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SOLVING THE SOVEREIGN DEBT CONUNDRUM: NML CAPITAL V. ARGENTINA: A LAW AND ECONOMICS PERSPECTIVE

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ABSTRACT

Sovereign bond contracts create unique legal problems for bondholders, issuers, and courts. Specifically, when a sovereign becomes insolvent, there is no international workout mechanism through which the sovereign's debt can be efficiently restructured. Absent a mechanism similar to bankruptcy for sovereigns, some bondholders may attempt to resist restructuring in an effort to obtain a legal judgment for the full value of their initial investment. Until recently, the legal status and rights of these holdout creditors has been uncertain. However, a recent Second Circuit decision upheld creditors' rights to hold out or resist a sovereign's attempt to restructure its debt. Of course, this decision creates a host of other problems related to collective action and efficiency. International legal scholars remain uncertain whether such judgments are enforceable against a sovereign. The Supreme Court of the United States has accepted a petition for certiorari regarding enforceability issues and is considering a petition for the underlying question of holdout creditors' rights.

This paper highlights the complexities and complications that have brought sovereign debt to the forefront of international legal scholarship. Although scholars and politicians have proposed solutions to the sovereign debt dilemma, the paper argues that none of the proposed solutions provides an adequate remedy to the problem. Using an original economic model, the paper argues that an Argentinian default (repudiation) is the socially optimal response to the *NML Capital* decision and will lend the most stability to the sovereign debt market. However, as a repeat player in the international bond market, Argentina has an individual incentive to comply with the Second Circuit's order and pay

the holdout creditors. Finally, the paper considers how the Supreme Court may provide a more realistic avenue to alter the adverse incentives that the Second Circuit's decision created.

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INTRODUCTION

For centuries, the issue of securities has provided a mechanism for borrowers and debtors to obtain capital quickly for immediate use. This mechanism has proven equally beneficial for lenders and creditors, by affording them an opportunity to lend capital now for repayment at a premium (or with accrued interest) in the future. However, this system is not without risks. As long as debtors and creditors have existed, civil society has recognized that sometimes debtors fail to pay their debts[1] and has created policies to govern the creditor-debtor relationship.[2] Most importantly, institutions and mechanisms have evolved in order to protect creditors from borrowers who fail to pay their debts or default. Interest rates, the use of collateral, bankruptcy regimes, and even criminal proceedings have evolved in the interest of creditor protection to ensure that lenders are afforded safeguards *ex ante* and judicial recourse *ex post*. However, when the borrower is a sovereign state, courts and creditors alike face a host of obstacles that make traditional safeguards impracticable.

Using the current conflict between NML Capital and the Republic of Argentina as a case study[3], this paper will first analyze the specific problems that sovereign debt presents for both creditors and courts. Second, it will argue that given the current legal state of sovereign debt and the absence of an appropriate solution, a particular outcome to the *NML Capital* case is socially optimal. Part I will provide an overview of the facts of *NML Capital v. Argentina*. Part II will use the case's particular facts and the arguments made by each party to illustrate the legal challenges and complexities of enforcing

[1] *Psalm* 37:21-22 "The wicked borrow and do not repay, but the righteous give generously."
[2] *Deuteronomy* 15:1-2 instructed that outstanding debts should be expunged from the creditor's books every seven years.
[3] NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012).

sovereign debt agreements. After recognizing the obstacles that sovereign debt presents, Part III will provide a framework for analyzing external solutions and judicial outcomes. Part IV will explore various solutions to these obstacles that have been employed by international business transaction lawyers or proposed by supranational organizations. After concluding that none of the current proposals or remedies effectively mitigate the problems outlined in Part II, Part V will return to the conflict between NML Capital and Argentina. This section offers an economic model for analyzing the a lender's decision to restructure or holdout. This model will help evaluate the externalities of the judicial decision, as well as the subsequent action by the parties involved. Particularly, this section will identify the socially optimal response to the Second Circuit decision, but it will also explain why Argentina's individual incentives render the country unlikely to respond in the socially optimal way. Finally, Part VI will analyze the decisions before the United States Supreme Court and offer suggestions for how the nation's highest court can correct the adverse incentives created by the Second Circuit's decision.

PART I: A CASE STUDY: *NML CAPITAL LTD. V. REPUBLIC OF ARGENTINA*

A. Background Facts

In the 1990s, investors from the "developed world" began investing heavily in "emerging markets" like Argentina. Between 1992 and 1994, foreign direct investment into Argentina averaged $3.6 Billion US Dollars annually.[4] At the time, Latin American and South America were widely thought to be the next big area for economic growth, so prospects for investors seemed promising.[5] Looking to capitalize on widely available foreign and domestic investment, Argentina began issuing securities pursuant to a Fiscal Agency Agreement ("FAA") in 1994.[6] This bond issuance offered investors coupon rates ranging from 9.75% to 15.5%, with maturities ranging from April of 2005 to September 2031.[7] Notably, the FAA contained a "*pari passu*" clause, which stated that securities issued pursuant to that agreement should "at all times rank *pari passu* without any preference among themselves."[8] The clause further stated "the payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness…"[9] This second portion is often referred to as the "Equal Treatment Provision" in the court opinions and briefs. The *pari passu* clause generally, and the Equal Treatment Provision specifically are important, as they contain critical, yet vague language whose intent and meaning became the focal point of the litigation between the parties.

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[4] Robert Bouzas & Daniel Chudnovsky, *Foreign Direct Investment and Sustainable Development: The Recent Argentine Experience* (May 2004) (unpublished manuscript) (On file with Universidad de San Andres), *available at* http://www.iisd.org/pdf/2004/investment_country_report_argentina.pdf.
[5] Patrick J. Regan, *South of the Border: Investors Discover Latin America*, FINANCIAL ANALYSTS JOURNAL, Vol. 48, No. 6 (Nov.-Dec., 1992), at 9-12.
[6] NML Capital Ltd. v. Republic of Argentina, 699 F.3d 246, 251 (2d Cir. 2012).
[7] *Id*.
[8] *Id*.
[9] *Id*.

The boom of the early 1990s was quickly followed by a sharp decline for the Argentine economy. Argentina entered a recession in 1998 and concerns about the country's massive external debt soon followed.[10] Political and economic turmoil came to a head in December of 2001 when unemployment reached nearly 20%, decimating Argentina's tax revenues and sparking domestic outcry against Argentine government policies.[11] It seemed almost certain that Argentina would default on the $132 Billion US dollars in foreign debt that it accumulated through the 1980s and 1990s, including the FAA bonds. Argentina implemented austerity measures that included severe cuts to government salaries and spending, reduction of government pensions, and even conversion of private pension funds to Argentine treasury bills in order to service Argentina's massive foreign debt accumulation.[12] The country also restricted withdrawal of bank deposits to counter the run on domestic banks. However, austerity measures failed to comply with requirements set by the International Monetary Fund (IMF), and the bank discontinued its support system for the South American country.[13] While the austerity measures were insufficient to gain the support of the international community, their severity triggered riots by Argentine nationals, resulting in 20 deaths and a series of crucial political resignations.[14]

Following the widespread rioting and the resignation of President Fernando de la Rua, Argentina's Assembly nominated Adolfo Rodríguez Saa to serve as interim

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[10] International Monetary Fund, The Role of the IMF in Argentina, 1991-2002, Issues Paper/ Terms of Reference for an Evaluation by the Independent Evaluation Office (IEO). July 2003.
[11] *The Events that Triggered Argentina's Crisis*, BBC News (Dec. 21, 2001), http://news.bbc.co.uk/2/hi/business/1721103.stm.
[12] *Id*.
[13] International Monetary Fund, *supra* note 10.
[14] BBC, *supra* note 11.

president.[15] On the second day of his eight-day tenure in office, Saa went before the Argentine Assembly and declared a temporary moratorium on principal and interest payments on more than $80 billion of Argentina's public external debt, including the FAA Bonds.[16] Each year since 2001, Argentina renewed the moratorium and has refused to pay the external debt.[17]

In 2005, Argentina began to restructure its outstanding debt by issuing an exchange offer to its creditors. This exchange offer created new, unsecured and unsubordinated debt for which holders of old FAA bonds could exchange their current securities at a rate of 25 to 29 cents on the dollar.[18] By accepting the new bonds, the creditors agreed to forgo remedies and rights afforded by the original FAA agreement. The Exchange Offer explicitly warned creditors that their FAA bonds would likely remain in default indefinitely and that failure to tender FAA bonds would likely result in forfeiture of any payment pursuant to the original agreement.[19] Essentially, the Exchange offer gave creditors an ultimatum: either agree to the terms of the restructuring or face the likelihood of nonpayment on Argentina's prior obligations.

To strengthen the threat, Argentina's legislature passed a "Lock Law" prohibiting the Executive branch from making new exchange offers or settling on the FAA bonds in or out of court.[20] The Lock Law also required that the FAA bonds be removed from foreign securities markets and exchanges. After the exchange offer closed in June of

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[15] *Id*.
[16] Pamela Druckerman, A*rgentina Hasn't Exempted IMF From Moratorium on Paying Debts*, WALL ST. J., Jan. 4, 2002, *available at* http://online.wsj.com/article/SB101009064044793320.html.
[17] *See* NML Capital Ltd., 699 F.3d at 251.
[18] *Id* at 252.
[19] *Id*.
[20] *Id*.

2005, 76% of the outstanding FAA bonds had been exchanged pursuant to the restructuring.[21]

Argentina suspended the Lock Law in 2010 in an attempt to exchange the remaining 24% of FAA bonds for the restructured bonds.[22] The terms of the second restructuring were virtually identical, including a warning that outstanding FAA securities may remain in default indefinitely. After the second exchange offer, less than 9% of the 1994 FAA bonds remained outstanding.[23] Until the time of an injunction by the Second Circuit in February of 2012, Argentina paid all of its debt obligations to the restructured bondholders, but did not make payments to the remaining FAA bonds (hereinafter referred to as "holdouts").

Between 2009 and 2011, the plaintiffs in *NML Capital v. Argentina* filed suits for injunctive relief pursuant to the *pari passu* clause and Equal Treatment Provision within the FAA. The plaintiffs sought to enforce the Equal Treatment Provision by suspending payments to bonds issued pursuant to the 2005 and 2010 Exchange Offers, without also making payments on the earlier FAA debt. The plaintiffs (holdouts) argued that making payments to the restructured debt while not also making payments to the earlier debt violates the Equal Treatment Provision, which states that the FAA debt "shall at all times rank at least equally with all its other present and future unsecured and unsubordinated external indebtedness." By failing to make payments to its earlier debt obligations, the holdouts argued that Argentina failed to meet its contractual obligations and subordinated the FAA debt.

