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Is It Possible to Improve Sovereign Debt Restructuring?

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Abstract

Sovereign debt crises constitute one of the most pressing shortcomings in the current state of financial globalization. The evolution of international sovereign credit markets has made sovereign debt restructuring processes more complex. Unlike in corporate bankruptcies, sovereign debt defaults entail systemic national and global macroeconomic implications. The current contractual approach to sovereign debt restructuring may become increasingly less effective in overcoming problems requiring collective action. However, this is the only viable option at present. Recent proposals from the International Capital Market Association (ICMA) could substantially improve this approach. Although interesting as an idea, the statutory alternative is still not feasible.

Keywords: Sovereign debt, public debt, restructuring, vulture fund, international financial system.

…All sciences of reality can serve two ends: knowing reality and operating upon it. The first gives rise to the theoretical usage of science; the second, to its practical usage. The practical application of the economic sciences, like that of any other branch of knowledge, is governed by ethics. Economic laws are not moral laws; but the functioning of an economic system… ultimately depends on the moral forces of society.

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INTRODUCTION

Globalization in its current state, characterized by the high mobility of private capital, provides vast opportunities to developing countries, the very nations repeatedly racked by sovereign debt crises. Since the mid-1990s, these crises have been resolved relatively quickly and with high participation rates, in the majority of experiences. However, in light of recent events, this may not be the case in the future. Among the holdouts—those holders of debt that refuse to accept the terms of a debt restructuring package—"vulture funds" can cause serious complications by buying debt from governments in or close to being in default, at very low prices, to later demand, by way of the courts, total payment, including interest. Strikingly, these investors are not truly concerned with facilitating credit to the countries and rather use their negotiating power to extract extraordinary profit.

The financial turbulence that beset emerging countries in the 1990s prompted the International Monetary Fund (IMF) to propose the Sovereign Debt Restructuring Mechanism in 2001, and its reformulation in 2002. Conceived of as a framework for bankruptcy procedures, the proposal failed due to a lack of support from the international community. Instead, the orderly restructuring of sovereign debt concept won out, drawing on a market-based contractual approach. When the holdouts complicated the landscape, governments began to include collective action clauses (CAC) in their debt issuances. More recently, interest has been revived in approaches emphasizing statutory mechanisms, especially after the ruling in favor of the vulture funds in their dispute against Argentina.

This research revolves around the hypothesis that sovereign debt restructuring has become increasingly complex, and aims to determine if the mechanisms currently in place could optimize these processes. The paper begins with a description of the trials and tribulations of developing countries in matters of debt and default, continues with a characterization of the restructuring processes in these nations, and an explanation of the contractual and statutory approaches, followed by the details of the scope of *pari passu* clauses, and finalizes with some conclusions.

SOVEREIGN DEBT AND DEFAULT

Although debt itself does not necessarily run counter to growth, it can give rise to serious difficulties, reflecting one of the major imperfections of the current international financial architecture. One important aspect of this topic analyzes the nature of debt in developing countries. According to the traditional Eaton and Gersovitz (1981: 290) model, countries generally experience periods of high and low income relative to the trend, and it is this variability in income that is a key factor in determining the amount of sovereign debt. Pursuant to this logic, sovereign debt should be counter-cyclical, because countries take on debt in hard times and repay their obligations in good times, all of which fits nicely with Keynesian policies, as well as the neoclassical models of optimal fiscal policy.

However, loans to developing countries, in particular private loans, have tended to behave rather pro-cyclically. This, in turn, can be associated with the pro-cyclical behavior of fiscal policies, as well as monetary and currency policies, especially during boom times, exacerbating the effect of capital shocks and abrupt changes to the terms of exchange (Ffrench Davis, 2008: 25). As such, a forward-thinking fiscal policy in the good years and/or an adequate institutional framework and/or a growth strategy able to confront unfavorable circumstances could have prevented crisis episodes or mitigated their impact (Marx *et al.,* 2006: 56).

