recovery instruments*

Lenders may argue that they are being asked to defer or reduce their claims when the country is at the nadir of its economic fortunes. What happens, however, if the economy of the debtor country improves in the future? Isn't it fair, the creditors will ask, that they recoup some portion of the financial sacrifice they will have endured in the debt restructuring to make that future prosperity possible?

This sentiment has led to the inclusion in the financial packages offered to private creditors in a number of sovereign debt restructurings of what are generically called “value recovery instruments” or “VRIs”. VRIs most prominently made their appearance during the Brady era, when commercial banks were asked to accept haircuts on their long-outstanding sovereign loans. In the Brady packages for oil exporting countries like Mexico, Venezuela and Nigeria, participating creditors were offered warrants linked to the price of oil. The theory was that if the price of oil in the future exceeded an inflation-adjusted benchmark price, this would be a fair proxy for concluding that a degree of prosperity had returned to the debtor country. In that situation, the argument went, it would be only fair that the sovereign begin making payments on warrants issued at the time of the restructuring.

In countries that did not rely on the export of a single commodity like oil for a significant portion of foreign currency earnings, creditors occasionally insisted on receiving an instrument (or a feature) linked to the debtor country's future Gross Domestic Product. Costa Rica included such a feature in its commercial bank debt restructuring in 1989. If Costa Rica's GDP in any future year (subject to caps and a sunset provision) exceeded 120% of the 1989 level of GDP in real terms, additional payments would be due on the restructured debt. Uruguay in its Brady deal of 1991 issued instruments that paid off if the benchmark price of a basket of Uruguayan commodity exports (deflated by the price of oil -- an import) exceeded a target level. Other countries that incorporated a GDP-linked instrument or feature in their debt restructuring packages were Bulgaria (1994), Bosnia and Herzegovina (1997), Argentina (2005/2010), Greece (2012) and Ukraine (2015).

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<sup>29</sup> Jeromin Zettelmeyer, Christoph Trebesch and G. Mitu Gulati, ‘The Greek debt Restructuring: An Autopsy’ (2013) 28(75) *Economic Policy* 513

### *Loss reinstatement features*

One of the perennial worries in sovereign debt workouts, for both official and commercial lenders, is the problem of the backsliding sovereign. What happens if, once the debt restructuring is completed, the sovereign borrower reverts to the behavior and policies that landed the country in a debt crisis in the first place? Moreover, all sovereign debt restructurings are premised on an unspoken covenant. The creditors grant debt relief on the assumption that the sovereign will perform its obligations on the new terms embodied in the debt restructuring. If the sovereign breaches its side of that covenant by defaulting again on its restructured debt, should not the lenders be restored to their positions status quo ante the restructuring?

One technique for commercial lenders to address this concern is called a “principal reinstatement” feature. It provides that if a debtor country seeks another round of restructuring of the same debts in the future, some or all of the principal amount forgiven in the first round will balloon back, thus allowing the lenders to come to the negotiating table in the second round with their original claim unimpaired. Ecuador first used this technique in its debt restructuring in 2000. Belize included a principal reinstatement feature in its 2013 restructuring. A similar concept was used by the Seychelles (2010) and by St. Kitts and Nevis (2012), although in those cases the restoration of principal would have been triggered by a failure of the debtor country to implement its IMF program.

### *Parity of treatment undertakings*

Lenders don’t like to look foolish. And nothing makes them look more foolish than getting caught granting a sovereign borrower significant debt relief while other, similar-situated, lenders avoid doing likewise. This paints the participating institutions as gullible, incompetent patsies. In extreme cases, some lenders may refuse to participate in a debt restructuring unless this risk can be addressed.

