BOND TRUSTEES AND DEBT SUSTAINABILITY IN SOVEREIGN DEBT RESTRUCTURING

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ABBREVIATIONS AND ACRONYMS

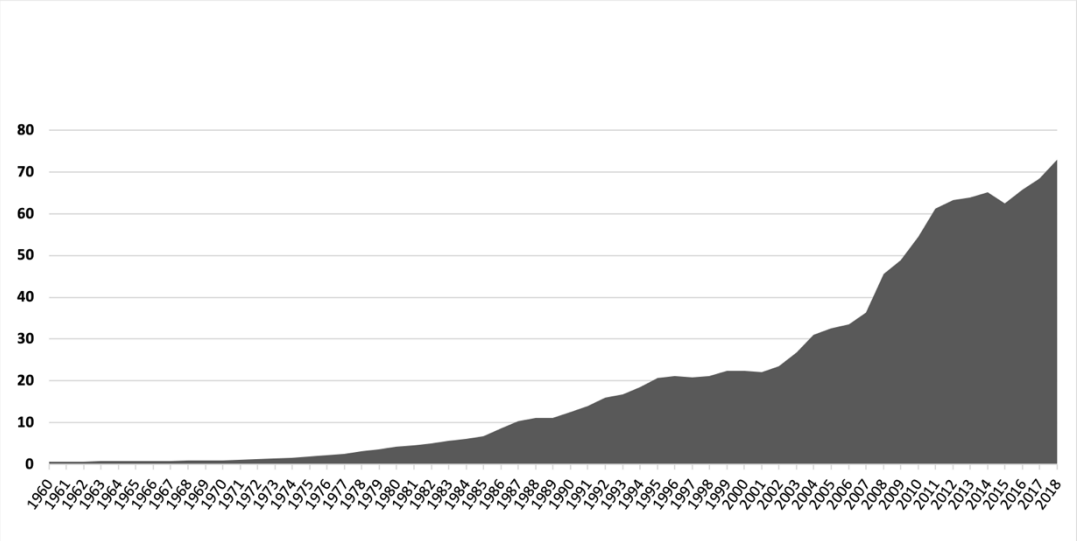
ABA	American Bar Association
BIS	Bank for International Settlements
BNYM	Bank of New York Mellon
CACs	Collective Action Clauses
CFB	Corporation of Foreign Bondholders
DSA	Debt Sustainability Analysis
FBPC	Foreign Bondholders Protective Council, Inc.
FSA	Financial Services Authority (UK)
G-10	Group of Ten
G-20	Group of 22 Systematically Significant Economies
GCAB	Global Committee of Argentina Bondholders
IMF	International Monetary Fund
LIC	Low-Income Countries
LLC	League Loans Committee
LoN	League of Nations
MACs	Majority Action Clauses
NML	NML Capital, Ltd
SDGs	Sustainable Development Goals
SDR	Sovereign Debt Restructuring
SEC	Securities and Exchange Commission (US)
TIA	Trust Indenture Act 1939 (US)
TIRA	Trust Indenture Reform Act 1990 (US)
WPPSS	Washington Public Power Supply System
WB	World Bank
WHO	World Health Organisation

INTRODUCTION

Motivation for this Thesis

One of the most detrimental consequences of the global financial crisis of 2008 has been a sharp increase in sovereign debt all over the world.[1] As a result, financial markets have experienced significant turmoil, such as the repercussions from the Greek sovereign debt crisis. About a decade later, there are solid grounds for supposing that financial markets will face even more government debt turbulence in the short-term perspective due to the COVID-19 outbreak. Governments are forced to accumulate more debt for enormous fiscal stimulus to tackle with the economic effect of the pandemic. Even before the pandemic, there was a worrisome buildup of the government debt as evident from Figure 1. At the beginning of 2020, the International Monetary Fund (IMF) alerted about a large number of lower-income economies being at high risk of experiencing debt distress.[2] The ever-increasing government debt raised multiple concerns regarding debt sustainability and the implications for future generations.[3]

Figure 1: Public debt global, 1960-2018 (Trillions of United States dollars)



Source: UN Inter-agency Task Force on Financing for Development[4]

[1] Kenneth Rogoff and Carmen Reinhart, 'Growth in a Time of Debt' (2010) 100 American Economic Review 573, 577.

[2] IMF, *Press Release 'the IMF Executive Board Discusses the Evolution of Public Debt Vulnerabilities in Lower Income Economies'* (No 20/33 from February, 10, 2020).

[3] See Lee C Buchheit and Mitu Gulati, 'Responsible Sovereign Lending and Borrowing' (2010) 73 Law & Contemporary Problems 64.

[4] The chart is constructed based on the data used in publication by the UN Inter-agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2020* (United Nations Publication ISBN 978-92-1-101422-8, 2020), 128.

While it is still early to measure the consequences of the pandemic for the debt buildup, the IMF projected that a gross government debt among all countries will increase by more than 13 per cent of GDP just in one year, 2020.[5] Such a sizeable one-off jump up will bring the debt to more than 96 per cent of GDP – levels not seen since World War II. With a rising public-debt burden, there is a higher risk of sovereign debt default and necessity in sovereign debt restructuring (SDR) to return the debt to a sustainable level and recover the economy from the crisis.[6]

In this regard, the strain on public finance is mostly felt by the developing countries due to more fragile economies and constraints to issue or borrow hard currencies at will. In the extraordinary time of the pandemic, some developing countries are faced with the dilemma of whether to pay back the creditors or to direct the funds for public needs such as health care. In less than a month since the World Health Organisation (WHO) announced that the COVID-19 outbreak is a pandemic, over 90 countries requested the IMF for emergency financing struggling to cope with the effects of the pandemic.[7] In anticipation of the imminent sovereign debt crisis, the G-20 responded to the upcoming wave of defaults by bilateral debt relief suspending repayment of official bilateral credit from the low-income countries. However, the situation with sovereign debt owed to private-sector creditors is more problematic. It is doubtful that private-sector creditors will agree on sovereign debt restructuring or at least on a standstill in the same voluntary manner as the G-20.

The expansion of actors and instruments in sovereign debt markets through bond financing generated a coordination problem among bondholders during the debt restructuring process. There is the risk that an individual bondholder will be passive or act against the restructuring slowing down or even precluding the process of restructuring even though it is in the general interest of bondholders as a group, not to mention the population of the country experiencing the shortage of funds for public welfare. In particular, the disruptions to sovereign debt restructuring by frivolous litigation is considered as one of the main threats. An unresolved sovereign debt crisis

[5] IMF, Transcript of the April 2020 Fiscal Monitor Press Briefing, (April 15, 2020), Available at <https://www.imf.org/en/News/Articles/2020/04/15/tr041520-transcript-of-the-april-2020-fiscal-monitor-press-briefing>.

[6] David Beers and Jamshid Mavalwalla, 'Database of Sovereign Defaults, 2017' (2017), 15.

[7] IMF, *Press Release 'IMF Executive Board Approves Proposals to Enhance the Fund's Emergency Financing Toolkit to US$100 Billion'* (No 20/143 from April 9, 2020).

could trigger a deep recession, [8] like the 'lost decade' of Latin America during the 1980s, causing poverty and a social crisis. In the worst-case scenario, it could spill over into outbreak of civil unrest or even armed conflict.[9]

There are many debates on how to address the problem of bondholder coordination in sovereign bonds: whether to establish a multilateral legal framework or adjust the current voluntary regimes[10] of restructuring through selective regulation or by contractual tools,[11] e.g., collective action clauses. In particular, the importance of this problem was publicly acknowledged by the General Assembly of United Nations on September 9th, 2014 in Resolution 68/304 deciding to elaborate and adopt a multilateral legal framework for sovereign debt restructuring processes.

Since the establishment of a multilateral legal framework is practically unachievable in the current political environment, a more viable solution is to tweak the current contractual framework in conjunction with soft law to mitigate the coordination problem. As shown through history, institutions protecting bondholders' rights are essential for the settlement of sovereign defaults.[12]

Aim of the Research

What is much needed under current conditions is a technique to solve coordination problems and ensure fairness and democratic procedure in sovereign debt restructuring by prevention of frivolous acceleration of bonds and litigation. An exceptional tool which has the potential to cope with contemporary coordination problems is the trust arrangement.

This dissertation is an attempt to shed light on a trust arrangement as an institution against coordination problems in sovereign debt restructuring. It aims to uncover drawbacks in the legal and institutional structure of the trust arrangement

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[8] Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts* (International Monetary Fund 2012), 6.

[9] Matthias Goldmann, 'Sovereign Debt Crises as Threats to the Peace: Restructuring under Chapter VII of the UN Charter' (2012) 4 Goettingen Journal of International Law 153, 155.

[10] As Krasner defined regimes as: 'sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations.' Stephen D. Krasner, 'Structural Causes and Regime Consequences: Regimes as Intervening Variables' (1982) 36 International Organization 185, 186.

[11] For example, see Anna Gelpern, 'A Skeptic's Case for Sovereign Bankruptcy' (2013) 50 Houston Law Review 1095 And Andrew G. Haldane and others, 'Analytics of Sovereign Debt Restructuring' (2005) 65 Journal of International Economics 315.

[12] Rui Pedro Esteves, 'Quis Custodiet Quem? Sovereign Debt and Bondholders: Protection before 1914' (2005) Mimeo, University of California, Berkeley, 35.

and suggest solutions to fulfil its potential in remedying the coordination problem. The thesis is an extended invitation to policymakers and practitioners to engage with different ways of thinking about the use of the trust arrangement in sovereign debt markets.

In this context, this thesis probes into the current contractual and more broadly, regulatory regimes and practice for sovereign debt restructuring. More precisely, it argues that the trust arrangement is of great benefit to sovereign bond markets and restructuring processes.[13] Bond issuances structured through trust arrangements can provide further advantages in easing the coordination problem complementary to the recently promoted standardised collective action clauses by the International Capital Markets Association.[14] Regardless of the future vector of sovereign debt restructuring,[15] the properly structured trust arrangements would remain beneficial in facilitating interaction among bondholders and ensuring the observance of their rights.

This thesis contributes primarily to the debate on creditor coordination problems in sovereign debt restructuring. Despite many theoretical papers on the topic of coordination problems among bondholders in sovereign debt markets, especially about the use of the majority action clauses, there are only a few studies on trust arrangements.[16] Even less research has been done regarding trustees' actual performance in sovereign debt restructuring.[17] This situation is further complicated by scarce data on trust arrangements in sovereign debt markets.[18] As a result, there

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[13] Of a similar view are Anna Gelpern, 'Sovereign Debt: Now What?' (2016) 41 Yale Journal of International Law 45, 92; Anna Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines' (2016) 11 Capital Markets Law Journal 251, 273.

[14] See the model collective action clauses by ICMA, Available at <https://www.icmagroup.org/resources/Sovereign-Debt-Information/>.

[15] It could be contract, soft law or statutory based or a combination of them.

[16] Among a few papers on the topic are Lee C Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds' (2018) 13 Capital Markets Law Journal 410; Sönke Häseler, 'Trustees Versus Fiscal Agents and Default Risk in International Sovereign Bonds' (2012) 34 European Journal of Law and Economics 425; Sönke Häseler, 'Individual Versus Collective Enforcement Rights in Sovereign Bonds' (2012) 77 Law Review 1040.

[17] Lee C Buchheit and Sofia D Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?' (2016) 31 Butterworths Journal of International Banking and Financial Law 457; R. Auray, 'In Bonds We Trustee: A New Contractual Mechanism to Improve Sovereign Bond Restructurings' (2013) 82 Fordham Law Review 899; Mitu Gulati and Lee C Buchheit, 'The Coroner's Inquest: Ecuador's Default and Sovereign Bond Documentation' (2009) International Financial Law Review 22.

[18] Andrea E. Kropp, W Mark C Weidemaier and Mitu Gulati, 'Sovereign Bond Contracts: Flaws in the Public Data?' (2018) 4 Journal of Financial Regulation 190 (Stressing that information on about the use of trust arrangement and its terms presently omitted from commercial databases).

is a lack of awareness or understanding of the benefits of trust arrangements among market participants.[19]

In practice, trustees are passive in representing bondholders due to divergent interests between them. This divergence is exacerbated by the peculiar relationship structure and the way the bond documentation is drafted and negotiated. As a result, trust arrangements are bringing suboptimal results in tackling with coordination problems in sovereign debt restructuring or avoided altogether.

Assessing the utility of trust arrangements to address coordination problems, this thesis is driven by the puzzle: How to better balance (i) the need for smooth sovereign debt restructurings, which by definition entails some losses for creditors, with (ii) bondholders' legitimate interests? As a solution, it seems that incentives for bond trustees to pursue debt sustainability will achieve both goals.

This thesis strives to provide an approach that reconciles the divergent interests of the creditors and a sovereign borrower in sovereign debt restructuring. This approach can be further used as an objective in constructing a legal and institutional framework for trustees in sovereign bond markets.

Structure and Content of the Thesis

Following the introduction, this dissertation proceeds in six chapters. Chapter 1 provides an introduction into international sovereign bond markets. Further, it stresses the importance of the governing law of the sovereign bond markets for the debt restructuring process. In particular, this chapter argues that the process of sovereign debt restructuring primarily depends on the contractual rights of bondholders. Based on the bondholders' rights allocation, SDR procedure can encounter a different set of coordination problems. Those problems are explained and exemplified with recent developments in debt restructuring practices. It seems that a recent change in the creditor composition due to the spread of bond finance and empowerment of the individual creditors to enforce a debt contract has vastly exacerbated coordination problems among creditors.

Chapter 2 provides a tentative inquiry into the evolution of the mechanisms to coordinate creditors, with a focus on bondholders and institutional frameworks which facilitated this coordination. The goal is less to display the details of specific

[19] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts' (2015), 14.

cases than to understand more generally the challenges and corresponding development of coordination mechanisms, institutions and legal framework which adapted to the new realms of international finance over the long run. In this regard, sovereign debt crises revealed that the development of the legal framework and institutions for bondholder coordination lagged behind financial innovation. While the challenges for SDR changed with the political and legal environment, the main issue has persistently remained the same – the coordination problems of bondholders.

Chapter 3 contextualises and explain the evolution of the trust arrangement in sovereign debt markets. It is structured chronologically, guiding the reader from the medieval practices in which the essence of the bond trustee emerged to corporate bond issues where the practice of the trust arrangement matured and finally towards early and modern uses of the trust arrangement in sovereign bonds. Archival work at the archives of the League of Nations at the UN headquarters in Geneva allowed finding intriguing primary sources, which are mostly unpublished, on the studies devoted to the regulatory initiative of the League of Nations committee on sovereign bonds. Further, this chapter reflects on the place of the trust arrangement in the current legal framework for international sovereign bonds.

As portrayed in Chapter 4, the choice of the legal structure has important implications for the institutional set-up and allocation of the bondholders' rights as individual or collective. Further, this chapter assesses the role of the trustee in various situations through the contractual analysis of the bond issue. It is argued that a trust arrangement is a more capable legal structure of sovereign bonds for the coordination of bondholders than a fiscal agency agreement. The trust arrangement has distinct advantages for ameliorating coordination problems in sovereign debt restructuring ensuring checks and balances due to the involvement of the trustee as an intermediary with discretionary powers.

Chapter 5 portrays the impediments for the proper functioning of the trust arrangement. It starts with the analyses of critical junctures for corporate bond trustees when their performance was scrutinised and regulated. Further, an in-depth study assesses the functionality of the trustees through case studies of sovereign bond restructurings performed by Argentina in 2016 and Ecuador in 2008. It argues that bondholders were suffering from the passivity of the trustees in each case. Against its original purpose to preclude only holdout litigation, a trust arrangement works as a significant barrier against enforcement of the bondholders' rights in general.

Degraded creditor rights, coupled with the poor performance of the trustees in crisis events, explain the resistance of the creditors to implement a trust arrangement in bond issues. Under such circumstances, the trust arrangement seems to be unsuccessful in securing a collective best interest of bondholders as a group in sovereign debt restructuring.

Finally, Chapter 6 contends that the root of the trustees' passivity is the agency problem which is assessed under the law and economics prism. The agency problem is aggravated by the asymmetric relationships between parties in the bond issue, the contract of adhesion nature of the bond contract, and the lack of almost any boundaries imposed by law or courts. In order to ameliorate the agency problem, there are various ways to incentivise a trustee to act in the best interest of bondholders. Those incentives are classified as competitive, monetary and liability incentives and discussed providing concrete proposals on how to employ them. In respect of liability incentives, the spotlight is brought on fiduciary obligations. It is a core element to restore the balance between parties by prompting an agent to act in the best interest of the principal. Setting a normative benchmark, such as to promote the best interest of the bondholders for the trustee's discretionary actions, provides the necessary flexibility and guidance for the trustee. As a final point, this chapter proposes that the best interest of bondholders in sovereign debt restructuring is captured in sovereign debt sustainability.

The thesis concludes that a bond trustee guided by the IMF and WB debt sustainability assessment in restructuring and remedial proceedings against the debtor will not only advance the collective bondholders' interest within the scope of its mandate but also by establishing clarity and certainty about its actions will increase the likelihood and speed of sovereign debt restructuring processes and thereby promote debt sustainability. It is a win-win situation for both creditors and a sovereign borrower because it strives to solve the agency problem between a trustee and bondholders and the coordination problem among creditors in sovereign debt restructuring at the same time. Moreover, the achievement of debt sustainability fosters an equilibrium between the interests of private creditors and a borrower country, taking into account its socio-political aspects.

CHAPTER 1. THE MARKET FOR INTERNATIONAL SOVEREIGN BONDS AND CREDITOR COORDINATION PROBLEMS

Whether sovereigns can issue debt[1] under their own law or subject to their own jurisdiction affects the borrower's room for manoeuvre ex post,[2] as a flexible legal environment may have direct repercussions for the stability of the state. At the same time, the mere fact that bond restructuring under foreign law or jurisdiction may undergo a rigid and time-consuming process is not a shortcoming per se. It could be a valid and hailed illustration of the sanctity of contract and supremacy of law as a borrower cannot coerce bondholders and expedite a restructuring on its own terms through a distortion of the applicable law or judicial integrity. The actual problem stems from the abuse of imperfect bond restructuring norms by involved actors, leading to grave consequences far beyond the circle of the contractual parties. The instances of such misuse are conventionally grouped under the notion of coordination problems, which is discussed in this chapter. Therefore, this chapter is primarily focused on the origin and implications of creditor coordination problems. The first part of this chapter portrays two recent primary shifts responsible for the aggravation of coordination problems in sovereign debt restructuring: (i) proliferation of the bonded debt and (ii) the increasing importance of law for sovereign debt restructuring.[3] In turn, the second part of this chapter describes coordination problems in sovereign bonds, with a focus on (i) holdouts and (ii) frivolous litigation, and their implications for debt restructuring.

[1] The words 'bond,' 'debenture,' 'loan,' and 'note' are used interchangeably, and are not meant, unless specifically mentioned, to denote a specific type of obligation or maturity in this thesis.

[2] Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315, 321.

[3] For more technical details on impact of law see Chapter 4. Bond Trustees and the Restructuring of International Sovereign Bonds at p 101.

I. INTERNATIONAL SOVEREIGN BONDS AND THE ROLE OF LAW

A. Bonds in the Sovereign Debt Constellation

Sovereign debt comprises an extensive array of financial instruments and involved counterparties. One of the most common ways to group sovereign debt is to use such universal categories as public or official and private creditors.[4] The former includes creditors privileged by international public law like states and international organisations which provide bilateral and multilateral loans correspondingly. Private creditors represent a highly heterogeneous group of lenders utilising more diverse and complex debt instruments, e.g. bonds, governed by private law. For instance, the private creditor's group can be further subdivided into sophisticated ones, on the one hand, e.g. institutional investors, hedge funds, investment banks, and on the other hand retail investors whose expertise and underlying motivation differs. Moreover, even creditors of every subgroup such as 'sophisticated creditors, a hedge fund and investment bank do not necessarily share the same interest'[5] and hence can be distinguished and classified into narrower clusters.

Apart from that, the market for sovereign debt is usually also categorised based on the territorial origin of funding into internal and external credit. While a debt owed to official creditors has a purely external nature, a debt provided by private creditors may be internal and external or even combine both features for the same debt instrument. In this regard, the share of external public and private debt has important implications for debt sustainability of the country.[6] This accounts especially for developing countries whose economy is more fragile to shocks, such as volatility of exchange rates and commodity prices, the outflow of the capital, as was exemplified by the Latin American debt crisis in the 1980s, the Mexican Peso crisis of 1994 and the Asian financial crisis of 1997.[7]

While official debt still constitutes to be a major source of external funding for some developing countries, the proportion of sovereign debt held by foreign

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[4] Rodrigo Olivares-Caminal, 'Sovereign Bonds: A Critical Analysis of Argentina's Debt Exchange Offer' (2008) 10 Journal of Banking Regulation 28, 34.

[5] Rodrigo Olivares-Caminal, *Legal Aspects of Sovereign Debt Restructuring* (2009), 385.

[6] Mauro Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation* (Springer International Publishing 2015), 3.

[7] UNCTAD, *Trade and Development Report 2015* (United Nations Publication ISBN 978-92-1-112890-1, 2015), 124. UNCTAD: Trade and development report 2015, 124-129.

private investors has increased dramatically after the Global Financial Crises.[8] A crucial nuance lays in a composition of those foreign private investors' holdings. The authors of an extensive study showed that at end-2012 about 80 per cent of total foreign holdings in emerging market government debt (excluding official foreign loans) were attributed to foreign nonbank investors while the part owned by foreign banks had shrunk.[9] Those observations can be explained by a recent shift in the form of instruments used by private investors. On the brink of the 21st century, private creditors of emerging markets switched from commercial bank loans to bonds.[10]

In the middle of the 20th century, sovereign bonds were a small fraction of external debt stock associated with developed countries having investment-grade ratings.[11] However, sovereign bonds' outstanding amount rapidly increased at the end of the century from about $20 billion in 1980 to about $225 billion in 1993.[12] The event associated with a turning point for a rapid utilisation of a bond financing by highly indebted emerging countries is the implementation of the Brady plan in the 1990s constituting an exchange of outstanding foreign bank loans into new sovereign bonds. Such debt instruments being more suitable for secondary market transactions than bank loans shortly became popular among a diverse group of creditors, creating a new liquid secondary market and becoming a significant source[13] of funding for emerging countries. Since 2010, bonds denominated in foreign currency have been the fastest-growing source of financing even for lower-income economies.[14]

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[8] Serkan Arslanalp and Takahiro Tsuda, *Tracking Global Demand for Emerging Market Sovereign Debt* (International Monetary Fund 2014), 19 (The investor is foreign if his residency differs from the country which sells debt).

[9] Ibid (According to authors 'as of end-2012, we estimate that foreign nonbanks (i.e. foreign asset managers[, insurance companies, pension funds, and investment funds]) held about US$800 billions of EM government debt, or about 80 percent of total foreign holdings (excluding foreign official loans)').

[10] Unitary Training Programs on Foreign Economic Relations, Doc 1, Sovereign Debtors and Their Bondholders (2000), 4.

[11] Philip R Wood, 'Essay: Sovereign Syndicated Bank Credits in the 1970s' (2010) 73 Law and Contemporary Problems 7, 7.

[12] HV Morais, 'Legal Framework for Dealing with Sovereign Debt Defaults' in Robert C. Effros (ed), *Current Legal Issues Affecting Central Banks*, vol 5 (International Monetary Fund 1998), 323.

[13] Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation, 351*; see also Daniel Marx, Jose Echague and Guido Sandleris, 'Sovereign Debt and the Debt Crisis in Emerging Countries: The Experience of the 1990s' in Chris Jochnick and Fraser A. Preston (eds), *Sovereign Debt at the Crossroads: Challenges and Proposals for Resolving the Third World Debt Crisis* (Oxford University Press 2006), 68.

[14] IMF and WB, 'The Evolution of Public Debt Vulnerabilities in Lower Income Economies' (2020), 17 ('Eurobond issuances have almost tripled from an average of $6 billion per annum during 2012–16 to about US$16 billion per annum in 2017– 18 and several countries have become new issuers').

At the same time, a new instrument due to dispersed base of stakeholders has brought new risks associated with a more complex debt restructuring process. Resolution of a debt crisis involves tens of thousands of bondholders spread worldwide.[15]

B. Legal Aspects of Sovereign Bonds

Especially those bonds are at risk of the obstructed restructuring process that are regularly named as international sovereign bonds.[16] While at first glance the roots of the definition of international sovereign bonds can be associated with the fact of participation of foreign creditors in the process of purchasing and holding sovereign bonds or because the bonds are denominated in a foreign currency, the definition refers to the applicable law. It is common to use a governing law or a jurisdiction as a benchmark for the definition:

> 'International sovereign bonds are defined as bonds issued or guaranteed by a government or central bank under a law other than the law of the issuer (or where a foreign court has jurisdiction over claims arising under the bond), in the freely traded form with fixed maturities, normally in excess of one year.'[17]

With the rapid development of technologies and globalisation of financial markets, it is no more practical to group the bonds concerning the location of creditors as the prior distinctive characteristics are blurred now. For instance, it became popular, partly because of the low yields of debt in developed countries for foreign creditors to invest into domestic bonds of emerging countries,[18] which have a higher return and were initially devised for the local investors.

While the impact of the law is usually underplayed in the sovereign debt field due to widespread opinion that the sovereign immunity doctrine leaves creditors

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[15] Marx, Echague and Sandleris, 'Sovereign Debt and the Debt Crisis in Emerging Countries: The Experience of the 1990s', 68.

[16] See IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use' (2002), 3*;* IMF, *Staff Report Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* (2014); and IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts' (2015) .

[17] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 2.

[18] Eduardo Borensztein and others, *Sovereign Debt Structure for Crisis Prevention* (International Monetary Fund 2005), 9 (Providing examples of how international and domestic debt markets have become recently integrated in Argentina, Uruguay, Mexico and Russia).

empty-handed, it has a crucial and ever-expanding role in structuring sovereign debt markets.[19]

The modern market for international sovereign bonds is relatively sizable with the outstanding stock at an approximate level of US$ 915 billion on July 31, 2015.[20] International sovereign bonds are used mostly by emerging countries. The explanation behind it is that exposure to well-established foreign law and judicial system grants more certainty to private creditors lending to developing countries.

Unlike developed countries, their emerging peers experience difficulties in issuing domestic local-currency bonds due to a structural lack of credibility for monetary and fiscal policy, and creditors' fears of inflation and default.[21] Indeed, a study of sovereign defaults during 1820–2003 by Sturzenegger and Zettelmeyer provided a stylised fact that in the post-war period defaults occurred only in developing countries, particularly those situated in Africa and South America.[22] A vivid outlier from a non-defaulted group of developed countries is Greece, which underwent a restructuring of the record-breaking amount of sovereign debt in 2012.[23]

It is worth noting that developed countries also issue sovereign bonds to foreign investors in high quantity; however, most of them use their local law and currency.[24] Thereby, those securities constitute domestic bonds usually issued under a special set of regulation which characterised by its simplicity and differs significantly from the rules for sovereign bonds issued in the same jurisdiction but by a foreign government.[25] It is argued that strong domestic institutions that protect

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[19] W Mark C Weidemaier and Mitu Gulati, 'The Relevance of Law to Sovereign Debt' (2015) 11 Annual Review of Law and Social Science 395 (Authors stress that 'legal rules and institutions (a) decide when a borrower is sovereign, (b) define the consequences of sovereignty by drawing (or refusing to draw) artificial boundaries between the sovereign and other legal entities, (c) play some role in cases of state and government succession, and (d) determine the extent to which the rules of sovereign immunity can be changed by contract').

[20] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 9.

[21] Borensztein and others, *Sovereign Debt Structure for Crisis Prevention, 3.*

[22] Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (MIT Press 2006), 10.

[23] Jeromin Zettelmeyer, Christoph Trebesch and Mitu Gulati, 'The Greek Debt Restructuring: An Autopsy' (2013) 28 Economic Policy 513, 2 (Stating that the Greek debt exchange of 2012 'set a new world record in terms of restructured debt volume and aggregate creditor losses, easily surpassing previous high water marks such as the default and restructuring of Argentina 2001-2005').

[24] UK Gilt bonds, U.S. Treasury bonds, Japanese government bonds.

[25] The US issues Treasury bonds under the premises of 31 U.S.C. Subtitle B, Chapter II, Subchapter A, while foreign governments follow the Schedule B of the Securities Act of 1933 for a bond issue.

investors are prerequisites for issuing debt under domestic parameters.[26] However, for every rule, there is an exception, and the situation is somehow different for some developed countries who are members of the Eurozone which sometimes issue bonds subject to foreign law making them vulnerable to the same risks as emerging countries have during a debt restructuring process.[27] The reason for borrowing under foreign law for governments even when they are members of the Eurozone is lower rates, which are especially evident in times of crisis.[28] In other words, a single currency of the union does not eliminate political and financial risks associated with a country.

Therefore, the focus of this thesis is explicitly set on the study of international sovereign bonds which are prone to complicated and protracted debt restructuring process due to legal leverage possessed by bondholders through bonds' exposure to foreign governing law or jurisdiction. Even though governing law and jurisdiction are fundamental characteristics of any contract, they portrait some distinctive features and have important implications if one of the parties to a contract is a sovereign state itself.

Governing Law

From the outset, it is necessary to mention that there is a rising belief among experts of sovereign debt that private law cannot cope sufficiently with a myriad of various aspects which emerge from global financings, such as geopolitical interests, economic growth, global financial stability, global governance, development and human rights.[29] Nevertheless, the status quo in sovereign debt still shows the prevalence of private law in emergency events, like sovereign bond restructuring. Therefore, special attention should be paid to the governing private law applicable to a specific sovereign bond contract to address problems in sovereign debt restructuring.

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[26] Michael Bradley, Irving De Lira Salvatierra and G Mitu Gulati, 'A Sovereign's Cost of Capital: Go Foreign or Stay Local' (2016) Duke Law School Public Law & Legal Theory Series.

[27] Gregory H Shill, 'Boilerplate Shock: Sovereign Debt Contracts as Incubators of Systemic Risk' (2015) 89 Tulane Law Review 751, 55.

[28] Marcos Chamon, Julian Schumacher and Christoph Trebesch, 'Foreign-Law Bonds: Can They Reduce Sovereign Borrowing Costs?' (2018) 114 Journal of International Economics 164; Andrew Clare and Nicolas Schmidlin, 'The Impact of Foreign Governing Law on European Government Bond Yields' (2014) Available at SSRN 2406477.

[29] Juan Pablo Bohoslavsky and Yuefen Li, 'Filling a Legal Global Gap in Sovereign Financing: UNCTAD's Principles' 7, in *Matthias Audit and Stephan Schill, The Internationalization of Public Contracts (Bruylant 2016).*

Sovereign bonds issued in the international markets can be governed either by domestic or by foreign law. Over the last 200 years, governing law practices undergone significant changes shifting from public to private contracting.[30] It was unthinkable to issue sovereign bonds under foreign law about until the beginning of the twentieth century. Domestic statutes and practically non-existent documentation reflect the understanding of the sovereign bonds as an exercise of a state's public functions.[31] However, after World War II, the practices shifted to private law contracting with the widespread use of the covenants and foreign governing law, which can be seen as a way to protect bondholders against default.[32]

A paradoxical situation, inconceivable for contractual relationships between private commercial parties, emerges to the extent that relationships under a bond contract are governed by domestic law because a state should apply those rules to itself which it proclaims, creating a possibility for abuse. In this regard, domestic law can be easily manipulated by the issuer to unduly extract benefits from bonds. For instance, the law can be changed to alter the applicable debt restructuring procedure, as was the case in the 2012 Greek debt restructuring when the unanimous consent of all bondholders to allow for a restructuring requirement in bonds governed by Greek law was substituted by the binding effect of the collective action provision on holdouts introduced by legislation.[33] In a flagrant scenario, a sovereign may even directly change the payment terms through new domestic regulation. A treatise by Wood specifies moratorium, exchange controls, laws that annul contractual provisions, and legal tender laws as instances how sovereigns may change the law to the detriment of their creditors.[34]

Investors aware of risks, especially concerning the emerging market borrowers, typically avail themselves of a highly developed and more credible foreign jurisdiction which is not prone to the said conflict of interests. A foreign

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[30] Michael Waibel, 'Eurobonds: Legal Design Features' (2016) 12 Review of Law & Economics 635, 635.

[31] Ibid.

[32] Ibid.

[33] See Zettelmeyer, Trebesch and Gulati, 'The Greek Debt Restructuring: An Autopsy', 525 (Stating that over 86% (€177.3 billion) of Greek bonds eligible for restructuring were issued according to Greek law, and without retrospective inclusion of the collective action clause through legislation the Greek debt restructuring would be practically unfeasible).

[34] *Philip R Wood, Conflict of Laws and International Finance, vol 6 (Sweet & Maxwell 2007), 70.*

governing law of a bond contract guarantees that a sovereign debtor could not interfere with rules applicable to creditor-debtor relations.

The choice of the governing law has crucial implications for determining and interpreting contractual relationships, as every jurisdiction has its own body of law and existing practice and hence provides the framework for the sovereign debt restructuring, i.e., litigation and transactional aspects of a debt restructuring depend on the applicable law.

The most popular laws of foreign jurisdictions for international sovereign bonds coincide with the global financial centres, and is leading by New York law, followed by English law; together those laws govern approximately 96 per cent of the total outstanding stock of international sovereign bonds.[35] There is a tendency to employ the governing law of that country which has closer economic and political ties with a sovereign borrower: while Latin American countries tend to prefer to issue bonds under the U.S. law, its European and African peers mostly select English law.

Given this situation, the primary focus of the analysis is on the norms and practices relating to sovereign bonds governed by New York law and English law. At the same time, the findings in this monograph can be extrapolated, with some adjustments, to the law of other jurisdictions.[36]

Choice of Forum

The governing law aspect shall be distinguished from that of the applicable jurisdiction, which also affects parties to the contract in case of a dispute yet in a different way. The primary purpose of the applicable jurisdiction clause is the choice of the forum, which will have the power to adjudicate the dispute between the parties to a bond contract. Alternatively, an arbitral tribunal instead of a foreign court may be employed for the same task by the inclusion of an arbitration clause. The use of arbitration for settling a dispute arising from sovereign debt is unusual. Nevertheless, arbitration clauses have been used by some countries such as Brazil.[37] According to

[35] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 3 (‘As of July 31, 2015, of the total outstanding stock of international sovereign bonds, approximately 50 per cent are governed by New York law and approximately 46 percent by English law (as a share of nominal principal amount)’).

[36] Rodrigo Olivares-Caminal and others, *Debt Restructuring* (1st edn, Oxford University Press 2011), 418 (The author notes that ‘bonds issued under German law are comparable to bonds issued under New York law; and, bonds issued under Japanese and Luxembourg law are comparable to bonds issued under English law’).

[37] Prospectus of 21 July 2016 for 5.625% Global Bonds due 2047 issued by Federative Republic of Brazil, at p 13.

Brazilian law, foreign courts could not adjudicate on the merits any dispute involving the state.

Borrowers are concerned about getting a fair trial and creditors prioritise a forum which provides fair and speedy judgement. Like with the choice of governing law, creditors are aware that domestic courts of the sovereign borrowers are prone to be biased. There is a risk that a domestic court will not satisfy a monetary claim against a government.[38] Furthermore, a sovereign can alter legislation to limit remedies available to a bondholder.

Besides, the reason to choose one or another jurisdiction for creditors may also reside in a higher probability to enforce the judgement granted by a local court in a particular jurisdiction due to the availability of assets.[39] As stated by some commentators, a trading volume toward the United States, the United Kingdom and Europe constitute an important factor for choosing a forum, as traded assets can be used to satisfy a court decision.[40]

The choice of law and choice of the forum are independent categories even though they usually concur: legal relationships between the parties involved, even though with some limitations resulting from sovereign immunity,[41] are adjudicated by the domestic courts of the state of applicable governing law. Concurrence between the governing law and applicable jurisdiction ensures to resolve uncertainty when a court applies an unfamiliar to itself law.[42] However, a bond issue can be governed by laws of one country but at the same time be subject to adjudication by the court or arbitration panel in another country.

While it is difficult and, in some instances, improper to prioritise applicable jurisdiction over the applicable law, it seems that the former trumps the latter. Jurisdictions in exceptional cases may decline to apply a governing law of the contract if there is a conflict with the law or public policy of the forum.[43] In the end,

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[38] Stephen J. Choi, Mitu Gulati and Eric A. Posner, 'The Evolution of Contractual Terms in Sovereign Bonds' (2012) 4 Journal of Legal Analysis 131, 139.

[39] Albert S Pergam, 'Eurocurrency Credits: Legal Questions and Documentation', *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer 1985), 279*; Issam Hallak, 'Courts and Sovereign Eurobonds: Credibility of the Judicial Enforcement of Repayment' (2003) CFS Working Paper No 2003/34.*

[40] Issam Hallak, 'Governing Law of Sovereign Bonds and Legal Enforcement' in Robert W Kolb (ed), *Sovereign Debt: From Safety to Default* (John Wiley & Sons 2011), 209.

[41] W Mark C Weidemaier*,* 'Sovereign Immunity and Sovereign Debt' (2014) University of Illinois Law Review 67, 69.

[42] Olivares-Caminal and others, *Debt Restructuring,* 390.

[43] Philip R Wood, *Conflict of Laws and International Finance*, vol 6 (Sweet & Maxwell 2007), 36 and 64.

the power of the court to interpret the law in its manner makes the letter of the law a secondary concern for the creditors.

C. Restructuring of International Bonds as a Part of Sovereign Debt Constellation

Whereas the primary enquiry of this thesis is devoted to the legal structure and restructuring mechanism of international sovereign bonds, a stipulation is required. The categorisation of sovereign debt from either a legal or an economic perspective, e.g., into international and domestic, is inadequate for sovereign debt crisis management. It is problematic due to the easiness of how debt composition and legal characteristics may alter, especially during the turbulent time of debt restructuring.[44] Such categorisation cannot provide an efficient all-embracing basis for the debt crisis management, which usually affect every constituency of the sovereign debt, i.e., bilateral, multilateral and private debt.[45]

However, due to the lack of a universal institutionalised debt restructuring mechanism every debt crisis management procedure usually consists of a chain of separate restructuring events of different debt instruments with different creditors and governed by a different set of rules. Those restructuring events typically are performed synchronically and have a cumulative effect on achieving a sustainable level of debt. In this regard, debt sustainability is defined 'as a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure.'[46]

Therefore, a study of distinct mechanisms of restructuring has a crucial impact on the overarching goal of debt crisis management. Moreover, restructuring of international sovereign bonds seems to be the most chaotic domain which needs improvement.[47]

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[44] Gelpern Anna and Setser Brad, 'Domestic and External Debt: The Doomed Quest for Equal Treatment ' (2004) 35 Georgetown Journal of International Law 795, 796 (Stating that 'today, a lawyer's domestic bond - one that is governed by local law - may well look like external debt to an economist, because it is denominated in foreign currency and/or held by an offshore fund. Even more common, a lawyer's external bond - one that is governed by foreign law - looks like domestic debt to an economist, because it is held by a bank or other local financial institution).

[45] See Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, 'Restructuring Sovereign Debt: Lessons from Recent History' (2013) In IMF Seminars, Conferences and Workshops Financial Crises: Causes, Consequences, and Policy Responses, 28 (Concluding that 'twin restructurings' of external and domestic debt have become the norm in recent years').

[46] Timothy Geithner, 'Assessing Sustainability' (2002) International Monetary Fund, Policy Development and Review Department 1.

[47] UNCTAD, *Trade and Development Report 2015,* 129.