Not to minimize the fact that countries are responsible for their own fiscal policies, but it should also be borne in mind that countries are subject to the worldwide financial cycles with booms and collapses. This is especially risky for a significant number of developing countries, which, after receiving vast amounts of financing during the booms, are hit with an abrupt collapse during the downswing of the cycle (Ocampo, 2011: 13-14). Throughout the course of economic history, sovereign debt crises have been recurrently sensitive to the cycles of global capital flows. In turn, the countries that tend to take on more debt than they are capable of repaying during times of prosperity become more vulnerable once the inevitable crises come. When emerging markets face negative external shocks, their pro-cyclical debt bubbles burst, typically pushing them towards default (Reinhart and Rogoff, 2008: 32-54). As such, although the policies that countries adopt are crucial, the nature of the international capital markets play more than a trivial role in an explanation of this topic.

Likewise, the traditional literature assumes not only that countries borrow when the economy contracts and repay their debt when the economy is expanding, but also that, in light of the propensity of indebted countries to default instead of repay, rational creditors anticipate this behavior by not lending beyond a certain debt level (Eaton and Gersovitz, 1981: 289). Although in this literature, during inauspicious times, repayments—and therefore defaults—do not exist, the empirical evidence shows that these two events occur precisely during these time periods (Panizza *et al.,* 2009: 667).

Sovereign debt crises frequently happen together with other types of crises. One approach underscores the fact that in an environment of multiple equilibriums, panic among international investors leads to the sudden withdrawal of capital, and with it, serious currency and financial crises that trigger debt crises (Radelet and Sachs, 1998: 3). Another model points to financial fragility expressed in three essential ways: contagion, resource transfers caused by real depreciation or recession, depressing imports in order to reverse the sign of the current accounts, and deteriorating corporate balance sheets, as well as some aspects of the economic policy tied to this fragility (Krugman, 1999: 66-70). An alternative model posits that sovereign debt crises in developing countries go hand in hand with balance of payments crises, where there are fixed exchange rates in place, as well as bank runs. Because external reserves may be the only means of facing external obligations, the loss of these reserves prevents countries from maintaining these fixed rates. Because banks are so fragile, the massive loss of deposits pushes the country towards the brink of crisis. Each of these so-called crisis triplets exacerbates the others, which has a negative impact on the economy. The immediate origin of the economic collapse may reside in the financial accounts of the payments balance (such as a sudden break in capital influx), in the foreign exchange markets, or even in the banking system, depending on the particularities of each country (Krugman and Obstfeld, 2006: 611-612). Recent studies about the experiences of financially dollarized emerging economies with fixed exchange rates emphasize the systemic nature of the crisis triplets. In a context of growing systemic risk, the macroeconomic risk is more important than banking indicators, foreign currency deposits are a temporary treatment for foreign exchange risk, liquidity flows through the borders, with the potential to produce a contagion effect, and bank runs generally accelerate all of the events towards collapse (Levy Yeyati *et al.,* 2011).

Various empirical studies have found that defaults are extremely harmful, due to the negative effect they generate contemporaneously on the growth of the product (Furceri and Zdzienicka, 2011: 14). Empirical evidence also suggests that defaults, rather than triggering the crisis, represent an inflection point of the crisis. This does not mean that policies that lead to defaults are not exempt from costs but rather that, on the contrary, the majority of the consequences of the default are generally felt in the markets even before it becomes official (Levy Yeyati and Panizza, 2011: 103). The Argentine case illustrates the point. The vertical decline of the product following the collapse of convertibility was brief. Contrary to the prevailing opinion, the severe economic and political events that occurred at the end of the regime were not followed by more profound contraction, but rather by extraordinarily rapid recovery. The Argentine economy displayed a “V” type trajectory consisting of a phase of economic collapse at the end of convertibility and a subsequently rapid rebound (Damill *et al.,* 2005: 26).

SOVEREIGN DEBT RESTRUCTURING

General Characteristics

Legally speaking, the fundamental difference between the debt of a person or individual company and sovereign debt revolves around how these debts are enforced. There is no legal procedure stipulating how to enforce sovereign debt and therefore, public assets are immune from seizure, even if there is a ruling in favor of the creditors against a government in default. The properties of the debtor are within its national borders or receive special protection provided by embassies, central bank funds, etc.

