

## Public Symbol in Private Contract: A Case Study

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### Abstract

This article revisits a recent shift in standard form sovereign bond contracts to promote collective action among creditors. Major press outlets welcomed the shift as a milestone in fighting financial crises that threatened the global economy. Officials and academics said it was a triumph of market forces. We turned to it for insights on contract change and crisis management. Our research suggests that the incident might have broader implications. The contracting parties and others involved in the shift apparently used private contract terms to send public signals in ways that are rarely discussed in contracts literature. This article is based on our work in the sovereign debt community, including over eighty interviews with investors, lawyers, economists and government officials. Despite widespread public enthusiasm for contract reform, in private, few participants described the substantive change as an effective response to financial crises; many said it was simply unimportant. Most explained their own participation in the shift as a mix of symbolic gesture and political maneuver, designed to achieve goals apart from solving the technical problems for which the new contract terms offered a fix.

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## I. Introduction

Stewart Macaulay's classic study of Wisconsin manufacturers found that contracts often played a bit part in the business relationships they purported to govern.<sup>1</sup> Businessmen deliberately refrained from spelling out transaction particulars in writing, and failed to provide for some entirely foreseeable contingencies. Even when deals went sour, few resorted to legal sanctions, preferring instead to resolve disputes informally. Macaulay's findings were stunning because they did not comport with the prevailing model of business actors following detailed contracts replete with legal consequences for every conceivable contingency. His study raised three kinds of questions for contract scholarship going forward. First, how should courts interpret terms deliberately left vague by the parties? Second, if contracts (or, for that matter, the law) did not govern business relationships, what did? Third, why would anyone spend time and money on contract terms that were, in the parties' own words, beside the point?

Answers to the first two questions are the subject of a distinguished literature.<sup>2</sup> The third question has received relatively little attention until recently.<sup>3</sup> While our project did not start out

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<sup>1</sup> Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *Amer. Soc. Rev.* 55 (1963).

<sup>2</sup> See e.g., Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 *Va L. Rev.* 1089 (1981) for a classic treatment of the first question. Macaulay's own study focused on answering the second question. Although it addresses statutes and ordinances more than contracts, Ellickson's research on economic relations among cattle ranchers offers critical insights into the second question. Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* (1991).

<sup>3</sup> Mark C. Suchman, *The Contract as Social Artifact*, 37 *L. & Soc. Rev.* 91 (2003), offers the broadest theoretical framework for answering the third question. The large and growing literature on the "boilerplate" phenomenon (see *infra* n. \_\_) addresses one aspect of the question – why parties fail to reform suboptimal terms. Few studies offer an affirmative case for including contract terms that might be technically suboptimal. But see e.g., Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 *Chi.-Kent L. Rev.* 29 (2001) at 56, suggesting that the signaling value of contract terms may be distinct from their mechanical function.

trying to answer the third question, our findings point in its direction. We studied sophisticated market actors who deliberately changed their contracts, in an apparent attempt at contingency planning. But most of them told us that they were not worried about the contingency the new terms addressed, and insisted that these terms were at best marginally useful, most likely unimportant, in managing risks associated with default. They said they adopted the terms in their private contracts primarily to send a public message to non-parties – other governments, international institutions, and the broader markets – in hope of getting political, reputational, and economic benefits. And now, for the story of Collective Action Clauses.

In June 1997, a developing country defied convention. It issued New York law bonds that let 75% of the bondholders change key financial terms.<sup>4</sup> Until then, standard form New York law contracts required unanimous consent. But no one seemed to notice the innovation, and just about no one followed suit.

In February 2003, another developing country issued New York law bonds with a 75% amendment threshold.<sup>5</sup> The world of international finance erupted in applause and criticism.<sup>6</sup> Major press outlets, finance ministers and senior executives publicly pondered the shift.<sup>7</sup> Other countries adopted similar provisions under the rubric of “collective action clauses” or “CACs”. Academic study of sovereign debt contracts took on new importance. This article is part of an effort to understand what happened and what it means.

Standard – or “boilerplate” – terms in complex financial contracts rarely change.<sup>8</sup> The basic

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<sup>4</sup> See Offering Circular for the Republic of Kazakhstan, \$350 million, 8.375% Notes due 2002, Issued on October 1, 1997 (on file with authors)

<sup>5</sup> See Pricing Supplement and Prospectus for the United Mexican States, \$1 billion, February 2003 (on file with authors) (also available at sec.gov).

<sup>6</sup> See e.g., Statement of G-7 Finance Ministers and Central Bank Governors [http://www.g8.fr/evian/english/navigation/news/previous\\_news/ministerial\\_meetings\\_communiques/statement\\_of\\_g-7\\_finance\\_ministers\\_and\\_central\\_bank\\_governors.html](http://www.g8.fr/evian/english/navigation/news/previous_news/ministerial_meetings_communiques/statement_of_g-7_finance_ministers_and_central_bank_governors.html), Part III infra, and n. [272 – email] infra.

<sup>7</sup> Id. An April 25, 2006 Westlaw search in the ALLNEWS database for all articles discussing “Collective Action Clauses” in the sovereign debt context yielded over 400 hits, including numerous references to official statements.

<sup>8</sup> See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Cal L. Rev. 261 (1985) and Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or “The Economics of Boilerplate”)*, 83 Va. L. Rev. 713 (1997), for key early treatments of the subject. For analysis of bond contracts among sophisticated commercial parties, see William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667; Choi & Gulati, *supra* n. \_\_\_. For a recent survey of the issues in boilerplate contracting, see Symposium on

theoretical explanation of boilerplate attributes it to learning and network effects, and associated “switching costs”.<sup>9</sup> Theory suggests that market participants attach value to contract terms solely because they have been used in the past and are well-known (learning effects) or are widely used now and/or are expected to be widely used in the future (network effects). As a result, firms might adopt terms that are suboptimal on their own merits just because they are well understood or widely used. Switching may be costly for a single firm because it takes time and effort to produce a new term that works and to educate the target audience about its meaning. There is no guarantee that investors, analysts and judges will interpret the term in a way that is favorable to its original proponent or – as the example in our opening paragraphs illustrates – that others will adopt the term in the foreseeable future.

Despite several prominent empirical studies of contract standardization, boilerplate change is still poorly understood because it happens so rarely, slowly and quietly. Contract terms do not normally feature on the editorial pages of the Wall Street Journal, the Economist, or the Financial Times, let alone in dozens of academic articles in law, economics and political science.<sup>10</sup> Against this background, the dramatic and public shift in sovereign bond documentation beginning in 2003 offers a rare perspective on the contracting process and boilerplate change.

The CAC episode is unusual in another respect. World leaders generally do not know what boilerplate is, much less feature it in communiqués reserved for big-picture concerns like global economic imbalances. Yet for nearly a decade CACs had a guaranteed spot in summit

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Boilerplate Contracts, 104 Mich. L. Rev. 821 (2006); see also Omri Ben-Shahar, Foreword, 104 Mich. L. Rev. 821 (2006) (an overview of the symposium articles).

<sup>9</sup> See Kahan & Klausner, *supra* note \_\_, at \_\_.

<sup>10</sup> See e.g., John B. Taylor, Loan Rangers, *The Wall Street Journal*, April 19, 2006, Sovereign Bonds, *The Financial Times*, May 11, 1999, and *The Economist*, February 13, 1999 at 21, March 27, 1999, at 22, 71, and April 24, 1999, at 72 and n. \_\_ *infra*. The legal academy has hosted three symposia in as many years (in the *Emory Law Journal*, the *Chicago Journal of International Law* and the *Georgetown Journal of International Law*) featuring extensive discussions of CACs. A basic search of the academic databases in economics, political science and law reveals a large body of CAC research. See, e.g., Jose Wynne & Federico Weinschelbaum, Renegotiation, Collective Action Clauses and Sovereign Debt Markets, 67 *J. Int'l Econ.* 47 (2005); Barry Eichengreen, Kenneth Kletzer & Ashoka Mody, Crisis Resolution: Next Steps, Pacific Basin Working Paper Series 03-05, Federal Reserve Bank of San Francisco (2003); Kenneth M. Kletzer, Sovereign Bond Restructuring, Collective Action Clauses, and Official Crisis Intervention, IMF Working Paper, No. 03/134 (2003); Andrew G Haldane, Adrian Penalver, Victoria Saporta & Hyun Song Shin, Optimal Collective Action Clause Thresholds, Bank of England Working Papers 249 (2004) (at <http://www.imf.org/external/np/res/seminars/2004/60/pdf/haldan.pdf>); Sayantan Ghosal & Marcus Miller, Co-ordination Failure, Moral Hazard and Sovereign Bankruptcy Procedures, 113 *Econ. Journal* 276 (2004).

statements alongside financial stability and currency regimes.<sup>11</sup> Moreover, boilerplate theory does not usually contemplate a role for the public sector in promoting a switch to optimal private contract terms.<sup>12</sup> But in the case of collective action clauses, governments not party to the contracts got credit for playing a central role in the shift.<sup>13</sup> Judging from recent policy initiatives, the apparent success of the CAC campaign may have created a new model where economic policy proposals are framed in terms of private contract reform. The latest public-sector effort to promote GDP-indexed bonds cites the CAC experience as an inspiration and even adopts some of the organizational features of the earlier initiative, such as the expert contract drafting group.<sup>14</sup>

For all its value as precedent, the public sector's role in the CAC episode remains unexplored. Proponents in the Bush Administration called the shift "market-based" even as market commentary attributed it to government pressure. On the other hand, neither the United States nor any other G-7 government appears to have issued direct threats or bribes, the traditional instruments of "hard power" used to pressure developing countries.<sup>15</sup> Financial industry regulators refused to mandate CACs or otherwise promote their inclusion, despite pressure from prominent economists and some officials.<sup>16</sup> It may be that the "soft power"<sup>17</sup> of G-7 ideas

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<sup>11</sup> E.g., U.S. Actions at the G-8 Summit, White House Press Release, June 2, 2003 (available at <http://www.whitehouse.gov/news/releases/2003/06/20030602-10.html>); G-7 Finance Ministers Adopt Financial Crises Action Plan, Department of Finance (Canada) Release, April 20, 2002 (available at <http://www.fin.gc.ca/news02/02-034e.html>); G-20 Finance Ministers' and Central Bank Governors' Meeting: Delhi Communique, November 23, 2002 (available at [http://www.g20.org/Public/Communiques/Pdf/2002\\_india.pdf](http://www.g20.org/Public/Communiques/Pdf/2002_india.pdf)).

<sup>12</sup> It does not preclude it either. In their original study, Kahan and Klausner advocate private standard-setting bodies for contracts on the model of the existing standard-setting bodies for industrial products; some of the product standard-setters are state-run. See Kahan & Klausner, *supra* n. \_\_\_ at 761-764. See also Robert B. Ahdieh, *The Role of Groups in Norm Transformation: A Dramatic Sketch in Three Parts*, 6 *Chi. J. Int'l L.* 231 (2005) (arguing that groups, including groups of government officials, played a key role in inducing the shift to CACs). Our focus is on the government's role in promoting a substantively optimal contract term, as distinct from contract standardization or procedural improvements. Examples of the latter include the role of the U.S. Federal Reserve in promoting standardization in derivatives contracts coordinated by private industry bodies, or the role of the Federal Reserve Bank of New York and the U.K.'s Financial Services Authority in improving the documentation and clearing practices for credit derivatives. See e.g., Gillian Tett, *Bankers Get Lucky with Clean-Up of Credit Derivatives Trades*, *The Financial Times*, July 28, 2006, at 22.

<sup>13</sup> See Section III(i)-(iii) *infra*.

<sup>14</sup> G-24 Seminar on GDP-Indexed Bonds, Friday, April 21, 2006, webcast available at <http://www.imf.org/external/mmedia/view.asp?eventid=577>.

<sup>15</sup> One way of exerting economic power is through loan conditionality of the International Monetary Fund (IMF), trade or other agreement links. Uruguay is a possible exception. See e.g., n. [318] *infra*.

<sup>16</sup> See e.g., Barry Eichengreen, *Restructuring Sovereign Debt*, 17 *J. Econ. Persp.* 75 (2003).

<sup>17</sup> Political scientist Joseph Nye first used the term in the 1980s to describe "the ability to get what you want by attracting and persuading others to adopt your goals. It differs from hard power, the ability to use the carrots and sticks of economic and military might to make others follow your will." Joseph S. Nye, Jr., *Propaganda Isn't the Way: Soft Power*, *International Herald Tribune*, January 10, 2003. See generally, Joseph S. Nye, Jr., *Soft Power*:

convinced developing countries of the CACs' inherent virtues. But no emerging markets official was willing to tell us that they participated in the CAC shift because the clauses could alter the course of a crisis. Moral suasion – the regulatory cousin of soft power – is a plausible explanation for the shift.<sup>18</sup> Scholars have pointed out that in the sovereign debt context, suasion can include a wide range of approaches from implicit coercion to purely informational “cueing” to help overcome network effects.<sup>19</sup> Which – if any – of these suasion tactics worked and why?

A final lingering puzzle of the CAC episode is just how few private or public sector participants in it express strong feelings about the clauses as such. We spoke with dozens of actors whose websites and speeches proclaim the seminal importance of the CAC shift (usually as they claim paternity), yet in the interviews, a scant few described the change itself as important in addressing the problem of sovereign debt restructuring or financial crises in the emerging markets. Many were unsure of how the new clauses would work in crisis; most said they were probably good, none said they were clearly bad. More participants volunteered strong feelings about the process that led to the shift – praising cooperation, grumbling about wasted time and official meddling. Was this another instance of wasted lawyering, or transnational process for its own sake?<sup>20</sup>

If true in part, this description is incomplete and not entirely fair. Most participants suggested that their effort on CACs had less to do with the clauses' literal purpose (facilitating future contract modification) than with their relative utility in advancing other goals, such as signaling commitment to a new crisis management strategy, currying political favor, or establishing reputations in the market. Some were successful in achieving these goals; others failed. Their

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The Means to Success in World Politics (2004).

<sup>18</sup> The classic example of moral suasion is the regulatory approach of the Bank of England (BOE) before the United Kingdom established a unified financial regulator in 2001. The approach developed largely “outside the law” based on deep historical relationships between the central bank and the financial institutions it regulated. See e.g., Heidi Mandanis Schoone & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 *Mich. J. Int'l L.* 595 (1999). Its effectiveness was attributable partly to the trust between the regulator and the regulated institutions, including but by no means limited to the Bank of England's (“BOE”) capacity to credibly threaten enforcement “with a raised eyebrow”. *Financial Regulation: Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure*. GAO Report October 2004 at <http://www.gao.gov/htext/d0561.html>.

<sup>19</sup> Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 *Emory L.J.* 691, 694 (2004) (“cueing” may include a signal that the term will be widely used).

<sup>20</sup> Macaulay, *supra* n. \_\_ (parties ignoring contracts); Annelise Riles, *The Network Inside Out* (2000) at 171-178 (women's issues “networkers” working for the sake of the Network and its paraphernalia, with the effect of shutting out politics and the women in whose name the networking takes place).

collaboration produced a revealing study in the uses of contract form and ways of governance.

We depart from earlier quantitative and analytical studies of sovereign debt contracts<sup>21</sup> in favor of an interview-based approach.<sup>22</sup> We have collected over eighty accounts of the CAC shift from market participants, officials and others who took part in it, and have supplemented these with our own observations from the daily work of law firms and government offices, conferences and negotiations, press accounts, official documents, and – of course – the debt contracts themselves. We tried to be comprehensive in two ways: first, by reaching out to everyone involved in the CAC shift (about 150-200 people by our estimate) and second, by soliciting different perspective on the same events – for example, interviewing issuers, underwriters, investors and the lawyers on both sides in the early CAC deals. Based on the interviews and our own experience with this community since the early 1990s, we believe that we contacted over half of all direct participants in the shift. We obtained multiple accounts of virtually every incident we describe. But we deliberately eschewed statistical survey tactics in favor of free-form interviews that allowed our contacts to frame their accounts in their own terms<sup>23</sup> and produced the nuance that we found

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<sup>21</sup> See e.g., Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 *Emory L.J.* 929 (2004) and *infra* n. \_\_\_.

<sup>22</sup> Interviews serve many purposes in social science; their format varies accordingly. For example, in statistical surveys designed to assess social trends, standardized questionnaires are put to a representative sample of the population. Interviews are structured to produce quantifiable results. See e.g., Earl Babbie, *The Practice of Social Research*, (5<sup>th</sup> ed. 1989) for an accessible textbook treatment of survey methodology, including questionnaire design at 139-160 and sampling at 163-207. Historians use less structured interviews to elicit accounts of past events from contemporaries; the goal is to gather reliable evidence of such events. Oral history often supplements documentary evidence. See Trevor Lummis, *Listening to History: The Authenticity of Oral Evidence* (1987) at 39-40 and 42 (contrasting survey and oral history methods). David K. Dunaway & Willa K. Baum, eds., *Oral History: An Interdisciplinary Anthology* (1984) is an influential collection of perspectives on oral history methods. In ethnography, interviews are part of “participant observation” designed to discover cultural norms and practices. Traditional classics include Bronislaw Malinowski, *Argonauts of the Western Pacific* (1922), E.E. Evans-Pritchard, *The Nuer* (1940), and, in the American legal context, Karl N. Llewellyn and E. Adamson Hoebel, *The Cheyenne Way* (1941, 1953). Law scholars have increasingly used the full range of interview approaches. See e.g., Kenneth M. Casebeer, *Holder of the Pen: An Interview with Leon Keyserling on Drafting the Wagner Act*, 42 *Miami L. Rev.* 285 (1987), Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999--Part I*, 56 *Bus. Law.* 653 (2001), G. Mitu Gulati & William A. Klein, *Economic Organization in the Construction Industry: A Case Study of Collaborative Production under High Uncertainty*, 1 *Berkeley Bus. L.J.* 137 (2004), Bruce M. Price, *A Butterfly Flaps its Wings in Menlo Park: An Organizational Analysis of Increases in Associate Salaries*, 2005 *Wis. L. Rev.* 713, Margareth Etienne, *The Ethics of Cause Lawyering: An Empirical Examination of Criminal Defense Lawyers as Cause Lawyers*, 95 *J. Crim. L. & Criminology* 1195 (2005) and John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 *J. Corp. L.* 1 (2005) (describing “business ethnography” at 9-12). Our approach favors Conley and Williams, and the use of interviews by Dezalay and Garth (which they describe as “reflexive sociology”). Yves Dezalay & Bryant G. Garth, *The Internationalization of Palace Wars: Lawyers, Economists, and the Contest to Transform Latin American States* (2002) (hereinafter “Palace Wars”).

<sup>23</sup> Cf. Etienne, *supra* n. \_\_\_ at 16 and Yves Dezalay & Bryant Garth, *Dealing in Virtue: International Commercial*

lacking in prior studies, including our own.

Below we first review the sovereign debt context, the contract provisions at the center of the study, and the process that led to the shift in 2003. Second, we recount alternative explanations for the shift that have been published to date. We then describe the findings from our interviews and conclude with implications for contract change, the uses of contract, and governance.

## II. The Setting

### *i. Emerging Markets Sovereign Debt: Actors and Contracts*

The history of government borrowing goes back to ancient times, as does the history of government debt default.<sup>24</sup> Our focus is on the external debt of emerging markets governments, which traditionally has meant money borrowed from foreign residents in foreign currency under foreign law – for example, Mexico’s dollar-denominated, New York-law bonds marketed to U.S. residents.<sup>25</sup>

Tradable bonds first became the instrument of choice for sovereign borrowers in the 19<sup>th</sup> century. Bondholders in London, and later Paris and Berlin financed commodity-exporting economies on the periphery, with default spikes every decade or so. U.S. bondholders joined the party early in the 20<sup>th</sup> century, mainly sending money to Latin America. With the Great Depression came a

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Arbitration and the Construction of a Transnational Legal Order 17 (1996) (hereinafter, “Arbitration”) on the value of encouraging interviewees to present their own picture of the relevant legal field: “it serves to identify what they seek to appear to be and what they reject, thereby serving to define the principles of opposition that structure the field and shape change over time”.

<sup>24</sup> See e.g., Nancy Birdsall & John Williamson, *Delivering on Debt Relief* 14 (2002) for a short overview of sovereign lending and default going back to Greek city-states’ defaults to the Delos Temple.

<sup>25</sup> The distinction is important because since the period we study, governments have begun to shift away from such borrowing into local currency, often local law debt. Structural Changes in Emerging Sovereign Debt and Implications for Financial Stability, in International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues*, Chapter III, April 2006 (hereinafter, “Structural Changes”). As countries remove restrictions on capital flows, the link among currency, governing law and residence of the holder has weakened. While economists usually focus on currency and residence of the holder, for purposes of this project, we are only concerned with governing law. See Anna Gelpern & Brad Setser, *Domestic Debt and the Doomed Quest for Equal Treatment*, 35 *Geo. J. Int’l L.* 795, 795-96 (2004) for a discussion of the different and evolving definitions of domestic and external debt used by lawyers and economists.



massive wave of defaults that halted sovereign bond issuance for decades.<sup>26</sup> In the 1970s, developing countries took out loans from commercial banks in New York and London, financed with deposits from oil-exporting nations. A series of loan defaults ushered in the 1980s debt crisis, which stunted growth for a decade in parts of the developing world, and threatened the health of major international banks. The crisis ended – at least in theory – when banks agreed to exchange their loans for Brady Bonds, named after the U.S. Treasury Secretary who helped broker the solution. Trading in the Brady Bonds paved the way for new issues. Today’s emerging markets debt market was born.

The Economist defines emerging markets as developing countries, explained in turn as a euphemism for poor countries.<sup>27</sup> The term is also used occasionally to describe all countries with annual per capita income below \$10,725, classified as low- and middle-income by the World Bank.<sup>28</sup> This excludes high-income or “mature markets” issuers such as the United States and the other G-7 economies with well-established domestic financial systems, steady access to domestic and international investors, and the capacity issue debt in their own currency.<sup>29</sup> We prefer a narrower definition, which reflects the fact that only a minority of all poor and middle-income countries have market access on any meaningful scale. JP Morgan’s Emerging Markets Bond Index Global (EMBI Global) includes U.S. dollar-denominated debt instruments of governments and state-owned entities in 33 countries, for which dealers quote prices daily.<sup>30</sup>

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<sup>26</sup> For different perspectives on this history, see e.g., Albert Fishlow, *The Debt Crisis in Historical Perspective*, in Miles Kahler, ed., *The Politics of International Debt* (1986) at 37, Barry Eichengreen & Michael Bordo, *Crises Now and Then: What Lessons from the Last Era of Financial Globalization?*, November 2001, available at <http://www.econ.berkeley.edu/~eichengr/research/goodhartfestschriftjan9.pdf>, and Vinod K. Aggarwal, *Debt Games: Strategic Interaction in International Debt Rescheduling* (1996). At the end of the 19<sup>th</sup> century, British bondholders had about a third of their overseas portfolio in foreign government debt. Eichengreen & Bordo, *supra*, at 10. For analysis of the recurring crisis and serial default phenomena see, respectively, Charles P. Kindleberger & Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises* (2005) and Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance*, 2003 Brookings Papers on Economic Activity 1.

<sup>27</sup> “Emerging Markets” in *Economics A-Z*. Economist.com, available at <http://www.economist.com/research/Economics/alphabetic.cfm?LETTER=E>; see also Ashoka Mody, *What is an Emerging Market*, 35 *Geo. J. Int’l L.* 641 (2004).

<sup>28</sup> The World Bank, *Country Classification*, available at [www.worldbank.org/datastatistics](http://www.worldbank.org/datastatistics): “Economies are divided according to 2005 GNI per capita, calculated using the World Bank Atlas method. The groups are: low income, \$875 or less; lower middle income, \$876 - \$3,465; upper middle income, \$3,466 - \$10,725; and high income, \$10,726 or more.”

<sup>29</sup> *Id.* and *Structural Changes*, *supra* n. \_\_\_.

<sup>30</sup> Gloria M. Kim, *EMBI Global and EMBI Global Diversified: Rules and Methodology*, J.P. Morgan Securities Inc., December 2004. As of July 14, 2006, the countries represented in EMBI Global were Argentina, Brazil, Bulgaria, Chile, China, Colombia, Cote d’Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, Hungary,

Market participants frequently use this index as a proxy to describe emerging markets external debt as an asset class. In April 2006, EMBIG market capitalization was \$292 billion. Mexico, Brazil, Russia and Turkey comprise over half this total (Argentina was a big presence until its \$100 billion default in 2001); a dozen countries account for nearly 90%. Over 40% of the debt in the index is investment grade.<sup>31</sup> Total external debt outstanding issued by EMBIG countries, including instruments denominated in Euro and others not included in the index is probably close to \$400 billion.<sup>32</sup> For comparison, foreign-currency debt issued by mature markets governments (such as New Zealand's Yen-denominated securities) is at about double the emerging markets total. However, mature markets governments are often able to sell local-currency debt to foreign investors: at the end of April 2006, foreign residents held just over \$2 trillion in dollar-denominated U.S. Treasury securities.<sup>33</sup> Emerging markets debt is actively traded: EMTA, a traders' association, reported trading volume at \$4.7 trillion in 2004.<sup>34</sup>

The number of people involved in emerging markets sovereign debt is small, partly due to the small number of large-volume issuers. Compared to 33 countries in the EMBIG, over 2,500 companies are listed on the New York Stock Exchange alone.<sup>35</sup> Raising money abroad is most often the responsibility of a country's finance ministry, occasionally of the central bank; stand-alone debt management offices have gained popularity recently. The core government team for a new issue is usually about half a dozen people.

When an emerging markets government wants to issue debt abroad, it normally hires an international investment bank to "manage" the offering – design and market the instruments, and, for underwritten deals, commit to buy the debt. These so-called "sell-side" institutions

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Indonesia, Iraq, Lebanon, Malaysia, Mexico, Morocco, Nigeria, Pakistan, Panama, Peru, Philippines, Poland, Russia, Serbia, South Africa, Tunisia, Turkey, Ukraine, Uruguay, Venezuela, and Vietnam. The older EMBI+ index includes 18 countries, has higher liquidity requirements than EMBI Global and excludes the debt of parastatals and local governments. Gloria M. Kim, Emerging Markets Bond Index Plus (EMBI+): Rules and Methodology, J.P. Morgan Securities Inc., December 2004.

<sup>31</sup> Gloria M. Kim, EMBI Global Regional and Country Composition and Statistics, JP Morgan, July 14, 2006, available at [www.morganmarkets.com](http://www.morganmarkets.com).

<sup>32</sup> Jennie Byun & William Oswald, Emerging Markets External Debt as an Asset Class, JP Morgan, April 26, 2006, available at [www.morganmarkets.com](http://www.morganmarkets.com).

<sup>33</sup> U.S. Department of the Treasury and Federal Reserve Board, Major Foreign Holders of Treasury Securities, June 15, 2006 available at <http://www.treas.gov/tic/mfh.txt>.

<sup>34</sup> EM Background: History and Development, EMTA, available at <http://www.emta.org/emarkets/>, last visited on July 16, 2006.

<sup>35</sup> [www.nyse.com](http://www.nyse.com)

compete for mandates from governments; often two or more institutions are appointed “co-lead managers” for an issue. Sell-side bankers refer to the issuing governments as their clients; their fees are a portion of the issue proceeds. About half a dozen investment banks dominate the scene, with another handful managing an occasional issue for a marginal sovereign. Sell-side banks have research departments that report regularly on the emerging markets. In theory, research and investment banking are separated by “Chinese walls”.<sup>36</sup> When sell-side research analysts speak of clients, they refer to the investors, also known as the “buy-side”.

There is no authoritative source of information on investors in emerging markets sovereign debt. Sell-side research departments occasionally survey their clients and governments occasionally try to get a fix on their creditor base; neither effort produces a comprehensive picture.<sup>37</sup> Less concentrated than the sell-side, the buy-side universe in the sovereign world is still small – a few dozen funds hold most of the external debt for most emerging markets governments, except where domestic, expatriate or retail investors are a significant presence. The funds are a mix of “dedicated” and “crossover” institutions, active trading accounts and “buy and hold” investors. Dedicated investors commit to put all or some of their money in risky emerging markets assets, as in, for example, a Latin America or Southeast Asia Fund.<sup>38</sup> Crossover investors are generally more risk-averse, often regulated entities such as pension funds and insurance companies that may invest a portion of their portfolio in the emerging markets to boost returns in good times, when yields are low on mature markets assets.<sup>39</sup> Riskier debt attracts active traders that look for a quick profit in arbitraging price and interest rate differences worldwide.<sup>40</sup> Hedge funds are

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<sup>36</sup> For a skeptical account of the separation between research and investment banking in emerging markets finance, see Paul Blustein, *And the Money Kept Rolling In (And Out): Wall Street, the IMF, and the Bankrupting of Argentina* 61-71 (2005).

<sup>37</sup> See *Structural Changes*, supra n. \_\_ at 95, and Byun & Oswald, supra n. \_\_ at 34-35.