II. CREDITOR COORDINATION PROBLEMS IN SOVEREIGN BONDS AND IMPLICATIONS FOR DEBT RESTRUCTURING

A. Holdouts in Debt Restructuring

The coordination problem among creditors during the debt restructuring process is a fact of life.[48] There is always a risk that an individual bondholder will be passive or pursuing pecuniary interest will act against the restructuring slowing or precluding the process. Back in 1740, David Hume pointed out the coordination problem observing that:

> 'Two neighbours may agree to drain a meadow, which they possess in common; because it is easy for them to know each other's mind; and each must perceive that the immediate consequence of his failing in his part, is, the abandoning the whole project. But it is very difficult, and indeed impossible, that a thousand persons should agree in any such action; it being difficult for them to concert so complicated a design, and still more difficult for them to execute it; while each seeks a pretext to free himself of the trouble and expense, and would lay the whole burden on others.'[49]

An application of game theory to sovereign debt restructuring reveals that the coordination problem among creditors is a classic example of the 'prisoner's dilemma.'[50] In its variation, the 'creditor's dilemma,' the bondholders are inclined to pursue individual remedies in debt restructuring even though it is in the general interest of bondholders as a group to reach a restructuring agreement with a borrower. Depending on the conditions of the restructuring offer and the borrower's ability to repay, nonparticipation of some creditors can make all creditors worse-off.[51]

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[48] Lee C Buchheit and Mitu Gultai, 'Sovereign Bonds and the Collective Will' (2002) 51 Emory Law Journal 1317, 1324 ('This was, is, and ever shall be the "holdout creditor problem" in a debt workout').

[49] David Hume, David F Norton and Mary J Norton, *David Hume: A Treatise of Human Nature: Volume 1: Texts* (Clarendon Press 2007), 345.

[50] Stephen Bainbridge, 'Comity and Sovereign Debt Litigation: A Bankruptcy Analogy' (1986) 10 Maryland Journal of International Law and Trade 1, 12; William N. Eskridge, Jr., 'Les Jeux Sont Faits: Structural Origins of the International Debt Problem' (1984) Virginia Journal of International Law 281, 347; John A. C. Conybeare, 'Public Goods, Prisoners' Dilemmas and the International Political Economy' (1984) 28 International Studies Quarterly 5.

[51] Bi Ran, Marcos Chamon and Jeromin Zettelmeyer, 'The Problem That Wasn't: Coordination Failures in Sovereign Debt Restructurings' (2016) 64 IMF Economic Review 471, 475.

What is crucial to understand is that the 'creditor's dilemma' has repercussions on the debtor as well, especially in the absence of incentives for creditors provided by a bankruptcy system.[52] It is estimated that sovereign debt restructuring takes on average almost eight years to complete, and most debtors emerged out of default more indebted when they defaulted.[53] Therefore, the resolution of the 'creditor's dilemma' should take into account that protection of the sovereign debtor is at least an equally important policy goal as regulation of competition among creditors.[54]

As stated by the UNCTAD Trade and Development Report, recurrent sovereign debt crises constitute the biggest threat to global financial governance.[55] Its cause seems to be in the divergence between economics and law due to the absence of a multilateral 'bankruptcy' framework for sovereigns which would deal with coordination problems.[56] Various international and non-governmental organisations, academics and politicians have tried to fill this gap by unsystematic contractual or regulatory proposals;[57] however, the legal development still has lagged to accommodate the novel needs of the financial system placing the actors into distress and uncertainty.

The central aspect of the restructuring of the sovereign bonds is that in the absence of any statutory restructuring mechanism, the process has a consensual nature. In contrast to corporate borrowers, sovereigns do not have the possibility to use bankruptcy procedures that provide a 'set of tools' specifically alleviating value destruction of the insolvent company, e.g., debtor-in-possession financing, automatic stay, etc. Those tools designed to provide strong incentives to achieve a consensus between a borrower and creditors about restructuring.[58] As a result, the only option available to the sovereign – ad hoc restructuring procedure – must be as quick as possible in order to mitigate the destructive effect of the lengthy default. Unless the

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[52] Jeffrey D Sachs, 'Do We Need an International Lender of Last Resort?' (1995), 6.

[53] David Benjamin and Mark LJ Wright, 'Recovery before Redemption: A Theory of Delays in Sovereign Debt Renegotiations' (2009) Available at SSRN 1392539.

[54] Rory Macmillan, 'Towards a Sovereign Debt Work-out System' (1995) 16 Northwestern Journal of International Law & Business 57, 75.

[55] UNCTAD, *Trade and Development Report 2015,* 147.

[56] This monograph does not have a purpose nor intention to assess the necessity for, pros and cons of multilateral 'bankruptcy' framework for sovereigns.

[57] Some examples of the proposals are provided at p 50.

[58] Steven L Schwarcz, 'Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach' (2000) 85 Cornell Law Review 956, 959 ('Agreement on a plan of reorganization is rewarded, failure to agree is penalized. As a result, most corporate restructurings are consensual').

bonds under restructuring incorporate collective action clauses which allow a majority of bondholders to bind the rest, those creditors who do not accept a restructuring offer may pursue any enforcement action to get full repayment. However, even the presence of the collective action clauses does not guarantee an unproblematic restructuring.[59] Naturally, this creates a disincentive to every bondholder to accept the restructuring in the first place.

Private creditors' cooperation in sovereign debt restructuring has never been smooth even during the period characterised by the concentration of institutional creditors, commercial banks, in the 1970s and 1980s.[60] Some banks chose to holdout and collected payments without extending additional credit, which was expected from every bank involved in debt restructuring, to tackle with a debt problem.[61] The landmark case in this regard is Allied Bank Int'l v Banco Credito Agricola de Cartago, where only one, Fidelity Union Trust Company of New Jersey, of the thirty-nine banks in the Allied Syndicate refused to participate in the restructuring and initiated an enforcement procedure.[62] A similar situation happened in A.I. Credit Corp. v. Government of Jamaica. Among 113 banks and other financial institutions that restructured the debt in 1984, only AICCO pursued litigation.[63] Those cases were the harbingers of the growing threat of frivolous litigation in sovereign debt restructuring due to the development of the secondary markets for sovereign debt.[64] The usual strategy involves buying distressed debt on the secondary market at a fraction of its face value and enforcing full repayment.

The expansion of actors and instruments in the sovereign debt market through bond financing exacerbated coordination problems among creditors during the debt

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[59] W Mark C Weidemaier, Mitu Gulati and Anna Gelpern, 'When Governments Write Contracts: Policy and Expertise in Sovereign Debt Markets' in Grégoire Mallard and Jérôme Sgard (eds), *Contractual Knowledge: One Hundred Years of Legal Experimentation in Global Markets* (Cambridge Studies in Law and Society, Cambridge University Press 2016), 111 ('While Greece demonstrated that CACs could not block holdouts, Argentina demonstrated that holdouts were a real threat. Suddenly, the triumph of 2003 and the brand-new European initiative modelled after it looked woefully incomplete').

[60] Charles Lipson, 'Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts' (1985) 38 World Politics 200, 203 (Commenting on difficulties related with debt renegotiations among commercial banks that 'aside from the technical difficulties of rescheduling so many types of financial instruments, there is no simple harmony of interest among creditors').

[61] Marx, Echague and Sandleris, 'Sovereign Debt and the Debt Crisis in Emerging Countries: The Experience of the 1990s', 67.

[62] 733 F.2d 23 (1984).

[63] 666 F.Supp. 629 (1987).

[64] The concern was raised by the U.S. Department of Justice already in the 1990s, see Pravin Banker Associates, Ltd. v Banco Popular del Peru, 895 F.Supp. 660 (1995).

restructuring process. The more participants are involved in a restructuring, the more acute are the coordination problems. Distinct from creditors in sovereign bond markets, commercial banks involved in syndicated loans are usually exposed to subsequent financial relationships, e.g., participation in future syndicated loans, correspondent banking facilities or interbank lines of credit.[65] Such interaction among banks has a direct impact on their behaviour during a debt restructuring, which is characterised by an economic conception of repeated games. The basic idea is that the likelihood of future reprisal can deter participants in the restructuring from short-run opportunism.[66]

Furthermore, banks are susceptible to political pressure, e.g. from the bank regulators, in their decision whether to demand full enforcement of the sovereign debt contract or consent to the debt restructuring.[67] Such informal mechanisms facilitate policy coordination and are especially crucial in the absence of an official institution for debt restructuring.[68] However, the sovereign bond market due to its highly dispersed and heterogeneous base of creditors, which usually will not have other grounds for interaction among themselves, is lacking the abovementioned leverage to enhance coordination.

The creditors' base of the sovereign bond markets was numerous and with heterogeneous interests already at the beginning of the 19th century.[69] With the increasing size and complexity of the modern financial markets, this characteristic became even more distinct. A sovereign bond issue is usually held simultaneously by various creditors such as retail investors, brokers, banks, hedge funds, pension funds and insurance companies. It is suggested that the New York market for sovereign bonds is dominated by institutional investors, whereas the London market

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[65] M. Milivojević, *The Debt Rescheduling Process* (Frances Pinter Publishers, Limited 1985), 94*; Donald R Lessard and John Williamson, Financial Intermediation Beyond the Debt Crisis (Institute for International Economics 1985),* 42.

[66] Joseph Farrell and Eric Maskin, 'Renegotiation in Repeated Games' (1989) 1 Games and Economic Behavior 327, 327.

[67] Lee C Buchheit, 'The Role of the Official Sector in Sovereign Debt Workouts Symposium: Sovereign Debt Restructuring' (2005) 6 Chicago Journal of International Law 333, 339; Rory Macmillan, 'The Next Sovereign Debt Crisis' (1995) 31 Stanford Journal of International Law 305, 331.

[68] Lipson, 'Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts', 205.

[69] Frank Griffith Dawson, *The First Latin American Debt Crisis: The City of London and the 1822-25 Loan Bubble* (Yale University Press 1990), 213 ('The £21,000,000 Latin American debt was owned initially by at least 25-30,000 bondholders').

has higher participation of the retail investors.[70] However, it seems that the borders are blurred as in both markets we can observe high numbers of retail creditors. It is estimated that bond restructurings of Argentina in 2005 under New York law and Ukraine in 2000 under English law affected 600,000 and 100,000 retail investors, respectively.[71]

Another complication adds the fact that the horde of the bondholders is mostly anonymous and neither borrower nor the bondholders themselves know the identity of their peers.[72] This is due to the practice of issuing bonds as bearer instruments or as permanent global bonds which are held indirectly through clearing systems.[73] The accounts of the clearing systems are confidential precluding identification and direct engagement of the bondholders.[74] On top of that, there is usually another layer of intermediaries, banks, which in their turn maintain accounts for the beneficial owners.[75] The anonymised environment makes it more difficult and expensive to coordinate bondholders. The non-participation of the bondholders in debt restructuring is not necessarily dictated by the will to holdout but can occur due to the bondholders' unawareness about the ongoing restructuring.

On top of the information asymmetry, the coordination problem is exacerbated by high transaction costs. Bondholders incur information costs to determine the optimal terms of debt restructuring and also face communication costs of agreeing and successfully voting for the changes,[76] primarily due to the requirement of a high approval rate for a successful vote, which can vary but typically is 75 per cent of a bondholder quorum.[77] How could one expect the participation of

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[70] W Mark C Weidemaier and Mitu Gulati, 'How Markets Work: The Lawyer's Version', *From Economy to Society? Perspectives on Transnational Risk Regulation*, vol 62 (Emerald Group Publishing Limited 2013).

[71] Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts* (International Monetary Fund 2012), 21.

[72] Buchheit and Gultai, 'Sovereign Bonds and the Collective Will', 1320.

[73] Mark B Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back' (2010) 73 Law and Contemporary Problems 273.

[74] Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation,* 367.

[75] Andrew Yianni, 'Resolution of Sovereign Financial Crises–Evolution of the Private Sector Restructuring Process' (1999) 6 Financial Stability Review 78, 82.

[76] Marcel Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights' (2002) 77 New York University Law Review 1040, 1057.

[77] See Mitu Gulati & Eric A. Posner Stephen J. Choi, 'The Dynamics of Contract Evolution' (2013) 88 New York University Law Review, 26; Mitu Gulati and Anna Gelpern, 'Innovation after the Revolution: Foreign Sovereign Bond Contracts since 2003' (2009) 4 Capital Markets Law Journal 85, 91.

retail investors if even fund managers are strongly opposed to being a part of the restructuring procedure? Fund managers prefer to either sell the bonds or 'free ride' on other's efforts to restructure due to lack of resources and considering restructuring as something out of their business scope.[78]

Besides the absence of the institutionalised framework and some informal mechanisms for greater coordination in sovereign bond restructuring, contractual arrangements which could partially substitute a restructuring regime, in fact, are another source of risk. Sovereign bond contracts are often portrayed as a classic example of boilerplate contracts, i.e. contract terms are highly standardised among market participants for the specific type of the transaction.[79] While those contracts have some significant benefits such as facilitating liquidity and creating a market for a financial instrument via network effects, by the same token, deeply embedded terms of the contract may be a reason for negative externalities.[80] Contractual provisions which became a market practice are tremendously rigid in adapting to new realities that even clearly obsolete terms may be used without changes for a long time by inertia. Moreover, in extreme scenarios, boilerplate terms[81] may cause a domino effect: 'a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences.'[82]

Relating to sovereign bond contracts, provisions like the controversial *pari passu* clauses, widespread absence of enhanced collective action clauses[83] and the dominance of fiscal agency agreements instead of trust structures,[84] which empower individual bondholders and aggravate creditor coordination problems, is a serious peril to orderly debt restructuring.

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[78] G-10, *The Resolution of Sovereign Liquidity Crises* (A Report to the Ministers and Governors Prepared Under the Auspices of the Deputies, 1996), 35.

[79] For an excellent overview and analysis, see Mitu Gulati and Robert E. Scott, *The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design* (University of Chicago Press 2012) and Mitu Gulati & Stephen J. Choi, 'Innovation in Boilerplate Contracts: An Empirical Examination of Soverign Bonds' (2004) 53 Emory Law Journal 930.

[80] Shill, 'Boilerplate Shock: Sovereign Debt Contracts as Incubators of Systemic Risk', 762.

[81] American Bar Foundation, *Commentaries on Indentures* (American Bar Foundation 1971), 3 (boilerplate terms are defined by the ABA as 'practically "non-negotiable", not in the sense that they cannot be negotiated, but in the sense that they seldom are in fact negotiated and as a practical matter in most cases ought not to be').

[82] Steven L Schwarcz, 'Systemic Risk' (2008) 97 Georgetown Law Journal, 198.

[83] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 9 (As of July 31, 2015, 'approximately 6 percent of the outstanding [international sovereign bond] stock includes enhanced CACs, of which New York law governed bonds account for approximately 4 percent').

[84] Ibid.

The literature provides abundant theoretical and practical information on coordination problems in capital markets[85] and *inter alia* among sovereign creditors during restructuring. Initially, most of the studies were devoted to the economic analysis of coordination problems in a sovereign debt restructuring.[86] From an economic perspective, coordination problems are explained by conflict between creditors' individual and collective interest which develops into the free-rider problem.[87]

However, its mechanics is dependent on case-by-case legal characteristics of contract renegotiation and enforcement. Typically, an uncooperative bondholder will hold out from a restructuring offer and will use litigation as a tool to enforce the original bond terms or get a better deal from a sovereign borrower. Holdout and litigation are acknowledged as the most acute threat to sovereign bond restructuring.[88] Even a small number of holdouts, estimated as few as five to ten per cent for corporate bond restructuring, could eliminate the beneficial effect of the restructuring if a borrower is forced to pay the full face value of the bond.[89] Moreover, as most sovereign bond restructurings are performed in combination with the provision of IMF funds and concessional lending from other international actors, there is a high risk that those 'rescue' funds will be misallocated to the holdout creditors instead of to be used for the public interest of the country's population.

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[85] E.g., see Lucian Arye Bebchuk and Marcel Kahan, 'A Framework for Analyzing Legal Policy Towards Proxy Contests' (1990) 78 California Law Review 1071, 1080 (discussing collective action problem in context of shareholder voting).

[86] See W.R. Cline, *International Debt and the Stability of the World Economy* (Institute for International Economics 1983); and Paul Krugman, 'Financing vs. Forgiving a Debt Overhang' (1988) 29 Journal of Development Economics 253.

[87] Krugman, 'Financing vs. Forgiving a Debt Overhang', 254 (Meaning that 'any individual creditor would be better off if it could opt out of the new lending [or write-downs] and let other creditors carry the burden'*).*

[88] See Das, Papaioannou and Trebesch, 'Restructuring Sovereign Debt: Lessons from Recent History', 20; Julian Schumacher, Christoph Trebesch and Henrik Enderlein, 'Sovereign Defaults in Court' (2018) Available at SSRN 3134528, 14; IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts'; Weidemaier, Gulati and Gelpern, 'When Governments Write Contracts: Policy and Expertise in Sovereign Debt Markets', 111.

[89] IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use', 2; John C. Coffee and William A. Klein, 'Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations' (1991) 58 The University of Chicago Law Review 1207, 1214.

B. Frivolous Litigation

The fact of litigation and enforcement of borrower's obligations does not constitute a problem per se. A threat originates from individual bondholder rights to demand full repayment if they are used to extract a beneficial settlement holding out of the debt restructuring at the expense of the majority bondholders who participate in the restructuring. With recent legal developments, such frivolous litigation seems to be the most significant present obstacle for orderly sovereign debt restructuring.[90] Frivolous litigation hinders debt sustainability as the conditions of the debt restructuring designed to restore debt sustainability cannot account to the full extent what percentage of the non-participated bondholders turns to litigation and the outcome of it.

It should be noted that the term 'holdout litigation' is used omnipresently in the literature to describe any litigation initiated to free ride and secure a better deal than envisaged by sovereign debt restructuring. However, from the legal point of view, it makes sense to distinguish between pre-restructuring litigation and after-restructuring litigation even though both of them stem from the same coordination problem.[91] In this regard, the holdout litigation corresponds to after-restructuring litigation as it is pursued by the creditors who held out from the debt restructuring.

While CACs can ameliorate holdout litigation to some extent as they force the non-participating bondholders to accept the conditions of the restructuring, they are not preventing after-restructuring litigation if some bond issues do not pass a voting threshold to be restructured.[92] The Greek debt restructuring of 2012 is a vivid example as it left about Euro 6.5 billion or 30 per cent of the total value of debt governed by foreign law in unrestructured claims prone to litigation even though all the related bond issues contained collective action clauses.[93]

Further, CACs have no use in precluding pre-restructuring litigation. To the contrary, the CACs can incentivise the pre-restructuring litigation in order to secure a better deal.[94] The IMF recently noted that the severeness of the coordination

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[90] UNCTAD, *Trade and Development Report 2015,* 137.

[91] Sturzenegger and Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*.

[92] N.B. single limb CACs aggregating all outstanding issues can solve this problem, but it will take long time, if at all, before they will be a part of all bond documentation.

[93] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring' (2014), 5.

[94] See Chapter 4.IV.C. Collective Legal Action at p 120.

problems in a pre-default situation when a swiftness in debt restructuring is essential.[95]

A keynote case is a legal confrontation between Argentina and distressed debt fund NML Capital, Ltd and includes both instances of the pre-restructuring and holdout litigation. The Argentine *pari passu* saga started over a decade ago. As early as 1994, Argentina issued international bonds under the fiscal agency agreement.[96] After a few years of economic hardship and unsuccessful attempts to stabilise its financing,[97] Argentina defaulted on the external sovereign debt at the end of 2001. It was the largest sovereign default in history, involving approximately US$102.6 billion.[98]

In 2005, Argentina started the restructuring procedure, maintaining its recalcitrant position towards investors.[99] In effect, it was a 'take it or leave it' offer. Argentine politicians repeatedly pointed out that the hold-out of the restructuring investors would not be paid.[100] The pressure on the bondholders culminated in the enactment of Law 26,017 (Lock Law), which prohibited any further restructurings and payments to the hold-out creditors. Interesting enough that the practice of embodying some restructuring terms into domestic law prior negotiations with creditors was occasionally used by sovereign borrowers to empower their bargaining position in the past as well.[101]

Before the exchange was settled, NML Capital initiated pre-restructuring litigation. It planned to attach defaulted bonds tendered to the debtor by participating bondholders in the 2005 debt exchange and sell them in satisfaction of the future judgments. It was not the first time Elliott Associates, a hedge fund behind NML Capital entity, used a legal strategy to interfere with debt flows to force a sovereign

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[95] IMF, 'Refromig the Fund's Policy on Non-Toleration of Arrears to Official Creditros' (2015), 13.

[96] See Fiscal Agency Agreement between the Republic of Argentina and Bankers Trust Co., dated 19 October 1994.

[97] See generally *Brad Setser and Anna Gelpern, 'Pathways through Financial Crisis: Argentina' (2006) 12 Global Governance 465.*

[98] NML Capital, Ltd., 699 F.3d 246, 252 (2d Cir. 2012).

[99] Ibid, 252.

[100] Ibid.

[101] Edwin Montefiore Borchard and J.S. Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles*, vol I (Beard Books 1951), 310 (Chilean government in negotiation with bondholders took a stance that its authority in negotiating the settlement could not surpass the limits imposed by recently passed Law No. 5580 of January 31, 1935 which embodied the restructuring offer).

debtor into a settlement.[102] However, this time NML Capital failed. The courts of appeal in upholding the judgment of the lower court refusing the attachment stated that the court

> 'acted within its discretionary authority to vacate the remedies in order to avoid a substantial risk to the successful conclusion of the debt restructuring. That restructuring is obviously of critical importance to the economic health of a nation.'[103]

This represents one of the examples when courts recognise public interests in sovereign debt litigation. However, the history shows that another time, another court could come to a different, less lenient for a sovereign borrower conclusion.[104]

In the end, the 2005 offer was closed with a 76 per cent participation rate.[105] Five years later, the second restructuring took place with similar conditions as those applied in the 2005 offer. The Lock Law was temporarily suspended to legitimise the 2010 offer, exemplifying how the sovereign borrower can change domestic law for its own interests. After the 2010 offer was closed, the total participation rate increased to 93 per cent.[106] Both 2005 and 2010 offers were structured according to the regime laid down by the trust indenture.

In contrast to hold-out bonds, payments on the restructured 2005 and 2010 bonds were made in time up to the point where they were effectively blocked by the New York court. One of the hold-out bondholders, NML Capital, Ltd. (NML), persistently attempted to collect the money[107] by escalating Argentina's cost of default. As a holder of the bonds issued under the 1994 fiscal agency agreement governed by New York law, NML used its individual enforcement rights and initiated litigation. After protracted proceedings, New York courts decided that Argentina was violating the *pari passu* clause in its old non-restructured bonds under the 1994 fiscal

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[102] Elliott Associates LP v Republic of Panama, 975 F.Supp. 332 (S.D.N.Y. 1997); Elliott Associates LP v Banco de la Nacio ́n (Peru), 194 F.3d 363 (2d Cir. 1999).

[103] EM Ltd. v Republic of Argentina, 131 Fed.Appx. 745 (2d Cir. 2005).

[104] Matthias Goldmann and Grygoriy Pustovit, 'Public Interests in Sovereign Debt Litigation: An Empirical Analysis' (2018) Available at SSRN 3122602.

[105] Ibid.

[106] See 'Moody's: Holdout Creditors Have Not Been an Obstacle to Sovereign Debt Restructurings', Moody's, Available at <https://www.moodys.com/research/moodys-holdout-creditors-have-not-been-an-obstacle-to-sovereign--pr_270542>.

[107] W Mark C Weidemaier and Anna Gelpern, 'Injunctions in Sovereign Debt Litigation' (2014) 31 Yale Journal on Regulation 189, 194 ('At various times, NML has tried to seize defaulted bonds tendered in the 2005 debt exchange, central bank funds on deposit at the Federal Reserve Bank of New York and the Bank for International Settlements, owed by French companies to Argentina, the presidential airplane, and a military ship docked in Ghana').

agency agreement and was therefore ordered to make the 'ratable payments' to NML concurrent with or in advance of its payments made on the 2005 and 2010 restructured debt.[108] The judgment shook up financial markets because of its innovative interpretation of the *pari passu* clause[109] and triggered an extensive discussion within academia.[110] However, the mere conclusion that Argentina had breached the contractual clause was not enough to make Argentina pay. Therefore, the court envisaged an unusual remedy for the sovereign debt litigation, namely the specific performance allegedly required by the *pari passu* clause.

The design of the injunction placed Argentina in a dilemma: either pay everyone ratably or default on everyone at the same time.[111] As a lever regarding Argentina, the court threatened to sanction financial market intermediaries and any other parties for contempt of court if any of them would be involved with Argentina in the payment on the 2005 and 2010 restructured debt without ratably paying NML. Argentina disregarded the injunction, trying to fulfil its payment obligations on 30 June 2014 only towards exchange bondholders. The sovereign timely deposited the required US$539 million with the Bank of New York Mellon, which is the indenture trustee for bonds governed by New York law.[112] Naturally, fearing liability in the financial mecca, the trustee resisted forwarding the money further to the bondholders, contrary to the court's order. Starting from June 2014, the payments[113] due on the 2005 and 2010 restructured debt were not received for many months violating the most important bondholder right to receive interest payments on time.[114]

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[108] See NML Capital, Ltd., 699 F.3d 246, 265 (2d Cir. 2012).

[109] Rodrigo Olivares-Caminal, 'The Pari Passu Clause in Sovereign Debt Instruments: Developments in Recent Litigation' (2013) 72 BIS Papers No 72 121, 121.

[110] See, e.g., Anna Gelpern, 'Sovereign Damage Control' (2013) Peterson Institute for International Economics Working Paper 2013-PB13 1, W Mark C Weidemaier, Robert Scott and Mitu Gulati, 'Origin Myths, Contracts, and the Hunt for Pari Passu' (2013) 38 Law & Social Inquiry 72 and Benjamin Chabot and Mitu Gulati, 'Santa Anna and His Black Eagle: The Origins of Pari Passu?' (2014) Available at SSRN 2397929.

[111] Weidemaier and Gelpern, 'Injunctions in Sovereign Debt Litigation', 196.

[112] See the official statement by Argentina, dated 26 June 2014, Available at: <http://www.prensa.argentina.ar/2014/06/26/50961-la-argentina-pago-los-bonos-de-los-que-entraron-en-el-canje.php>.

[113] See 'Investors sanguine as Argentina defaults', Financial Times (online), 31 July 2014, Available at: <http://on.ft.com/1ocza01>.

[114] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1045.

Once the protracted litigation was settled in 2016, providing an outrageous return worth multiple times their original investments for the holdout creditor,[115] it became a dangerous precedent for further sovereign debt restructurings. As stated by the International Monetary Fund, the court ruling may induce a wave of holdout instances, as the version of *pari passu* clause, which is especially favourable to holdout creditors, contained in Argentina's bond contract is widespread in New York and English law bonds issued after 2000.[116] Tomz and Wright estimate that 74 per cent of existing bonds of the main emerging market borrowers contain such version of the *pari passu* clause.[117] Also, from the economics perspective, a new enforcement mechanism granted by the court's injunction provides nearly equal chances for repayment in case of holding out as of participating in a restructuring.[118] Moreover, a new risk that repayments to creditors agreed for restructuring can be blocked creates an additional disincentive to participate in the restructuring in the first place.[119]

A separate risk left as a legacy out of Argentina's debt litigations is the inception of class actions against sovereign borrowers upon default. HW Urban GmbH v Republic of Argentina case is prominent as the first class action by bondholders against a sovereign certified by a US court.[120] And likewise, Abaclat and Others v. Argentine Republic is the first ICSID arbitral proceedings involving groups of bondholders.[121] In analogy to corporate bond practices, such precedents cleared the road to increase in litigation by decreasing its costs for bondholders and to non-meritorious suits, which 'may be brought by plaintiffs' lawyers as class actions with the quiescence of a bondholder with a minimal economic stake in the

[115] Elli Louka, *The Global Economic Order: The International Law and Politics of the Financial and Monetary System* (Edward Elgar Publishing 2020), 276 (According to estimations, lenders received 186-952 percent return on the provided credit).

[116] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring', 10 ; also, see Anna Gelpern 'Missed Payment Date Musings - Offshore Openings, Free Riding the Free Riders, and Argentina's 'Uniqueness' Available at <http://www.creditslips.org/creditslips/2014/06/missed-payment-date-musings.html> and Mark Weidemaier 'Argentina's (not so) unusual pari passu clause' Available at <http://www.creditslips.org/creditslips/2012/11/argentinas-not-so-unusual-pari-passu-clause.html>.

[117] Michael Tomz and Mark LJ Wright, 'Empirical Research on Sovereign Debt and Default' (2013) 5 Annual Review of Economics 247, 256.

[118] Julian Schumacher, *Sovereign Debt Litigation in Argentina: Implications of the Pari Passu Default* (2015), 4.

[119] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring', 12.

[120] HW Urban GmbH v Republic of Argentina (No 02 Civ 5699 (TPG), 2003.

[121] Abaclat and Others v Argentine Republic, ICSID Case No. ARB/07/5.

outcome',[122] against sovereigns. The class action procedure de facto allows a judge to determine the terms of the exchange offer, i.e. debt restructuring, performing the role of a bankruptcy court all the while escaping the proper check and balances imposed by the bankruptcy regime.[123]

Besides the developments in the New York case law, an additional motivation for creditors litigation and hold out in sovereign debt restructuring emanate from European practices. In particular, a recent 'precedent of treating holdouts so gently' in Greek debt restructuring.[124] Precisely the risk of litigation in the UK is seen as a reason not to impose a coercive haircut on Greek English-law bondholders which hold out from the restructuring.[125]

Further, a court decision under English law in Assenagon Asset Management SA v. Irish Bank Resolution Corporation Ltd complicated future sovereign debt restructurings. The ruling by High Court undermined the efficacy of the use of exit consents to incentivise acceptance of debt restructuring terms by establishing additional limits on how coercive exchange offer can be.[126]

According to commentators, sovereign debt litigation and enforcement has changed dramatically over the last few decades. The litigants could use different creative strategies pursuing different legal outcomes, albeit linked to the same collective action problem.[127] The Argentine case is not merely an outlier but a proper indicator of the trend towards a more hostile legal confrontation between a sovereign borrower and its creditors with increasing negative externalities for the former.[128] In particular, the number of debt crises involving litigations has increased more than fivefold in comparison to the number experienced in the 1980s and early 1990s, and disputed amounts account now on average 4 per cent of restructured debt or 1.5 per cent of debtor country GDP tending to increase.[129]

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[122] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1056.

[123] John Drage and Catherine Hovaguimian, 'Collective Action Clauses (CACs): An Analysis of Provisions Included in Recent Sovereign Bond Issues' (2004) 17 Financial Stability Review, 12.

[124] Zettelmeyer, Trebesch and Gulati, 'The Greek Debt Restructuring: An Autopsy', 553.

[125] Ibid.

[126] Assenagon Asset Management SA v Irish Bank Resolution Corporation Ltd [2012] EWHC 2090 (Ch) (27 July 2012).

[127] For more details see Chapter 4.IV.C. Collective Legal Action at p 120.

[128] Schumacher, Trebesch and Enderlein, 'Sovereign Defaults in Court', 1 (Authors derive the conclusion from an extensive analysis of sovereign debt litigation cases in jurisdictions which constitute major markets for sovereign debt, such as New York and London).

[129] Ibid.

A striking fact is that mostly smaller and poorer countries which already have substantial economic problems are exposed to destructive sovereign debt litigation.[130] Those countries are an easy target for formidable multibillion distressed debt funds which are mainly accountable for litigation.[131] According to the empirical research, the impact of litigation generally results in such negative externalities for a country as (i) a loss of access to international capital markets, (ii) a decline in international trade, and (iii) delays in crisis resolution.[132]

It worth noting that delays, especially those caused by holdouts due to its various enforcement strategies to induce the borrower into a settlement by disrupting its trade and capital flows,[133] in sovereign debt restructuring usually have a direct impact on the population of the country by aggravating their economic conditions,[134] and may even preclude the observance of vital human rights.[135]

[130] Ibid (For instance, 'two HIPC examples are Nicaragua (in the 1990s) and Liberia (in the 2000s) where lawsuits amounted to 5.9% and 4.3% of GDP, respectively').

[131] Ibid ('distressed debt funds now account for 75% of cases').

[132] See ibid.

[133] Ibid ('the externalities caused by such creditor action can be much larger than the value of the litigated claims themselves, e.g. in the Republic of Congo, where litigious creditors blocked the country's oil exports for years.').

[134] Andrei Shleifer, 'Will the Sovereign Debt Market Survive?' (2003) 93 The American Economic Review 85, 87 (Stating that 'litigation delays settlement, possibly prolonging recessions and raising the cost of IMF programs.').

[135] Juan Pablo Bohoslavsky and Matthias Goldmann, 'An Incremental Approach to Sovereign Debt Restructuring: Sovereign Debt Sustainability as a Principle of Public International Law' (2016) 41 The Yale Journal of International Law 13, 31.

CHAPTER 2. EVOLUTION OF CREDITOR COORDINATION IN SOVEREIGN BOND MARKETS

This chapter provides context and background for the emergence of trusteeships to be explained in Chapter 3. It is an inquiry into the evolution of coordination mechanisms between sovereign creditors, with a focus on bondholders, and institutional frameworks which facilitated this coordination. The goal is less to display the details of specific cases than to understand more generally the development of coordination mechanisms, institutions and legal framework which adapted to the new realms of international finance over the long run.

In this regard, sovereign debt crises revealed that the development of the legal framework and institutions for bondholder coordination lagged behind financial innovation. The challenges for sovereign debt restructuring changed with the political and legal environment. However, the main issue has persistently been the same – coordination problem of bondholders. New circumstances require adaptation and deployment of new legal solutions.

I. FORMATION OF INTERNATIONAL SOVEREIGN BOND MARKETS AND BONDHOLDER COORDINATION

A. Early Sovereign Debt Market and Institutions Coordinating Creditors

Sovereign bonds are an old financial instrument which has been used by states since a long time ago. Contrary to conventional wisdom created by the proliferation of bank loans in the second half of the 20th century, as a matter of fact, bonds were a major instrument used by private creditors to finance governments for many centuries.[1] For instance, Italian city-states, which are considered as the birthplace of modern public debt,[2] used bonds to borrow from its wealthy citizens but also from foreign lenders to finance warfare and budgetary expenses back then in the 13th

[1] Michael Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (Student edition edn, Princeton University Press 2007), 201 (Referring to the 'episode of bank lending to foreign sovereigns is a historical blip').

[2] See Charles P Kindleberger, *A Financial History of Western Europe* (Oxford University Press 1993); and James Macdonald, *A Free Nation Deep in Debt: The Financial Roots of Democracy* (Farrar, Straus and Giroux 2003).

century.[3] Nevertheless, issues of bondholders' coordination, especially before the 19th century are understudied.[4] This is partly explained by scarce and fragmented information available to scholars.

While the majority of the scholarship is focused on institutions for bondholder coordination that emerged after the second half of the 19th century, such as the Corporation of Foreign Bondholders in England and the Foreign Bondholders Protective Council in the United States, it seems that, at least on a basic level, the institutional structure used by Italian city-states to administer debt as of 13th century has similarities with modern structures of bond financing and might bear interesting policy-related parallels to current sovereign debt issues. In particular, institutional and legal solutions were used to coordinate and protect the interests of bondholders.

The use of government agencies by Venice and Florence, the *Camera degli imprestiti* and *Monte* respectively,[5] recalls the fiscal agency structure where the governmental agency is an agent of the borrower fulfilling routine tasks associated with the lifespan of bonds. Additionally, those agencies facilitated transactions with sovereign bonds on surprisingly liquid secondary markets in early Italian republics where '[g]overnment credits could be sold, used as collateral, or given as dowry,' by registering every operation of transfer of title as the bonds were not a bearer instrument.[6] The use of non-bearer bonds allowed to identify and coordinate an owner of a security if renegotiation of the bond terms were necessary.

Furthermore, the creation of semiprivate consortium *Casa di S. Giorgio* in 1407 as a financial intermediary to manage the debt of Genova represents a more sophisticated organization. It was an institutionalised creditors committee with broad powers, which fulfilled the role of creditors' representative and mediated their interests with the state, and at some point, even got control over revenues of the state as collateral for debt and payment of interest.[7] Institutionally, the *Casa di S. Giorgio* was governed by eight *Protectors* who were elected among major bondholders by

[3] See Luciano Pezzolo, 'Bonds and Government Debt in Italian City-States, 1250-1650' (2005) The origins of value: The financial innovations that created modern capital markets 145, 147 and 154.

[4] For instance, see Marc Flandreau, 'Sovereign States, Bondholders Committees, and the London Stock Exchange in the Nineteenth Century (1827–68): New Facts and Old Fictions' (2013) 29 Oxford Review of Economic Policy 668, 673('as researchers must know … but curiously ignore, bondholders committees were started long before the creation of the CFB').

[5] Pezzolo, 'Bonds and Government Debt in Italian City-States, 1250-1650', 152.

[6] Ibid.

[7] Ibid.

the communal *Great Council*[8] on an annual base.[9] According to Pezzolo, the consortium with this structure enjoyed autonomy from the Genoese government in the unstable political environment, characterised by changes in the government, and successfully protect sovereign creditors having full jurisdiction over sovereign debt disputes.[10]

A similar institutional structure for public debt management was employed later by the papal government in the early sixteenth century through the establishment of the legally recognised consortia of bondholders – colleges – which along with efficient fulfilment of administrative and payment functions also defended the interests of bondholders.[11] In contrast to the collective model of governance at the Genoese *Casa di S. Giorgio*, a college was headed by a banker who usually bought the lion's share of securities straight from the Apostolic Chamber. Besides, a Cardinal-protector was designated as a middleman for Apostolic Chamber with college.

As in many other cases,[12] the relationships between banks and bondholders were prone to conflict of interests. Moreover, the lack of information exacerbated this conflict.[13] Presumably, to prevent heads of colleges from abusing their powers towards creditors, their relations were regulated. For instance, creditors were conferred in 1609 with a right to receive interest payments from heads of college even in instances when the corresponding money was not received from the Apostolic Chamber.[14]

In this regard, the earlier institutions entrusted to manage debt enhanced coordination in the government bond market by consolidating information about the identity of the bondholders and, in some instances, even by acting on behalf and for the interest of bondholders. Those structures tried to balance the power between

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[8] Chrisitne Shaw, 'Counsel and Consent in Fifteenth-Century Genoa' (2001) CXVI The English Historical Review 834, 834 (‘the main Genoese consultative and deliberative assembly - called by modern historians for the sake of convenience the Great Council *(Gran Consiglio*’).

[9] Luciano Pezzolo, 'Sovereign Debts, Political Structure, and Institutional Commitments in Italy, 1350–1700' in D'Maris Coffman, Adrian Leonard and Larry Neal (eds), *Questioning Credible Commitment: Perspectives on the Rise of Financial Capitalism* (Cambridge University Press 2013), 172.

[10] Ibid.

[11] Ibid.

[12] See fn 30.

[13] Pezzolo, 'Sovereign Debts, Political Structure, and Institutional Commitments in Italy, 1350–1700', 189 (Relatives and friends living in the Eternal City were the main sources of information for the potential investors in papal bonds).

[14] Ibid.

creditors and their agents by employing collective decision-making bodies elected on temporary bases (as was the case in Genoese *Casa di S. Giorgio)* and liability incentives such as the unconditional right to receive payments from the consortia of bondholders.

Those innovative institutional structures for sovereign debt administration with centralised involvement of creditors contributed to the creditors' confidence in Genoese and papal bonds as some of the most reliable securities in Early Modern Europe.[15] Nevertheless, those structures were not transparent for bondholders and prone to conflict of interests.