The restructuring of sovereign debt can be defined as an exchange of governmental debt instruments, such as bonds or loans, for new debt instruments or cash through a legal process. Any time debt is restructured, two processes are at play: the rescheduling of debt payments and the reduction of the amount of debt. The first step consists of postponing the maturities of the old debt, possibly by including lower interest rates, entailing debt relief insofar as the contractual terms of future payments are modified. The second step consists of reducing the nominal value of the old debt instruments. Although debt restructuring generally happens after default, it is also possible to restructure the debt before a default occurs (Das *et al.,* 2012: 7-8).

There are some additional features intrinsic to sovereign debt restructuring. In bankruptcy procedures, it is not only the formal creditors demanding the resources of the country but also the active workers and pensioners who may be harmed if the "vulture" creditors receive total repayment. There are also issues of agency, because the costs of restructuring are assumed by different political actors than those who generated the problems in the first place, which distorts the incentives. However, the fundamental difference between bankruptcy for an individual enterprise and for a State with systemic implications consists of the fact that while a single corporate default does not have significant macroeconomic implications, the bankruptcy of a large number of companies or sovereign debt restructuring typically has significant macroeconomic consequences, in particular when accompanied by changes in the exchange rate (Stiglitz, 2014).

Aiming to better understand the international debt markets, it is important to examine the changes that took place in the 1990s as a result of the events of the 1980s. In the 1980s, emerging countries could negotiate with creditors directly. Investors comprised a relatively homogenous group and there were fewer players involved than there would be later on. Investors were essentially foreign banks with preferentially close interaction with their regulators, which made it possible to coordinate the process if necessary. In the 1990s, financing overwhelmingly came from the direct issuance of bonds, while resolutions required negotiating with a large number of bondholders scattered around the world, including residents of emerging countries. The investment base was characterized not only by its atomicity and diversity, but also for holding debt instruments issued in many different countries pursuant to various legislations and in different currencies (Marx *et al.,* 2006: 68).

At the end of the 1980s, the resolution of the Latin American debt crisis through the Brady Plan permitted the exchange of loans previously taken out for the issuance of new securitized instruments: Brady Bonds. It was then when the debt securities market of developing countries became highly liquid. In principal, this change ushered in optimistic expectations of better risk distribution, but in reality, the higher number and increased heterogeneity of stakeholders also increased the risk that refusal by any one of them to participate in debt restructuring would make resolving debt crises more complicated (Eichengreen, 2006: 438).

One crucial point to bear in mind when considering this topic pertains to achieving restructuring in an efficient, orderly, and predictable fashion. In this regard, the literature analyzes two central questions about the loss of social efficiency and moral hazard. The first is derived from problems of information and coordination, which reduce social economic welfare and are generally lose-lose, because value is destroyed without any compensatory benefit, in the sense that a loss on the side of the debtors does not produce any gain for the creditors (Sturzenegger and Zettelmeyer, 2007: 270). A lack of information about the willingness and/or capacity of the debtor to repay can reduce efficiency by encouraging creditors and debtors to partake in prolonged and costly disputes, delaying the terms to agree to a restructuring (Haley, 2014). Moreover, the inefficiencies derived from a lack of coordination impede individual creditors from realizing that cooperation with other creditors—rather than individual actions—could produce the best results (Schadler, 2012). Delayed restructuring agreements can also prompt economic stagnation, because in the interim, the lenders do not receive interest, while the debtor country is prevented access to international capital markets. If the situation is prolonged, the exchange rate may collapse and banks with obligations in foreign currency may also experience a crisis, at a high cost to the country. In this case, country officials will be forced to dip into the reserves and raise interest rates, both of which are scenarios that come at a cost to society (Eichengreen, 2006: 435). Uncertainty about the best way to overcome a sovereign debt crisis can also lead to further delays and inefficiency. The challenge of figuring out whether the debtor suffers from lack of liquidity or insolvency brings with it the equally challenging choice of formulating the right policy response. In a context of uncertainty, policymakers opt to avoid or postpone the implementation of policy measures, which, although necessary, may be controversial, because they cannot guarantee that these measures are entirely necessary (Brooks and Lombardi, 2015).