The architects of a sovereign debt workout may attempt to reduce the lenders’ anxiety by including in a restructuring package a covenant promising that other lenders will not be given preferential treatment. The most famous example of such a provision, discussed above in the section on engagement with official creditors, is the “comparable treatment” clause in a Paris Club Agreed Minute (see above). A more notorious version of a parity of treatment clause in a restructuring of commercial debt is Argentina’s 2005 Rights Upon Future Offerings (RUFO) clause. It reads as follows:

*Rights upon Future Offers. . . . [I]f at any time on or prior to December 31, 2014, the Republic voluntarily makes an offer to purchase or exchange (a “Future Exchange Offer”), or solicits consents to amend (a “Future Amendment Process”), any outstanding Non-Performing Securities, each Holder of Securities*

*shall have the right, for a period of 30 calendar days following the announcement of any such Future Exchange Offer or Future Amendment Process, to exchange any of such Holder's Securities for (as applicable):*

*(i) the consideration in cash or in kind received by holders of Non-Performing Securities in connection with any such Future Exchange Offer, or*

*(ii) debt obligations having terms substantially the same as those resulting from any such Future Amendment Process, . .*

..

Unlike the Paris Club “comparable treatment” approach, which prohibits offering sweeter deals to other creditors, commercial lenders word these clauses as a covenant to give participating lenders the benefit of any sweeter deal that may be offered down the road to holdouts. This difference in approach reflects two different underlying visions:

- Commercial lenders are driven by a fear of legal liability. They worry that forcing a borrower to promise that it will not pay other lenders on preferential terms might be portrayed as a tortious interference with the borrower’s contracts with those other lenders.
- The Paris Club approach is driven by long-term balance of payment considerations: it aims at ensuring that the debt restructuring it provides is in line with the framework identified by the IMF to fill in the financing gap of the debtor country, and that it will not lead to more payments to other creditors instead of restoring the financial situation of the debtor country.

The syndicated loan agreements in the 1980s ensured no single bank would receive preferential treatment in a subsequent restructuring by including “sharing clauses”. These clauses aimed to: (a) prohibit the borrower from discriminating against the lenders by making payments to only some and not all the lenders; and (b) discourage a syndicate member from unilaterally enforcing its rights under the loan syndication since it will be liable to share the proceeds of the litigation. However, the clauses ultimately began to inhibit the ability of sovereign borrowers to negotiate debt relief arrangements with willing lenders. Debt-for-debt exchange clauses were subsequently added to restructuring agreements, to allow the debtor to exchange bank debt for bonded debt (and eliminating the sharing clauses in the meantime), giving way to the Brady deals of the late 1980s that ended the debt crisis of the era and was the advent of bonded debt as the primary form of sovereign lending. See Case Study: Mexico 1987.

## Mexico 1987

### Innovation – Debt-for-debt exchange clauses

The sovereign debt restructuring agreements of the 1980s were hugely centripetal. They forced the commercial banks that had originally lent to a sovereign borrower individually or as part of a syndicated loan into massive restructuring agreements to which hundreds of banks might be parties. The smaller banks and the regional banks, however, were wary of this forced togetherness. They feared that in a pinch their larger bank colleagues -- those enjoying close relationships with the sovereign debtors -- might find a way to get themselves paid while leaving the little guys behind. To assuage these concerns, the restructuring agreements contained a battery of clauses designed for one purpose -- to ensure that no bank could receive better treatment for its share of the loan than that enjoyed by all the other banks. A good example was the sharing clause. This provision required any bank that received a disproportionate payment of its loan to share those funds ratably with all the other lenders.

By the end of the decade of the 1980s, however, these contractual provisions requiring equal treatment of all banks began to inhibit the ability of sovereign borrowers to negotiate debt relief arrangements with willing lenders. A lender could not, for example, offer to write off a portion of its loan in return for the pledge of collateral security for the balance.

In 1987, Mexico secured the consent of its Bank Advisory Committee to include in the country's debt restructuring agreements a seemingly innocuous clause permitting qualified debt-for-debt exchanges. As drafted, this clause permitted the debtor to exchange any bank's interest in the restructured loan for a new debt instrument as long as the average weighted life of the new instrument was greater than the average weighted life of the debt it was replacing. Importantly, the clause was explicit in severing the sharing clause and negative pledge clause links between the new instrument and the old restructuring agreement.

Debt-for-debt exchange provisions quickly found their way into the restructuring agreements of other countries like the Philippines and Venezuela. They proved to be the most significant legal innovation of the late 1980s. Debt-for-debt exchange clauses paved the road for the introduction of the Brady Plan in 1989 (which ended the Latin American debt crisis starting in 1990).