<sup>38</sup> The IMF estimated that 30-40% of the funds invested in the emerging markets in 2001 came from dedicated investors. See International Monetary Fund, *Involving the Private Sector in the Resolution of Financial Crises Restructuring International Sovereign Bonds* (January 11, 2001), at 16, available at <http://www.imf.org/external/pubs/ft/series/03/ips.pdf>. Such investors usually measure their performance relative to an index such as EMBI+ or EMBIG. International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* (December 2002), at 36, available at <http://www.imf.org/external/pubs/ft/gfsr/2002/04/pdf/chp3.pdf>. See Blustein, *And the Money*, supra n. \_\_ at 70-73 on the paradoxes of index investing.

<sup>39</sup> Until recently returns on emerging and mature markets assets rarely correlated. See *Structural Changes*, supra n.

<sup>40</sup> Active traders and speculative investors can be especially important in the run-up to or after the default. They buy distressed debt at a deep discount, and often agree to harsh restructuring terms because they may still reap large profits relative to the low purchase price. Commentators have often conflated distressed debt buyers and holdout

often associated with such investment strategies, but proprietary trading desks at large institutions can behave similarly. Some buy-side outfits have their own research departments. Domestic residents and institutions in the issuing countries are an increasingly important investor category in some cases, as are retail investors (real people investing directly), especially for governments raising money in Europe and Japan.<sup>41</sup> .

Six trade associations cater to the investor community. Three of these focus on the emerging markets; the rest deal overwhelmingly with mature markets securities.<sup>42</sup> All but one trade group claim to represent both the buy-side and the sell-side; one was established specifically to represent the buy-side.

Lawyers in this practice mirror the market's concentration.<sup>43</sup> Half a dozen U.S. law firms, all but one headquartered in New York, document nearly all New York-law sovereign issues. A handful of London-based firms dominate the English-law sovereign market. Few of these firms have more than one or two partners specializing in sovereign debt.<sup>44</sup> The senior lawyers in this cohort tend to be veterans of the 1980s loan crisis; the younger ones spent their early days documenting new bond issues in the 1990s.

Sovereign bond documentation usually consists of a disclosure statement distributed to investors (and, in the case of a registered public offering, filed with securities regulators), a distribution agreement between the issuer and the managers, and a series of agreements, including the debt instrument itself – a promise to pay – that governs the relationship between the sovereign debtor

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litigants, even though the two business models are quite different. See Anna Gelper, *After Argentina*, Institute for International Economics Policy Brief PB05-02, available at [www.iie.com/publications/pb/pb05-2.pdf](http://www.iie.com/publications/pb/pb05-2.pdf) (September 2005), at 7.

<sup>41</sup> Id. For example, German and Italian retail investors held a significant portion of Argentina's debt at the time of its default in 2001. In the United States, suitability rules and other constraints under federal securities laws have generally precluded the development of an active retail market.

<sup>42</sup> These are the Emerging Markets Creditors Association (EMCA, [www.emcreditors.com](http://www.emcreditors.com)), EMTA ([www.emta.org](http://www.emta.org)), The Institute of International Finance (IIF, [www.iif.com](http://www.iif.com)), the Securities Industry Association (SIA, [www.sia.com](http://www.sia.com)), the Bond Market Association (BMA, [www.bondmarkets.com](http://www.bondmarkets.com)), and the International Capital Market Association (ICMA, [www.icma-group.org](http://www.icma-group.org), a product of the merger between the International Primary Market Association (IPMA) and the International Securities Market Association (ISMA)). SIA and BMA have recently announced their intention to merge.

<sup>43</sup> Compare Dezalay and Garth's description of the small and tightly linked international arbitration community, Dezalay & Garth, *Arbitration*, supra n. \_\_\_ at 10.

<sup>44</sup> Cleary Gottlieb is an exception. See Choi and Gulati, supra n. \_\_\_.

and its bondholders. Innovations such as shelf registration and medium-term note programs enable governments to establish a document umbrella that applies to a large portion of their issues and thereby to streamline documentation for any single borrowing. The key contracts are a product of issuer-manager negotiations, with their respective lawyers. Buy-side investors generally do not see the disclosure statement<sup>45</sup> until the marketing phase, with little room for detailed negotiation. As a result, it is up to the managers and their lawyers to negotiate a document package they can sell. Structuring, negotiating, and selling a sovereign issue can take anywhere from a few days to several months; complex restructurings take even longer.

Unlike other financial contracts, the sovereign lot has had trouble establishing its free market credentials. When one of the parties is a government, power politics inevitably sway the invisible hand. Governments enjoy special immunities, and so might choose to walk away from foreign debts when it suits their domestic political purposes.<sup>46</sup> They have few credible ways to commit to pay or to follow contractual default procedures, and no sovereign bankruptcy regime to fill the gap. The resulting debt contracts are inevitably incomplete.<sup>47</sup> A sovereign debt crisis is often a political crisis with strategic implications beyond financial stability. From this angle, it is unsurprising that governments occasionally take interest in one another's debt contracts.<sup>48</sup>

Before the trend towards restricting sovereign immunities took hold in the second half of the 20<sup>th</sup> century,<sup>49</sup> foreign ministries were often the only channel for bondholders seeking redress.<sup>50</sup> But rich country governments did not always side with their nationals – bondholder concerns have had to compete with other parts of the foreign policy agenda. The U.S. Government was

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<sup>45</sup> Not one investor reported reading the underlying contracts.

<sup>46</sup> On the economics and politics of sovereign debt and specifically, the question of why sovereigns repay their debts, see Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 *Rev. Econ. Stud.* 289, 289-90 (1981) (discussing the reputational model); Harold L. Cole et al., *Default, Settlement, and Signaling: Lending Resumption in a Reputational Model of Sovereign Debt*, 36 *Int'l Econ. Rev.* 365 (1995) (similar); Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?* 79 *Am. Econ. Rev.* 43, 46-47 (1989) (discussing the enforcement model).

<sup>47</sup> See Patrick Bolton & Olivier Jeanne, *Sovereign Debt Structuring and Restructuring: An Incomplete Contracts Approach* (2002) (unpublished manuscript on file with authors).

<sup>48</sup> See Miles Kahler, *Explaining the Debt Crisis*, in Kahler, ed., *supra* n. \_\_, at 16-22; for a more recent overview of official actors involved in sovereign debt restructuring, see Lex Reiffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* 24-45 (2003) at 24-45; for a lawyer's perspective, see Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 *Chi. J. Int'l L.* 333 (2005).

<sup>49</sup> See, e.g., *Republic of Argentina v. Weltover*, 504 U.S. 607 (1992); Georges R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later*, 88 *Am. J. Int'l L.* 257 (1994).

<sup>50</sup> See e.g., Rory Macmillan, *Toward a Sovereign Debt Work-out System*, 16 *Nw. J. Int'l L. & Bus.* 57, 80-84 (1995).

implicated in managing the 1980s Latin American debt crisis both because of the region's strategic significance and because sovereign defaults threatened the health of major U.S. banks.<sup>51</sup> The next generation of crises started with Mexico's near-default in 1994, averted with the help of a \$50 billion U.S.-led rescue package.<sup>52</sup> It culminated with Argentina's massive bond default in 2001, where foreign policy concerns were no less salient even in the absence of bilateral financing.<sup>53</sup>

The wave of calamity that started with Mexico's 1994 "Tequila Crisis" turned public attention to sovereign bond contracts.<sup>54</sup> It also spawned countless academic and policy projects to identify and reassess contract terms that could impact crisis management.<sup>55</sup> Amendment procedures quickly emerged as central among these.

## *ii. Meet the Clauses*

Contract terms are rarely named for social science theories. Collective Action Clauses are the exception. Collective action problems in economics and political science describe the circumstances where individuals acting rationally to maximize self-interest generate an outcome detrimental to their interests as a group.<sup>56</sup> Free-riding and prisoner's dilemma are variants of the problem. Collective action clauses in sovereign debt contracts describe provisions that address collective action problems that might arise among creditors, such as the incentives to rush for the exits (sell the debt), rush to the courthouse, or hold out and free ride on a restructuring

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<sup>51</sup> See e.g., Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 *Fordham Int'l L.J.* 1802, at 1802-1815.

<sup>52</sup> Moises Naim & Sebastian Edwards, eds., *Mexico 1994: Anatomy of an Emerging Market Crash* (1998).

<sup>53</sup> Eric Helleiner, *The Strange Story of Bush and the Argentine Debt Crisis*, 26 *Third World Q.* 951, 965 (2005).

<sup>54</sup> While many of the crises did not involve foreign sovereign bonds, these were seen as a key source of vulnerability. See Edwin M. Truman, *Debt Restructuring: Evolution or Revolution?* 1 *Brookings Papers on Economic Activity*, 341-346 (2002), and Nouriel Roubini & Brad Setser, *Bail Ins and Bail Outs*, Chapter 8 (2004).

<sup>55</sup> See e.g., Tobjorn Becker et al., *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?*, at <http://www.imf.org/external/pubs/ft/wp/2001/wp0192.pdf> (2001); Barry Eichengreen & Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?* (NBER Working Paper No. 7458) (2000); Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, *Fin. Stability Rev.*, June 2000; Anthony Richards & Mark Gugiatti, *Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets*, 6 *Int'l Fin.* 415 (2003); Mark Gugiatti & Anthony Richards, *The Use of Collective Action Clauses in New York Law Bonds of Sovereign Issuers*, 35 *Geo. J. Int'l L.* 815 (2004).

<sup>56</sup> Mancur Olson generalized the analysis of collective action problems in "The Logic of Collective Action: Public Goods and the Theory of Groups" (1971).

agreement.<sup>57</sup> Creditor coordination failures delay debt restructuring, ultimately reducing recovery for creditors as a group. All other things being equal, large groups lacking social cohesion are more prone to collective action problems. Hence the move from regulated bank syndicates to more dispersed bondholder constituencies was expected to cause disruption in sovereign debt management.<sup>58</sup>

Domestic bankruptcy regimes address creditor collective action problems for corporate, individual and municipal debtors. No bankruptcy law applies to sovereign debtors. By the mid-1990s, a chorus of lawyers, officials and academic economists anticipated a sovereign bond crisis and predicted chaos. Both academics and economists in the “official sector” (here the IMF and its dominant shareholders) framed the policy challenge in collective action terms.<sup>59</sup> The presumption that any attempt at bond restructuring would lead to systemic disruption was so strong in 1994 that few were willing to risk amending its domestic-law dollar-indexed *tesobonos* – the instruments at the center of Mexico’s crisis – even if technically it could have been done by fiat.<sup>60</sup> Mexico’s ties to the United States and other factors instead weighed in favor of a rescue loan.

Working groups of officials from systemically important economies assembled in the aftermath of crises in Mexico and throughout Asia considered and rejected sovereign bankruptcy as a political non-starter. Their reports released in 1996 and 1998 advocated widespread adoption of contract terms – some old, some new – to improve creditor coordination and bind potentially disruptive minorities.<sup>61</sup> In practice, these recommendations targeted New York Law bonds,

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<sup>57</sup> See Eichengreen, *supra* note \_\_, at \_\_ (Journal of Econ Perspectives article); Thomas Jackson, *The Logic and Limits of Bankruptcy Law* 11-14 (1986).

<sup>58</sup> This description has always been somewhat stylized – some syndicates included dozens, even hundreds of banks, while some bond issues are closely held.

<sup>59</sup> See e.g., GROUP OF TEN, *THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES: A REPORT TO THE MINISTERS AND GOVERNORS PREPARED UNDER THE AUSPICES OF THE DEPUTIES* (1996) (hereinafter the “Rey Report”), available at <http://www.bis.org/publ/gten03.pdf> and Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (1995), a volume commissioned by the Bank of England as part of its work on the Rey Report.

<sup>60</sup> An op-ed in *The Financial Times* reflected widely felt sentiment: “As the Mexican crisis showed, the world financial system desperately needs a mechanism to draw bondholders together to renegotiate foreign government debt.” Rory Macmillan, *Personal View: New Lease of Life for Bondholder Councils*, *The Financial Times*, August 15, 1995, at 11. In fact, the Mexican crisis showed little, since the rescue package preempted bondholder mischief by paying them off. See n. 176, *infra*, and accompanying text.

<sup>61</sup> See Rey Report, *supra* n. \_\_, and Report of the Working Group on International Financial Crises (October 1998)

which dominated the sovereign debt market and had few of the recommended terms, even if they played no role either in Mexico or in Asia.<sup>62</sup> Issuers and investors publicly dismissed the prospect of coordination failures and rejected what they claimed was official intrusion in their contracts.<sup>63</sup> Despite a handful of prominent supporters in the market,<sup>64</sup> contract reform initiative stayed with the academy and the official sector. By 1998, the term “Collective Action Clauses” or “CACs” came to describe the universe of terms they advocated; the name had stuck.<sup>65</sup>

Lawyers may seem like bit players in this story so far. But neither the officials nor the economists who advocated CACs had intuited the content of the clauses on their own. Trade journals and manuscripts circulating among practitioners by the mid-1990s identified four kinds of terms. Most prominent were modification provisions that would allow a qualified majority of creditors (usually 75% in principal amount) to change payment terms over minority objections. These had been common in English and Japanese law bonds, but were virtually unheard of in New York and German law bonds. Second, a related set of terms would restrict an individual creditor’s capacity to demand full repayment (accelerate) or sue the debtor. Clauses that require creditors to share litigation proceeds with their comrades had been used in syndicated loans and were being proposed for bonds, to dampen incentives to sue. Third, collective representation or engagement clauses would organize bondholders and channel their activities through a trustee or a creditor committee. Deputizing the trustee to accelerate, sue and share the proceeds combines the representative function with the brake on individual enforcement described earlier. Finally, initiation clauses would help the debtor initiate a restructuring, and might sanction a payment suspension and a “cooling off” period.

Recent market practice brought two other provisions into the limelight, both involving

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(hereinafter the “G-22 Report”), available at <http://www.bis.org/publ/othp01d.pdf>.

<sup>62</sup> New York law bonds accounted for about seventy percent of all emerging markets paper in 2002. See International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* (December 13, 2002) at 44, available at <http://www.imf.org/external/pubs/ft/gfsr/2002/04/pdf/chp3.pdf>, and *The Design and Effectiveness of Collective Action Clauses* (June 2002), available at <http://www.imf.org/external/np/psi/2002/eng/060602.htm>.

<sup>63</sup> See *infra* n. [170] and accompanying text.

<sup>64</sup> See, e.g., Lee C. Buchheit, *The Collective Representation Clause*, *Int’l Fin. L. Rev.* September 1998; Ed Bartholomew, Ernest Stern & Angela Liuzzi, *Two-Step Sovereign Debt Restructuring: A Market-Based Approach in a World Without International Bankruptcy Law*, 35 *Geo. J. Int’l L.* \_\_\_ (2004).

<sup>65</sup> The term “collective action clauses” appears to have been used for the first time in the G-22 Report.



amendment. Traditionally, terms other than key financial terms could be amended with a simple majority vote. This made it easier for countries exchanging distressed bonds for new ones to solicit “exit consents” from participating creditors to disfigure the old bonds by stripping away jurisdiction, immunity and other important provisions. Ecuador was the first among sovereigns to use the tactic, which proved controversial with investors. The second new term was a twist on modification, introduced in Uruguay’s 2003 debt restructuring, which allowed the issuer to amend multiple bond issues together, with the consent of a higher fraction of all holders (for example, 85% in outstanding principal across all issues) *plus* a lower fraction of each individual issue (for example, 65%).<sup>66</sup>

Other contract terms, such as negative pledge, *pari passu*, cross-default, jurisdiction and waiver of immunity, have drawn attention in crisis and are critical to the restructuring outcome; however, these generally lie outside the CAC rubric.<sup>67</sup>

By all accounts, Mexico’s SEC-registered 12-year global note issue launched in February 2003 tipped the markets in the direction of CACs. Mexico’s sole – momentous – innovation was in the modification provisions. Departing from the unanimity convention under New York law, the notes allowed amendment of financial terms by holders of 75% of outstanding principal. In a concession to creditors, Mexico raised the threshold for amending most other terms from 50% to 66 2/3%; several non-financial terms including status and waiver of immunity now required 75%.<sup>68</sup>

Trade association data from March 2006 suggest that since Mexico, at least 24 other countries – including Brazil, South Korea, Turkey, and South Africa – have issued bonds with majority modification provisions under New York law contracts, most using the 75% threshold for

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<sup>66</sup> See, e.g., Lee C. Buchheit & G. Mitu Gulati, Exit Consents in Sovereign Bond Exchanges, 48 UCLA L. Rev. 59 (2000), Lee C. Buchheit and Jeremiah S. Pam, Uruguay’s Innovations, 19 J. of Int’l Banking L. & Reg 28 (2004) and Yan Liu, Collective Action Clauses in International Sovereign Bonds (August 2002) (available at <http://imf.org/external/np/leg/sem/2002/cdmfl/eng/liu.pdf>).

<sup>67</sup> See Anna Gelper, For Richer, For Poorer: Sovereign Debt Contracts in Crisis, 1 J. Int’l Banking Reg. 20 (2000) for an overview of clauses that had attracted official attention in the mid-1990s.

<sup>68</sup> For one of the many official sector announcements of the Mexico 2003 shift, see <http://www.imf.org/external/np/sec/pn/2003/pn0353.htm>.

financial and key non-financial terms (“reserve matters”).<sup>69</sup> Of the 25 total, six countries used a trustee for one or more issues. Uruguay, Argentina and the Dominican Republic were the only ones to allow aggregated majority voting across instruments; all three did so in the context of a comprehensive distressed debt exchange that swept in most of their outstanding debt stock. Two countries not included in the set of 25 because they used English law contracts adopted engagement clauses to spell out procedures for appointing bondholder representatives, and promised to pay their bill; however, the market has not followed their example to date.

When we speak of the “CAC shift”, we refer principally to the shift from unanimous to majority modification provisions in New York law bonds, which is virtually complete for new issues. As of February 2006, the stock of bonds with CACs was at 60% of the total outstanding – up from 40% in just three years.<sup>70</sup>

As noted at the start of this article, CACs were introduced twice over the past decade. Mexico’s 2003 issue was hailed as the market mover by the official sector, and has attracted virtually all the commentary. But six years earlier, a group of less prominent issuers including Bulgaria, Kazakhstan, Egypt, Lebanon and Qatar used majority modification clauses in their New York law bond issues aimed at the European market and exempt from SEC registration. These had little market impact, and attracted no official or academic attention until after Mexico in 2003. Although we focus on the shift that began in 2003, we discuss the earlier episode because the contrast is illuminating.

### III. Official Stories and Published Explanations

The Mexico-led shift inspired a host of press releases, public statements, articles in the popular and trade press, and renewed academic activity on the subject of CACs. Most authors tried to explain why Mexico and those that followed it changed their contract forms. We found nine

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<sup>69</sup> EMTA, Sovereign Bond Documentation Charts, available at [www.emta.org](http://www.emta.org). Several countries started with 85% and switched to 75% in subsequent issues.

<sup>70</sup> International Monetary Fund, Report of the Managing Director to the International Monetary and Financial Committee on the IMF’s Policy Agenda, April 20, 2006, at 8, available at <http://www.imf.org/external/np/pp/eng/2006/042006.pdf>. The total includes all international bonds, not just ones governed by New York law. Most of the outstanding bonds without CACs were issued before 2003.

categories of explanations, each emphasizing a different causal factor. In addition, we include an account of the “lost issues” six years before Mexico. These public accounts served as background for our own interviews.

*i. Fear of SDRM.* In this account, CACs prevail because they are the lesser of two evils. The IMF had proposed the Sovereign Debt Restructuring Mechanism (SDRM) as a statutory regime to deal with creditor coordination problems. Borrowers and private creditors publicly rejected SDRM as an IMF power grab designed to encourage defaults and reduce demand for official money.<sup>71</sup> Before SDRM, neither sovereigns nor their creditors had shown any enthusiasm for CACs.<sup>72</sup> With SDRM on the horizon, CACs began to look attractive.<sup>73</sup> Mexico and others then adopted CACs for fear that SDRM would prevail without an alternative method of dealing with sovereign insolvency.<sup>74</sup> The nuanced version of this story had Mexico adopting CACs to stop the talk of SDRM, which was harming the asset class regardless of the initiative’s ultimate prospects.<sup>75</sup>

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<sup>71</sup> Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 *Geo. J. Int’l L.* 299 (2005), is the authoritative account of the initiative. The Economist explained the CAC shift this way in May 2003:

Why have borrowers changed their minds? One reason is fear. Once the SDRM was mooted – a far worse idea than collective action clauses in borrowers’ eyes – the thought that it might be put into effect focused minds on the search for a market based alternative.

Dealing With Default, *The Economist*, May 8, 2003.

Paul Blustein’s book on Argentina’s crisis concludes:

The triumph of CACs over the SDRM offered some depressing insights into the difficulty of making headway on international financial reforms. The idea of introducing the clauses had been proposed years earlier and had stalled amid opposition from Wall Street; only when the more radical SDRM reared its head did private financiers come around to backing CACs as the lesser evil.

Paul Blustein, *And the Money*, supra n. \_\_. This sentiment appears in a number of other accounts, including the one by Sean Hagan, General Counsel of the IMF and one of the architects of the SDRM. See Hagan, supra n. \_\_ at 390-94 (2005); Melvyn Westlake, *Battle of the Heavyweights*, *Emerging Markets*, Sept. 27, 2002, at 16; *A Better Way to Go Bust*, *Economist*, Feb. 1, 2003, at 64; See also Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?* 53 *Emory L. J.* 783, 766 (2004) (separating objections to the SDRM into the more and less “principled” ones).

<sup>72</sup> See Hagan, supra note \_\_, at 319-20.

<sup>73</sup> “Developing countries are issuing new bonds that should make it easier to clear up or head off defaults,” *The Economist*, May 8, 2003; *Deutsche Bank Emerging Markets Daily*, February 26, 2003, at 8.

<sup>74</sup> See Hagan, supra note \_\_ at 320 (citing Adam Lerrick & Allan H. Meltzer, *Sovereign Default: The Private Sector Can Resolve Bankruptcy Without a Formal Court*, *Q. Int’l Econ. Rep.*, Apr. 2002, at 2: “With bailouts ruled out, the private sector is confronted with a choice: accept regulation or find its own solution to make restructuring work.”). See also Barry Eichengreen et al., *Crisis Resolution: Next Steps* (IMF Working Paper No. WP/03/196, Oct. 2003) (pointing out that the IIF’s embrace of collective action clauses would never have happened in the absence of the SDRM initiative), available at <http://www.imf.org/external/pubs/ft/wp/2003/wp03196.pdf> (last visited Nov. 2, 2004).

<sup>75</sup> Roubini & Setser, *Bailouts*, supra note \_\_, at 313.

ii. *U.S. Pressure.* Beginning in the fall of 2002 Bush Treasury officials appeared to make CACs a centerpiece of their strategy to eliminate public sector bailouts. Trade and financial press frequently reported in early 2003 that Treasury arm-twisting caused Mexico and others to try CACs.<sup>76</sup> In a forthcoming book, the leading advocate of CACs in the U.S. Government characterizes the efforts as broad-based “diplomacy” and persuasion.<sup>77</sup> Some in the market pointed to Mexico’s special relationship with the United States, and cited unconfirmed rumors of a quid pro quo.<sup>78</sup>

iii. *G-10 Expert Drafting Group.* The working group of officials, convened by the G-10 governments,<sup>79</sup> commissioned “eminent lawyers” from relevant jurisdictions to draft model CACs. The group included partners from leading law firms representing both sovereigns and their investment bankers, and had the imprimatur of the official sector. One explanation of the group’s role suggests that it served as a coordinating mechanism to overcome network effects,

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<sup>76</sup> See *Dealing With Default*, supra note \_\_ (“American pressure also played a part. The Treasury made no secret of its preference for the clauses.”). More recently, see Blustein, *And the Money*, supra note \_\_, at 230 (“Eventually, with U.S. clout working its usual magic, CACs won endorsement from the G-7 and the IMF’s policy-setting committee of member-country finance ministers, and several emerging-market countries began issuing bonds with the clauses in 2003.”); David Skeel, *Why Contracts are Saving Sovereign Bankruptcy*, *Int’l Fin. L. Rev.*, March 2006 at \_\_ (“With some serious arm twisting by the U.S. Treasury, Mexico finally broke the logjam in 2003”).

<sup>77</sup> John Taylor, *Essential Reform of the International Financial System: Collective Action Clauses*, available at <http://www.stanford.edu/~johntayl/Essential%20Reform%20of%20the%20International%20Financial%20System,%20CACs.htm>

<sup>78</sup> Felix Salmon, *Blazing a Trail Down Mexico Way*, *EuroMoney*, April 2003. See also John Authers, *Mexico Sends Signal with Bond Clauses*, *Financial Times*, February 26, 2003 (“I think Mexico is building up a war-chest of favours to the US Treasury, which it’s going to claim at some point in the future,” said Walter Molano, of BCP Securities. Molano also said that ‘This deal is going to be an orchestrated success, because there’s an enormous amount of political reputation riding on this, specifically for the US Treasury.’”); Matthieu Wirz, *Mexico Introduces CACs to Rocky Reception*, *International Financing Review*, March 1, 2003 (“Bankers and investors point to the heavy hand of US Treasury and recognition of the inevitability of CAC implementation to explain the decision.”); Fernando J. Losada, *Mexico: Going Nowhere Fast*, *ABN-AMRO Emerging Markets Fortnightly*, March 5, 2003, at 31 (“The authorities in Mexico were apparently persuaded by the US Treasury and some leading Wall Street bankers to attempt to issue such a bond.”).

<sup>79</sup> The Group of Ten (G-10) comprises 11 rich economies with significant financial sectors (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States). The G-10 started out as an informal group of countries that had agreed to lend money for the IMF’s General Arrangements to Borrow in 1962. Based at the Bank for International Settlements in Basel, the G-10 has historically focused on monetary and banking aspects of financial stability. “Finance Ministry and Central Bank Deputies of the Group of Ten usually meet three times a year. Various committees and working parties of the Group of Ten are also convened as needed to analyze issues of common interest to a range of countries.” See <http://www.bis.org/press/p060123.htm>. Central Banks play a bigger role in the G-10 than in other similar fora, such as the G-7.

especially the fear that no one would follow the first mover in adopting CACs.<sup>80</sup>

*iv. Law Firms.* Like the last explanation, this one credits the CAC shift to the party that helped overcome network effects. Choi and Gulati suggested that Cleary Gottlieb Steen & Hamilton – with its large stable of sovereign clients – had disproportionate influence in inducing the CAC shift. In their account, the CAC shift had roots in the new use of exit consents (another Cleary Gottlieb invention), which created uncertainty about the value of unanimity and opened a window for innovation.<sup>81</sup> Cleary Gottlieb’s own firm brochure takes credit for pioneering innovative techniques in the sovereign debt market, such as collective action clauses.<sup>82</sup> The Cleary Gottlieb story is consistent with Kahan and Klausner’s prediction that large volume intermediaries drive boilerplate change. Here the elite law firm caused the shift, motivated not only by the value of the new term to its many clients but also perhaps by the reputational value to it of being seen as a market leader.<sup>83</sup>

The Choi-Gulati study ran into criticism from prominent sovereign debt lawyers, including those they credited with the shift. Lawyers said that the study had missed the plot by giving all early-moving issuers equal weight, even though the first few were more important than later ones.<sup>84</sup> Had the authors understood this dynamic, they would have given more credit to two other law firms, Sullivan & Cromwell and Arnold & Porter.<sup>85</sup>

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<sup>80</sup> See Ahdieh, *The Role of Groups*, supra note \_\_, at 240-241 and 245-46 (on the G-10 experts and other groups, some formed in response to the specter of SDRM); Choi & Gulati, *Innovation*, supra note \_\_, at 970; see also Elmar B. Koch, *Collective Action Clauses, The Way Forward*, 35 *Geo. J. Int'l L.* 665 (2004) (asserting the report of G-10 working group provided the necessary guidelines or framework for the market to formulate their clauses). Less directly, but setting out the role of the G10 drafting committee as a key element in the progress towards CACs, see John Drage and Catherine Hovaguimian, *Collective Action Clauses: an Analysis of Provisions Included in Recent Sovereign Bond Issues 2-3* (Bank of England 2004) (available at <http://www.bankofengland.co.uk/fsr/fsr17art9.pdf>); Pierre Francois-Weber, *Sovereign Debt (re)Structuring: Where do we Stand?* *Financial Stability Review*, Banque De France, p. 105, No. 7, November 2005 (noting that the “spread of Collective Action Clauses (CACs) follow[ed] the Quarles Report by the Group of 10”) (available at [http://www.banque-france.fr/gb/publications/rsf/rsf\\_112005.htm](http://www.banque-france.fr/gb/publications/rsf/rsf_112005.htm)).

<sup>81</sup> See Choi & Gulati, *Innovation*, supra note \_\_, at 934, 936, 944-47.

<sup>82</sup> See [http://cgsh.com/files/tbl\\_s5102SiteFileUpload/File5788/4/Cleary\\_Gottlieb\\_Firm\\_Brochure.pdf](http://cgsh.com/files/tbl_s5102SiteFileUpload/File5788/4/Cleary_Gottlieb_Firm_Brochure.pdf) (last visited September 5, 2006).