B. Issues and Arguments

[21] *Id* at 253.
[22] *Id*.
[23] *Id*.

1. Meaning of the *pari passu* clause and equal treatment provision

In response to the plaintiff's allegations, Argentina made the same substantive claim twice, first in the Southern District of New York before Judge Thomas Griesa, and a second time before the United States District Court of Appeals for the Second Circuit, before Judge Barrington Parker. Argentina's argument was that the clause against subordination referred only to formal, legal subordination. Subordination, they argued, only occurred when a sovereign created discriminatory legal rankings and gave certain legal priorities to other classes of debt.[24] Applying this interpretation, Argentina argued that it did not subordinate the FAA debt by making payments to the Exchange Offer debt, because the sovereign did not alter the "legal ranking" of the two relative to each other.[25]

The plaintiffs' argument was based on an alternate interpretation of the clause. Subordination, they argued, referred to both legal and *de facto* subordination.[26] By this standard, Argentina's decision to make payments to the restructured debt and not to the FAA debt *did* constitute subordination, as it provided benefits (payments) to one class of debt that it did not provide to another. [27]

Judge Thomas Griesa of the United States District Court of the Southern District of New York agreed with the plaintiffs, holding Argentina's *de facto* subordination violated the *pari passu* clause in the FAA.[28] Upon appeal, the Second Circuit affirmed that holding.[29] Judge Parker held that while the plaintiffs' more liberal interpretation of the *pari passu* clause was the correct interpretation, Argentina would be found in

[24] *Id* at 256-257.
[25] *Id*.
[26] *Id* at 258.
[27] *Id*.
[28] *Id* at 256
[29] *Id* at 265.

violation by either standard.[30] Even under the more stringent "legal subordination" standard, Argentina would still be in default.[31] By enacted legislation prohibiting payments pursuant to the FAA, the sovereign created a legal designation between classes of debt, one of which was denied payment through legislative action. [32]

2. Remedy

Notwithstanding the factual dispute as to whether Argentina subordinated the FAA debt, Argentina's second argument attacked the remedy awarded by the Southern District of New York. The district court granted the plaintiffs' request and required Argentina specific performance on the contract.[33] In the context of this case, that specific performance took the form of an injunction and enforcement of the *pari passu* clause. The injunction prohibited Argentina from making payments to the exchange offer debt without also making payments to the FAA debt.[34] However, Argentina argued that specific performance violated the terms agreed upon in the FAA because the agreement contained an acceleration clause. The acceleration clause provided that in the event of default, Argentina should pay damages to its creditors equal to the full amount it owed. [35] While it may seem counterintuitive that Argentina would argue for enforcement of the acceleration clause, which would require substantial payment to the holdouts, Argentina knew such a remedy would be unenforceable against a sovereign.

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[30] *Id* at 260.
[31] *Id*.
[32] *Id*.
[33] *Id* at 255-256. Note that in this context, specific performance did not mean that Argentina was required to make payments. The court awarded specific performance with respect to the equal treatment provision, and enjoined payment to the restructured debt without also paying the holdouts.
[34] Note: the formula for calculating how payments should be made (pro rata, full, equal quantity) was remanded and is the subject of the current appeal. If upheld, the Southern District of New York's decision would require Argentina to make a "ratable payment" to the holdouts and would enjoin third parties from executing payments to holders of restructured debt.
[35] NML Capital Ltd., 699 F.3d at 251.

On appeal, the Second Circuit affirmed the lower court's award of injunctive relief and specific performance.[36] The court noted that although the FAA did contain an acceleration clause, New York law allowed the court to award other forms of relief when equitable and necessary and when not explicitly prohibited by the contract. [37]

While the contract clearly did not contain a prohibition against specific performance, the court of appeals did have to address the issue of whether specific performance was equitable and necessary. On this point, the Second Circuit reviewed the district court's ruling and applied a "clear abuse of discretion" standard.[38] To address the question of necessity, the court observed that through the Lock Law, Argentina made clear its intention not to comply with legal decisions that provide monetary relief to holders of FAA debt. Because of its status as a sovereign, Argentina could follow through with that intention. Thus, the court held that an alternate remedy was necessary for the plaintiffs.[39] When assessing the equity of such a decision, the court used a balance of equities approach. Again, the court noted that because of its status as a sovereign nation, Argentina would be able to violate its contractual obligations with impunity because a US Court could not force the Argentine government to make a payment.[40] Because a monetary award was unavailable, the appellate court held that lower courts should afford relief to plaintiffs through other judicial avenues that they could enforce and would serve the court's equitable purpose.[41]

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[36] *Id* at 265.
[37] Id at 261, *citing* Guiness Harp Corp v. Jos. Schlitz Brewing Co., 613 F2d 468, 473 (2d Cir. 1980). *See also* Winter v. Nat. Res. Def. Council, Inc., 555 U.S. 7 (2008) (noting that "the balance of equities and consideration of the public interest are pertinent in assessing the propriety of any injunctive relief, preliminary or permanent.").
[38] *Id* at 257.
[39] *Id* at 262.
[40] *Id* at 263.
[41] *Id* at 262.

However, on appeal, Argentina argued that the Foreign Sovereign Immunities Act (FSIA) barred US courts from requiring the country to pay plaintiffs with immune property located outside the US.[42] Section 1609 of the FSIA states that "the property in the United States of a foreign state shall be immune from attachment and arrest and execution."[43] Likewise, the appellate opinion notes that courts are barred from granting "by injunction, relief which they may not provide by attachment."[44] In response, Judge Barrington asserted that the injunction would not violate section 1609 of the FSIA, because none of Argentina's property would be "attached, arrested, or executed." Rather, the injunction works through third parties such as intermediary banks to prohibit payment from traveling from Argentina to holders of the exchange offer debt. [45] Thus, none of Argentina's property was affected by the decision.[46] Yet, the injunction had the effect of prohibiting Argentine funds from moving to exchange offer creditors if Argentina did not also make payments to FAA debt.

[42] *Id* at 257.
[43] 28 U.S.C.A. § 1609 (West 2013).
[44] *Id*.
[45] NML Capital Ltd., 699 F.3d at 263. Note: How third parties and intermediaries would be affected by the injunction was a topic to be clarified upon remand to the Southern District of New York.
[46] *Id*.

PART II: THE UNIQUE PROBLEMS ASSOCIATED WITH SOVEREIGN DEBT

The arguments Argentina made in response to the holdout creditor's allegations are illustrative of the general problems associated with sovereign debt. The first set of problems address the ability of creditors to bring claims against debtors because of their status as sovereign entities.

A. Immunity under the Act of State Doctrine or Foreign Sovereign Immunities Act (FSIA)

Disputes against sovereigns are generally subject to two important principles of American and International law: the Act of State Doctrine and the Foreign Sovereign Immunities Act (FSIA).

The Act of State Doctrine generally holds that US courts should not pass judgment on the actions of a sovereign state acting through its governmental bodies. As stated in *Underhill v. Hernandez*,

> Every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment on the acts of the government of another, done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.[47]

It seems logical that a state's financial decisions, such as whether to issue bonds and whether to default on said bonds, would fall within the protection of the act of state doctrine. If so, sovereign bondholders would be left helpless in the event of sovereign default, even if the circumstances that led to the default were completely within the control of the sovereign.

While the Act of State doctrine has significant implications for sovereign immunity and international law generally, the reasoning behind the doctrine is actually

[47] Underhill v. Hernandz, 168 U.S. 250, 252 (1897).

grounded in the concept of separation of powers.[48] Recognizing that the doctrine's purpose is to safeguard the powers of the executive branch from judicial encroachment in matters of foreign affairs, it is not surprising that the doctrine is not a major concern with respect to sovereign debt. The judicial branch will only apply the Act of State Doctrine to matters affecting foreign affairs, as those are enumerated powers of the executive branch. However, sovereign debt disputes are contractual in nature, not foreign affairs. Therefore, the Act of State Doctrine will rarely be used to afford the executive exclusive control over sovereign debt disputes, as sovereign debt is not wholly within the realm of foreign affairs. Thus, sovereign debt disputes avoid being barred from judicial action by the Act of State Doctrine.

A much more relevant concern is the Foreign Sovereign Immunities Act (FSIA). Codified in 28 U.S.C.A. §1604, the FSIA grants foreign states judicial immunity from proceedings in the courts of the United States.[49] However, this immunity is subject to certain exceptions, including an exception for a sovereign acting with a commercial purpose.[50] In a case unrelated to the *NML Capital* dispute, the Supreme Court in held that an earlier Argentine default on sovereign bonds did fall within the commercial activities

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[48] Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398 (1964) ("The text of the Constitution does not require the act of state doctrine; it does not irrevocably remove from the judiciary the capacity to review the validity of foreign acts of state. The act of state doctrine does, however, have 'constitutional' underpinnings. It arises out of the basic relationships between branches of government in a system of separation of powers. It concerns the competency of dissimilar institutions to make and implement particular kinds of decisions in the area of international relations. The doctrine as formulated in past decisions expresses the strong sense of the Judicial Branch that its engagement in the task of passing on the validity of foreign acts of state may hinder rather than further this country's pursuit of goals both for itself and for the community of nations as a whole in the international sphere.")

[49] 28 U.S.C.A. § 1604 (West 2013).

[50] 28 U.S.C.A. § 1604(a)(2) (West 2013) ("A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case… in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.").

exception.[51] Further, because the default occurred within the sovereign's territory (and thus outside the US courts' jurisdiction), the plaintiff was required to demonstrate that the default also had a "direct effect" in the United States. The court liberally construed the direct effect requirement and held that because the place of payment was New York, the Argentine default had a direct effect in the United States.[52]

However, if a sovereign wished to avoid the reach of US courts, it would not be difficult to do so. By making the payments to intermediaries outside of the United States, a sovereign default would still fall within a commercial exception, but would fail the requisite direct effects test. Indeed, making payments to intermediaries is a very common practice in the sovereign debt market. However, few sovereign debtors choose this shield from US courts. In fact, most do not attempt to escape US judicial reach at all and explicitly accept US or foreign jurisdiction.

Rather than avoid foreign judicial reach, most sovereign debtors take a different approach entirely and waive their right to immunity under the FSIA.[53] *Ex ante*, this waiver sends a message to potential creditors that the sovereign intends to stand accountable for its debt and is willing to submit to the American judicial system for adjudication in the event of default. With this kind of assurance in place, creditors are willing to lend to the sovereign at a lower interest rate because they perceive the risk to be mitigated by the ability to seek judicial recourse.