The second question presents various aspects to consider. One of them is the fact that policymakers frequently have incentives to borrow more than what is socially optimal. Although policy imperfections generally lead to suboptimal debt management policies, the ruling class—typically self-interested—makes little effort to implement measures that could produce benefits for its successors (Bucheit *et al.,* 2013: 8). In turn, over-indebtedness is tied to moral hazard, which results from the presence of an international lender of last resort. The IMF's loan history has engendered the expectation that it will come to the rescue of countries with debt problems in virtually any situation (Schadler, 2012). According to Eichengreen (2006: 436-437), the interactions among the IMF, private investors, and the citizens of the debtor country are telling. Investors may have incentives to lend in excess to the official receivers of aid, and the IMF usually recovers the loans it makes, while the residents of the debtor country end up paying for the loans from the institution, through taxes. In this way, IMF intervention may mean that part of the burden of sovereign default shifts from the private sector lenders to the citizens of the debtor country. In this regard, it is fitting to question the reason why private investors compromise themselves with excessive and risky loans to countries, when this leads to the unsustainable rise of sovereign debt.

Another aspect of moral hazard is seen in the fact that policymakers are hesitant to undertake the restructuring of their own debts (IMF, 2013). This may arise from the desire of policymakers to keep their jobs, which they generally lose after a debt default, even if this comes at a cost for society as a whole (Panizza *et al.,* 2009: 682). Shortsighted governments, far from taking into account the long-term costs involved in the over-accumulation of debt, also postpone default to prevent the loss of the external resources that would force them to cut spending. The same logic leads governments to increase the debt capacity in the short term, even at the expense of the higher cost of a future default (Acharya and Rajan, 2014: 6-7). Finally, policymakers may choose to postpone simply because they assume that the consequences of the inevitable default will be somehow limited, but the strategic cost in terms of reputation will be high. In this way, the defaults tend to be of the former type (Bucheit *et al.,* 2013: 11).

Types of Sovereign Debt Restructuring

Key to any analysis of sovereign debt restructuring in the current context of institutional arrangements is the fact that relationships between creditors are governed by incomplete contracts (Stiglitz, 2014). In order to ensure timely and orderly restructuring, it becomes necessary to clearly outline the procedures for restructuring at the time the bonds are initially issued. Specifying the terms of the restructuring in the bond contracts may contribute to mitigating many of the problems that emerge during the restructuring phase (Brooks and Lombardi, 2015).

The current contractual approach, also known as the market-oriented decentralized approach, is a decentralized process pursuant to which the affected country sets up negotiations with its various creditors. The mechanism to counteract complications consists of the CAC clauses, which permit a qualified majority of bondholders to accept the terms of the restructuring, even when the minority dissents. From the perspective of the creditors, this prevents the holdouts from abusing their position in light of any indulgence by the majority. From the perspective of the debtors, this would permit coming to an agreement more quickly, preventing the threat of contentious disputes.

Although sovereign debt restructuring does offer the chance to start anew, it is still a complex process. Debt contracts may or may not contain CACs. If they do not have them, restructuring will not be concluded until all of the creditors agree with the proposal. If there is a unanimity rule, holdouts may emerge, as well as vulture funds, undermining the restructuring process even when there is no real disagreement about the capacity and/or willingness of the debtor to pay. Additionally, problems can be exacerbated through the use of credit default swaps, where the holder of a bond may be better off in case of default, because the payments of the security would only be activated upon default (Guzmán, 2014).

Recently, the International Capital Market Association (ICMA), which counts banks, investors, and the most significant debt issuers among its ranks, has proposed new terms to address the failings of foreign sovereign bond contracts. If they were to be broadly implemented, the new clauses would allow governments to restructure these bonds pursuant to three alternative theories. The first, subject to a vote, if 75% of the series agrees on the new terms, the remaining minority shall be bound to those terms. However, if the CAC operates on a series basis, a creditor or group of creditors may block the restructuring of that series and demand total payment from the debtor, as was the case of the litigation between NML Capital Ltd and Argentina and many bondholders governed by foreign laws in Greece. These clauses have become common for bonds with jurisdiction in England for quite some time and in New York since 2003 (Gelpern, 2014).