*Credit enhancement*

The present value of bonds issued in a sovereign debt restructuring (the “new bonds”) will be enhanced if the sovereign debtor can persuade a creditworthy third party to issue a partial guarantee of amounts due under the bonds or if the sovereign can post collateral security for the new bonds. An example of the former technique is the Republic of the Seychelles 2010 debt restructuring in which new bonds of the Republic benefited from a partial guarantee issued by the African Development Bank. The most prominent examples of sovereign bonds that benefited from collateral security are the Brady bonds issued in the 1990s. Most Brady bonds were secured as to principal due at maturity by the pledge of U.S. Treasury zero-coupon obligations (or an equivalent high-grade issuer) and some also benefited from the pledge of cash collateral to achieve a rolling partial interest guarantee.

*Contractual improvements.*

A sovereign looking to encourage private creditor participation in a debt restructuring may be able to offer its lenders a sweetener in the form of an upgrade in contractual terms. If the original debt instruments that the sovereign is attempting to restructure have less-than-fully-robust legal protections for the holder (such as a choice of the sovereign’s own law as the governing law of the instrument; submission to the jurisdiction of local courts; the absence of cross-default protections; etc.), these infirmities may be corrected in the new instruments issued in the restructuring.

The most visible recent example of such an upgrade occurred as part of the Greek debt restructuring of 2012. Most of the bonds affected by that restructuring were governed by Greek law, a feature that facilitated their restructuring with the help of a legislatively-imposed “class voting mechanism” (in effect, a “stick”, see Box below). As part of the restructuring, however, the Greek Government offered participating holders new bonds governed by English law (and thus not subject to the fiat of the Greek Parliament).

A much earlier example was the Russian “Prins /IANs” bond exchange of 2000. Unlike Greece, this transaction involved no upgrade in governing law (both old and new bonds were governed by English law). The old instruments, however, were bonds issued by a state-owned bank, Vnesheconombank, while the new instruments were Eurobonds of the Russian Federation enjoying all of the contractual features of bonds targeted to international markets (including expanded cross-acceleration clauses, see box). Eurobonds of this type had been issued by Russia since 1996 and constituted the only class of Russian Federation debt instruments that had survived Russia’s 1998-2000 default unscathed. The Russian authorities were therefore offering creditors a type of debt instrument that had never been tainted by default, suggesting that the authorities would have reasons to keep it default-free in the future (as has indeed been the case).

The technique of upgrading the legal characteristics of a debt contract to induce creditors to accept a restructuring offer was an essential feature of the Brady bond exchanges in the early 1990s. In all but two cases, the limited amount of bonds that had been issued by emerging market countries undergoing debt restructurings in the 1980s had continued to be serviced normally despite concurrent restructurings of bank loans, bilateral credits, trade lines and interbank deposits. For a time at least (lasting until the late 1990s), sovereign bonds enjoyed a halo that suggested (but did not promise) an exemption from future debt restructurings. As a condition to giving the debt relief required by the Brady Plan, the commercial bank lenders of that era therefore demanded a switch from their syndicated loans -- which had been serially restructured over the prior decade -- into new bonds, immediately dubbed "Brady bonds".



## Russia 2000

### Innovation – Contractual improvements

Following the collapse of the Soviet Union in 1992, Vnesheconombank (VEB) -- the agency responsible for the USSR's international trade and financial relations -- defaulted on foreign currency loans from Western banks. After several years of negotiation and partial payments, the Russian Federation, as the Soviet Union's legal successor, reached a restructuring agreement by which the banks' Soviet era claims were exchanged for a bundle of "Principal Bonds" (Prins), "Interest Arrears Notes" (IANs) and some cash. Prins and IANs remained foreign currency obligations of VEB (*without* an explicit guarantee of the Russian Federation).