<sup>83</sup> An April 30 visit to the Cleary Gottlieb website revealed several references to the firm’s role in helping Mexico develop these clauses for the market. See, e.g., April 11, 2003 News Release on Mexican Bond Issuance (available at <http://www.cgsh.com/english/news/NewsDetail.aspx?id=302>).

<sup>84</sup> See Responses to Choi & Gulati by Sergio Galvis and Lee Buchheit (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=800264#PaperDownload](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=800264#PaperDownload)).

<sup>85</sup> Sullivan & Cromwell’s website features their role in the CAC shift:

First use of collective action clauses (2003). We played an integral part in the debate about the

v. *Lee Buchheit*. More than any other, the name of one lawyer has been associated with the CAC saga. He was among the first to urge the adoption of collective action clauses, and among the first to propose actual draft clauses, in a popular trade journal. He was one of the three New York lawyers on the G-10 drafting group and a senior partner at Cleary Gottlieb, the firm that represented both Mexico and Uruguay. An article in *Latin Finance* put all this together to credit Buchheit with CAC paternity.<sup>86</sup>

vi. *Big Institutional Investors*. In the wake of the CAC shift, a front-page article in the Wall Street Journal claimed that big institutional investors – in particular, Mohammed El Erian at Pimco – induced the shift to CACs.<sup>87</sup> Their willingness to buy a large share of Mexico’s first CAC issue, and the advance assurance that they gave Mexico to that effect, made the deal possible. Once the deal was a success, the ball was rolling.

vii. *Trade Associations*. This explanation credits the release of model “marketable” clauses by a group of seven leading creditors’ associations<sup>88</sup> with catalyzing the CAC shift. The so-called “Gang of Seven” clauses endorsed by buy-side and sell-side investors in New York and London included an amendment threshold between 85% and 90%, an engagement clause, and a number of other provisions that addressed creditor concerns with potential misbehavior by the sovereign debtor. An April 2003 article in *Euromoney* reasoned that the release of creditor consensus

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development of collective action clauses, which represent a market-based response to the hold-out problem that arises when debt becomes distressed. Collective action clauses were first used by United Mexican States in its successful February 2003 bond offering, where we represented the underwriters. (Available at <http://www.sullcrom.com/practice/servicedetail.aspx?firmService=21&pdText=PDInfoText3&pdname=LR021969>) (last visited April 30, 2006).

Arnold & Porter is similarly proud:

Firm Advises Brazil on Innovative \$1 Billion Global Bond Issue ... As the first such bond issue, the deal is being seen as a major event shaping the policy debate on the resolution of sovereign debt crises, and other emerging market issuers are starting to follow suit.

(Available at [http://www.arnoldporter.com/case.cfm?publication\\_ID=743](http://www.arnoldporter.com/case.cfm?publication_ID=743)) (last visited April 30, 2006).

<sup>86</sup> In an article on the twenty innovators who had helped transform the Latin American financial markets, *Latin Finance* listed Mexico’s adoption of CACs among Buchheit’s accomplishments. *Breaking the Mold*, *Latin Finance*, December 2005, at 24.

<sup>87</sup> Craig Karmin, *Power Player: A Fund Chief Flexes Muscles When Countries Need a Loan*, *Wall Street Journal*, Section A, October 26, 2004. See Felix Salmon, *The Emerging Markets Heavyweight*, *Euromoney*, September 2003, Volume 34 (profiling Mohammed El Erian and describing his influence in the market for emerging market securities).

<sup>88</sup> See *supra* n. \_\_\_ for the list of associations. The clause initiative predated the ISMA-IPMA merger.

clauses signaled market acceptance of CACs in principle, and made their adoption in some form a foregone conclusion.<sup>89</sup>

*viii. Pre-Emption.* This explanation goes specifically to Mexico's motives, and suggests that preemption might have been dominant among them.<sup>90</sup> Mexican officials said in interviews that going first allowed them to set a market standard. Gelpern wrote that Mexico may well have acted out of concern that less creditworthy countries under G-7 pressure would adopt industry-sponsored CACs, and pay extra to do it.<sup>91</sup> This would create adverse precedent for Mexico to overcome. In a preemptive strike, Mexico adopted a 75% modification threshold and rejected most of the other proposed innovations.

*ix. Argentina.* For nearly three years after its bond default, Argentina simply refused to enter into meaningful negotiations with its creditors and the IMF.<sup>92</sup> Some prominent commentators said that recognizing how little creditors could do to force sovereigns like Argentina to behave, "led the private international financial community to become much more willing to endorse some official reforms to make sovereign debt rescheduling more orderly, most notably through the use of [CACs] in new international bond issues."<sup>93</sup>

*x. "Prehistoric" CACs and Inadvertence.* We have found only one published story about the use of CACs in New York law bonds before Mexico, which involved Bulgaria, Kazakhstan, Qatar, Lebanon, and Egypt. Gugiatti and Richards, who studied these early issues to identify the effect of CACs on bond prices, report that not only did the market pay little attention, but that the borrowers themselves seemed unaware, or at least indifferent, to the shift.<sup>94</sup> The study notes that

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<sup>89</sup> Felix Salmon, *Blazing a Trail Down Mexico Way*, *Euromoney* April 2003.

<sup>90</sup> See *Dealing With Default*, supra note \_\_, at \_\_ ("[S]elf interest led Mexico to go first. It hoped that by starting the ball rolling, it would brand collective-action-clauses as a sign of good credit, rather than of weakness"); see also Gelpern, supra note \_\_, at \_\_; Salmon, *Blazing*, supra note \_\_, at \_\_.

<sup>91</sup> Wirtz, supra n. [78]. Mexican officials, "denied any link between the US and Mexico's use of CACs, but frankly admitted the advantage of setting a standard before the clauses become more widely used." Anna Gelpern, *How Collective Action Is Changing Sovereign Debt*, *Int'l Fin. L. Rev.*, May 2003, at 20.

<sup>92</sup> See Arturo Porzecanski, *From Rogue Creditor to Rogue Debtor: Implications of Argentina's Default*, 6 *Chi. J. Int'l L.* 311 (2005), Helleiner, supra n. \_\_, Blustein, *And the Money*, supra n. \_\_.

<sup>93</sup> Helleiner, supra n. \_\_ at 965; cf. Ernesto Zedillo, *Argentina or the "Principles"?* *Current Events*, *Forbes*, 5/23/05 ("Argentina's financial collapse was the impetus for serious discussions on how to improve the system.") (available at [www.forbes.com/currentevents](http://www.forbes.com/currentevents)).

<sup>94</sup> Mark Gugiatti & Anthony Richards, *The Use of Collective Action Clauses in New York Law Bonds of Sovereign*

each of these early issuances was documented by the London office of a New York Law firm. In the authors' view, the innovation was "somewhat inadvertent" – a combination of the lawyers' comfort with New York law and their lack of familiarity with Euromarket boilerplate.<sup>95</sup> The firms were doing New York law deals, but cut and pasted contract terms from an English law form.<sup>96</sup>

#### IV. The Interviews

This section sets out the accounts we have collected from participants in the CAC shift. Our contacts spoke to us in the expectation of confidential treatment based on the political and market sensitivity of the information they shared; we have coded the interviews to preserve anonymity. We proceed roughly in the order of the published explanations above, which form the background public story of the shift. This way, our materials will come across as overlay – occasionally adding richness and depth, perhaps more often, altering the appearance of the underlying story.

##### *i. SDRM: The Phantom Menace*

The overwhelming majority of our contacts connected the CAC shift with SDRM. Only two said that the CAC shift might have happened without the threat of SDRM; we will return to their views shortly. Most market participants offered two basic versions of the explanation. In the first version, the official sector had wanted to foist a statutory regime on the market, but backed down in the face of market resistance, settling for CACs as "second best". Here is how one investor put it:

There were enough parties of interest in the world of finance [opposing SDRM] that political forces in Washington stood down. The White House listened to this ... 'maybe

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Borrowers, 35 Geo. J. Int'l L. 815 (2004); See also Anthony Richards & Mark Gugiatti, Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets, 6 Int'l Fin. 415, 421 & n.12 (2003) (reporting on the degree of indifference among legal advisers in these initial deals to the use of collective action clauses). Robert Gray, a senior official with ICMA, confirms the Richards and Gugiatti observations and further suggests that their finding of lawyer indifference to the early changes also extended to the issuers, underwriters, and investors involved in those initial deals). See Robert Gray, Collective Action Clauses: Theory and Practice, 35 Geo. J. Int'l L. 693, 703 (2004).

<sup>95</sup> See supra note [89].

<sup>96</sup> Gugiatti & Richards, The Use of Collective Action Clauses, supra note \_\_\_, at 815, 826.



we were making too many enemies, we need a second best.’ CACs were that second best.<sup>97</sup>

In another market view, more common among those familiar with public sector efforts to promote CACs in the 1990s, officials announced SDRM out of frustration with the market’s failure to adopt CACs – or any other fix to the collective action problem that governments foresaw and markets dismissed.<sup>98</sup> SDRM was the nuclear fix, a way to ensure that “the private sector would pay attention finally to what government thinks.”<sup>99</sup>

Our interviews and correspondence confirm that industry representatives had tried more than once to trade their acceptance of CACs for the official sector’s commitment to “drop” SDRM,<sup>100</sup> which implies that they had thought such a bargain to be within the power of their official interlocutors. A dozen or so contacts described a particularly contentious gathering of investors, emerging markets issuers, and G-7 officials hosted by the U.S. Treasury in late September 2002 on the margins of the World Bank-IMF Annual Meetings. The parties reportedly tried to reach consensus on CACs, but failed in large part because the United States would not take SDRM off the table.<sup>101</sup> One participant described the meeting as a “debacle”. Mexico’s Finance Minister Francisco Gil Diaz “got up and said forget it, we are never doing CACs!” – a gesture the Minister appears to have reprised regularly at international gatherings in the run up to February 2003.<sup>102</sup>

Did the G-7 and the IMF truly aim for a statutory regime, settling for CACs as the face-saving fallback? Or was SDRM a ploy to induce a market fix to collective action problems, after nearly

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<sup>97</sup> Interview 070206

<sup>98</sup> See Hagan, *supra* n. \_\_ at 4.

<sup>99</sup> Interview 111705

<sup>100</sup> See e.g., Salmon, *supra* n. \_\_; Letter to Paul H. O’Neill from the heads of EMTA, IIF, IPMA, BMA, SIA, ISMA, and EMCA, dated December 6, 2002 (on file with authors):

We believe that a market-based approach to strengthening crisis management holds the only promise for success. Consequently, we have taken the lead in developing marketable collective action clauses (CACs) that could command the support of both investors and issuers. Regrettably, that effort was set back by the “two-track” approach reinforced in September, an approach which was seen by a number of investors as well as issuers as signaling that a sovereign debt restructuring mechanism (SDRM) could override what is achieved through CACs.

<sup>101</sup> See e.g., Interviews 100605, 092705 and Paul H. O’Neill, Keynote Address to the Institute of International Finance, Washington, D.C., September 28, 2002, available at <http://www.treasury.gov/press/releases/po3077.htm> (where O’Neill refers to the meeting several days earlier but commits to pursue both CACs and SDRM).

<sup>102</sup> Interview 100605

a decade of market resistance to official pleas? And were the G-7, and especially the United States, deliberately driving a hard bargain, holding SDRM over the markets to secure unconditional surrender on CACs? Interviews with officials suggest a more nuanced story, and raise the possibility that SDRM itself came of a loss of control by the United States and a measure of coordination failure among the G-7.

Most accounts of the IMF's initiative<sup>103</sup> start with Argentina. In August 2001, that country secured its last IMF loan before defaulting on nearly \$100 billion in foreign bonds. The Bush Treasury, eager to distance itself from Clinton-era bailouts,<sup>104</sup> was searching for a way to inject some form of market discipline in the Argentine package. Inspired in part by the financial engineering of the Brady Plan and in part by its faith in market ingenuity, the Treasury team pressed the IMF to set aside \$3 out of \$23 billion for a "market-based, voluntary restructuring operation".<sup>105</sup> It soon became clear that restructuring \$100 billion with \$3 billion would take more magic than engineering. But some of the early design meetings introduced Paul O'Neill, the eccentric first Treasury Secretary of the second Bush Administration, to negative pledge constraints in sovereign debt contracts.<sup>106</sup> Apparently O'Neill did not take well the prospect that a contract clause might interfere with debt restructuring for an insolvent sovereign. In September 2001, he publicly called for an international agreement on sovereign bankruptcy.<sup>107</sup>

Days earlier, O'Neill had hosted a private breakfast for Horst Koehler, the Managing Director of

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<sup>103</sup> The intellectual history of sovereign bankruptcy precedes SDRM, tracing at least as far back as Adam Smith. See Kenneth Rogoff & Jeromin Zettelmeyer, *Early Ideas on Sovereign Bankruptcy: A Survey* (March 2002) (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=879533](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=879533)).

<sup>104</sup> See e.g., John B. Taylor, *The Bush Administration's Reform Agenda At the Bretton Woods Institutions: A Progress Report and Next Steps*, Testimony Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 19, 2004, available at <http://www.treasury.gov/press/releases/js1662.htm> (describing post-Mexico packages of the 1990s as an example of short-term tactics that risked distorting market incentives), and Taylor, *Loan Rangers*, supra n. \_\_ (defining his legacy as putting a brake on the IMF bailouts of the 1990s). For an example of the intellectual influences behind this position, see Lerrick & Meltzer, supra n. 69.

<sup>105</sup> Interview 121405

<sup>106</sup> A standard negative pledge clause restricts the borrower's capacity to pledging collateral to secure future debts. Most private lenders to sovereigns require negative pledge commitments; the World Bank uses a particularly onerous form of the clause in its standard loan documentation.

<sup>107</sup> "We need an agreement on an international bankruptcy law, so that we can work with governments that, in effect, need to go through a Chapter 11 reorganization instead of socializing the cost of bad decisions." Paul O'Neill, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, One Hundred Seventh Cong. 33 (2001)

the IMF, and Anne Krueger, his newly-appointed First Deputy.<sup>108</sup> Several senior staff were in attendance. One participant told us that at breakfast, O’Neill “waxed poetically” about international bankruptcy.<sup>109</sup> Another reported O’Neill saying something like, “We need an international bankruptcy court ... and do it by December.”<sup>110</sup> The IMF had quietly explored sovereign bankruptcy analogues several times in the preceding decade, each time without an action mandate from its major shareholders. For the IMF officials at the Treasury breakfast, O’Neill’s call signaled a massive institutional boost. Visibly elated, “Horst and Anne sort of floated out of the place.”<sup>111</sup>

In contrast, O’Neill’s deputies first took his words as a bit of rhetorical gloss. As they saw it, the Secretary had identified a problem – inflexible debt contracts – and commissioned a solution. Statutory sovereign bankruptcy was a possible solution, but one that was obviously costly (at a minimum, requiring Congressional approval) and more importantly, too *dirigiste* for most of the Bush team’s free market sensibilities. One team member, a trained lawyer, suggested that any necessary bankruptcy functions could be synthetically replicated in a private contract. Initial conversations with outside experts (mostly academic economists) and staff unearthed the earlier CAC initiatives, going back to 1996. Senior officials became convinced that “not only was it possible, it was smarter to do it contractually.”<sup>112</sup> But by then, the IMF machine was in full gear designing the new statutory framework.

Some participants in the August breakfast say they saw right away that O’Neill’s deputies and Krueger took him completely differently. But Treasury officials, still completing transition to the new Administration, thought they had time to bring Fund management “back on the reservation.”<sup>113</sup> They miscalculated. Krueger gave her first speech launching SDRM in

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<sup>108</sup> The IMF’s first deputy is traditionally nominated by the United States. Krueger, a prominent conservative economist, was a Bush White House choice. For the announcement of her appointment, see e.g., <http://news-service.stanford.edu/news/2001/june13/krueger-613.html>

<sup>109</sup> Interview 121605

<sup>110</sup> Interview 121405

<sup>111</sup> Id.

<sup>112</sup> Id.

<sup>113</sup> Id.

November 2001.<sup>114</sup> IMF had sent an advance copy to the Treasury but heard nothing back. Krueger may have assumed she had what “clearance” she needed; Treasury officials assumed more substantive consultations would ensue.

Market reaction to Krueger’s speech was quick and scathing. One New York lawyer recalled that the speech “scared the Bejesus out of” some business contacts: “It’s VIII(ii)(b) again, but much, much worse!” – referring to an earlier official attempt to sanction nonpayment under Article VIII(ii)(b) of the IMF Charter.<sup>115</sup> A buy-side money manager summarized market concerns as two-fold: discomfort with “institutionalizing a process by which your contracts would be trumped” and having that process run by an institution like the IMF, controlled by the G-7 and exposed to their shifting policy priorities.<sup>116</sup> Many others suspected Fund motives, and accused it of conflicts of interest: the IMF is often the largest creditor of a sovereign in distress.

Once the idea was out, it proved hard to squash. By all accounts, O’Neill had no problem with CACs, but refused to allow his deputies to end the statutory experiment. A celebrated industry captain before his Treasury stint, he fancied the idea of different groups competing to design solutions to his problem.<sup>117</sup> Competition began to resemble confrontation the following spring when Krueger and John Taylor, Treasury Under Secretary for International Affairs, both spoke at a conference on sovereign debt restructuring at the Institute for International Economics, a Washington think tank. Krueger delivered a modified version of the first SDRM proposal, scaling down the IMF’s role.<sup>118</sup> Taylor endorsed CACs in a speech that was widely read as

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<sup>114</sup> Anne Krueger, Speech at the American Enterprise Institute, International Financial Architecture for 2002: New Approach to Sovereign Debt Restructuring (Nov 26, 2001), available at <http://www.imf.org/external/np/speeches/2001/112601.htm> (visited Mar 22, 2005).

<sup>115</sup> Interview 121305. See Daniel K. Tarullo, Rules, Discretion, and Authority in International Financial Reform, *J. Int’l Econ. L.* 613 (2001) at 674.

<sup>116</sup> Interview 070206. Many in the market never bought into the IMF’s efforts to distance itself from the actual management of the restructuring process – no technical changes could convince the skeptics that SDRM was anything other than a power grab by the IMF.

<sup>117</sup> Interview 121405. In the fall of 2002, O’Neill publicly called for a competition of ideas:

Simply put, our goal is to change the way that debt is restructured, not to tie ourselves to one approach or another. If there were a third approach to consider, we would welcome that opportunity as well. Don’t throw stones at our best efforts to fix this system – throw ideas. The competition of ideas will ensure that we develop the most sensible system to bring predictability to sovereign debt restructuring. We will explore every option, every means to our goal, assess its flaws and strengths, and modify it accordingly.

See O’Neill, *supra* n. \_\_.

<sup>118</sup> Anne O. Krueger, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Speech at the conference on "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, Washington,

dismissing SDRM as a matter for academic speculation.<sup>119</sup> Officials and staff involved in preparing the speech swear that Taylor had never intended to slight Krueger, a former Stanford colleague, and certainly did not mean “academic” as a pejorative. The following account is typical:

He was asked to speak at a conference, he had views to share. Fairly sure he was not doing it to be Machiavellian. He was being analytical. She thought that the U.S. was supporting her ... There was pressure after for John not to be in Anne’s face ... she was ‘slightly’ upset.<sup>120</sup>

Taylor considered Krueger a friend; he also knew that she was revising the original design – perhaps he had expected their approaches to converge.<sup>121</sup> Looking back, it is hard to see how a U.S. proposal with no role for the Fund could escape being perceived as profoundly threatening. In any event, the press and the markets reported the speeches as open conflict between the IMF and its largest shareholder.<sup>122</sup> The bad signal that sent may well have trumped the substance of either initiative. Days later, Taylor’s new deputy Randal Quarles was in the press endorsing a two-track approach – where the Fund and the G-7 would explore both CACs and SDRM in an effort to improve crisis management.<sup>123</sup>

Krueger had some support inside the Bush White House. But the nature and depth of this support are a matter of contention. [Taylor recounts in a forthcoming book being called to the White House and told to go easy on the Fund.]<sup>124</sup> Krueger was friendly with National Security Adviser Condoleezza Rice (both had taught at Stanford). When they occasionally dined together, Krueger would mention the SDRM, and Rice would respond with general

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DC, April 1, 2002, available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=454> and Paul Blustein, IMF Scales Down 'Bankruptcy' Plan The Washington Post April 2, 2002, at E1.

<sup>119</sup> John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Speech at the conference on "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, Washington, DC, April 2, 2002, available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=455>; for press reactions see infra ns. [141 and 142].

<sup>120</sup> Interview 121305B.

<sup>121</sup> Interview 061506

<sup>122</sup> See e.g., Paul Blustein, IMF Crisis Plan Torpedoed; Treasury Official Rejects Proposal a Day After It Is Advanced, The Washington Post, April 3, 2003, at E1; Sovereign Bankruptcies The Economist, April 6, 2002 and Alan Beattie & Raymond Colitt, US Scorns IMF Plan for Bankrupt Governments: Proposals to Help Countries in Crisis Sort Out Their Debts without Fear of Litigation Have Met a Cool Response, The Financial Times, April 6, 2002, at 7.

<sup>123</sup> See e.g., Paul Blustein, IMF Reform Plan Makes Comback; U.S. Eases Stand on 'Bankruptcy' Idea, The Washington Post, April 9, 2002, at E4 and O'Neill says US view on IMF Debt Restructuring Plan Misinterpreted, AFX European Focus April 9, 2002, available on LexisNexis.com.

<sup>124</sup> John B. Taylor, International Financial Warriors [Due out September 2006] at \_\_\_

encouragement.<sup>125</sup> Senior White House staff apparently considered and rejected the idea of elevating either SDRM or CACs beyond the Treasury.<sup>126</sup> A Treasury official characterized White House interest as “discomfort with the press playing up the conflict between Treasury and IMF ... It was an arcane issue at the White House.”<sup>127</sup>

National Economic Adviser Larry Lindsey and CEA Chairman Glenn Hubbard were among the few top White House officials to weigh in on the substance of the debate, generally in line with the contractual approach.<sup>128</sup> Hubbard even gave a keynote speech at an IMF conference on SDRM. He proposed a mix of contractual innovation and a voluntary dispute resolution mechanism that echoed some features of the SDRM, combined with restructuring incentives and tighter conditions on IMF lending.<sup>129</sup> Even though in substance Hubbard’s idea was much closer to Taylor’s than to Krueger’s, his rhetoric was telling – he called CACs a “Treasury proposal”, as if to distance the rest of the Administration from the controversy. Some Treasury officials saw Hubbard’s “third way” as a worrisome diversion.<sup>130</sup> But for IMF staff the speech sounded the death knell for SDRM – they had assumed that the White House was with Krueger.<sup>131</sup> Hours later, things got surreal as Quarles delivered yet another ritual endorsement of the two tracks, promoting the clauses but encouraging the IMF to keep refining their SDRM proposal.<sup>132</sup> An IMF staffer complained privately that he wished the United States would just end the charade

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<sup>125</sup> Interviews 032306 and 121405. Some Administration insiders suggested to us that Rice was merely being polite without delving into the initiative’s substance.

<sup>126</sup> Interview 122005

<sup>127</sup> Interview 061506

<sup>128</sup> Id. and R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Remarks at the Conference on the Sovereign Debt Restructuring Mechanism, International Monetary Fund, January 22, 2003, available at <http://www0.gsb.columbia.edu/faculty/ghubbard/speeches/1.22.03.pdf>. Hubbard delivered nearly identical remarks several months earlier at the American Enterprise Institute, a conservative think tank. R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Remarks at the American Enterprise Institute Conference on the IMF’s Sovereign Debt Proposal, October 7, 2002, available at <http://www.whitehouse.gov/cea/EnhancingSovereignDebtRestructuringAEIOct72002.pdf>.

<sup>129</sup> Hubbard, January 22, 2003, *supra* n. \_\_\_.

<sup>130</sup> Interview 061506

<sup>131</sup> Hubbard’s audience was likely unprepared to parse yet another proposal; the big question on everyone’s mind was whether the White House was with the SDRM or against it. There is some evidence that Hubbard did indeed intend his speech as a signal against. One guest at a conference luncheon recalls Hubbard asking privately, “Was I clear enough?” – a question that confirmed the impression around the table that the speech sought to end the IMF experiment. Interview 052506. On the other hand, it is not clear that White House officials cared much one way or another about the substance; they just wanted the controversy to end. A prominent academic heading an advisory body, Hubbard may have been testing out yet another theoretical construct that could simultaneously help solve the restructuring problem and end the Treasury-IMF contest.

<sup>132</sup> For a discussion of the impact of Quarles’ remarks on the lawyers in the audience, see *infra* ns. \_\_\_

and put his colleagues out of their misery.

Active controversy around SDRM and CACs lasted for about a year and a half from Krueger's first speech. Some senior U.S. and IMF officials suggested quietly it was a no-win battle, and tried to distance themselves from both sides to the extent possible.<sup>133</sup> As best we know, their reasons were some combination of believing that neither initiative was likely to succeed, that CACs were marginal, while SDRM was too intrusive. Some said that at the Fund, Krueger "owned" the initiative so completely that it left little room for others of her stature.<sup>134</sup> "It was going to be her legacy" and was her battle to fight.<sup>135</sup> On the other hand, our contacts often pointed to a small cohort of "true believers" in SDRM, comprising Krueger and several senior IMF staff, sustained in their design work by encouragement from O'Neill, the desire to boost the role of the IMF, at least acquiescence from the White House, and importantly, by support from European capitals.

By the end of the 1990s, European officials had come to lead the opposition to outsize IMF packages. Germany's insistence on hard lending limits typified this view, as did an influential joint paper by the Bank of England and the Bank of Canada, advocating debt standstills and lending limits.<sup>136</sup> Unlike the newly minted Bush appointees, many European representatives in the CAC-SDRM debate were veterans of the "private sector involvement" wars of the late 1990s.<sup>137</sup> Wary of discretion, which had let the United States steamroll over their objections, and weary of the old CAC initiatives that looked in retrospect like a fig-leaf for U.S.-led bailouts, the Europeans wanted firm crisis management rules.<sup>138</sup> SDRM was their chance, thanks to the space

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<sup>133</sup> Interviews 121205 and 122005.

<sup>134</sup> Interview 052506. A long-time observer of sovereign debt restructuring interpreted Krueger's ownership as the first sign of doom: "When it came out, [SDRM was the] Anne Krueger proposal – not IMF, not Koehler – first clue to me that it was dead on arrival." Interview 060606

<sup>135</sup> Interview 0502506.

<sup>136</sup> Paul Blustein, *The Chastening* (2001) at 170-174, Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds*, unpublished paper of the Bank of England and Bank of Canada, November 2001, available at <http://www.bankofengland.co.uk/publications/other/financialstability/boeandboc.pdf>. This staff paper came with the explicit endorsement of the heads of their respective central banks. As the authors note, the paper circulated widely in the official finance circles before being publicly released.

<sup>137</sup> Roubini & Setser, *supra* n. \_\_, Interview 021706. See *supra* n. \_\_ and accompanying text. Blustein describes private sector involvement, a term that emerged in the context of the 1990s crises and the accompanying IMF packages, as "a code phrase for inducing banks and investors to accept part of the burden for resolving a crisis by reducing or stretching out their claims." Blustein, *The Chastening*, at 174. See *infra* n. \_\_ and accompanying text.

<sup>138</sup> See generally, Tarullo, *supra* n. \_\_. Tarullo contrasts the European position with the strongest proposal for a rule

created by O'Neill.<sup>139</sup> Europe's over-representation in the IMF Board made its support impossible to ignore, even if the U.S. alone could have blocked the supermajority vote to amend the Charter.<sup>140</sup>

With the U.S. tied to the parallel tracks for as long as O'Neill was in office, the most vocal resistance to SDRM in the IMF Board came from large emerging market issuers, notably Mexico and Brazil.<sup>141</sup> One official called the SDRM "a wrong idea at the wrong time", noting flatly that if it had prevailed, his country would have lost all market access.<sup>142</sup> In private, borrowers also worried about losing access to IMF funds; some raised the IMF's conflict of interest.<sup>143</sup> In public, they framed their resistance in the language of large-volume market issuers, as in this example: "From the point of view of [this issuer], all discussions of default, possibility of making default easier, were not genial. ... Our scenario is not default."<sup>144</sup>

Mexico's CAC issue came two months after O'Neill's stormy departure from office in December 2002.<sup>145</sup> It is hard to speculate whether either event alone was sufficient to shelve SDRM. The IMF conference where Hubbard and Quarles appeared to speak at cross-purposes came between O'Neill's resignation and the appointment of his successor, John Snow, and may have been a symptom of the interregnum. (Mexico's spokesman at the conference reiterated his country's

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based system by Meltzer and others; he does not dwell on the disagreements between the Clinton Administration and its European allies. Id. at 641. European officials were not against CACs – most came across to us as both supportive and optimistic about their value – merely skeptical of their capacity to reduce bailouts. See e.g., Interview 091106.

<sup>139</sup> Brad Setser, The Political Economy of SDRM (January 8, 2005) (unpublished draft on file with authors).