Second, the voting structure requires a minimum threshold of support for each series and for all of the series to be restructured. If at least 50% of each series and 66.66% of the total debt agree to the new terms, the remaining creditors are bound to those conditions. However, any series that does not come up with 50% of the vote may exit the restructuring and demand total payment. At the moment, four countries have used a similar mechanism in bonds with jurisdiction in New York and England. In turn, governments in the Eurozone have applied this mechanism for all of their long-term bonds, starting with issuances in 2013.

Third, a major innovation proposed by the ICMA requires a single vote calculated over the aggregate base of all of the affected series. If 75% of the total approves the new terms, the rest of the creditors would then be bound and no creditor would be allowed to exit the arrangement. By not requiring a series by series vote, this procedure eliminates the chance for one group to take control within a special issuance and therefore block the restructuring of that issuance, making it an essential tool to deal with the problem of collective action.

Although the second option still permits the “vulture funds” to inhibit the restructuring process for a particular bond series, the third makes that impossible, entailing a significant innovation as compared to previous clauses. However, it is no simple task to bring together all of the investors while the new initiative is still imperfect and problems persist. Because the new provisions will not be retroactively applied, it will take a considerable amount of time before the entire debt stock includes them (Eichengreen, 2014). In spite of these challenges, the ICMA model may be a step forward for the contractual approach. Its major advantage is that the new contracts are voluntary. The initiative is the outcome of intense debate among the private sector, sovereign issuers, and representatives of the official sector, looking for a solution to slow the proliferation of litigation, as was seen in Argentina (Gelpern, 2014).

Efforts to adopt an alternative to the contractual system are not new. At the end of the crisis in Mexico in 1995, the literature spoke at length of the need to overcome the difficulties in the provision of new financing. The proposal was to reorganize the IMF not as a lender of last resort but rather, preferably, as an international bankruptcy court. The literature advocated for more aggressive debt reduction to allow the affected governments to regain solvency, arguing that the era of lack of access to international financial markets must be brought to an end (Sachs, 1995: 14-15).

In the early 2000s, the need to create a better scenario for restructuring sovereign debt became apparent. Various statutory versions that preceded the turn of the century had already proposed changes to the laws in order to create rules or institutions in which the agreement of the majority or the supermajority of creditors could be imposed over the demands of the holdouts, giving priority to new financing and safeguarding debtor countries from lawsuits during the moratorium or the negotiations (Rogoff and Zettelmeyer, 2002: 495).

A subsequent round of proposals gave rise to a new statutory-based approach: the Sovereign Debt Restructuring Mechanism. According to Krueger (2002: 33-40), a purely contractual approach, even with ambitious CACs, would be unable to resolve the fragilities of the system. In her judgment, by contrast, the establishment of a universal treaty for obligations, besides including partial amendments to national legislation, would prevent creditors from looking for different jurisdictions in which to enforce their claims,[2] would ensure uniformity of the text by permitting a single institution to have the authority to standardize interpretation, would avoid the problem of free riding—whereby countries would be reluctant to introduce new legislation until a certain number of other countries did it—, and would facilitate the creation of a single international judicial body with the power to rule on disputes and oversee voting. Although an amendment to the IMF Articles would be required to lend legal force to the mechanism, it would not entail a significant extension of the fund's legal authority, but would rather grant power over the most important decisions in the restructuring process to the debtor and a supermajority of creditors. The proposal could include postponement of litigation once payments are suspended, mechanisms to protect the interests of creditors during the suspension, the provision of new financing for private creditors, and the approval of the final restructuring agreement. Basically, this regime would entail an international bankruptcy mechanism with limited faculties. Despite interest in the topic, the proposal floundered from a lack of political support.