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[51] Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 614 (1992).
[52] *Id*. at 618-619.
[53] Panizza et. al., *The Economics and Law of Sovereign Debt and Default*, JOURNAL OF ECONOMIC LITERATURE, Vol. 47, No. 3, (Sept., 2009) ("… such waivers are in fact routinely included in bond covenants. As a result, under U.S. law (and that of several other major jurisdictions), sovereign immunity no longer plays an important role in shielding sovereign debtors from creditor suits.")

Thus, two doctrines that would prevent creditors from bringing suits against defaulting sovereign debtors are rendered virtually irrelevant in modern debt conveyances. However, the FSIA presents a more substantial challenge in the context of enforcing and awarding judicial remedies.

B. Attachment/ Enforcement of Judicial Awards

While it is common to for a sovereign to waive its right to judicial *immunity* under §1604, the FSIA provides other protections to sovereigns against *enforcement* of *US* judicial decisions. Because courts cannot enforce judicial awards over assets that are not subject to the court's jurisdiction, sovereign assets located outside of the US are generally unavailable for adjudicatory remedies. Moreover, the FSIA even shields sovereign assets located within the United States from "attachment, arrest, and execution."[54] Although debt instruments typically waive the sovereign's judicial immunity, a waiver of judicial immunity under §1604 does not imply a waiver of asset protection under §1609.[55] However, just as the general provision for judicial immunity contains a commercial activities exception[56], so too does the protection against attachment.[57] Sovereign assets used for commercial activities are excluded from the FSIA's asset protection under §1610.[58] Stated differently, a sovereign's assets being used for governmental functions

[54] 28 U.S.C.A. § 1609.
[55] Walters v. Industrial and Commercial Bank of China, Ltd., 651 F. 3d 280, 288 (2d Cir. 2011) ("…the FSIA's provisions governing jurisdictional immunity, on the one hand, and execution immunity, on the other, operate independently. As the *Restatement (Third) of Foreign Relations Law of the United States* explains, this means that "a waiver of immunity from suit does not imply a waiver of immunity from attachment of property, and a waiver of immunity from attachment of property does not imply a waiver of immunity from suit.").
[56] 28 U.S.C.A. § 1604.
[57] 28 U.S.C.A. § 1610.
[58] 28 U.S.C.A § 1610 (West 2013) ("The property in the United States of a foreign state, as defined in section 1603(a) of this chapter, used for commercial activity in the United States, shall not be immune from judicial attachment in aid of execution…").

are immune from attachment, but if a sovereign is acting in its capacity as a commercial actor, assets used for such purposes are not afforded FSIA protection.

In the zenith of state-supported industry, a court may have found it easy to identify sovereign assets being used for commercial purchases. However, industries have become increasingly private in recent decades. Sovereigns have relatively few commercial assets, and even fewer assets located within the jurisdiction of US courts. The FSIA's exemption for attachment thus creates a difficult dilemma in which courts can adjudicate against a sovereign but are unable to award a monetary judgment for damages. Thus, courts have had to work around this problem by issuing different forms of remedies that often implicate and adversely affect third parties.

C. Third Party Interests

This predicament described above is one-reason third parties often become key players and parties of interest in sovereign debt disputes. For example, in the *NML Capital* case against Argentina, the court was unable to award monetary damages to the holdout creditors. Instead, it was forced to issue an injunction prohibiting Argentina from performing on other contracts (the Exchange Offer bonds) without also performing on the FAA bonds. This implication for third parties is obviously less desirable, as it adversely affects other economic actors who would otherwise be unaffected by a holdout dispute between a sovereign and its creditors. Thus, the FSIA protects sovereign assets but at the expense of third parties.

This will likely be a problem in all sovereign debt disputes. Courts would like to penalize a sovereign who breaches a contractual obligation. The ability to do so would properly align the interests of the sovereign and creditors. However, the FSIA prohibits

courts from enforcing this remedy. Rather, courts are forced to issue injunctions and alternative remedies whose effect is most harmful to third parties, such as other creditors and financial intermediaries. In this respect, Argentina's default is illustrative. Some of the parties most concerned with the litigation and the Second Circuit's opinion are parties not directly involved with the litigation. Financial intermediaries like New York Mellon Corp, the indenture trustee for the restructured bonds, submitted amicus briefs throughout the *NML Capital* litigation. One of the issues on remand, and now before the Second Circuit, is how a ruling in favor of the holdout creditors can be enforced against third parties.

D. General Collective Action Problems

When a sovereign becomes unable to meet its debt obligations, it typically will attempt to restructure its debt to extend the period over which payments are made or lower the premiums paid. However, at the first sign of insolvency, each creditor has an individual incentive to renegotiate the terms of his or her holdings to get the most favorable terms at the expense of his counterparties. Each individual creditor has an incentive structure that is divergent from the best interest of the entire class of debt. This is the classic collective action problem. To mitigate this problem, sovereigns will typically offer a uniform exchange, as Argentina did in 2005 and 2010.

When one examines this collective action problem in the context of sovereign debt restructuring, it becomes evident why the decision in *NML Capital v. Argentina* is so significant. If courts recognize the rights of holdouts to enforce the original terms of the debt issue, they create a significant incentive for creditors to decline debt restructurings in order to enforce the more favorable terms of the initial offering. On the other hand, if

courts refuse to enforce the original terms of the debt, they will give sovereigns the right to unilaterally force modified terms on their creditors. Stated differently, courts would prohibit creditors and sovereign debtors from "bargaining in the shadow of the law," because the sovereign knows that the law will not force them to abide by the initial terms of their contracts.

E. *Pari Passu*

The primary question concerned in the *NML Capital* litigation was over the interpretation of the *pari passu* clause, and the meaning of the Equal Treatment Provision. However, before discussing the interpretation or meaning of these provisions, it is appropriate to understand where they came from and why they are present in sovereign debt contracts.

When a private (non-sovereign) actor issues bonds or another form of debt, that issuer presents potential investors with a decision in risk allocation. There is a chance that the issuer will default on its promise to pay the bonds later. In the corporate context, there is a possibility that the value of the firm's debt obligations will surpass the value of its current assets or assets it can generate in the foreseeable future. When a corporation or firm finds itself in this situation, the borrower and its assets can be liquidated through bankruptcy. At liquidation, its assets are converted into cash, and that cash is distributed to creditors. However, lenders have long recognized that the priority for cash disbursements in liquidation is important. Thus, the *pari passu* clause evolved as a mechanism to ensure that, in the event of liquidation, creditors are treated equally and are paid on a *pro rata* basis. This is especially important when the corporation has the ability to issue new debt with different contractual terms. The *pari passu* clause ensured that no

new debt would be given priority over more senior debt, and vice versa, between the borrower and other creditors.

However, a sovereign state cannot be liquidated. In essence, sovereigns are protected as "permanent going concerns." This presents an important question: if a sovereign is not subject to liquidation, what is the purpose of the *pari passu* clause in sovereign debt contracts?[59] If there is never a possibility that the assets of a sovereign will be liquidated, what protections, if any, does the clause provide investors or debtors in the sovereign debt context? These questions are garnering substantial attention in today's economic literature. But the precise legal meaning of pari passu is outside of this paper's scope. It is the manner in which these clauses are enforced and the economic ramifications of their enforcement that is most relevant for this paper's consideration.

[59] Mitu Gulati and Robert Scott attempt to answer this question in their book, THE THREE AND A HALF MINUTE TRANSACTION. The authors argue that because sovereigns are not subject to liquidation the *pari passu* clause is a largely archaic term that has become boilerplate language in modern sovereign debt contracts. Through their book, the authors argue that such boilerplate language has a tendency to outlive its useful purpose because of the structure of law firms and the rate at which contracts are created. *See generally*, MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION (2013).

PART III: FRAMEWORK FOR ASSESSING A SOVEREIGN DEBT SOLUTION OR SYSTEM

The preceding section outlined the problems and challenges that sovereign debt presents and the following section will analyze legal and political responses that may mitigate the problems. However, before proceeding to that analysis, it is necessary to articulate the socially desirable goals and features that any remedy or system should encompass. These aims should serve as a metric for assessing the feasibility, effectiveness, and desirability of any changes to the sovereign debt system.

From an efficiency and societal wealth-maximizing perspective, any system or solution affecting sovereign debt should have a few main objectives. Choi, Gulati, and Posner provide a helpful structure through which to frame the analysis.[60] First, they note that sovereigns always exist in one of two states.[61] The first, they call the "good state," characterized by economic health and the ability to pay debts.[62] On the other hand, the "bad state," results from external or internal economic hardships and results in the sovereign's inability to pay its debts.[63] As the authors note, one primary difficulty with sovereign debt contracts is the difficulty for investors to distinguish between sovereigns in good states and sovereigns in bad state. They assert that sovereign debt contracts have several goals, many of which are also applicable for a resolution of the sovereign debt problem outlined above. The authors note that these goals should be to

> Encouraging sovereigns to repay in the good state; enabling value-increasing restructurings in bad states; preventing debtors from seeking to exploit divisions among creditors in order to opportunistically reduce their debt burden; and

[60] Stephen J. Choi, et al., *The Evolution of Contractual Terms in Sovereign Bonds,* 4 J. LEGAL ANALYSIS 131, 132 (2012).
[61] *Id*.
[62] *Id*.
[63] *Id*.

> preventing debtors from taking risks in order to externalize the cost of default on creditors. [64]

Like sovereign debt contracts generally, any resolution to the sovereign debt dilemma should also seek to achieve the goals mentioned by Choi, Gulati, and Posner. Namely, such a system should encourage restructuring in "bad states" so that each creditor can recover as much of their original investment as possible.

However, it should be clear that restructuring is not always a socially optimal solution. Indeed, holdouts should and do serve an important purpose in the context of sovereign debt restructuring. Without a system of rights and obligations owed to holdout creditors, sovereigns would have no incentive to negotiate in good faith with their creditors. Likewise, sovereigns in the "good state" may find it easy to behave opportunistically and force a restructuring when it is not absolutely necessary in order to eliminate their burden to meet its debt obligations. [65] In this respect, holdout rights serve as the backbone to good faith negotiation. This is often referred to as negotiating "in the shadow of the law."

To summarize, any external mechanism or judicially created solution to the sovereign debt problem should create the incentive for creditors to undertake good-faith restructuring negotiations with a sovereign who cannot meet its obligations (i.e., is in a "bad state") and should deter such restructuring when a sovereign is financially healthy.