<sup>140</sup> See e.g., Edwin M. Truman, Rearranging IMF Chairs and Shares: The Sine Qua Non of IMF Reform in Edwin M. Truman, ed., Reforming the IMF for the 21<sup>st</sup> Century (April 2006) at 203 (proposing a consolidated European seat). See also Lorenzo Bini Smaghi, IMF Governance and the Political Economy of a Consolidated European Seat in Truman, ed., at 233-255 (explaining the paradox of Europe's nominal over-representation against the lack of coordination among European chairs in the IMF), Ariel Buiara, The Bretton Woods Institutions: Governance without Legitimacy? in Ariel Buiara, ed., Reforming the Governance of the IMF and the World Bank (2005) at 8-34 (linking a flawed Board representation system with lack of organizational legitimacy), and Ngaire Woods, Unelected Government: Making the IMF and the World Bank More Accountable, 21 The Brookings Review 9, Spring 2003, available at <http://www.brookings.edu/press/review/spring2003/woods.htm> (criticizing constituency representation).

<sup>141</sup> And since Mexico was part of the Spanish constituency, it could only voice its objections intermittently, when it held the constituency chair. Interviews 121305, 121205, 061606 and 072406.

<sup>142</sup> Interview 080406

<sup>143</sup> Interview 121205

<sup>144</sup> Interview 061606; Interview 121205 illustrates a similar sentiment. Both CACs and SDRM raised concerns with signaling default; to some, SDRM raised them more starkly.

<sup>145</sup> On O'Neill's resignation, see Ron Suskind, The Price of Loyalty: George W. Bush, the White House and the Education of Paul O'Neill (2004); Interview 121605.



opposition to both tracks, suggesting that finance leaders should better focus on building hospitals, not morgues.) Most of our interviews tie O’Neill’s departure, SDRM and Mexico’s issue together, as in this version, which is unusual for bringing broader geo-strategic issues to bear on the CAC-SDRM debate:

Of course now we had an alternative, we could see the alternative happening, it is easier to say we do not have to talk about [SDRM] anymore. Maybe it is easier for the U.S. not to support SDRM. Period. Certainly O’Neill had to be gone. With O’Neill’s departure, [the U.S.] could say to the MD, the U.S. will never support this, and you need our vote. At about the same time, there was a big blowup at the UN about Iraq – after that, it became clear the UN process was failing, falling apart ... With those U.S.-European battles, it made no sense to have battles [at the IMF] for no good reason. When Koehler said the U.S. is against, it’s over ... Koehler was never a true believer.<sup>146</sup>

In retrospect, it looks like O’Neill’s initial set-up of a competition between IMF staff and his own framed the entire episode. As Taylor put it diplomatically, “The existence of an alternative proposal advocated by the IMF (and in particular by my colleague Anne Krueger) also had bearing on our financial diplomacy plan.”<sup>147</sup> One official recalled O’Neill saying, “If SDRM solves it, good, if your way solves it, good. He was very, quite direct. ‘Read my lips – I want the problem solved. Don’t swat Anne down. I’m behind Anne and you will get in line.’ Awkward – ... In the end, I think it was a good thing from the point of view of process that we didn’t swat down the SDRM. ... With O’Neill out of the building ... the heart of Treasury support was gone. ... Mexico moved, others moved ... ‘We said all along, may the best process win, and it did.’”<sup>148</sup> But another contact suggested that O’Neill’s insistence on keeping SDRM alive may have done more harm than good:

Some people feel that [SDRM] was a forcing factor. I am not sure. Private sector was so alarmed, it ran the risk of scaring [them] away from the whole deal. Did not make much difference. ... The underlying story is O’Neill versus Snow. O’Neill wanted to have it [SDRM] out there. Snow was very comfortable about ending SDRM. The whole thing changed.<sup>149</sup>

Perhaps the greatest irony of the episode is that by all accounts, SDRM’s ultimate chances of implementation had always been slim to none. The IMF charter is an international treaty;

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<sup>146</sup> Interview 121305. See e.g., Interviews 121605, 121305B.

<sup>147</sup> Taylor, *Essential Reform*, supra n. \_\_.

<sup>148</sup> Interview 121405.

<sup>149</sup> Interview 061506

amending the charter requires a super-majority vote of its Board and approval by member states, which for the United States would implicate the U.S. Congress.<sup>150</sup> The leading economic policy officials in the Bush Administration came to office deeply skeptical of the role of the international financial institutions, and especially the way in which the Clinton Administration had used them to battle international crises. Several years before his appointment, Taylor had even suggested abolishing the IMF altogether (he later distanced himself from the statement).<sup>151</sup> The idea that this Administration would spend political capital to expand IMF power at the expense of private contracts, and that the skeptical Congress would blithely go along, verges on inconceivable.<sup>152</sup> One long-time European observer put the skepticism in broader perspective:

I always thought SDRM was dead in the water – because countries just do not cede sovereignty. The Rey Report said as much. It was a waste of the Fund’s time, anyone’s time. It was not a credible alternative.<sup>153</sup>

Many other contacts, including investors and emerging markets officials who worked hard to defeat the proposal, said they had always assumed it would die – eventually.<sup>154</sup> As some of the later accounts suggest, eventually may not have been soon enough.

In sum, if the SDRM initiative had a role in the CAC shift – and our interviews certainly suggest that it did – then this may be the ultimate story of inadvertence. The political transition in the United States and the Argentine crisis, bound up in this story, are the salient distinguishing features between the successful shift in 2003 and the failed official campaign for CACs in the late 1990s. A brand-new, enterprising U.S. Treasury Secretary, unaware of the old CAC initiatives, got peeved at the negative pledge clause in Argentina’s bonds, and unleashed a powerful statutory alternative that made CACs seem handsome by comparison to the markets. O’Neill’s intervention empowered IMF management (led by another Bush appointee) and long-time European advocates of rule-based crisis resolution, but also energized his own deputies to

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<sup>150</sup> Articles of Agreement of the International Monetary Fund, Article XVIII, available at [www.imf.org](http://www.imf.org), and The Bretton Woods Agreements Act, 22 USC Sec. 286c.

<sup>151</sup> Adios IMF? International Monetary Fund, Uncommon Knowledge (a Hoover Institution video program), December 15, 1998, video and transcript available at <http://www.uncommonknowledge.org/99winter/320.html>.

<sup>152</sup> See e.g. Interview 060606

<sup>153</sup> Interview 021706

<sup>154</sup> See e.g., Interview 121205, 060606. The incentive to claim foresight ex-post is obvious. But we heard similar sentiment from scores of officials, investors and observers long before SDRM was shelved.

work hard to preempt them. The White House allowed the space for competition by deeming the controversy too technical and insignificant to intervene. The entire kaffuffle lasted long enough either to convince the markets of the merits of the contractual solution, or to create enough uncertainty about the outcome to make it worth the markets' while to preempt the debate.

ii. *Invisible Hands*

Bush Administration officials came up with CACs in the fall of 2001, knowing little or nothing of the prior life of the initiative in the 1990s. One official implicated in the clauses' comeback described a tinge of awkwardness when learning he had re-invented the CAC wheel: "It's round, it rolls, look what I've discovered!"<sup>155</sup> A staffer privy to both iterations of the CAC campaign was more charitable: "There was a lot of pressure for a radical alternative, and to his credit, John [Taylor] did not yield to the pressure, but dusted off the CACs."<sup>156</sup> The subtlety was lost on some market observers:

I did not pay much attention to the early rounds – it did not make sense to. We thought it would go away. And for a period it seemed they [CACs] vanished ... and then they reemerged. I try to stay away from Washington, I am not a lobbyist – here Washington lobbied us, invaded ... I thought they were on a tear to fix ... but fix the wrong thing. Boy they sure got CACs. Now you can bind 25%.<sup>157</sup>

In this and other accounts, market-based change came courtesy of successive Washington invasions. This explanation raises yet more questions. If U.S. pressure catalyzed the CAC shift in 2003, what were the ingredients of the winning strategy? Why did U.S. advocacy fail the first time around in the 1990s? And did the early history of the initiative contribute to its eventual success?

Mexico's 1994 crisis solidified the public consensus that the era of bond crises had arrived, and was worse than the 1980s loan crisis.<sup>158</sup> Officials and experts pointed out that foreign bank loan restructuring took a decade, and both the instruments and the creditors were fewer and more

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<sup>155</sup> Interview 121405.

<sup>156</sup> Interview 121305B.

<sup>157</sup> Interview 111705

<sup>158</sup> See ns. [59-61] *supra* and accompanying text.

flexible in the 1980s.<sup>159</sup> By the mid-1990s, emerging market sovereign bonds had acquired a reputation as a near-sacred asset class partly because they seemed technically difficult to restructure, but also partly for their association with the moral commitment the official sector had made in sponsoring the Brady Plan.<sup>160</sup> The Bradies were meant to be inflexible to instill fear of default in the hearts of wayward debtors, and even contained a provision that turned out in retrospect to be near-comical bluster – a promise that they would never be restructured. Beginning in 1995, academic and trade journals began publishing lawyers’ bond restructuring proposals; yet more ideas circulated informally in the sovereign debt community.<sup>161</sup>

On the official side, concern about bond restructuring went hand in hand with concern about mega-bailouts: many in the finance circles fumed at the \$50 billion Mexico package.<sup>162</sup> Central banks took the lead in making sure it did not happen again. A series of central bank deputies’ meetings beginning in February 1995 produced a G-10 working party under the leadership of Jean-Jacques Rey, the Belgian central bank deputy chosen, in the words of one participant, “because he was neutral – not American but not crazy Bundesbank – no bailouts.”<sup>163</sup> But the Rey group’s mandate was “a reaction to what you [the United States] did – there has got to be a better way of handling sovereign liquidity crises.”<sup>164</sup> The fruits of the group’s work, known informally as the Rey Report, came out in May 1996. It considered and rejected statutory sovereign bankruptcy as neither feasible nor appropriate (suggesting private sector entities may wish to study the issue further) and proposed among other things, a “market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate

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<sup>159</sup> Until the late 1990s, bonds were generally thought to be difficult to restructure owing to a large number of creditors with no political motive to cooperate. *Id.* The Brady Bonds, which were the predominant model for emerging markets sovereign bond contracts, were especially problematic because they had been designed as “not market instruments but rather as crisis instruments created specifically by the creditor banks as a prerequisite for agreeing to significant debt and debt service reduction.” James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, *Int’l Fin. L. Rev.* March 1996, at 14.

<sup>160</sup> See 1996 G-10 report, *The Resolution of Sovereign Liquidity Crises* (the “Rey Report”) (available at <http://www.bis.org/publ/gten03.pdf>); Vincent Truglia et al., *Sovereign Risk: Bank Deposits vs. Bonds*, Moody’s Investor Service Special Comment, Oct. 1995 (surveying recent history of selective sovereign default and implications for different instruments); Azmat Zuberi & David Roberts, *Preferred Creditors and the Sovereign Ceiling*, Duff & Phelps Credit Rating Co., Mar. 19, 1996.

<sup>161</sup> See e.g., Symposium – The New Latin American Debt Regime, in 16 *NW J. Int’l L. & Bus.* (Fall 1995) symposium; Hurlock & Alexander, *supra* n. \_\_; J.B. Hurlock, *Sovereign Bankruptcies: Countries Cannot Always Pay*, White & Case (1995), unpublished, cited in Eichengreen & Portes, *supra* n. \_\_ at 65.

<sup>162</sup> See e.g., Blustein, *The Chastening*, *supra* n. \_\_ 172.

<sup>163</sup> Interview 100705.

<sup>164</sup> *Id.*

consultation and cooperation” between debtors and creditors, as well as among creditors. This specifically included majority modification to improve restructuring predictability.<sup>165</sup>

It is not entirely clear how the contract proposal made its way into the report. Some later commentators credit a paper by economists Barry Eichengreen and Richard Portes, commissioned by the British Treasury and the Bank of England in connection with their work in the Rey group.<sup>166</sup> But Eichengreen and Portes themselves, as well as working party members we interviewed, describe the bond clause proposals as “already out there” and part of the crisis management discussion.<sup>167</sup> Veterans of the 1980s crisis, some of whom participated in the Rey effort, said that the lengthy, costly and traumatic restructuring delays they attributed to high-majority and unanimity requirements in loan contracts played a big role in framing their concerns.<sup>168</sup> Some private practitioners had expressed similar worries several years before the 1994 Tequila Crisis.<sup>169</sup>

In market surveys commissioned for the Rey Report, investors roundly dismissed the contract proposal:

Market participants opposed any change to the present structure of bond contracts. The general view among the respondents was that bonds represent a simple promise by the borrower to pay, and their attractiveness as an investment vehicle reflects their character as easily transferable, unencumbered and difficult-to-restructure securities.<sup>170</sup>

To be fair, investors also dismissed sovereign bankruptcy and bondholder committees – they pretty much wanted to be left alone. We were privy to similar outreach efforts later in the late 1990s, which elicited roughly the same market response.

Nevertheless the clause proposal, initially mocked as a “tinny deliverable,”<sup>171</sup> survived and prospered for almost five years. After the Rey Report, clauses reappeared in a report on crisis

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<sup>165</sup> The Rey Report, supra n. \_\_\_\_.

<sup>166</sup> Eichengreen & Portes, Crisis? What Crisis?, supra n. \_\_\_\_.

<sup>167</sup> Id., Interviews 100705, 021706, 010306 and 081706.

<sup>168</sup> Interview 092705

<sup>169</sup> Lee C. Buchheit, Making Amends for Amendments, Int’l Fin. L. Rev. February 1991 at 11.

<sup>170</sup> Rey Report at 35.

<sup>171</sup> Interview 092705

resolution by the Group of Twenty-Two systemically significant economies in the aftermath of the Asian financial crisis, and as part of the International Financial Architecture Initiative in 1999. One staffer suggested this resilience was due to a combination of intellectual appeal and bureaucratic convenience:

[CACs offered a] very elegant, simple theoretical framing. It worked in the economics world. Collective action problems are a well-accepted category that a legal problem falls into – a well-accepted model of market failures ... Government is only involved if there is a market failure. It is easy to show market failure here. ... Very powerful framing overlapped with the concern in the legal world whether document standards in New York law Brady Bonds made sense -- set up in a way -- exit -- no more restructuring -- that made it harder down the line. This simple accepted model of potential problem that worked both in legal and economic world – there was an element of truth to the arguments – got elevated and expanded into a notion that because CACs are not there, there is no market solution, the only option is a bailout. Somehow it went from “absence of CACs makes restructuring harder than it should be” to “there will always be bailouts”.

Jeff Sachs was pushing international bankruptcy<sup>172</sup> – seemed too far. Traded securities difficult to restructure – means a bailout next time – the Mexico problem – not tenable. As always the case, you put the unattractive options as the first bullet and the third, everyone picks the option in the middle. The option in the middle was to do something that makes tradable bonds easier to restructure.<sup>173</sup>

The intellectual appeal story is plausible partly because of the large number of academic economists involved in CAC policies over time. Lawrence Summers and John Taylor are the best-known of the lot, but the economics PhDs involved over time and at the highest levels numbered in the dozens. It helps explain the search for market failures, and the willingness to commission academic studies in support of the effort.

The bureaucratic story requires elaboration. Virtually all the officials who discussed the topic with us made clear that their advocacy of CACs related to a bigger policy objective. If Mexico-style full bailouts were no more, bond restructuring was inevitable. In the late 1990s, CACs became part of the effort to signal that the official sector would not stand in the way of sovereign

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<sup>172</sup> See Jeffrey D. Sachs, Do We Need an International Lender of the Last Resort, Frank Graham Lecture, Princeton University (April 1995) (available at <http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf>). For a more recent iteration, see Jeffrey D. Sachs, Roadblock to a Sovereign Bankruptcy Law, 23 *Cato Journal* 73 (2003) (available at <http://www.cato.org/pubs/journal/cj23n1/cj23n1-8.pdf>).

<sup>173</sup> Interview 112205. This statement sets out for CACs the classic ingredients for dissemination of policy ideas. Cf. Hall, *infra* n. [354].

bond restructuring, and in some cases may even demand it. The implications of that judgment translated into two big policy shifts in the late 1990s under the rubric of “private sector involvement in crisis management,” or “PSI”.<sup>174</sup> First, the Paris Club of government-to-government creditors would condition its relief on the sovereign debtor’s commitment to seek private bond restructuring terms comparable to the official concessions.<sup>175</sup> Second, the IMF would extend to bonds its willingness to finance countries in default on private debt.<sup>176</sup> Several participants said that at the time, CACs ended up on the “laundry list” of “things to be for” in operationalizing PSI.<sup>177</sup> Despite three years of market resistance beginning with the Rey Report investor surveys, the clauses still had an inoffensive, vaguely market-friendly ring to the official ear.

But in the late 1990s CACs never quite overcame their status as an adjunct initiative. A former Clinton White House official suggested that Treasury Secretaries Robert Rubin and Lawrence Summers never seemed eager to push hard on the CAC front.<sup>178</sup> Several staffers observed that Rubin and Summers had expressed their respective reservations differently:

Rubin was happy to have us talk about it, but would not have supported drafting model clauses. . . . “These guys have a problem coming down the pike – [they will have to] restructure bonds – if they can’t do it, this is when it will happen. This will not be solved until they believe it is a problem, and when they do, then they will solve it better than we ever had.” Larry was worried that it would make us look feckless. We publicized it a certain amount, but how they structure contracts is not our business. If this is our primary recommendation and they do not do anything about it, we look feckless.<sup>179</sup>

The delicate state of the global economy weighed heavily against regulation or even heavy pressure on market participants: “Although we believed that CACs would not in any basic sense

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<sup>174</sup> See supra n. \_\_ and accompanying text.

<sup>175</sup> See Jeffrey Keegan, *Growing Chorus of Regulators Want Sovereign Bondholders to Share the Pain*, INVESTMENT DEALER’S DIG., May 3, 1999; Kristin Lindow et al., *Pakistan’s Paris Club Agreement Implies New Official Strategy Regarding Seniority of Sovereign Eurobonds*, MOODY’S INVESTORS SERVICE GLOBAL CREDIT RES., Mar. 1999, at 3. Bank loans had been subject to “comparability” since the 1970s.

<sup>176</sup> Before 1989, the IMF refused to finance countries in arrears to private creditors. This empowered the creditors to hold up both their own as well as the IMF’s financing. As bank restructurings progressed, the Fund changed its policy to allow lending even if the country was in still in default on its loans, provided the country was complying with its policy program. With some qualifications, the policy expanded to cover default on bonded debt in the late 1990s. INT’L MONETARY FUND, FUND POLICY ON LENDING INTO ARREARS TO PRIVATE CREDITORS—FURTHER CONSIDERATIONS OF THE GOOD FAITH CRITERION 3-9 (July 30, 2002), available at <http://www.imf.org/external/pubs/ft/privcred/073002.pdf>.

<sup>177</sup> Interviews 091305, 092705

<sup>178</sup> Interview 010306

<sup>179</sup> Interviews 091305, 092705

change the situation, [they were a] highly charged symbolic political thing since the Rey Report.” Moving precipitously might “screw up fragile equilibrium.”<sup>180</sup> Mulling the CACs’ eventual success, another participant in the Clinton-era debates admitted being torn between feeling “sheepish – they made it happen when we could have done it in 1999-2000 – and what I used to think then ... which is that ... in the hierarchy of priorities ... it is not number one, number two, or number three.”<sup>181</sup>

The overall tone of the PSI effort of the 1990s was more burden-sharing than privatization. CACs were part – even if the mildest part – of a policy package that signaled “we want banks to take a hit.”<sup>182</sup> The official sector was not about to get out of the crisis management business; rather, private creditors that got a subsidy post-Mexico would now be asked to pay their way. In the late 1990s, the official sector was essentially united around bond comparability and lending into arrears on bonded debt. These were measures that governments could and did implement on their own, with minimal cooperation from the private sector. Once they did, officials could wait and see how bond restructurings might pan out. Within two years, Pakistan, Ukraine and Ecuador had secured high participation rates in distressed bond exchanges without significant litigation.<sup>183</sup> Of these, Ecuador was especially influential because it managed to restructure New York law Brady Bonds without CACs, thanks in large part to another market-generated contractual innovation – exit consents.<sup>184</sup>

The context had changed by the time CACs reemerged in 2002, several years after the Paris Club and IMF policies had been implemented. Large IMF packages were going strong and getting even larger under the new U.S. Administration, which had made opposition to bailouts an important plank of its foreign economic policy.<sup>185</sup> The new U.S. leadership framed this opposition as leaving the market to its own devices – getting the public sector out of crisis

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<sup>180</sup> Interview 010306. For a sense of the international economic environment and public perceptions of the role of the U.S. economic policy team, see Joshua Cooper Ramo, *The Committee to Save the World*, *Time Magazine*, February 15, 1999, at <http://www.time.com/time/asia/asia/magazine/1999/990215/cover1.html>.

<sup>181</sup> Interview 102105

<sup>182</sup> Interview 010306

<sup>183</sup> See e.g. Interview 091106, suggesting that the Paris Club was reasonably satisfied with the market’s “practical, pragmatic” response to bond comparability.

<sup>184</sup> Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, *Int’l Fin. L. Rev.* December 2000, at 17, and Buchheit & Gulati, *Exit Consents*, *supra* n. \_\_.

<sup>185</sup> Roubini & Setser, *supra* n. \_\_ at \_\_ and Tarullo, *supra* n. \_\_ at 651.



management, rather than making the private sector pay.<sup>186</sup> On the other hand, for many European officials SDRM seemed like a natural next step in escalating the PSI debate.

The free-market contingent at the U.S. Treasury needed an alternative that would promise to reduce bailouts, empower market forces, and look credible enough to preempt SDRM. From that perspective, CACs – long rejected by Wall Street – were arguably the worst candidate. On the other hand, once SDRM was out of the box, the time constraint was real, especially if one believed as some did that the debate itself was harmful to the markets. No other palatable alternative had materialized. Republican officials may have found special philosophical appeal to a fix that literally “came from the markets” in the form of standard English-law contracts, and bonus bureaucratic appeal to a fix that looked familiar and essentially harmless to the finance officials in all the major industrial countries and even some emerging markets countries that had to buy into CACs to make the shift happen. Within two years, CACs went from being a symbol of “bail-ins” to being a symbol of market-friendly reasonableness.<sup>187</sup>

Taylor made a point of noting the early history of CACs in his public statements and private outreach.<sup>188</sup> Several officials specifically credited the education efforts of the 1990s with the initiative’s quick progress in the 2000s, speculating that if CACs had first sprung up on the eve of Argentina’s default, they would have taken another decade to adopt.<sup>189</sup> Most of our interviews with investors and emerging markets officials suggest limited to no knowledge of the history. Some of this may be due to personnel changes. One executive prominent in the 2003 shift speculated that he was too junior to have been included in the CAC conversations of the late 1990s.<sup>190</sup> (A Washington team met with the head of his operation in 1999.) Another investor privy to both iterations of the initiative described a subliminal learning process: “People were worn out ... also knew that the public sector lived for that stuff and would never wear out.”<sup>191</sup> In

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<sup>186</sup> Taylor contrasted the Bush Administration’s approach to their predecessors’: “They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government-induced bail-ins of the private sector.” Taylor, *The Bush Administration’s Reform Agenda*, supra n. \_\_\_. Whether this market focus went beyond rhetoric and the extent to which it made for sound policy is much debated. See e.g., Roubini & Setser, *Bailouts*, supra n. \_\_\_.

<sup>187</sup> Interview 010306

<sup>188</sup> Taylor, *Essential Reform*, supra n. \_\_\_.

<sup>189</sup> Interview 102705

<sup>190</sup> Interview 030306

<sup>191</sup> Interview 070206

retrospect, early advocacy certainly increased the volume and sharpened the focus of CAC information in the public domain; the drumbeat also raised awareness of bond contracts among some creditors and helped frame the mandate for groups like EMCA, discussed below.

For European officials, the life of CACs between 1995 and 2003 looked much more like a continuous effort ten years in the making,<sup>192</sup> even if it proceeded in fits and starts and in distinct phases:

As for the two iterations, there are clear distinctions. I do not think they are completely and absolutely distinct – they [led] into one another. Excuse the analogy, it is like the process of labor – one contraction leading into another. But they were significantly different. ... People who think of success or failure in the international domain bring up the idea of a hegemon. The fact that the U.S. was behind this was necessary but wasn't sufficient. The U.S. was certainly behind the first phase as well.<sup>193</sup>

One official divided the policy push into three phases – the 1995-1996 Rey Report, which was essentially a G-10 only exercise outreach notwithstanding, the 1998 G-22 report on crisis resolution, authored by a group of officials from major industrial and emerging market economies in equal numbers, and the “Taylor-Quarles” phase, which mobilized an even broader range of actors, including lawyers and diverse members of the investor community.<sup>194</sup> Another European described a more diffuse process:

I do not particularly subscribe to individuals make a difference school of thought. If the Rey report had not been written, if Eichengreen-Portes hadn't produced the report, if O'Neill hadn't encouraged Krueger to give her SDRM speech – the Quarles working group, Taylor's advocacy, Buchheit's advocacy (and these people were important advocates) – would have taken place in a vacuum.<sup>195</sup>

On balance, even if market outreach had limited visible effect, it seems fair to trace the education and buy-in process among officials to 1995, and for a small but important subset, even further back to the restructurings of the late 1980s. There is some irony to the fact that CACs' most important and powerful proponents in the official sector – Deputy-level Bush Treasury officials – were also the last to arrive on the scene. It helped that their career staff were familiar with the clauses, and that their principal international interlocutors knew about them and were in principle

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<sup>192</sup> Interviews 021706, 091106, and 071006

<sup>193</sup> Interview 021706

<sup>194</sup> Id.

<sup>195</sup> Interview 071006

open to them. The accretion of press and academic studies that made CACs look harmless at worst, and often helpful, boosted the officials' rhetorical arsenal and increased their comfort with advocating new terms.<sup>196</sup>

The way in which the new team pursued CACs is instructive. As Under Secretary for International Affairs, John Taylor was head of Treasury's international division; Quarles was his deputy. They oversaw an organization of 150 or so staff, organized into "functional" and geographic offices<sup>197</sup> -- a division common in international bureaucracies. Functional offices are responsible for policies that span geographic regions, such as international debt, development, trade, investment, terrorist finance, and U.S. participation in institutions such as the IMF and the World Bank. "Country" offices are responsible for policy with respect to specific countries and regions, and generally maintain staff-level communications with other finance ministries and central banks. The functional office responsible for U.S. policy in the IMF and the G-7 process had the "lead" in staffing the CAC initiative, with input from in-house lawyers and the office of the U.S. representative at the IMF.

Between Krueger's first speech in November 2001 and the summer of 2002, the lead office collected research on the clauses, and consulted with academic economists, some emerging markets issuers, and selected market participants (mostly trade groups and research economists at large investment banks). Early efforts focused on including CAC advocacy in important policy signaling documents, such as G-7 communiqués, speeches and other public statements by senior U.S. officials, meetings with foreign counterparts, and market outreach. This was essentially similar to the late 1990s tactics.

At their meeting in April 2002, the G-7 Finance Ministers and Central Bank Governors adopted an Action Plan to strengthen crisis prevention and resolution.<sup>198</sup> G-7 ministers' meetings usually yield statements and communiqués, broader-brush documents meant to signal economic trends and policy intentions. An "action plan" signaled new urgency and specificity – an

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<sup>196</sup> Interviews 100705, 061506, and see *infra* ns. \_\_\_ and accompanying text.

<sup>197</sup> <http://www.treas.gov/organization/org-chart-122005.pdf>

<sup>198</sup> Action Plan, April 20, 2002, available at <http://www.treasury.gov/press/releases/po3015.htm>. See Blustein, *The Chastening*, *supra* note \_\_\_, for a discussion on the role of the G-7 Finance Ministers' meetings and G-7 Deputies' channels in international economic policy.

emphasis on results reflecting the public style of the new U.S. team. “Contingency clauses” were the first item in the plan, followed by limits on IMF lending, greater transparency in official decision-making, and further work on SDRM (which “would take time”). The one-page plan described the clauses in considerable detail, tracking Taylor’s speech a few weeks earlier. CACs also appeared in G-7 statements in the 1990s, but their prominence in this “action” document meant a promotion.