B. Boom of the Sovereign Debt Market and Lagged Development of Coordination Mechanisms

The next innovation in sovereign bonds might be attributed to the emergence of the international market for sovereign bonds in the 18th century in the Netherlands, which allowed sovereign states to escape the territorial limits of budgetary financing through taxation by taping foreign lenders.[16]

One of the main developments which proclaimed the beginning of the modern capital market for sovereign loans and bonds was the disentanglement of political considerations from financial ones in foreign lending by adopting a policy of neutrality by the Dutch Republic in 1713.[17] The new policy allowed a Dutchman to invest in the debt of foreign governments even though it could be seen from a political perspective as financing an adversary state.

Initially, most of the foreign sovereign debt held by Dutch investors was British, however, after the consolidation of British debt in 1751 it lost its lucrative appeal, and Dutch creditors turned to more promising financing of its close neighbours expanding the array of sovereign borrowers with time.[18]

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[15] Ibid.

[16] James Riley, *International Government Finance and the Amsterdam Capital Market, 1740–1815* (Cambridge University Press 1980), 103; The importance of debt for modern state budgets is discussed in Chapter 6.III.C. Social Justice and Sovereign Debt Restructuring.

[17] Jan de Vries and Ad van der Woude, *The First Modern Economy: Success, Failure, and Perseverance of the Dutch Economy, 1500–1815* (Cambridge University Press 1997), 142.

[18] Ann M Carlos and Larry Neal, 'Amsterdam and London as Financial Centers in the Eighteenth Century' (2011) 18 Financial History Review 21, 39.

The heyday for the Dutch sovereign debt market came only some decades later.[19] At the end of the 18th century, largely because of North Atlantic geopolitical tension the Dutch commerce went into decline,[20] and a shift from commercial to sovereign financing occurred. Among various governments issuing debt on the Dutch sovereign debt market were Great Britain, France, Sweden, Poland, Russia, and Spain.[21] This change had a fundamental influence on the sovereign debt market as it preserved 'the individualistic credit structure of commercial finance' which is prone to overextension of accepting credit and liquidity crises as a result.[22] One may expect that along with an expansion of foreign lending, new legal and institutional frameworks emerged to enhance coordination between creditors and their protection. However, the new market was not prepared to respond to risks of dealing with sovereign debt stemming from asymmetric information and powers of stakeholders; creditors blindly believed in the reliability of unsecured sovereign bonds.[23]

This period was characterised by relationships with highly asymmetrical information, unprotected interests of creditors and flawed institutional structure. There was not a countervailing force to oppose unsound sovereign borrowing as sovereign bondholders at the Amsterdam market were rarely acting together;[24] the interaction between a sovereign and bondholders occurred in individual, *ad hoc* fashion. One of the reasons is that the identification of creditors was a difficult task, because of the practice of issuing bearer securities compromised the use of lists of subscribers and records of performed transactions.[25] It was difficult to locate bondholders even for borrowers, with the only opportunity to do it on the payment dates when bonds were presented for payments. The investors base was heterogeneous and consisted of rentiers, greater and lesser bourgeoisie including members of the liberal professions, and institutional investors, such as religious and charitable organisations.[26]

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[19] Marten Gerbertus Buist, *At Spes Non Fracta: Hope & Co. 1770-1815; Merchant Bankers and Diplomats at Work* (Nijhoff 1974), 520.

[20] Larry Neal, *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason* (Cambridge University Press 1993), 226.

[21] Riley, *International Government Finance and the Amsterdam Capital Market, 1740–1815, 44*.

[22] Ibid.

[23] Ibid.

[24] Ibid.

[25] Ibid.

[26] Ibid.

Also, as was noted by contemporaneous professional market participants, the financial literacy of investors was low, and they rarely assessed investment opportunities but relied on the advice of intermediaries.[27] Moreover, even if creditors tried to evaluate the creditworthiness of the sovereign debtor there was lack of sources to do it. Dutch periodicals did not provide sufficient political or commercial news, and hence information was usually obtained from unreliable private sources.[28]

Furthermore, there was no institution to protect the interests of bondholders. All main intermediaries of the Amsterdam sovereign debt market, such as bankers, brokers, and commission agents, were biased in favour of borrowers.[29] The relations of those market intermediaries with borrowers and lenders are characterised by double agency problem,[30] as they were simultaneously agents of both parties to the loan: debtor state and bondholders.[31] Under such institutional premises, it was exceptionally difficult for intermediaries to maintain a balance between diverging interests of principals: borrowers and lenders. In the case of the Dutch Republic capital market, bankers and commission agents attracted by potential benefits usually sided with borrowers to the detriment of creditors' interests. They were inclined to maintain better relationships with borrowers as only they allotted commissions and on top of that typically provided alternative commercial and financial prerogatives for intermediaries which successfully secured financing previously.[32]

The case of the Austrian serial defaults on bonds held mainly by Dutch investors at about 1800 is indicative in this regard.[33] In 1805, an anonymous Dutch bondholder, suffering considerable losses from three restructurings of Austrian debt in less than ten years, charged two Dutch banking houses, Verbrugge & Goll (since 1778 Goll & Co.) and Joan Osy & Zoon, which managed most of the Austrian bond issues in this period. The bankers were charged 'with negligence in permitting

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[27] Ibid (As stated by William Short: 'The money lenders in general are a class of heavy dull men, the sum of whose ideas consists in a few constant habits').

[28] Ibid and de Vries and van der Woude, *The First Modern Economy: Success, Failure, and Perseverance of the Dutch Economy, 1500–1815, 146*.

[29] Riley, *International Government Finance and the Amsterdam Capital Market, 1740–1815, 41*.

[30] An agent could pursue a self-interest instead of acting in the best interest of the principal.

[31] Riley, *International Government Finance and the Amsterdam Capital Market, 1740–1815, 52*.

[32] Ibid (Among alternative inducements the author names provision of insider information on state affairs which might trigger the price of commodities and securities, grant of commercial privileges and goods supply opportunities, etc).

[33] This example is drawn from ibid.

revision of the original conditions of Austria's foreign loans without the consent of lenders.' However, no civil liabilities were incurred by the bankers for haircuts suffered by the bondholder. It is crucial to mention that the bankers, in response to claims, identified themselves as 'only the agents of borrowers in a contractual relationship between borrower and lender alone.' Nevertheless, it is justified to say that Goll & Co. made some attempts, alas belatedly and vainly, to secure interests of creditors by establishing in 1808 an administrative office to manage Austrian securities in circulation to assist in the recovery of prices.

Moreover, intermediaries not only withdrew themselves from protecting the interest of creditors but also disturbed key information for investment decisions in order to achieve high participation of creditors in the issue of bonds. For instance, one of the common practices was to delusively market a loan as the last one,[34] meaning that the state is not willing to undertake additional debt in the foreseeable future. Another example of wrongful conduct is withholding information from the public that proceeds of loans are used to service outstanding debts, which indicates on lamentable condition of borrower's finances.[35]

All those practices arising from information asymmetries, weak institutional frameworks and poor coordination among creditors, combined led to the distorted perception of the risk by creditors.[36] This predictably resulted in a crisis with heavy losses for investors[37] and contributed to the demise of Amsterdam as a major capital market at the beginning of the 19th century.[38]

After the Napoleonic wars, Amsterdam gave away its status of the leading market for sovereign debt to London and was forced to play complementary roles.[39] The sovereign bond market became more complex with the further advance of

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[34] Ibid (Even though banking house 'knew that Russia wished to open an extended series of issues, and in fact preparations for subsequent loans were usually underway before the completion of the one current').

[35] Ibid.

[36] de Vries and van der Woude, *The First Modern Economy: Success, Failure, and Perseverance of the Dutch Economy, 1500–1815, 146* ('In the 1780s all foreign bonds paid interest rates in the 4.5 to 5.0 percent range, while the bonds of Holland paid 4 percent (before taxes)').

[37] Riley, *International Government Finance and the Amsterdam Capital Market, 1740–1815, 246* ('Combined losses from annulments and inflation between 1793 and 1840 would therefore be estimated at no less than f. 469 to 539 million, or 35 to 49 percent of the 1790 capital stock').

[38] de Vries and van der Woude, *The First Modern Economy: Success, Failure, and Perseverance of the Dutch Economy, 1500–1815,* 158.

[39] Carlos and Neal, 'Amsterdam and London as Financial Centers in the Eighteenth Century', 24 and Neal, *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason,* 223.

financial innovation increasing the mobility of capital. A remarkable event, which is named by Ferguson as the birth of the Eurobond market, occurred in 1822 when the Rothschilds devised and successfully executed the issue of Russian bonds simultaneously in dual markets and dual currencies. Under such an arrangement, investors could choose to demand the annuity payment in Russian roubles in St. Petersburg or pounds sterling in London.[40]

New bonds with its holders dispersed in two distanced and legally different jurisdictions, civil and common law, demanded new tools for creditor coordination. However, the change of the market's location from Amsterdam to London did not seriously affect the institutional structure of the sovereign debt market. As with the Amsterdam market, creditors on the London market were still scattered, had piecemeal information about sovereign borrowers[41] and heavily relied on intermediaries.[42] In this regard, Flandreau and Floris argue that the reputation of underwriters was vital if not the only source of information for creditors. Few superior firms such as Rothschilds and Barings were allegedly a quality mark signalling the high quality of the sovereign bond issue.[43]

However, there were no intermediaries whose task would have been the coordination of creditors and the promotion of their collective interest, especially if debt restructuring was necessary. Those market participants, which factually coordinated creditors, had little incentives not to cheat them. Information asymmetries and conflict of interests between investors and intermediaries recall the double agency problem from the Amsterdam market. Intermediaries had an unfeasible task to balance the interests of both their principals, creditors and borrowers. For instance, banks and venture capitalists, which provided investment advice to creditors, at the same time were underwriters of the securities issue.[44] Bearing the risk of losses from bonds unsold to the public, underwriters could not

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[40] Niall Ferguson, 'The First "Eurobonds": The Rothschilds and the Financing of the Holy Alliance, 1818–1822' in William N. Goetzmann and K. Geert Rouwenhorst (eds), *The Origins of Value: The Financial Innovations That Created Modern Capital Markets* (Oxford University Press 2005), 323.

[41] Gerardo della Paolera and Alan M. Taylor, 'Sovereign Debt in Latin America, 1820-1913' (2013) 31 Revista de Historia Económica, Journal of Iberian and Latin American Economic History 173, 205 (Before 1870s there were only a few newspapers which provided information 'on bond pricing and volumes traded, and also quotes on the political economy events of different countries.').

[42] Marc Flandreau and Juan H Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830' (2009) 69 The Journal of Economic History 646, 647.

[43] See ibid.

[44] Ibid.

provide unbiased information to creditors about these securities. For that reason, there were instances when banks, while distributing securities, concealed their underwriter role.[45]

A weak institutional framework, the acute problem of information asymmetry[46] and the absence of creditors collective involvement before the middle of the 19th century resulted in outrageous fraudulent schemes. The example is the issuance of securities by a factiousness state 'Poyais' organised by notorious Gregor MacGregor in 1822,[47] which were traded after the issuance almost on par with Peru's, Chilean's and Colombian's bonds.

Another example is loans issued to the public without prior approval of the debtor governments of Colombia and Chile.[48] Reckless lending to newly independent Latin American states culminated in the sovereign debt bubble of 1822-1825, which is referred to as the first instance where British foreign bondholders encountered a sovereign default on a mass scale.[49] This revealed the inadequacy of mechanisms for debt restructuring at the time, which will be analysed in the next part.

II. COLLECTIVISING BONDHOLDERS DURING THE FIRST LONG ERA OF BOND FINANCE

Bonded debt settlements, as it is now, in the 19th century were the product of negotiation and compromise for the mutual benefit of the involved parties. Until the post-war period, negotiations usually ended with an agreement to capitalise interest arrears and maturity extensions with occasional cases of reduction of interest payment or principal.[50] Unilateral settlements imposed by a debtor state seldom

[45] Ibid.

[46] Larry Neal, 'The Financial Crisis of 1825 and the Restructuring of the British Financial System' (1997) 22nd Annual Economic Policy Conference at the Federal Reserve Bank of St Louis, 34.

[47] Flandreau and Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830', 646 and 660.

[48] Giorgio Fodor, 'The Boom That Never Was? Latin American Loans in London: 1822-1825' (2002) University of Trento Discussion Paper No 5, 31.

[49] Neal, 'The Financial Crisis of 1825 and the Restructuring of the British Financial System', 16.

[50] Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (MIT Press 2006), 13.

occurred even in the past when the threat of litigation and attachment of its foreign property was not an issue for a sovereign debtor.[51]

Besides the main parties to readjustment – debtor government and creditors, issuing houses often tried to participate in negotiations and in some cases, took a leading role in the successful restructuring of the debt.[52] The practice of bondholder coordination by issuing banks prevailed in pre-war Germany and to some extent in Belgium and France.[53] However, having different motivations from creditors,[54] their actions often conflicted with bondholders' interest.[55] Therefore, bondholders lacking legal remedies to enforce their rights embraced the task of self-coordination through bondholder committees to leverage their position in sovereign debt restructurings. Although the experience of bondholders' committees in the pre-war period is largely positive for the orderly debt restructuring process, it seems that in the current legal environment, this solution will not yield similar results.

A. State Intervention

The most obvious way to fill the vacuum of the institutional framework for bondholder coordination was by involving the government to coordinate and defend its nationals holding foreign bonds vis-à-vis foreign governments. In fact, during the times of absolute theory of sovereign immunity, diplomatic protection was the only legal way to enforce the recovery of sovereign debt, as creditors did not have recourse either to domestic or to foreign courts and adjudicated bodies.[56] While there are many

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[51] Edwin Montefiore Borchard and Justus S Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles*, vol I (Beard Books 1951), 304 (One of rare examples, is Chilean decree law No. 5580 of January 31, 1935 establishing 'a plan for the service of Chile's external bonds, interest and amortization, in substitution for the service arrangement originally stipulated').

Other cases of debt repudiation, such as by the Soviet Union in 1918 and Costa Rica in 1920, are rather an exception and characterised by political than economic grounds. These cases were based on the illegitimacy of the previous regimes' debt. See Odette Lienau, *Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance* (Harvard University Press 2014).

[52] Gerardo della Paolera, Alan M Taylor, *Straining at the Anchor: The Argentine Currency Board and the Search for Macroeconomic Stability, 1880-1935* (University of Chicago Press 2007), 109 (E.g., the House of Rothschild, one of the most prestigious underwriters of the 19th century, headed a committee of Argentine creditors. The negotiations with Argentina government ended with a successful debt restructured in 1893).

[53] Rui Pedro Esteves, 'The Bondholder, the Sovereign, and the Banker: Sovereign Debt and Bondholders' Protection before 1914' (2013) 17 European Review of Economic History 389, 393.

[54] See supra fn 29; also Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries, 199* (According to his analyses 'of 637 foreign bonds launched during the 1920s reveals that the underwriter served as a fiscal agent in 84 percent of the cases').

[55] See Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 182 ff*; della Paolera and Taylor, 'Sovereign Debt in Latin America, 1820-1913', 212.

[56] For details see infra p 54.

instances when repayment matched a diplomatic or military intervention by a home state of the bondholders, a major question is whether the involvement of governments was a deliberate and consistent policy or largely coincident with actions out of some broader political interests of the state spillover on other inferior goals such as the recovery of sovereign debt for private creditors.

The most well-known and referenced cases of involvement of the British government, as a dominant country of foreign investments of those times,[57] in sovereign debt disputes are against Mexico in 1861, the Ottoman Empire in the 1870s, Egypt in 1880 and Venezuela in 1902.[58] However, one of the earlier instances of state intervention was the involvement of the British government in the restructuring of the first Anglo-Peruvian debt.[59]

The story originates from the issue of two series of bonds in 1822 and 1825 for a total sum of £1.491.480. Being already highly indebted, which once again hints to severe information asymmetries between sovereign borrowers and creditors and inadequate mitigation of it by market intermediaries, the government of Peru defaulted on its entire debt the same year when the last tranche was received. Not incidentally, the year of 1825 is generally characterised by a debt crisis for many Latin American countries.[60] It was a sudden bust after the booming lending caused by the realisation that the Latin American ventures were a bubble.[61]

For fifteen years, the British government withstood from decisive actions to defend the interest of bondholders, merely deploying British good offices in Lima to support bondholder's agents in negotiations with the Peruvian government. Only in the early 1840s, the British government began to more actively intervene in the dispute due to the start of costly guano supply from Peru. A special decree of 15 January 1842 was enacted requiring Peru to deposit half of its profits from guano

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[57] Herbert Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War* (Yale University Press 1930), 102.

[58] See Edwin Montefiore Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims* (Banks Law Publishing Company 1919), 313 and Michael Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge University Press 2011), ch 2; Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 287.

[59] The further analysis of restructuring is based on a journal article by William M Mathew, 'The First Anglo-Peruvian Debt and Its Settlement, 1822–49' (1970) 2 Journal of Latin American Studies 81.

[60] Neal, *The Rise of Financial Capitalism: International Capital Markets in the Age of Reason,* 172.

[61] William Smart, *Economic Annals of the Nineteenth Century ...: 1801-1820*, vol I (Augustus M. Kelley 1964), 295.

sales in Britain with the Bank of England to pay back the creditors. However, there are signs that this arrangement was mostly a personal initiative of Belford Wilson, the British pro-consul in Lima, than a policy of the British government to protect and represent bondholders. Moreover, despite the absence of payments to creditors, this decree was never enforced by the British government.[62]

A few years later, negotiations for a settlement began under consistent pressure exercised by creditors through the Committee of Spanish American Bondholders on the British government.[63] Again, the actions of the British government were very tentative and avoided any official diplomatic and even more so military intervention.

The bondholders using collective action took the lead in the settlement by appointing Messrs Maclean Rowe & Co. as their agent in Lima to conduct negotiations with Peru in 1847. Yet, the agent's participation proved to be unsuccessful. The agent submitted a restructuring proposal, but it was rejected with considerable delay by Peru. Peruvian authorities regarded the bondholders' agent as an incompetent party to conduct restructuring negotiations.

Presumably, after an intervention from Her Majesty's Government, direct negotiations between Peru and the bondholders' committee picked up some steam, and a restructuring agreement was signed on 31 January 1849. It was consequently abided by Peru propped by the collateralization of guano exports.[64] While the involvement of the British government certainly played a role in prompting restructuring of Anglo-Peruvian debt, Mathew suggests that the driving force to settle with bondholders was internal politics of Peru and its desire to tap the London money market, rather than the threat of diplomatic or military sanctions by Majesty's Government.[65]

Nevertheless, even such relatively cautious involvement of the British government into creditor coordination and protection vis-à-vis sovereign borrowers

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[62] Catalina Vizcarra, 'Guano, Credible Commitments, and Sovereign Debt Repayment in Nineteenth-Century Peru' (2009) 69 The Journal of Economic History 358, 372.

[63] About the committee see at p 57.

[64] Vizcarra, 'Guano, Credible Commitments, and Sovereign Debt Repayment in Nineteenth-Century Peru', 361.

[65] Other scholars have a concurrent view with regard Peru's motivation to settle the debt. For instance, see Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries,* 143; Vizcarra, 'Guano, Credible Commitments, and Sovereign Debt Repayment in Nineteenth-Century Peru', 371; and Desmond C. Platt, *Finance, Trade, and Politics in British Foreign Policy : 1815 - 1914* (Clarendon Press 1968), 34.

was an exception. There is evidence that in general, the British government was averse to act in the interest of bondholders.[66] Flandreau and Flores offer a plausible explanation arguing that the demands of British bondholders for trade sanctions were contrary to the competing interest of British merchants.[67] The latter wanted to maintain business with the Latin American market and exercised a considerably more political influence than bondholders.

Similarly, there were competing interests between British bondholders and British investors in the mid-19th century. For instance, the latter held substantial participation in the Mexican mining industry and were adamant at preserving peaceful relations between countries to safeguard their property.[68] It is not surprising that the same divergence of interests between the financial and commercial communities could be observed more than 80 years later when in 1937 the initiative of the bondholders' community for an embargo on trade credits for Egypt was opposed by bankers and traders.[69] Systematic research on sovereign debt enforcement via trade sanctions dismissed its use and relevance for sovereign debt restructurings even in cases when it was highly promising.[70]

According to Costeloe, the British government maintained a policy of no official intervention for the whole of the nineteenth century.[71] However, in 1848, on the initiative of Viscount Palmerston, it deliberately framed the doctrine of its involvement in sovereign debt disputes in such a way to permit the choice of any action it deemed suitable.[72] There is a view that the policy of no official interference

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[66] See Platt, *Finance, Trade, and Politics in British Foreign Policy : 1815 - 1914, 34*; Charles Lipson, 'International Debt and National Security: Comparing Victorian Britain and Postwar America' in Barry Eichengreen (ed), *The International Debt Crisis in Historical Perspective* (MIT Press 1989), 192; Waibel, *Sovereign Defaults before International Courts and Tribunals, 23*, Michael P Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888* (Praeger Publishers 2003), 301 ff.

[67] Flandreau and Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830', 649.

[68] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 315.

[69] Barry Eichengreen and Richard Portes, 'Settling Defaults in the Era of Bond Finance' (1989) 3 The World Bank Economic Review 211, 220.

[70] Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries,* 232 (For instance, the author 'found only two references to trade sanctions in more than 96,000 newspaper clippings about sovereign debt').

[71] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 312.

[72] Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War, 103*; and Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 314.

was entrenched due to strong lobbying by the Committee of Spanish American Bondholders.[73]

Interestingly enough, the government clearly understood that discretionary support to creditors was a useful way to mitigate creditor moral hazard: 'implicit repayment guarantees […] to creditors modify the relative risk properties of financial instruments ex post, prompting creditors to assume excessive risk ex ante.'[74] This argument is reciprocal, as borrowers with implicit guarantees of non-intervention on the part of the creditors' government are likely to be less responsive to the claims of creditors not fearing diplomatic retaliation.

Even though there were some cases when the repayment of debt was presumably an outcome of gunboat diplomacy by home states of bondholders, a prominent work of Tomz argues that there is no direct relationship between default and military intervention, as events were usually complicated by disputes relating to civils wars, territorial conflict, and tort claims besides financial problems.[75] In this regard, the vigorous interference of the British government to defend holders of Egyptian bonds in 1880 was deeply intertwined with imperial ambitions to control the Egyptian government and a matter of access to the Suez Canal.[76] Furthermore, British involvement into the establishment of the Ottoman Public Debt Administration in 1881 to fulfil obligations towards foreign bondholders was dictated among other things by the strategic and security interest in safeguarding the land route to India.[77] Similar considerations played an important role concerning diplomatic enforcement of the Greek and Persian debts on the brink of the 19th

[73] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 318.

[74] See Waibel, *Sovereign Defaults before International Courts and Tribunals, 25* (With a reference to Viscount Palmerston); and Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 312.

[75] Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries, 153* and Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 277 ff.

[76] Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War,* 108; and Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 314.

[77] Lipson, 'International Debt and National Security: Comparing Victorian Britain and Postwar America', 196; and David McLean, 'Finance and "Informal Empire" before the First World War' (1976) 29 The Economic History Review 291, 293.

century.[78] Furthermore, '[e]ven the famous intervention against Venezuela in 1902 was a tort case, not a bondholder war.'[79]

States mainly disregarded even the submission of sovereign bond cases to arbitral tribunals as a less intrusive way of diplomatic protection. A partial explanation for the reluctance of states lies in the unwillingness of tribunals prior to the Venezuelan arbitrations of 1903 to exercise jurisdictions for bond disputes in the absence of express authorisation for such disputes in the protocol, even if the protocol mentioned settlement of 'all claims'.[80]

As time passed, creditor governments tried to distance even further or at least disguise[81] their involvement in the enforcement of sovereign debt for private creditors. This incremental trend is evidenced by attempted or passed legal initiatives. The adoption of the Drago-Porter Convention in 1907 put some limits on the use of armed forces to enforce sovereign debt.[82] This principle became peremptory, without exceptions and generalised further to other constituencies of international relationships with the appearance of the Charter of the United Nations in 1945.[83] Later in the 1950s, a significant drift in understanding the limits of sovereign immunity began which finally transfigured in the replacement of the absolute theory of sovereign immunity by a restrictive theory in the US, the UK and customary international law in the 1970s, clearing the path for direct litigation between creditors and sovereign borrowers in foreign courts.[84]

Finally, in 2001, a grandiose plan to establish a statutory Sovereign Debt Restructuring Mechanism was launched by the IMF, which would ultimately

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[78] Lipson, 'International Debt and National Security: Comparing Victorian Britain and Postwar America', 200; McLean, 'Finance and "Informal Empire" before the First World War', 297.

[79] Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries, 153*; similar view is depicted by Lipson, 'International Debt and National Security: Comparing Victorian Britain and Postwar America', 203.

[80] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 266*.

[81] Lee C Buchheit, 'The Role of the Official Sector in Sovereign Debt Workouts Symposium: Sovereign Debt Restructuring' (2005) 6 Chicago Journal of International Law 333, 341(Arguing that control over a debtor country's fiscal affairs can be implicitly performed by creditor country via international institutions, e.g. the IMF by use of conditionality).

[82] Convention Respecting the Limitation of the Employment of Force for Recovery of Contract Debts, The Hague October 18, 1907 (However, it contains an exception allowing the use of armed forces if the debtor state is impeding the arbitration or its fulfilment).

[83] See Article 2 (4) of the Charter of the United Nations.

[84] Restrictive view on sovereign immunity was firstly acknowledge as the State Department policy in the letter by Jack B. Tate (26 Dep State Bull 984-85 June 23, 1952) but it was enacted only a few decades after in the Foreign Sovereign Immunities Act 1976 in the US and the Immunities Act 1978 in the UK.

separate sovereign debt from the diplomatic intervention of creditor government assuming that based on a universal treaty 'a single international judicial entity […] would have exclusive jurisdiction over all disputes that would arise between the debtor and its domestic and international creditors and among such creditors.'[85] Interesting to note that an ideologically similar proposal in favour of an international institution to adjudicate sovereign debt claims was advocated by German scholars almost a century before the IMF's initiative.[86] On both occasions, those plans were rejected; nevertheless, the idea to create a statutory *forum* for sovereign debt disputes has not vanished. It was revived later and put out on the global policy agenda by the United Nations deciding to elaborate and adopt a multilateral legal framework for sovereign debt restructuring processes.[87] Once again, the proposal was rejected but the initiative ended with the adoption of the Basic Principles on Sovereign Debt Restructuring Processes.[88]

B. Legal Remedies

Without state intervention, bondholders had mainly to rely on self-protection, which was challenging to maintain in an environment lacking judicial remedies against sovereign borrowers. Besides general reservations whether a bondholder may receive a fair trial in domestic courts of a sovereign borrower as discussed previously,[89] another obstacle was that many states even in the late 1910s, let alone earlier times, declined to subject themselves to suits involving public debt matters.[90]

Additionally, opposite to the present realities, it was almost impossible to sue a state in a foreign court due to sovereign immunity, as most of the courts, e.g.,

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[85] Anne O Krueger, 'A New Approach to Sovereign Debt Restructuring' (2002), 34.

[86] See 'Denkschriften: Errichtung eines Internationalen Schiedsgerichts für Streitigkeiten zwischen Privatpersonen und Ausländischen Staaten', *Berliner Jahrbuch für Handel und Industrie*, vol I (Berlin G. Reimer 1912), 497; Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 329.

Also see an earlier call by French scholar Alfred Neymarck in favour of public financial law ('le droit public financier') to regulate sovereign debt relationships and a proposal to create an international organisation 'La Banque des Etats' to supervise the issuance of foreign debt of states and guarantee its performance. Alfred Neymarck, *Finances Contemporaines: Questions Economiques et Financieres 1872-1904* (Librairie Guillaumin et cie 1905), 138.

[87] G.A. Res. 68/304 (September 9, 2014).

[88] G.A. Res. 69/319 (September 29, 2015).

[89] See supra at p 20.

[90] Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 305.

English, German, Austrian and the United States courts, declined to exercise jurisdiction over foreign states in connection to lawsuits regarding sovereign bonds.[91]

One of the revealing cases exemplifying the attitude of English courts toward lawsuits against sovereign borrowers is Crouch v. Crédit Foncier of England where the court argued with respect sovereign bonds that '[t]here can hardly properly be said to be any right of action on such instruments at all, though the holder has a claim on a foreign government.'[92]

In Twycross v Dreyfus case, the court went even further by doubting whether sovereign bonds constitute a binding agreement and mentioning the consent of the debtor state to be sued as a requirement for bonds enforceability in courts.

> '[…] these so-called bonds amount to nothing more than engagements of honour, binding, so far as engagements of honour can bind, the government which issues them, but are not contracts enforceable before the ordinary tribunals of any foreign government, or even by the ordinary tribunals of the country which issued them, without the consent of the government of that country.'[93]

Furthermore, the court described a 'national faith (that means the national honour, the national faith in the sense of good faith)' of the state as the only recourse for bondholders to demand fulfilment of bond terms. This view that the obligation of the debtor state is not binding in law has received much criticism on the point that sovereign immunities were wrongly interpreted as a substantial defence instead of the procedural.[94]

The United States courts similarly rejected jurisdiction over foreign states which had treaty relations with the United States. In Hassard v United States of Mexico, the suit to recover defaulted bonds and attach the property of the foreign state, the court proclaimed that '[i]t is an axiom of international law, of long-established and general recognition, that a sovereign State cannot be sued in its own courts, or any other, without its consent and permission.'[95]

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[91] Ibid.

[92] Crouch v Crédit Foncier of England (1873) LR 8 QB 374.

[93] Twycross v Dreyfus (1877) 5 Ch. D. 605.

[94] Clive M Schmitthoff, 'The International Government Loan' (1937) 19 Journal of Comparative Legislation and International Law 179, 188; F. A. Mann, 'The Law Governing State Contracts' (1944) 21 British Year Book of International Law 11, 13.

[95] For detailed discussion of this principle see also Mason v Intercolonial Ry. of Canada, 197 Mass. 349 (1908) and Oliver American Trading Co. v Government of U.S. of Mexico, 5 F.2d 659 (1924).

This principle was safeguarded by the United States District Attorneys, acting on instructions from the Attorney-General of the United States, by intervening into court's procedure as *amicus curiae* and calling court's attention to its lack of jurisdiction.[96]

While in England and other countries of the Anglo-American system[97] it was not allowed to initiate suits, including *ex contractu, quasi ex contractu or ex delicto,*[98] against foreign states without their voluntary submission to jurisdiction, it is curious to observe that the administrative law of some Continental Europe states already differentiated between public (*jure imperii*) and commercial (*jure gestionis*) acts of a state. This distinction was stimulated by increased state trading, especially in the 20th century.[99] For example, if a lawsuit involved a transaction of the state with *jure gestionis* nature, Belgium, French, Greek and Italian courts have exercised their jurisdiction.[100] The courts viewed a sovereign bond as an instrument of private law and inferred a voluntary consent to the jurisdiction from the bond contract or specific facts such as the assignment of the property or funds as security in the creditor country.[101]

Nevertheless, even if a satisfactory judgement were granted to the creditor, it usually would not be executed against the property of a foreign state even in the same jurisdiction.[102] Likewise, the fate of non-enforceability of the foreign judgement would occur in a third country.[103] As stated by the Protective Committee Investigation of the US Securities and Exchange Commission (SEC), the prospects of successful enforcement were tiny even if obligations of the debtor were guaranteed by certain revenues and property, which was a widespread practice in 19th century,

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[96] Hassard v United States of Mexico, 46 A.D. 623 (1899).

[97] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 162.

[98] John Westlake, *A Treatise on Private International Law* (7th edn, Sweet & Maxwell 1925), 267.

[99] Albert Venn Dicey and John Humphrey Carlile Morris, *Dicey, Morris and Collins on the Conflict of Laws : 2* (15th ed. edn, Sweet & Maxwell 2012), 339.

[100] See Schmitthoff, 'The International Government Loan', 186 and Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 166*.

[101] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 162.

[102] Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims, 307;* Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 158 and 169*.

[103] Frank Griffith Dawson and Ivan L Head, *International Law, National Tribunals, and the Rights of Aliens*, vol 10 (Syracuse University Press 1971), 257 (For an example of English courts).

due to the lack of efficient machinery to foreclose assets, only debtor's courts could perform this task.[104]

C. Multilateralisation: the Emergence of Bondholders' Committees

Even though there were many instances of unofficial governmental support,[105] creditors barely got any support from their governments with repayments, especially not such support which relied on threatening or using force against borrowers.[106] In rare cases, the negotiations were directly steered by the creditor government, as it was with respect of the substantial Argentinian default of 1891 which restructuring held with the support of the Bank of England.[107] In the majority of cases, creditors governments, being reluctant to intervene in sovereign debt disputes, explicitly encouraged bondholder associations to perform a primary role in the coordination of bondholders in negotiations with foreign states.[108]

As a response to the powerlessness of an individual creditor to enforce debt repayment through litigation or at least to rely on legal instruments to renegotiate debt with a sovereign borrower, in conjunction with weak diplomatic protection from creditor countries, bondholders began to unite into groups represented by committees. By multilateralization, bondholders were able to accumulate leverage in negotiations and lobbying for diplomatic protection,[109] share their costs,[110] impose heavier economic sanctions on the debtor particularly by shutting down his access to financial markets, e.g., through obstructing new issuance of debt on stock

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[104] SEC, Rep., Pt. V (May 14, 1937), 15 ff.

[105] See Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 244 ff.; Borchard, *The Diplomatic Protection of Citizens Abroad, or, the Law of International Claims,* 308; Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 301 ff.; Eichengreen and Portes, 'Settling Defaults in the Era of Bond Finance', 217 ff.

[106] For details see a section on State Intervention at p 45.

[107] Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War,* 108 ('[The Bank of England], however, declared itself not responsible for the proceedings or outcome').

[108] Waibel, *Sovereign Defaults before International Courts and Tribunals,* 26.

[109] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 305 ff.; and Lipson, 'International Debt and National Security: Comparing Victorian Britain and Postwar America', 202.

[110] For instance, according to Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 250 (The Committee of Mexican Bondholders joined Corporation of Foreign Bondholders in 1876 primarily for financial reasons).

exchanges.[111] Bondholder committees were usually the sole hope for bondholders to recover their investments due to the ineffectiveness of other mechanisms of debt restructuring.[112]

For much of the nineteenth and twentieth centuries, the main utility of bondholders' committees laid in their ability to inform bondholders about sovereign borrowers in default and on the status of negotiations with them. The scarcity of information available for bondholders was an important issue, especially before the 1870s – prior to the emergence of additional news sources such as Annual Reports by the Corporation of Foreign Bondholders (CFB).[113] In the case of the Mexican debt restructuring, Michael Costenloe noted that:

> "Those bondholders who lived in London also had access to the Committee's office where letters and other documents received... Most, however, did not live in the metropolis. One of bondholders in 1844 wrote to the Mexican Minister requesting details of the restructuring happened in 1837, 'I reside at a distance of nearly 300 miles from London and only gleam my information from newspapers on these matters and the information they give is very meagre and not always to be depended upon."[114]

Besides that, the information on foreign debt was scarce, the available one could have been manipulated.[115] As one may see, reports and other information from committees which appeared regularly in the press had an essential function for bondholders and their coordination. There was a widespread practice by committees to engage agents

[111] See Eichengreen and Portes, 'Settling Defaults in the Era of Bond Finance', 215; Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War,* 105; Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 174; Waibel, *Sovereign Defaults before International Courts and Tribunals,* 103.

[112] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 303.

[113] della Paolera and Taylor, 'Sovereign Debt in Latin America, 1820-1913', 206; about paucity of information in the beginning of 19th century see Flandreau and Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830', 660.

[114] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 158.

[115] Fodor, 'The Boom That Never Was? Latin American Loans in London: 1822-1825', 32 ('It is clear that there was a tight knit group that met regularly and exchanged information, paying journalists to promote loans and companies').

in the debtor countries whose task was to assess and report about political and other developments crucial for debt repayments.[116]

Also, committees performed an auditing function by advising bondholders whether a borrower was negotiating in good faith.[117] This information was crucial for the operation of a reputational mechanism as with its help creditors could 'distinguish between fair-weather payers and lemons' to bar the devious defaulting government from refinancing until an old debt is settled.[118] To enforce such sanctions, bondholder's committees had close relations with European stock exchanges, which refused to quote new loans to defaulted governments unwilling to negotiate in good faith.[119] In order to identify the 'lemons,' the London Stock Exchange relied on information from CFB.[120] In fact, the general policy to exclude the listing of securities by sovereign borrowers in arrears was established by the London Stock Exchanges in 1827,[121] long before the creation of the CFB in times of active proliferation of the ad hoc private bondholders' committees.

Ad hoc private bondholders' committees

Initially, private bondholders' committees were fragmented based on the nationality of bondholders and concerning to the individual state which owed them money. For instance, in the late 1820s, British investors created *ad hoc* regional committees with the task to restructure the debt of a specific state such as Colombia, Guatemalan, Spanish and Portuguese bonds. It was not rare that a few independent committees popped up to restructure the same debt.[122] Understandably, this atomised structure to

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[116] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 157 (Although, this information was also a source for insider trading by members of the Committee of Mexican Bondholders); Mathew, 'The First Anglo-Peruvian Debt and Its Settlement, 1822–49' (Another example is the use of information for speculation on the market by the committee for Peruvian bonds).

[117] Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries,* 228.

[118] Ibid.

[119] See Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War,* 114; and supra fn 111.

[120] Barry Eichengreen and Richard Portes, 'After the Deluge: Default, Negotiation, and Readjustment During the Interwar Years' in Barry Eichengreen (ed), *The International Debt Crisis in Historical Perspective* (MIT Press 1989), 15.

[121] Flandreau, 'Sovereign States, Bondholders Committees, and the London Stock Exchange in the Nineteenth Century (1827–68): New Facts and Old Fictions', 676 (The new policy was the outcome of the lobbying by displeased bondholders of the Spanish government, which tried to list a Spanish debt on the LSE while being in default for more than 5 years).

[122] Frank Griffith Dawson, *The First Latin American Debt Crisis: The City of London and the 1822-25 Loan Bubble* (Yale University Press 1990), 195.

protect the interests of creditors was not optimal as it did not provide sufficient economies of scale. Therefore, there were attempts to create an umbrella organisation which would represent wider groups of bondholders.

One of the earliest efforts was to create a private committee for all the Spanish American republics in default, led by the banker Alexander Baring in 1828, but it was unsuccessful lacking enough political support. Only eight years later, a similar plan was implemented by the creation of the Committee of Spanish American Bondholders via the voluntary merger of the regional committees.[123] Once created, representatives of the regional committees became founding members of the Committee of Spanish American Bondholders with power to add new members.[124] The committee was composed of several separate groups which dealt only with bondholders of the particular debtor state.[125] There were also instances of spin-off such as the departure of the Mexican bondholders' group from the Committee of Spanish American Bondholders in 1850 who formed their own Committee of Mexican Bondholders.[126]

Bondholders' private committees were usually quickly accepted by debtor and creditor governments as a counterparty for negotiations. The emergence of private committees certainly facilitated the procedure of debt restructuring as bondholders ended to be an amorphous mass. Also, committees were able to perform tasks continually and better than bondholders independently.[127]

However, the legal standing of private committees was often called to criticism duly arguing that a private committee usually did not have any authority to settle disputes on behalf of bondholders and that the separate consent of every bondholder was still required.[128] Also, as claimed by the Permanent Secretary Edmund Hammond, one of the main adversaries of the official intervention by the British government on behalf of bondholders, the committees not being a chartered or permanent organisation were not bound to follow decisions of their

[123] Ibid.