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[64] *Id* at 133.
[65] *Id* at 132.

PART IV: POSSIBLE SOLUTIONS TO THE SOVEREIGN DEBT DILEMMA

The problems outlined in Part II present a number of questions and very few answers. How, if at all, will the dilemma of sovereign debt be resolved? Does the solution to the problems outlined above lie within the reach of the US Judiciary? Could an external institution, such as the International Monetary Fund provide a mechanism or solution to remedy the problems with the sovereign debt market? Should creditors and debtors create new and innovative contractual provisions to govern future contracts? Likewise, are there mechanisms utilized in other areas of law amenable to sovereign debt contracts? Should actors within the sovereign debt market look outside the law completely and rely on a traditional interest rate regime to monitor sovereign debt transactions? This section will present and evaluate some of these ideas and questions.

A. Allow Interest Rates to Regulate

One may wonder why any external action, judicial or otherwise, is necessary to regulate sovereign bonds at all. After all, one of the first lessons in any economics course is the trade-off between risk and reward. Investors require a higher return or premium on investments that they perceive to be more risky. Therefore, government bonds, which have traditionally been thought to be the most secure and "safe" of all investments, typically carry a very low rate of interest. However, investors with the same risk preferences will demand a substantially higher return for equity investments in the stock of publicly traded corporations, because these investments are thought to be riskier than government bonds. Some may reasonably argue that this basic economic principle should be sufficient to govern the sovereign debt market. Stated succinctly, the complete risk

associated with any security should be adequately reflected by the premium or interest rate the particular security offers an investor.

If a security's return were sufficient to regulate the sovereign debt market, bonds of countries with a high risk of default would offer a substantially higher market premia than those from more secure countries. Additionally, markets would be quick to adjust to new market information. When a country's economic outlook became less certain, its bonds would exchange for discounts on secondary markets and new bond issues would have to offer greater interest rates to lenders. In this way, investors could choose investments that meet their risk preferences. Sovereign bonds with a high risk of default would be rated like "junk bonds," but would offer risk-taking investors substantial premia. In theory, this premium over more secure bonds would fully encompass the added risk of default. Rather than seeking judicial awards, investors would simply incur the loss associated with their risky investment as they do when they buy equity investments.

However, bond markets do not operate so efficiently. It seems as though the sovereign debt market operates with significant market distortions and informational asymmetries. Sovereign debt offers judicial recourse (the effectiveness of this recourse is debatable) making the interest rates and similar measures of return in sovereign debt contracts much less effective than in equity investments. Further, the risk of a sovereign debt investment is often unknown *ex ante*. Stated differently, it is often the case that a sovereign must default before an investor is fully aware of the risk associated with the sovereign. This is supported by research that shows that bond spreads increase *after*

default shocks, not leading up to them.[66] Further, the information about an investment in a sovereign bond is skewed by the possibility of a third-party insurer, such as the IMF or in the case of Europe, a monetary union.[67] This information asymmetry undermines the effectiveness of bond markets as information forcing mechanisms. Further, research has shown that sovereign bond interest rates are often tied more to the business cycle and worldwide macroeconomic factors than the specific risk associated with the sovereign issuing the bonds.[68] Thus, as is often the case in economic questions, if more information could be reflected in the market *ex ante*, interest rates may have a higher likelihood of providing an adequate policing mechanism for sovereign debt. However, macroeconomic uncertainty and the unique legal status of sovereign bonds make interest rates alone insufficient to regulate the market for sovereign debt.

B. Create a new "International Financial Architecture" or "Sovereign Debt Restructuring Mechanism" (SDRM)

Perhaps the most controversial solution to the sovereign debt problem has been a proposal by Anne Krueger of the International Monetary Fund. Recognizing that domestic bankruptcy courts provided a convenient an effective tool to solve the collective action problem for private, domestic workouts, the IMF proposed a similar system for sovereign states in 2001.[69] Rather than outline a detailed proposal for how a system would operate, Krueger made a generalized assessment regarding the problems with sovereign debt, such as the collective action problem and the danger of opportunistic

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[66] Cristina Arellano, *Default Risk and Income Fluctuations in Emerging Economies*, 98 AMERICAN ECONOMIC REVIEW 690, 691 (2008).
[67] See discussion of Syndications and Third-Party Insurers below.
[68] Mark Aguiar & Gita Gopinath, *Defaultable Debt, Interest Rates, and the Current Account*, 69 J. OF INT'L ECON. 64, 82 (2006) ("… making interest rates relatively less sensitive to the amount borrowed and relatively more sensitive to the realization of the shock.").
[69] Anne Krueger, First Deputy Managing Director of the International Monetary Fund, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address Before the National Economists' Club Annual Members' Dinner (November 26, 2001).

holdouts.[70] Krueger suggested that the IMF could lend its strong institutional support for countries struggling to effectively restructure their debt obligations. Moreover, she noted that the IMF already undertakes substantial monitoring efforts when countries are within the IMF's assistance program and are in danger of default.[71] These monitoring efforts are necessary to ensure a defaulting sovereign does not engage in opportunistic fiscal policy. The IMF's unique position would allow the institution to alleviate the burden on individual creditors to monitor a defaulting sovereign's actions. Krueger's proposal outlined four key goals of a future sovereign debt restructuring mechanism (SDRM): (1) preventing holdout creditors from disrupting good-faith negotiations, (2) providing creditors with a guarantee that the debtor country will act responsibly during the "stand still" period, (3) providing financial support and guarantees to private lenders who will need additional incentive to cooperate with and make loans to a defaulting sovereign, and (4) binding minority creditors to a restructuring agreement once it has been agreed to by a large enough majority.[72] Likewise, Krueger hoped that such a system would rarely be utilized, but would rather provide a predictable and well-developed operation, such that debtors and investors would be able to reach a mutually beneficial solution by negotiating "in the shadow of the law," not in court.[73] Some believe that a SDRM would afford creditors more rights and bridge the disparity in bargaining leverage between sovereigns and their lenders.[74]

While some have been quick to defend Krueger's SDRM proposal, others have

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[70] *Id*.
[71] *Id*.
[72] *Id*.
[73] *Id*.
[74] Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 CHI. J. INT'L L. 333, 343 (2005).

argued that the implementation of such a program faces too many challenges and has too many inherent flaws to be practicable.[75] As a primary concern, many have noted that sovereigns are unwilling to cede control over a workout process to any third party and will continue to refuse to relinquish complete autonomy absent a better incentive to do so.[76] Others alleged that an IMF controlled system would limit the bargaining power of creditors and would be an "efficient medium through which the geopolitical wishes of the G-7 governments could be imposed on private sector lenders."[77] However, such leverage affects both sides of the creditor-debtor equation, as the ability to impose an economic standstill upon a sovereign would give the IMF substantial leverage over creditors, but also significant power over the autonomy of sovereigns.[78] Critics like Celeste Boeri have found problems with the IMF's Sovereign Debt Restructuring Mechanism (SDRM) even more numerous:

> There are three main problems with the IMF's statutory approach. First, it could potentially be applied retroactively to debt already incurred under different terms. Second, the costs of administration and enforcement may exceed the benefits. Third, it generates confusion over the IMF's role in the world order as a lender of last resort, not a sovereign debt manager.[79]

Finally, some have pointed to the recent "successes" of cases like Argentina, to illustrate that "borrowers and lenders can work out bond defaults on their own."[80] However, the description of sovereign debt problems above and the ongoing struggle between

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[75] LEX REIFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY (Brookings Institution Press 2003), *See Generally* Ch. 11.
[76] A. Michele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 EMORY L. J. 997, 1020 (2004).
[77] Buchheit, *supra* note 74, at 343.
[78] Daniel K. Tarullo, *Neither Order nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 EMORY L. J. 657, 676 (2004).
[79] Celeste Boeri, *How to Solve Argentina's Debt Crisis: Will the IMF's Plan Work?*, 4 CHI. J. INT'L L. 245, 253-254 (2003).
[80] Buchheit, *supra* note 77, *quoting* Mary Anastasia O'Grady, *Americas: Argentina's Lessons for Global Creditors*, WALL. ST. J A15 (Mar 4, 2005).

Argentina and its creditors render this characterization as a "success" quite questionable. Even Krueger's general proposal highlighted a fair number of questions such a system would present, such as the legal basis for such a mechanism and how the IMF would be able to enforce the policies set forth through any plan. [81]

Recently, the emergence of the Collective Action Clause (discussed below) has eclipsed continued efforts towards a SDRM. Particularly, United States' recent aversion to such an effort has led many to conclude that the SDRM proposition is completely off of the table:

> The IMF's SDRM received a substantial blow during the fund's spring meeting of 2003. During this meeting, Treasury secretary John Snow cited markets moves toward collective action clauses and concluded that it was "neither necessary nor feasible to continue working on SDRM." In fact, this pronouncement by Secretary Snow has caused at least one source to declare that the SDRM is "officially dead."[82]

C. Escrow and Neutral Third Parties

The use of escrows is an investment protection technique that has proven useful in dealing with sovereign counterparties in the context of joint ventures. This tool is premised on the idea that a sovereign cannot expropriate funds that are automatically held outside of its borders in foreign bank accounts. Thus, by channeling funds directly to a foreign third-party, investors in a foreign joint venture agreement can minimize the political risk associated with conducting business with a sovereign. Because sovereign debt agreements also contain political risk, this mechanism may be an effective tool to utilize in sovereign debt contracts. However, this contractual tool has not been tested or analyzed in the academic literature.

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[81] Krueger, *supra* note 65.
[82] Jonathan Sedlak, *Sovereign Debt Restructuring: Statutory Reform or Contractual Solutions*, 152 PENN. L. REV. 1483, 1484 (2004).