One official described the plan as a U.S.-British compromise to diffuse European support for SDRM and present a united G-7 front for CACs. Shortly after giving the speech that launched the CAC campaign, Taylor traveled to Russia. On the way back, he stopped for a G-7 meeting in London. There, Taylor and his U.K. counterpart agreed to frame CACs as a predicate for limiting IMF lending in crisis – a policy long advocated by the Europeans.<sup>199</sup> For the Clinton Treasury, CACs were marginal and strict limits were unacceptable (and in any event not credible); for their successors, both CACs and limits sent a message against bailouts. Concerned that the other G-7 members would see any U.S-British deal as suspect, Taylor and his colleague asked the Canadian deputy to present what became the Action Plan.<sup>200</sup>

Everyone reports that Treasury’s CAC strategy shifted either in the summer of 2002, or following the disastrous meeting with issuers and investors in September.<sup>201</sup> Staff in “country” offices were charged with learning the issuance pipeline for their region in the last quarter of 2002 and early 2003, working with in-house lawyers and using informal market contacts. The lead functional office put together a composite log and coordinated an intensified outreach plan with calls from Taylor, Quarles, and other officials to finance ministers, deputies, and debt

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<sup>199</sup> Interview 061506. See supra n. \_\_\_ and accompanying text. The Clinton Treasury had a powerful ally in U.S. Federal Reserve Board Chairman Alan Greenspan. Greenspan, Rubin and Summers were loath to tie their own hands, and in any event had viewed hard IMF lending limits as not credible. A senior Bush Administration official suggested that CACs gave lending limits credibility in Greenspan’s eyes. Others who knew Greenspan speculated that he went along with the deal because the new limits were still plenty flexible, while the clauses were harmless and possibly beneficial. Interviews 061506 and 100705

<sup>200</sup> Interview 061506. Canada chaired the G-7 process that year. The Canadian finance ministry welcomed the new approach as reflecting ideas Canada had been pressing for years to reform international financial architecture. A chronology accompanying the Canadian press release dates the architecture reform effort to the start of Mexico’s Tequila crisis in December 1994, and features Canada’s advocacy of CACs and its own CAC issue in 2000. G-7 Finance Ministers Adopt Financial Crises Action Plan, Press Release of the Department of Finance, Canada, April 20, 2002, available at <http://www.fin.gc.ca/news02/02-034e.html>.

<sup>201</sup> See supra n. \_\_\_ and accompanying text.

managers in the issuing countries. With issuers' permission, U.S. officials and staff also contacted the lawyers and investment bankers involved.

Our official sector contacts were eager to stress that there was no “arm-twisting”, that no threats were made and no rewards were promised. Taylor and others have described an exercise in persuasion;<sup>202</sup> the briefings and reports we have seen do nothing to refute this characterization. It is difficult to ascertain how the conversations were perceived on the other end. While none of our investor and emerging markets contacts would admit to having their own arms twisted, many seemed certain that twisting was going on elsewhere. U.S. officials and staff involved in the calls describe the response as mixed – some ministers knew nothing of the clauses; others said they had heard issuing with CACs would be costly. Everyone was polite, but no one volunteered. Smaller, shakier issuers said they could not afford to jeopardize their market access; others said they had no plans to default, did not need new clauses, and would not risk paying a penalty for no good reason.<sup>203</sup> The outreach log from January 2003 records lots of “broadly supportive” and “maybe next time” sentiment. Issuers pointed to the bankers, bankers pointed to the issuers, everyone pointed to the investors. One prominent advocate painted this picture:

Don't think any of them saw it as in their own interest. Lawyers – why should they change? They have a template, they are making good money. Countries risk the yield going up. Imagine a finance minister [who is] responsible for spreads going higher. Investment community saw it as taking power away from them...<sup>204</sup>

Against this background, broadening investor outreach was a key aspect of the new strategy. As noted earlier, in the first half of 2002, officials were in frequent contact with trade associations and sell-side research analysts. The buy-side was usually represented in these discussions by members of EMCA, a group that emerged out of Ecuador's Brady Bond default in 1999.<sup>205</sup> EMCA had been vocal in opposing any contract change that would diminish investor protections.<sup>206</sup> By the end of 2002, U.S. officials engaged with a broader cross-section of buy-side investors, including large investors who reached out to the Treasury and tried to distance

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<sup>202</sup> Taylor, *Essential Reform*, supra n. \_\_\_\_.

<sup>203</sup> Interviews 061506, 121305B.

<sup>204</sup> Interview 061506

<sup>205</sup> We discuss EMCA's role in detail in Section IV(v) below. Background on EMCA is available at <http://www.emcreditors.com/about.html>

<sup>206</sup> For the EMCA response to Mexico's February 2003 issuance with CACs, see [http://www.emcreditors.com/pdf/EMCA\\_Press%20Release\\_2\\_26\\_03.pdf](http://www.emcreditors.com/pdf/EMCA_Press%20Release_2_26_03.pdf).

themselves from EMCA positions.<sup>207</sup> On the sell-side, the team shifted focus from research to bankers “actually doing deals”:

After we really got down into the dirt [in late 2002], making calls to the debt managers in the countries and to the real live investment bankers actually doing the deals, these people knew very little about the whole CAC debate. It was quite astonishing. The people doing the deals hadn't been going to the conferences, could have cared less, hadn't heard much from the conference goers, and didn't know much at all. They just knew how to generate fees. So, the private sector talking heads weren't worth much.<sup>208</sup>

By late 2002, outreach to issuers suggested that no single country was willing to go first. As an alternative, the U.S. Treasury and its allies in the investor community tried to get a group of highly rated issuers, potentially including Mexico, Korea, Poland and South Africa, to announce together their intention to issue with CACs. The announcement would not be linked to any particular issue that might fail. To set the stage, they planned a meeting with the target issuers in late February, a week or so before John Snow's first G-7 Finance Ministerial. The objective was to have large investors reassure the countries that they were willing to buy their debt with CACs and did not expect to charge a penalty.

At the last minute, Mexico canceled. It later turned out that Mexican officials were meeting with their bankers and lawyers to plan for the country's first CAC issue. By many accounts, U.S. officials found out about the issue shortly before the launch. According to Mexican officials, the Finance Minister broke the news casually at the end of a lunch with the new Treasury Secretary.<sup>209</sup> One senior U.S. official describes intense coordination leading up to the launch, where Treasury pledged and delivered a public statement of support and procured similar backing from the G-7; others suggest this was a compressed process following Mexico's surprise revelation.<sup>210</sup> Within days of Mexico's announcement, at Snow's first G-7 meeting, the United

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<sup>207</sup> Interviews 100605 and 030306

<sup>208</sup> Interview 121605

<sup>209</sup> Interview 121205

<sup>210</sup> Interviews 061606, 121605. While the specific form and timing of the issue appear to have been a surprise, file memos indicate that Mexican officials told their U.S. counterparts that they were ready to move in principle as early as January. See *infra* n. \_\_; see also U.S. Treasury Statement Regarding Decision by Mexico to Issue Bonds with Collective Action Clauses (February 24, 2003), available at <http://www.treasury.gov/press/releases/200322418171120575.htm>.

States signaled the end of the two tracks. SDRM was officially shelved in April.<sup>211</sup>

Just as SDRM was identified with Anne Krueger, in 2002-2003 many came to see CACs as John Taylor's initiative. Some observers familiar with early CAC efforts said Taylor's voluntary contractual initiative was doomed on arrival. Comments from the audience at his April 2002 speech predicted nothing would happen without a government mandate; hallway chatter bordered on disparaging – but Taylor seemed undaunted.<sup>212</sup> In less than a year, he proved them all wrong. For a non-lawyer, Taylor had an impressive grasp of how key clauses worked; he missed no opportunity to raise CACs in speeches and testimony, and asked for frequent progress reports on the initiative. He was deeply invested in the targeted, intensive outreach. Our contacts at all levels described encounters where Taylor – an exceptionally mild-mannered man – showed visible frustration with the slow progress to CACs, most notably in late 2002. One person remembered getting a call while Christmas-shopping at Target -- “Nothing is happening, we need to do something!”; another only tangentially involved with CACs recalled Taylor's reaction to a CAC-less bond that had gone forward without Treasury's knowledge -- “There is no excuse, we should be calling everyone!”<sup>213</sup>

Some suggest CACs made sense as a defensive move on Taylor's part – “the principal aim was to stop SDRM and his mad boss.”<sup>214</sup> Yet among all U.S. participants in the CAC episode, only academic economists (of which he is one) expressed Taylor's level of enthusiasm for the clauses' substantive value and their potential importance in crisis. Taylor's website puts CACs among his most important accomplishments at the Treasury, under the headline “Essential Reform of the International Financial System: Collective Action Clauses”, and alongside Iraq's reconstruction, terrorist financing, and China's exchange rate. In speeches, he has credited the success of the CAC effort partly to the post-9/11 spirit of international cooperation. We have no way of knowing whether this conviction was genuine; if it were, we can only speculate on the reasons. But we cannot help wondering whether a cooler, more pragmatic approach to CAC advocacy in 2002 might have failed just as its predecessors did in the late 1990s: “History needs a midwife in

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<sup>211</sup> G-7 Action Plan Implementation, April 2003, April 12, 2003, available at <http://www.treasury.gov/press/releases/200341213252315778.htm>

<sup>212</sup> Interview 010306.

<sup>213</sup> Interviews 121405, 121605

<sup>214</sup> Interview 010306

this situation. John was the midwife.”<sup>215</sup>

### *iii. Ritual Experts*

Several published accounts of the CAC shift focus on the role of experts, especially lawyers and economists, in educating the officialdom and the markets. Our interviews suggest that shift participants used expertise in unexpected ways.

We have already noted the impetus that economic theory gave to the clause initiative by framing the bondholder collective action problem and the holdout dilemma.<sup>216</sup> Two other instances of expert deployment stand out in the CAC campaign. The first is the eminent lawyers’ team commissioned to draft model clauses under the auspices of a G-10 working group chaired by Quarles. The second is the group of econometric studies that asked whether investors demand a higher price for bonds with CACs than for those without.

In June 2002, shortly after the release of the G-7 Action Plan, the G-10 established a working group of officials to infuse more content in the CAC exhortations.<sup>217</sup> Quarles was in the chair. We have no evidence that the group was intended as a “counter-design” project to balance the IMF’s work on SDRM; however, in retrospect it certainly appears to have played some such function. The group’s product, released in just three months, contained two parts: an official report recommending clauses for inclusion principally in New York law bonds, and a set of model clauses drafted by an advisory group of “eminent lawyers” who represented sovereign debtors and creditors in jurisdictions where most external sovereign debt is issued (England, Germany, Japan and New York). The effect was to produce a tangible alternative to SDRM and the industry clauses released four months later, an alternative that had “intellectual heft”<sup>218</sup> and appeared to come pre-endorsed by major countries and law firms in the sovereign market.

Quarles’ personal role in the enterprise was critical. Before joining the Bush Administration, he

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<sup>215</sup> Interview 092705

<sup>216</sup> See *supra* notes [53, 183, 190].

<sup>217</sup> Group of Ten, Report of the Working Group on Contractual Clauses, September 26, 2002, available at <http://www.bis.org/publ/gten08.pdf>.

<sup>218</sup> Interview 121605



was a partner at Davis Polk & Wardwell in New York;<sup>219</sup> he had also held a domestic finance appointment in the Bush I Treasury. In his new government stint he soon gained a reputation as an engaged listener, a quick thinker and a dynamic interlocutor even among those who disagreed with him. One sell-side banker who met Quarles several times described him as “that guy who looked like a died-in-the-wool Republican” – and in the same breath recalled being “pleasantly surprised” with his willingness to listen and delve into substance.<sup>220</sup>

Some said the drafting effort was Quarles’ idea; others saw his chairmanship as a U.S. effort to control G-10 mission creep. Belgian officials in particular were keen to use the CAC campaign to bolster the role of the G-10, a forum where Belgium and other “small Europeans” not part of the G-7 play an important role. Even some European participants in the working group characterized it at least in part as a Belgian play for relevance.<sup>221</sup> We heard this sentiment from the U.S. side:

I was so glad that Randy chaired it. ... After the G-7 supported [clauses], the G-10 decided this would be something to do. It is a group always looking for something to do.<sup>222</sup>

Taylor was not at the meeting that sanctioned the working group, and though he went along with it, he was never entirely comfortable with the appearance of officials prescribing contract text to market participants.<sup>223</sup> He had a point: even as the group’s report put distance between its own recommendations and the eminent lawyers’ model clauses, and even as insiders all attested to Quarles’ scrupulous enforcement of that distance in the process, virtually all our market contacts perceived the model as the official position on the merits. This was especially significant with respect to the 75% amendment threshold for “reserve matters” (key financial and legal terms):

Randy was not shy about 75%. The report said certain countries, certain profiles, certain problems ... but 75% is the mandated number.<sup>224</sup>

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<sup>219</sup> To our knowledge, his practice did not include sovereign debt.

<sup>220</sup> Interview 060706

<sup>221</sup> Interview 021706

<sup>222</sup> Interview 061506. Considering the history of the Rey Report, the suggestion that the G-10 came to CACs late was not entirely fair.

<sup>223</sup> Interviews 090205, 061506

<sup>224</sup> Interview 111705. The G-10 Report specifically cautioned against thresholds above 75%. Group of Ten, *supra* n. \_\_ at 5. The fact that official pronouncements on IMF lending to Argentina hinged on participation levels in the bond exchange, and that Argentina’s exchange in the spring of 2005 secured 76% bondholder participation, no doubt colored market thinking.

Other G-10 recommendations for New York law bonds included trustees or permanent bondholder representatives, elected bondholder representatives to negotiate in restructuring (engagement), brakes on acceleration and litigation, and additional disclosure by the issuer.<sup>225</sup>

The extent to which the G-10 effort helped convince some of the early movers is a matter of debate. One of the “eminent lawyers” who was also involved in an early CAC issue suggested that “[t]he G-10 report gave enough legitimacy to the use of the clause” for issuers to experiment.<sup>226</sup> A U.S. official said that the G-10 template added to Mexico’s comfort.<sup>227</sup> But at least some Mexican officials expressed concern at the proliferation of drafting and discussion fora: “discussions at IIF, G-10, U.S. – process not leading anywhere. It was seen as reopening every single item in the contract.”<sup>228</sup> Soon U.S. officials found themselves reassuring some issuers that the G-10 would not make a fuss if they went ahead with clauses different from the template.<sup>229</sup>

By late 2002-early 2003, some in the United States began to worry that G-10 had started a “runaway process”, with other groups threatening to form on the heels of the Quarles-led effort. European support for a code of conduct for sovereign debt management<sup>230</sup> and renewed efforts to include CACs in the debt issued by EU member states were threatening to dilute the focus on a core set of clauses and a core group of issuers.<sup>231</sup>

Mexico soon made the concerns moot. At the IMF conference on SDRM in January 2003,<sup>232</sup> even as Mexican finance officials delivered the customary public nays, they let their U.S.

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<sup>225</sup> Group of Ten, *supra* n. \_\_.

<sup>226</sup> Interview 092205 (email 072106)

<sup>227</sup> Interview 121405

<sup>228</sup> Interview 121205

<sup>229</sup> Interviews 061506, 121605

<sup>230</sup> Banque de France Staff, *Towards a Code of Good Conduct on Sovereign Debt Re-Negotiation*, January 2003, available at <http://www.fesur.org.uy/publicaciones/Trichet-proposal.rtf>. This proposal was incorporated in the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging markets. The Principles were released jointly by the IIF, IPMA and several key emerging markets issuers in the fall of 2004. Key Principles Agreed To Strengthen Emerging Markets Finance, Press Release, November 22, 2004, available at <http://www.iif.com/press/pressrelease.quagga?id=98>. See n. [367] *infra*.

<sup>231</sup> We discuss the impact of G-7 and other mature markets issuers including CACs in their debt in section \_\_ below.

<sup>232</sup> Interview 100605.

counterparts know that they had commissioned a set of clauses from their long-time counsel at Cleary Gottlieb, and were in principle willing to use them if the conditions were right. Worries about a price penalty remained the biggest concern.

The question of whether investors would charge more for CACs had haunted the clause enterprise from the start. It had several distinct iterations. The first often came out in “market outreach”: when told about CACs, investors who had never heard of them before said flatly that “orderly” restructuring meant easier restructuring, and that they wanted more money from any issuer for any clause that made debt easier to restructure. This was true even for investors who held billions of dollars in English-law CAC bonds. A charitable interpretation of this reaction has CACs as a signaling device. A country switching to CACs (unlike the country that has them as a matter of course in its English-law contracts) signaled that it was thinking about default. This meant that it was more likely to default, and possibly – depending on how the clauses actually worked in crisis (which no one knew or wanted to spend time figuring out) – would lead to lower recovery in a restructuring.<sup>233</sup> A cynic might describe the investor response as reflexive: when buying new issues, most do not plan to be around for default, and therefore do not spend more than a nanosecond on how it might pan out. The only thing to do in a nanosecond is ask for more money:

CACs’ utility is next to nothing. Guys do not read prospecti – is that the proper plural? – until next to default. Guys like me will ask for five extra basis points even if it is not worth it, something to hang our hat on.<sup>234</sup>

Economists in the academy and in the government might have had a reflexive reaction of a different sort. If indeed there was a bondholder collective action problem, and if CACs helped solve it, then somewhere, somehow it all must surface in the bond price. One possible effect might even be beneficial to the issuer – if CACs reduced deadweight loss to the bondholders from a prolonged, messy restructuring, then an average bondholder that wanted to get a deal done quickly might forego a few basis points for the sake of a smoother process. On the other

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<sup>233</sup> Interview 060706. Note that generally, the only time the country worries about the price is when it first issues the bonds – that is when the interest rate is set for the life of the bond. Secondary market trading is a matter among investors.

<sup>234</sup> Interview 060706B. This comports with the view that contractual “deviance” alone may carry a penalty, in Omri Ben-Shahar and John A.E. Pottow, *On the Stickiness of Default Rules*, 33 Fla. St. L. R. 651 (2006).

hand, to the extent the country had to convince fewer creditors to accept its restructuring proposal, it might offer a worse deal to the marginal bondholder<sup>235</sup> -- a price penalty would be in order.

One senior government economist said he was surprised at the absence of any pricing studies at the time of the Rey Report in 1995-1996.<sup>236</sup> In the next few years, a number of studies appeared, almost all of which seemed to have been commissioned by official entities (the Bank of England, the IMF, the Australian Central Bank).<sup>237</sup> The studies differed on specifics. But the bottom line was that the price penalty was going to be minimal or zero. The most prominent of these studies, by Eichengreen and Mody,<sup>238</sup> suggested that costs would go down for highly rated countries that used CACs because markets did not expect them to engage in opportunistic defaults; and, therefore, would value the flexibility that CACs could offer. The implicit message in the Eichengreen-Mody studies was that the CAC initiative would best be led by a country with a high credit rating. Early in 2003, Mexico fit the bill perfectly.

Several of our official sector contacts – all economists – said that the pricing studies increased their comfort level with promoting CACs.<sup>239</sup> But one advocate not normally prone to post-modern musings implied that the studies’ value was in large part rhetorical:

We always cited Barry [Eichengreen]’s work. Of course, econometrics can never prove beyond shadow of a doubt ... I used it in advocacy ... to neutralize the bad stuff they were hearing. ... If I were [an emerging markets debt manager], I would still be awfully worried.<sup>240</sup>

The “bad stuff” came mostly from investors, often mediated through investment bankers. A number of them were also trained economists. Nevertheless, some big buy-side players dismissed the pricing studies with flourish:

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<sup>235</sup> William W. Bratton & G. Mitu Gulati, Sovereign Debt Reform and the Best Interest of Creditors, 57 Vand. L. Rev. 1, 56-61 (2004) (citing Patrick Bolton & David S. Scharfstein, Optimal Debt Structure and the Number of Creditors, 104 J. Pol. Econ 1 (1996)).

<sup>236</sup> Interview 100706

<sup>237</sup> See supra note \_\_ (citing studies by Eichengreen & Mody, Becker, Richards & Thaicharoen, and Gugiatti & Richards); see also K. Tsatsaronis, The Effect of Collective Action Clauses on Foreign Sovereign Bond Yields, BIS Quarterly Review, International Banking and Financial Market Developments, pp 22-23 (1999).

<sup>238</sup> Barry Eichengreen & Ashoka Mody, Would Collective Action Clauses Raise Borrowing Costs, NBER Working Paper (2000) (available at <http://www.nber.org/papers/w7458.pdf>).

<sup>239</sup> Id., Interview 061506

<sup>240</sup> Id.

Academic studies on pricing were useless as they always are. [They] grossly misunderstand how investors behave, investor sophistication. The data sets they use would make [a quantitative analyst] cringe.<sup>241</sup>

Investment bankers were more muted, but kept coming back to marketing concerns:

They [emerging markets clients] were petrified. Very hard to imagine how [CACs would result in] terms that were better for them, and very easy to imagine how it could be worse. The official sector was winking and nodding that they would indemnify – but it is not clear how they could have done it.<sup>242</sup>

Even as U.S. officials consistently reported that their Mexican counterparts worried about the price penalty above all, a senior debt manager recalled that the Mexican team paid little attention to the pricing studies.<sup>243</sup> Of course this did not mean that issuers did not care about pricing, simply that their thinking about price was largely influenced by factors other than academic studies.

A sell-side banker explained that by 2003 investors analyzed Mexico much as they did a high-grade U.S. corporate issuer, focusing on discounted cashflows rather than the probability of default.<sup>244</sup> Nevertheless, Mexican officials and their bankers worked hard to make any potential price effects virtually untestable. On the one hand, the first CAC bond had to be far enough away from the most liquid issues on Mexico's yield curve, so that it could not be compared directly. On the other hand, it could not be so far "off-the-run" as to risk being illiquid, with CACs getting the blame. The result was a success by all accounts. The most critical analyst report suggested less than a 25 basis point penalty.<sup>245</sup> Most others came in much lower; Mexico and its advisers maintain it paid none.<sup>246</sup> Several months after Mexico's first issue, traders in the secondary market no longer bothered to ask whether the bonds they got had CACs; investment bankers filling their orders no longer volunteered.<sup>247</sup>

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<sup>241</sup> Interview 030306

<sup>242</sup> Interview 060706

<sup>243</sup> Interview 121206

<sup>244</sup> Interview 060706

<sup>245</sup> Losada, *supra* n. [79] at 31.

<sup>246</sup> See e.g., Salmon, *supra* n. \_\_, Alonso Cervera, Mexico, in *Emerging Markets Economics Daily*, Credit Suisse First Boston, February 27, 2003, at 7, Interviews 121205, 060706. Early reports and interviews attributed the lack of a price penalty to Mexico's creditworthiness and the remoteness of default.

<sup>247</sup> Interview 091305

In sum, the experts' role in the CAC campaign was hardly straightforward. In the case of the G-10 working group and its "eminent lawyers", the principal benefit of the technical work was not optimal contract language, but a process that created the appearance of broad-based consensus and legitimacy for some set of CACs. The G-10 report also created a straw man, a presumption, and a yardstick by which subsequent model and actual clauses, as well as policy actions, could be measured. This role is distinct from the one Ahdieh described when he credited the G-10 with helping overcome network effects: we could get no issuer or investor to tell us that the model clauses put them at ease or signaled a market-wide shift following the model.<sup>248</sup> On the other hand, by opening half a dozen contract terms, the G-10 process may have increased uncertainty and created the impetus for Mexico to preempt further public experimentation. Like the model clauses, the academic pricing studies responded to demand from the official sector. They added to the comfort level among CAC advocates, and may have helped diffuse demands for a CAC subsidy. As we show later, they may have helped spur the broader market shift once Mexico moved. But for much of the CAC campaign, the studies simply fed into a rhetorical loop, a ritual retort to ritual investor threats about a default scenario that for issuers and investors alike remained imponderable and unpondered.

*iv. Product Design*

The most consistently told story in our interviews is that the lawyers did *not* push Mexico to adopt CACs in February 2003. Lawyers and non-lawyers alike agreed that neither Cleary Gottlieb (representing Mexico), nor Sullivan & Cromwell (representing the lead managers) took a firm position on the merits before Mexico made up its mind. What role did the lawyers play in this shift? We asked this question of every contact that might have had knowledge of the transaction – lawyers, bankers, investors, and officials. Most said that Mexico's lawyers initially came across as wary of changing the standard documentation. Mexican finance officials took the early legal memos to suggest that "with all the legal architecture, CACs did not add much or take away much. No value added."<sup>249</sup> The decision to shift was made at the Mexican finance ministry, with the approval of the minister himself. Consultations with Cleary Gottlieb were

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<sup>248</sup> See Ahdieh, *supra* n. \_\_\_. We do not count statements from lawyers or policy makers who participated in the G-10 effort.

<sup>249</sup> Interview 121206

important in the decision mix, but not decisive. Once Mexican officials had made the decision, they approached Cleary, J.P. Morgan and Goldman Sachs to execute it. Sullivan & Cromwell lawyers did not urge their clients to resist and collaborated in the draft.

Our impressions appear to contradict both the Choi-Gulati studies and the original Kahan-Klausner framing that focused on high-volume intermediaries. Underlying both sets of studies is an image of lawyers and bankers who design a fix to multiple clients' problem, with the incentive to diffuse their invention in the market. But accounts of the process leading up to Mexico's issue suggest that virtually no one involved saw the holdout problem as either terribly problematic for Mexico or in need of an imminent fix. With or without CACs, "deals got done" is the phrase we heard often and from different lawyers. The real problem on which lawyers and clients appeared to agree was a proliferation of official initiatives. That required a somewhat different fix. This observation from a banker involved in the deal is typical:

In [the lawyer's] mind, CACs were in because my client wants it, Treasury wants it. If ... truly effective fifteen years from now, my client does not care because they do not plan to default.<sup>250</sup>

While they did not drive the decision to shift, the lawyers played a critical role in determining the precise form of the new terms and how the shift was executed. Lawyers and clients described the process in similar terms. First, Mexican officials commissioned an analytical memo that fed into the decision to go forward. A little over a month later, the clients decided to go ahead, called the lawyers down to Mexico City, and asked them to draft the contracts. The deep relationship between Mexican finance officials and their counsel, going back to the 1980s, was important in broadening the lawyers' role.

Our contacts told us that the form of Mexico's CACs was born of a team effort. The fact that most deal protagonists knew one another from prior transactions (not surprising given the small community) surely helped. Both sets of clients and their lawyers sought to keep innovation to a minimum for fear that the market's tolerance for innovation was limited. The end result was a version of the G-10 majority amendment provisions using the 75% threshold, modified to be

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<sup>250</sup> Interview 060706

more consistent with standard form documentation for U.S. issuances. Mexico passed on the other G-10 recommendations, such as a trustee. A lawyer involved in the deal observed that an 85-90% amendment threshold would have made investment bankers' lives easier, but would have set disastrous precedent for Mexico.<sup>251</sup> Lawyers said they were well-aware of the English law convention (75% of a quorum) and of corporate restructurings using English law amendment provisions; we got the strong sense that going above 75% of outstanding principal in New York law bonds would have been a sign of weakness, at least for a strong credit like Mexico – it enhanced neither the issuer's, nor the lawyer's reputation. Market chatter in response to Brazil's use of 85% two months later confirms this view.<sup>252</sup> In retrospect, none of the investment bankers involved in Mexico's first issue complained to us about 75%.<sup>253</sup> On the other hand, one banker recalled inserting a provision that made certain kinds of exit consents more difficult to obtain; after Mexico's documentation became market standard, he expressed regret at not pressing for a wider range of similar protections.<sup>254</sup>

Lawyers also argued against elaborate investor consultations before bringing the first issue to market. They and others worried that instead of allaying investor jitters about CACs, the meetings would dilute the contract language against Mexico's interests:

When the U.S. Government was talking to everyone ... arranging meetings between the country and buy-side – We said, Nonsense! ... Immediately after launching the deal, discussions with buy-side – tense – “We want this, we want that ...” They were offended they didn't get to design the product. In the end, they bought the deal.<sup>255</sup>

Less than two months after the Mexican prototype hit the markets, Brazil and Uruguay were offering new variations on CACs. Brazil's clauses were more conservative, limited to majority amendment and raising the voting threshold to 85% from Mexico's 75%. Uruguay's clauses were significantly more aggressive. It went with the 75% amendment threshold, and added aggregation across bond issues – made easier by the fact that Uruguay was exchanging its entire debt stock. It used a trust structure instead of a fiscal agency agreement, which brought

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<sup>251</sup> Interview 030106

<sup>252</sup> See *infra* ns. \_\_ and accompanying text.

<sup>253</sup> Interviews 013106, 060706

<sup>254</sup> Interview 013106. The provision elevated events of default to the level of a reserved matter requiring a 75% vote to amend (instead of 2/3), but only if amended in conjunction with an exchange offer. United Mexican States, *supra* n. \_ at 8.

<sup>255</sup> Interview 030106



collective representation and litigation-retardant benefits. Uruguay also added bondholder protections in response to investor concerns.

Some contacts suggested that this diversity reflected competition among law firms and lawyers eager to define the new market standard and reap the reputational benefits. Arnold & Porter represented Brazil, Cleary Gottlieb represented Uruguay, Sullivan & Cromwell represented Brazil's investment banks, and Shearman & Sterling represented the bankers for Uruguay. All four firms are major players in the sovereign market.

Those involved in the deals did not report a story of competition to set the standard, either among the individual lawyers or their firms. What we did hear was that even lawyers in the same firm did not always agree on the form that CACs should take. Mexico and Uruguay both used Cleary Gottlieb, but adopted different modification provisions. Although Brazil and Mexico both had Sullivan & Cromwell representing the lead managers, they used different voting thresholds (75% and 85%) for their early CACs.

The differences over what form CACs should take appear to have broken down in terms of those lawyers who described CACs primarily as a response to official pressure, and those who looked to CACs first and foremost to solve the holdout creditor problem. This is not to say the first group did not understand CACs or did not think they were valuable, but simply that they conceived of their own mandate differently. Lawyers advising early CAC movers often saw themselves as part of a team that engineered a deal with high participation and no price penalty, which in turn would help establish the viability of CACs as a concept, subject to later technical revision (one lawyer even told the press that his client might revise its CACs as market standards evolve<sup>256</sup>). The clauses had to work and be a net improvement for their clients, but above all, they had to sell and sell quickly – hence this group of lawyers appeared inclined to minimalism. One lawyer summed up the enthusiasm this way: “We all think having CACs will be better than not ...Not only are they a good idea, but not particularly intellectually challenging.”<sup>257</sup>

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<sup>256</sup> Salmon, Brazil, *supra* n. \_\_.