[124] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 162.

[125] Ibid.

[126] Ibid.

[127] Ibid (For instance, '[Committee of Mexican Bondholders] met more than 200 times in just three years between 1850-1853, 'besides numerous meetings of sub-committees').

[128] CMB Proceedings (May 1830), 24 (Speech of the Mexican Minister Manuel Gorostiza).

predecessors.[129] Another drawback was originating from competition among *ad hoc* committees for the same or diverse issues of a sovereign debtor bringing chaos and disadvantages to all concerned parties.[130]

Quasi-official bondholders' committees

The lack of legitimacy and legal continuity undermined the position of private committees as appropriate parties in negotiations. The apparent need for a more centralised and institutionalised organisation was exacerbated by the increased frequency of sovereign defaults in the mid-nineteenth century, which led to the formation of the first quasi-official bondholders' committee in London in 1868. The Corporation of Foreign Bondholders was formed by the general meeting of holders of foreign bonds and incorporated in August of 1873, however, the official legislation 'Corporation of Foreign Bondholders Act' was passed on July 25, 1898. One of the main achievements of the statute was safeguarding CFB's independence by limiting the participation and influence of issue houses in its affairs.[131]

Furthermore, various studies provided evidence that the involvement of CFB in settlements was to the advantage of bondholders.[132] According to Barry Eichengreen and Richard Portes, British bondholders received a higher rate of return on bonds issued in the 1920s than their U.S. counterparts who did not have a similar national quasi-official bondholders' committee for representation at that time.[133] Also, Rui Pedro Esteves demonstrated that the involvement of CFB in settlement process yielded better recovery rates and shorter duration of debt negotiations than other different institutional solutions adopted by bondholders over the period 1870–1914.[134]

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[129] Costeloe, *Bonds and Bondholders: British Investors and Mexico's Foreign Debt, 1824-1888,* 185.

[130] Sec SEC Rep., Pt. V, 136-138, 374 ff.; Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 189.

[131] See Feis, *Europe, the World's Banker 1870-1914: An Account of European Foreign Investment and the Connection of Word Finance with Diplomacy before the War, 113*; and Esteves, 'The Bondholder, the Sovereign, and the Banker: Sovereign Debt and Bondholders' Protection before 1914', 393.

[132] Paolo Mauro, Nathan Sussman and Yishay Yafeh, *Emerging Markets and Financial Globalization: Sovereign Bond Spreads in 1870-1913 and Today* (Oxford University Press 2006), 162 ff.

[133] Eichengreen and Portes, 'After the Deluge: Default, Negotiation, and Readjustment During the Interwar Years', 26; and Eichengreen and Portes, 'Settling Defaults in the Era of Bond Finance', 234.

[134] See Esteves, 'The Bondholder, the Sovereign, and the Banker: Sovereign Debt and Bondholders' Protection before 1914'.

The success of the CFB made it a model for other central national organisations of bondholders in the Netherlands, France, Belgium, Germany and later in the United States.[135] The US analogy of the CFB was formed in 1933 with great involvement of the Roosevelt Administration due to massive defaults by foreign states. Nearly every third sovereign loan floated in the US was in arrears. By this time, the United States acutely experienced an inadequacy of private committees in coordinating bondholders which forced the government to sponsor the creation of the Foreign Bondholders Protective Council, Inc. (FBPC).[136] The SEC's investigation later approved the activity of FBPC as a better and more efficient alternative to bondholders' committees organised by third parties to default or issuing bankers.[137] A similar conclusion is derived from recent empirical research by Esteves.[138]

Both the British CFB and the American FBPC were sanctioned by their governments and enjoyed their support in protecting the interests of holders of foreign securities in default. At the same time, those committees were positioned as non-governmental, non-for-profit and disinterested agencies allowing them to act disregarding potential tensions for foreign policy.[139]

From three available methods of evidencing representation of bondholders such as power of attorney, a deposit of bonds (trust) and mere informative, both CFB and FBPC used the least intrusive one.[140] Committees merely advised bondholders and did not conclude a binding agreement with a foreign debtor on behalf of bondholders.[141] In this regard, CFB was explicitly formed with the purpose 'to act as a mediator between the Foreign Government and Bondholders.'[142]

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[135] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 203.

[136] Ibid (Stating that 'committee … only occasionally consisting of bondholders').

[137] SEC, Report (Washington, D.C. 1936-1938), Part V (Protective Committees and Agencies for Holders of Defaulted Foreign Governmental Bonds), 302, 737.

[138] See Esteves, 'The Bondholder, the Sovereign, and the Banker: Sovereign Debt and Bondholders' Protection before 1914', 403.

[139] SEC, Rep., Pt. V, 412, 447 (Foreign Bondholders Protective Council was founded 'with the view of providing central and disinterested agency [to bondholders]').

[140] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 182* (as an exception CFB sometimes required from bondholders to deposit bonds but it was usually prescribed on request of borrowers).

[141] See ibid (re status of CFB). And Waibel, *Sovereign Defaults before International Courts and Tribunals, 104* (FBPC 'did not act as agent, nor did it enter into any kind of agreement with a bondholder').

[142] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 204* (From the report of the committee approved by the Council of CFB on February 2, 1869).

Nevertheless, there were drastic differences in the way how committees of the US and English organisations operated. The council of CFB had a centralised approach to form committees to conduct negotiations for a particular default situation and as a rule to follow the recommendations of such committees. In contrast, the council of FBPC performed those functions itself, rarely forming special committees, although occasionally consulting with private committees. Such an approach, even if interesting in theory as a way to spark healthy competition between private committees, in practice brought considerable disadvantages such as additional delay to create committees, lack of relevant experience and political ties, high administrative expenses for bondholders. The outcome of different policies is concisely phrased by Edwin Borchard in that '[t]he English method assures harmony between Council and committee; the American method does not.'[143]

Even though national bondholders' organisations facilitated the debt restructuring process on the country level, nonetheless, such composition led to collective action problems at the global level as cleavages in the views on a proposed settlement appeared between committees representing bondholders of different nationalities. This phenomenon was called 'national sectionalism' by Borchard, stating that such behaviour was detrimental to the common interest of bondholders and delayed sovereign debt settlements.[144]

The problem of 'national sectionalism' occurred during the restructurings of Turkish debt in 1875, Portuguese debt in 1892 and Greek debt in 1894 when bondholders' committees from rivalling states could not find a compromise delaying the restructuring of the defaulted debt.[145] For instance, the Portuguese debt renegotiation alone involved different committees of English, French, German, Dutch and Belgian nationals holding Portuguese bonds, which could not find a compromise on such terms of restructuring as *inter alia* guarantees of payments, and priority of claims on the assigned revenues; it took several projects of restructuring and about ten years to find an acceptable settlement for all bondholders' groups.[146] Likewise, relations between the US and European quasi-official bondholders'

[143] Ibid.

[144] Ibid.

[145] See William H Wynne, *State Insolvency and Foreign Bondholders: Selected Case Histories of Goveernmental Foreign Bond Defaults and Debt Readjustments*, vol 2 (Beard Books 2000), 304; Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 311.

[146] Wynne, *State Insolvency and Foreign Bondholders: Selected Case Histories of Goveernmental Foreign Bond Defaults and Debt Readjustments,* 371.

committees were tense, especially when discussions turned to the priority of claims.[147]

The League Loans Committee as a supranational bondholders' committee

To mitigate 'national sectionalism' central agencies were created in different countries to promote cooperation and protection of bondholders for the mutual benefit of all groups without prejudice to nationality or place of issue.[148] For instance, this happened when the major European bondholders' committees agreed not to enter into any separate settlements concerning Tsarist debt repudiated by the Soviet government. In October 1928, an International Committee was formed by local bondholders' committees to collectively deal with defaulted debt, albeit it failed to restructure Tsarist debt.[149]

The League Loans Committee (LLC) was one of the most remarkable examples of a central agency being the outcome of genuinely international collaboration under auspices of League of Nations. In the mid-1920s the League of Nations, mainly through its permanent organs – the Council, the Financial Committee and the Secretariat – carried out nine schemes of reconstruction in six European countries. Every scheme of reconstruction involved an international loan, the so-called nine League loans, for which bonds of the loans were issued in various countries, totalling to £81.8 million.[150] It is important to note that those bonds were ordinary sovereign bonds and the League of Nations neither issued nor guaranteed them. However, since those bonds were issued under the express sanction of the League of Nations for the special purpose 'to promote the post-war reconstruction of Europe,' it supported bondholders out of moral responsibility.[151]

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[147] Eichengreen and Portes, 'Settling Defaults in the Era of Bond Finance', 216 ('disagreement over the issue proved so profound as to undermine cooperation among the two bondholders' committees, leading them to conduct separate negotiations with Colombia').

[148] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 311.

[149] Lyndon Moore and Jakub Kaluzny, 'Regime Change and Debt Default: The Case of Russia, Austro-Hungary, and the Ottoman Empire Following World War One' (2005) 42 Explorations in Economic History 237, 249.

[150] *League of Nations*, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations* (Series of League of Nations Publications: II Economic and Financial, League of Nations 1930).

[151] *League of Nations*, *Memorial of the League Loans Committee (London) to the Council of the League of Nations as of July 18th, 1932* (League of Nations Official Journal 13, 1932); *League of Nations*, *Second Meeting (Public) of the Council of League of Nations (October 7th, 1932)* (League of Nations Official Journal 13, 1932); League of Nations, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations,* 38.

The formation of the bondholders' committee for the League loans was initiated by the Governor of the Bank of England in 1932 to withstand calamities of the Great Depression. The crisis hit especially heavily the economies of Austria and Poland, but other recipients of League loans also suffered to some extent.[152] As of July 1932, at least some positions of the League loans issued to Austria, Bulgaria, Greece and Hungary were in default.[153] The committee's main objective was to protect the interest of bondholders in the restructuring of all League loans whenever the tranches were floated, although about half of tranches were placed in the London capital market. It positioned itself as a mere negotiating agency and claimed complete impartiality *vis-à-vis* all groups of creditors, without distinction based on nationality or place of issue, and debtors. The LLC acted less intrusively in its dealings with parties to debt negotiations and had fewer powers to represent bondholders in comparison to the CFB.[154] Nevertheless, the uniform approach to all creditors, and perhaps the high-level of the patronage, ensured a successful outcome for renegotiations led by LLC.[155]

However, further initiatives to aggregate different national bondholder's organisations stalled due to the changes in global political and financial landscape provoked by WWII. After the demise of the League of Nations and its offspring LLC, no equivalent centralised bondholders' committee emerged under the auspices of a multilateral treaty. With the post-war proliferation of bilateral and multilateral public loans, the importance of sovereign bonds and hence institutions designed to facilitate its restructuring ebbed. The American and British quasi-official bondholder's organisations become redundant in the 1970s and ultimately went out of business a decade later.

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[152] Kirsten Wandschneider, 'Central Bank Reaction Functions During the Interwar Gold Standard: A View from the Periphery' in Jeremy Atack and Larry Neal (eds), *The Origins and Development of Financial Markets and Institutions from the Seventeenth Century to the Present* (Cambridge University Press 2009), 403.

[153] See *League of Nations*, *Memorial of the League Loans Committee (London) to the Council of the League of Nations as of July 18th, 1932*.

[154] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 214.

[155] E.g., as was described by the Financial Committee of the League of Nations in respect Hungarian bond restructuring the 'proposals for a permanent and definitive settlement of the loan issued in 1924 under the auspices of the League have been made which the League Loans Committee, London, described as fair and equitable. These proposals have been accepted by the holders of the majority of the bonds.' See *League of Nations*, 'Work of the Financial Committee at Its Sixty-Fifth Session: Supplementary Report Relating to Hungary, Submitted to the Council on January 27th, 1938' (1938) 19 League of Nations Official Journal 127.

Bondholders' committees in the modern age

With the return of sovereign bonds as a significant source of public debt, many scholars began to draw parallels from the nineteenth to mid-twentieth century historical experience of sovereign bond markets in discussing current policies and problems. In particular, there have been calls to revive bondholders' committees as an effective solution against collective action problem initiated by Eichengreen and Portes.[156] The solution is based on the reputational mechanism to enhance cooperation between debtors and borrowers.[157]

Rory Macmillan also suggested that institutions analogous to bondholders' councils of the nineteenth and early-twentieth century may be helpful to solve the collective action problem. His idea contemplates the creation of national bondholder councils in key jurisdictions like New York and England, which would represent bondholders based on governing law and jurisdiction of the bonds irrespective of their nationality or place of residence.[158]

Initially, Richard Portes proposed a similar idea, arguing in favour of the creation of permanent national committees similar to CFB and FBPC which 'would give a venue for building a common understanding of payment capacity; for resolving issues of equity as between creditors; and developing procedures that ensure comparability over time, from one case to the next.'[159] However, in his revised proposal, he claimed that an international alter ego of CFB and FBPC as a single organisation dubbed 'New York Club' would be able to cope with the aggregation problem by simultaneously overseeing negotiations with all bondholders.[160]

In practice, since 2000, some attempts to use bondholders' committees to facilitate debt restructuring were recently observed in such cases as Argentina (2004), the Dominican Republic (2005), Grenada (2005 and 2013), Belize (2007 and 2012),

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[156] See Barry Eichengreen and Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (Centre for Economic Policy Research 1995).

[157] See Mauro, Sussman and Yafeh, *Emerging Markets and Financial Globalization: Sovereign Bond Spreads in 1870-1913 and Today,* 162 ff.

[158] Rory Macmillan, 'Towards a Sovereign Debt Work-out System' (1995) 16 Northwestern Journal of International Law & Business 57, 89.

[159] Richard Portes, 'The Role of Institutions for Collective Action' in Charles F. Adams, Robert E. Litan and Michael Pomerleano (eds), *Managing Financial and Corporate Distress: Lessons from Asia* (Brookings Institution Press 2000), 65.

[160] Richard Portes, 'Resolution of Sovereign Debt Crises: The New Old Framework' in François Bourguignon, Pierre Jacquet and Boris Pleskovic (eds), *Annual World Bank Conference on Development Economics 2004, Europe: Economic Integration and Social Responsibility* (The World Bank 2007), 181.

Seychelles (2008), Greece (2011), and St. Kitts and Nevis (2012).[161] However, apart from the Greek case, their results were rather timid. In this regard, the success of the bondholders' committee in the Greek case can be mainly attributed to the active involvement of the official sector through so-called Troika,[162] and prevalence of the major institutional investors, many of which were members of the Institute of International Finance – an organization whose two senior officials co-chaired the committee.[163]

In the Argentinian debt restructuring, Global Committee of Argentina Bondholders (GCAB) was created to represent a highly dispersed base of creditors.[164] According to the estimates, the restructuring of the Argentine debt in 2005 involved 600,000 retail investors.[165] The GCAB was an umbrella organisation which comprised various bondholders' committees such as Task Force Argentina acting on behalf of Italian retail investors which constituted an astonishing number of 450,000 Italian persons and entities holding bonds for an aggregated nominal amount of $12 billion,[166] the Argentina Bondholders Committee representing institutional investors, the Argentine Bond Restructuring Authority for German, Austrian and Luxembourg retail investors, and Bank of Tokyo-Mitsubishi and Shinsei Bank representing Japanese bondholders.[167] Despite that the GCAB, according to its claims represented approximately 75 per cent of Argentine bonds held abroad, the Argentine government never recognised this committee and abstained from any official negotiations.[168]

There is a view that the committees' failure resulted from their *ad hoc* nature which as in the nineteenth century is inferior to an institutionalised approach;

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[161] Annamaria Viterbo, 'The Role of the Paris and London Clubs: Is It under Threat? (Draft)' (2017) The Hague Centre for Studies and Research, 23 (On file with author).

[162] Jeromin Zettelmeyer, Christoph Trebesch and Mitu Gulati, 'The Greek Debt Restructuring: An Autopsy' (2013) 28 Economic Policy 513.

[163] See Viterbo, 'The Role of the Paris and London Clubs: Is It under Threat? (Draft)', 24.

[164] For the general information about Argentinian default see at p 30.

[165] Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts* (International Monetary Fund 2012), 21 (Another major case of Ukrainian debt restructuring involved approximately 100,000 retail investors).

[166] Abaclat and Others v Argentine Republic, ICSID Case No. ARB/07/5, para 68.

[167] Mary Anastasia O'Grady, 'Argentina Plays 'Chicken' with the IMF' (*The Wall Street Journal,* 2004) <https://www.wsj.com/articles/SB107542676735516108> accessed August 11, 2018 (The approximate nominal value of the involved bonds is $25 billion).

[168] Viterbo, 'The Role of the Paris and London Clubs: Is It under Threat? (Draft)', 24.

bondholders' organisations in Argentinian debt restructuring were vulnerable to competing committees and the dominance of issuing banks.[169]

However, it seems that a genuine reason for the inadequacy of bondholders' committees to solve collective active action problems in modern times is different. Committees of the pre-World War II period operated in a different legal environment. Previously, bondholders lacked legal remedies against borrowers;[170] it significantly shaped their incentives to participate in settlements. Non-accepting bondholders merely did not have legal or diplomatic recourse and had to agree on the terms of a settlement negotiated by the committees.[171] Otherwise, the prospects of a better deal were close to zero. In other words, the risk of a collective action problem was always present, but individual creditors did not have incentives and leverage to act against the collective interest of all bondholders, and hence collective action problem did not materialise.[172]

In contrast, the current age of the restrictive theory of sovereign immunity allows bondholders to use judicial machinery to demand full contractual repayment individually.[173] Moreover, bondholders have obtained new means to enforce repayment, e.g. injunctions founded on *pari passu* clauses.[174] Considering a hefty monetary stake before sovereign creditors and inventiveness of private actors, there are more enforcement strategies which will be tested in front of national courts. Even if litigation is not successful enough to bring repayment directly through enforcement, it can still be used as powerful leverage to extract individual concessions from a borrower and other creditors. Therefore, it is highly unlikely that bondholders' committees, which have no authority to bind bondholders to any restructurings, would preclude bondholders from attempts to get a better deal using newly available legal leverage.

In this regard, to make the use of councils effective Rory Macmillan advocated in his 'Blueprint for Sovereign Debt Work-out System' that unlike CFB and FBPC, the new councils would be able to bind bondholders. The committees of

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[169] Esteves, 'The Bondholder, the Sovereign, and the Banker: Sovereign Debt and Bondholders' Protection before 1914', 403.

[170] See Chapter 2.II.B. Legal Remedies at p 51.

[171] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 198*.

[172] A similar view is shared by Macmillan, 'Towards a Sovereign Debt Work-out System', 85.

[173] Albeit some limitations are imposed and a trend towards contractual approach in sovereign debt restructuring mechanism stipulates more restrictions in autonomy of bondholders.

[174] See Chapter 5.II.B. Actions against the Bond Trustee in the Argentine Pari Passu Saga.

the councils would derive their legitimacy through a cumbersome election of representatives to the committee by bondholders of each series. Also, according to the proposal, the rights to sue should be exclusively vested in the bondholder council.[175] However, this proposal seems unnecessary complex considering that a comparable outcome for restructuring procedure could be fulfilled by least efforts using already available contractual tools, e.g., collective action clauses and trust arrangements. Moreover, bondholder committees bestowed with new powers should also bear fiduciary duties towards bondholders, which are absent under the current legal design.[176]

Likewise, concerning the auditing function of committees, its value is greatly undermined by the diminished importance of stock exchanges which could provide screening and monitoring roles, and even sanction defaulted states.[177] There is a view that quotation of sovereign debt on stock exchanges no longer add value to investors.[178] The quasi-auditing function is performed by the credit rating agencies in the current market structure.[179]

Nevertheless, committees may still have some value as a forum to aggregate bondholders for negotiations. However, the outcome will not be desirable unless some contractual limitations are imposed to bind the minority. Also, committees may provide benefits by being a centralised source of information for bondholders, but again with advances in ways of exchange of information this function seems to be less relevant then it was a century ago.

Moreover, the function of information conduit is also at least partially performed by bond trustees who are already in place and can perform this task from the beginning of the crisis while it takes time to set up a bondholders' committee.[180] Yet, the role of the bondholders' committee and a trustee should be seen as a complementary one. In some crisis events, it could be helpful to supplement the

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[175] See Macmillan, 'Towards a Sovereign Debt Work-out System', Chapter V.

[176] Philip R Wood, 'How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency' (2013) 14 Business Law International 3, 12.

[177] See supra fn 111.

[178] Elisabeth de Fontenay, Josefin Meyer and G Mitu Gulati, 'The Sovereign-Debt Listing Puzzle' (2016) Available at <https://scholarshiplawdukeedu/faculty_scholarship/3689>.

[179] See Rasha Alsakka and Owain ap Gwilym, 'Rating Agencies' Signals During the European Sovereign Debt Crisis: Market Impact and Spillovers' (2013) 85 Journal of Economic Behavior & Organization 144; John Kiff, Sylwia Barbara Nowak and Liliana B Schumacher, 'Are Rating Agencies Powerful? An Investigation into the Impact and Accuracy of Sovereign Ratings' (2012).

[180] For more information on creditor committees see Chapter 2.II.C. Multilateralisation: the Emergence of Bondholders' Committees.

existing permanent representative by ad hoc representatives with exceptional powers.[181]

[181] G-10, *The Resolution of Sovereign Liquidity Crises* (A Report to the Ministers and Governors Prepared Under the Auspices of the Deputies, 1996), 46.

CHAPTER 3. TRUSTEESHIP AS AN INSTITUTION IN SOVEREIGN BOND MARKETS

Before the mid-20th century, negotiations between private creditors and sovereign borrowers did not occur under a legal framework, offering a real threat of judicial enforcement. The private creditors used the leverage of the reputational considerations and market access for the sovereign borrowers with the support of diplomatic, market and military powers of their home countries. Courts were not involved in sovereign debt issues, and legal suits were not seen as a tool which could influence negotiations. Times have changed, and law became an indispensable if not a decisive factor in sovereign debt restructurings. Jeremy Bulow and Kenneth Rogoff are the pioneers who suggested that creditor-country courts motivate repayment via a threat of direct sanctions.[1] The rights stipulated by sovereign debt contracts have become binding and enforceable.[2] Thus, sovereign debt litigation as a way to settle sovereign disputes represents a set of incentives and boundaries. Indeed, as it was compared to corporate insolvency systems, modern sovereign debt restructurings have occurred "in the shadow' of the law … without the need – and expense – of actually commencing formal court-administered proceedings."[3]

With the formation of the judicial enforcement approach in dealing with sovereign debt disputes, new negative externalities appeared such as a coordination problem among bondholders because individual creditors have got more effective legal instruments to obtain a better settlement acting alone than pursuing a collective action.[4] One way of dealing with the new problem is to devise contractual and institutional set-ups which would align the interests of bondholders. A trust arrangement in sovereign bonds is one of such additional structures which despite its promising features is generally disregarded.

There is scarcely any information regarding the emergence of the trust arrangement in sovereign bond issues. Only a few studies are covering the underlying

[1] Jeremy Bulow and Kenneth Rogoff, 'A Constant Recontracting Model of Sovereign Debt' (1989) 97 Journal of Political Economy 155, 158.

[2] Ibid.

[3] Anne O Krueger, 'A New Approach to Sovereign Debt Restructuring' (2002), 10.

[4] See Chapter 1.II. Creditor Coordination Problems in Sovereign Bonds and Implications for Debt Restructuring.

idea to use the trust structure for sovereign debt issues and its legal construction.[5] Even less is known about the use of trust arrangement in a post-WWII world when a crucial shift towards sovereign debt litigation occurred.[6]

Therefore, this chapter is aimed to fill in the blank spots by explaining and contextualising the evolution of the trust arrangement in sovereign debt markets. It is structured chronologically guiding the reader from the medieval practices where the essence of the bond trustee emerged via corporate bond issues where the practices of trust structures matured and finally towards early and modern uses of the trust structures in sovereign bonds.

I. EVOLUTION OF THE TRUSTEESHIP FROM MEDIEVAL PRACTICES TO MODERN CORPORATE FINANCE

The origins of the modern corporate trust deed came from medieval lending practices. Its predecessor, also known as the mortgage trust, was used to secure a debt by collateralising land. Its invention solved an acute hardship for debtors associated with mortgaging by using a deed upon the condition or a bond of defeasance – schemes of conveyance available in about the 15th century in England.[7] The difficulty was that the common law did not recognise equity of redemption in the land for those schemes in case of the default on loan. Practically, it meant that the borrower loses the land but also is still personally liable for the incurred debt.[8] The trust deed solved this problem as the land conveyed to a creditor or a third party using a trust deed had to be used to cover the debt obligations, and any surplus returned to the borrower.[9] Later, the practice of using a trust deed changed in the way that the possession of the property was not transferred to a creditor or a third party anymore. It is assumed that

[5] E.g., Edwin Montefiore Borchard and Justus S Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles*, vol I (Beard Books 1951); F Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans* (Sweet & Maxwell 1936).

[6] For the accounts on developments of sovereign immunity see p 50.

[7] James G Smith, 'A Forgotten Chapter in the Early History of the Corporate Trust Deed' (1927) 61 American Law Review 900, 901 (Those two instruments had the same aim but operated in opposite ways. According to the deed upon condition, a conveyance of the land to the lender becomes absolute if the loan is not paid. In contrast, a bond of defeasance was giving in conjunction with the deed whereby the borrower transferred the land absolutely to the lender stating that the conveyance would be inoperative if the credit was paid).

[8] Ibid.

[9] HW Chaplin, 'The Story of Mortgage Law' (1890) 4 Harvard Law Review 1, 11 (Later, the practice of using a trust deed as a form of security became popular for bonded debts in the United States).

this practice of leaving the borrower with the actual possession of the property was first brought by Jewish money lenders in London.[10] While this practice was officially endorsed by the Statutes Merchant in 1285 stipulating the registration of such debt, it did not become widespread for centuries.[11]

In the process of the evolution of English law, a trust deed became distinct from other forms of collateralisation used in modern times such as a mortgage by deed of condition or trust in its general meaning, e.g., a family trust. The mortgage by deed of the condition is not regarded as a trust. Moreover, a trust's distinctive feature, in its general meaning, is that the corpus of the trust transferred by a settlor is under control of the trustee for a beneficiary. In contrast, in a trust deed, the corpus of the trust stays under control of the settlor, i.e. the borrower.[12] This characteristic is vital for business operations, and one should not be surprised that trust deeds became a usual practice in corporate finance.

Trust deeds in the modern sense became frequently used to secure corporate debentures in the late XIX century England, as they allowed to create a formal effect to the charge contained in the debenture.[13] A debenture itself created only an equitable charge conferring equitable rights for debenture holders against other creditors or the corporation.[14] It means that the legal title or any ownership rights are not transferred to the creditor. Furthermore, from the practical standpoint, the owner of a debenture must have recourse to the court in order to enforce a priority granted by a charge over lower-ranked creditors. An available alternative for a creditor would be to use a mortgage debenture which allows its holder to use or control the company's property directly. However, in this case, the mortgaged property would be separated from a company and could not be used by it diminishing the business value of the debt. The novelty advantage brought by trust deeds permitted companies to retain possession of the property until it defaults. Once the default happened, the trustee could use remedies without recourse to the court, e.g., enter into the

[10] Harold D Hazeltine, 'The Gage of Land in Medieval England. II' (1904) 18 Harvard Law Review 36, 44.

[11] Smith, 'A Forgotten Chapter in the Early History of the Corporate Trust Deed', 902.

[12] Ibid.

[13] Edward Manson, *The Debentures and Debenture Stock of Trading and Other Companies* (William Clowes 1894), 53.

[14] Leonard A Jones, *A Treatise on the Law of Corporate Bonds and Mortgages: Being the 3d Edition of "Railroad Securities," Revised* (Bobbs-Merrill Company 1907), 45.

administration of or sell the property assigned as security, which was unfeasible based merely on an equitable charge of a debenture.

However, as pointed by Edward Manson, a barrister-at-law and Oxford scholar of that time, '…the chief use of a trust deed (besides passing the legal estate) is that it organises the debenture-holders.'[15] He described creditors as 'a heterogeneous, scattered, and shifting the body of persons, many of them are absent from the country, many are ignorant, apathetic, unbusiness-like.'[16] Moreover, trustees were seen as experienced professionals who can deal with vagaries of corporate defaults in a better way than bondholders themselves.[17] It was recommended to use a trust deed not only where it is crucial to the debenture-holders to have the legal estate vested in trustees for them but also if the issued debt was large and had a long maturity.[18] Trusteeship allowed the company to deal with the debenture-holders as a class preventing the possibility to holdout.[19]

The earliest applications of the trust arrangement by US corporations are attributed to a loan to the Morris Canal & Banking Company[20] arranged in Amsterdam dated March 29, 1830.[21] The widespread use of trust indentures in the United States, which is a similar instrument to the English trust deed,[22] is generally regarded to be later in time than in England. This device gained appreciation during the railroad boom of the mid-19th century.[23] The enterprises were financed by loans obtained from state governments instead of the conventional source of financing from the issue of stocks. In order to secure issues of bonds, railroad companies had to use

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[15] Manson, *The Debentures and Debenture Stock of Trading and Other Companies,* 54.

[16] Ibid.

[17] Ibid (The author elaborates that '[a] timid debenture-holder, fancying things were going wrong, might easily wreck the company's business by an inopportune intervention').

[18] Ibid; The same recommendation was provided in 1971 by the American Bar Foundation, American Bar Foundation, *Commentaries on Indentures* (American Bar Foundation 1971).

[19] See Manson, *The Debentures and Debenture Stock of Trading and Other Companies,* 55.

[20] New Jersey State Archives, 'Morris Canal & Banking Company: Microfilm Collection' (*New Jersey State Archives,* <http://www.nj.gov/state/archives/pdf/morrisCanalSale.pdf> accessed July 11, 2017 (The company was chattered by the State of New Jersey to improve transportation between the coal mines of Pennsylvania, the iron forges of Morris County, and the great marketplace of New York City).

[21] Smith, 'A Forgotten Chapter in the Early History of the Corporate Trust Deed', 904.

[22] Lee C Buchheit and Sofia D Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?' (2016) 31 Butterworths Journal of International Banking and Financial Law 457, 462.

[23] Francis Lynde Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures* (Some Phases of Corporate Financing, Reorganization, and Regulation, Macmillan 1916), 1 ff.; For general information about railroad boom in the US, see Cleona Lewis and Karl T Schlotterbeck, *America's Stake in International Investments* (Brookings Institution 1938), 28 ff.

trust indentures, which explains an exponential increase in recorded trust indentures.[24] The necessity of using trust indentures is based on the inability to use a traditional real estate mortgage lien to vest the mortgage title in bearer bondholders, whose identity was anonymous.[25] As a solution, a trustee held a mortgage title for the bondholders' benefit.[26] The American Bar Foundation regards such contractual development as a significant factor in the economic growth of the US because it induced creditors to invest money on a long-term basis even in highly risky ventures, such as the construction of the railroad.[27] It was observed that the trustee's integrity and professionalism considerably influenced the saleability of corporate bonds.[28]

Nevertheless, corporate mortgage bonds had some limitations, even if a trust structure was employed. The main concern was that a lien to holders of one issue of bonds could be an impediment for additional bond issuances by a corporation. As a response, which occurred before World War I, innovative drafters substituted the lien on the corporate property by stricter covenants to safeguard the interests of creditors and at the same time to provide more flexibility for the borrower in future rounds of financing. Even though such a debt instrument did not create any lien on the property anymore, the use of trusteeship was preserved as the corpus of the trust could consist of contractual rights only. As George F Palmer put it, '[t]he subject matter of a trust under a trust indenture consists primarily of the legal interests which in the aggregate constitute the security behind the bonds.'[29] Some contractual rights under the indenture vis-à-vis the issuer are vested in a trustee for the benefit of bondholders.[30] Those changes denote an advent of the contemporary characteristics of the trust structure when a trustee holds in trust only contractual rights for the benefit of bondholders but do not possess any property. Among those contractual rights vested

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[24] Smith, 'A Forgotten Chapter in the Early History of the Corporate Trust Deed', 904 ('In the decade of the eighteen forties there are a score of instances on record where the railroads used the trust deed to secure issues of bonds, and in the decade of the eighteen fifties there are over 150 instances on record').

[25] A bearer bond is defined as 'a bond payable to the person holding it. bearer bond. The transfer of possession transfers the bond's ownership.' Black's Law Dictionary (8th ed. 2004), 536.

[26] American Bar Foundation, *Commentaries on Indentures, 5*; and Frederic C Rich, 'International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation Note' (1980) 21 Virginia Journal of International Law 269, 272.

[27] See American Bar Foundation, *Commentaries on Indentures, 5*.

[28] Martin D Sklar, 'The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder' (1989) 106 Banking Law Journal 42, 44.

[29] George E Palmer, 'Trusteeship under the Trust Indenture' (1941) 41 Columbia Law Review 193, 203.

[30] American Bar Foundation, *Commentaries on Indentures,* 5.

in the trustee is the issuer's covenant to pay, the proceeds of that covenant and the benefit from other issuer's obligations.[31]

Another reason to preserve a trust structure in unsecured issues was that a trustee proved to be useful machinery to protect bondholders by representing them and being accountable according to fiduciary responsibilities.[32] Furthermore, practitioners observed a change that trustees on top of the standard provision to foreclose the mortgage also received exclusive rights to sue on the bond.[33] In this regard, the trust arrangement was also seen as a mechanism to protect the debtor from misuse of enforcement rights by a creditor resulting in the borrower's bankruptcy.[34] According to Johannes Zahn, discretion and responsibility of the bond trustee coupled with the limitation of creditors' enforcement rights would be helpful to introduce the principle of protecting the debtor to business life.[35] It strikes that collective action problems in bonded debt and the way to counter them are almost identically discussed by scholars of early 20th and 21st centuries.

Until 1880 usually, one or several individuals were acting as trustees. However, corporate trusteeship, i.e. a legal entity whose business is focused on the provision of trustee services under a trust arrangement, became a standard practice later.[36] In this regard, trust corporations ensure the continuity of work done by trustees.[37] Furthermore, they are important to ensure certainty of the applicable law if a lawsuit is initiated against trustees of different nationality, domicile, and residence.[38] Also, it is a way to mitigate the conflict of interests, e.g. in contrast to

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[31] Philip R Wood, *International Loans, Bonds, Guarantees, Legal Opinions*, vol 3 (The Law and Practice of International Finance Series, 2nd edn, Sweet & Maxwell 2007), 291.

[32] Terence Prime, *International Bonds and Certificates of Deposit* (Butterworths 1990), 298.

[33] Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures, 67*; Johannes CD Zahn, 'The Trustee in German-American Industrial Loans' (1932) 12 Boston University Law Review 187, 220.

[34] Zahn, 'The Trustee in German-American Industrial Loans', 191.

[35] Ibid.

[36] Smith, 'A Forgotten Chapter in the Early History of the Corporate Trust Deed', 911 and Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures, 11*.

[37] After the untimely death of the trustee of the Municipality of Danzig loan, it took the Council of the League of Nations more than two months to appoint a new trustee in succession. Besides, this time gap when bondholders were absent of their 'leader', a new trustee without prior involvement in the case had to step in into his position in the middle of the debt restructuring procedure. Also, new arrangements for representation had to be re-established for a new trustee. See, *Thirteenth Report of the Trustee of the Municipality of Danzig 7% Mortage Loan of 1925 (March 1938)* (League of Nations Official Journal 19, 1938).

[38] See Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 49.

agents under banks syndicates trust corporations are not involved in other commercial activity which might thwart bondholders' interests.[39]

The Anglo-American domestic practices to use the institution of a trustee in corporate bond issuances became frequent in other systems of law with the proliferation of international industrial loans in the early 20th century.[40] In particular, it was imposed by the US and its corporations who wanted to retain their domestic legal institutions once they become major lenders to foreign borrowers after the WWI. Some scholars note that the establishment of the trustee as an enforcer of bondholders' rights in international loans became a particularly crucial practice due to the distance and the lack of knowledge of foreign law.[41] It seems especially sensible in complex sovereign bonds which were issued and targeted at investors in various jurisdictions.

II. THE FIRST PRACTICES OF THE TRUST STRUCTURES IN SOVEREIGN BONDS

According to Edwin Borchard, the practice to use trustees in sovereign bond issues was borrowed from American corporate finance, when during the period of reconstruction after WWI, American bankers provided funding to industrial corporations of Continental Europe through the placement of bonds.[42] While there is agreement that the trust arrangement was transplanted from corporate practices, there is a controversy as to which legal system provided the prototype. For instance, a contemporary practitioner argued that the terms of the first League loan, the Austrian Government Guaranteed Loan 1923-1943 (the Austrian loan 1923), which is considered to represent the first use of trust device in sovereign loans,[43] mirrored the rules of English private law.[44] However, the absence of the determined governing law and choice of forum in the League loans contracts[45] makes it complicated to establish the prototype legal system for international sovereign bonds and brought

[39] Wood, *International Loans, Bonds, Guarantees, Legal Opinions,* 312.

[40] Zahn, 'The Trustee in German-American Industrial Loans', 190.

[41] Ibid.

[42] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 46*; see also Note by Ernst H. Feilchenfeld from June 6th, 1937 submitted to the League Study Committee, R4611 (LoN Archives, Geneva), 1.

[43] Ibid.

[44] John Fischer Williams, *Chapters on Current International Law and the League of Nations* (Longmans, Green and Co. Print 1929), 398.

[45] See infra fn 77.

difficulties into the operation of the trust arrangement as discussed in the next sections.

There are numerous accounts of why trust arrangements were introduced into international sovereign loans. According to the official version of the League of Nations, the whole system of trust arrangement was devised with the intent that in the event of default only the use of the League machinery was permitted and the home state of bondholders would not be entitled to any separate actions, thus eliminating political tensions between nations.[46] From the economic point of view, the utility of using trustees was in pre-emptive discouragement of sovereign defaults by imposing additional contractual obligations on debtors.[47]

Nevertheless, it seems that a decisive factor was connected to practical aspects of the debt. The presence of the collateral and guarantees in League loans,[48] e.g. pledged revenues, taxes and other collateral, required some third party to administer it, and the use of trustees was a preferable solution. Describing the drafting process of the Austrian loan of 1923, drafters explained

> 'that machinery was required for the convenient supervision of the Reserve Fund, for the enforcement of the Guarantees and for the administration of the Pledged Revenues not only during the appointment but also after the termination of the functions of the League Commissioner General. Following the practice adopted in England in most cases where security was provided by the terms of a loan it was decided that there should be Trustees…'[49]

The Austrian loan of 1923 was the first post-war international loan, and according to its drafters, the subsequent League loans had similar terms and used trusteeships.[50] Among them are the German loans of 1924 (Dawes) and 1930 (Young) and loans to some central European countries.

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[46] League of Nations, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations* (Series of League of Nations Publications: II Economic and Financial, League of Nations 1930), 53.

[47] Juan H Flores Zendejas, 'Financial Markets, International Organizations and Conditional Lending: A Long-Term Perspective' in Grégoire Mallard and Jérôme Sgard (eds), *Contractual Knowledge: One Hundred Years of Legal Experimentation in Global Markets* (Cambridge Studies in Law and Society, Cambridge University Press 2016), 79.

[48] For the avoidance of doubt, the loans were neither issued nor guaranteed by the League of Nations but only facilitated.

[49] See Memorandum by Freshfield, Leese and Munns submitted to the League Study Committee, Doc. I.L. 14 (Geneva, December 7, 1936), 1.

[50] Ibid.