That 1997 settlement was short-lived, however. Following the August 1998 Russian currency crisis, VEB missed payments on Prins in December 1998 and subsequently on both Prins and IANs. This triggered a new round of negotiation between Russia and its Bank Advisory Committee which led to the exchange, in August of 2000, of Prins and IANs for a set of new Eurobonds issued by the Russian Federation. One wag on the Russian negotiating team dubbed those new bonds "The Instruments Formerly Known as Prins". The new bonds involved significant reductions in both face value and present value, which made this the harshest post-Brady debt restructuring at the time.<sup>30</sup>

At the same time however, creditors received a set of Russian Federation Eurobonds that Russia had continued to service throughout the 1998-99 crisis, and whose contractual features arguably made them much safer than Prins and IANs. This included an upgrade in the obligor (now the sovereign directly, rather than VEB), as well as cross-acceleration clauses that implied that default on the new bonds would trigger default on any future issues of Russian Federation Eurobonds (and vice versa). As a result, the exchange attracted a very high participation rate (about 99 percent), in spite of the high haircut.

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<sup>30</sup> See Alejandro Santos, 'Debt Crisis in Russia: The Road From Default to Sustainability' in David Owen and David O. Robinson (eds), *Russia Rebounds* (International Monetary Fund 2003) 154; Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (MIT Press 2007); Sergei Gorbunov, 'The Russian Federation: From Financial Pariah to State Reformer' in Barry Herman, José Antonio Ocampo and Shari Spiegel, *Overcoming Developing Country Debt Crises* (Oxford University Press 2010).

## Sticks

Carrots, even juicy ones, can only go so far in enticing a deeply-dyed holdout to join a debt restructuring. Sovereigns also have more coercive tools in their arsenal to persuade otherwise unwilling creditors to join a deal. Most of these “sticks” are designed to resolve the collective action problems inherent in a debt restructuring process that must be undertaken in the absence of a formal bankruptcy code. Collective action problems can arise when the majority of creditors conclude that it is in their best interest to agree to a restructuring proposal but a few maverick lenders want to hold out in the hope of realizing a preferential recovery. If the perceived holdout risk is significant, creditors who would otherwise have agreed to participate in a restructuring may be unwilling to do so for inter-creditor equity and fiduciary liability reasons. Full payment of holdout creditors -- if the aggregate size of their claims is significant -- can also reduce the sovereign’s available resources to pay its restructured creditors. That will be salty insult added to the previous injury of the debt restructuring.

### *Implicit or explicit threats of nonpayment*

Behind every sovereign debt restructuring will be a threat, implicit or explicit, that holdout creditors will not be paid, or at least not paid anytime soon. Normally, this is done obliquely. A sentence along these lines is likely to appear in the disclosure document for the restructuring:

*Regrettably, the Republic of Ruritania does not now foresee the circumstances in which it will have the financial resources to pay in full any eligible claims that are not tendered in this restructuring.*

Some sovereigns, however, dispense with subtlety and deliver the message bluntly. The most famous example of this occurred in the Argentine bond restructuring of 2005. The Argentine Government went so far as to pass a law forbidding any payment or settlement with holdout creditors and the related disclosure document warned bondholders to abandon hope if they did *not* enter here (the debt restructuring).

Threats of nonpayment can be a powerful tool to achieve full (or near-full participation) in a debt exchange, provided it is combined with an exchange offer that is considered sufficiently attractive relative to the prospects of holding out.<sup>31</sup>

### *Collective Action Clauses*

Perhaps the most common tool for dealing with holdout creditors in sovereign bonds is the use of collective action clauses (“CACs”). CACs, long a

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<sup>31</sup> Ran Bi, Marcos Chamon M and Jeromin Zettelmeyer, ‘The Problem that Wasn’t : Coordination Failures in Sovereign Debt Restructurings’ (2016) 64(3) IMF Economic Review 471.

feature of bonds governed by English law, first made their appearance in sovereign bonds governed by New York law in the early 2000s. In their first-generation form, CACs enabled a qualified majority of bondholders of a specific bond issuance (typically 75 percent) to bind the minority *of the same issuance* to the terms of a restructuring.

While these first-generation “series-by-series” CACs were useful, they risked the possibility that a creditor, or a group of creditors, could obtain a blocking voting position in a particular series and thus nullify the operation of the CAC in that series. The vulnerability of first-generation CACs to holdout creditors was shown in the Greek restructuring of 2012. Holdouts obtained a blocking position in about half of Greece’s foreign law-governed bond series, thereby frustrating the operation of CACs.