<sup>257</sup> Interview 052506D

On the other hand, those who drafted CACs primarily to address a holdout problem tended to advocate the more aggressive clause forms. Buchheit at Cleary Gottlieb stands out in this group for having advocated clauses to battle holdouts even before the Rey Report.<sup>258</sup> Unlike most sovereign debt lawyers whose work includes a mix of new issuance and restructuring, Buchheit's sovereign practice is almost all restructuring. An elegant and prolific writer, he had published at least half a dozen articles on CACs in trade and academic press before the Mexico shift. The first of these appeared in 1991, on the heels of some particularly contentious renegotiations of syndicated bank loans where individual banks had held the rest hostage.<sup>259</sup> In 1998-1999, he published a series of columns in the leading trade publication proposing specific CACs for bonds,<sup>260</sup> and more articles elsewhere discussing ways of addressing the holdout problem. He became something of a public intellectual on sovereign debt matters, frequently called upon by the official sector (for the G-10 "eminent lawyers" group, among other efforts), but also a deeply polarizing figure among some creditors for his aggressive representation of distressed countries. At a recent conference, the economist who coined the term "Washington Consensus" introduced Buchheit as "The Man Who Invented Exit Consents".

Despite his long public association with CACs, our interviews suggest that Buchheit had little or no role to play in Mexico's decision, or the execution of its first CAC issue. But many point to Buchheit's instrumental role in designing Uruguay's CACs in April 2003, which went well beyond Mexico's surgical response to official initiatives.

Uruguay's documentation, including aggregation and the trust structure, became the model for Argentina and the Dominican Republic, represented by other lawyers at Cleary Gottlieb, as well as Iraq, a Buchheit client – all comprehensive debt restructurings. Argentina added a twist by introducing a trust indenture that covered both New York and English-law bonds. Most recently Grenada (another Buchheit client) used the trust structure and eliminated a bondholder's individual right to sue for missed payments.<sup>261</sup> To the extent U.S. pressure for CACs played a

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<sup>258</sup> See Latin Finance Article, *supra* note \_\_\_\_.

<sup>259</sup> Buchheit, Making Amends for Amendments, *supra* n. \_\_\_\_.

<sup>260</sup> See *supra* ns. \_\_\_\_.

<sup>261</sup> Before Grenada, actions for accelerated claims had to be brought through the trustee but individual suits for missed payments could be brought individually. The effect of Grenada's innovation was to eliminate another weapon in the holdout creditors' arsenal.

role in these cases, it certainly did not seek to go beyond the Mexican majority amendment model.

Uruguay and even more so Grenada were smaller and less sophisticated issuers than Mexico, Brazil, or Argentina. Our interviews suggest that smaller issuers were more likely to look to their lawyers for substantive strategic decisions, which in turn may have given more of an opening to an entrepreneur like Buchheit. His lengthy involvement with CACs and the official sector may have prompted him to respond to official pressure in ways different from other lawyers. Taylor's philosophical discomfort with endorsing specific clauses made minimalism the natural response for those who worried about government pressure more than they did about holdouts – it also offered two good reasons for Mexico's preemption strategy.<sup>262</sup> For those like Buchheit who worried about holdouts, official advocacy offered a window of opportunity to fix the problem; the others' minimalist tendencies worked to narrow that window.

In the Buchheit story, a market actor who had identified a market failure did play a key role in producing a set of clauses which address that failure. It was not the role reported in the published stories, which focused on Mexico's CAC move. Instead, Buchheit's role as market innovator emerged in the window created by the Mexico shift and occurred in the background, with a fraction of the fanfare that accompanied the first issue.

v. *Great Men and Little Funds*

“Market resistance” is the standard explanation for the eight-year lag between the Rey Report and February 2003. In contractual boilerplate studies – assuming CACs were optimal for the parties – it immediately evokes network effects and switching costs. We used our interviews to try to unpack the forces behind investor resistance to CACs.

Interviews and official records suggest that large sell-side investment banks often acknowledged the theoretical value of CACs in principle, but generally rebuffed official requests to intervene with their sovereign clients. A banker ultimately involved in an early CAC issue put it this way:

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<sup>262</sup> Mexico could be as minimalist as it pleased, while preempting another country's egregious minimalism.

“Treasury would call and we would say that we are not an arm of the U.S. Government, we work for the issuers.” He pointed out that he might have advocated for CACs if he could have assured an issuer that a new legal term would save it even a fraction of a basis point – but a cost savings seemed utterly improbable.<sup>263</sup> An official outreach log entry for this firm reads “Will not raise CACs with issuers.”<sup>264</sup> Once issuers made up their minds to move, the bankers – much like the lawyers – were instrumental in designing the early issues and setting the market standard.

In contrast to the Klausner-Kahan study where end investors are characterized as diffuse and invisible, the buy-side was prominent throughout the CAC episode. But the buy-side came in several varieties. EMCA got the most attention and stirred up the greatest passions. It was staffed entirely by investors with busy day jobs. Many of its leaders joined up in reaction to what they saw as sell-side fecklessness, official venality and issuer treachery in Ecuador and Argentina. But they also expressed higher motives, such as improving the asset class or bridging the intractable information gaps that plagued emerging markets sovereign debt:

Market people thought the government people were morons. Government people said, why are you buying this stuff, you know what it is... Markets see [the IMF] as the transfer agent for their money to developing countries. Developing countries see it as the paymaster that makes sure that creditors get paid. Both cannot be right.<sup>265</sup>

Publicly, EMCA styled itself as the voice of the bondholder grassroots, and had initially distanced itself from the older, more professionalized trade groups with significant sell-side membership and roots in the 1980s debt crisis. EMCA’s penchant for public purity positioned it as the arch-enemy of both SDRM and CACs. But the group was the first on the investor side to propose a package of clauses that included majority amendment. EMCA’s “Model Covenants for New Sovereign Debt Issues” circulated informally as early as May 2002, four months before the G-10 clauses and eight months before the consensus clauses later endorsed by seven market associations including EMCA itself.<sup>266</sup>

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<sup>263</sup> Interview 013106; see also Interview 060706. This does not mean that the institution was renouncing its “network coordinating” responsibilities in general. Since CACs were expected to carry a penalty, and since there was no agreement among market participants on the grounds for such a penalty, the optimal standard was unclear and the need for standardization not obvious.

<sup>264</sup> CACs: Country/Firm Outreach Overview As of January 28, 2002 [sic], on file with authors.

<sup>265</sup> Interview 060706B

<sup>266</sup> EMCA, Model Covenants for New Sovereign Debt Issues, May 3, 2002, available at

Like the official initiatives to promote creditor collective action, EMCA clauses technically removed the unanimity constraint. In hindsight, market contacts point to these clauses as evidence that investors had always accepted CACs in principle. But EMCA's effort addressed fundamentally different problems – issuer misbehavior and sovereign immunities. One member said that EMCA clauses came about after investors “saw Argentina acting the way it did” in late 2001-early 2002.<sup>267</sup> Drafted by a lawyer who had successfully sued several emerging markets governments, the clauses proposed to facilitate injunctive relief, waive central bank immunities, and broadly expand the universe of assets and protections available to creditors. The amendment threshold was 95% for an expanded list of reserve matters including key financial terms, 75% for most other terms, and 100% for the amendment provisions themselves.

EMCA said that it took the official sector at its word – if Treasury really wanted a market fix for financial crises, and granting its decision to go about the fix by altering private contracts – we, the market, would organize to claim the terms we really want. In effect, these bondholders tried to use the official initiative, including Taylor's reluctance to be prescriptive, as a vehicle to revisit some of the contractual battles that led to EMCA's birth. Their clause package would help defeat exit consents and enshrine a broad interpretation of the *pari passu* clause to facilitate debt enforcement.<sup>268</sup> CAC advocates outside the bondholder community saw a Trojan horse, and the package went nowhere.

EMCA's effectiveness and power base were not entirely clear. On the one hand, its board

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[http://www.emcreditors.com/pdf/model\\_convenants.pdf](http://www.emcreditors.com/pdf/model_convenants.pdf).

<sup>267</sup> Interview 120906

<sup>268</sup> See supra ns. \_\_\_ and accompanying text. EMCA was established in part to protest Buchheit's aggressive use of exit consents on behalf of Ecuador. Investors who later became part of EMCA's leadership also protested Ecuador's attempt to restructure its Brady Bonds while sparing its Eurobonds; they claimed that the treatment of secured bondholders violated Ecuador's *pari passu*, or equal treatment undertaking (most considered this to be a misapprehension of the clause). *Ecuador: A Case for Comparability?*, EMERGING MARKETS DEBT REP., Mar. 29, 1999, at 13; Felix Salmon, *The Buy Side Starts to Bite Back*, EUROMONEY, Apr. 2001, at 46. An unorthodox interpretation of the *pari passu* clause by a Belgian court in a case involving Peru briefly raised hopes for a new enforcement channel against sovereign debtors. *Elliott Assocs., L.P. v. Banco de la Nacion*, 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000) (executed Aug. 31, 2000); *Elliott Assocs.*, 2000 WL 1449862 (96 Civ. 7916 (RWS), 96 Civ. 7917 (RWS)). However, mainstream commentary (including from EMTA) strongly suggested that the Belgian decision was an outlier, at least when applied to the customary form of the *pari passu* clause. Gulati & Klee, supra n. \_\_\_, EMTA Position Regarding the Quest for More Orderly Sovereign Work-Outs (Oct. 17, 2002), available at <http://www.emta.org/ndevelop/keymsg1.pdf>. EMCA's clause package would alter that form to ground the creditor-friendly interpretation.

members had remarkable access to high level U.S. officials, and its public reactions to events of concern (such as sovereign defaults and G-7 policy turns) were quick and forceful; on the other hand, its ability to hold its own base together and speak for the entire emerging markets buy-side community were patently limited. Mexico's CAC issue and Argentina's restructuring both occasioned indignant EMCA press releases, but drew participants from its membership.<sup>269</sup> EMCA's limited influence on the contractual front had a structural reason. We noted in Section II that buy-side investors do not normally negotiate sovereign bond contracts; the sell-side does it for them. Issuer's and underwriter's counsel do the drafting. Investors can and do make their views known to issuers and the sell side – hence the expanded list of reserve matters in Mexico and the virtual disappearance of aggressive exit consents after Ecuador – but typically, to buy or not to buy is the only decision the buy side gets to make, sometimes with the help of in-house lawyers, but often without. Some sovereign debt lawyers told us they simply have no occasion to interact with the buy-side. EMCA leaders understood this structural predicament and saw the public campaign for CACs as an opening for more direct input into contract terms. But Taylor's refusal to be prescriptive cut both ways – he would not protest Brazil's 85% threshold, nor would he carry the water for EMCA *on pari passu*.

Several of our public and private sector contacts said that by the fall of 2002, some large emerging markets investors were dissociating themselves from the EMCA leadership position, which they characterized as too vocal, inflexible, and “legalistic” (they attributed the latter to the presence of lawyers-turned-fund-managers on EMCA's board):

We invest based on economic fundamentals. Legal minutia is not what we do. ... These legal provisions – we are money managers – do we read them? ... We are supposed to be smart enough, invest in a liquid market – if there is a debt crisis, you are not supposed to have the debt! ... SDRM was ridiculous. ... Everyone agreed that CACs are a decent step forward. Once they are introduced, we'll see how the market reacts – if anyone cares.<sup>270</sup>

Late in 2002, several executives responsible for large dedicated emerging markets funds

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<sup>269</sup> The standard EMCA explanation for this investor behavior is that bondholders are clueless, sleepy, docile sheep – “the only one less equipped than the public sector was the private sector.” Interview 070206. Some members offered another reason for the difficulty of coordinating even a small group of investors. At least when it comes to litigation and possibly other forms of aggressive enforcement, money managers must get permission to proceed from the account holders. Few are willing to undertake this additional level of coordination. Hedge funds and proprietary traders do not have this problem. Interview 120905

<sup>270</sup> Interview 030306.

contacted the official sector and offered help with getting a country to adopt CACs. They proposed a meeting to reassure high-quality issuers of their willingness to buy CAC bonds; as noted earlier, the meeting was scheduled but Mexico backed out.

When Mexico launched its first CAC bond, EMCA was furious. The following view, emailed the day after the deal closed, is indicative:

First, the procedure made the whole deal feel like a jam-job. EMCA had draft covenants on the table for nearly two years. We were not even consulted before this deal was put on the table. Kind of pathetic. After years of Buchheit et al complaining that the buy-side cannot organize itself, when we finally \_do\_ organize, the issuers and allied officials ignore us. This does not engender good will on the part of the market. (That, of course, is probably not on the officials' agenda anyway.) ... [M]ost dedicated EM investors believe that the UST and Cleary were behind much of this deal. As a technical matter it was not so much elegant as clever/sneaky to bring the first CACs ... in Mexico. Crossover investors are a big part of the Mex investor base, so there was no need to force these bonds onto the dedicated EM investors who are the key buyers of the lower grade EM credits. ... The 75% threshold is a joke. EMCA and EMTA said as much. The trigger level leaves the clause open to easy abuse by distressed sovereigns. It is unlikely to be an issue in Mex, since the probability of default is so low for this credit. ... The trigger level is the key to making CACs effective vs a joke. And what happened to all of the other covenants that the buy-side asked for? The negotiations over bond docs have been a joke – nothing has started.<sup>271</sup>

Many contacts told us of a contentious conference call organized by the lead managers, Goldman Sachs and JP Morgan, shortly after the launch. Most of the sentiment was along the lines of the preceding quote. One of the larger investors “piped up and lauded the Mexicans on taking an important step forward and asserted that if people were so skeptical of the issuers’ motives maybe they should be investing in another asset class ... but he was a lone positive voice.”<sup>272</sup> One sell-side banker said in retrospect that the conference call represented “95% of the noise [that] occurred” in response to CACs.<sup>273</sup> Many said to us that EMCA activists represented a small fringe of the investor community. But even if that were true, at the time, the deal managers could ill afford to dismiss them – “We have five major institutional investors ... are saying ‘if you buy this you destroy the asset class’ ... They are thought leaders.”<sup>274</sup>

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<sup>271</sup> Email, March 4, 2003.

<sup>272</sup> Email, February 24, 2003.

<sup>273</sup> Interview 013106

<sup>274</sup> Interview 060706

One thought leader who got credit for the CAC shift from the press and government officials was Pimco's Mohamed El-Erian. El-Erian was among the largest investors in emerging markets assets, a former IMF staffer, and one of EMCA's founding board members (he resigned after 2001).<sup>275</sup> He often spoke publicly on policy issues relevant to the asset class, and to many was taking on the role of a buy-side "senior statesman". We have heard from multiple sources that he engaged actively with the official sector in the winter leading up to the CAC shift, and had offered to work with major issuers to help broker the shift. But just as many contacts said that he was unhappy at not being consulted ahead of time about Mexico's issue and did not buy it for reasons that had to do with some combination of money and principle.<sup>276</sup>

EMCA was one of three market associations active in the CAC episode in the United States. The Washington-based Institute of International Finance and New York-based EMTA (formerly the Emerging Markets Traders Association) both engaged regularly with officials throughout the private sector involvement campaign of the 1990s, and especially in the CAC-SDRM debate. IIF was founded early in the 1980s debt crisis, with a membership comprising leading commercial banks that were also the dominant creditors to troubled sovereigns. In addition to serving as an industry forum for major financial institutions and a liaison with the official sector, IIF periodically publishes economic and market research. EMTA started in the early 1990s with a mission to facilitate trading in the Brady Bonds and later all emerging markets debt. Although its membership and some of its activities are broadly similar to IIF's, it focuses more on improving trading practices, market and legal infrastructure, and serves as the authoritative clearing house for information in these areas; it hosts research conferences but does not produce independent economic analysis. A former Bush I Treasury official is the head of IIF; EMTA's head is a former Shearman & Sterling partner who was active in the Brady restructurings. Both organizations aspire to represent both sell-side and buy-side investors; they are often seen as closer to the sell-side, an impression that was reinforced with EMCA's appearance on the scene.

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<sup>275</sup> About EMCA, Directors 2001 and Directors 2002, available at [www.emcreditors.com/list\\_directors\\_2001.html](http://www.emcreditors.com/list_directors_2001.html) and [www.emcreditors.com/list\\_directors\\_2002.html](http://www.emcreditors.com/list_directors_2002.html).

<sup>276</sup> After Brazil, El-Erian wrongly predicted that lower credit issuers would stay with higher amendment thresholds. See Salmon, Brazil, supra n. \_\_.



IIF leadership was in frequent contact with Taylor and his colleagues from the earliest days of the CAC initiative. Charles Dallara, the head of IIF, took the lead as a liason between the group of seven interested industry associations and the U.S. Treasury; much of the focus was on defeating SDRM. Treasury officials said they valued IIF's early support for the contractual approach, but worried that the group did not appear to have a way of operationalizing the support quickly: "Charles's initial reaction was positive. But it wasn't 'We're doing it' – not operational."<sup>277</sup> Some at IIF saw Treasury's campaign as much too public and adversarial – the problem was not CACs themselves, but the public sector cramming them down on the market, in 2002 just as much as in 1996:

[I] believe from the bottom of my heart, if G7, Treasury, IMF – anyone – had serious discussions about CACs on a voluntary basis, could have had CACs in bonds four years earlier.<sup>278</sup>

Treasury's outreach to individual issuers and institutions, which Taylor considered key to the ultimate success of the CAC shift, was counterproductive in this view. When approached in his individual capacity, each market participant was bound to "talk his book" – hence some of the more vituperative responses to early official overtures. The function of a trade association like IIF was to act in the collective interest of the market, to bring out the inner statesman in the financier.<sup>279</sup>

But in 2002, Treasury was in a hurry. Whether IIF could have delivered CACs in the relevant time frame is subject to debate. Buy-side and sell-side investors involved in early CAC issues consistently and colorfully dismiss IIF efforts as irrelevant. Then again, most of the deal participants were mid-level executives. IIF tended to work through "senior statesmen" at the higher rungs of major global institutions. Most of them knew one another from having worked together on the loan restructurings of the 1980s, a time when the informal norms of this small community of elite bankers, lawyers and government officials ruled the roost. Skeptics dismissed the "great men" approach as a relic of the 1980s that simply could not deliver in the

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<sup>277</sup> Interview 061506

<sup>278</sup> Interview 060606

<sup>279</sup> Id.

diffuse, diverse world of the capital markets.<sup>280</sup> But surely support at the very top could not hurt.

While IIF appeared to lead negotiations with the official sector, EMTA played a central role in the last key design exercise leading up to Mexico's issue. Following EMCA's clause proposal and the formation of the G-10 working group on clauses, the onus was on the industry mainstream to produce a set of terms that stood a realistic chance of being adopted. The goal was partly to pre-empt SDRM, but also to address the one problem around which there was consensus among market participants – the problem of “the rogue debtor”.<sup>281</sup> EMTA, EMCA, IIF, the London-Based IPMA and three broader securities industry groups released the “marketable clauses” package on January 31, 2003, together with an early version of the code of conduct for sovereign restructurings.<sup>282</sup> These clauses were a far cry from EMCA's, but shared the same essential impetus – creditors were willing to yield on majority amendment for key financial terms (this time at 85% of the outstanding principal provided 10% did not object), in exchange for much more robust investor protections, disclosure and safeguards against the use of exit consents. The process of building consensus among the “Gang of Seven” trade associations took time; their clauses were the last to arrive on the scene. But their release really did signal a turning point – by early February 2003, every market constituency as well as the government of every major financial jurisdiction was on record supporting some form of clauses; the only question was which form would prevail.

Yet again, industry endorsement of CACs was hardly on the merits, as a robust solution to a real collective action problem. Years later, one of the leaders of the “marketable” drafting effort called the entire CAC episode “make-work”. He speculated that successful holdout litigation against Peru in 1996 had galvanized official efforts to solve a holdout problem that was not really there:

Suing a sovereign is so damn hard – being a holdout is hard, not smart. ... The official sector was offended by what happened to Peru – someone bought low and shook down Peru. ... It offended their sense of fairness in the financial system. I was pretty offended while the Brady deal was going on, but not when [the holdout] collected. Peru was flush.

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<sup>280</sup> See e.g., Interviews 052506D, 013106, 030306.

<sup>281</sup> Porzecanski, *supra* n. \_\_.

<sup>282</sup> EMCA, EMTA, IIF, IPMA, ISMA, BMA and SIA, transmittal package with marketable clauses and code of conduct, January 31, 2003, available at [www.emta.org/ndevelop/Final\\_merged.pdf](http://www.emta.org/ndevelop/Final_merged.pdf).

It paid when it did not have to pay.<sup>283</sup>

A sell-side banker involved in an early CAC deal said he “suspected that Taylor was smart enough to realize that whether [issuers] include or exclude CACs meant not a hill of beans – which turned out to be the case. I thought it was entirely political.”<sup>284</sup> And a buy-side money manager summarized the general sentiment this way:

Conceptually it is hard to argue against CACs if they are written well. [CACs] removed the very small probability that holdouts would stop a country from conducting a generalized restructuring. The issue is nonsense, but CACs if properly drawn would [be] the appropriate theoretical response. If you think that holdouts are a small problem, [amendment threshold] should be above 90%. If you are of the other view – they should be as low as possible. This begs the question whether the public sector was concerned with a smooth and efficient workout, or with their capital being trapped. ... [CACs are] a potentially reasonable theoretical answer to a remote but plausible theoretical problem. Get into compound complex sentence that the average investor group does not worry about.<sup>285</sup>

vi. *The Ultimate Market Story*

It is worthwhile at this point to pull together the different interview strands that address Mexico’s own motives for moving first. SDRM was malingering at the IMF, the U.S. Treasury had lobbied Mexico for months, and drafting efforts were proliferating. But these factors weighed against what seemed like unwavering resistance at the highest levels in the Mexican government. The core Mexican team responsible for making the decision consisted of three officials led by the Finance Minister. The Minister himself went so far as to write a scathing 13-page letter to O’Neill in November 2002, expressing his intractable opposition to both CACs and SDRM.<sup>286</sup> What changed the minds so drastically that (apparently, on a weekend) Mexican officials called their lawyers down to Mexico City to implement the change?

We often heard two explanations of this turn around. Market participants, both lawyers and bankers, told of a rumor that some other country, some small country, was going to launch an offering using industry-sponsored clauses with high amendment threshold. Such unfavorable

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<sup>283</sup> Interview 111705. See discussion of Elliott v. Peru at supra n. [268].

<sup>284</sup> Interview 060706

<sup>285</sup> Interview 070206

<sup>286</sup> Interview 100605, 121405

CACs risked becoming market standard if Mexico did not preempt this unnamed small country. Others focused on Mexico's leading role in opposing SDRM. An influential trade press account of the CAC shift suggested that taking SDRM off the table was the most likely quid pro quo that Mexico extracted out of the United States.<sup>287</sup>

Both stories are problematic, even though we heard them from multiple sources. Not one of our contacts had a clue as to the identity of the country in the small country-bad clauses rumor, raising the possibility that it was just that – a rumor. In public and in private, Mexican officials expressed only a general desire to preempt bad precedent, and concern about proliferating public and private initiatives that threatened to destabilize the boilerplate. Bankers and lawyers involved in the deal echoed the sentiment.

As for fear of SDRM and the quid-pro-quo theory, it rings only partly true. Based on the accounts already described, it is unlikely that a U.S. Treasury under John Snow would have continued the two-track charade much beyond the spring of 2003. Hubbard's keynote at the IMF conference on January 22 signaled to a wide spectrum of interested parties that White House support was not there. On the other hand, even after Mexico's debut, a market-wide shift looked far from certain.<sup>288</sup> Mexico's issue was a hopeful sign and a powerful rhetorical weapon for the contract contingent, but not mission accomplished. And in any event, even wholesale adoption of CACs was never an adequate substitute for statute in the SDRM camp. Almost two years and two dozen CAC issues since Mexico, one U.S. contact speculated that if a vote were held on the day of our interview, a majority of the IMF Board would have supported SDRM.<sup>289</sup>

So what moved Mexico? Mexican officials tell the ultimate market story – an issuer with significant market power that perceived a threat to this power from a mix of official meddling and bondholder activism:

For us, the issue was our role as issuer. We were concerned about the state of discussion on the markets ... What generated the change? We didn't like the fact of being pushed

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<sup>287</sup> Salmon, *supra* n. \_\_. Like Salmon, we found no evidence of other tradeoffs, for example, on immigration or trade policy. The fact that the White House was uninterested in CACs makes these kinds of tradeoffs unlikely.

<sup>288</sup> See *infra* ns. \_\_ and accompanying text for efforts to maintain momentum for the contract shift after Mexico's initial issue.

<sup>289</sup> Interview 121305. The figure of 70% was widely circulating in late 2002-early 2003. Interview 013106

around by international initiative where our fate was not very clear.<sup>290</sup>

This is not so much a story of Mexico eager to get the best possible clauses into its debt, or Mexico worried that SDRM would come to pass, but of Mexico worried that talk of SDRM – *and* clauses – would not stop. The talk got everyone thinking about default (the morgues), threatened to create uncertainty in the markets about G-7 and IMF behavior in crisis, and to increase the cost of capital for the very countries that were supposed to benefit from the initiatives.

We have no way of knowing whether the story of market and political leadership that we read in the press and heard from Mexican officials in fact reflects their true motives for using CACs. Virtually all the lawyers, bankers and investors involved in the first CAC deal, as well as the G-7 officials who lobbied Mexico, all stress the reputational factors and U.S. pressure and de-emphasize the CACs' substantive value. The limited scope of Mexico's CACs supports the point. To the extent Mexico wanted to use the CAC incident to create a perception of autonomy and leadership, it was wildly successful. A European observer put it this way:

Mexico may have been ahead of the curve ... They not only earned the respect of the official sector (that didn't mean anything to the Mexicans) – they showed the markets that they were ahead of the markets. ... They are too intelligent, too sophisticated to have believed SDRM was a realistic possibility.<sup>291</sup>

The market participants and officials we interviewed were uniformly effusive about Mexican debt managers' intelligence, sophistication, financial acumen, and investor relations style. Mexico, they said, was not like any other emerging markets issuer. Observers spoke of a “revolutionary experience”, a “transformation of mentality between 1994 and 2000”, of getting “out of the victim mentality” that plagues the emerging markets.<sup>292</sup> Mexican officials “may well have been the only adults in the whole crowd”:

[Mexico's Deputy Secretary of Finance Agustín] Carstens had been Mexican ED [Board representative] at IMF. He was always very open minded and into modernizing the IMF – he was ok on transparency etc, which put him in contrast with many of his EM colleagues on the Board. In FinMin, he worked a lot with markets. I actually think Agustín was being internationalist minded at the time and believed that he thought

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<sup>290</sup> Interview 121206

<sup>291</sup> Interview 021706

<sup>292</sup> Interview 060606

Mexico should be internationalist to show that it was playing a greater role as a responsible player on the global scene. He and Alonso Garcia should be mega-stars of the article.<sup>293</sup>

While Mexico's circumstance and leadership indeed stood out at the time, it seems prudent to note – as many of our contacts did – that the shift conceived in the turmoil of the 1990s finally happened under extraordinarily benevolent market conditions, when interest rates in mature market economies were at all-time lows and investors were flocking to emerging market debt.<sup>294</sup> Mexican debt was investment grade, and was generating significant interest from crossover investors. The government had pre-financed itself for the year, so did not really need the money (it used the proceeds of the CAC issue to retire more costly Brady Bonds). It was difficult to envisage a better time.<sup>295</sup> Even so, the experiment was not riskless:

At the time, Mexico could issue \$1 billion on a day's notice; everyone knew our contracts. [Issuing with CACs] disturbed it a little bit without an immediate benefit for Mexico. ... Push [to] strengthen international financial system. ... Instead of opening the book in the morning and closing six hours later oversubscribed, three days working the phones. Some committed clients surprised, some sensed betrayal – [because Mexico had] not consulted them.<sup>296</sup>

Mexican officials involved in the first CAC deal describe the clauses as generally beneficial, but suggest that the principal public benefit from Mexico's move was to let business people return to doing business:

Both debtors and creditors like having a set of contracts, and proceed to issue. Impractical to make the issue of contracts ... [Settling procedural terms] allows to focus on the substantive issues of the transaction – issues, rights, options – this is what the market participants want.<sup>297</sup>

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<sup>293</sup> Interview 121605. Carstens holds a PhD in Economics from The University of Chicago, and is the Deputy Managing Director of the IMF at the time of this writing. "ED" stands for Executive Director.

<sup>294</sup> A biweekly sell-side research note a few weeks before Mexico's launch described the market conditions: EM debt has soared in recent days in moderate volume, allowing the asset class to deliver a year-to-date return in excess of 2%. The rally in the US Treasury market, where 10-year yields have dropped from 4.20% two weeks ago to below 4.00% at present, is creating a hothouse effect for investors in EM bonds. Portfolio managers in the US and Europe continue to receive inflows of funds looking to be invested in EM bonds.