Another practical issue in favour of the trusteeship observed by a contemporary scholar of the League loans was that the possibility of enforcing separate and individual bondholders' rights had to be restricted by a mandatory trustee due to a large number of bondholders entitled to guarantees.[51] Finally, some scholars claim that the primary goal of the trust arrangement was to protect bondholders.[52] Such a diverse array of proposed reasons is not surprising as a bond trustee to some extent can fulfil all of them.

The report published by the League of Nations helps to understand more the practical reasons and mechanics of using trustees for the first time in sovereign debt instruments in the League loans.[53] For first League loan issues, depending on the size of a loan, one to three persons were appointed to a board of trustees, most of whom were members of the Financial Committee, a permanent body of the League of Nations. That contrasts with practices of the contemporary international corporate finance where only large banks or trust companies were chosen for this role.[54] While the circumstances for and terms of League loans vary, in no case trustees had a right to interfere into the administration of the debtor state nor any right akin to that of foreclosure. The trustees' mandate was strictly defined in such a way that their main powers arose only if and when default occurred, which corresponds to the current way of regulating bond trustees in the US and the UK.[55] The current or minor duties of trustees consisted:

> 'in constituting reserve funds, transmitting interest payments on due dates, managing the assigned revenues account after the reconstruction schemes are concluded, retaining the amounts necessary for the service of the loan and automatically reimbursing the balance to the Government,.. liberating the proceeds of loans.'[56]

One of the trustee's main powers was the right to call for additional revenues to be assigned if the original ones fell below a certain level. Moreover, in some

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[51] Williams, *Chapters on Current International Law and the League of Nations,* 397.

[52] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 49.

[53] See League of Nations, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations*.

[54] Zahn, 'The Trustee in German-American Industrial Loans', 192.

[55] See Grygoriy Pustovit, 'Sovereign Debt Contracts: Implications of Trust Arrangements for Financial (in)Stability' (2016) 17 European Business Organization Law Review 41.

[56] League of Nations, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations,* 52.

schemes of the financial reconstruction, trustees were empowered to veto any measures diminishing the revenues or security of the bondholders.[57] Also, in the event of default, trustees could compensate bondholders from the previously assigned revenues.[58] In all these cases of trustees' discretion, the debtor government had a right to appeal to the Council of the League of Nations, whose decision was final and binding. In addition, the Council, according to the legally binding Protocols, defining the obligations of the governments interested in a loan,[59] was empowered to appoint or nominate trustees. In general, the role of the Council for League loans trustees was akin to the role of contemporary courts for corporate bond trustees, as special provisions in the Protocols gave the Council powers of interpretation of the Protocol and contractual terms of the bonds. The Council's decision was binding for the parties under the loans.

A. Trusteeship: Cleavage Between Anglo-American and Continental Legal Systems

The introduction of the trust arrangement into the framework of sovereign bonds in the word of contemporary scholars was abrupt and ill-considered.[60] Problems stemmed from attempts to introduce an Anglo-American bond trustee in the League loans legal framework where borrowers had Continental legal systems. By this time, the concept of the bond trustee was largely unknown to Continental legal systems. However, some affinity to the concept of the trusteeship at that time could be attributed to the institution of the Treuhand under German law. Some scholars claim that in its simple form, Treuhand originated in the 13th century,[61] but it developed into its present form only at the end of the 19th century during the codification of German law, which culminated in the enactment of the BGB (Bürgerlichen

[57] E.g. League loans to Hungary (1924), Bulgaria (1926), Estonia (1927).

[58] League of Nations, *Principles and Methods of Financial Reconstruction Work Undertaken under the Auspecies of the League of Nations, 53* ('[A]mounting at the time of the issue of the loan to anything between two and six times the amount required for annual service').

[59] The protocol had to be signed by the government of the debtor state and ratified according to required formalities of concerned country.

[60] See Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans*; Clive M Schmitthoff, 'The International Government Loan' (1937) 19 Journal of Comparative Legislation and International Law 179, 180; Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 46.

[61] Shelley A Stark, *Hidden Treuhand: How Corporations and Individuals Hide Assets and Money* (Universal-Publishers 2009), 138.

Gesetzbuch). Albeit, the newly codified law of Germany did not contain provisions on trusts and fiduciary relationships. The office of the Treuhänder, originally in connection with mortgages, was introduced by some special and ancillary statues.[62] Its further development mostly occurred in an unusual way, especially for Continental legal systems, through becoming customary law.[63] The functions of the Treuhänder were characterised by the Kammergericht[64] (the highest state court for the state of Prussia) as following:

> '(1) General Treuhänd functions, namely investment and administration in the name of the Treuhänder of another's assets; (2) Protection of creditors against risk of loss, protective associations *vis-a-vis* foreign governments and companies; (3) Auditing of ledgers and balance sheets; (4) Advising in economic matters and in matters concerning taxation and investments.'[65]

While the listed functions of the Treuhand are similar to those of a bond trustee in the Anglo-American tradition, there were many impediments in German law which limited the application of the Treuhand in bond issues and made it practically unfit for the role of a bond trustee.[66] The law of other jurisdictions from the Continental legal system was even less matured and prepared for the introduction of the trusteeship.[67]

Some ideological cleavage between Anglo-American and Continental legal systems exists because Continental systems with the Roman concept of two kinds of rights only, i.e. *jura in rem* and *jura in personam,* were unable to fully perceive the legal construction of the trusteeship, which requires the trichotomy of legal rights, equitable interests, and contracts.[68] The divergence in the treatment of the trust arrangement in different legal systems is apparent if one analyses (i) the relationship

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[62] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans,* 15.

[63] Stark, *Hidden Treuhand: How Corporations and Individuals Hide Assets and Money,* 141.

[64] Decision Ia 449/22 of September 20, 1922.

[65] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 40*.

[66] Ibid (Some of those impediments are (i) absence of remedies against transferee, (ii) no 'real subrogation,' (iii) no 'primary acquisition,' (iv) no protection for beneficiary not identical with settlor).

[67] See ibid.

[68] Schmitthoff, 'The International Government Loan', 180.

between the trust and third parties, and (ii) the contractual relationship between trustee (Treuhander) and settlor/beneficiary (Treugeber).[69]

The first point is that the Anglo-American trust is characterised by a clear effect on third parties, which can be summarised that trust property is protected from a personal creditor of the trustee. This was different in German law because it did not allow agreements to stipulate restriction of the powers of conveyance against third parties.[70] In situations where a property or some rights were transferred to a Treuhänder for the benefit of the third party and not a settlor itself, the property was not protected against creditors of the Treuhänder. As a result, this principle completely debased the main characteristic of the trusteeship to segregate and protect the trust property from third parties.

The second point concerns the distinctive feature of the Anglo-American system which is the division of claims to the property into legal rights and equitable interests in order to create fiduciary relationships between the trustee and the beneficiary instead of a mere agency.[71] In contrast, German law prescribed the inalienability of rights, which means that a Treuhänder cannot be conferred upon some selective rights in order to have restricted or modified ownership.[72] All the property rights had to be vested in a Treuhänder notwithstanding the purpose of the scheme; this creates an opportunity for abuses by trustees. Also, the Continental legal system misses the co-existence of two different sets of courts, courts of equity and courts of law. The courts of equity would implement an incomplete trust contract and guide a trustee in the execution of its duties in extraordinary situations. At least at first, courts from various Continental legal systems struggled to grasp the legal relationships between the trustee and bondholders out of the trust agreement. National courts were coming to opposite conclusions: while ‘French Courts ruled that the Trustee is the joint ‘mandataire’ of the bondholders, [on the other hand, in]

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[69] Stefan Grundmann, 'Trust and Treuhand at the End of the 20th Century. Key Problems and Shift of Interests' (1999) 47 The American Journal of Comparative Law 401, 402

[70] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans,* 28.

[71] Ibid; and Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 47.

[72] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 31* (Citing Art. 137, BGB).

the Austrian case […] it was held that the Trustee had nothing whatsoever to do with the bondholders.'[73]

B. The First Test for the Sovereign Bond Trusteeship: Litigation Against the BIS

The dispute inflicting bonds under the Young loan of 1930 is revealing for the difficulties in using trustees in sovereign bond issues and the related cleavage between Anglo-American and Continental legal systems. From the beginning, the devised trust arrangement had some weak points that attracted criticism. One of them was an incentive structure of this trust arrangement for which the Bank for International Settlements (the BIS) was appointed as a trustee. There are valid concerns whether the BIS being a commercial and policy institution was a proper nominee for the function of a bond trustee, which could be fulfilled by any private financial institution with less exposure to conflicts of interests. First, the BIS was founded by central banks which are at the same time its shareholders, creditors and debtors.[74] Second, it simultaneously acted as a trustee for governments and bondholders receiving reparations from Germany.[75]

As it is in medicine, the full scale of the problem becomes apparent only after the autopsy. Similarly, the legal issues are revealed after an assessment of the claims by the courts. The landmark case is in re Aktiebolaget Obligationsinteressenter v. the Bank for International Settlements,[76] where a Swedish bondholder brought a suit against the trustee of the Young loan of 1930 for violating the *pari passu* and gold clauses by following express instructions of the German Reich that the loan should be paid only at the nominal value to some bondholders including the plaintiff. This case went through all three instances of the Swiss judiciary and is known as the only recorded case against a trustee of sovereign bonds before courts prior to WWII. Furthermore, thanks to some archival work at the League of Nations archives the view of the courts is supplemented by the view of the lawyers who either participated

[73] Ibid (Citing the Kerr's case by Cour de Toulouse, July 18, 1900, Cour de Cassation, February 19, 1908 and the decision of the Austrian Supreme Court of May 4, 1904, Bd, 41, No 2687 respectively).

[74] Ibid.

[75] See John Fischer Williams, 'The Legal Character of the Bank for International Settlements' (1930) 24 The American Journal of International Law 665, 670.

[76] Die Praxis des Bundesgerichts, XXV, 331. English translations in the League Study Committee, Doc. I.L. 18 (Geneva, February 11th, 1937) (I am very grateful to archivists of the League of Nations Archives for their help in locating the materials).

in the negotiation, drafting of the contracts, or were approached by the League of Nations to lodge their expert opinion on the matter.

The courts rejected the claim for compensation of the Swedish bondholder against the trustee on account of the alleged wrong distribution of available loan money. The courts did not find a breach of duties under the contract by the trustee in obedience to the debtor's instructions to distribute payments even though this distribution according to the court 'indisputably infringed both the gold clause and *pari passu* clause.' Such an outcome is objectionable for trust relationships under the Anglo-American legal system. According to English law, 'a trustee is not the agent or representative of anyone. He is the trustee of the trust fund, and his duty is to administer it in the interest of the beneficiaries following the provisions of the trust deed.'[77] However, if the same relationships are assessed through the prism of the Continental legal system, where the rules of agency would prevail, the position of the courts becomes more reasonable. As discussed in the previous section, the concept of the trusteeship could not be fully mirrored under the Continental legal systems.

While the position of the courts is widely condemned by Anglo-American lawyers,[78] it seems that within the given circumstances the court had to make controversial choices. The first thing one should keep in mind is that the Swiss courts' line of reasoning could have been politically motivated *per se* as it involved the interpretation of the German Reich's actions, which were a reprisal devised from the point of international law against those states which departed from the gold standard.[79] Also, the court might have pursued the goal of safeguarding the newly established international institution in their country – the BIS. [80]

The second factor is, as was shown by Weiser, the poor drafting of the trust contract partially owing to Continental lawyers, who tried to adjust to the legal

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[77] See Memorandum by Mr. A.P. Fachiri submitted to the League Study Committee, Doc. I.L. 17 (Geneva, February 10th, 1937), 6.

[78] See Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles, 52* (stating that '[t]hree successive Swiss courts labored with the proper solution of the question, only to give evidence of the profound confusion created by the attempt to transplant the institution of the loan trust in the unfavorable soil of Continental law.'); Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 49* (Naming it as '[t]he rather destructive effect of a recent decision of the Federal Court').

[79] See supra fn 76. Judgement given on May 26th, 1936, by Swiss Federal Court Swiss (The court explicitly mentioned it in the judgement).

[80] Anna Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines' (2016) 11 Capital Markets Law Journal 251, 267.

concepts of a legal system different from the ones familiar to them, but in the end lacked some traditional characteristics of Anglo-American trusts hindering the functionality of the trust.[81] For instance, contrary to the essence of the trust, the BIS as a trustee did not have any defined duties and powers in the case of default to protect bondholders. The trust arrangement lacked one of its main features, such as the ability of the trustee to sue the debtor on behalf of bondholders.[82] Nor did the trust contract provide for a trustee's duty to invest trust money or to segregate the trust property from the trustee and that of third parties. Even a general definition of the relationship between the trustees and the bondholders varied in League loan contracts. Some contracts provided that the trustees are 'to represent the interests of bondholders,' some merely stated 'trustees for the bondholders', and some contracts did not stipulate any definition in this respect whatsoever.[83] Besides ambiguities evoked by the absence of concrete provisions in the trust agreement, some provisions created additional confusion. In particular, a clause in General Bonds provided that the borrowing state is indebted to the trustee in the amounts borrowed, at the same time a clause in 'definitive bonds' stated that the government is directly and unconditionally indebted to the bondholder. Reading those clauses in conjunction *de jure* doubled the amount borrowed, while it was obviously not the case.[84] After all, the wording of the agreements paired with the governing law used by the Swiss courts for interpretation formed the trust arrangement into something defective and legally unrecognisable.

Nevertheless, the judgements of the Swiss courts (i.e., the courts of first instance, first and second appeal) are of great magnitude in many respects. Like in

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[81] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans,* 71 ff (The further analysis of trust agreements in the next paragraph is based on his work).

[82] And it is not a question of the utility of such a lawsuit in the paradigm of absolute sovereign immunity, but a question of the full functionality of the trusteeship as established institution. Besides, in some bond contracts, the borrowers explicitly accepted jurisdiction of the external adjudicated bodies. For instance, the disputes out of the 5% 1932 and 1937 bonds of the Czecho-Slovak Republic have to be laid before the Permanent Court of International Justice. (Report of the Committee for the Study of International Loan Contracts, League of Nations (Geneva, 1939), 39).

[83] Report of the Committee for the Study of International Loan Contracts, League of Nations (Geneva, 1939), 17.

[84] The Swiss courts patched this drawback by treating the German Reich's indebtedness to trustee as a manifest to explain how the transfer of funds should be routed through the trustee to bondholders. See the judgement (supra fn 76.) on pp 8 and 12.

Wood, *International Loans, Bonds, Guarantees, Legal Opinions,* 291, (The duplicate covenant to pay both the trustee and bondholders are common in Eurobond issues done in a bearer form. However, a special provision in the trust contract stipulates that the payment to bondholders discharge the parallel covenant pro tanto).

case of recent decisions in re NML Capital v Argentina, the Swiss judgments pushed the legal discussion in sovereign debt matters further beyond established frontiers. To name a few examples, the courts' deliberation on the performance of the gold clause and *pari passu* clause in sovereign bonds is considered to be the first judicial inquiry in the concept of equal treatment of the bonded creditors long before the notorious cases devised by Elliott Associates.[85] In the context of the trust arrangement, there are particular two issues which were addressed by the court and got voluminous criticism.[86] Those issues are (i) the choice of the governing law and (ii) classification of the relationships between the trustee and bondholders by the courts.

Governing Law

Apart from other drawbacks, the trust agreement was silent on questions of the governing law and choice of forum. According to an expert approached by the League of Nations after studying twenty-eight international sovereign loans, from which a considerable proportion were League loans, only very few of them contained provisions on the applicable law, forum and the means for representation of bondholders.[87] As contemporary observers explained it, the Austrian government and institutions to the first League loan contract were not able to agree on the applicable law and left it to the discretion of the courts.[88] Since then a 'carte blanche' provision on the applicable law was used in the subsequent League loans. Such a situation exposed trustees simultaneously to various jurisdictions. For example, the trustee could be dragged before national courts (i) in the place of the trustee's domicile or residence, (ii) in the place where the trustee had property, and (iii) even in some countries like France due to the mere fact of issuance of bonds to local citizens.[89] According to an expert memorandum by A.P. Fachiri, a similar situation happened

[85] For the analysis of these issues please address a thoughtful text by Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines'.

[86] See supra fn 78.

[87] See Memorandum by Mr. AP Fachiri submitted to the League Study Committee, Doc. I.L. 17 (Geneva, February 10th, 1937), 8.

[88] See Memorandum by Freshfield, Leese and Munns submitted to the League Study Committee, Doc. I.L. 14 (Geneva, December 7th, 1936), 2.

[89] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans*.

concerning the Austrian Guaranteed Loan 1923-1943 when various bondholders sued the trustees of the bonds residing in France, Belgium and Sweden.[90]

In Aktiebolaget Obligationsinteressenter case, the courts had to decide on the applicable law. The BIS, which was the defendant in this case, argued that Anglo-American law, which is familiar with the concept of the trusteeship, should be applied to determine the duties of the trustee. However, the verdict was different. The court of first instance decided to follow Swiss law as the law of the place of performance referring to the domicile of the BIS. Both the court of appeal and the Swiss Federal court acknowledged the position of the lower court, specifying that the defendant's obligations of administration were to be performed in Basel.[91] It seems to be a suboptimal solution, but under the given circumstances, the choice was somewhat limited.

The Swiss courts of every instance attempted to identify any provision of the bond which would contain an express stipulation to the governing law of the contract, but in vain. Furthermore, the courts tried to deduce from the circumstances whether there was an agreement between the parties on the law to be applied. In this regard, the court of first instance provided extended arguments why it could not conclude that the parties tacitly agreed that English law should apply:

> 'in particular this conclusion cannot be drawn in respect of tranches of the Loan issued in countries which do not come into the sphere of Anglo-Saxon law. Further, from the designation 'trustee', employed in the Loans to describe the position of the defendant, it cannot be deduced that the provisions relating to trust in English law are to be applied, since this designation through the translations and paraphrases added in brackets – trustee = 'Beauftragte der Inhaber der Schuldverschreibungen', 'ombud för obligationsinnehavarne', 'mandatory of the bondholders', 'représentant des obligataires' – receives a purport at variance with the English idea of a trustee. Finally, the impossibility of having recourse, in cases of doubt, to so-called

[90] See Memorandum by Mr. AP Fachiri submitted to the League Study Committee, Doc. I.L. 17 (Geneva, February 10th, 1937), 4-5 (Unfortunately, the exact outcome and more importantly the reasoning of the courts in these suits are unknown. It was only stated by Mr. Fachiri that those actions have either been dismissed or are still pending).

[91] See supra fn 76. Judgement given on November 29th, 1935, by the Court of Appeal of the Canton of Basel-Stadt, 6.

court of equity, which might give the defendant guidance, militates against the application of English law.'[92]

These details show awareness and to some degree the willingness of the court to apply the Anglo-American concept of trust. But it was practically unattainable; even the lawyers from Freshfield, Lees & Munns, who drafted the Austrian loan 1923, saw that 'English law cannot be applicable to Trusteeship of this kind because the supervision of the [English] Courts is lacking.' The lack of such guidance, which cannot be challenged by any party providing a safe harbour for a trustee, was also acknowledged as a major difficultness for the operability of the trusteeship.[93]

Trust Relationships

Once the choice of the governing law was set on Swiss law, the fate of the claim was practically decided, because Swiss law on trusteeship and fiduciary duties of that time were even less developed than German law and laws of some other Continental countries.[94]

In defence of the courts, it should be mentioned that the case could have been dismissed from the very beginning because the clause (f) of Art. VI of the General Bond, which deals with the payment of capital and interest, vested the exclusive rights of its interpretation in the trustee without providing any recourse to bondholders. However, the courts still elaborated on the position and duties of the trustee. The analysis of the decisions of every court instance shows that with every subsequent judgement, the courts gradually came closer to the understanding of the bond trusteeship in its Anglo-American meaning.

In this regard, the court of first instance concluded that the BIS was merely a paying agent of the German Reich and therefore should follow its instruction even if it breached the bond contract. While the court of appeal upheld the judgement of the first instance, its analysis of the relationships between the trustee and bondholders was different. It grasped that the trust arrangement also provided some duties for the

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[92] Ibid 2.

[93] See Memorandum by Freshfield, Leese and Munns submitted to the League Study Committee, Doc. I.L. 14 (Geneva, December 7, 1936), 2-3.

[94] See Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 45* ('Positive legislation in Switzerland not only knows nothing of Trust, Treuhand or Fiducia but definitely rules out the first and foremost field of application of the German and Austrian Fiducia, namely the Sicherheitsiibereignung; the impossibility of its application necessarily deprives the learning of Trust and trust-like schemes of much of its practical interest').

trustee to act in favour of the bondholders. The court perceived that '[t]he relationship in question is rather to be conceived as a mandate-like contract of a special kind producing effects between three parties, the defendant being given a position similar to that appertaining by law to the bailee holding a pledge (Art. 860 Z.G.B.), representative of creditors and bondholders in accordance with Art. 875 Z.G.B. In this position, the defendant has in the first place to perform as between debtor and creditors the service of the loan payments. Also, it is bound to see, as far as possible, that the German Reich observes the conditions of the loan.'[95]

Finally, the Swiss Federal Court went as close to the definition of the trusteeship under Anglo-American law as it might have been possible under the limits of the contemporary Swiss law by stating that the scheme between German Reich, the BIS and bondholders is 'a mandate-like, three-sided contract sui generis, for the purport of which the conditions of the loan contract are exclusively decisive.'[96]

The courts stated that the legal relations of the defendant to the borrower and bondholders are not to be qualified as a mandate due to (i) the irrevocability of the obligations and (ii) greater freedom of the trustee who is not obliged to follow the instructions of either party if they diverge from the bond contract. Those are the main features of the trust arrangement.[97]

The Swiss courts' decisions played a major role in catalysing scholarly debates and establishing of the League of Nations' committee to address the drawbacks in sovereign debt contracts, including the application of the bond trusteeship.

C. League of Nations Recommendations on Bond Trusteeship

Despite the blow suffered by trust arrangements in Europe from the decisions in re Aktiebolaget Obligationsinteressenter,[98] it was still seen as a salutary institution in

[95] See supra fn 76. Judgement given on November 29th, 1935, by the Court of Appeal of the Canton of Basel-Stadt, 7.

[96] See supra fn 76. Judgement given on May 26th, 1936, by the Swiss Federal Court, 12.

[97] Philip Rawlings, 'The Changing Role of the Trustee in International Bond Issues' (2007) 2007 Journal of Business Law 43, 48.

[98] Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines', 273.

connection with sovereign bonds.[99] It got a relatively wide application in pre-World War II capital markets as about 24 per cent of sovereign bonds provided for a trust structure.[100] There were attempts to fix the flaws of the trusteeships.

The scholarly community proposed ways how to design a trust arrangement in sovereign bonds properly.[101] The proposals by Weiser are focused on issues such as the centralisation of bondholders, arbitration and conflict clauses. The prevailing goals of his proposals are to clarify that the role of the trustee is to protect the interests of bondholders and to outline the apparatus for the smooth operation of the new institution in sovereign bonds. However, in his own words, he 'does not dare to go the length of depriving individual bondholders of the possibility of suing under their bonds or of introducing into international loans the *novum* of representative action.'[102]

Moreover, the League of Nations established the Committee for the Study of International Loan Contracts to overcome difficulties in sovereign debt contracts and sanctioned the committee to collaborate with the International Institute at Rome for the Unification of Private Law.[103]

According to the League Committee experts, the Swiss court departed from the flawed conclusion that the trustee was a paying agent of the borrower and had to follow its instructions contrary to the *pari passu* clause.[104] The League Committee's final report of 1937 contained a broad array of recommendations to improve bondholder coordination, which was contrary to recent official proposals focused more on non-binding methods as trustees and bondholder representation.[105]

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[99] See Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 91*; and Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles* ('trustees … may have some bearing on starting adjustment negotiations and determining their results'). Similar views are expressed by contemporary experts, e.g., see Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines', 253 ('Germany's interwar default and its aftermath highlight the perennial importance of trustees').

[100] W Mark C Weidemaier, Mitu Gulati and Anna Gelpern, 'When Governments Write Contracts: Policy and Expertise in Sovereign Debt Markets' in Grégoire Mallard and Jérôme Sgard (eds), *Contractual Knowledge: One Hundred Years of Legal Experimentation in Global Markets* (Cambridge Studies in Law and Society, Cambridge University Press 2016), 97.

[101] Weiser, *Trusts on the Continent of Europe: A Study in Comparative Law with an Annex Containing Suggestions for the Drafting of General Bonds of International Government Loans, 94 ff.*

[102] Ibid.

[103] Report of the Committee for the Study of International Loan Contracts, League of Nations (Geneva, 1939); Schmitthoff, 'The International Government Loan', 180; and Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines', 274.

[104] Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines', 266.

[105] Weidemaier, Gulati and Gelpern, 'When Governments Write Contracts: Policy and Expertise in Sovereign Debt Markets', 97.

Essentially, it can be viewed as the beginning of the collective action clauses. In particular, the committee already saw a threat of litigation for sovereign debt restructuring and market institutions. It advocated for a bondholder vote to initiate litigation as a remedy, which requires the presence of an additional actor who would perform the proceedings, and a trustee was a solid option in that regard.[106] Among the League Committee's crucial recommendations regarding the institution of the trustee in sovereign bonds were:

- neutrality of the trustee from both the debtor state and bondholders;
- trustee's independence in its decision-making;
- irrevocability of the trustee's appointment;
- limitation of the trustee's liability to the cases of wilful misconduct;
- to rename the 'trustee' in order to prevent the confusion with family trustees which gives a false sense of security in bondholders;
- for the general protection of bondholders in some countries, which lack councils of foreign bondholders, it is reasonable to have a legal representative of all bondholders like a trustee whose decision should be binding on all bondholders;
- international loan contracts should explicitly specify the governing law;
- submission of the disputes to an arbitration tribunal by following a proposed standardised arbitration clause in the contract, especially when disputes involve matters of interpretation of the contract.

However, with the outbreak of the WWII and demise of the League of Nations, the initiatives to improve the trust arrangement in sovereign bond issues halted for many decades. Nevertheless, the problems of the bond trusteeship and findings of the scholars in the interwar period are still relevant and can provide a solid basis for improvement of the current sovereign debt legal framework.

III. THE MODERN AGE OF THE TRUST STRUCTURES IN SOVEREIGN BONDS

This part portrays the return of the trust arrangement, together with the comeback of the bonded debt, and the obstacles found by it in the post-WWII period. The ICMA-NAFMII Working Group described the trust structure as 'one of the fundamental

[106] Report of the Committee for the Study of International Loan Contracts, League of Nations (Geneva, 1939).

arrangements in international bond markets.'[107] However, despite that trust structures employed in the capital markets have 'proved an immensely powerful and flexible instrument of modern finance,'[108] they generally draw less attention from scholars than family trusts.[109] Moreover, if one would like to narrow the search to a more specific application of the trust arrangement in modern sovereign bond markets, one would discover a meagre scholarship on the topic. Little, if at all, has been written about the development of trust structures in sovereign bond issues in the post-WWII period.

The reincarnation of sovereign bonds as the main instrument of funding for governments occurred at the turn of the 1990s.[110] While issuers had an option to choose a trust arrangement for new bond issues, the fiscal agent structure began to dominate the US markets.[111] In contrast, the English law sovereign Eurobond issues adhered to a trust structure.[112] It is difficult to say exactly why and at what moment drafters decided to use a fiscal agency structure instead of the trust arrangement for bond issues under New York law. Such a decision seems especially odd taking into the account that the use of trust arrangement is a compulsory practice in corporate bond issues under US legislation.[113]

The conventional explanation is that competitive underwriters to decrease the expenses associated with bond issues preferred fiscal agent structures failing to stress

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[107] ICMA-NAFMII Working Group, 'International Practices of Bond Trustee Arrangements' (2018) Available at <https://wwwicmagrouporg/assets/documents/About-ICMA/APAC/ICMA-NAFMII-WG-International-Practices-of-Bond-Trustee-Arrangements-031218pdf>, 42.

[108] Ewan McKendrick (ed), *Goode on Commercial Law* (4th edn, Penguin Books 2010), 165.

[109] Rawlings, 'The Changing Role of the Trustee in International Bond Issues', 43.

[110] For more details see p 14.

[111] See IMF, *Legal Aspects of Standstills and Moratoria on Sovereign Debt Payments and Their Effect on Actions by Creditors* (EBS/96/26, 1996), 6; Robert Gray, 'Collective Action Clauses: Theory and Practice Essays' (2004) 35 Georgetown Journal of International Law 693, 705; and Lee C Buchheit, 'Supermajority Control Wins out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story' (2007) 26 International Financial Law Review 21, 21; G-10, *The Resolution of Sovereign Liquidity Crises* (A Report to the Ministers and Governors Prepared Under the Auspices of the Deputies, 1996), 16; Edward F Greene and Ronald Adee, 'The Securities of Foreign Governments, Political Subdivisions, and Multinational Organizations' (1985) 10 North Carolina Journal of International Law and Commercial Regulation 1, 12.

[112] Elmar B. Koch, 'Collective Action Clauses: The Way Forward Essays' (2004) 35 Georgetown Journal of International Law 665, 667; John Drage and Catherine Hovaguimian, 'Collective Action Clauses (CACs): An Analysis of Provisions Included in Recent Sovereign Bond Issues' (2004) 17 Financial Stability Review, 5; Augusto Repetto, Esteban C Buljevich and Maria E Rodriguez Beltran, 'Collective Action Clauses and Workouts' in Esteban C Buljevich (ed), *Cross-Border Debt Restructurings: Innovative Approaches for Creditors, Corporates and Sovereigns* (Euromoney Books 2005), 346.

[113] See infra at p 131.

to sovereign issuers the value of having trustees.[114] However, there might be another reason which is not mutually exclusive to the previous one, but, considering the importance of reputational theory for sovereign debt markets, could be the decisive one. Some light is shed on this by Lee Buchheit, who suggested that fiscal agent structures could become widespread based on path-dependency and boilerplate nature of the sovereign debt market.[115] It appears that the roots stem from the first issues of sovereign bonds very long before the Brady plan. In the 1970s, they were carried out only by developed countries with investment-grade ratings.[116] Neither developed countries nor their creditors were concerned with the possibility of default and holdout litigation. Given this fact, the fiscal agent structure seemed to be adequate to cover the range of events of default and undertakings without resorting to the trust arrangement.[117] Therefore, to signal to the market *ex ante* that no debt renegotiations would ever be needed, issuers purposefully turned down the trust structure which has much more utility in restructurings. Soon after, once emerging countries entered sovereign bond markets, they followed the trend of the developed nations, entrenching the practice of using fiscal agent agreements, in order not to send a wrong signal to investors and as a result to bear a higher cost of financing.[118]

This story mirrors the developments in another bond market. Initially, the issuance of corporate bonds was a prerogative of the best credit-rated companies, i.e. those having an investment grade. It changed in 1977 when the first bonds with below investment grade rating, dubbed junk bonds, were issued in a great amount.[119] In less than ten years, the outstanding amount of junk bonds on the US corporate market rapidly increased almost sevenfold.

Similarly to the situation with bonds issued by emerging countries, during the emergence of the new junk bond markets, sometimes bond documentation from

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[114] Anna Gelpern, *Sovereign Debt Crisis: Creditor's Rights vs. Development* (JSTOR 2003) 228; Gray, 'Collective Action Clauses: Theory and Practice Essays', 705.

[115] Buchheit, 'Supermajority Control Wins out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story', 21.

[116] Charles P Goodall, 'Eurobonds Issued with the Benefits of Trust Deeds' (1983) 2 International Financial Law Review 19, 19; Rawlings, 'The Changing Role of the Trustee in International Bond Issues', 45; Philip R Wood, 'Essay: Sovereign Syndicated Bank Credits in the 1970s' (2010) 73 Law and Contemporary Problems 7, 7.

[117] Goodall, 'Eurobonds Issued with the Benefits of Trust Deeds', 19.

[118] From the interview with Lee C Buchheit.

[119] Robert A Taggart Jr, 'The Growth of the "Junk" Bond Market and Its Role in Financing Takeovers' in Alan J. Auerbach (ed), *Mergers and Acquisitions* (University of Chicago Press 1987), 8.

investment-grade bond issues was borrowed.[120] Analogously to the debt of developed countries, the risk of default by investment-grade corporate issuers was small, and investor protection in the bond documentation was not an important issue. The same terms appeared in junk bonds overlooking the need for more investor protection considering that the risk of default and restructuring was significantly higher.

Additional factors which potentially influenced the choice in favour of fiscal agent structure reflect the creditors' attitude in the 1990s such as (i) some unwillingness by the US creditors to use trustees due to their perceived passivity,[121] and (ii) some opposition by creditors to constrain their individual rights under a trust arrangement.[122] It seems that certain investors like distressed debt funds had by then recognized the opportunity to make profits from holding out.[123] To facilitate orderly debt restructurings by using collective action clauses and trust structures would therefore not be in their interest. The absence of the trustee and difficulty of rescheduling public bonds coupled with relatively small amounts, in fact, enhanced the position of bondholders in a hierarchy of creditors.[124]

Finally, it seems that due to previous practices of shielding sovereign bonds from restructurings,[125] parties involved in the issue of bonds could be short-sighted to the potential changes in restructurings practices and neglect those contractual terms, including trust structure, aimed to facilitate the coordination of bondholders in debt readjustments.

Despite the numerous legal and technical advantages of the trust arrangement, the fiscal agent structure persisted during the 1990s.[126] Sovereign issuers and other market participants stubbornly declined to use trust structures despite numerous recommendations by reputable institutions.

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[120] Rawlings, 'The Changing Role of the Trustee in International Bond Issues', 45.

[121] Gray, 'Collective Action Clauses: Theory and Practice Essays', 706.

[122] G-10, *The Resolution of Sovereign Liquidity Crises, 31* ('A large proportion of the interviewees seemed not to favour such clauses because, in their view, they represent serious infringements of their creditor rights.'); For explanation of limitations on creditors' rights see Chapter 4.II. The Impact of the Legal Framework on Sovereign Debt Restructuring at 104.

[123] See CIBC Bank and Trust (Cayman) v Banco do Brasil, 886 F. Supp 1105 (S.D.N.Y. 1995). This case is known as the first major success by a distressed debt fund in sovereign debt litigation.

[124] Philip R Wood, *Project Finance, Subordinated Debt and State Loans* (Sweet & Maxwell 1995), 161.

[125] G-10, *The Resolution of Sovereign Liquidity Crises,* 1 and 29.

[126] Buchheit, 'Supermajority Control Wins out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story', 21.

One of the first international players who drew attention to the legal structure of sovereign bonds was the Group of Ten (G-10). In its report of 1996, it specifically addressed legal practices relating to the collective representation of debt holders in restructuring procedures called to deal with debtor's liquidity problems. One of the solutions for sovereign liquidity crises suggested by the G-10 was to include certain contractual provisions in international debt contracts aimed for (i) the collective representation of debt holders, (ii) qualified majority voting to alter the terms and conditions of the debt contract, and (iii) the sharing of proceeds among creditors.[127] Acknowledging the importance of the permanent collective representative and particularly trustees to achieve the designated aims, the report provides a survey of different national legislation and practices on the forms of collective representation in international debt offerings.[128] However, no specific recommendations regarding a unified approach for trust structures in sovereign bond contracts were mentioned.

While the G-10 outlined the road towards the development of new practices of using trust arrangements in sovereign bond contracts, it did not actively lead the market participants, timidly suggesting that this was a prerogative of the private sector.[129] A cautious position was dictated by the lack of information on the effect of such contractual provisions on the operation of sovereign bond markets and the scepticism shown regarding proposed contractual amendments by 'most of the market participants surveyed.'[130] The prevailing view of the creditors was that a sovereign bond is a 'sacred' obligation to pay and any amendment of contractual terms facilitating restructurings would undermine the disciplinary mechanism against defaults.[131] Also, collective action clauses in international sovereign debt were seen as a largely market-driven initiative which should be left entirely to the market participants guided by the freedom of contract principle.[132]

In response to the Asian financial crisis of 1997, the group of 22 systematically significant economies (G-22) issued a report in 1998 aimed to strengthen the architecture of the international financial system by providing concrete

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[127] G-10, *The Resolution of Sovereign Liquidity Crises,* 15.

[128] Ibid.

[129] Ibid.

[130] Ibid.

[131] Ibid.

[132] Ibid (Any public-sector intervention was seen in the negative light, e.g., 'the proposed EU Directive on unfair terms in consumer contracts may affect the market participants' freedom of contract').

proposals. Following mostly the proposals by the G-10 in 1996, one of the chapters of the report dealt with a coordination problem among creditors in sovereign debt restructuring and noted the threat of disruptive litigation.[133] While the report does not contain any information on the use of trust arrangements, it discusses the merits of CACs and, in particular, sharing clauses – an integral part of the trust arrangement[134] – against litigation.[135] Also, the G-10 reiterated the growing need to address bondholder coordination in debt restructurings and endorsed the use of the CACs.[136]

In 1999, after the bitter experience of several financial crises in developing countries which brought up difficulties in bondholder coordination,[137] the International Monetary Fund praised the large-scale adoption of a trust structure in issues of international sovereign bonds as an *ex ante* measure.[138] This shift was dictated by the institutional constraints from the absence of CACs for a new paradigm for sovereign debt restructuring, which now saw private sector involvement as a critical component to forestall and resolve financial crises,[139] because bonded debt became so important for sovereigns.[140] The involvement of the private sector usually means a roll-over of the existing commitments or decrease of the repayment claims.[141] Then again, no particular recommendations were provided except mentioning provisions authorising a trustee to negotiate with the debtor on behalf of bondholders, but without authorising the trustee to bind them to any agreement. In the view of many directors, to give an impetus to the introduction of collective action provisions, developed countries had to lead by example and use trustees for their own bond issues. Nevertheless, it did not turn out that way.

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[133] G-22, *Report of the Working Group on International Financial Crises* (Reports on the International Financial Architecture, 1998), 19 ff.

[134] See Chapter 4.IV.D. Sharing of the Proceeds at p 123.

[135] G-22, *Report of the Working Group on International Financial Crises,* 20.

[136] G-10, *Group of 10 Communiqué (PSI and CACs) from September 26, 1999.*

[137] See details on financial crises at p 13.

[138] IMF, *Report on Progress in Strengthening the Architecture of the International Financial System* (Report of the Managing Director to the Interim Committee from September 24, 1999), para. 30; similarly see IMF, *Report on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System* (Report of the Acting Managing Director to the International Monetary and Financial Committee from April 12, 2000).

[139] See IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises* (Executive Board Meeting 99/28 from March 17, 1999); IMF, *Report on Progress in Reforming the IMF and Strengthening the Architecture of the International Financial System;* IMF, *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund* (from April 29, 2001).

[140] See at p 14.

[141] Anne O Krueger, 'A New Approach to Sovereign Debt Restructuring' (2001) address at the Annual Members' Meeting of the National Economists' Club (Nov 26, 2001)

The first substantive shifts from a fiscal agent structure to a trust structure occurred with the proliferation of the distressed debt funds in the secondary sovereign debt markets whose strategy to collect the debt's par value is based on litigation. In this regard, the legal characteristics of the fiscal agent structure make it vulnerable to attachments orders.[142] Payments made to bondholders through a fiscal agent structure are the property of the sovereign borrower until they reach each bondholder's account.[143] During such a transit, the funds are subject to attachment. This vulnerability in pair with an innovative strategy was successfully applied by Elliott Associates against Peru to enforce the judgements[144] through attachment orders in different US states. Also, in 2000, Elliott Associates convinced the Belgian court that a *pari passu* clause in a debt contract between parties stipulates a pro-rata repayment of the debt among all creditors, which effectively prohibited the fiscal agent of Peru and clearinghouse Euroclear from paying interest on Peru's Brady Plan bonds to various other creditors.[145] This prohibition compelled Peru to hastily settle the case on disadvantageous conditions to avoid a default on its newly restructured debt under the Brady Plan. [146]

A similar strategy succeeded a few years later in the LNC Investments against Nicaragua case where a Belgian court prohibited a fiscal agent and Euroclear to transit money to bondholders who had agreed to the restructuring.[147] Even though this ruling was subsequently reversed by the Brussels' Appellate Court,[148] it substantially changed the attitude to the enforceability of sovereign debt in such way that even special legislation was enacted in Belgium to counter restraining orders of the type used by Elliott Associates and LNC Investments.[149] Moreover, it was a catalyst for the Republic of Peru and Nicaragua to replace a fiscal agent structure by

[142] See at p 103.