In the context of sovereign bonds, the funds that are in danger of unjust expropriation are internal tax revenues owed to creditors under the terms of sovereign bond contracts. In theory, the terms of a bond offering could specify that the requisite tax revenues to meet a country's debt obligations could be directly deposited into a third-party escrow immediately after collection. If effective, this would eliminate the possibility that a sovereign could reallocate the revenues to internal projects or make preferential payments to its domestic debt holders. In theory, the escrow would undertake those responsibilities and allocation decisions.[83]

However, the problems that are concerns for sovereign debt are not completely eliminated by the use of escrows and third parties. Tax revenues collected by the national treasury could easily be expropriated prior to being channeled to the escrow. While this would violate the terms of the bond contract, this seems of little consequence from the perspective of a sovereign. Often the actions that lead to a sovereign default are also against the terms of its bond contracts, but internal considerations often outweigh obligations to debtors, causing the countries to willfully breach. However, contrary to a domestic contract breach where both parties are subject to the same jurisdiction, contractual breaches in the sovereign context provide limited opportunities for creditor recourse. Furthermore, just as there is a concern about yielding control of a sovereign's affairs in the context of a Sovereign Debt Restructuring Mechanism, it seems probable that these same concerns would be raised if a country were asked to submit its tax revenue decisions to a neutral third-party. Since bond terms are authored by issuing

[83] For an overview of Joint Ventures Agreements as a means of political risk mitigation, see generally, Frederick J. Phillips-Patrick, *Political Risk and Organizational Form*, 34 J. OF L. AND ECON., 675 (1991).

countries, it is even less likely that a sovereign would willfully cede control over tax revenues by offering this type of arrangement.

D. Syndication and Third Party Guarantees

Another possible means by which creditors could be afforded protection in the context of sovereign debt is through syndication or third-party guarantees. Under this process, third parties such as the IMF or another sovereign could act as an insurer of an issuing country's sovereign debt. Such an arrangement would have the effect of lowering the interest rate demanded by investors and increasing the security of their loan. In the event of default, another party would be tied to the investment, providing an alternate source for investment recovery.

To some extent, a process like this already exists in practice. The IMF often provides financial assistance to struggling sovereigns in order to help avoid default.[84] The IMF is able to make temporary, interest free loans to countries in financial distress and can also lend needed liquidity through "Stand-By Arrangements," in which the IMF acts as the guarantor of loans made to the distressed country. In exchange for such support, the IMF imposes certain market-based regulations on the distressed sovereign. In this way, the IMF acts similarly to the Federal Deposit Insurance Corporation (FDIC) to regulate and stabilize investments, but on an international scale. However, the IMF's refusal to continue support for Argentina in its darkest hour in December of 2001 is illustrative of why the IMF alone cannot secure the entire sovereign debt system.[85] The IMF provides support for distressed sovereigns that behave according to its market-based rules. However, many sovereigns do not abide by market-based standards for conduct and

[84] The Role of the IMF in Argentina, 1991-2001
[85] *Id*.

often their conduct has led them to the default in the first place. Thus, the IMF provides a helpful form of investment protection, but only to a limited degree. Further, once default has occurred, the IMF ceases to be useful as a source of investment recovery.

Likewise, the European Union's economic and monetary integration has created a similar mechanism within the Euro-zone. The recent Cyprus bailout has shown that deep economic and monetary integration between nations can serve as an impetus for bailouts by stronger economies. However, this arrangement has been far from successful. If anything, the Cyprus debt debacle and future concerns about Greece, Italy, and Spain have cast serious doubt on the long-term viability of the European Union. It seems increasingly unlikely that countries like Germany will repeatedly agree to costly bailouts to maintain the financial stability of its currency. There is also concern that deep integration can lead to the moral hazard problem, where a sovereign undertakes substantially more risk because at least some of the burden is spread among its counterparties. Fiscally responsible countries derive little benefit from economic integration when less-responsible countries are able to take advantage of their strong economies and rely on them for bailouts.

E. Collective Action Clauses and Uniform Action Clauses

The mechanism that has seen the most widespread success is a private contractual solution known as the Collective Action Clause (CAC). As noted above, the prevalence and success of CAC's have virtually eliminated the possibility of a Sovereign Debt Restructuring Mechanism. Until recently, most sovereign bonds issued under New York law required unanimity to restructure the entire class of debt (Uniform Action Clauses,

UAC's).[86] UAC's force sovereigns to either persuade the entire class of bonds or negotiate restructuring efforts with each individual creditor. This standard exacerbated the collective action problem and allowed holdouts to behave opportunistically. However, bonds issued under the so called, "London Law" usually only required a supermajority of bondholders to agree for the restructured plan to be binding on the entire class of debt (CAC's).[87] CAC's have become standard features of sovereign debt contracts over the last decade.[88] Since Mexico implemented a CAC in 2003, "virtually all" of new sovereign debt contracts have included a CAC, and the inclusion of these provisions has been dubbed the "Mexico Standard."[89] In theory, debt issued pursuant to this standard is much easier to restructure, as obtaining the consent of a supermajority can bind the entire class of debt and eliminate holdout creditors such as the NML Capital plaintiffs. While the precise threshold varies by country and across bond issues, [90] the required threshold is usually between 50% and 75%.[91]

A variation on a minimum voting threshold is for CAC's to appoint a trustee to negotiate on behalf of an entire class of debt. While formally distinct, this approach has the same effect on the collective action problem. Putting the task of restructuring decisions in the hands of a single actor (who is usually a member of the class and has similar interests to the class) serves to coordinate the efforts of disaggregated, interested parties.

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[86] Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L. J. 929, 932 (2004).
[87] *Id*.
[88] Sergio Galvis & Angel Saad, *Collective Action Clauses: Recent Progress and Challenges Ahead*, 35 Geo. J. Int'l L. 713 (2003).
[89] Ed Bartholomew, et al., *Two-Step Sovereign Debt Restructuring: A Market Based Approach in a World without International Bankruptcy Law*, 35 GEO. J. INT'L L. 859, 860 (2003).
[90] Innovation in Boilerplate Contracts, *supra* note 86.
[91] Choi, et al., *supra* note 60.

However, CAC's do not solve the problem entirely. In order to be effective, a sovereign must still be able to persuade the requisite threshold of debtors to agree to a restructuring proposal. Especially when this threshold is upwards of 75%, that is no small task. Perhaps most critically, the outcome of *NML Capital* could substantially handicap the ability of sovereigns to persuade creditors not to holdout. The Second Circuit's decision to issue an injunction and effectively require Argentina to compensate to the holdouts may have adversely altered the incentive structure and encouraged creditors to holdout, rather than restructure. If so, sovereigns may have trouble executing future debt restructuring efforts, even with CAC's in effect.

In short, the international community has failed to produce a viable solution for the sovereign debt conundrum. One argument against the IMF's Sovereign Debt Restructuring Mechanism was that actors have had recent "success stories" in independent negotiations. This argument alleges that a supranational mechanism is not necessary when actors can privately reach the same, effective resolution of disputes. In response, Lee Buchheit appropriately characterized this "success" as "a bit like concluding that World War I stands for the proposition that, left on their own, nationals can work out their differences.[92] While the last decade has shown that sovereign debt restructurings are *possible*, few would call the recent efforts to restructure sovereign bond obligations a success. Negotiations are marred by holdouts, ongoing collective action problems, and an inability to enforce judicial awards against sovereigns. Thus, while the international community of scholars, investors, and financial institutions have proposed and discussed a number of solutions and remedies outlined above, none have proven effective or practicable. The state of affairs has not been substantially changed by these

[92] Buchheit, *supra* note 74, at 343.

proposals and mechanisms; sovereigns and investors are left to negotiate terms, restructure debts, and resolve disputes subject only to national judicial remedies.

PART V: JUDICIAL RESOLUTION ABSENT AN EXTERNAL MECHANISM

As noted above, sovereign debt presents substantial obstacles for debtors, creditors, and courts. As the preceding section showed, the present legal environment has failed to provide an immediate panacea. However, private remedies such as collective action clauses have become prominent in most sovereign debt agreements. While these clauses seem to alleviate the holdout problem for future debt restructurings, their effectiveness remains uncertain. For reasons outlined below, the success of collective action clauses will be entirely dependent upon the judicial resolution of the dispute between NML Capital and Argentina and the subsequent behavior of the parties.

This section will first explain why the court's decision in *NML Capital* is so critical to the future of sovereign debt. After explaining that the NML case will set precedential incentives for future debtors and creditors, the next subsection outlines the outcome alternatives for the case and the incentives created by each. Finally, this section concludes by making a normative argument that it is socially desirable for Argentina to default on its current debt obligations.

A. Why the Judicial Outcome is Important

As noted in Part III, collective action clauses have become standard in sovereign debt agreements. By empowering a majority of debt-holders to agree to a debt restructuring on behalf of the entire class of debt, collective action clauses limit the ability of holdouts and vulture creditors to impede the restructuring process. However, the danger of holdout is not eliminated. There is always a chance that the requisite number of creditors will not agree to the restructuring. This would result in either the terms of the debt issuance remaining unchanged (no restructuring) or would result in the

same state of affairs as is present in the Argentina debt instruments, where the collective action clause is absent completely and the sovereign must obtain individual consent to restructuring. Therefore, the ability of a class of debt to meet the minimum threshold set by the collective action provision is of monumental importance to the clause's effectiveness.

This section will offer a model for examining how an individual will calculate a decision to accept a debt restructure. That model will be used to explain how the outcome of the *NML Capital v. Argentina* case could affect the decisions of future creditors to agree to restructuring terms. Finally, that analysis will be applied to CAC's to show that the decisions following the *NML Capital* litigation have the ability to seriously handicap CAC provisions in future debt contracts.

An individual debt holder's decision to accept a restructuring agreement will depend upon her perception of the likely opportunity cost to doing so. In this parlance, the opportunity cost of restructuring is holding out. Stated differently, a holder of sovereign debt faced with the option to restructure will make an assessment of her expected utility under the terms of the restructure compared to her expected utility from holding out (not restructuring). This decision can be illustrated by the following model:

$$(P_1)x + (1 - P_1)z = (P_2)y + (1 - P_2)\,z$$

In this model, the left side of the equation represents the expected value of holding out, while the right side represents the expected value of restructuring. P_1 is the probability of receiving the full amount due under the original debt agreement (x). Initially, the model assumes that the only two outcomes are (1) receiving the full amount due (x), or (2)

receiving zero payments (z). Thus, the probability of not being compensated for a sovereign default at all is represented by $1\text{-}P_1$, because the two possibilities represent all possible outcomes. On the right side of the equation, the value to the creditor under the restructured debt agreement is represented by y, and the probabilities of being paid that amount or not being paid at all (z) are represented by P_2 and $1\text{-}P_2$, respectively. Assuming that creditors are rational and behave in ways that maximize their expected utility, the model suggests that when the creditor perceives her expected pay-off after restructuring to be higher than holding out, she will choose to restructure. But when she perceives the restructuring opportunity to be less desirable (lower utility) than her current agreement, she will decline the proposed debt restructuring terms and opt to holdout.

It is important to note at this stage in the model that the term "perception" is a very important adjective with respect to the expected values for holding out and accepting the restructuring. Whether accurate or not, a creditors perception of her expected payoff is completely determinate of her decision. Thus, an incorrect assumption or a change in perceived likelihood of a particular outcome may disproportionately affect her decision.