ABNAMro Emerging Markets Fortnightly, February 9, 2005, at 1. See e.g. Interview 060706, 070206 and 070706.

<sup>295</sup> See e.g., Interview 030106

<sup>296</sup> Interview 121206. See *infra* n. \_\_ for more on the investor reaction. Note this official's use of "clients" to denote investors in his country's debt.

<sup>297</sup> Interview 121206

In this framing, which we heard repeated in conversations with other emerging markets contacts, government debt managers are first and foremost market participants, whose principal mission is to minimize borrowing costs. We got the distinct sense that when these officials spoke of a disequilibrium that prompted the CAC shift, they referred to the flurry of public sector crisis resolution initiatives. For them, public good and international prestige came by way of being market actors *par excellence*.<sup>298</sup>

vii. *At the Tipping Point*

Mexico's sound economy and sterling reputation made it the perfect first mover in February 2003. These same qualities gave skeptics the perfect excuse to dismiss it as precedent. Mexico was not like the rest of the emerging markets; maybe its CAC issue should be viewed much as the G-7 countries' attempts to "lead by example", putting clauses in their own foreign-currency debt – a face-saving but irrelevant gesture.<sup>299</sup>

The next two countries to launch CAC issues were Brazil and Uruguay, both in April 2003. Unlike Mexico, neither Brazil nor Uruguay had been doing quite so well. Brazil had been out of the international markets for over a year. It had only just elected a leftist government under President Luis Ignacio Lula da Silva, prompting questions in the markets about its economic policy course. Uruguay had suffered a shock from Argentina's financial crisis, including a massive bank run that only stopped with the help of an IMF package that amounted to \$500 for

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<sup>298</sup> Here it is useful to contrast Mexican and U.S. accounts of the months leading up to the first CAC issue. Mexican officials and their advisers stress the fact that the decision was made independently and all but sprung on the U.S. Treasury, even as they express gratitude for U.S. and G-7 support. U.S. officials emphasize long-term, painstaking coordination. See *supra* n. \_\_\_ and accompanying text.

<sup>299</sup> See e.g., G-7 Finance Ministers Adopt Financial Crises Action Plan, *supra* n. \_\_\_, Paul Martin, Statement Prepared for the International Monetary and Financial Committee, Prague Czech Republic, September 24, 2000, available at <http://www.fin.gc.ca/news00/00-072e.html>, Speech by Mervyn King, Deputy Governor of the Bank of England, 20th Anniversary of the Indian Council for Research on International Economic Relations, The International Financial System: A New Partnership (2001), available at <http://www.bankofengland.co.uk/publications/speeches/2001/speech138.htm>, describing initiatives by Canada and the United Kingdom to "lead by example" by including CACs in their foreign-currency debt. Emerging markets officials and market participants we spoke to uniformly dismissed such efforts as irrelevant. A European official described the principal value of leading by example as rhetorical: "It helped rhetorically in the debate – took away a cheap short argument. If I were an [EM] issuer, I would not be interested in what zero-risk countries are doing" Interview 071906.

each Uruguayan.<sup>300</sup> The CAC announcement came as part of a comprehensive debt restructuring, a last-ditch effort to avoid default. If Brazil and Uruguay could use CACs, even hardened skeptics would have to concede that the shift was on its way.

We heard two kinds of explanations for Brazil's and Uruguay's moves. The first attributed the shift to competition among lawyers and law firms to set the market standard for CAC issues. As discussed earlier, we found no evidence of such competition. The second explanation brought back U.S. pressure as the dominant factor. As with Mexico, the pressure was there, but the way in which it worked, and the extent to which it was effective, were all highly context-specific.

In early 2003, Brazil had more credit outstanding with the IMF than any other country – and was about to draw more, and extend its repayment period before the year's end.<sup>301</sup> From this perspective, it could ill-afford a public spat with official creditors. But Brazil also has been for a long time if not the largest, then among the two-three largest emerging markets issuers in the world: it accounts for about 21% of the EMBI and 16% of the EMBI Global, with Mexico as its nearest competitor.<sup>302</sup>

In the short-term, Brazil faced incredibly hard times in the market. ... Everything could be used against us. We had to preserve relations with bondholders at any cost.<sup>303</sup>

With Mexico, Brazil led the opposition to SDRM in the IMF Board. Some Brazilian officials said that initially they did not see much light between CACs and SDRM – both gravely threatened the country's fragile market access. But faced with a combination of SDRM's resilience and a growing sense of market acceptance for some form of CACs, they came to describe clauses as a “good compromise”, “reasonable, not disruptive”, and ultimately, a “Pareto improvement”.<sup>304</sup>

Two factors affected the timing of Brazil's first CAC issue. First, unlike Mexico, it needed the money and so had to launch in favorable market conditions for its own sake, if not for the CAC

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<sup>300</sup> Felix Salmon, Uruguay's Elegant Transformation, Euromoney, February 2004.

<sup>301</sup> International Monetary Fund, Financial Statements, Financial Year Ended April 30, 2003, at 18, available at <http://www.imf.org/external/pubs/ft/quarter/2003fy/043003.pdf>.

<sup>302</sup> See supra n. \_\_\_\_.

<sup>303</sup> Interview 080106

<sup>304</sup> Interviews 080406 and 061606



cause. Second, Mexico had to go first. We believe that had Brazil returned to market in January instead of April, its CACs would have had to wait. Mexico's first move established the presumption that CACs carried no penalty; Brazil tested it. Mexican and Brazilian finance officials knew one another and had discussed CACs and SDRM; however, we have no evidence that they had specifically coordinated their respective CAC debuts.

Our contacts described Brazil's first CAC issue as "part of a very clear indication on many fronts of where we stood."<sup>305</sup> Brazil stood in a delicate spot. With Lula's election, it desperately needed to reassure investors of its free-market credentials – "evolutionary, rather than revolutionary – that was our sound byte"<sup>306</sup> – which made any discussion of potential default anathema. According to trade press, Brazil "absolutely had to have a hugely successful deal to mark its reintroduction to the capital markets."<sup>307</sup> On the other hand, if Brazil saw itself ultimately as part of the Mexico cohort, issuing with CACs was not all bad: "We wanted to do it, it was time to do it."<sup>308</sup> Brazil needed G-7 support to continue drawing exceptional sums from the IMF at a very delicate time for its economy and political system. In a more subtle sense, Brazil needed to signal to the markets that the United States and the G-7 will stand by it in the event things took a turn for the worse.

The resulting compromise, a majority amendment clause with an 85% threshold – in contrast to Mexico's 75% -- is easy to explain in this context, even as it drew vigorous criticism from others in the sovereign debt world.<sup>309</sup> Conspiracy theorists blamed Brazil's lawyers and investment bankers; in our conversations, Brazilian officials insisted that the decision was their own. Critics said that the 85% threshold signaled both that Brazil was a weaker credit, and that the threshold itself made a difference.<sup>310</sup> Arguably this was counter to everything that Mexico had tried to accomplish in designing its first move.

But Mexico's offer was structured specifically to launch CACs; launching CACs was at best a

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<sup>305</sup> Interview 061606

<sup>306</sup> Interview 080406

<sup>307</sup> Felix Salmon, Brazil Goes off on a CAC Tangent, Euromoney, June 2003.

<sup>308</sup> Interview 080406

<sup>309</sup> Salmon, Brazil, supra n. [316].

<sup>310</sup> Interview 060706

third-tier objective for Brazil. And Brazil was spectacularly successful in meeting its first-tier objective – the issue was oversubscribed, with an order book total of \$7 billion for a \$1 billion offer, spread among 430 accounts.<sup>311</sup> Brazil has since shifted its amendment threshold to 75%, in line with Mexico’s, validating it as the new market standard. In retrospect, its officials describe the episode as “technical progress”; some go out of their way to praise Taylor’s reasonableness and sensitivity.<sup>312</sup>

CACs were not foremost on the minds of Uruguayan officials facing imminent default on a debt stock of over \$5 billion. But in an odd way, legal provisions became deeply entangled with the business and policy aspects of the debt exchange:

We did not like to default on debt. Did not know about CACs, SDRM. But by chance immersed into a very sharp debate among lawyers, U.S. Treasury, IMF – something we realized months later – trying to solve fundamental problems.<sup>313</sup>

The essential debate in Uruguay’s case had to do with its IMF package and the terms of its debt restructuring. Uruguayan officials prized the country’s reputation as a reliable borrower – it did not have its neighbors’ history of defaults. But because much of its debt was held domestically, they also worried that a default, or deep debt reduction, would spur another bank run.<sup>314</sup> But the official sector was ill-disposed to finance another bailout of private creditors. Some Uruguayans suspected that theirs was becoming a test case for a new regime that would lead into SDRM.<sup>315</sup> More likely IMF was still reeling from Argentina’s default and accusations that the Fund had financed patently unsustainable policies and last-ditch debt exchanges that increased Argentina’s already unsustainable debt.<sup>316</sup> IMF staff and some market participants grumbled that Uruguay’s proposed restructuring terms were too rich – a mere extension of maturities – and would leave its

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<sup>311</sup> Salmon, Brazil, supra n. \_\_\_\_.

<sup>312</sup> Interview 061606

<sup>313</sup> Interview 122005

<sup>314</sup> Salmon, Uruguay, supra n. \_\_\_\_.

<sup>315</sup> “Ex-post we realized that IMF was trying to force us to go to SDRM approach.” Interview 122006

<sup>316</sup> See generally, Michael Mussa, Argentina and the Fund: From Triumph to Tragedy, Policy Analyses in International Economics 67, Institute for International Economics (2002) (criticizing IMF disbursements in the run up to default) and The Republic of Argentina, Prospectus Supplement Dated Jan 10, 2005 and Prospectus Dated Dec 27, 2004, filed pursuant to Rule 424(b)(5) under the US Securities Act of 1933, Registration No 333-117111 at 165-166 (describing a pre-default debt exchange that increased the net present value of Argentina’s debt by \$9.5 billion), available online at <http://www.sec.gov/Archives/edgar/data/914021/000095012305000302/y04567e424b5.htm#214>

debt levels dangerously high, guaranteeing another restructuring shortly.<sup>317</sup>

Against this background, Uruguay was probably the only one of the early movers that had approached CACs recognizing that they might be used in the foreseeable future – even granting the team’s deep conviction that its proposed financial path was sustainable. Uruguayan officials report that they had decided to use CACs in late January, a month before Mexico’s issue. Even though Cleary Gottlieb represented both Mexico and Uruguay, the bankers and their lawyers were all different, and we found no evidence that the documentation work on the two issues was coordinated in any meaningful way. Everyone involved in Uruguay’s issue said that Mexico’s success made it easier to sell Uruguay’s more radical clause package. But at least one lawyer speculated that Uruguay would have tried CACs even if Mexico had not gone first, piggybacking on the G-10 recommendations. A G-7 official was more blunt: “Do you really think that Uruguay would, in coming to us to support big IMF money and an Exchange Stab[ilization] Fund loan, have not had CACs in their exchange?”<sup>318</sup>

Uruguay’s deal was intensively marketed for months and made specific accommodations in response to investor requests, which generated good will. The team did not have to worry about a CAC price penalty, since in a restructuring the price is set in the offer. Participation was the only open variable. Uruguay’s exchange closed a month after it was launched, with over 90% participation; the holdouts were later paid off. So far, Uruguay has not needed to restructure again.

Uruguay is also the only case we know where the participants produced a pro-forma calculation after the exchange to see how CACs might have changed the results.<sup>319</sup> The exercise suggests that single-issue CACs of the Mexican and Brazilian variety would have increased participation by a few percentage points each. The big jump came with aggregation, which added up to ten percentage points, depending on the single-issue voting threshold. Of course such a calculation cannot reveal how investor behavior would change, if at all, with the advance knowledge that

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<sup>317</sup> Salmon, Uruguay, *supra* n. \_\_\_, Interviews 121205B, 013106

<sup>318</sup> Interview 121605

<sup>319</sup> Buchheit and Pam, Uruguay’s Innovations, *supra* n. \_\_\_. As part of its comprehensive restructuring, Uruguay amended several small Japanese bonds using CACs already in its Japanese-law contracts.

their bonds could be amended.

Countries such as Argentina and the Dominican Republic that have restructured since Uruguay have all built on its basic model, including aggregation. An Argentine official said that by the time his government announced its intention to use CACs, it was a non-issue – the clauses had become market standard. He even recalled proposing to lower the amendment threshold below 75%, but was outvoted.<sup>320</sup>

Once Mexico, Brazil and Uruguay shifted, the floodgates opened. We spoke with some of the officials, lawyers and bankers involved with the shifts for nine sovereigns that followed the first three movers: South Africa, South Korea, Turkey, Italy, Panama, Venezuela, Chile, Belize, Argentina and Dominican Republic. For none of these countries were we able to discern even a minimal amount of drama in the shifts to CACs. Our contacts said that there simply was no story to tell at this stage of the CAC shift. After, Mexico, Brazil and Uruguay, the market controversy around CACs vanished.

This is not to say that these issuers all would have shifted to CACs simply because Mexico, Brazil and Uruguay had done so. U.S Treasury officials and staff kept working the phones for months after Mexico, and CACs remained a talking point at every major official meeting. Some market contacts even reported that the effort escalated after Mexico. From the public sector, we did not get a sense of escalation, but certainly of continued pressure and an intense desire to maintain momentum behind “the market solution”. Two officials reported that later in 2003 South Africa went so far as to issue in London in Euros under New York law as a favor to the United States – quite a change from earlier the same year when, according to outreach records, it had declined to join the first movers’ group.<sup>321</sup> Treasury advocacy gave the impetus, but the experiences of Mexico, Brazil, and Uruguay seemed to have given the sovereigns and their advisers confidence that CACs would not raise borrowing costs.

As in every other case we have described, almost none of the professionals involved in this set of

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<sup>320</sup> Interview 121305. One of the lawyers involved in Argentina’s exchange said that CACs were “a foregone conclusion”. Interview 052506D

<sup>321</sup> Interviews 121405, 121605, Salmon, Brazil, supra n. \_\_\_\_.

CAC issues mentioned the need to solve the holdout problem as the motive for the shift. By all accounts, the impetus came from the U.S. Treasury, transmitted primarily through government-to-government channels. Long-term considerations of what contract clauses would facilitate orderly debt restructuring in default did not seem to merit discussion. This was true both at the individual lawyer/banker level as well as at the level of their firms. No one suggested to us that particular private firms had chosen to pursue strategies with respect to pushing the CAC shift.

We remained puzzled at the speed with which the shift had occurred following the move by the first handful of sovereigns. While resistance to the first few moves had been intense, the matter became a non issue two months later. When we pressed our contacts, they pointed to market education. Even if all the official drumbeat and private commentary between 1996 and 2003 was not enough to overcome the first mover problem,<sup>322</sup> once that problem was solved, education kicked in. From the mid-1990s, the market learned the value of CACs; it was now ready to use them. In response, we suggested that it was improbable that the most sophisticated players in the international financial markets needed seven years to learn that unanimity requirements were prone to a far greater holdout problem than were clauses requiring a majority vote. The next set of explanations was typically more nuanced and came in two versions: the economist version and the lawyer version.

The economist version of the story, which we heard from both bankers and officials, boiled down to one factor – price. Economists in the public and the private sector disagreed vigorously on the existence of a holdout problem in need of a solution; but they agreed that for the CAC shift to happen, participants needed a better sense of the cost to sovereigns of switching to CACs in their New York law bonds. For debt managers and their bankers to be comfortable with a switch, they needed assurances that the penalty would be minimal. If academic pricing studies helped frame official advocacy,<sup>323</sup> then real investor behavior and market research in Mexico, Brazil, and Uruguay demonstrated palpably, in the market’s own terms, that price penalty worries were a red herring – at least when market conditions were sweet.

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<sup>322</sup> See supra n. \_\_\_ and accompanying text.

<sup>323</sup> See supra n. \_\_\_ and accompanying text.

For the lawyers, the key issue was not pricing, but the cost of deleting a protection that had been in New York law sovereign bonds as far back as anyone could remember. Every one of the clauses in a standard form document is there for some historical reason, a number of the leading lawyers explained. Some major event temporarily altered the balance between debtor and creditor or among creditors. New clauses typically arose as responses to such events.<sup>324</sup> When someone proposes to alter a clause, lawyers want to know why it had been included in the first place – or what protection would be lost by removing it. That loss often cannot be discerned just by reading the text of the clause.

Quarles apparently sought to address this concern with his intervention at the IMF conference in January 2003.<sup>325</sup> Quarles' former firm, Davis Polk, had played a leading role in the era of railroad bankruptcies and equity receiverships (roughly between 1880 and 1930). Collusion among large creditors and large equity interests in the big workouts of that era threatened to squeeze out minority creditors. The response culminated in the creation of a corporate bankruptcy system where workouts would be supervised by a federal judge. So as to protect minority creditors outside bankruptcy, publicly issued corporate bonds in the United States were required to mandate unanimous approval for any changes to key payment terms. Quarles knew this history and was able to explain the origins of unanimity provisions. These clauses, he explained were a function of the move to statutory corporate bankruptcy. The existence of a bankruptcy system where holdout problems would be settled meant that outside bankruptcy, creditors could live with the onerous unanimity requirement. The United Kingdom saw no similar statutory reform, which is why English law corporate bonds continued to have majority amendment provisions. By some accounts, Quarles' speech reassured many U.S. lawyers that there was no hidden danger in switching to CACs.

Even as he re-endorsed the two-track approach in the same speech, Quarles' history lesson neatly reinforced the CACs-SDRM opposition. It implied that CACs made sense only in the absence of a bankruptcy system; bankruptcy made them inessential. Statutory sovereign bankruptcy was just what the private sector wanted to avoid.

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<sup>324</sup> See Buchheit, *How to Negotiate Eurocurrency Loan Agreements*

<sup>325</sup> See *supra* n. \_\_\_ and accompanying text.

The facts in Quarles' speech were not new to academic researchers; Skeel and Tarullo had both pointed to the history in their respective analysis of CACs.<sup>326</sup> Policy makers and a handful of sovereign debt lawyers knew it as well, including Buchheit, who had described it in an article published before Quarles' speech.<sup>327</sup> But other lawyers knew little of the history and were concerned about altering a clause that had long been part of the standard form. Some of these lawyers told us that Quarles' remarks influenced them because they had come from a high level official and were both credible and widely discussed.

*viii. Late Shifters and Non-Shifters*

To our knowledge, only four emerging markets sovereigns issued New York law bonds without CACs after Mexico's February 2003 issue. These were Israel, the Philippines, China and Jamaica. Their stories help illuminate the market shift from a different angle.

Take Israel and the Philippines first. Both adopted CACs with a delay, in 2004. With the Philippines, the answer was that it was still issuing bonds under its old, pre-Mexico prospectus that had unanimity provisions. With Israel the answer was even simpler. As one of our contacts explained it, apparently no one had told Israel early on about the new clauses. It appears that the U.S. Treasury had not been expending effort to persuade Israel to shift.<sup>328</sup> Several of our official sector contacts and an IMF progress report recalled variously Israeli resistance and a technical problem involving U.S. guarantees for Israeli debt, which surfaced after the lobbying began. The problems were soon fixed, and each country included CACs its second post-Mexico offering.

China and Jamaica have done multiple offerings since Mexico, but, as of this writing, neither has shown any indication of switching to CACs. In neither case did any of our contacts suggest that the issuers' resistance was due to a deeply held view about the holdout threat. Instead, the reasons for not shifting relate in part to the nature of their interactions with the U.S. Government.

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<sup>326</sup> See David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (2001); David Skeel, Can Majority Action Provisions do it all? 51 *Emory L. J.* 417 (2003), Tarullo, *supra* n. \_\_ at 670-671.

<sup>327</sup> See Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will* 51 *Emory L. J.* 1317 (2003).

<sup>328</sup> Israel was not on the outreach log in January 2003. The country is not a major emerging markets issuer; its debt is not part of the EMBI Global and much of it would not qualify because it is fully guaranteed by the United States.

With China, the story is public and intuitive. Thanks to mammoth foreign capital inflows and its policy of maintaining a low fixed exchange rate relative to the U.S. dollar, China's government is one of the U.S. Treasury's biggest creditors. The United States has been lobbying China at the highest levels on issues ranging from the dollar-yuan exchange rate to North Korean nuclear ambitions. China has shown no inclination to fold under pressure. On CACs, Treasury reportedly started late, but lobbied hard, and at high levels. In response, China cited price penalty fears – even in the aftermath of Mexico and Brazil.<sup>329</sup> We do not know whether this was its true motive or a polite way to demur.

Jamaica is a much smaller economy that needs foreign capital. It issues frequently in the United States, in Europe, and in the Caribbean, although it is a small part of the asset class (its debt is not part of the EMBIG). At the time of the initial CAC shift, Jamaica owed more than half its debt to bilateral and multilateral government donors, even though private bondholders were its single largest category of creditors.<sup>330</sup>

An early IMF progress report on CACs attributed Jamaica's reluctance to use them to the fact that it issued under pre-Mexico documentation, much like the Philippines.<sup>331</sup> Its 2003-2004 issuance schedule supports this explanation – most of the issues are either take-downs under earlier documentation or targeted at European and Caribbean investors.<sup>332</sup> A subsequent IMF report in 2006 singled out Jamaica as the only country to have issued without CACs since June 2005<sup>333</sup> (China rarely taps the market). To the extent Jamaica was lobbied in 2003-2004 and was not inclined to oblige, it had an easy excuse based on its issuance schedule. But we also have no evidence that Jamaica was subject to intense pressure from the United States early on, perhaps because it was not a systemically significant issuer. Jamaica, like China and Israel, was not on the outreach list in January 2003. One staffer described Treasury engagement with Jamaica at

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<sup>329</sup> Interview 061506

<sup>330</sup> Government of Jamaica, Prospectus, \$700,000,000 Debt Securities, August 25, 2004, at 60, available at [http://www.sec.gov/Archives/edgar/data/53078/000119312506037559/d424b2.htm#tx65283\\_20](http://www.sec.gov/Archives/edgar/data/53078/000119312506037559/d424b2.htm#tx65283_20).

<sup>331</sup> Progress Report to the International Monetary and Financial Committee on Crisis Resolution, September 28, 2004, Item 4, available at <http://www.imf.org/external/np/pdr/cr/2004/eng/092804.htm>. See also Drage and Hovaguimian, *supra* n. \_\_ at 2.

<sup>332</sup> Government of Jamaica, *supra* n. \_\_ at 60.

<sup>333</sup> International Monetary Fund, Report of the Managing Director, *supra* n. \_\_ at 8.



that time as “minimal ... more like nonexistent on the financial side – they were not on the radar screen.”<sup>334</sup> By June 2005, the CAC shift was seen as a done deal, Taylor had left the Treasury, and U.S. outreach efforts on behalf of CACs had subsided across the board.

Our market contacts reported that neither China nor Jamaica saw any reason to accommodate Treasury on the CAC front, unless the United States was willing to make it worth their while to do so. And for its part, Treasury had no carrots or sticks to apply to recalcitrant sovereigns when “soft power” proved insufficient.

Again, the holdout problem seems to have played no role in the decision against shifting to CACs. From this alternative perspective of the non-shifters, the key variable was the role of the U.S. Government and not the substance of the contract term.

*ix. The Meaning of Argentina*

No public or private account of the CAC shift passes without mention of Argentina. One of the largest emerging markets issuers, Argentina also has the distinction of suffering the largest sovereign bond default in history in 2001. Until then, picky people liked to point out that almost none of the big crises of the 1990s had featured foreign sovereign bonds, which had been the overwhelming focus of reform efforts: Mexico’s and Russia’s were about domestic debt, Thailand’s, Korea’s and Indonesia’s about bank and corporate debt.<sup>335</sup> Ecuador, Pakistan and Ukraine had foreign bond crises, but were just too small to occasion the cataclysm. Their bond restructurings went quickly; Ukraine even used the CACs already in its English law bonds – but Pakistan did not and Ecuador could not, with no apparent difference in outcome among the three.<sup>336</sup> Argentina was just the sort of crisis experts had prophesied – hundreds of thousands of creditors, 150 different bond issues in six different currencies and eight different jurisdictions. It took Argentina three years to launch a foreign bond exchange, which has left over \$20 billion in holdouts and has been plagued by dozens of lawsuits.<sup>337</sup> The crisis shocked and shamed the

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<sup>334</sup> Interview 072506. The office responsible for Jamaica in 2003 also followed all of Latin America.

<sup>335</sup> *Supra* n. \_\_.

<sup>336</sup> Dixon & Wall, *supra* n. 55 at 142, 150-151.

<sup>337</sup> For an original analysis of Argentina litigation, see Marcus Miller & Dania Thomas, *Sovereign Debt*

system and got everyone, notably Paul O’Neill,<sup>338</sup> energized to do something about it.

Would Argentina have panned out much differently if all its bonds had CACs? We found no one who said that it would have. Argentina’s reluctance to initiate a deep debt restructuring before default had little to do with its debt contracts and everything to do with its domestic politics and the workings of its currency regime.<sup>339</sup> The delay in launching debt restructuring after default and the hostile tone of the operation, again were a function of politics at the highest levels. While the restructuring contributed to President Nestor Kirchner’s reputation for delving into detail, we have no evidence that he knew the intricacies of Argentina’s amendment provisions.

What of the litigation? After all, Argentina’s debt swap was held up for over two months thanks to a creative holdout lawsuit attempting to attach defaulted bonds tendered by participating holders. The delay cost everyone money, and cut deeply into some traders’ profits. But it had precisely the opposite impact on participating holders from what theory had predicted: instead of demanding their own bonds back and holding out for more, the creditors who had already tendered wanted the restructuring to go on as soon as possible, even if – especially if – the litigants got paid in full. One of EMCA’s last public acts was an amicus brief in the holdout lawsuit, asking the Second Circuit to make sure that Argentina consummated the restructuring regardless of the holdout settlement.<sup>340</sup> In the event, the holdouts lost and Argentina went forward with one of the most aggressive debt reduction deals in recent memory. Since then, its economy has grown briskly, its debt is back in the index, and foreign creditors have flocked to Argentine domestic bonds.

Does this mean that CACs would have made no difference at all? Of course not. Pro-forma calculations in the aftermath of Uruguay’s exchange suggest that if Argentina had used aggregated majority amendment provisions, at least the passive holdout number might have been a fraction of \$20 billion. Defaulted debt still outstanding is a huge contingent liability for the

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Restructuring: The Judge, the Vultures, and Creditor Rights (May 2006) (on file with authors).

<sup>338</sup> Supra n. \_\_- and accompanying text.

<sup>339</sup> See e.g., Blustein, *And the Money*, supra n. \_\_; Brad Setser & Anna Gelpern, *Pathways through Financial Crisis: Argentina*, \_\_ *Global Governance* \_\_ (2006).

<sup>340</sup> Brief of the Emerging Markets Creditors Association as Amicus Curiae, *NML Capital, Ltd., v. Republic of Argentina* (2d Cir. Apr. 20, 2005) (No 05-1543(L)-CV).

government that could one day materially constrain its external financial activities. On the other hand, even if most of the \$20 billion in holdouts would have gone away under aggregation, those determined to litigate would have had little trouble buying up a large enough share of one small debt instrument at 20 cents on the dollar to force it out of the exchange and leaving them free to litigate.

In sum, Argentina's crisis certainly motivated just about everyone in the sovereign debt world to redouble efforts to improve crisis resolution. But remedies differed depending on the proponents' diagnosis of the problem that Argentina revealed. As we saw earlier, the prospect of another IMF bailout prompted the U.S. Treasury Secretary to commission a fix to overcome inflexible debt contracts, and the ensuing competition between SDRM and CACs. Default drove industry groups to put proposals on the table designed to address bad faith on the part of the sovereign debtor. On the other hand, no one has suggested to us that the prevailing fix – CACs – would have produced a substantially quicker, smoother restructuring, with less suffering or smaller losses for anyone involved.

*x. The 1997-2001 Shift in England: Inadvertence or Market Response?*

Mexico's shift in February 2003 is often described as the first instance of a sovereign issuer under New York law using CACs. But two researchers from the Central Bank of Australia, Mark Gugliatti and Anthony Richards, discovered that this was not exactly correct. Mexico, as best we know, was the first of the large sovereign issuers to use CACs in a public offering registered with the SEC. But between 1997 and 2001, at least five smaller sovereign issuers -- Lebanon, Egypt, Qatar, Bulgaria, Kazakhstan – used CACs in New York law bonds issued privately in the U.K.

What caused this departure from convention that appears to have passed well under everyone's radar screen? In their research, Gugliatti and Richards, did not articulate a precise causal story, but speculated that New York lawyers in London had more or less mechanically copied English law forms, changing only the governing law clause.

We spoke to many of the lawyers and bankers involved with these early CAC deals, and first investigated the inadvertence story. On the part of the lawyers, there was no inadvertence. They knew exactly what they were doing in using English-style CACs. Indeed, they were specifically concerned about using CACs in New York law bonds, where unanimity was the standard. JP Morgan, the bankers in the first of these deals (Kazakhstan in 1997) investigated the question of whether there would be a pricing penalty, found that there would not be, and the deal went ahead. The New York-based JP Morgan team that worked on Mexico's first CAC issue in 2003 appeared to be much like the rest of the world – unaware of the early London issues.