[143] Mark B Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back' (2010) 73 Law and Contemporary Problems 273, 286.

[144] Elliott Associates LP v Banco de la Nation, 12 F Supp 2d 328, (1998) and 194F 3d 363, (1999).

[145] Rodrigo Olivares-Caminal and others, *Debt Restructuring* (2nd edn, Oxford University Press 2016), 658.

[146] Ibid.

[147] LNC Investments LLC v Republic of Nicaragua, Docket No 240/03 (Brussels Commercial Ct, September 11, 2003); Rodrigo Olivares-Caminal, 'Sovereign Bonds: A Critical Analysis of Argentina's Debt Exchange Offer' (2008) 10 Journal of Banking Regulation 28, 35.

[148] République Du Nicaragua contre LNC Investments LLC, Euroclear Bank S.A., General Docket No 2003/KR/334 (Ct App of Brussels, 9th Chamber, March 19, 2004).

[149] Olivares-Caminal and others, *Debt Restructuring,* 665.

a trust structure in all subsequent bond issues under the New York and English laws to hedge a threat of attachments.[150]

Also, a trust structure was used by Congo (Brazzaville) during the 2007 debt restructuring due to the risk that judgment creditors could attach the payment streams on the newly issued debt instruments.[151] Once funds are deposited with the trustee, it holds them on behalf of the bondholders, precluding the possibility of the attachment due to sovereign's arrears.[152] In 2017, the ability of the trust structure to shield funds destined for bondholders from attachment underwent judicial scrutiny. The New York court vacated the restraining notices of the judgment creditor on the basis that Congo had no proprietary interest in the restrained funds once they reached the trustee.[153]

The year 2000 was remarkable for the use of collective action clauses in sovereign debt contracts owing to a great extent to the strong advocacy by the G-10 and the IMF. In this year, the UK started to use CACs in all its foreign currency debt,[154] and the German government reassured the capital markets that CACs in sovereign bonds were valid under its national law.[155]

In 2001 and 2002, the IMF launched two initiatives to address the problems of sovereign debt restructurings: the creation of the statutory regime, and the 'contractual approach' to enhance the restructuring process. Both initiatives were seen as complementary solutions by the IMF staff.[156] It is interesting to note that during a keynote speech by Anne Krueger unveiling a new initiative of the IMF to create a sovereign debt restructuring mechanism, as one of the motives for

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[150] Olivares-Caminal, 'Sovereign Bonds: A Critical Analysis of Argentina's Debt Exchange Offer', 37.

[151] Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back', 285.

[152] Rodrigo Olivares-Caminal and others, Debt Restructuring (1st edn, Oxford University Press 2011), 397.

[153] Commissions Import Export S.A. v Republic of the Congo 17 Misc. 246 (PIG) (S.D.N.Y. 2017).

[154] See the Announcement by Bank of England from 11 January 2000 about Publication of a new Information Memorandum for the UK Government Euro Treasury Note programme, <https://www.bankofengland.co.uk/-/media/boe/files/news/2000/january/uk-government-euro-treasury-notes-january-2000.pdf>, accessed on 21.03.2018.

[155] See the Statement by the German Federal Government from 14 February 2000 on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German law (**'**Acknowledging that the Act on the Joint Rights of Bondholders of December 4, 1899 does not apply to sovereign bonds, and hence the CACs are allowed under the principle of freedom of contract').

[156] IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use' (2002), 2.

introducing the statutory regime she repeatedly stressed the disrupting power of the holdout creditors by citing litigation initiated by Elliott Associates against Peru.[157] Under the umbrella of the 'contractual approach', the IMF staff specifically proposed to introduce collective enforcement provisions into New York and German law bond issues based on the model of trust deeds governed by English law.[158] Apart from the well-established function of trustees to enforce claims of bondholders, trustees were seen as a most promising channel of communication between a debtor and the bondholders.[159]

In September of 2002, the G-10 released another report on contractual clauses in sovereign debt. This time, presumably shaped by financial havoc in Argentina, the sentiments of the international community changed. In contrast to their previous view,[160] there was a wide agreement that some effective procedures are needed to restructure sovereign debt crises expeditiously.[161] The report provided specific recommendations on modifications of sovereign bond contracts to facilitate workouts. Those recommendations were designed as a package to balance concerns expressed by both sovereign debtors and creditors. While majority amendment clauses were the most critical component of the package, an important role was also assigned to the trust structure in sovereign bonds. The report took the market practice for sovereign bonds issued under trust deeds under English law as a point of reference and provided model clauses for trustees in sovereign bonds governed by US law addressing such issues as (i) meetings of bondholders, (ii) acceleration by trustees (iii) limitations on suits. The G-10 promoted the use of the trust structure in sovereign bond issues, recognising, in sync with the IMF, that it would provide an effective channel of communication between the sovereign debtor and bondholders and a safety valve against disruptive litigation.

It seems that the G-10 position was based on the tenants expressed by the undersecretary of Treasury for International Affairs John B Taylor portraying the U.S. policy regarding the process of sovereign debt restructuring in emerging markets. Remarkably, his first public address in April 2002 contains a bold proposal to employ majority enforcement provisions, which resemble a trust structure, to limit

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[157] Krueger, 'A New Approach to Sovereign Debt Restructuring'.

[158] IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use', 14.

[159] Ibid.

[160] See supra fn 131.

[161] G-10, *Report of the G-10 Working Group on Contractual Clauses* (2002), 1.

individual bondholder rights and provide a representative with the power to negotiate with the debtor and initiate litigation on behalf of bondholders.[162] However, six months later, his updated position presented at the Emerging Markets Trade Association (EMTA) conference was drastically cut down. Praising the support of the EMTA, which is presumably the reason for such a pivot, the updated proposal included only an acceleration clause instead of previously stated majority enforcement provisions.[163] A month later, a consortium of seven private-sector trade associations largely mirrored Taylor's updated view on the CACs reform. The trade associations' proposal, while endorsing various collective action clauses, took a stance against the use of the trust structure to restrict the right of individual bondholder enforcement action and distribution of the proceeds.[164] This seems to corroborate the earlier point that investors do not favour trust structures for the limits they impose on their individual rights.

In April 2003, EU member states agreed to lead by example by including CACs based on the framework developed by the G10 in their international debt issuance.[165] Among the 'core' clauses which the Member States and the Community were expected to use in implementing the EU commitment was a trust structure.[166] However, as shown by an EU report one and a half years later, only a few member states had implemented trust structures, namely Finland, Ireland, Lithuania Slovakia, Spain, United Kingdom.[167]

In December 2003, the revised Guidelines for Public Debt Management prepared by the IMF and the World Bank for the first time included recommendations to use CACs and in particular trust arrangements in sovereign bonds governed by foreign law.[168]

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[162] John Taylor, *Sovereign Debt Restructuring: A Us Perspective* (2002), 3.

[163] John Taylor, *Using Clauses to Reform the Process for Sovereign Debt Workouts: Progress and Next Steps* (2002) 3 ('And there is also an initiation clause "to inhibit precipitous litigation as a practical matter." With this initiation clause "bonds should require 25 percent bondholder vote to accelerate principal for event of default and provide for a 75 percent vote to rescind acceleration').

[164] EMCA EMTA, IIF, IPMA, ISMA, SIA and TBMA, *Marketable Bonds Package* (Discussion Draft 1/31/2003, 2003).

[165] See European Union, Previous work on CAC following G10 commitments, Available at <shorturl.at/ehkB7>.

[166] EFC Working Group on Government Bond and Bill Markets, 'Common Understanding on Implementing the EU Commitment Regarding the Use of Collective Action Clauses' (2003).

[167] EU Economic and Financial Committee, *Implementation of the EU Commitment on Collective Action Clauses in Documentation of International Debt Issuance* (ECFIN/CEFCPE(2004)REP/50483 final, 2004).

[168] IMF and WB, 'Guidelines for Public Debt Management' (2003), 19.

Nevertheless, the trust structure did not gain an immediate adoption in bond issues under New York law even after the explicit recommendations at the G-10 and IMF.[169] Even the IMF acknowledged that official calls to use collective action clauses had little impact on market practices.[170] One of the major reasons seems to be opposition by major financial market associations, which view the trust arrangement as undue restrictions of the individual bondholder's actions.[171] Also, the markets presumably viewed English–style trustee deed bonds as subordinated to American-style fiscal agency agreement bonds, which reflected on the pricing and composition of new bond issues.[172] Besides, the infamous inertia of the sovereign debt markets and a 'first mover' problem stubbornly slowed down the pace of reforms.[173]

Only a few years after the G-10 report, the trust structure based on the G-10 model started to emerge in issues under the New York law. Initially, they were chosen by several small developing nations,[174] whereas Uruguay and Indonesia were the first-movers.[175] Further, Argentina used a trust structure for the bonds she issued in connection with her sovereign debt restructuring in 2005 presumably due to bitter experience of holdout litigation. However, trusteeships did not spread quickly. Only 10.8 per cent of post-2003 sovereign bond issues adopted the trust structure under New York law.[176]

With the promotion of collective majority clauses in New York sovereign bonds and a shift of the perception from individual to collective litigation, issuers

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[169] Koch, 'Collective Action Clauses: The Way Forward Essays', 678.

[170] IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use', 4.

[171] See Koch, 'Collective Action Clauses: The Way Forward Essays', 678 and 681 (Such associations as Emerging Markets Trade Association (EMTA), the Institute of International Finance (IIF), the International Primary Market Association (IPMA), the Bond Market Association (BMA), the Securities Industry Association (SIA), the International Securities Market Association (ISMA), and the Emerging Market Creditors Association (EMCA) sent a petition to the G-10 in support of continuation to use fiscal agent structure in sovereign bond issues under the New York law).

[172] See IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises,* 56.

[173] IMF, 'Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use', 11.

[174] Anna Gelpern and Mitu Gulati, 'Innovation after the Revolution: Foreign Sovereign Bond Contracts since 2003' (2008) 4 Capital Markets Law Journal 85, 94.

[175] Drage and Hovaguimian, 'Collective Action Clauses (CACs): An Analysis of Provisions Included in Recent Sovereign Bond Issues', 5; and Koch, 'Collective Action Clauses: The Way Forward Essays', 678.

[176] W Mark C Weidemaier and Mitu Gulati, 'How Markets Work: The Lawyer's Version', *From Economy to Society? Perspectives on Transnational Risk Regulation*, vol 62 (Emerald Group Publishing Limited), 125.

began to resort more and more to trust arrangements by the mid-2000s.[177] Nevertheless, from all outstanding bonds issued between 2000 and 2008, only 24 per cent used a trust structure under English law and 28 per cent under New York law.[178]

In the wake of the European sovereign debt crisis, the trust arrangement has received renewed attention from academia and international institutions. For instance, the anti-crisis regulatory framework established by the European Council recommended the use of trustees in euro area government bonds to limit disruptive litigation, although it is not mandatory.[179]

Also, the IMF has started to monitor the use of trust arrangements in sovereign bond issues. In its recent reports, it acknowledges the merits of trustees to curb holdout litigation.[180] At the same time, the IMF is concerned that the trust arrangement could lose this function in a post-restructuring situation. This means that holdout bondholders can direct the trustee to start litigation after the exchange of old bonds for new bonds as the holdouts obtain enough voting power once the bonds of those agreeing to the restructuring are cancelled. However, there is a way to overcome this potential problem by using a 'cryonic solution' suggested by Lee Buchheit and Mitu Gulati.[181] According to the proposed scheme, the old bonds are not cancelled but deposited to the 'custodian trustee,' and hence holdout creditors are left with the same voting power as before the restructuring.

Surprisingly, the report by the IMF portrayed that trust arrangements were used in approximately 81 per cent of international sovereign bond issues under New York law between October 1, 2014, and July 31, 2015. At the same time, trust arrangements appeared only in 23.5 per cent of issues under English law.[182] This

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[177] Buchheit, 'Supermajority Control Wins out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story', 21 ('recent bond issuances have shifted to the use of trust structures (e.g. Argentina on its bonds subjects to English and New York law, Belize, Dominica, Ecuador, Grenada, Uruguay, and Mexico)').

[178] Sönke Häseler, 'Trustees Versus Fiscal Agents and Default Risk in International Sovereign Bonds' (2012) 34 European Journal of Law and Economics 425, 434.

[179] Ignacio Tirado, 'Current EU Mechanisms to Confront Sovereign Insolvency: A Normative Analysis against the Benchmark of the UNCTAD Principles' in Carlos Espósito, Yuefen Li and Juan Pablo Bohoslavsky (eds), *Sovereign Financing and International Law: The UNCTAD Principles on Responsible Sovereign Lending and Borrowing* (Oxford University Press 2013), 310.

[180] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts' (2015), 13; IMF, 'Second Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bonds Contracts' (2016), 8.

[181] Lee C Buchheit and Mitu Gulati, 'Restructuring Sovereign Debt after NML v Argentina' (2017) 12 Capital Markets Law Journal 224.

[182] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 17 (Calculated based on the data in the report).

represents a rapid shift in bond issues under New York law from the fiscal agent structure to the trust one. Especially with the adoption of the trust structure by large emerging market issuers such as Mexico, Chile and Argentina in their New York law governed bonds, drawing the parallel with the significance of the employment of collective majority clauses by Mexico in 2003 for the popularity of such clauses, it seems to become a preferred market practice. Interesting to note that the bond issue by Mexico in 2014, which was the first occasion of using a trust structure instead of the fiscal agency by this issuer, has been well-received by investors and even obtained the lowest yield ever for a 10-year dollar bond.[183]

In contrast, the English law sovereign bonds, which are usually associated with practices of using trustees, showed different findings by preferring fiscal agent structures.[184] This is explained through the sensitivity to the higher costs of trust structures on the part of lower-income issuers who tend to be involved in most of the English law issues.[185] Yet, it also may reflect that England has a more dispersed market of law firms representing sovereign issuers, which results in lack of force which would be able to drive the innovation.[186] Contrary to the US, there is no leader in England like Clearly Gottlieb which promotes the use of trust arrangements in sovereign bond issues.[187]

With increasing recognition that disruptive litigation is a real threat to sovereign debt restructuring, one can observe growing support in favour of adopting trust arrangements in sovereign bond issues coming from public institutions, including the United Nations.[188]

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[183] Alejandro Díaz de León, 'Mexico's Adoption of New Standards in International Sovereign Debt Contracts: CACs, Pari Passu and a Trust Indenture' (2016) 11 Capital Markets Law Journal 12, 23 (furthermore the bond documentation for the first time contained the new CACs and the ranking clause proposed by ICMA).

[184] Although the numbers are low, there is a trend towards more frequent adoption of the trust deeds by sovereign debtors issuing under English law. See Allen & Overy, 'Uses and Abuses of Collective Action Clauses in Sovereign Bonds' (2013) 14 Business Law International 269, 292.

[185] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 13.

[186] Gelpern and Gulati, 'Innovation after the Revolution: Foreign Sovereign Bond Contracts since 2003', 101.

[187] From the interview with Lee C Buchheit.

[188] Financing for Development Office (UN), 'Sovereign Debt Restructuring: Further Improvements in the Market Based Approach (Technical Study Group Report)' (2017), 13 (Stating that '[i]t is timely to promote the general use of trust indentures in the context of sovereign bond issues in order to prohibit or discourage individual bondholders from pursuing litigation').

CHAPTER 4. BOND TRUSTEES AND THE RESTRUCTURING OF INTERNATIONAL SOVEREIGN BONDS

This chapter portrays that the choice of the legal structure has important implications for the institutional set-up and allocation of the bondholders' rights as individual or collective. Further, it assesses the role of the trustee in various situations through the contractual analysis of the bond issue. It is argued that a trust arrangement is a more capable legal structure of sovereign bonds for the coordination of bondholders than a fiscal agency agreement. The trust structure has distinct advantages for ameliorating coordination problems in sovereign debt restructuring, ensuring checks and balances due to the involvement of the trustee as an intermediary with discretionary powers.

I. INTERNATIONAL SOVEREIGN BONDS: FISCAL AGENCY VERSUS TRUST STRUCTURE

When it comes to the question of the contractual structure of sovereign bonds governed by New York law and English law, the issuer has basically two options: the deal can be structured on the basis either of a fiscal agency agreement or of a trust indenture, which is known in English practices as a trust deed.[1] Bondholders derive their rights from those contracts.[2] Technically, those contracts are incorporated by reference into the bond instruments having a binding effect on all successive bondholders without any difference whether the bond was bought during the initial issuance or at some point at the secondary market.[3]

Both fiscal agency agreements and trust indentures determine the terms of the debt security, but they design relations between the involved parties differently and especially vary with respect to the allocation of bondholders' rights. Those

[1] The notions of the trust indenture and trust deed are used interchangeably unless indicated otherwise. Trust arrangement and trust structure have the same meaning.

[2] Marcel Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights' (2002) 77 New York University Law Review 1040, 1041.

[3] Ravi C Tennekoon, *The Law and Regulation of International Finance* (Butterworths 1991), 205. See also, Barcelona Traction, Light and Power Company Limited, (Belgium v Spain) Second Phase [1970] ICJ Rep 3, para 69 of the separate opinion by Sir Fitzmaurice.

relationships and legal design differences are of utmost importance for sovereign debt restructuring.

The main difference between the two structures is that only a trustee serves as a representative of bondholders and, at least in theory, enhances the protection of the bondholders. In contrast, a fiscal agent does not have any fiduciary or principal-agent relationship with bondholders and acts only as an agent of the issuer, the sovereign debtor. It means that a fiscal agent acts on behalf of the issuer and is subject to his control. However, those lines can be blurred sometimes, and a fiscal agent can have some duties vis-à-vis bondholders.[5] This was the case prior to WWII when drafters of the fiscal agency agreements often conferred on a fiscal agent the duty to represent bondholders and even enforce the debt against a debtor in courts.[6] At present, the delineation between the fiscal agency and trust structures is distinctive and fiscal agents do not have any principal-agent relationships with bondholders. For the sake of analysis, the fiscal agency agreement and trust arrangement are considered in their distinctive forms.

In essence, the fiscal agency agreement 'merely specifies the mechanics of issuing the debt securities and paying the principal and interest.'[7] It represents a two-party contractual relationship between an issuer and a fiscal agent. By means of the fiscal agency agreement, in order to facilitate the performance of the sovereign's obligations under the bond contract,[8] an issuer designates a fiscal agent. This structure gained popularity among sovereigns as it is easier and cheaper to implement than a trust arrangement.[9]

The notion of 'fiscal' shall be understood in a broader sense than merely tax issues and involves various financial matters occurring in the course of bond's lifespan.[10] The fiscal agent is usually authorised to provide payment and perform

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[4] Quadrant Structured Products Co. v Vertin, 16 N.E.3d 1165 (N.Y. 2014) ('An 'indenture' is essentially a written agreement that bestows legal title of the securities in a single trustee to protect the interests of individual investors who may be numerous or unknown to each other').

[5] See supra fn 14.

[6] Edwin Montefiore Borchard and Justus S Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles*, vol I (Beard Books 1951), 44 (Those practices disregarded 'the legal notion of agency and insensible to the logic of situation').

[7] Edward F Greene and Ronald Adee, 'The Securities of Foreign Governments, Political Subdivisions, and Multinational Organizations' (1985) 10 North Carolina Journal of International Law and Commercial Regulation 1, 12.

[8] A 'bond contract' refers to the contract document, such as a trust indenture, a fiscal agency agreement and conditions of the debt securities.

[9] See Chapter 3.III. The Modern Age of the Trust Structures in Sovereign Bonds, at p 88.

[10] Rodrigo Olivares-Caminal, *Legal Aspects of Sovereign Debt Restructuring* (2009), 395.

administrative functions, e.g. the payment and cancellation or replacement of coupons and bonds,[11] the publication of notices to the bondholders and acting as a depositary for the issuer's accounts.[12]

A fiscal agent does not fulfil any fiduciary duties vis-à-vis bondholders[13] except when holding in trust the money received from the issuer destined for payments of principal and interest.[14] This characteristic peculiar to the trust arrangement was supposedly employed to withstand a risk of attachment by the sovereign's creditors; however, there are still doubts whether such a legal construction will survive a judicial probe.[15]

In contrast to the fiscal agency agreement, the trust indenture employs a more complex structure and historically was used for more complicated and secured bond issues.[16] An issuer concludes an agreement with a trustee for the benefit of prospective bondholders, which stipulates the rights and obligations of those parties. Although apparently under such a contract design, the trustee has a contractual relationship with the issuer, this relationship does not correspond to the principal-agent model. In a legal sense, no agency is established because the trustee 'has no power to make the one employing him a party to a transaction, and is not subject to control over his conduct.'[17]

Akin to fiscal agent, a trustee also performs administrative functions;[18] however, his primary responsibility lies to represent and protect the rights of

[11] Daniel D Bradlow, *International Borrowing: Negotiating and Structuring International Debt Transactions* (International Law Institute 1986), 194.

[12] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts' (2015), 10.

[13] Albert S Pergam, 'Eurobonds: Trustees, Fiscal Agents and the Treatment of Default', *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer 1985), 336.

[14] AMH Smart, 'Fiscal Agency or Trust Deed' (1982) 1 International Financial Law Review 18, 18.

[15] Mark B Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back' (2010) 73 Law and Contemporary Problems 273, 286.

[16] See Chapter 2.II. The First Practices of the Trust Structures in Sovereign Bonds.

[17] See Restatement (Second) of Agency § 2 cmt. b (1957).

[18] Augusto Repetto, Esteban C Buljevich and Maria E Rodriguez Beltran, 'Collective Action Clauses and Workouts' in Esteban C Buljevich (ed), *Cross-Border Debt Restructurings: Innovative Approaches for Creditors, Corporates and Sovereigns* (Euromoney Books 2005), 334 (Among those functions are acting as a paying agent, registrar and transfer agent for the bonds).

bondholders.[19] In this regard, bondholders are the beneficiaries of the trust.[20] It is unusual though that a trustee does not hold any property in trust but only some specific rights which were irrevocably transferred from bondholders.[21] Using such a structure, a trustee becomes a permanent representative of the bondholders for the entire duration of the debt instrument. It is important to preserve the structure; otherwise, the bondholder would be able to terminate the trustee's authority[22] and escape limitations imposed by collective action clauses. The trustee usually is a bank or a trust company, independent from the underwriter, and appointed by the issuer. This feature should ensure professionalism and mitigates conflicts of interests.[23]

II. THE IMPACT OF THE LEGAL FRAMEWORK ON SOVEREIGN DEBT RESTRUCTURING

The contractual background of the bond issue always playing an important role in debt restructuring. This is particularly crucial for a sovereign debt restructuring, which lacks a statutory mechanism to fill in the gaps of the contract. Therefore, once the proposal for Sovereign Debt Restructuring Mechanism was abandoned in the early 2000s,[24] the official and private sectors were left with the 'contractual approach' as the only viable solution to address shortcomings of the sovereign debt restructuring. The main feature of this approach is the inclusion of the collective

[19] Ewan McKendrick (ed), *Goode on Commercial Law* (4th edn, Penguin Books 2010), 166 ('trustee being the vehicle for the collective protection and enforcement of the rights of the of the [bondholders]'); Bradlow, *International Borrowing: Negotiating and Structuring International Debt Transactions, 194*.

[20] Bradlow, *International Borrowing: Negotiating and Structuring International Debt Transactions, 194*.

[21] Philip Rawlings, 'The Changing Role of the Trustee in International Bond Issues' (2007) 2007 Journal of Business Law 43, 48.

[22] Tennekoon, *The Law and Regulation of International Finance, 227*.

[23] Mauro Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation* (Springer International Publishing 2015), 221.

[24] Paul Blustein, 'Bankruptcy System for Nations Fails to Draw Support' *Washington Post* (Washington, D.C. 2 April 2002) ('Anne O. Krueger, the IMF's first deputy managing director, conceded that because of insufficient political backing there is at present no chance for the legal changes necessary to establish a „sovereign debt restructuring mechanism') see also John W. Snow, *U.S. Secretary of Treasury, Statement at the Meeting of the International Monetary and Financial Committee (April 12, 2003)* (Available at <http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm> 2003) (Stating that '[…], it is neither necessary nor feasible to continue working on SDRM').

actions clauses (CACs) into the bond terms.[25] However, the turn to majority action clauses put a blind eye on crucial features of trust structures.

The use of CACs originates in 19th century English law practices to resolve a problem when a solvent corporate borrower under the pressure of liquidity issues could be forced into liquidation by recalcitrant creditors, who abstain from a debt restructuring.[26] Speaking about sovereign borrowers, the state cannot be liquidated and its assets foreclosed in the same manner as an insolvent corporate entity, but a sovereign can have solvency problems which are similar in nature to corporate insolvency. In this regard, CACs are called upon to mitigate both liquidity and solvency problems of the state by providing an environment for an orderly and expedient debt restructuring through cooperation between bondholders.

In order to achieve a sustainable level of debt for the country in crisis, it may be sensible to use ad hoc tools to relax rigid legal and contractual commitments, as the legal structure of finance can aggravate a financial crisis by imposing pre-determined, binding, non-negotiable, pro-cyclical legal commitments.[27] However, following the law-finance paradox, the use of ad hoc tools to depart from predetermined commitments will undermine the credibility of law.[28] Therefore, a more suitable solution is the employment of carefully designed safety valves, which are mechanisms embedded in law or contracts that serve to readjust commitments in the face of future uncertainty. Safety valves will allow actors to take into account and price the probability that some commitments can be readjusted in the future, and hence the credibility of law will be mostly preserved. In this regard, CACs and a trust structure, in particular, are safety valves to be used in sovereign debt crises.

The goal of CACs is to enhance coordination and cooperation among bondholders and speed up the negotiation process by pre-emptively constraining the freedom of bondholders, which can be used by minority holders to obstruct debt restructuring. It is worthwhile noting that those issues are relatively novel for sovereign bond financing, but a longstanding feature of corporate bonds,[29] and hence,

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[25] Robert B Ahdieh, 'Between Mandate and Market: Contract Transition in the Shadow of the International Order' (2004) 53 Emory Law Journal 691.

[26] See Rodrigo Olivares-Caminal and others, *Debt Restructuring* (2nd edn, Oxford University Press 2016), 722 and Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation, 355*.

[27] Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315, 318.

[28] Ibid.

[29] See Mark J Roe, 'The Voting Prohibition in Bond Workouts' (1987) 97 The Yale Law Journal 232.

some parallels are useful for analysis. As meticulously noticed by Marcel Kahan in his paper on US corporate bonds, it is crucial to investigate obstacles for bond restructuring through the legal prism distinguishing individual and collective bondholder rights.[30] These legal rights and obligations of the parties involved into sovereign debt restructuring are an amplifier but also a solution for coordination problems. In this regard, CACs are the contractual embodiment of the collective bondholder rights.

The notion of CACs in sovereign debt sphere is often used interchangeably with majority action clauses (MACs).[31] MACs restrict the individual use of rights attached to sovereign bonds by providing a minimum voting threshold for triggering an amendment of the bond terms, especially the core provisions such as payment terms, for all bondholders irrespective of their vote.

Since the appearance of the 'contractual approach', the market participants favoured MACs over other collective action clauses, including trust structures.[32] Starting from 2003, once Brazil and Mexico employed new provisions for its New York law governed bonds, approximately within a year at least twelve more countries introduced the MACs into their bonds issues.[33] The inclusion of the MACs became a market practice, and as of 2014, approximately 80 per cent of all outstanding foreign law bonds do include them.[34] The preliminary experience of using MACs in sovereign debt restructurings provides promising signs that the provisions were useful in achieving high creditor participation.[35]

However, there are some other categories of CACs which are useful to mitigate other collective action problem during a sovereign debt restructuring. Those types of CACs can be grouped into collective representation clauses and collective enforcement clauses.[36] The former clauses serve to enhance the communication and

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[30] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights'.

[31] Olivares-Caminal and others, *Debt Restructuring,* 721.

[32] See infra at p 98.

[33] IMF, 'Progress Report to the International Monetary and Financial Committee on Crisis Resolution' (2004), 3.

[34] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring' (2014), 18.

[35] Ibid.

[36] Ahdieh, 'Between Mandate and Market: Contract Transition in the Shadow of the International Order', 698; A similar approach to group the clauses is mentioned by Andrew Yianni, 'Resolution of Sovereign Financial Crises–Evolution of the Private Sector Restructuring Process' (1999) 6 Financial Stability Review 78.

negotiation process between bondholders and an issuer by assigning a representative forum for bondholders while the later clauses are helpful to curb holdout litigation.

Although a fiscal agency agreement can contain collective action clauses, a fiscal agency agreement in its unencumbered form does not have a purpose of collectivising bondholders and does not fall into any type of collective action clauses. In contrast, a trust arrangement is a CAC because its provisions enhance coordination among bondholders. Trust arrangements mainly function as collective representation clauses and collective enforcement clauses. Also, the trust structure facilitates the performance of the CACs in general and is considered as a more suitable structure than a fiscal agency agreement.[37]

While it is widely known that the origin of majority action clauses under English law goes back to a drafting initiative of Sir Francis B Palmer in 1879,[38] one particular aspect is unsaid that those clauses preferred a specific institution – trusteeship. An important lesson for sovereign bond contract drafters seems to be that in the 19th century MACs were used in a close bundle with a trust arrangement as they can properly complement and balance each other.[39] The question of inclusion of the MACs was dependent on the decision to use a trust deed. In this regard, a trust deed of the 19th century usually contained MACs as a counterweight to secure control by bondholders over the property and trustees.

In contrast, the current contractual reforms addressing collective action problem in debt restructuring started with the adoption of the standardised MACs in sovereign bond contracts but did not address the institutional framework, which is created by the trust arrangement in bond issuances. Within the same period when at least fourteen countries adopted MACs, only Uruguay and Indonesia began employing a trust structure.[40] Even the 'game-changing' Mexican issue of New York law bonds with MACs was structured as a fiscal agency agreement exemplifying the proverbial 'cart before the horse.'[41] Perhaps the only critique of such practices was

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[37] Repetto, Buljevich and Rodriguez Beltran, 'Collective Action Clauses and Workouts', 334.

[38] Francis B. Palmer and others, *Company Precedents for Use in Relation to Companies Subject to the Companies Acts, 1862 to 1890 ...: With Copious Notes and an Appendix Containing Acts and Rules* (7th Edition edn, Stevens and Sons 1898), 802.

[39] Ibid (The author underlined that 'it is usually considered preferable to have a trust deed setting out the full [majority action] clauses').

[40] IMF, 'Progress Report to the International Monetary and Financial Committee on Crisis Resolution', 10 and Sergio J Galvis and Angel L Saad, 'Collective Action Clauses: Recent Progress and Challenges Ahead' (2004) 35 Georgetown Journal of International Law 713, 717.

[41] United Mexican States, $1 billion at 6.625 per cent Notes Due 2015 (26 February 2003).

briefly mentioned by Lee C Buchheit stating that '[i]t is awkward to ask a fiscal agent (the issuer's own agent) to administer the operation of a collective action clause.'[42] It seems that the author is concerned with the potential conflict of interest a fiscal agent might have between the interests of the bondholders and the debtor.

A trust arrangement is an organic supplement to MACs. It works as a safety valve against frivolous litigation but also enhances the information-sharing and coordination of bondholders. As policy and private actors have shown their persistent interest in improving further the contractual framework of sovereign bonds by using a trusteeship,[43] the next sections assess the role of the trustee in various situations through the contractual analysis of the bond issue. It is argued that a trust arrangement is a more capable legal structure of sovereign bonds for the coordination of bondholders than a fiscal agency agreement. The trust structure has distinct advantages for sovereign debt restructuring ensuring checks and balances due to the involvement of the trustee as an intermediary with discretionary powers.

III. COLLECTIVE REPRESENTATION CLAUSES

The role of the trustee as an information conduit is praised due to the convenience of having a single point of contact instead of trying to reach out to numerous and often anonymous bondholders not only during negotiations with the debtor or court proceedings but also for solving administrative issues.[44] Any other involved actors such as the lead manager or the fiscal agent do not have any formal obligation to act as a channel for communication.[45] Establishing a streamlined communication with investors is crucial for bondholder voting and also for investor protection. It is a difficult task for larger issuers with liquid securities even if a trustee is present and

[42] Lee C Buchheit, 'Supermajority Control Wins Out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story' (2007) 26 International Financial Law Review 21, 21.

[43] For more details see Chapter 3.III. The Modern Age of the Trust Structures in Sovereign Bonds, at p 88.

[44] See Smart, 'Fiscal Agency or Trust Deed'; Charles P Goodall, 'Eurobonds Issued with the Benefits of Trust Deeds' (1983) 2 International Financial Law Review 19; Pergam, 'Eurobonds: Trustees, Fiscal Agents and the Treatment of Default'; Rory Macmillan, 'The Next Sovereign Debt Crisis' (1995) 31 Stanford Journal of International Law 305, 341; Richard Portes, 'The Role of Institutions for Collective Action' in Charles F. Adams, Robert E. Litan and Michael Pomerleano (eds), *Managing Financial and Corporate Distress: Lessons from Asia* (Brookings Institution Press 2000), 63.

[45] Robert Gray, 'Collective Action Clauses: Theory and Practice Essays' (2004) 35 Georgetown Journal of International Law 693, 705.

even more so without a trustee.[46] Furthermore, a bond trusteeship is not merely a contractual arrangement between a borrower and a creditor, but an institution which has a margin of discretion and therefore can fulfil some additional functions such as monitoring of the contractual-terms performance and even representation of the bondholders.

A. Monitoring

One of those functions is the monitoring of the borrower's compliance with the covenants of the bonds.[47] A trustee fulfils this function by assessing various reports and certificates received from the borrower but also by engaging independent experts.[48] It is widely discussed that atomised bondholders lack incentives to screen and monitor the borrower as rigorously as banks which provided substantial loans to the borrower.[49] Individual bondholders will mostly free-ride by relying on the monitoring efforts of others.[50]

The task becomes more problematic for holders of sovereign bonds due to the specifics of dealing with a nation-state.[51] Some accountability of the borrower and provision of the information on its financial condition is required to monitor the fulfilment of the debt obligations by a sovereign. This accountability raises controversies about the alleged infringement of the sovereignty of the state, making states resistant to monitoring activities, especially if they are coming from individual creditors. In this regard, the initiative to monitor coming from an intermediary such as a trustee, who represents a class of bondholders, seems to have better chances to

[46] Paul Burke and Sara Elizabeth Beckmeier, 'Improving Bondholder Communication' (2014) 20 Journal of Structured Finance 93.

[47] Macmillan, 'The Next Sovereign Debt Crisis', 341; Anthony Herbert, 'Why Have a Trustee for a Eurobond Issue?' (1987) 2 Journal of International Banking Law 1, 48.

[48] Pergam, 'Eurobonds: Trustees, Fiscal Agents and the Treatment of Default', 337.

[49] Anthony D F Coleman, Neil Esho and Ian G Sharpe, 'Does Bank Monitoring Influence Loan Contract Terms?' (2006) 30 Journal of Financial Services Research 177; and in the context of the sovereign debt see Issam Hallak and Paul Schure, 'Loans Versus Bonds: The Importance of Potential Liquidity Problems for Sovereign Borrowers' in Robert W Kolb (ed), *Sovereign Debt: From Safety to Default* (John Wiley & Sons 2011).

[50] Ramon E Johnson and Calvin M Boardman, 'The Bond Indenture Trustee: Functions, Industry Structure, and Monitoring Costs' (1998) 8 Financial Practice and Education 15, 15.

[51] Mitu Gulati, *Political Risk and Sovereign Debt Contracts* (Duke Law Scholarship Repository 2011), 13.

succeed.[52] Also, the fact that the issuer has contractually agreed to provide a trustee with information helps to leverage the trustee's position.[53]

Moreover, monitoring of the sovereign debtor should be seen in a broader perspective than merely ensuring the fulfilment of the debtor's obligations. Monitoring by trustees is similar to the role of bondholders' committees, which for centuries provided information to capital markets on the financial health of the sovereign borrower and nature of the default enhancing the transparency of the market and strengthening the reputational basis for lending and repayment.[54]

Another crucial aspect is that proper monitoring helps to proceed with a pre-emptive debt restructuring addressing the notorious problem that debt restructurings have often failed to re-establish debt sustainability as they came 'too late'.[55] There is evidence that the pre-restructuring period takes twice as long as the subsequent negotiation phase and is related to a higher GDP decline of the borrowing state.[56] Sovereign borrowers tend to postpone a debt restructuring till the last moment for political motives.[57] Furthermore, even an initiative coming from the sovereign borrower to renegotiate sovereign debt can be a reason for a credit rating downgrade by credit agencies.

Also, in an environment of highly dispersed bondholders, no individual creditor has enough incentives to act proactively and restructure the debt before the default even if its occurrence is highly probable. Under the current system, neither

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[52] Marc Flandreau and Juan H Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830' (2009) 69 The Journal of Economic History 646, 651 (Arguing that financial intermediaries could monitor sovereign borrowers effectively as they are not 'an amorphous lot').

[53] E.g., see Trust Indenture between Belize and the Bank of New York Mellon, dated 20 March 2013, U.S. Dollar Bonds Due 2038.

[54] Michael Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (Student edition edn, Princeton University Press 2007), 234; See also about the main utility of the bondholder committees at p 55 of this thesis.

[55] IMF, 'Sovereign Debt Restructurings–Recent Developments and Implications for the Fund's Legal and Policy Framework' (2013), 2 ('[…] the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems, especially in pre-default cases').

[56] Brett House, Mark Joy and Nelson Sobrinho, 'Sovereign Debt Restructurings: The Costs of Delay' (2017) Mimeo, 2017.

[57] Rodrigo Olivares-Caminal and others, *Debt Restructuring* (1st edn, Oxford University Press 2011), 420.

debtor governments nor creditors have incentives to act proactively.[58] The trustee can carry out this function that mitigates the social costs associated with the default.[59]

By way of the monitoring of the sovereign debtor, a trustee provides the early warning signs of a debt problem, so a borrower can address the problems at their initial stage or begin a pre-emptive restructuring with creditors if other policies proved to be insufficient.[60] In this regard, pre-emptive restructurings take on average a shorter period to implement. Hence, the costs of restructuring are lower.[61] At the same time, pre-emptive sovereign debt restructurings have a lower haircut for creditors and ensure faster economic recovery of the borrower.[62]

Those goals can be achieved only if accurate and timely information is coming from the borrower. This was recognised by the Working Group of G-10 which recommended to enlarge the scope of information which sovereign is required to provide to its bondholders in general and especially following an event of default.[63] In this respect, more detailed or even confidential information, which the borrower would not share publicly, could be received and treated by a trustee.[64]

Furthermore, the trustee can facilitate the use of GDP-linked bonds by monitoring the fulfilment by the sovereign of its obligation to report and quality of the submitted data. The idea of performance-linked debt is not new. Back then in the early fifteenth century, the House of St George, an institution which managed Genoa's public debt, used performance-linked loans where returns depended on the yield of the taxes.[65] The contractual provisions which connected the repayment to the economic situation of the country were used in the 19th century debt issues and known

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[58] UNCTAD, *Trade and Development Report 2015* (United Nations Publication ISBN 978-92-1-112890-1, 2015); Lee C Buchheit and others, 'Revisiting Sovereign Bankruptcy' (2013) Available at SSRN 2354998.