With the model as the baseline, it is possible to explain why the majority of the creditors in the *NML Capital* case decided to accept the restructuring. Economic turmoil and a failing Argentine economy support the assumption that the probability of being paid in full pursuant to the original debt agreement was very low, if not zero ($P_1 = 0$). Further, Argentina's affirmative agreement not to pay the outside debt reinforced the assumption that creditors holding the original debt agreements would not be paid. Thus, a creditor would likely accept any offer to restructure that carried with it a greater certainty

of payment. If we assume that the perceived probability of being paid under the restructured debt agreement is .8 (there is still a chance Argentina will default on its new debt agreements) and that the terms of the restructure are twenty-four cents on the dollar, a creditor's assessment of options may have looked like this:

$$(P_1)x + (1 - P_1)z = (P_2)y + (1 - P_2)\,z$$

$$(0)1 + (1)0 = (.8).24 + (.2)\,0$$

$$0 < (.8).24$$

Here, a creditor will accept an expected pay-off of less than twenty cents on the dollar (.8 x $0.24 = $0.19) to her original investment because the likelihood of being paid if she does not restructure is zero. So if the expected value of the distribution under the original debt agreements was zero, why do any creditors ever hold?

The holdouts in the *NML Capital* case (apparently with good reason) perceived the chance of being paid through the original agreements as greater than zero. In the example above, if they believed they had at least a twenty percent chance of receiving a judicial award enforcing their original right to full payment, it would be in their best interest to hold out. This *ex ante* assessment is where perception and the outcome of *NML Capital v. Argentina* become critical. While many of the creditors perceived their chances of recovery by holding out as virtually zero, the holdouts perceived it to be higher. After the Second Circuit's decision, it seems that the holdouts were correct, as the court is in the process of upholding their rights under the original agreement. In this way, the courts decision will substantially affect future debt holders' cost-benefit analysis. If the decision is upheld, the Second Circuit's holding would clearly assert that the probability of being compensated as a holdout is greater than zero.

Thus, the *NML Capital* outcome is significant for three important reasons. First, by upholding the rights of the hold out creditors, the court drastically affected the probability that holdout creditors will be paid (P_1) by asserting that they have judicially enforceable rights when a sovereign makes payments to other debtors. Second, the court's decision will also affect the expected quantity that holdout creditors (x) and creditors that agree to restructuring (y) can expect to receive. This second question, along with the status of third party intermediaries, is the question that was remanded to the District Court in the Second Circuit's decision. Its precise outcome is still unknown. Finally, the court's decision may ultimately affect the probability that a sovereign will make payments to restructured debt. The first effect (the increased rights of hold-out creditors) is most important for the purposes of this paper. However, the second and third reasons may also substantially affect the decision to restructure.

1. Upholding the rights of hold-out creditors (P_1)

While the final status of *the NML Capital v. Argentina* outcome is still undetermined, the Second Circuit's decision confirmed the holding of the lower court and upheld the rights of the holdout creditors to seek damages pursuant to the original debt agreement. By upholding the *pari passu* clause and deciding that a sovereign debtor's payments to restructured debt without payments to the original debt was *de facto* subordination, the court substantially affected the probabilities in the model above. Prior to this decision, most creditors believed the probability of recovery for a holdout (P_1) was virtually zero. However, the Second Circuit has revealed that is no longer a prudent assumption. Stated differently, creditors will now perceive their chances of recovering when they hold out as substantially higher than zero. So while the probability of recovery

if a creditor restructures is *seemingly* unaffected by the court's decision,[93] the probability of recovering if a creditor does not accept has increased substantially. In the terms of the model, P_1 is now a non-zero, positive probability.

The obvious effect of this decision will be to increase the number of holdouts when sovereigns try to restructure debt agreements. If a creditor believes she has a substantial likelihood of recovery under the original terms, her incentive to restructure falls relative to her incentive to holdout.

2. An unknown change to the quantity of recovery (*x* and *y*; $P_1=P_2$)

The issue of damage calculation was one of the issues that the Second Circuit remanded to the district court. The Second Circuit asked the Judge Griesa to clarify the formula by which the payments to the original debt should be calculated relative to the payments made to the exchange debt. Judge Greisa explained that the amount Argentina would be required to pay to the holdouts is calculated relative to the amount being paid to the restructured debt. The "ratable payment" (x) due to the holdouts should be the "payment percentage" multiplied by the amount due to the holdouts. The payment percentage is calculated as the amount being paid to the exchange bonds divided by the amount due to the exchange debt. Thus, x is calculated as follows:

$$x = \frac{Paid\ on\ Exchange\ Debt}{Due\ on\ Exchange\ Debt} \times (Due\ on\ Original\ Debt)$$

It follows that in order to make full payments on the exchange debt, Argentina must fully compensate the remaining amount due under the original debt. With respect to the model, this decision inextricably links the amount paid to the original debt (x) and the amount

[93] This assertion is not necessarily true. As will be discussed later, upholding the rights of holdout creditors may substantially affect the probability that restructured debt will recover. However, at this stage, it is helpful to think of the two independently.

paid to the restructured debt (y) and holds a constant proportion between the two. If this calculation holds on appeal, it seems unlikely that a future creditor would ever willingly restructure. If a sovereign must pay an equal percentage of what it owes to the original debt and to the exchange debt, it would be against any actor's interest to exchange an entitlement to full compensation ($x=1$) for a fractional amount ($y=.24$) if the probabilities of recovery are also equal($P_1=P_2$). The Second Circuit's opinion suggests that these probabilities are also inextricably linked, as they held that payments could not be made to exchange debt without making the aforementioned ratable payments to the original debt. It is notable that this calculation is on appeal and has yet to be confirmed by the second circuit. However, if Judge Griesa's holding stands, this calculation, perhaps even more so than the likelihood of payment absent exchange, will substantially decrease a creditor's incentive to restructure debt and increase her incentive to holdout.

3. A change to the probability of being paid if restructured (P_2)

The final effect that the NML Capital decision will have is a decrease in the probability of being paid the full amount promised under the terms of the debt restructure. Prior to the decision, Argentina regularly made its payments pursuant to the 2005 and 2010 debt agreements. However, if the Republic wishes to continue to make these payments in full, it will have to also fully pay the original holders of the debt. This presents obvious problems, as Argentina did not have sufficient funds to pay the amount owed to the original debt, which is why they restructured. While the gross amount they will have to pay will be reduced by the percentage of creditors who accepted restructuring, the amount owed to the holdouts is still upwards of $1.3 Billion. Since it is unlikely that Argentina will be able to make full payments to both the holdout and the

restructured debt, it is likely that the Republic will have to make a proportional payment to both classes, marking a clear "win" for the holdouts and a clear loss for the restructured debt.

As applied to the model above, the *NML Capital* decision (1) increased the probability of hold-out payment (P_1) to a non-zero, positive amount, (2) linked the amount payable to holdout and restructured debt (x and y) to a constant proportion (P_1=P_2), and (3) required the likelihood of payment to holdouts and restructured debt to be equal to one another. Thus, the decision has altered the ex ante decision model as follows:[94]

$$(P_1)\frac{x}{r} + (1 - P_1)z = (P_1)\frac{y}{r} + (1 - P_2)\,z$$

Taken together, these three outcomes suggest the judicial decision in *NML Capital* will tend to incentivize more holdouts. In fact, the model seems to indicate that no creditors will accept restructuring agreements, as now it is never in an actor's best interest to do so. The Second Circuit has required that the probability of payment for each be equal, as well as the fractional payment to each class. Thus, the only difference between the expected recovery for holdouts and restructured debt is the quantity Argentina agrees to pay each class. Because the whole point of restructuring debt is to alleviate a debtor's burden, it would not make sense for the restructured terms to be *higher* than the original.[95] Therefore, when faced with the decision of whether to restructure or holdout, a rational creditor will always holdout if the NML Capital changes go into effect.

[94] Where "*r*" is a fractional amount reflective of the required "payment percentage."
[95] However, a debtor may be able to spread payments out and reduce its immediate financial burdens. If time considerations are controlling, a restructured debt agreement may result in a higher gross amount paid throughout the course of the debtor-creditor relationship, with the incremental payments shrinking.

However, collective action clauses are intended to allow for a majority of creditors to require the entire class of debt to restructure. Stated differently, they are intended to alleviate the holdout problem. But with the incentive structure shown above, creditors will have no reason to restructure in the first place. Here, the result would be that no creditors restructure, which would render collective action clauses useless.

B. Why Argentina's Response is Important

As noted in the preceding section, the judicial outcome of *NML Capital*, seems to meet one of the two main criteria set forth in Section III. To its credit, the current judicial resolution upholds the backbone of good-faith negotiations by enforcing the rights of holdout creditors. By upholding those rights in such a strong way, the court effectively reinforced the notion of "bargaining in the shadow of the law." However, while protecting the rights of creditors, the judicial outcome also substantially decreased the incentive to restructure when it is socially optimal to do so. When a sovereign is in a "bad state" and is unable to pay its full debt obligations, it is in the best interest of all parties involved for the creditors to cooperate and consent to a restructuring agreement. If a sovereign and its creditors are not able to successfully undertake a debt restructuring, it is likely that none of the creditors will recover, and the sovereign will simply be unable to make any payments. While the recent addition of collective action clauses to sovereign debt agreements is meant to alleviate that problem, the model outlined above suggests that the judicial decision will undermine the effectiveness of collective action clauses in creating a coordination tool.

However, the judicial response is only half of the equation. Because of Argentina's unique role as a sovereign, the judicial remedy in the *NML Capital* case was

limited to an injunction. Through its ability to control third parties, the Second Circuit was able to prohibit Argentina from paying the exchange debt without also paying the holdouts. The court was unable to force Argentina to pay the amount owed on the original bonds. Thus, Argentina still has a fair amount of autonomy with respect to its response to the judicial decision. This section will argue that while it may seem counterintuitive, the socially optimal response (i.e., the response that yields the greatest total social utility) to the judicial outcome is for Argentina to default (or completely repudiate) and not make payments to either class of debt. However, the socially optimal response is not the optimal response for Argentina. Because Argentina is a repeat player in the international debt market, it is likely that the sovereign will comply with the Second Circuit's decision to the greatest extent possible in order to ensure that it can obtain relatively low-cost financing in the future.