Recognizing the limitations of series-by-series CACs, a few international sovereign bond issues provide for a limited form of aggregation in the form of “two-limb” CACs (see Case Study: Uruguay).

### Uruguay 2003

#### Innovation -- Aggregated Collective Action Clause

At the strong urging of the G-10 countries, collective action clauses were introduced into sovereign bonds governed by New York law starting with a United Mexican States bond issued in February 2003. Mexico used a conventional form of CAC that operated only within the four corners of the bond containing the clause. In a debt restructuring involving multiple series of bonds containing such clauses, a separate CAC vote would be needed for each series. This was a weakness of traditional CACs -- it can be relatively easy for holdout creditors to amass a 25% blocking position in a single series.

Four months after the Mexican issue, Uruguay restructured its international bonds in May 2003 and incorporated an “aggregated” CAC in the new instruments. The aggregated CAC permitted *all* holders of *all* series to vote together on a proposed restructuring, thus making it more difficult for a holdout creditor to accumulate a blocking position. The Uruguay clause became the model for so-called “two-limb” aggregated CACs such as those adopted ten years later by members of the European Monetary Union for use in all euro-area sovereign bonds issued after January 1, 2013.

These second-generation CACs still allow holdouts to control an issue, albeit with greater effort and cost. While the required 66⅔ percent threshold for each individual series under the aggregation clauses is easier to achieve than the

typical 75 percent threshold under series-by-series CACs, creditors may still obtain a blocking position with respect to a particular series. In such cases, the particular holdout series would be excluded from the restructuring, while the restructuring would still be carried out for other series so long as the two-limb voting thresholds are met.

In 2014, the international community endorsed the use of a menu of alternative voting procedures, including a third-generation style CAC: single-limb aggregated CACs. These CACs are now the standard market practice for bonds issued under New York and English law. Single-limb CACs have the benefit of requiring only a single vote calculated on an aggregated basis across all affected bonds. By eliminating the requirement of a series-by-series vote (i.e., the second limb), a single limb voting procedure removes the possibility of obtaining a controlling position within a particular issuance to block the restructuring of that issuance. While most international sovereign bonds issuances issued after 2014 have included single-limb aggregated CACs, a large stock of international sovereign bonds does not have them. Euro area sovereigns, for their part, are required by the ESM treaty to include two-limb aggregated “euro CACs”.<sup>32</sup>

#### *Exploiting the local law advantage*

Suppose a country wishes to restructure debt issued under its own law. This opens the possibility of the ultimate stick -- threatening to change the local law to facilitate the debt restructuring. As long as such legislative changes pass muster under the country’s constitution (particularly constitutional protections for property rights), and possible international agreements signed by the issuer, they should be valid. A change in local law is a risk that investors take when they buy local law-governed debt instruments.

For this reason, emerging market bonds targeted to foreign investors have generally been issued under foreign law, making the use of the local law advantage moot in external debt restructurings. Furthermore, even when foreign investors purchased local law debt in domestic financial markets, as was the case for the famous Russian GKO in 1996 and 1997, subsequent restructurings did not use the local law advantage, largely because local law instruments tended to be issued in domestic currency, making it easy to expropriate foreign holders through other means such as devaluation, inflation or capital controls.

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<sup>32</sup> See ‘Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring’ Policy Paper (2 September 2014) <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Strengthening-the-Contractual-Framework-to-Address-Collective-Action-Problems-in-Sovereign-PP4911> last accessed 2 August 2018

Recently, however, there has been an important exception -- sovereign debt instruments issued by euro area governments. Developed countries tend to issue most sovereign debt under local law, perhaps because investors trust the government not to exploit this feature to their advantage. At the same time, however, euro area sovereign debt is “foreign currency denominated” in the sense that the issuing country has no unilateral control over euro area monetary policy.