[59] See generally Eduardo Borensztein and Ugo Panizza, *The Costs of Sovereign Default* ('IMF eLibrary' 2008).

[60] House, Joy and Sobrinho, 'Sovereign Debt Restructurings: The Costs of Delay'.

[61] Udaibir S Das, Michael G Papaioannou and Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts* (International Monetary Fund 2012), 33.

[62] Tamon Asonuma and Christoph Trebesch, 'Sovereign Debt Restructurings: Preemtpive of Post-Default' (2016) 14 Journal of the European Economic Association 175.

[63] G-10, *Report of the G-10 Working Group on Contractual Clauses* (2002) 3.

[64] Philip R Wood, *International Loans, Bonds, Guarantees, Legal Opinions*, vol 3 (The Law and Practice of International Finance Series, 2nd edn, Sweet & Maxwell 2007), 285.

[65] Luciano Pezzolo, 'Sovereign Debts, Political Structure, and Institutional Commitments in Italy, 1350–1700' in D'Maris Coffman, Adrian Leonard and Larry Neal (eds), *Questioning Credible Commitment: Perspectives on the Rise of Financial Capitalism* (Cambridge University Press 2013), 171.

as the prosperity clause.[66] In the modern age, the League of Nations promoted the use of performance-linked debt featuring its advantages for debt sustainability.[67] The basic idea of the GDP-linked bonds is to tie the bond repayment terms to the capacity to repay and hence to reduce the likelihood of a sovereign debt crisis.[68] As a result, GDP-linked bonds raise the maximum sustainable level debt of a sovereign and reduce the probability of default leading to a significant increase of the welfare.[69] For those reasons, academics[70] and official sector policy-makers have actively promoted the adoption of the GDP-linked bonds.[71]

As a bottom-up initiative, the private sector drafted the London Term Sheet with the reference terms which can be used for GDP-linked bonds issue.[72] Even though the London Term Sheet does not specify whether the GDP-linked bonds should be issued under the trust structure,[73] it seems that its use is preferable. In fact, a trust structure is a crucial infrastructure for the operation of the GDP-linked bonds.[74] Depending on the frequency of the coupon payments, the GDP data should be periodically disseminated to investors. Once again, the collective action problem occurs with regard to the party which will monitor the quality of the data and regular reporting in order to calculate the applicable payment for a specific period. A trustee monitoring the sovereign borrower can alleviate the commonly criticised problem of GDP misrepresentation aimed at reducing interest payments.[75]

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[66] Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 308.

[67] Ibid.

[68] James Benford, Thomas Best and Mark Joy, 'Sovereign GDP-Linked Bonds' (2016) Bank of England, Financial Stability Paper No 39, 5.

[69] David Barr, Oliver Bush and Alex Pienkowski, 'GDP-Linked Bonds and Sovereign Default' in Joseph E. Stiglitz and Daniel Heymann (eds), *Life after Debt: The Origins and Resolutions of Debt Crisis* (Palgrave Macmillan UK 2014), 270.

[70] Andrei Shleifer, 'Will the Sovereign Debt Market Survive?' (2003) 93 The American Economic Review 85, 89 (Proposing to tie the return of sovereign securities to commodity prices or economic performance to address the hardship of sovereign borrowers in economic downturn).

[71] E.g. see policy papers and press releases by the IMF, G20, Bank of Canada, Bank of England and Deutsche Bundesbank: IMF, 'State-Contingent Debt Instruments for Sovereigns' (2017); Communique´ of G20 Finance Ministers and Central Bank Governors Meeting Chengdu, China, 24 July 2016; Martin Brooke and others, 'Sovereign Default and State-Contingent Debt' (2013) Bank of Canada Financial Stability Paper 2013-3; Benford, Best and Joy, 'Sovereign GDP-Linked Bonds', Deutsche Bundesbank Press Release, 1 December 2016.

[72] Allen & Overy, *London Term Sheet - GDP Bonds* (DRAFT: 21/09/16, 2016).

[73] Ibid.

[74] IMF, 'State-Contingent Debt Instruments for Sovereigns', 36 (Arguing that robust institutions and careful contract design are needed to mitigate investor concerns with respect to state-contingent debt instruments).

[75] Brooke and others, 'Sovereign Default and State-Contingent Debt', 15.

B. Representation in Negotiations

Even during the times of a more homogenous creditor community, which comprised mostly banks, a sovereign debtor could not engage in negotiations with each creditor, and therefore advisory or steering committees were used to aggregate the creditors.[76] With the advent of bond financing, this issue became even more relevant.[77]

Even when the majority action clauses (MACs) are implemented, some coordination problems persist. According to Pitchford and Wright, while MACs are substantially decreasing creditor coordination problems in free-riding on the debt settlement itself, MACs may be a cause of "a 'free-rider' effect in which creditors delay settlement to avoid sharing in negotiation costs" because independently from their active or passive role in negotiations, all bondholders will have common settlement terms.[78] In this regard, the costs for negotiations can be more than 3 per cent of the value of a restructuring.[79]

Furthermore, bondholders ceased to be involved in the direct possession and transfer of the bond certificates with the new practices of the late twentieth century to issue bonds in 'global' form.[80] The new practices inserted additional layers of intermediaries between the borrower and bondholders.[81] Beneficiaries of the bonds do not hold bond certificates themselves any more, but a bond issue became represented by a global bond held by a custodian, i.e. common depositary, on behalf of the clearing system where interests of that bond are traded primarily with the help of the intermediaries, e.g. the bank or broker which holds the bond as nominee for the beneficiary.[82] Under such conditions, when bondholders become ever more

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[76] Lee C Buchheit, 'The Collective Representation Clause' (1998) 17 International Financial Law Review 9, 9.

[77] For more details, see Chapter 1.I. International Sovereign Bonds and the Role of Law, at p 13.

[78] Rohan Pitchford and Mark L J Wright, 'Holdouts in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment' (2012) 79 The Review of Economic Studies 812, 832; Rohan Pitchford and Mark L J Wright, 'On the Contribution of Game Theory to the Study of Sovereign Debt and Default' (2013) 29 Oxford Review of Economic Policy 649, 662.

[79] Pitchford and Wright, 'Holdouts in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment', 832.

[80] Joanna Benjamin, Madeleine Yates and Gerald Montagu, *The Law of Global Custody* (2nd edn, Butterworth 2002), 14 (For the efficient settlement system, paper-form securities have been replaced by electronic records).

[81] For participant structure of the global securities see Wood, *International Loans, Bonds, Guarantees, Legal Opinions,* 214.

[82] Yianni, 'Resolution of Sovereign Financial Crises–Evolution of the Private Sector Restructuring Process', 82.

detached from the market operations with their bonds, the employment of a trustee as a centralised body to represent bondholders seems more sensible.[83]

As observed by practitioners, bondholders are reluctant to organize themselves into committees and rather prefer to contact a bond trustee to resolve a problem.[84] Therefore, instead of merely passing the information between a debtor and bondholders,[85] the trustee's position makes him an obvious candidate to facilitate the restructuring process and ensure an early contact between bondholders and a debtor. A trustee leading the negotiations will be reimbursed by the bondholders pro rata to the amount of their holdings precluding free riding on negotiation costs.

However, the current legal framework may preclude trustees from facilitating a negotiation process.[86] To discuss the modification of the bond terms, a trustee shall have authorization from the bondholders, otherwise, it can be seen as an infringement of the fiduciary duties by a trustee owned to bondholders, because any restructuring deal leads to some changes of the initial terms of the bonds and some losses for the creditors, at least on the paper. A bond trustee is in a similar position as an agent bank who cannot disregard the contractual instructions even if departing from them will be in the best interest of the syndicate.[87] This has resulted in the rejection of even favourable debt restructuring proposals to bondholders by trustees.[88]

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[83] Rawlings, 'The Changing Role of the Trustee in International Bond Issues', 47.

[84] Simon Hill and Tim Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?' (2010) 5 Capital Markets Law Journal 5, 15.

[85] Although even this basic function is important. For example, according to the provisions of the trust structure used by Uruguay:

'Before seeking the consent of any holder of a debt security of any series to a reserve matter modification affecting that series, Uruguay shall provide to the trustee (for onward distribution to the holders of the affected debt securities) the following information:

• a description of the economic or financial circumstances that, in Uruguay's view, explain the request for the proposed modification;

• if Uruguay shall at the time have entered into a standby, extended funds or similar program with the International Monetary Fund, a copy of that program (including any related technical memorandum); and

• a description of Uruguay's proposed treatment of its other major creditor groups (including, where appropriate, Paris Club creditors, other bilateral creditors and internal debtholders) in connection with Uruguay's efforts to address the situation giving rise to the requested modification.'

See República Oriental del Uruguay, Prospectus Dated April 10, 2003, Modifications, 75-76.

[86] IMF, 'The Design and Effectiveness of Collective Action Clauses' (2002), 15.

[87] Wood, *International Loans, Bonds, Guarantees, Legal Opinions,* 122.

[88] E.g., trustees of the Loan issued a protest against the debt settlement with Hungary despite that the League Loans Committee described it as fair and equitable; League of Nations, 'Work of the Financial Committee at Its Sixty-Fifth Session: Supplementary Report Relating to Hungary, Submitted to the Council on January 27th, 1938' (1938) 19 League of Nations Official Journal 127; See also Borchard and Hotchkiss, *State Insolvency and Foreign Bondholders: General Principles,* 57 and 315.

In order to address this problem, it was proposed to give a specific mandate to a trustee (or a fiscal agent) at least to passively participate in informal meetings with a debtor and other creditors to convey the information regarding restructuring proposals to bondholders.[89] This would facilitate inter-creditor coordination and expedite the restructuring by saving the time spent on the formation of the bondholder syndicates and appointment of their negotiators with sovereign borrowers.[90]

A bolder version of the same proposal, which became known as an engagement clause,[91] stipulates that a trustee or a fiscal agent will be authorised to hold a proactive discussion of the terms of the restructuring, with the express right to delegate this function. However, the acceptance of the terms should still be up to the bondholders' vote.[92] The use of the engagement clause in sovereign bond contracts was supported by the Under Secretary of the U.S. Treasury for International Affairs John Taylor,[93] and the G-10 recommended to couple this provision with a trust structure.[94] However, the first adopters of the engagement clause, e.g. Hungary, entirely omitted the use of the trust structure, presumably due to prevailed minimalist approach to CACs of that time.[95]

Even a more extreme proposal, first mentioned by Yakov Amihud and others in the context of corporate bonds and later transplanted to sovereign debt, recommends the establishment of the 'supertrustees' having the full power to bind the bondholders in debt restructurings.[96] While investing those powers in a trustee is

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[89] Buchheit, 'The Collective Representation Clause', 11.

[90] Ibid.

[91] The basic idea of the engagement clause is to provide a representative to engage in restructuring discussions or the mechanism to elect one. The identity of the representative under the engagement clause is not limited to the fiscal agent or trustee as was first proposed by Lee Buchheit.

[92] Buchheit, 'The Collective Representation Clause'.

[93] John Taylor, *Using Clauses to Reform the Process for Sovereign Debt Workouts: Progress and Next Steps* (2002).

[94] G-10, *Report of the G-10 Working Group on Contractual Clauses.*

[95] Galvis and Saad, 'Collective Action Clauses: Recent Progress and Challenges Ahead', 718 (The prevailed approach to CACs revolved around Mexico's minimalist model based on: '(1) a majority-amendment clause based on seventy-five percent of the total outstanding principal amount of bonds; (2) an enhanced disenfranchisement provision; and (3) an expanded list of reserved matters.').

[96] Yakov Amihud, Kenneth Garbade and Marcel Kahan, 'A New Governance Structure for Corporate Bonds' (1999) 51 Stanford Law Review 447; R. Auray, 'In Bonds We Trustee: A New Contractual Mechanism to Improve Sovereign Bond Restructurings' (2013) 82 Fordham Law Review 899.

not acceptable for the private-creditor community,[97] it was recommended by UNCTAD in its Sovereign Debt Workout Principles of 2015.[98]

The practical consequences of not designating a bondholders' representative upfront are that there might be a time gap, especially taking into account the coordination problem among bondholders, between the moment the restructuring negotiations started, and the election of a committee of bondholders' representatives. It seems natural to engage a trustee in negotiation process whose task is to protect bondholders' rights and who already would have been in place since the bond issuance if a trust structure was used. The experience of involving English trustees in Eurobond restructurings has been seen as beneficial to both the issuer and the bondholders.[99]

In any case, a trustee already brings flexibility because a trustee can do some amendments of the bond terms without convening a bondholder vote. Surely, the scope of those amendments is minimal, for instance, under English law trust deeds, they should not be 'materially prejudicial' to the interests of the bondholders, which excludes the issues involved in debt restructuring like a change of the payment terms.[100] In this regard, in situations when a bondholder vote is necessary, the trustee can proactively speed up the process by using its right to call a meeting.

Moreover, it seems that there is a workaround to the trustee's limitations to bind the bondholders in direct negotiations with a borrower. Once a trustee initiates a claim to recover the defaulted debt on behalf of all bondholders, it can conclude a settlement with a sovereign borrower de facto representing all bondholders via a court proceeding. The court could approve the settlement even if it compromises bondholders' claims under the conditions that it is still fair and equitable.[101] Furthermore, a settlement concluded during litigation provides benefits in the form of legal certainty. Once the court sanctioned the settlement, it becomes litigation-

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[97] See the discussion regarding a position of trade associations and its influence on the US sovereign debt restructuring policy, at p 97.

[98] UNCTAD, *Sovereign Debt Workouts: Going Forward Roadmap and Guide* (Available at <http://unctadorg/en/PublicationsLibrary/gdsddf2015misc1_enpdf>, 2015), 29.

[99] David Frauman, 'Insolvency: The Bust Boom' (2002) 16 The Lawyer 27, 27.

[100] Herbert, 'Why Have a Trustee for a Eurobond Issue?', 48 (Although trivial those issues maybe crucial and require quick actions. For instance, to 'deal with unforeseen legislative or fiscal changes and also to deal with changes in the group structure of the issuer or guarantor').

[101] James E Spiotto, *Defaulted Securities: The Guide for Trustees and Bondholders* (Chapman and Cutler LLP 2018), 157.

proof unlike the debt restructuring agreed directly between accepting bondholders and a sovereign borrower.

IV. COLLECTIVE ENFORCEMENT CLAUSES

Another type of CACs is collective enforcement clauses. It mitigates a creditors' dilemma[102] by precluding the creditors' race to the court in pursuit of being the first to seize (limited) assets of the creditor.[103] The basic idea of the collective enforcement provisions is to restrict the ability of bondholders to enforce a debt individually. While those restrictions are imposed through the allocation of the specific bondholders' rights via various contractual terms of the bonds, such as the event of default, acceleration clause, no-action clause, sharing clause, it is common to bundle those rights depending on the legal structure of the bond issue. Essentially, the use of the fiscal agency or trust structure bundles enforcement rights of bondholders having important consequences for the debt restructuring procedure.

Concerning the fiscal agency structure, virtually all the rights attached to the bonds are vested in the bondholders unencumbered.[104] This means that in the event of default,[105] every bondholder has the discretion to choose the corresponding legal measure from the enforcement arsenal provided by the bond contract and to act on its own. It goes without saying that individual bondholders can form a group and pursue a collective action; however, the main aspect is that individual bondholders have almost unencumbered rights to take legal actions at will.

In contrast, within the trust structure, most of the individual bondholder's rights to enforce the debtor's obligations are limited. Those rights are transferred to the trustee and performed at its discretion, usually binding the bondholders. The impact of the trust structure is generally described through the bondholders' altered ability to (i) declare a default of the contractual terms; (ii) declare the principal amount due and payable ('acceleration'); (iii) initiate the legal action against a debtor

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[102] See previous discussion, at p 29.

[103] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 12.

[104] Lee C Buchheit and Mitu Gultai, 'Sovereign Bonds and the Collective Will' (2002) 51 Emory Law Journal 1317, 1332.

[105] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1049 ('To understand the enforcement scheme, it is important to distinguish between a 'default' and an 'Event of Default'. A 'default' basically includes any breach of a provision in the indenture.' An 'event of default' includes a payment default and other events specifically specified in the indenture).

('no-action clause'); (iv) individually collect the recovered amount from the sovereign ('sharing clause').[106] In brief, the trust indenture is characterised by the collective enforcement of the bondholders' rights represented by the trustee who acts in the bondholders' interests.[107] Essentially, the trust structure provides the effect of a corporate bankruptcy regime by incentivising the bondholders to participate in a debt restructuring.[108]

A. Declaration of Default

While the acceleration of the bonds is a major event for both a borrower and creditors, in order to accelerate the principal, a specific event of default should be established. In a fiscal agency structure, it happens almost automatically at bondholders' will, but within a trust structure, the event of default can be declared only by a trustee who has some leeway of the discretion in deciding on this issue.[109] This mechanism already works as an additional safety valve. A trustee can avoid unnecessary cross-acceleration and technical defaults by deciding whether the event, which might be seen as a breach of contract, is materially prejudicial to bondholders. It could be the case that a breach of some contractual terms in a distressed situation may actually enhance the credit standing of the issuer in the long run.[110] However, for the mechanism to work properly, a bond trustee should perform his functions diligently.

B. Acceleration and Cross-default

The right to accelerate bonds making all debtor's future obligations due immediately is a powerful deterrence against a debtor's misconduct. It provides a creditor with the possibility of exiting the relationships with the debtor prematurely claiming the payment of the principal and accrued interest in advance of the stipulated schedule.

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[106] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 11; IMF, 'The Design and Effectiveness of Collective Action Clauses', 10; Gray, 'Collective Action Clauses: Theory and Practice Essays', 705.

[107] Macmillan, 'The Next Sovereign Debt Crisis', 341.

[108] Lee C Buchheit and Elena Daly, 'Minimizing Holdout Creditors: Carrots' in Rosa M Lastra and Lee C Buchheit (eds), *Sovereign Debt Management,* (Oxford University Press 2014), 15.

[109] Tennekoon, *The Law and Regulation of International Finance,* 228.

[110] Herbert, 'Why Have a Trustee for a Eurobond Issue?', 48. See also Terence Prime, *International Bonds and Certificates of Deposit* (Butterworths 1990), 294 (Stating that a way to overcome the difficulties with constructing a workable materiality test of any particular breach by the borrower is to leave the decision to the trustee).

At the same time, like any other powerful mechanism, it is prone to abuse and can be used by bondholders as leverage in negotiations. This is especially relevant for a fiscal agency structure which usually allows an acceleration by each bondholder.[111] The action of the single bondholder may spur a domino effect both inside and outside of the bond issue by 'crystallising' cross-default clauses forcing the debtor into insolvency.[112] As a rule of thumb, a cross-default clause in sovereign bonds is very specific and usually triggered by the actual acceleration of the maturity of the external public debt of a substantial nominal amount such as more than U.S. $25 million.[113] However, some sovereign bond documentation could state that a mere default on the payment of the principal or interest of specific value as a reason for a cross-default.[114]

To preclude an abuse by bondholders, most of the recently issued bonds require a vote of 25 per cent of the principal amount for acceleration with the possibility to rescind acceleration by the consequent vote of bondholders representing 50 per cent of the issue.[115] Essentially, this is the first line of defence against enforcement by an individual bondholder. Those provisions were promoted by the G-10 during the CACs reform in 2003 on par with the collective modification of the bond terms.[116] The inclusion of those provisions is not mandatory although they are recommended by the supplemental provisions of the Euro area Model CAC 2012.

A trust structure facilitates the acceleration procedure by additionally empowering a trustee to accelerate the debt after an event of default, seek financial advice on the proper course of action and convene a bondholders' meeting to decide on acceleration.[117]

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[111] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 11.

[112] Wood, *International Loans, Bonds, Guarantees, Legal Opinions, 295* and Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation,* 354.

[113] See Trust Indenture between Belize and the Bank of New York Mellon, dated 20 March 2013, U.S. Dollar Bonds Due 2038 (In this particular issue, the scope of the debt in cross-default clause is not limited to external public indebtedness, but unusually includes all public debt of Belize together with domestic indebtedness).

[114] See Fiscal Agency Agreement between the Republic of Argentina and Bankers Trust Co., dated 19 October 1994; and Trust Indenture between the Republic of Argentina and the Bank of New York, dated 2 June 2005, (Both containing similar triggers for the cross-default).

[115] Buchheit and Gultai, 'Sovereign Bonds and the Collective Will', 1330; Stephen J Choi, Mitu Gulati and Eric A Posner, 'The Evolution of Contractual Terms in Sovereign Bonds' (2012) 4 Journal of Legal Analysis 131, 147.

[116] For the details on the reform see p 93.

[117] Herbert, 'Why Have a Trustee for a Eurobond Issue?', 48.

C. Collective Legal Action

The main feature of the trust structure is its deterrent effect on disruptive litigation,[118] i.e. the 'mad bondholder' problem,[119] undermining debt restructuring negotiations after a default.[120] A no-action clause is a mechanism against the poor judgment of a single bondholder or a small group of bondholders who disregard the collective economic interest of the remaining bondholders.[121] While the no-action clause theoretically can be used without the trust structure, in practice, a trustee is essential for the operation of this provision.[122] Under the trust structure, a bondholder cannot initiate legal proceedings unless the trustee has failed to perform its duties or has abstained from following the qualified bondholder's request.[123]

Those provisions mitigate the coordination problem among bondholders following the default by a sovereign borrower. From the bondholders' point of view, a trustee as a common representative provides a way to enforce their claims without their direct participation and to share the enforcement costs among all bondholders of the particular issue.[124] At the same time, a trust structure benefits the issuer since

[118] Watts v Missouri-Kansas-Texas R.R. Co., 383 F.2d 571, 574 (1967) (It serves to 'prevent rash, precipitate, or harassing suits by bondholders who disrupt corporate affairs'... and to protect the issuer from a multiplicity of lawsuits').

[119] Herbert, 'Why Have a Trustee for a Eurobond Issue?', 49.

[120] IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 14.

[121] Akanthos Capital Management, LLC v CompuCredit Holdings, 677 F.3d 1286 (2012) (citing Feldbaum v McCrory Corp., 1992 WL 119095 (1992); The English courts concurred with the US courts interpretation in re Feldbaum v McCrory Corp, see Colt Telecom Group Plc, Re [2002] EWHC 2815, also Elektrim SA v Vivendi Hodings [2008] EWHC Civ 1178.

[122] Wood, *International Loans, Bonds, Guarantees, Legal Opinions, 287*, and Das, Papaioannou and Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts,* 43.

[123] Barcelona Traction, Light and Power Company Limited, (Belgium v Spain) Second Phase [1970] ICJ Rep 3, para 69 of the separate opinion by Sir Fitzmaurice. (Usually, a trustee should be requested by bondholders representing 25 per cent of the aggregate principal for bonds governed by the US law and 20 per cent under English law). See Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation, 527*; Marcel Kahan and Edward Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay' (2009) Northwestern University Law Review 281, 299.

[124] Louis Loss, *Securities Regulation 4* (3 edn, Little, Brown 1990), 1596 ('The trustee is the only agent dedicated to protecting the bondholders. Without it, collective action by bondholders would be very expensive and difficult to organize').

he can deal with a class of bondholders represented by a trustee and avoid instances of the holdout litigation.[125]

It is crucial to point out that so-called merger doctrine under the New York and English law is de facto precluding the sovereign borrower and qualified majority from using majority action clauses and exit consent technique.[126] Once the creditor receives a judgment based on a contractual claim, the terms of the contract and its amendments through consequent debt restructuring become inapplicable to this creditor even if the bond contract contains a majority action clause.[127] As a general rule, the relationships between a debtor and a creditor are framed by the judgment.[128] This creates an incentive for a bondholder to obtain a judgment as soon as possible following a default to insulate himself from amendments of the contract during the restructuring and get leverage in negotiations to extract a preferential treatment.

Furthermore, the race to the court in some jurisdictions is fueled by prescribing the priority of the levying against the borrower's assets based on the timing when the prejudgment attachment was served.[129] Once again, this creates an incentive to begin enforcement instead of the negotiation.

Additionally, the new system to issue bonds in 'global' form creates some legal complications in case of default for holders of the bonds if they are not issued under the trust contract.[130] In this case, bondholders could lack locus standi against the issuer; only a custodian can enforce the bondholders' rights under the 'global'

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[125] See the US case law, e.g. Birn v Childs Co., 37 N.Y.S.2d 689 (1942), ('[no-action clauses] prevent individual holders from getting special advantages for themselves and protect the rights and security of all holders as a class'). Similarly in England, e.g. Elektrim SA v Vivendi Hodings [2008] EWHC Civ 1178 ('[T]he purpose of the normal bond issue Trust Deed is that bondholders should act through the Trustee, and share equally in the fortunes of the investment, and not compete with each other. The bondholders are treated as forming a class, and give instructions to the trustee through a specified percentage of bondholders').

[126] For more information on the techniques, see Benjamin Liu, 'Exit Consents in Debt Restructurings' (2018) 13 Capital Markets Law Journal 116.

[127] Sean Hagan, 'Designing a Legal Framework to Restructure Sovereign Debt' (2005) 36 Georgetown Journal of International Law 299, 323.

[128] Director General of Fair Trading v First National Bank PLC [2001] 3 W.L.R. 1297 ('It is trite law in England that once a judgment is obtained under a loan agreement for a principal sum and judgment is entered, the contract merges in the judgment and the principal becomes owed under the judgment and not under the contract').

[129] New York Civil Practice Law and Rules §6226.

[130] See supra fn 82.

bond.[131] Similarly, the use of trustee will benefit the enforcement mechanism of the GDP-linked bonds, due to its new feature of the early redemption of the bonds if the borrower fails to provide required GDP data. Placing the right of early redemption in the hands of bondholders will risk ending up in holdout litigation.

In a recent debt restructuring by Argentina, some of the holdout creditors were precluded from litigation by the no-action clause of the trust structure.[132] It seems that vulture creditors would not have any interest in buying a distress sovereign debt where their enforcement rights are limited by a trust structure,[133] at least unless they could secure a position in the respective bond issue allowing to direct a trustee.

The scope of the no-action clause is broad and includes almost all potential issues for litigation except the suits against the trustee itself and cases regarding violation of the federal securities laws.[134] Even if, due to the passivity of the trustee, bondholders will get a right to enforce the accelerated amounts, there is a view that those bondholders cannot sue only for the amount owed to them but shall represent all bondholders in demanding accelerated payments on bonds.[135]

Some differences between the New York law and English law trust arrangements persist with respect to the application of the 'no-action' clause. While English practices do not restrain 'no-action' provisions and centralise all enforcement power within a trustee,[136] the US practices borrowed from corporate bond issues the exception that the individual bondholder has the right to sue for due interest and principal due and owing to his payments.[137] The differences are explained by

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[131] Benjamin, Yates and Montagu, *The Law of Global Custody, 15* (To solve this problem, the global bond is exchanged by the issuer for individual definitive bonds on default. If the issuer fails to exchange global bond within 30 days, according to the bond contract practices, the obligations of the issuer becomes void and simultaneously new direct obligations are created under a trust in favour of the creditors).

[132] Allan Applestein Tree FBO DCA Grantor Trust v Province of Buenos Aires, 2003 WL 1990206 ('In order to declare an outstanding principal amount immediately due and payable, the claimant must hold at least 25% of the aggregate principal amount of the outstanding notes of the series. Since plaintiff does not have such a holding, it can only claim unpaid interest').

[133] Lee C Buchheit and Sofia D Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?' (2016) 31 Butterworths Journal of International Banking and Financial Law 457, 457.

[134] See a detailed explanation at Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1050. However, there is a view in favour of more narrow scope of the no-action clause limiting it to the specific events drafted in the bond contract. Tammy C. Hsu, 'Understanding Bondholders' Right to Sue: When a No-Action Clause Should Be Void Comment' (2013) 48 Wake Forest Law Review 1367.

[135] Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 461.

[136] Colt Telecom Group Plc, Re [2002] EWHC 2503(Ch).

[137] This right is prescribed by Section 316(b) of Trust Indenture Act of 1939 and tested in courts, see Noble v European Mortgage & Investment Corp., 19 Del.Ch. 216 (1933) and Watts v Missouri-Kansas-Texas R.R. Co., 383 F.2d 571, 574 (1967).

fundamentally distinct approaches to the borrower's obligation to pay: under the US trust indenture, the debt is owed by the borrower directly to the bondholders, while under an English trust deed the debt is owed to the trustee, who passes the payments further to the bondholders.[138]

However, there is a trend towards convergence as New York law sovereign bonds started to contain enforcement provisions similar to English trust deeds.[139] In particular, the supplemental provisions of the Euro area Model CAC 2012 recommend the inclusion of the English law-based no-action clause. At the same time, those provisions imperfectly suggest that bondholders can be represented in litigation not only by a trustee but also by a fiscal agent who is an agent of the borrower. The ensuing conflicts of interest are obvious.

D. Sharing of the Proceeds

Another type of collective enforcement clause is the sharing clause. It first proved to be useful in syndicated loans to sovereign borrowers. According to this provision, an individual bank had to share ratably any recovery with other participants of the syndicate precluding preferential treatment of some creditors.[140]

The default of Iran in 1979 on its external loans showed how important the scope of the sharing clause is as some syndicate members refused to share recoveries received by way of Iranian deposit balances set-off following the narrow wording of the sharing clauses applied only to the disproportionate direct payments received from the borrower.[141] In response to the shock, the sharing clauses were changed to include various events, but for the most, they included the proceeds from litigation.[142] It is suggested that specifically due to the 'shielding effect' of the sharing clauses,

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[138] Lee C Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds' (2017) Available at SSRN 3095768.

[139] Buchheit, 'Supermajority Control Wins out - Creditors Have Turned Away from Litigation to Majority Rule Cover Story', 21; Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back', 283 (Referring to the bond issues by Grenada and Belize under the US law which omitted unconditional enforcement rights); Megliani, *Sovereign Debt: Genesis - Restructuring - Litigation,* 527.

[140] Macmillan, 'The Next Sovereign Debt Crisis', 332.

[141] Lee C Buchheit, 'The Sharing Clause as a Litigation Shield Sovereign Debt Column' (1990) 9 International Financial Law Review 15.

[142] Ibid ('[new sharing clauses] covered not only disproportionate payments received directly from the borrower, but also any application toward amounts due under the loan of the proceeds of a set-off, combination of accounts, counterclaim, litigation or otherwise').

there were no legal actions by commercial bank creditors during the debt restructuring in the 1980s, for example, by Brazil and Peru.[143]

Numerous authors writing in the 1990s reported that, in contrast to practices in syndicated loans, sharing clauses were generally absent in sovereign bond terms, providing perverse incentives to bondholders to escalate the disputes to the courts instead of searching for a consensus with a debtor.[144] It was a prevailing practice for a long time despite the understanding that sharing clauses in sovereign bond terms may fill the vacuum created by the absence of bankruptcy provisions, such as a mandatory *pari passu* treatment of creditors and fraudulent preference doctrine.[145] This is generally attributed to the proliferation of the unencumbered bondholder rights and fiscal agency agreements as the prevailing framework for bond issues established by the Brady bonds initiative.[146] Once again, the creditors were against any encroachment on their individual enforcement rights. Also, the creditors were disillusioned by previous bailouts in debt restructurings that sovereign bonds have a de facto legal priority vis-à-vis other debt instruments and will be paid in full in any case.[147]

With the use of the trust structures for sovereign bond issues, the sharing clauses got their way into the bond terms. In comparison to the sharing clauses in syndicated loans, those provisions have a narrower scope in sovereign bonds and are limited to the direct payments received from the debtor and proceeds out of litigation.[148]

Primarily for practical reasons, sharing clauses would not be operational under fiscal agency agreements as it would be an insurmountable task for

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[143] Ibid; Rory Macmillan, 'Towards a Sovereign Debt Work-out System' (1995) 16 Northwestern Journal of International Law & Business 57, 73. Although for every rule there is an exception as proved by the case of A.I. Credit Corp. v Government of Jamaica, 666 F.Supp. 629 (1987). One of the banks hold out and litigate even though the syndicate agreement contained sharing and rateable payment clauses.

[144] Macmillan, 'The Next Sovereign Debt Crisis', 332; Macmillan, 'Towards a Sovereign Debt Work-out System', 73; HV Morais, 'Legal Framework for Dealing with Sovereign Debt Defaults' in Robert C. Effros (ed), *Current Legal Issues Affecting Central Banks*, vol 5 (International Monetary Fund 1998), 324; Lee C Buchheit, 'Changing Bond Documentation: The Sharing Clause' (1998) 17 International Financial Law Review 17.

[145] Wood, *International Loans, Bonds, Guarantees, Legal Opinions,* 132.

[146] Philip J Power, 'Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings' (1996) 64 Fordham Law Review 2701, 2764. E.g. see Fiscal Agency Agreement between the Republic of Argentina and Bankers Trust Co., dated 19 October 1994, which lacks sharing provisions.

[147] Buchheit, 'Changing Bond Documentation: The Sharing Clause', 19.

[148] Allen & Overy, 'Uses and Abuses of Collective Action Clauses in Sovereign Bonds' (2013) 14 Business Law International 269.

bondholders to identify and claim for distribution of the recoveries obtained by other bondholders themselves.[149] Therefore, a sharing clause in sovereign bond requires an additional intermediary such as a trustee to receive and disburse the awarded sum pro rata among all bondholders. This scheme resembles a version of the sharing clause used in syndicated loans governed by English law.[150] A bank receiving a disproportionate payment has to transfer the excess amount to the paying agent who would treat it as a normal payment coming from the borrower for further distribution among creditors. The US-style loan agreements use a more cumbersome procedure which excluded an intermediary, i.e., a paying agent. The terms oblige the bank to share the excess amount directly with other banks through purchase of their participation in the principal of, or interest on the loans to equalise the recovery among all banks.

The exclusive positions of the trustee under sovereign bond contracts entitling him to commence legal actions and receive the recoveries make it easy to apply a sharing clause even if the bondholder base is numerous and dispersed among different type of creditors. A sharing clause will provide a second wave of disincentives, complementing a no-action clause, through the dilution of profits from litigation for the vulture creditor by distributing ratably the recovered sum among all bondholders.

It is important to note that recoveries should be shared among bondholders disregarding the fact of whether or not a particular bondholder directed a trustee to litigate, serving as an additional deterrent factor to initiate litigation.[151] Furthermore, there are claims that even in the abdicating trustee scenario, a situation when a trustee declines to enforce the debt, any bondholder can sue the borrower, but a recovered sum shall be still ratably shared among all bondholders.[152]

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[149] Olivares-Caminal and others, *Debt Restructuring,* 724.

[150] Lee C Buchheit, *How to Negotiate Eurocurrency Loan Agreements* (2 edn, Euromoney Publication PLC 2000), 77 (The further description of two basic kinds of the sharing clause is based on this source).

[151] Anne O Krueger and Sean Hagan, 'Sovereign Workouts: An IMF Perspective' (2005) 6 Chicago Journal of International Law 203, 214; IMF, 'Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts', 12.

[152] Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 461 (Effectively any litigating bondholder will perform the role of trustee).

V. BOND TRUSTEE AS A FIDUCIARY[153]

A key element of the trust arrangement is the involvement of the intermediary ensuring checks and balances. A trust arrangement is an exceptional tool which allows with the help of a new actor – a trustee – to implement a collective enforcement mechanism blocking the attempts of free-riding by individual creditors, and in conjunction with the sharing clause, it ensures fairness in the allocation of the burden of sovereign debt restructuring among creditors. Those purposes are attainable thanks to the unique feature of a trust arrangement in bond issuances – fiduciary relationships between bondholders and trustees. Some mechanism of collective action may be recreated with contractual clauses, but those mechanisms will be incomplete without a bond trustee.

In this regard, a bond trustee acts as an agent for the bondholders, who are beneficiaries or principles under the bond contract. This relationship between the trustee and beneficiary falls within a settled category of the fiduciary relationship.[154] To narrow down the scope of the fiduciary relationship, the indenture trustee is a fiduciary in commercial relationships, which can be described as 'mass-produced, non-personal relationships with numerous public entrustors [or beneficiaries, as in the case of sovereign bonds].'[155] It means that a bondholder has a legitimate expectation that a bond trustee will exercise discretionary authority to promote the bondholders' interest.[156]

Following the prudent man standard, the indenture trustee should 'obtain the best recovery possible for the holders under the circumstances.'[157] This standard requires the trustee who exercises the rights and powers conferred by the indenture 'to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs'.[158] In

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[153] This part is partially based on the author's paper Grygoriy Pustovit, 'Sovereign Debt Contracts: Implications of Trust Arrangements for Financial (in)Stability' (2016) 17 European Business Organization Law Review 41.

[154] Keech v Sandford [1726] Sel Cas Ch 61; Price v Blakemore [1843] 6 BEAV 507, Austin Wakeman Scott, *The Law of Trusts* (Little, Brown and Co 1939), 33.

[155] Tamar Frankel, 'Fiduciary Duties as Default Rules' (1995) 74 Oregon Law Review 1209, 1252 (it seems feasible to add beneficiaries to Frankel's definition, as the author himself argued, at 1224, that '[f]iduciary relationships can arise even if the fiduciary's promise to serve is made to a third-party other than the entrustor').

[156] Arklow Investments Ltd v Maclean [2000] 1 WLR 594. There are various additional factors, such as discretion, power to act and vulnerability of the beneficiary, that the court could take into account in defining the relationship as fiduciary.

[157] Spiotto (1990), para. XVIII-1.

[158] Trust Indenture Act, 15 U.S.C. § 77ooo(c).

practice, this means that in the event of default the trustee will act with some degree of flexibility in enforcing the issuer's obligations under the bond contract. The flexibility is demonstrated by the choice of actions permitted by the indenture for the purpose of recovering the bond value. The engagement of the trustee, performing a safety valve role in time of distress, will, instead of outright enforcement of the pre-determined obligations, make it possible to adjust those commitments or postpone enforcement, bringing more fruitful outcomes by providing the sovereign with the opportunity to recover, and consequently to maximise bondholders' recoupment.

There is much to be reaped from engaging a bond trustee, an experienced market player, in debt restructuring.[159] However, as exemplified further, there are some flaws in the performance of bond trustees in practice.

[159] David Christoph Ehmke, 'IX. Information, Coordination, and Fence', *Bond Debt Governance: A Comparative Analysis of Different Solutions to Financial Distress of Corporate Bond Debtors* (1st edn, Nomos Verlagsgesellschaft mbH & Co. KG 2018), 180.

CHAPTER 5. PERFORMANCE OF BOND TRUSTEES – EVIDENCE FROM PRACTICE

A bond trustee is the only professional institution in the transaction of the bonds issue which is present from the beginning to the end and specifically tasked to protect and represent bondholders. Neither the issuer nor the underwriter, nor the SEC or its UK counterpart the Financial Services Authority (FSA) does represent bondholders.[1] While a bond trustee is equipped with remarkable tools and discretionary powers to look after bondholders' interests, the conventional view on the trustee's role as a guardian of the bondholders is negative and connotated with passiveness. A bond trustee usually takes a reactive position awaiting the direction from the bondholders or a court for further actions.[2] Paradoxically, in times of trouble, such as a default situation, when the actions from the trustee are the most desired,[3] it usually prefers to bide its time before bondholders and other involved parties resolve the issue themselves.[4] Put differently, bond trustees usually do not satisfy the function of the 'efficient centralized enforcement' prescribed by law.[5] For instance, Charles Goodall observed that Eurobonds investors often complain about trustees who do not act actively enough in defining the materiality of an event of default and consequently, the route of their actions.[6]

As can be seen, the passivity of the bond trustees is a recurrent topic which has been discussed for more than a century since the inception of the bond trustee as

[1] Efrat Lev, 'The Indenture Trustee: Does It Really Protect Bondholders' (1999) 8 University of Miami Business Law Review 47, 72.