But again, the question remains why move in 1997? At the time, there was no direct official sector pressure on these sovereigns. The answer was that, at the time, U.S. law firms in the U.K. were allowed only to practice U.S. law. This was interpreted to mean that the U.S. lawyers in London could issue legal opinions only on contracts governed by some type of U.S. law. The smaller sovereigns retained U.S. law firms with London offices to document offerings on the European market, to customers who were familiar with English-law contracts. The goal was to follow the U.K. standard for investor comfort. But for these lawyers to do the job, the contracts had to be governed by U.S. law. After much debate, the decision was made to use English law forms but New York governing law. As it turned out, the market did not pay the slightest attention to this change. Kazakhstan started the trend; Bulgaria, Egypt, Lebanon, and Qatar followed.

Some of the lawyers who worked on these deals tell another story, which was all about governing law. That story, finally, did have to do with solving the holdout problem. At least some of the senior lawyers had worked on the Brady restructurings in the 1980s and 1990s and had witnessed the holdout problem first hand in cases such as Poland, which involved bank loans. In addition, some of the younger lawyers had worked on the more recent Ukrainian restructuring, which used English-style CACs to secure high participation. These lawyers had a strong substantive preference for the English law form.

At bottom, the inadvertent form-copying story does not hold up – the lawyers debated the amendment provisions and knew full well that they were deviating from convention. That said,

the portion of the story that attributes CACs to U.K. regulatory requirements for the legal profession is one of regulatory inadvertence. The U.K. authorities were not trying to promote CACs, but to protect U.K. law firms from U.S. competition. And then there is the story about lawyers who had seen how effective English-style CACs could be, and those that had been through the nightmare of attempting to organize a loan restructuring in the face of holdout creditors. This last story is a market story; a story about how CACs emerged in response to participants' experiences with holdouts.

Richards and Gugiatti found the five pre-Mexico CAC movers in a limited data search. Our interviews raise the possibility that there may be others. One lawyer told us that Argentina tried to include English-style majority amendment provisions in its first SEC-registered offering in 1993, based simply on the fact that it had the language in its English-law debt. Lead managers from Merrill Lynch reportedly refused.<sup>341</sup> But there may have been other, lower profile issuers that simply asked and faced little resistance.

## V. Implications

We started this project to learn the causes of the CAC shift and make sense of the conflicting theories in the press and academic studies. Spending time with participants in the shift reshaped our inquiry. Most seemed uninterested in talking about the substance of the clauses, or how their introduction might change behavior in crisis. We were usually the ones to raise the question of CACs' effectiveness; when we did, our interlocutors were uncertain, equivocal or outright dismissive. For them the CAC shift seemed to be not primarily or even secondarily about changing the substance of contract rights.

While the interviews did not yield the definitive causation story, our conversations did produce diverse accounts of the process that produced the contract change. These accounts suggested the deployment of the contract form for purposes other than those traditionally contemplated by lawyers or economists (ordering relationships among the parties, protecting against litigation risk). Instead, an actor's posture in the CAC debate – advocating, resisting, adopting – sent a

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<sup>341</sup> Interview 052506D

message to other actors in international finance about future behavior in crisis, relations with the official sector, and one's stature in the market.<sup>342</sup> This was case of contract as symbol or signal. The form and content of these messages in turn echo particular models of international economic governance.<sup>343</sup>

Below we elaborate the implications of our study for contract change and the uses of contract.

*i. Who Moved the Boilerplate?*

Sovereign issuers, buy-side investors, investment bankers and lawyers all vigorously resisted a move from unanimity to majority amendment. Proving that this resistance was due to network effects or other forms of “stickiness” requires establishing that CACs were optimal (if they were not, market resistance would be rational on the merits). We present no evidence one way or another on the last point. However, our contacts consistently explained their resistance in terms that clearly evoked the “stickiness” literature, notably network and learning effects. The difference between lawyers and others is instructive.

Investors usually said that departure from standard form signaled a country's increased willingness to default and maybe also a reduced likelihood of a public bailout. Investment bankers echoed investors, and issuers pointed to investment bankers as the reason for resisting change. These explanations echo Ben-Shahar's and Pottow's notion of “deviance”<sup>344</sup> – the importance of the fact that everyone in the New York market at the time was using the same form; departure from general usage was per se significant, a potentially negative signal that something different, hence problematic, and hence costly was going on. The fact that the same investors were holding billions of dollars in English-law debt riddled with much less favorable majority amendment provisions than those being proposed in New York was irrelevant – unanimity was not market convention in London; so CAC use there produced no negative

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<sup>342</sup> This is a quintessential instance of “contract as artifact” described by Suchman, *supra n. \_\_\_*.

<sup>343</sup> Philip G. Cerny, Mapping Varieties of Neoliberalism, IPEG Papers in Global Political Economy No. 12, May 2004, at 14-15.

<sup>344</sup> Ben-Shahar & Pottow, *supra n. \_\_\_*.

signals.<sup>345</sup> The fact that majority amendment in a single bond would have little effect was a second-order network-style explanation we heard. In this view, clauses are useless unless they are everywhere. (Hence the IMF's periodic progress reports on the proportion of sovereign bonds with CACs.) This argument was a weaker one for CAC opponents because it did not paint the clauses as harmful, merely not worth the trouble. As we suggest later, trouble in this case proved to be a manipulable variable.

Lawyers' grounds for resistance emphasized learning effects. The fact that unanimity had been passed down through history was key. Few knew exactly why unanimity had been adopted in the sovereign context. It may simply have been copied from the standard corporate forms, but no one we spoke to knew for sure. The uncertainty about precisely what value the clause brought or what contingency it had meant to address made lawyers reluctant to change it. Plus the entire contract document was wired to reflect unanimity,<sup>346</sup> leaping into the unknown by altering a single clause held untold risks. Some lawyers cited their improved understanding of the terms' roots in U.S. corporate bankruptcy history as a reason for eventually dropping their opposition. But others said they knew all along that unanimity was optional, were familiar with how English-law contracts worked, and either saw no compelling reason to propose the change to their clients or, as in the case of Argentina in 1993, tried but failed to persuade the investment bankers to switch.

If these explanations reflect real switching costs, how did the parties overcome them? The popular answer is government pressure. But this answer is near-useless. It fails to explain why U.S. and G-7 pressure did not work in the late 1990s, what pressure tactics worked in 2003, and why. We got the sense that by February 2003, Mexico and other issuers began to see the costs of resistance exceeding the benefits. Resistance was fodder for reform initiatives, including SDRM and the various clause packages, which created what Mexico's debt managers characterized as a threatening disequilibrium. Emerging markets officials described themselves in this setting as first and foremost market participants whose goal was to design and execute a least-cost borrowing strategy. G-7 initiatives raised all kinds of questions about subjects they simply did

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<sup>345</sup> A sell-side banker recalled asking buy-side CAC opponents how much yield they would forego to get unanimity in an English-law bond. They laughed. Interview 013106

<sup>346</sup> See Gulati & Choi, *Contract as Statute*, supra n. \_\_\_ at \_\_\_.

not want to discuss with their creditors, including the possibility of default, the likelihood of official support in default, and the terms on which this support might come. The debt managers described this public intrusion as a loss of control.<sup>347</sup> Adopting CACs offered a way to regain control and get back to business – a market-based solution to government meddling, not to the collective action problem touted in the public sector and the academia.

This scenario, which focuses on Mexico’s experience, presupposes several ingredients beyond periodic nagging from Treasury officials. To the extent the CAC episode holds policy lessons (a point of keen interest for our public sector contacts), these extra ingredients were key. First, borrowers and lenders had to agree that some minimal version of CACs was at least harmless. We heard some reports of learning through different channels, including official outreach, drafting groups and pricing studies, though none of them had a direct impact and many were even described as counterproductive. But by 2003, the idea of majority amendment – the simplest of the CACs – was widely understood even among investors who had never read a contract, and public debate had shifted to the voting thresholds. Second, for the disequilibrium to yield the right result, the threat of proliferating initiatives had to be real, and the CAC solution had to promise to end it. Here SDRM is significant not for its ultimate likelihood of success, but for its bizarre appearance, surprising persistence, and capacity to catalyze competing initiatives that presented new threats. The U.S. Treasury’s credibility in signaling that CACs really would “stop the madness” was important; such a signal may not have been possible before O’Neill’s departure. Finally, favorable market conditions created a window where investors would assess an emerging markets credit based on factors other than the imminence of default.

Uruguay’s experience only partly challenges this explanation. Several lawyers, investors and officials have said that it might have shifted even without Mexico. On the one hand, Uruguay’s desperate circumstances increased the official sector’s leverage across the board, CACs included. But unlike the Mexico team, participants in Uruguay’s restructuring were acutely aware of the possibility of default and repeated restructuring; holdouts were not an abstraction here.

Uruguay’s far-reaching CAC package shows signs of having been designed to address a real

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<sup>347</sup> All this of course is simply the definition of regulation – market participants fail to fix a problem and resent government intervention, except that there was no credible threat or power to regulate in this case, merely a threat to keep making noise.



prospect of restructuring. Other issuers went out of their way to put distance between their inclusion of CACs and the possibility of financial distress. Ironically, the fact that Uruguay introduced CACs in a distressed exchange, not a fresh issuance, may have made it easier to innovate. Price was not a variable. Investors faced the choice between imminent default and what was by all accounts a financially generous deal. Some investors read the generosity and Uruguay's extensive marketing efforts as a sign of good faith, possibly offsetting any harmful signal from including CACs. Most likely neither side had much choice, but at least they made the best of it and felt better about it.

The fact that Mexico went first made the sales job easier. Uruguay was part of what several of our contacts described as a "window of innovation" (similar to what Suchman calls a "period of ferment"<sup>348</sup>), where market participants and their lawyers consciously experimented with CAC forms. The window also gave lawyers a more prominent role.

This is significant because we found little evidence that lawyers or investment bankers – large-volume intermediaries at the center of Klausner's and Kahan's story – had driven the CAC shift in the first instance. The most radical innovation took place – and is probably still taking place – with small countries, not the big high-profile ones like Mexico. Suchman's description of lawyers as "pollinators" of organizational form in Silicon Valley supports this view.<sup>349</sup> In Suchman's study, small technology firms turn to lawyers for general business advice, not just technical legal support. Large emerging markets sovereigns like Mexico in 2003 needed targeted legal help. Government debt management had become a highly professionalized internal function, investor relations programs kept officials in regular contact with their investor base, and intermediaries were increasingly relegated to circumscribed tactical and technical roles. Sovereign clients defined the problem – as collective action or official interference – and commissioned a fix. In contrast, smaller, newer or poorer issuers like Uruguay, Grenada, and Iraq relied on their lawyers and bankers for a broader range of business decisions, including framing the problem. If Uruguay had gone first, our story might have turned out differently. But the market shift might have gone differently as well – or might not have happened at all.

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<sup>348</sup> Suchman, *Contract as Artifact*, supra n. \_\_\_ at 134.

<sup>349</sup> [Suchman, PhD Dissertation]

By mid-2003, the fuzzy learning story of 1996-2003 becomes stark. Investors appear to conclude within months that CACs carry no price penalty, and after Brazil's brief dalliance with 85%, stop paying attention to any relationship between credit quality and the voting threshold. Lawyers set aside historical concerns and embrace the new model. What some had first described as an investment grade experiment irrelevant to the asset class becomes emerging markets standard. Once market acceptance is decreed, contracts are put aside. Issuers and investors focus on financial terms, and show no signs of rewarding or penalizing further innovations on the CAC form – at least until the next crisis.

*ii. Public Symbol in Private Contract*

The biggest puzzle of our case is just how few participants embraced CACs with the aim of ordering debtor-creditor relations according to their terms. Issuers said they used CACs to stop G-7 initiatives, preempt creditor-driven innovation, and assert market leadership. Some on the creditor side said they saw potential benefit in accommodating the U.S. Treasury to ensure continued G-7 support for the emerging markets, even as the Bush Administration and its European allies touted the shift as a signal that public bailouts were no more. What is the significance of using contract in this way?

In 1941, Lon Fuller described what he called a “channeling function” of the contract form.<sup>350</sup> Contracting parties put their agreement in a particular legal form not only to serve as evidence in court or to constrain one another's commercial behavior, but also to signal something about their relationship to the outside world. More recently, Suchman described the notion of “contract as artifact”, where contractual devices serve not only as a technical fix but also as a symbol and gesture directed at non-parties.<sup>351</sup> In the CAC shift, the function of signaling to third parties appears to have been critical, even in Uruguay, where everyone was cognizant of the prospect of restructuring using the new clauses.

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<sup>350</sup> Lon L. Fuller, *Consideration and Form*, 41 *Colum. L. Rev.* 799 at 801-803.

<sup>351</sup> Suchman, *Contract as Artifact*, *supra* n. \_\_\_ at 108-115. See also Hill, *supra* n. \_\_\_.

Two aspects of the contract's public signaling function stand out in our study, and go beyond Fuller's and Suchman's respective constructs. *First, the same form in the same context can transmit different signals in the hands of different participants.* Mexico signaled market and, related, political leadership; investors signaled a cooperative relationship with the official sector (perhaps hoping for a payoff down the line), while the United States and its G-7 allies signaled a new approach to crisis management. By using CACs with a slightly higher amendment threshold, Brazil signaled both its good relations with the official sector and a willingness to accommodate creditors at a time when it worried about market access. By moving a Euro-denominated issuance from London to New York and using CACs, South Africa signaled cooperation with the United States.

*Second, our case study reveals that contracting parties are not the only ones using the contract form as a public signal.* The Bush Treasury and its counterparts in Europe embraced advocacy of specific provisions (majority amendment) to signal reduced willingness to back exceptional IMF packages.<sup>352</sup> Note, however, that none of our issuer, investor or lawyer contacts found the official sector's gesture credible – the intended audience for the signal refused to link CACs and IMF packages even where some believed independently that the Bush Administration was less prone to bailouts. Their skepticism went back to their dim view of the relative importance of CACs in a financial crisis – “a footnote to a footnote to a footnote”, in the words of one participant.<sup>353</sup> On the other hand, “footnote advocacy” helped frame a concrete policy objective, an action sequence that engaged all relevant public and private sector players, and a visible achievement in the name of the new crisis management regime. It is plausible that CACs were not adopted in the 1990s partly because the initiative had nowhere near the symbolic significance for the Clinton Treasury that it acquired for its successors, and was associated with bail-in rhetoric, which the market read as a hostile signal.

In contrast, there is no question that embracing CACs worked for Mexico. It had the effect of signaling both Mexico's leading position among emerging markets issuers and set it apart from shakier credits in the asset class, while also highlighting its special relationship with the United

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<sup>352</sup> G-7 countries that adopted CACs to “lead by example” used their own contracts as signaling devices.

<sup>353</sup> Interview 073106

States. In a sense, for Mexico, this was partially about status. Different actors suggested that Mexico was willing to incur the costs and risks of moving first, partially because it wanted to squash the SDRM and other policy initiatives, but also because risking a cost that others were reluctant to bear demonstrated its higher status as a creditworthy issuer and a political heavyweight.<sup>354</sup> The fact that the innovation was minimalist and symbolic, rather than a comprehensive overhaul with a view to restructuring, worked in Mexico's favor – it reaffirmed the prevailing impression that Mexico was not contemplating default, thereby reinforcing the status message.

Analyzing the CAC incident from the “artifactualist” perspective also helps relate this shift in the sovereign debt contracting regime to the literature on diffusion in sociology, law, and political science.<sup>355</sup> The CAC shift shows many ingredients of a standard diffusion story: an idea that, at least with respect to majority amendment, is simple and appealing to many different constituencies (economists, lawyers, policy-makers) and a confluence of bureaucratic structures and processes uniquely poised for transmission (links among financial policy makers, political transition in the United States, a history of U.S.-European conflicts on crisis management in the 1990s), which in turn created space for entrepreneurs such as O'Neill, Krueger, Taylor and Buchheit. The only problem with characterizing the CAC shift as a diffusion story is that it appears to be above all a diffusion of form, whose normative content is strictly contextual and shifting, as described earlier, and whose technical efficacy remains to be seen.

### *iii. Market Myths, Clauses as Governance and the Political Economy of Contract Change*

The two preceding sub-sections treat sovereign debt contracts as just another set of contracts

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<sup>354</sup> For more on the status and signal dynamics as they pertain to market leaders, see Kimberly D. Krawiec, *Organizational Form as Status and Signal*, 40 *Wake Forest L. Rev.* 977 (2005).

<sup>355</sup> See Suchman, *supra* n. \_ at 115-127 (a succinct overview of the diffusion literature, where he puts Klausner's and Kahan's boilerplate work and its progeny in broader context). Cf. Peter A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism across Nations* (1989) (a seminal collection of political economy writings exploring factors behind the dissemination and adoption of economic ideas), Ngaire Woods, *The Globalizers: The IMF, The World Bank, and Their Borrowers* (2006) at 65-69 (on the diffusion of Washington Consensus ideology) and Eric A. Feldman, *The Culture of Legal Change: A Case Study of Tobacco Control in Twenty-First Century Japan*, 27 *Mich. J.Int'l.L.* 743 (Spring 2006), a case study relating international norm transmission and national legal change (this case has a curious if superficial parallel to ours: a smoking ban that failed to take in the 1990s became a smashing success early the following decade).

among private parties. But they are much more than that. One half of each contract is a government, as are many of the interested third parties; the people involved are often powerful political actors. The blanket of sovereign immunities that makes traditional contract enforcement difficult<sup>356</sup> partly explains the salience of the symbolic and signaling functions discussed earlier. The process by which these symbols and signals are generated is by definition a political process, just as their content is by definition politically significant.<sup>357</sup>

Our interlocutors had a sophisticated apprehension of the CAC project.<sup>358</sup> In one instance, an investment banker who managed an early CAC issue described the function of the G-10 working group as creating “an epistemic community” around contract reform.<sup>359</sup> The political science literature on epistemic communities describes a mode of international governance where policy experts linked in transnational networks disseminate norms and values, which in turn help entrench them in national power structures and perpetuate institutional arrangements that reinforce these values.<sup>360</sup> Accepting our banker’s characterization, what norms and values were being disseminated, and how did the somewhat disjointed process we describe help frame these values?<sup>361</sup>

Market talk pervaded the CAC episode. CACs were summoned to solve a market failure in contracting behavior, one that was apparently revealed by the Mexican crisis in 1994 and the crises in East Asia and Russia.<sup>362</sup> In 2003, after more crises including Argentina’s mega default in 2001, the market finally solved the problem by adopting CACs. Bush and Clinton

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<sup>356</sup> *Supra* ns. \_\_.

<sup>357</sup> Even if, as in the case of Riles’ networks, their most visible accomplishment is to “generat[e] the effect of effectiveness”. Riles, *supra* n. \_\_ at 172.

<sup>358</sup> Cf. Riles, *Networks*, *supra* n. \_\_.

<sup>359</sup> Yes, the banker actually used the term. Interview 060706.

<sup>360</sup> See e.g., Emanuel Adler & Peter Haas, *Conclusion: Epistemic Communities, World Order, and the Creation of a Reflective Research Program*, 46 *International Organization* 367 (Winter 1992). Compare descriptions of functional disaggregation in Anne-Marie Slaughter, *The Real New World Order*, 76 *Foreign Affairs* 183 (1997), and fragmented governance in Dezalay and Garth, *Palace Wars*, *supra* n. \_\_ at 163-185. Echoing *Palace Wars*, many of our emerging markets contacts had trained in the United States and worked in U.S.-based institutions.

<sup>361</sup> This set of questions echoes the legal process literature in international law, which theorizes how states comply with international norms in the absence of robust enforcement, and particularly to the strand that explores how norms are shaped and internalized through international cooperation. See e.g., Abram Chayes & Antonia Handler Chayes, *The New Sovereignty* (1995) and Harold Hongju Koh, *Why Do Nations Obey International Law?* 106 *Yale L.J.* 2599 (1997).

<sup>362</sup> *Supra* n. \_\_.

Administration officials describe this logic in very similar terms.<sup>363</sup> Our study paints a different picture. None of the crises usually cited as the inspiration for CACs demonstrate a “market failure” of the sort that could have been solved by CACs. Few involved meaningful amounts of sovereign debt governed by New York law; those that did caused no special problems.<sup>364</sup> We are far from the first to make this point, but the large and growing CAC literature appears to elide its implications. Some of our contacts seemed uncomfortable with the dearth of predicted market failures to date; others seemed sure their day would come; no one knew or cared about amendment terms in *tesobonos*.

Our interviews highlighted the disconnect between the stylized history underpinning CACs and SDRM alike – large, statesmanlike, cooperative banks of the 1980s replaced by small, dispersed, obstreperous bondholders of the 1990s – and the vivid accounts we heard of small banks holding large loan restructurings hostage starting in the late 1980s, demanding payoffs and delaying economic recovery in the debtor countries. In contrast, the bondholder threat described in virtually every speech and article on sovereign debt from the mid-1990s appeared in theoretical, perennially prospective terms. Even Argentina has yet to change this pattern. The reasons for it are a matter for economic research beyond the scope of our project. Virtually all our contacts – CAC friends and foes alike – said that the next crisis would surely show if bonds are the problem they are meant to be, if CACs are useful and if the world needs an SDRM.

More broadly, no one we spoke to suggested that the invisible hand of the market could have produced the market-wide CAC shift without the heavy hand of the official sector (the experience of early, spontaneous and obscure CAC adopters such as Kazakhstan is instructive here). Yet market rhetoric framed the initiative. It was almost as if CACs came to represent “all things market” in public discourse on sovereign debt.

For the Bush Treasury, embracing contract as a flagship initiative signaled an ideological shift from Clinton-era “burden-sharing” within a publicly ordered crisis resolution regime, to

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<sup>363</sup> Robert E. Rubin, *In an Uncertain World* (2002) at \_\_\_.

<sup>364</sup> See e.g., Truman, *supra* n. \_\_\_.

privatized crisis management and a smaller role for international institutions like the IMF.<sup>365</sup> At the most basic symbolic level, “contract” was “market”, literally opposed to “statute”, or SDRM. The stark contrast was useful even though in substance, the IMF’s fix was quite close to CACs, and was barely more than a modest bondholder-led coordination initiative. When we pointed out the oddity of free-market champions engaging in tactics specifically rejected by their interventionist predecessors, such as commissioning draft clauses or directly lobbying individual market participants, we got a two-part answer: first, outreach was strictly limited to information and persuasion (no “hard power”), and second, it was all for the sake of getting the official sector out of crisis management. Against this background, O’Neill’s iconoclasm in embracing both SDRM and CACs made no sense symbolically, ideologically or bureaucratically.

Even though Bush Treasury officials and their European allies both condemned Clinton-era bailouts, European (and for that matter, the Clinton Treasury’s) support for CACs had none of the ideological resonance of the Bush Treasury advocacy. G-10 officials outside the United States generally avoided painting CACs and SDRM as polar opposites, nor were they seeking a reduced role for the IMF – if anything, they seemed to relish the public sector’s new involvement in contract substance. In this view, both CACs and SDRM were means to institute a rule-based crisis resolution system and end subsidies, while maintaining public ordering. But CACs worked best at the highest level of abstraction, signaling a philosophical shift – “contract as market”. Using other people’s contracts as a commitment device to foreclose bailouts required generalized belief in CACs’ technical efficacy and significance, which is yet to materialize.

Even though emerging markets officials had initially fought CACs along with SDRM, the way in which they fought and ultimately embraced the clauses resonates with the privatization story – to a point. Officials presented themselves in the first instance as market actors, and the interests of their countries as, above all, the interests of successful market borrowers. Their substantive position came across as the opposite of Europe’s: stop G-7 meddling in the markets (and our economic policies), but do not stop large rescue packages. Here contract – freedom of contract – meant national autonomy, even as it did not foreclose public sector support for the market.

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<sup>365</sup> Taylor, *Loan Rangers*, supra n. \_\_\_\_.

In 2003, CACs somehow came to channel all these norms, varying the emphasis for different constituencies. The clauses' success seemed to lie in their ability to bring together the different elements of the sovereign debt community in what many participants described as a rare constitutive moment. Everyone coalesced around a process-based mode of cooperation, collapsing the public/private distinctions, with contract as the preferred governance tool.<sup>366</sup>

## VI. Epilogue and Conclusions

In November 2004, the IIF unveiled “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets”, a document endorsed by major emerging markets issuers including Mexico and Brazil, large financial institutions, and two out of the seven trade associations that had come together in the CAC shift.<sup>367</sup> The G-20, a group of major industrial and emerging markets governments, welcomed the document but deliberately stopped short of endorsement.<sup>368</sup> EMTA distanced itself from the effort, partly because the Principles failed to take a strong enough stand on exit consents or engagement.

In January 2005, the Bank of England hosted a workshop on sovereign debt contracts. The usual suspects were in attendance – emerging markets officials, legal experts, underwriters and investors. The goal was to keep up momentum from the 2003 shift – perhaps prod on further innovation like engagement clauses, trustees, and aggregation.<sup>369</sup> Several participants came away convinced that further change was not about to happen.

In March 2005, Argentina announced the closing of its bond exchange, which brought in over \$60 billion in defaulted debt – a 76% participation rate. Holders of over nearly \$20 billion in old bonds refused the offer. The deal did not close until June. Dozens of lawsuits are still percolating through the U.S., European and Argentine legal systems. So far, no holdouts have been paid. Argentina is growing briskly. Since its intervention in the lawsuit that held up the

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<sup>366</sup> Cerny describes this as the new model of neoliberal economic governance. Cerny, *supra* n. \_\_\_\_.

<sup>367</sup> Institute of International Finance, Key Principles Agreed To Strengthen Emerging Markets Finance, Press Release, November 22, 2004, available at <http://www.iif.com/press/pressrelease.quagga?id=98>.

<sup>368</sup> Interviews 121605, 091106

<sup>369</sup> Paul Bedford, Sovereign Bond Contracts: A Workshop at the Bank of England, Bank of England Financial Stability Review, June 2005.



closing, EMCA has posted no new initiatives on its website.

In April 2005, John Taylor resigned from the U.S. Treasury and returned to teaching economics at Stanford. His successor publicly credited Taylor with ushering in the CAC shift, and proceeded to focus on global imbalances and China's exchange rate regime.<sup>370</sup>

The public window for contract reform had closed. To be sure, lawyers were still tinkering with the clauses in the privacy of their conference rooms, EMTA kept posting document highlights on its website, and trade press flagged the occasional novelty,<sup>371</sup> but neither the Wall Street Journal nor the Financial Times took interest. What happened?

As best we can tell, in the mid-1990s, a set of simple contract provisions emerged simultaneously in legal, policy and academic circles that were inspired in part by holdout problems in some bank loan restructurings of the late 1980s and early 1990s. These provisions promised a clear and achievable policy response to new crises that threatened to bring down the entire international financial system. No one thought that they were a silver bullet, but with limited options on the table, they could be a tangible step forward, and certainly did no harm.

What had initially looked like low-hanging fruit quickly turned into a formidable challenge due perhaps to market perceptions of switching costs, but also to disagreements about the likely effect of the clauses on the balance of power between debtors and creditors. The effect was only partly mechanical (a change in voting procedures); it was in large part symbolic (associated with more defaults and less official finance). Early proponents of the clauses in the official sector chose not to spend political capital to overcome these costs. A few years later, the same clauses acquired fresh political significance as a signal of new free-market policies in the United States and a reasonable alternative to a more radical public ordering regime. Even though the radical threat ultimately proved to be a red herring both in its content and its prospects, it succeeded in catalyzing the contract initiative and a process around it that ultimately brought together the

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<sup>370</sup> See, e.g., Treasury Official Tim Adams Addresses International Economics Conference on Reform of the International Monetary Fund, 9/23/05 US Fed. News (Pg. Unavail. Online) 2005 WLNR 15128789 (September 23, 2005) (referring to "progress on collective action clauses" as a "remarkable success story").

<sup>371</sup> See e.g., Skeel, *supra* n. \_\_\_. [International Financial Law Review]

entire world of emerging markets sovereign debt. CACs proved to be an open and flexible signaling device that, for a brief period, served multiple political purposes in the hands of diverse players. The CAC shift now seemed eminently worth the cost.

Some creditors tried and, by and large, failed to use the policy opening to rewrite standard form contracts to discipline sovereign debtors. A few market participants tried and, by and large, succeeded at introducing a comprehensive package of clauses in New York-law bonds to reduce the leverage of bondholder minorities. No one knows for sure how these clauses will work in the next crisis, and certainly not how investors might respond. Just about everyone we interviewed acknowledged that CACs might help on the margins – but will not change the policy response or the economic outcome. Perhaps the next crisis will have nothing to do with New York-law bonds. Do Ghanaian-law bonds have CACs?<sup>372</sup>

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<sup>372</sup> Kathryn Wells, Africa: Sovereigns Look Abroad: G8 Debt Relief Package Will Not Constrain Issuance Plans, *Euromoney*, August 2006.