1. An Argentine default as the socially optimal response to NML capital

As stated in Section III, the goals of a sovereign debt regime should be to maintain creditors' rights sufficient to garner good-faith efforts by the sovereign and to incentivize "efficient restructuring" (i.e. restructuring when a sovereign is in a "bad state"). However, the model presented above shows that the *NML Capital* decision, if upheld, presents a serious risk of disincentivizing any restructuring possibility. Yet, Argentina may substantially affect future creditors' decision calculus depending on its response. If the Second Circuit's injunction is upheld, Argentina seems to have three possible responses. First, it could attempt to continue to make full payments to the exchange debt and pay the original debt (the holdouts) in full. Second, the sovereign may decide not to make full payments, but rather make *pro rata* payments to each class.

Alternatively, the Argentine Republic could elect not to make payments to either class of debt. While this last option is not optimal for the short run interests of current creditors, it is the long-term best response for the stability of the sovereign debt system.

a. Payment in Full and Pro Rata Payments to both classes

By paying both classes of debt in full, Argentina would reinforce the incentives to hold out as outlined by the model above. Under this scenario, both the holdouts and the exchange debt would receive the full compensation that they agreed upon. However, this course would mark a clear victory for holdouts. If Argentina pays the holdouts in full, holders of the exchange bonds will know they essentially forfeited seventy-five percent of their legal entitlements. As noted, this undermines the effectiveness of collective action clauses. After seeing the holdouts recover in full, no future investors will willingly forfeit her legal right to full payment for a restructured amount.[96] So even with the minimum threshold collective action clauses create, it seems unlikely that any creditor will elect to restructure, let alone the requisite majority necessary for the collective action clause to be effective.

The same problem is true if Argentina makes *pro rata* payments pursuant to the Second Circuit's injunction. In this scenario, the holdouts would recover the same proportion of their original entitlement (a higher amount) as the exchange holders (a substantially lower amount). Again, future creditors have no incentive in this scenario to agree to a debt exchange or restructuring. If they know that they will ultimately be paid

[96] However, for this scenario to come to pass, the exchange debt still plays an important role. Without the exchange, Argentina's total debt would be so insurmountable that payment in full would not be an option. The restricting of 2005 and 2010 lowered Argentina's obligations with respect to 90% of its creditors. If not for those restructurings, payment in full would not be an option. This shows a circular problem: when none of the creditors restructure, none of the creditors will be able to recover. This problem is addressed below.

only a fraction of what they are owed, creditors will obviously choose the fraction of the larger amount (the original bonds) over the smaller amount (the exchange bonds). Again, every rational creditor will choose the maintain her original entitlements and none will restructure.

The difference between these two alternatives is really whether Argentina is able to increase the total amount it pays to creditors or whether the Republic has a fixed amount which it will be able to allocate to servicing its debt. The first scenario could lead to the first alternative in which both classes are paid in full. The second alternative where Argentina will pay a fixed amount and allocate that amount between the two classes of debt is more likely. If Argentina could substantially vary the total amount it pays to creditors (either through increased tax revenues or altered domestic spending habits), it probably would not have needed to restructure in the first place. However, the sovereign is bound by what it is able to collect in tax revenues, making this ability relatively unlikely. Instead, it is probable that Argentina knows that it can make a fixed amount of total payments to service all of its debt. Under this scenario, the decision to accept the exchange offer or continue with the holdout only affects the relative *allocation* of funds to the creditors. But the effect is the same for both scenarios. In both cases, it is in the creditors' best interest to hold out to gain a larger proportion of whatever sum is distributed.[97]

[97] Notably, under the scenario where Argentina will distribute a fixed amount among exchange and holdout creditors, if every creditor holds out, the effect will be identical to every party restructuring. For example, if Argentina's original debt obligations are $10 Billion, but the sovereign is only able to make payments in total of $2 Billion, Argentina will attempt to restructure to reflect their ability to pay. Their offer will probably be approximately $0.20 on each dollar owed. If every party agrees to the exchange, each creditor will receive 20% of his original entitlement. However, if no parties restructure, Argentina's obligations are still $10 Billion, but it is only able to pay 20% of that obligation. Again, each creditor recovers 20% of her original obligation. In this example, it does not matter whether the parties all restructure or all hold out, their recovery amount will be the same. However, the point is that when parties will choose between

b. The Effect of a Complete Argentine Default (or "repudiation" of debt)

Despite the incentives created by the Second Circuit, Argentina is in an incredibly influential position to *increase* stability in the sovereign debt market. They could do so by completely defaulting on both classes of debt and not making payments to either class. While this will result in short term losses for all of its creditors, a default will send a clear message to future creditors.

As noted above, the problematic effect of the Second Circuit's decision is the reality that if any amount is distributed to Argentina's original and exchange debt, the holdouts are the clear winners, as they recover a higher portion of the original entitlement at the expense of the exchange debt. However, the scenario plays out quite differently when no creditors recover. If Argentina chooses or is unable to pay any of its debt obligations as a result of the Second Circuit's injunction, future creditors will once again have an incentive to agree to restructuring offers. Argentina's refusal to pay would reinstate the real possibility that, under a certain set of circumstances where creditors holdout, some creditors would lose the entirety of their investment. If creditors perceive a very real possibility that widespread holdouts will result in complete default by the sovereign, they will once again have an incentive to restructure in good faith when a country is in a "bad state." In the case where each class of debt is paid an equal *pro rata*

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restructuring and holding out, none will willingly restructure. In a scenario when 90% of the creditors restructure and 10% hold out, the allocation of the $2 Billion at stake will play out as follows:

$$\$2\ Billion = (x\%)(10\%)(\$10\ Billion) + (x\%)(90\%)(\$2\ Billion)$$
$$x = 17.8\%$$

So Argentina will be able to make payments to each class of debt representing 17.8% of its obligation to each. However, since the holdouts are still entitled to their original $10 Million, they receive a higher *proportion* of their original entitlement (17.8%) whereas the restructured debt only receives 17.8% of their 20% entitlement under the restructure, or 3.57% of the original agreement.

share, as prescribed by the Second Circuit, that consideration is completely absent, leading to an outcome where every creditor chooses to holdout.

However, while an Argentine repudiation of debts may encourage many of the creditors to accept future offers to restructure, it still leaves open the possibility that a small percentage of creditors may try to "shirk" and attempt to recover substantial payoffs pursuant to the Second Circuit's decision. Essentially, it returns the state of affairs to the present case prior to the *NML Capital* decision. This consideration is why collective action clauses may once again be relevant if Argentina decides not to make payments to either class. After the *NML Capital* decision, future creditors need an impetus to shift their optimal decision from holding out to accepting a restructure. A complete default or repudiation by Argentina would serve that purpose; collective action clauses will not be undermined if most creditors regain the incentive to restructure when it is efficient to do so. So although a few creditors may want to behave opportunistically to recover a higher portion than their peers, collective action clauses will solve that problem for future contracts as they were intended to do. Therefore, while an offer to restructure may not persuade every creditor to accept the exchange, the offer need only persuade the requisite threshold specified by the collective action clause in order to be effective. Thus, while the short-term consequences of a refusal to pay are not desirable and may even constitute a bad faith effort by Argentina, such a repudiation would counteract *NML Capital v. Argentina's* debilitating effect on collective action clauses and the strong incentives to holdout it created. Therefore, a complete default is precisely the response that will yield the socially optimal response for future sovereign debt agreements.

2. Argentina's individual incentives do not align with the socially optimal outcome

Until this point, this analysis has not examined the problem from the perspective of Argentina as a rational, self-interested debtor. While an Argentine default may promote long-term efficiency from a social perspective, Argentina's individual interests suggest that it will not repudiate its debt obligations.

As a sovereign actor, foreign courts cannot force Argentina to make payments on its debts with assets located outside the foreign court's jurisdiction. In certain circumstances, foreign courts may be able to seize Argentine assets[98] being used for commercial purposes and liquidate them to satisfy Argentina's creditors.[99] However, short of those extreme circumstances, Argentina is under no legally enforceable obligation to repay its debt. Any choice to do so must stem from extra-legal motivations.

Argentina and its lawyers in the Southern District of New York and the Second Circuit have threatened to withhold payment to the holdouts.[100] If the Republic's threat holds true, the threat would have the effect of withholding payment from all debt holders, as the court ordered injunction would render third-party banks incapable of paying the exchange bondholders absent payment to holdouts. While these threats were probably made to elicit a favorable ruling in the *NML Capital* litigation and have only a short-term perspective, the arguments made above suggest that Argentina's threatened response is critical for maintaining a well-functioning sovereign debt system.

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[98] One of the more controversial parts of the Second Circuit's decision was a liberal grant for discovery proceedings which purport to allow NML Capital to identify all Argentinian assets around the globe. The Supreme Court has accepted Argentina's petition for certiorari to, which argues that this broad grant violates the Foreign Sovereign Immunities Act and asks the court to overturn the discovery grant.

[99] 28 U.S.C.A. § 1610.

[100] Peter Eavis, *Argentina's Bond Case is Being Closely Watched for Ramifications*, NY TIMES DEALBOOK (February 27, 2013), *available at* http://dealbook.nytimes.com/2013/02/27/argentinas-bond-case-is-being-closely-watched-for-ramifications/.