The difficulties derived from the events in Argentina and Greece revived debate about the effectiveness of the contractual approach. Based on the argument of the inferiority of private results with respect to Pareto optimality, Stiglitz (2014) shares the aforementioned vision proposing the creation of a sort of International Court fully entitled to deal with debt restructuring processes. Aiming to find a lasting solution for the problem of debt in developing countries, in September 2014, the United Nations General Assembly approved a resolution to establish a multilateral judicial framework for sovereign debt restructuring process, with an eye towards, among other goals, increasing the efficiency, stability, and predictability of the international financial system; achieving sustained, inclusive, and equitable economic growth; and attaining sustainable development, pursuant to national circumstances and priorities (United Nations, 2014).

The United Nations Conference on Trade and Development (UNCTAD) (2013) highlighted the fact that the contractual and statutory approaches are not mutually exclusive. The body released a framework document setting forth a debt settlement mechanism based on a multidisciplinary approach, emphasizing the interaction between economics and the law. The text proposes adopting a hybrid approach, in line with the reality that transcends the polarization between the contractual and statutory approaches to adopt one that encompasses, by contrast, the complementarities of the two. The statutory approach requires financial instruments to properly take on rapid financial globalization, while contracts require the statutes that provide them with context and definition.

Evaluating the pros and cons of the two perspectives—the statutory and the contractual—sheds light on various questions. One fundamental issue revolves around the importance of legal certainty. Because contracts must be honored, a breach of contract is not in and of itself positive (Tran, 2014). At the moment, the contractual approach has failed to resolve the issue of the hundreds of billions of dollars in bonds issued under original terms, because this approach is not retroactive. However, looking to the future, the amendments recently introduced clearly reinforce the contractual approach. By contrast, if the statutory approach were applied to all of the debt in circulation, it would ignore the legal faculties of the jurisdictions in which the government bonds were issued in the past. The contractual approach appears to be a better alternative because it would provide greater legal certainty, helping to maintain capital flows, which is particularly important for developing countries. In the statutory approach, making the required changes to laws would not be a simple process. Moreover, it seems unlikely that an international court would be better equipped to quickly satisfy the interests not only of sovereign governments in default and the various creditors, but also the interests of other stakeholders, such as workers and pensioners.

With respect to incentives for creditors, the contractual and statutory approaches are fundamentally different in two ways. The first focuses on resolving the basic problem of holdouts and, in some cases, discouraging lawsuits. The second, by contrast, contemplates a broader range of problems, including prioritizing new financing (Rogoff and Zettelmeyer, 2002: 496). However, in this case, it is useful to ask whether the international mechanism is able to effectively resolve such a profuse range of questions. With regard to incentives for debtors, the argument is that certain measures that facilitate restructuring may undermine the incentives of these actors, creating the potential for moral hazard. In the statutory scheme, the response to this behavior may consist of good incentives for debtors by way of the threat of reversing the previous status quo if the debtors fail to negotiate in good faith (Rogoff and Zettelmeyer, 2002: 497). However, in this case, as well, it is necessary to ask how effective this mechanism will be in aligning debtors to behave pursuant to the principles of the international convention.

In terms of the cost of debt, the changes introduced to facilitate debt restructuring and make it less costly could make these restructuring processes more frequent, consequently discouraging investors from granting loans to sovereign debtors, which, in turn, would raise the costs of foreign debt. In other words, the desire to make restructuring less costly will make international sovereign debt more costly (Brooks and Lombardi, 2015). The counter-argument is that countries do everything possible to avoid debt restructuring and that the fear of moral hazard among debtors is exaggerated. As such, creditors may turn to mechanisms that facilitate restructuring when sovereign debts become unsustainable due to vicissitudes not caused by the debtor (Eichengreen, 2006: 446).

Although the statutory approach may solve some of the problems that persist, experience has shown that bondholders are not willing to file their claims before an untested international bankruptcy court (Eichengreen, 2014). There is nothing to guarantee that this type of body would be transparent and exempt from arbitrariness. The agreements upon which these organizations are formed require a significant degree of cooperation among the stakeholders, which raises the question of their feasibility. The lack of global governance and the strong asymmetries at the heart of the international community may undermine its capacity to act collectively (Fanelli, 2010: 6-7).