As a result, the use of the local law advantage could have practical implications in euro area debt restructurings and was in fact prominently used in the only major debt restructuring in the euro area so far: Greece in 2012. It was arguably the main reason why the Greek restructuring succeeded in achieving both a large haircut and a high participation rate (Zettelmeyer et al, 2013). Importantly, this success relied on the fact that the local law advantage was *not* used to change directly the payment terms of the bond being restructured -- which may have been illegal under the Greek constitution and/or the European Charter of Human Rights -- but rather to “retrofit” a class voting mechanism equivalent to a single-limb aggregated CAC, making it much easier to deter potential holdouts (see Box).

In principle, the same procedure could be used in future euro area debt restructurings. However, euro area governments have, since 2013, issued bonds that include a form of aggregate collective action clause, making it harder to argue that dealing with holdouts justifies a class voting mechanism that is legislated *ex post*.<sup>33</sup>

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<sup>33</sup> Sebastian Grund, ‘Restructuring Government Debt under Local Law: The Greek Experience and Implications for Local Law’ (2017) 12(1) Capital Markets Law Journal 253 and Lee C. Buchheit and G. Mitu Gulati, ‘Sovereign Debt Restructuring in Europe’ (2018) 9(S1) Global Policy 65.

## Greece 2012

### Innovation – Retrofit Class Voting Mechanism

In 2012, the Hellenic Republic faced the daunting task of restructuring more than €200 billion of Greek Government bonds in the hands of private investors. To comply with its undertakings to its official sector sponsors (the European Union and the IMF), Greece needed to inflict at least a 50% principal haircut on those bonds, achieve a creditor participation rate exceeding 90% in the restructuring, and complete the entire exercise within five months. A tall order, by anyone's reckoning.

But Greece had an advantage that no emerging market country has enjoyed in a previous sovereign debt restructuring. More than 90% of the Greek Government bonds subject to the restructuring were governed by Greek law (rather than a foreign legal system such as the law of England or the law of the State of New York). This gave the Greek Parliament the ability to enact domestic legislation to facilitate the coming debt restructuring. The question was how to use that local law advantage in a manner that would be acceptable, as a matter of policy and precedent, to Greece's official sector sponsors and would survive the inevitable legal challenges.

The solution took the form of domestic legislation that effectively corralled all of the holders of Greek law-governed bonds into a single class for purposes of voting on the eventual debt restructuring proposal. If holders of two-thirds (by value) of those instruments voted to accept the restructuring, that decision bound all members of the class. The Greek Parliament's action thus replicated—for the sovereign's own bonds—the class voting mechanism typically found in corporate insolvency regimes. Using this mechanism, all of Greece's eligible local law debt stock was successfully restructured in March 2012.

### *Exit consents*

Another way to discourage potential holdout creditors is the use of a technique called exit consents. It works as follows: all holders of the old bond are invited to exchange it for a new bond reflecting the terms of the restructuring. When agreeing to tender the old bond in exchange for the new bond, the holders are asked to consent to modification to the old bond that would make the old bond less attractive to prospective holdout creditors. Exit consent modifications may not amend any provisions of the bond that require unanimous consent (such as payment terms), but theoretically any other provision of the bond is fair game for a simple majority amendment. So, for example, an exit consent might be used to eliminate the requirement that the old bonds remain listed on a stock exchange, delete the *pari passu* clause, remove the acceleration remedy or repeal one of more events of default.

Exit consents in sovereign bond restructurings were first used in Ecuador's bond exchange in 2000, and in a streamlined form in Uruguay's 2003

restructuring.<sup>34</sup> Since the introduction of CACs in New York law bonds, however, the utility of the exit consent technique has diminished. Virtually any change to a material term of the bond will now be governed by the CAC.