There is a vast body of economic literature that seeks to answer the question: "why do sovereigns repay their debts?" The answer to this question will reveal Argentina's individual considerations and may suggest whether it will repudiate its debt obligations. Many have argued that there is a strong reputational component to sovereign lending, and sovereigns choose to pay their creditors because doing so will maintain future lines of credit at lower interest rates.[101]

The logic behind this conventional approach to the risk-reward relationship is simple. When a sovereign defaults, bondholders are economically harmed and will be less likely to lend to the same sovereign in the future. While the precise relationship between a sovereign default and the risk premium associated with future bonds is difficult to predict *ex ante*[102], some have successfully calculated the risk premium *ex post*. Of notable significance for the case at hand, Kris Mitchener and Marc Weidenmier estimated the increased risk premium on Argentinian debt following a prior default during the Baring Crisis of 1890.[103] Throughout the 1870s and 1880s, much like the 1990s, capital flowed into Argentina at unprecedented rates, and lending to the South American country accounted for a substantial portion of international lending.[104] When Argentina ultimately defaulted on approximately £48 Million, Mitchener and Weidenmier estimate that the market premium on Argentinian bonds increased by 840

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[101] Herschel Grossman & John B. Van Huyck, *Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation*, (Nat'l Bureau of Econ. Research, Working Paper No. 1673, 1985).
[102] Aguiar et al., *supra* note 68, at 82.
[103] Kris Mitchener & Marc Weidenmier, *The Baring Crisis and the Great Latin American Meltdown of the 1890s*, (Nat'l Bureau of Econ. Research, Working Paper No. 13404, 2007).
[104] *Id*. at 3-4. ("As a result of the open capital markets that prevailed in the nineteenth century, Argentina was able to borrow extensively abroad. It was the fifth largest sovereign borrower in the world. It absorbed roughly 11 percent of all ne issues in the new London market between 1884 and 1890 and 40 to 50 percent of all lending that occurred outside the United Kingdom in 1888… Taylor suggests that 'the 188s stand out as a period of totally unprecedented capital inflows into an emerging market at any time in history.' The current account deficit, as a percentage of GDP, averaged 20 percent from 1884 to 1889.")

basis points in the year following the default and by more than 1,600 basis points in the five years following the default.[105] Essentially, these authors' research quantified the increase in the risk premium on Argentinian bonds following the country's default, even in a 19th century market that was far less sophisticated than today's. Other authors have shown similar negative effects on defaulting sovereigns. Sule Ozler showed a corresponding increase in risk premia for defaulting countries in the context of private lending agreements and estimated that a sovereign's default history accounted for between 11 and 50 percent of the risk premia private lenders charged to developing countries.[106] Eaton and Gersovitz argue that private lenders create maximum credit limits, or "credit ceilings" for defaulting sovereigns, which represent the maximum amount that the private lender will be willing to lend the sovereign in the future.[107] Although the private lending context is distinguishable from public bond markets, a sovereign's default should have similar negative repercussions for the public sector in both financing arrangements. Furthermore, Şenay Ağca and Oya Celasun show that the negative effects of sovereign default are not limited to the public sector. In their 2012 study, the authors identify a positive correlation between sovereign default risk and lending interest rates to corporate entities.[108] Ağca and Celasun suggest that a sovereign default increases the risk that a corporate entity will face higher tax burdens in the future, and therefore lenders and bond purchasers attribute a higher risk premium to corporations whose sovereign has defaulted.

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[105] *Id*. at 2.
[106] Sule Ozler, *Have Commercial Banks Ignored History?* (Nat'l Bureau of Econ. Research, Working Paper No. 3959, 1993).
[107] Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, THE REVIEW OF ECONOMIC STUDIES Vol. 48, No. 2 (April 1981).
[108] Şenay Ağca & Oya Celasun, *Sovereign Debt and Corporate Borrowing Costs in Emerging Markets*, 88 JOURNAL OF INT'L ECONOMICS 198 (2012).

Thus, it seems likely that the need for future financing, whether through the bond market or through private lending, will compel Argentina to honor the obligations that it owes to its creditors in line with the Second Circuit's holding. Argentina's refusal to pay its current debt obligations would result in higher rates of interest in the future and perhaps unwillingness by future lenders to purchase Argentine bonds. Some have criticized this view as over-simplified,[109] and have suggested that lenders must be able to threaten trade sanctions or other adverse effects to international trade in order to persuade a sovereign to honor its debt commitments.[110] However, even those authors do not completely discredit the reputational effects of a sovereign default on future credit terms.[111]

As is evident from Argentina's long history with sovereign defaults, Argentina is a repeat player in the international bond market and will necessarily need to obtain financing in the future. Thus, conventional logic seems to indicate that it is probable Argentina will attempt to make some good faith payments to its exchange bondholders

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[109] *See*, Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?* 79 AM. ECON. REV. 43 (March 1989) (The authors argue that reputational considerations alone are insufficient to keep developing countries from repudiating debt and that creditors must have the ability to issue sanctions upon or affect trade with a defaulting creditor in order to persuade sovereigns to perform on the loan contracts. However, the authors notably confine their analysis to development loan contracts. These are contractual lending agreements between a single institution, such as a bank, and a sovereign. Wile the reasoning the authors use may be similar; this situation is distinguishable from international bond offerings. First, bilateral lending agreements are likely to be much smaller in scale than an international issuance of bonds. Second, a repudiated lending agreement only negatively affects a single lender, whereas a repudiation of bonds affects hundreds or thousands of lenders on a worldwide basis.) *See also,* Kris Mitchener & Marc Weidenmier, *Supersanctions and Sovereign Debt Repayment*, (Nat'l Bureau of Econ. Research, Working Paper No. 8853, 2002. (Noting that the ability of a lender to effectively issue "supersanctions" such as military threats and trade interruptions was statistically correlated with lower risk premia on future lending terms with a defaulting sovereign.)

[110] Andrew Rose, *One Reason Countries Pay Their Debts: Renegotiation and International Trade*, (Nat'l Bureau of Econ. Research, Working Paper No. 8853, 2002)(Here, the author shows that a restructuring of a sovereign by the Paris Club results in significant reductions in international trade.)

[111] *Id*. at 1. (Noting that countries with poor repayment reputations have difficulty borrowing and difficulty obtaining favorable lending terms in the future.)

and likewise have to make *pro rata* payments to the holdouts. However, there is an alternative "altruism" consideration that may suggest that Argentina will not act as a rational, self-interested actor and instead will default on its obligations, despite the negative reputational benefits of such a default, in order to bestow positive effects on the sovereign bond market. Paul Rubin suggests this idea in the context of public goods.[112] In order for this altruistic approach to be a possibility, Argentina must (a) recognize the greater social utility of its default, (b) convince others that its motivations are altruistic and not opportunistic, and (c) be willing to bear the individual economic repercussions of such default discussed above. Even if Argentina could recognize the social benefit of a default on the economic system (a) and convince others of its good intentions (b), it is unlikely that Argentina could afford to act altruistically (c) given its current economic state. As discussed above, a default would impede Argentina's ability to borrow in the future, a consideration that would almost certainly outweigh any incentive to behave altruistically. Therefore, while an Argentine default would likely remedy the Second Circuit's decision and achieve stability in the sovereign bond market, it is unlikely that Argentina will take that course of action because it simply cannot afford to do so.

[112] Paul Rubin, *Public Goods and the Evolution of Altruism: The Case of Law*, POLITICS AND THE LIFE SCIENCES, Vol. 26, No. 2, pp. 26-32 (2007).

PART VI: CONCLUSION

Over the last decade, the market for sovereign debt has played out like a crime-thriller novel. Each subsequent development has added layers of complexity and has "changed the game" in some regard. The storyline has been set by foundational complications of sovereign debt. Subsequent discussions of an IMF sponsored Sovereign Debt Restructuring Mechanism contributed to one chapter in the story, but the plot was quickly complicated by the widespread implementation of collective action clauses in 2003. Now, it seems as though another chapter is beginning. If the *NML Capital* case is upheld and Argentina is forced to pay its holdout creditors, the decision reached by the Second Circuit will render Collective Action Clauses nearly useless. Under those facts, it will never be in a creditor's best interest to restructure debt holdings, as both holdouts and creditors will be paid in equal proportion to one another. However, after the judicial resolution of the lawsuit, Argentina has an opportunity to add yet another chapter.

At this point in time, it is impossible to know whether Argentina's short-term perspective will cede to a more strategic, long-term approach to financing. If so, one would guess Argentina will not follow-through on its threat to repudiate its debt and will at least partially pay its creditors. However, based on the model, analysis, and arguments made above, investors should cross their fingers that Argentina is shortsighted. While Argentina's threatened course of action (complete repudiation) will render the sovereign unable to secure favorable financing in the future and will leave holders of the 2005 and 2010 Argentine exchange bonds much worse off, these short term losses would benefit future holders of bonds and afford the rest of society a much more stable system for international sovereign debt.

However, recent petitions for certiorari to the Supreme Court of the United States may take the ultimate decision out of Argentina's hands and place it squarely in the hands of the United States judiciary. Currently, two petitions for certiorari have been submitted to the Supreme Court. The first petition, which the Supreme Court has already accepted, asks the court to overrule the Second Circuit's decision with respect to discovery of Argentinian assets abroad. This portion of the decision deals with the judicial enforcement of the court's holding. The second petition, which has been submitted to the court but not yet accepted, asks the court to overturn the Second Circuit's holding that the pari passu clause gives holdout bond holders full rights to payment relative to holders of restructured bonds. I will briefly analyze how these two petitions could affect the outcome of the Second Circuit's *NML Capital* decision.

The second petition, which addresses the policy question at the heart of the *NML Capital* holding, is somewhat easier to resolve. While the Second Circuit's holding is problematic in that it creates an incentive for future bondholders to refuse a restructuring when it is efficient to do so, the alternative holding would be equally problematic. If the Second Circuit would have held that the holdout creditors do not have equal rights to the restructured debt, the court would have severely handicapped future negotiations by limiting the judicial rights of holdout creditors. Stated differently, so long as holdout creditors have legally enforceable rights, both parties have an incentive to negotiate in good faith. This idea has been referred to as "bargaining in the shadow of the law," throughout this paper. A contrary holding by the Second Circuit would eliminate the legal backbone that promotes efficient negotiation. Therefore, if the Supreme Court overturned the Second Circuit's decision on the merits, the sovereign bond market would no longer

have a problem with opportunistic holdout creditors, but it would begin to have a problem with opportunistic sovereigns. Under a regime where holdouts do not have legally enforceable rights, a sovereign could act opportunistically and restructure whenever it desired to do so. Bondholders would be forced to restructure, as refusing to do so would result in complete non-payment of the sovereigns outstanding obligations. Therefore, if the Supreme Court chooses to accept the petition for certiorari based on the rights of the holdout creditors, the main holding of the Second Circuit should be upheld. Alternatively, the Supreme Court could deny the certiorari petition and implicitly uphold the Second Circuit's decision.

A more interesting possibility is that the Supreme Court could use the petition for certiorari related to enforceability and discovery as a way to uphold the rights of holdout creditors but to strip the Second Circuit's judgment of its teeth. Stated differently, the Supreme Court may uphold the intent of the Second Circuit's holding by affirming the rights of holdout creditors, but it would limit judgments in the holdouts' favor by disallowing discovery proceedings to identify sovereign assets within the reach of US court attachment. This second possibility would return the sovereign bond market to a similar state as before the Second Circuit issued the *NML Capital* decision. Blocking the discovery efforts of holdout creditors seeking to attach sovereign assets would markedly reduce the incentive to hold out in the wake of a sovereign debt restructuring and would substantially diminish the possibility of recovery.

As this paper has argued, an Argentinian repudiation of debt is the optimal outcome to the Second Circuit's decision. However, because it is unlikely that Argentina

will choose to repudiate its entire debt obligations, the best opportunity for stability in the sovereign bond market seems to lie in the hands of the Supreme Court.