NML Capital, LTD. *v*. Argentina

In the wake of a severe economic and social crisis, in December 2001, Argentina defaulted on its sovereign debt to the tune of around USD 81 billion. Aiming to fix the situation, the country offered two rounds of debt swaps, in 2005 and 2010. By the end of the second exchange, 92.4% of creditors had accepted the restructured offer, swapping the defaulted bonds for others under different terms. In 2011, a group of holdouts led by NML Capital, Ltd., affiliated with Elliott Management, filed against Argentina in the Southern District of New York, suing for total payment, including interest. In February 2012, Judge Griesa of the Southern District Court issued an injunction requiring Argentina to pay the petitioners the totality of the amount when the holders of bonds issued in the 2005 and 2010 exchanges and in October of the same year were paid. The Second Circuit Court of Appeals confirmed the ruling. In June 2014, the Supreme Court rejected the country's request to hear the case, while the Court of Appeals lifted the suspension, finalizing Judge Griesa's order. That same month, the judge designated a Special Master to advise and mediate between the parties to reach a definitive solution. As of now, no agreement has been reached (Ministerio de Economía, 2015).

Some have come out in favor of the ruling by the New York courts. The petitioners stated that Griesa's ruling must be enforced, because Argentina has plenty of resources to pay both the amounts owed on the bonds that were the subject of the case, as well as the amounts owed on the restructured bonds. They add that the country should avoid default and start to negotiate in good faith (Shearman and Sterling, 2014). The American Task Force Argentina (ATFA), which primarily represents the investment funds that did not accept the Argentine government's proposed exchanges, has stated that its creditors were willing to negotiate, while also noting that the South American country would benefit from lower interest throughout the next decade, significant savings for the companies and provinces, and immediate inflation relief, with no need for capital controls (*The Washington Post,* 2014).

Other voices supported the Argentine position. Solow (2014), an MIT professor and Nobel Prize winner in Economics, in a letter addressed to the United States Congress and signed by 100 other prestigious economists, expressed that if a debt crisis were to occur, the decision made by the Southern District Court could harm the capacity of the creditors and debtors to conclude orderly restructuring, which would negatively impact the workings of international financial markets. Furthermore, Ocampo (2014) holds that risky bonds pay their buyers a premium with respect to the perceived likelihood of default, and that it would be improper to force the complete amount of the initial conditions of the contract when this contingency had already taken place. The majority of the holdouts bought their bonds at very low prices, because the previous owners saw little chance of being paid.

Pari Passu **Clauses**

Pari passu (PP) is a Latin expression that means “equal footing.” Until the end of the 1990s, the most common version of this clause in sovereign debt agreements only protected the legal position of the debts of the creditors from the sovereign. This constituted a narrow interpretation of the clause, and excluded both payment periods and prorated payments. Starting at the end of the 1990s, the clause began to be interpreted more broadly, including not only the legal position, but also the obligation of payment, which required the debtor government to pay its creditors with prorated payments. The new version of the concept of prorated would play a major role starting in 2000, in the case of Elliott Associates *v*. Peru. Although a lower court in Belgium denied the application of the measure, a Court of Appeals in Brussels, upon request of the investment fund, accepted its argument, ruling that the PP clause not only impeded accepting the legal position of Peru, but also prohibited Peru from paying other creditors without first paying the prorated amounts to Elliott Associates (FMI, 2014: 38-40).

The ruling against Peru unleashed other cases that sought a similar interpretation of prorated payments. In the case of NLM Capital, Ltd. *v*. Argentina, the Southern District Court of New York went in the same direction. Aiming to strengthen its ruling, the Court also prohibited the trust and other parties in the payment chain from making any payment towards the restructured bonds unless the petitioner creditors were paid (FMI, 2014: 10-14).