### *Bond structures*

Issuers may reduce the threat of holdouts in the event of a restructuring by issuing bonds under a trust structure. Trust structures reduce the holdout threat by centralizing enforcement powers in the hands of the trustee. Trust structures may also have the benefit of shielding funds paid as debt service from attachment by creditors.<sup>35</sup> International sovereign bonds are typically issued under either fiscal agency agreements (FAAs) or trust structures. Under an FAA, the fiscal agent serves as an agent of the issuer, and its main responsibility is the making of principal and interest payments to the bondholders. Under trust structures (“trust indenture” under New York law or “trust deed” under English law), a bond trustee acts on behalf of, and has a number of responsibilities to, bondholders as a group. Historically, international sovereign bonds governed by New York and English laws tended to be issued under FAAs; as FAAs are marginally cheaper and easier to implement than trust structures. However, in recent years, the use of trust structures has increased, particularly in New York-law governed bonds.<sup>36</sup>

### *Protection of assets*

As noted at the beginning of the Chapter, in most countries—the United States and the United Kingdom included—sovereign assets enjoy significant protection from seizure by judgment creditors. This protection normally does not, however, extend to any assets that are used in commercial activity. For example, the proceeds of commodity sales by a sovereign—or a state-owned enterprise owned and controlled by a sovereign—are likely to be considered proceeds of the sovereign arising from commercial activity, and subject to attachment. Apart from legal immunities, countries faced with the prospect of litigious creditors sometimes take practical steps -- such as redirecting payment flows or changing ownership structures -- that are intended to shield vulnerable assets from attachment. One of the most extreme asset protection mechanisms was put in place during the Iraq restructuring,

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<sup>34</sup> See Lee C. Buchheit, ‘How Ecuador Escaped the Brady Bond Trap’ (2000) 19(12) *International Financial Law Review* 17; Buchheit and Pam (n31); Lee C. Buchheit and G. Mitu Gulati, ‘How to Restructure Venezuelan Debt (¿Cómo restructurar la deuda venezolana?)’ (2017) *Duke Law School Public Law & Legal Theory Series No. 2017-52* <[https://scholarship.law.duke.edu/faculty\\_scholarship/3758/](https://scholarship.law.duke.edu/faculty_scholarship/3758/)> last accessed 1 August 2018.

<sup>35</sup> See Lee C. Buchheit, ‘Trustees versus Fiscal Agents in Sovereign Bonds’ (17 October 2018) <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3095768](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3095768)> last accessed 1 August 2018

<sup>36</sup> ‘Progress Report on Inclusion of Enhanced Contractual Provisions in Sovereign Debt Contracts’ Policy Paper (18 September 2015) <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Progress-Report-on-Inclusion-of-Enhanced-Contractual-Provisions-in-International-Sovereign-PP4983> last accessed 2 August 2018

where the U.N. Security Council passed a resolution to immunize cash proceeds from Iraqi oil sales from attachment in all U.N. member states. (See Iraq Case Study).

**Iraq 2005 - 2008**

**Innovation – Immunization of Assets from Seizure**

In the spring 2003, the outstanding sovereign debt stock inherited from the previous regime, exceeded \$140 billion owed to an astonishing diversity of creditors -- other governments, banks, construction companies and trade creditors of many kinds. Iraq derived virtually all of its foreign currency earnings from the sale of oil. Creditors could therefore have strangled Iraq's economic recovery by attaching Iraqi oil shipments in the international markets and seizing the cash proceeds from the sale of that oil.

The solution took the form of a U.N. Security Council resolution -- Resolution 1483 of May 22, 2003 -- that encouraged a prompt restructuring of Iraq's debt and immunized all Iraqi oil sales, as well as the cash proceeds from the sale of that oil, from "any form of attachment, garnishment, or execution." All member states of the United Nations had to incorporate these immunities for Iraqi assets into their domestic law. Resolution 1483 was taken under Chapter VII of the U.N. Charter and thus was binding on all member states. The legal immunities for Iraqi assets provided by Resolution 1483 lasted until 2011. Under the cover of these legal immunities, Iraq successfully restructured most of debt stock on terms that gave Iraq debt relief (in net present value terms) of at least 80%.

X. The aftermath:

If a debt restructuring ends without full participation by the affected creditors, the sovereign will need to decide how it will treat the non-participants. A very small number of holdouts may allow the sovereign to pay them according to the original terms of their debt instruments (Ecuador 2000; Greece 2012). A more-than-trivial holdout population, however, probably portends a disagreeable bout of litigation with holdouts, as was illustrated in the case of Argentina in the aftermath of its 2001 default.

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