Recently, some issuers of sovereign debt—Ecuador and Greece—have altered the PP clause in new issuances, to exclude the prorated payment version. Honduras and Belize did not change the wording of the clause, but did clarify that it does not imply this type of payment. Colombia, Mexico, and Peru have pointed to the risk that the rulings of the New York courts may undermine sovereign debt restructuring. Other issuers have expressed intent to change the PP clause to specifically repudiate the prorated payment version.

It should be noted that the courts in Great Britain have ruled against the courts of New York. In 2005, the Financial Markets Law Committee (FMLC) detailed the role, usage, and meaning of PP clauses in sovereign debt obligations as a matter of English law. In the framework of the lack of formal insolvency procedures, the scope of PP clauses is limited to an obligation of the debtor government to not involuntarily subordinate one class of creditors either through the legislation or some other channel (FMLC, 2005: 22). Recently, the FMLC stated that its conclusions from that year are still applicable and have not been influenced by the rulings of the courts in the United States. In particular, the FMLC expressed its decision to apply an approach different from that used in the Argentine case, believing the specific enforcement resource to be unsuitable (FMLC, 2014).

In turn, the ICMA detailed that the PP clause meant that the sovereign debt issuer would have no obligation to make prorated payments with respect to any external debt and, in particular, would have no obligation to pay any external debt at the same time or as a condition of paying matured amounts for debt securities and vice versa (ICMA, 2014).

Basically, Argentina interprets the PP clause in the sense that the ruling from the New York courts places the petitioners in a much more favorable position than other creditors. On the other hand, the vulture funds—buoyed by the ruling in their favor—interpret it in the sense that Argentina has not behaved the same towards all of its creditors, because it is paying some while failing to pay others.

Bucheit and Pam (2004: 917-918) subscribe to the notion that the PP clause has changed since its origins when it was first applied to national instruments with guarantees. Now, over the past 30 years, it has been applied to international instruments with no guarantees, and therefore the more recent interpretation of this clause is incorrect. On the one hand, it is valid to suppose that the courts have reinterpreted the clause to legitimize the weight of contracts; on the other, it is equally valid to recognize that before this shift, countries with sovereign debt problems were already looking for new ways to deal with it. The same contractual flexibility that prompts novel restructuring techniques produces novel enforcement techniques (Bucheit, Gelpern *et al.,* 2013: 20). The counterpoint to these instances may lead to multiple successive rounds, which could in turn lead to an even more complex and prolific process.

CONCLUSIONS

Sovereign debt crises and restructuring are particularly complex matters in developing countries. Without meaning to minimize the importance of these countries' policies, the characteristics of the international sovereign credit markets in the current age of financial globalization are also significant aspects for analysis. In particular, the ruling of the New York courts in favor of NLM Capital, Ltd. in its case against Argentina not only imposed a high economic cost on the country, but also produced systemic global implications, in the sense that it sets a precedent for sovereign debt restructuring processes in the future.

The contractual approach may be increasingly less potent in mitigating problems related to collective action. The difficulties that came to light in recent restructurings have motivated the international community to propose initiatives to deal with this topic. These run the gamut from changing the current contractual approach to reformulating the statutory approach. In the future, new proposals could significantly improve these approaches.

An international sovereign bankruptcy mechanism pursuant to the statutory approach is something to keep in mind to find solutions to underlying market failures. Although this approach encompasses a broader range of problems through the contractual approach, it is currently not practicable. National governments are reluctant to cede power to supranational entities that to date have not proved themselves sufficiently ready to settle the various and ongoing challenges of globalization.

At present, although imperfect, the contractual approach is the only viable option. The statutory alternative, or the combination of both approaches to take advantage of complementarities, are both options that merit further research. In the future, whatever choice is made, it will require that both debtor and creditor countries act responsibly in a context of international cooperation. The international financial system essentially feeds off of interconnected regulations and agreements. It is desirable for all stakeholders to harmonize their interests to achieve global balance and improve on the current suboptimal state of affairs.

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[2] In many jurisdictions, the international treaty—once in effect—would automatically supplant the national legislation; in other jurisdictions, by contrast, the national legislation would have to be amended to include the terms of the treaty.