[2] Andrew Denny and Morgan Krone, 'When Bond Trustees Are Called to Action' (2016) 35 International Financial Law Review 9.

[3] F.O., 'Trustees: A More Muscular Role?' (2010) 10 Asset Securitization Report 28.

[4] Simon Hill and Tim Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?' (2010) 5 Capital Markets Law Journal 5, 15.

[5] Steven L Schwarcz and Gregory Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee' (2008) 59 Alabama Law Review 1037, 1039; Augusto Repetto, Esteban C Buljevich and Maria E Rodriguez Beltran, 'Collective Action Clauses and Workouts' in Esteban C Buljevich (ed), *Cross-Border Debt Restructurings: Innovative Approaches for Creditors, Corporates and Sovereigns* (Euromoney Books 2005), 338 ('Though trustees have the discretion to initiate proceedings, they rarely do so because of the risks and costs involved').

[6] Charles P Goodall, 'Eurobonds Issued with the Benefits of Trust Deeds' (1983) 2 International Financial Law Review 19, 20; Hill and Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?', 6.

an institution.[7] The strength of discussions increases after each major financial calamity followed by issuers' default on their bonds. In those stressful situations, bond trustees received scrutiny as bondholders suffering financial losses were dissatisfied with the performance of their guardians – bond trustees. In major cases, the dissatisfaction with the trustees' performance usually led to a quest for new rules to urge the trustees to guard the bondholders' interest more rigorously or even lambast the trustees as a useless institution which has to be dismantled.[8]

This part portrays the impediments for the proper functioning of the trust arrangement. It starts with the analyses of crucial historical points for corporate bond trustees when their performance was scrutinised and regulated. Next, the in-depth study assesses the functionality of the trustees through case studies of sovereign bond restructurings performed by Argentina in 2016 and Ecuador in 2008. It argues that bondholders were suffering from the passivity of the trustees in each case. Against its original purpose to preclude only holdout litigation, a trust structure works as an effective barrier against enforcement of the bondholders' rights in general. Degraded creditor rights, coupled with the poor performance of the trustees in crisis events, explain the resistance of the creditors to implement trust structures in bond issues. Under such circumstances, the trust arrangement seems to be unsuccessful in securing a collective best interest of bondholders as a group in sovereign debt restructuring.

I. CORPORATE BOND TRUSTEES

Since sovereign bond financing and respectively the use of the trust structure is a recent phenomenon in modern financial markets,[9] the assessment of sovereign bond trustees' performance rests as well on the analysis of the state of affairs in corporate bond markets, which have a wealth of knowledge on the topic of the trustee's

[7] Rhinelander v Farmers' Loan & Trust Co., 172 N.Y. 519 (N.Y.1902) ('It is unfortunately the case that the duties of trustees under railroad and other mortgages are too often performed in a perfunctory manner unless there is default in the payment of interest and the trustees are called upon to take possession of the property and foreclose the mortgage in pursuance of the express duties imposed upon them').

[8] See *infra* fn 22 and fn 46.

[9] For more details see p 14 of this thesis.

passivity and conflict of interests.[10] The sketched parallels between those two markets are justified because the legal framework of the sovereign bond transaction is based on the corporate one.[11] In fact, the flaws in the corporate bond trustees' performance are accentuated in the case of sovereign bond trustees due to exemptions from some regulatory practices.[12]

A. The Great Depression and the Trust Indenture Act 1939[13]

One of the most significant changes in the US legal framework for bond trustees occurred in response to the Great Depression.[14] For many decades prior to this financial crisis, the trust arrangement evolved independently from regulation, mostly through modification of the trust contract. For instance, the massive railroad reorganisations after the panic of 1893 triggered extensive debates and contractual evolution of the bond trusteeship.[15] Only after the financial collapse which caused the Great Depression, a new federal law in the form of the Trust Indenture Act 1939 (the TIA) was enacted.[16] The TIA, together with the Securities Act of 1933 and the Securities Exchange Act of 1934, was a part of the effort by Congress to re-establish creditors' trust in public financial markets.[17]

The new legislation was a result of SEC studies which uncovered severe abuses of trust structures causing losses to bondholders.[18] One of the blatant

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[10] George G Triantis and Ronald J Daniels, 'The Role of Debt in Interactive Corporate Governance' (1995) 83 California Law Review 1073, 1089; Yakov Amihud, Kenneth Garbade and Marcel Kahan, 'A New Governance Structure for Corporate Bonds' (1999) 51 Stanford Law Review 447; Tammy C. Hsu, 'Understanding Bondholders' Right to Sue: When a No-Action Clause Should Be Void Comment' (2013) 48 Wake Forest Law Review 1367.

[11] See Lee C Buchheit and Elizabeth Karpinski, 'Grenada's Innovations' (2006) 21 Journal of International Banking Law and Regulation 227, 230.

[12] See more on exemptions at p 132.

[13] This part is partially based on the author's paper Grygoriy Pustovit, 'Sovereign Debt Contracts: Implications of Trust Arrangements for Financial (in)Stability' (2016) 17 European Business Organization Law Review 41.

[14] There is a view that the development of the UK legal environment for the bond trustees equals in many respects the US path. See Frederic C. Rich, 'International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation Note' (1980) 21 Virginia Journal of International Law 269, 275.

[15] Francis Lynde Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures* (Some Phases of Corporate Financing, Reorganization, and Regulation, Macmillan 1916), 13.

[16] Rich, 'International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation Note', 274.

[17] Henry F Johnson, 'The Forgotten Securities Statute: Problems in the Trust Indenture Act' (1981) 13 University of Toledo Law Review 92, 93.

[18] SEC, Report on the Study and Investigation of the work, activities, personnel and functions of protective and reorganization committees, Part VI – Trustees under Indentures (1936).

manipulations of that time was the abuse by shareholders who bought with discount a certain amount of bonds issued by their corporation to achieve a voting majority in order to defer or even cancel the initially determined payments to the bondholders.[19] The studies of the SEC draw on a large number of cases uncovering flaws of the legal structure and responsible actions of the trustees, including cases of 'active fraud.'[20]

In general, the stock market crash of 1929 revealed that bondholders struggled with the collective action problem and in practice were unable to look after their interests. Furthermore, the situation was exacerbated by the fact that in most cases the trustee was not obliged to take remedial actions without the direction of the bondholders, which was hard to obtain due to the mentioned collective action problem. A contemporary commentator stated that '[t]heoretically the trustee of a corporate mortgage ought to have active supervision of the trust' while in practice it has wide immunities from the strict duties of a trustee and was not bound to take any enforcement action without notification about default and request by bondholders owning an amount beyond a certain threshold.[21] As a solution, the TIA was passed which reflects the SEC's recommendation that 'in the public interest and for the protection of investors' bond trustees should 'be transformed into active trustees with the obligation to exercise that degree of care and diligence which the law attaches to such high fiduciary position.'[22]

Specifically, the Trust Indenture Act of 1939 aims to avoid conflicts of interest between parties[23] and to protect corporate bondholders through mandatory requirements for trustees and the empowerment of the SEC to conduct a factual examination of its observance. It presupposes, among other provisions, that the definition of default in the trust arrangement is analysed by the SEC, that the notice to the indenture security holders of any such default is included in the registration statement, and that a written statement containing the analysis of these provisions is included in the prospectus.[24] The extent of analysis of these provisions is prescribed

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[19] Mark J Roe, 'The Voting Prohibition in Bond Workouts' (1987) 97 The Yale Law Journal 232, 251 ('What insiders lost by forgoing interest or principal payments, they recouped as stockholders').

[20] Talcott M Banks, 'Indenture Securities and the Barkley Bill' (1939) 48 The Yale Law Journal 533, 543.

[21] Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures, 52* (From 10 per cent to 25 per cent of the total principal amount of the issue).

[22] SEC, Report on the Study and Investigation of the work, activities, personnel and functions of protective and reorganization committees, Part VI – Trustees under Indentures 110 (1936).

[23] Schwarcz and Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee', 1070.

[24] The qualification procedure under Section 305(a)(2) of the Trust Indenture Act of 1939.

at the discretion of the SEC and is based on the necessity to protect the public interest or investors.[25]

Furthermore, the 1939 Act stipulates the minimum standards of responsibility and accountability for trustees, and mitigates the conflict of interests between the trustee, issuer and underwriter.[26] All this provides useful mechanisms for protecting corporate bondholders from the arbitrariness of corporate issuers, underwriters and trustees during the establishment of the trust provisions.[27]

The new legislation provided a legal framework for bond issuance to the public and relationships among the involved parties. However, it was unable to solve all the intricate issues of bondholder protection, and at times it has been considered a 'technical, burdensome and even archaic piece of legislation.'[28]

Furthermore, the sovereign bondholders were left out from the Trust Indenture Act's oversight and protection.[29] Why was sovereign debt excluded from the scope of application of the 1939 Act? Are the legal and economic relationships between a trustee and bondholders in sovereign debt different from relationships in corporate debt, and hence they should not be regulated in a similar way? This question may be answered in light of the enactment of the 1939 Act.

In the early years of the New Deal, the Protective Committee Study was performed by the SEC under the Securities Exchange Act of 1934 to study the problems of corporate bankruptcies and reorganizations. This study laid the basis for various legislative reforms such as adding Chapter X to the Bankruptcy Act and enactment of the Trust Indenture Act of 1939.[30] Initially, the Protective Committee Study should have led to the reform of all municipal and foreign debt arrangements together with corporate bankruptcies, reorganisations and voluntary debt readjustments.[31] It had been planned that restructuring of foreign government securities should have been subjected to a regime that would have largely followed the principles laid down in the overarching committee bill H.R. 6968 proposed by

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[25] See Section 305(c) of the Trust Indenture Act of 1939.

[26] Albert S Pergam, 'Eurobonds: Trustees, Fiscal Agents and the Treatment of Default', *Adaptation and Renegotiation of Contracts in International Trade and Finance* (Kluwer 1985), 338.

[27] As discussed in Chapter 6.I.B., the bondholders and to the great extant trustees are excluded from drafting process of the bond contract and the presence of regulation could protect their interest.

[28] Lev, 'The Indenture Trustee: Does It Really Protect Bondholders', 48.

[29] Pursuant to Section 304(a)(6) thereof.

[30] Richard W Jennings, 'Mr. Justice Douglas: His Influence on Corporate and Securities Regulation' (1964) 73 The Yale Law Journal 920, 934.

[31] Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Aspen Publishers 2003), 190.

Congressman Clarence Lea (Lea Committee Bill). In conjunction with the Lea Committee Bill, the bill S. 2344 Committee Print No. 2 titled as the Trust Indenture Act of 1937 (1937 Bill) was intended to regulate almost all trust indentures, including indentures for issuances of securities by foreign governments.

However, both the Lea Committee Bill and the 1937 Bill were politically outweighed by restrictive norms and were turned down as a result of fierce opposition from different political groups, including Foreign Bond Associates, Incorporated, which was an investment firm with one of the largest holdings in foreign bonds in the US.[32]

Having learned from the setback, in the subsequent versions of the Trust Indenture Act, the SEC focused on the single legislative issue of long-term corporate debt. Thus, the SEC deliberately omitted the regulation of trustees in sovereign bond issuances, including several other legislative topics, for the sake of expediency and to avoid a rebuff from the opposing lobbyists.[33]

B. Washington Public Supply System and the TIA Reforms

The cascade of defaults in the 1980s brought back the debate on the role and responsibilities of the bond trustee. This time, the examination of the trustee's conduct, and new regulation, in response, was triggered by multi-billion defaults on the US industry revenue bonds.[34] These are tax-exempt bonds issued by a municipal or state authority on behalf of a private sector company in order to accomplish a specific project beneficial for the community and backed by the revenues from this project. While those bonds are exempted from the TIA, similar to the situation for sovereign bonds, the trust structure is usually employed by custom.[35]

An unprecedented default by the Washington Public Power Supply System (WPPSS) on its industry revenue bonds for constructing nuclear power plants in 1983 brought bond trustees back into the spotlight. The abrupt termination of the projects due to significant cost overruns and the further legal battle ended up in $7.2 billion

[32] Ibid.

[33] Ibid.

[34] Phil Hall, 'Bond Trustees Reexamine Role' (1989) 81 American Bankers Association ABA Banking Journal 42, 42.

[35] American Bar Association, 'Annotated Trust Indenture Act Report' (2011) 67 Business Lawyer 977, 981.

losses for bondholders.[36] It was the largest municipal bond default in history for a long time until recently the Commonwealth of Puerto Rico broke the record in 2016.[37]

In a suit filed by the trustee on behalf of the bondholders against WPPSS, the Washington Supreme Court decided that the WPPSS had lacked the legal authority to issue the bonds under Washington state law and the bonds were void and unenforceable.[38] It is interesting to note that Puerto Rico is using a similar legal strategy for some of the defaulted bonds in its present default.[39] The WPPSS case sparked certain context-specific questions, such as whether the bond trustee could have reasonably foreseen the termination of the projects due to cost overruns and more importantly that the bond issue would be found invalid.[40] From the general point of view on the bond trusteeship, the debate focused on the overly passive and inadequate role of the trustees to protect the bondholders' interest prior to default.[41]

Those events led to a re-examination of the bond trustee's role among other types of trustees and the creation of the voluntary guidelines for bond trustees by American Bar Association (ABA).[42] Furthermore, a five-year legislative process ripened the Trust Indenture Reform Act 1990 (TIRA), being the first comprehensive revision of the fifty-year-old TIA. It addressed various issues concerning eligibility and appointment of the trustee and the problem of conflict of interest. In particular, by prohibiting the trustee to be a creditor of the issuer or its affiliates, the TIRA

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[36] Dan Fischer, 'WPPSS and Hammersmith: Increased Credit Risk Protection Resulting from Unprecedented Defaults Note' (1992) 9 Arizona Journal of International and Comparative Law 513, 518.

[37] Moody's, 'U.S. Municipal Bond Defaults and Recoveries, 1970-2016' (2017) ('There were four Moody's-rated municipal defaults in 2016, all related to the Commonwealth of Puerto Rico (Caa3 negative). Total debt affected was $22.6 billion in 2016, by far the highest annual default volume in the 47-year study period').

[38] Chemical Bank v Washington Pub. Power Supply Sys., 99 Wn. 2d 772 (Wash. 1983).

[39] Nicole Acevedo, 'Billions of Puerto Rico's debt might be invalid, federal oversight board says', 15 January 2019 (NBC News) <https://www.nbcnews.com/news/latino/billions-puerto-rico-s-debt-might-be-invalid-federal-oversight-n958846>.

[40] Theodore J Sawicki, 'The Washington Public Power Supply System Bond Default: Expanding the Preventive Role of the Indenture Trustee Comment' (1985) 34 Emory Law Journal 157, 161.

[41] Ibid (Proposing to introduce the expanded reasonable foreseeability standard in order to turn a bond trustee into active guardian of the bondholders). Similarly, the concerns regarding the lack of oversight and monitoring prior default by trustees in securitisations were raised in Moody's report of 2003, see Moody's, *Moody's Re-Examines Trustees' Roles in Abs and Rmbs* (Structured Finance Special Report, February 1, 2003).

[42] Hall, 'Bond Trustees Reexamine Role', 42.

tackled a problem which has been singled out for a long time.[43] Moreover, the TIRA required automatic incorporation of the provisions of the act, with a retrospective application to indentures qualified before the enactment of the TIRA, into an indenture without the need to recite them, reducing the administrative burden on the SEC to review the indentures and increasing the investor protection as there was no mechanism to enforce the absent terms.[44] Nevertheless, it is argued that the TIRA has benefited more the trustee and issuer than bondholders as no substantial changes were introduced regarding a proactive role of the trustee and its duties.[45]

In 1996, relatively shortly after the amendment introduced by the TIRA, the House of Representatives passed a bill which considered drastic changes or even outright repeal of the TIA.[46] One of the proponents for dismantling the TIA in his statement for the hearings on the topic described trustees as 'redundant,' 'little more than functionaries, noted mainly for their passivity, inertia and indecision.'[47] The critics of the TIA, conceivably following a general trend of liberalisation and deregulation of the financial markets, claimed that large creditors are competent to represent the bondholders after default and if necessary can introduce a bond trustee as a protective mechanism without the impositions of the TIA.[48] This logic, looking from the wealth of the literature on inter-creditor conflict of interest,[49] seems to be at least doubtful. One of the examples that large creditors are unable to overcome the collective action problem in both corporate and sovereign bond markets are the proliferation of the hedge funds and distressed funds whose tactic is to gain an

[43] John P Campbell and Robert Zack, 'Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: A Proposal to End It in the Public Interest' (1976) 32 Business Lawyer (ABA) 1705, 1706.

[44] Michael Vincent Campbell, 'Implications of the Trust Indenture Reform Act of 1990 Breathing New Life into the Trust Indenture Act of 1939' (1992) Annual Review of Banking Law 181, 223.

[45] Lev, 'The Indenture Trustee: Does It Really Protect Bondholders', 59.

[46] H.R. 3005, the 'Securities Amendments Act of 1996.'

[47] James Gadsden, 'Trust Indenture Act under Attack' (1996) 113 Banking Law Journal 967, 968.

[48] Ibid.

[49] Gary D Chamblee, 'Reducing Battles between First and Second Lien Holders through Intercreditor Agreements: The Role of the New Aba Model Intercreditor Agreement Task Force' (2008) 12 North Carolina Banking Institute 1.

N.B. inter-creditor conflicts in sovereign bond markets are more acute due to absence of the bankruptcy procedure which imposes a level-playing field for creditors. Lee C Buchheit, 'The Search for Intercreditor Parity' (2002) 8 Law and Business Review of the Americas 73; Skylar Brooks and others, 'Identifying and Resolving Inter-Creditor and Debtor-Creditor Equity Issues in Sovereign Debt Restructuring' (2015) CIGI Policy Brief No 53.

advantage over other bondholders in negotiations with the borrower.[50] Also, institutional investments do not bother with the fate of the small (retail) bondholders from the same issue.[51]

Even though the TIA has its limitations, e.g., provisions which allow the trustee to remain passive by 'hiding behind' issuer declarations and counsel opinions,[52] it provides at least some basic standard of protection to public investors.

C. The Global Financial Crisis

The credit crunch prompted large-scale bond defaults in different sectors and jurisdictions testing the abilities of the trustees to act exercising their discretion and enforce debt instruments on behalf of the bondholders. The inquiries addressed to bond trustees mostly regarded significant market events, e.g., involving Lehman group. For example, (i) due to credit rating downgrades trustees were asked by issuers to agree to a reduction in credit rating prescribed by the documentation in order not to trigger remedial actions against the issuer, (ii) as a result of the failures of swap counterparties, trustees were often required by issuers to permit the issuer's termination of the swap agreement which is necessary to crystallise a termination payment, (iii) because some agents servicing structured finance deals became insolvent trustees were asked by issuers and bondholders to agree to the removal or replacement of the relevant agent.[53] Besides the fact that some of the modifications may require complex inspection of the deal documentation, they may have no apparent benefit to the bondholders complicating the choice of the discretionary action by a bond trustee.

One of the most affected areas, being the epicentre of the financial crunch where the trustees had to struggle with defaults, were the markets for structured finance and in particular mortgage-backed securities. The US mortgage melt-down revealed that trustees due to the lack of incentives were passive in exercising their

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[50] With regard corporate bonds see Steven L Schwarcz, 'Fiduciaries with Conflicting Obligations' (2010) 94 Minnesota Law Review 1867, 1886; Regarding the problem in sovereign bonds see a part II.B. Actions against the Bond Trustee in the Argentine Pari Passu Saga of this chapter at p 142.

[51] See a part II.C.Ecuador's Default of 2008: Protection of Small Investors of this chapter at p 155.

[52] Lev, 'The Indenture Trustee: Does It Really Protect Bondholders', 92.

[53] Hill and Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?', 9.

authority,[54] such as to request loan files from banks, and obstructed investors from pursuing litigation against servicers.[55]

By the same token, bond defaults by Asian issuers in the wake of the global financial crisis highlighted that 'certain trustees have been reluctant, uncooperative or even obstructive' in enforcing debt instruments.[56] The trustees were more focused on demanding and negotiating indemnities than taking enforcement action to protect bondholders' interests.[57] In New Zealand, the series of the collapse of financial companies exposed problems with the actions of the trustees, including a lack of capability, poor reporting and weak trust deeds.[58] These revelations led to new legislation strengthening supervision of the trustees and introducing a licensing regime for all corporate trustees.[59]

In defence of the bond trustees, it should be mentioned that trustees in the aftermath of the financial crunch had to deal with an unprecedented scale of major crisis events, issues unrelated to the normal work of the trustee such as the revision of the fundamental terms or commercial matters of the deal, competing requests from bondholders, all of that exacerbated by the ambiguity of the poorly-drafted documentation. In this regard, among various critics of the bond trustees, some expressed nevertheless the view that they responded 'extremely well' to an unexpected situation and developed processes and approaches of dealing with those issues.[60]

All in all, it is evident that a trust arrangement for corporate bonds has a long history of attempts to remedy the deficiencies in performance of the corporate bond trustees.

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[54] The issues with incentives for bond trustees are described in Chapter 6.II. Ways to the Mitigate the Agency Problem at p 170.

[55] John Hintze, 'Clarity on Trustee Responsibilities Arrives Slowly' (2013) 13 Asset Securitization Report, 9.

[56] Saptak Santra, 'Bondholders, Fight Back' (2010) 29 International Financial Law Review 26, 26.

[57] Ibid.

[58] See Treasury of New Zealand, *Regulatory Impact Statement* (Available at <https://treasurygovtnz/sites/default/files/2010-02/ris-med-tlr-dec09pdf>, 2009).

[59] New Zealand Financial Markets Authority, *Regulations to Improve Supervision Regime for Trustees* (Press Release, Available at <https://fmagovtnz/news-and-resources/releases-from-the-minister-of-commerce/regulations-to-improve-supervision-regime-for-trustees/> from August 30, 2011).

[60] Hill and Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?', 20.

II. SOVEREIGN BOND TRUSTEES

While the previous chapter exposed numerous problems faced by the bondholders with a corporate bond trustee, it appears that in the case of sovereign bond trustees, the situation is even worse. Bondholders find themselves at a stalemate: on the one hand, in practice, trustees are not bound to protect bondholders' rights; on the other hand, bondholders' individual capabilities to protect themselves are limited.[61] From the overall perspective of the sovereign debt market, coordination problems among bondholders have been replaced by agency problems between a bond trustee and bondholders, mainly shifting negative outcomes from sovereigns to bondholders.

A trust structure works against its original purpose to preclude only holdout litigation. Instead, it became as an effective barrier against enforcement of bondholders' rights in general. Degraded creditor rights, coupled with the poor performance of the trustees in crisis events, explain the resistance of the creditors to implement trust structures in bond issues. Under such circumstances, the trust arrangement seems to be unsuccessful in securing the collective best interest of bondholders as a group in sovereign debt restructuring.[62]

The passivity of trustees at times creates an impenetrable barrier for the exercise of bondholder enforcement rights contrary to the intention of Congress in 1939 at the enactment of the TIA.[63] It seems that the almost 80-year-old findings of the Protective Committee Study in its influential 'Trustees Under Indentures' report, stating in regard to corporate bonds that 'typically the trustees do not exercise the elaborate powers which are the bondholders' only protection [but act as] merely a clerical agency', can be projected on the current trustees of sovereign bond issuances.[64] The argument becomes stronger once the problems generated by the status quo are taken into account.

There are ample examples to criticise the passivity of sovereign bond trustees in representing bondholders' interests. For instance, in the majority of analysed indentures (63 per cent) the Protective Study Committee found that trustees were

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[61] For a discussion of limits to individual enforcement imposed by trust arrangements, see Chapter 4.II. The Impact of the Legal Framework on Sovereign Debt Restructuring at p 104.

[62] See Chapter 6.III.D. Sovereign Debt Sustainability Equals the Best Interest of Bondholders at p 189.

[63] Mark B Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back' (2010) 73 Law and Contemporary Problems 273, 287.

[64] SEC, Report on the Study and Investigation of the work, activities, personnel and functions of protective and reorganization committees, Part VI – Trustees under Indentures 110 (1936).

under no obligation to issue a notice of default, and usually disregarded defaults unless otherwise requested by the bondholders.[65] Furthermore, though having no power to waive the default, the trustee of sovereign bonds still could do so de facto by withholding the notice of default, in contrast to the trustee of corporate bonds, without being restrained by any law.[66] Similar provisions were included in the trust indenture used for the 2005 and 2010 restructurings of the Argentine debt,[67] which very likely resulted in the ambiguous actions taken by the trustee as discussed below.

In effect, bondholders still do not have any legal protection, which should be provided by the trustee. There is agreement between various experts in sovereign debt management that trustees will not initiate litigation against the sovereign debtor on their discretion.[68] The trustee performs only a passive role and, contrary to its function, needs to be urged to act in the interest of the bondholders.[69] Through a vote, according to the terms of the trust indenture, the bondholders can usually direct the trustee to initiate proceedings. For instance, in line with general practice in sovereign bonds, the Argentina Indenture 2005 prescribes a threshold of 25 per cent in aggregate principal amount of outstanding debt of any series for directing the trustee, which is practically difficult to achieve. Even if successful, the direction of the trustee can be a timely and challenging process, due to the collective action problem among bondholders, stripping bondholders the benefits of swiftness and flexibility in their enforcement actions.[70]

Furthermore, investors cannot act on their own as most of the bondholders' rights to initiate legal proceedings, aside from the enforcement of any due payment of the principal and interest,[71] are vested with the trustee,[72] and can only be initiated

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[65] Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance,* 195.

[66] Trust Indenture Act, 15 U.S.C. § 77ooo(b) (A trustee should not withhold the notice of default unless believing in good faith that doing so is in the bondholder's best interest).

[67] See Section 4.4(c) on p 23 of Trust Indenture between the Republic of Argentina and the Bank of New York, dated 2 June 2005 (hereinafter Argentina Indenture 2005), (stating that in case of default by Argentina, trustee '… may (but is not required to) institute any action or proceedings at law or in equity for the collection of the sums'), as well as Section 4.6. on p 24 (it provides the trustee with discretion but does not require him to proceed to protect and enforce the rights under the trust indenture).

[68] International Law Association (Sovereign Bankruptcy Study Group), 'The Legal Approach to Sovereign Bankruptcies' (2016), 14; IMF, 'The Design and Effectiveness of Collective Action Clauses' (2002), 12.

[69] See Argentina Indenture 2005, supra fn 67.

[70] Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back', 292.

[71] See Argentina Indenture 2005, supra fn 67.

[72] At the same time, such construction of rights mitigates a holdout problem.

independently under the condition that the onerous procedures are observed.[73] Stand-alone enforcement of the due payments without accelerating the par value, *inter alia*, due to high litigation costs,[74] seems an economically unreasonable endeavour.

After all, an indenture for sovereign bonds still expressly provides that the trustee may refrain from taking actions that may involve personal expenses or liabilities unless the security holders furnish it with an indemnity.[75] It represents another roadblock on the bondholders' way to enforce their rights. Some practitioners describe the demanded indemnities as exorbitant.[76] Moreover, in practice, any bondholder, for lack of control over the trustee, will be averse to providing a blank-check indemnification.[77] Often, this ends up in a few months' delay to the enforcement actions due to the negotiation of the indemnities.[78]

The recent practice of issuing sovereign bonds under trust arrangements has not been long enough to test the performance of the bond trustees in critical situations and more so to have fully-fledged judiciary probes into their actions. [79] Nevertheless, it seems from anecdotal evidence that sovereign bond trustees are even more passive than their corporate bond colleagues. Describing the work of the sovereign bond trustees, financial lawyers from the field are not shy to make use of sharp epithets

[73] See Section 4.8. of the Argentina Indenture 2005, supra fn 67 (which allows the bondholder to initiate a legal proceeding only after the following procedure has been complied with: (a) to furnish the trustee with the notices of default and default continuance; (b) to make a written request to the trustee to institute a concrete legal proceeding which has been adopted by the holders of at least 25 % of the aggregate principal amount of the outstanding debt securities; (c) to provide the trustee with a reasonable indemnity and/or security against the costs, expenses and liabilities to be incurred in the legal proceedings; (d) once the trustee has failed to institute the legal proceeding on its own, to make sure that 60 days have expired after the receipt of notices and indemnity and/or security against the costs by the trustee).

[74] See Julian Schumacher, Christoph Trebesch and Henrik Enderlein, 'Sovereign Defaults in Court' (2018) Available at SSRN 3134528 (The authors conclude that litigation in the US and the UK courts is a costly and long process).

[75] See Section 4.11(c) on p 26 and Section 5.1(g) on p 27 of the Argentina Indenture 2005, supra fn 67.

[76] Lee C Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds' (2017) Available at SSRN 3095768.

[77] Marcel Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights' (2002) 77 New York University Law Review 1040, 1062.

[78] Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back', 294.

[79] For more details see Chapter 3.III. The Modern Age of the Trust Structures in Sovereign Bonds at p 88.

describing them as 'pathologically passive, pusillanimous and pernickety.'[80] There is a conviction among experts that trustees at times abuse their bondholders.[81]

The following sections provide case studies where bond trustees were reluctant to protect bondholders' interests and enforce their rights upon defaults on sovereign bonds by Argentina and Ecuador. It is evident from the recent cases that the value of trust arrangements to ease collective action problems is diminished.

A. Bypassing a Bond Trustee in Litigation against Argentina

The Argentine saga provides one of the worst examples of the dysfunctionality of trusteeships in relation to sovereign bonds. Before diving into an analysis of the trustee's actions with regard to *pari passu* injunctions, it is worthwhile to note that an overwhelming majority of Argentine bonds litigated in the US courts were issued under a fiscal agency structure, which gave bondholders unencumbered rights to initiate legal action. The bond restructurings of 2005 and 2010 concluded between Argentina and participating bondholders, in contrast, employed a trust structure.

There are a few outliers where the old bonds were issued under trust contracts. Specifically, only four cases out of a total of 173 cases against Argentina involve trust structures.[82] What is striking is that none of them was initiated by a trustee. Creditors began the litigation themselves and had to overcome a no-action clause contained in the trust deed. In one case, a no-action clause precluded creditors from further litigation.[83] Another case, while discussing precisely the purpose of the no-action clause in connection with the amendment of the sovereign immunity clause through exit consents designed by the 2005 restructuring, has avoided the issue of the legal standing of the creditor to initiate a legal suit itself.[84] In two other cases, the

[80] Lee C Buchheit and Sofia D Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?' (2016) 31 Butterworths Journal of International Banking and Financial Law 457, 461; Sönke Häseler, 'Individual Versus Collective Enforcement Rights in Sovereign Bonds' (2012) 77 Law Review 1040, 8 (Quoting the correspondence with Michael Chamberlin, Executive Director of the Trade Association for the Emerging Markets 'Trustees are notable for their caution, occasional incompetence and being subject to institutional constraints (need indemnities, may have conflicts of interest or be subject to political suasion) that make them less effective as litigants than individual holders.'); Anna Gelpern, *Sovereign Debt Crisis: Creditor's Rights vs. Development* (JSTOR 2003) 228.

[81] Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds'.

[82] Matthias Goldmann and Grygoriy Pustovit, 'Public Interests in Sovereign Debt Litigation: An Empirical Analysis' (2018) Available at SSRN 3122602 (The database is on file with the author).

[83] For details on no-action clause see Chapter 4.IV.C. Collective Legal Action.

[84] Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 2004 WL 2290900 (S.D.N.Y. 2004) and 2005 WL 289723 (S.D.N.Y. 2005); See details of the case at p 159.

courts bypassed the trustee's prerogatives to litigate under a no-action clause even though the defendant raised a defence that creditors could not start an individual action under the bond contract.[85] Without discussing details, the court stated that 'the Trustee has thus far refused to pursue claims against the Republic' and allowed bondholders to continue litigation.[86]

B. Actions against the Bond Trustee in the Argentine Pari Passu Saga

Shortly after the pari passu injunctions, prescribing Argentina to make a ratable payment to holdout creditors for every payment to exchange bondholders, became effective,[87] Argentina transferred €225,852,475.66 and $230,922,521.14, for a total aggregate amount of approximately $539 million (Funds), into the Bank of New York Mellon's (BNYM) accounts at Banco Central de la Republica de Argentina to fulfil its upcoming interest payment on the exchange bonds on 30 June 2014.[88] Contrary to the pari passu injunctions, Argentina did not make simultaneously a ratable payment of approximately $1.5 billion to holdout creditors violating the pari passu injunctions.[89] Because the injunctions prohibited the agents and participants in the payment process of the exchange bonds from (aiding and abetting any violation of injunctions in) making a ratable payment by Argentina,[90] the BNYM, a trustee under exchange bond indenture, kept the Funds and did not forward them further to the exchange bondholders.

Furthermore, once the holdout creditors identified that Argentina had transferred the money to the trustee, they immediately initiated actions to enforce

[85] Barboni et al. v Republic of Argentina, 06-cv-5157 (S.D.N.Y. 2006); Brecher v Republic of Argentina, 2009 WL 857480 (S.D.N.Y. 2009) and 2010 WL 3584001 (2010).

[86] Brecher v Republic of Argentina, 2009 WL 857480 (S.D.N.Y. 2009).

[87] For background information regarding the Argentine pari passu saga see p 30.

[88] Transcript of Proceedings at p 157, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 27 June 2014), Document 579-1.

[89] See Ibid fn 88 and Transcript of Proceedings at. p 18, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 18 June 2014), Document 537.

[90] Order, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 23 February 2012), Document 371.

their money judgments by attaching those funds. They requested a court order directing the trustee to turn over the funds to satisfy plaintiffs' judgments.[91]

The paradox of this situation lies in the fact that the trustee received the money due to the exchange bondholders from the borrower; however, it was barred by the court from making a payment to them. De facto, the US judicial system brought a sovereign nation into a default on its restructured $29-billion bonds and triggered circa $1 billion in credit-default swaps.[93] As collateral damage, the injunctions imposed an unnecessary risk on the financial intermediaries, including the trustee.[94] Also, the rights of the exchange bondholders, 93 per cent of all bondholders, who had recognised the grave economic hardship of Argentina and agreed to a substantial haircut in sovereign debt restructuring were impaired.

In this respect, in order to assess the actions of the trustee as a guardian of bondholders, it is necessary to understand (i) the trustee's response to the non-payment situation and its qualification following the terms of indenture as a default event, and (ii) the trustee's actions to persuade the court to release the money from the injunction and even to undertake some alternative solutions as the enforcement of the payments.

Trustee's Response to the Non-payment Situation and Its Qualification[95]

It is crucial to understand that the event of default under the contractual terms was triggered not only to hold Argentina liable but also to identify the role of the trustee in the representation of the bondholders, because after a default, the trustee's

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[91] See Motion for Miscellaneous Relief, Allen Applestein, et al v Republic Argentina, case 1:02-cv-04124 (S.D.N.Y. 7 August 2014), Document 130. Similar 'turnover' motions were filed in case 1:02-cv-01773-TPG; case 1:03-cv-04693-TPG; case 1:03-cv-08120-TPG; case 1:04-cv-03314-TPG; case 1:04-cv-06137-TPG; case 1:04-cv-06594-TPG; case 1:04-cv-07504-TPG; case 1:05-cv-00177-TPG; case 1:05-cv- 02943-TPG; case 1:05-cv-03089-TPG; case 1:05-cv-04299-TPG; case 1:05-cv-04466-TPG; case 1:05-cv-06002-TPG; case 1:05-cv-06200-TPG; case 1:05-cv-06599-TPG; case 1:05-cv-08195-TPG; case 1:05-cv-08687-TPG; case 1:05-cv-10636-TPG; case 1:06-cv-13085-TPG; case 1:07-cv- 00098-TPG; and case 1:07-cv-05807-TPG.

[92] Order denying turnover motions, Allen Applestein, et al v Republic Argentina, case 1:02-cv-04124 (S.D.N.Y. 27 October 2014), Document 152; Summary Order, D.C.A. Grantor Trust v Republic of Argentina, case 1:14-4221 (2nd Cir. 16 October 2015).

[93] Sheelah Kolhatkar, Argentina's Secret Plan to Escape Default, Bloomberg Business (4 August 2014), https://perma.cc/5HBB-TU24.

[94] Elizabeth G. Atkins, 'Collateral Damage: An American Judge's Innovative but Misguided Attempt to Resolve the Enforcement Problem of Sovereign Debt Current Developments 2014-2015' (2015) 28 Georgetown Journal of Legal Ethics 371, 391.

[95] This part is based on the author's paper Pustovit, 'Sovereign Debt Contracts: Implications of Trust Arrangements for Financial (in)Stability'.

fiduciary responsibilities ratchet up sharply under New York law.'[96] In this regard, it should be ascertained whether Argentina breached its payment obligations under the bond documentation.

The injunction by the New York court and its consequences spurred different responses in financial markets. Even though exchange bondholders did not receive the due payments, there were many speculations as to whether Argentina was in default of its contractual obligations. The views can be divided into two groups: those considering that Argentina had fulfilled its obligations, and those deeming that Argentina had defaulted, even though, in some cases, applying different default definitions, for instance, technical default, selective default and formal default.

Concerning the first view, Argentina announced its position in an official communiqué under the self-explanatory title 'Argentina Pays' on 29 June 2014, just a few days after depositing money with the trustee. The communiqué stated that Argentina had made a timely payment and complied with the terms of the prospectus and contract of the exchange bonds.[97] Even though the event of default assumed by the opponent group had already occurred, Argentina moreover maintained that there had been no event of default under the terms of the trust indenture, and the trustee had failed to perform its obligations with regard to the transfer of the funds to the bondholders.[98] Also, no notice of default had been given; as stipulated by the trust indenture, Argentina should promptly notify the trustee within 15 days after becoming aware of the occurrence of an event which with the giving of notice or lapse of time or both would become an event of default as denoted by the indenture.[99]

One may argue that the interpretation provided by Argentina was not dictated by its legal position per se, but merely by the outcome of its protracted offensive stance in the negotiations with holdout creditors. This assumption seems plausible as the government's standpoint in the negotiations was politically framed by electoral promises directed against any repayment to NML. Additionally, at the time of the court-driven negotiations, Argentina was already cut off from capital markets, and

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[96] See Chapter 4.V. Bond Trustee as a Fiduciary at p 126.

[97] See Official Communiqué of the Argentine Government, dated 29 June 2014, Available at: <http://www.embassyofargentina.us/fil/ckFiles/files/officialcommuniqueoftheargentinegovernment-argentinapays.pdf>.

[98] See Note to the trustee and legal notice, dated 6 August 2014, Available at: <http://www.economia.gob.ar/DESENDEUDAR/es/doc/Nota-BoNY-y-Legal-Notice1.pdf>.

[99] See Argentina Indenture 2005, supra fn 67.

default on restructured bonds would not materially change its funding sources; on the contrary, it would decrease the Argentine repayment burden, at least in the short term.

Ultimately, Argentina's position was apparently influenced by a combination of different factors, but it is also evident that, regardless of the underlying reasons, even sovereigns seek to justify their actions legally, which underpins the importance of law in sovereign debt restructuring.

The proponents of the second view considered the factual non-receipt of the funds by the exchange bondholders as a breach of contract, thus starting the countdown of the 30-day grace period before an event is considered an event of default.[100] According to Daniel Pollack,[101] the court-appointed mediator, once the grace period lapsed on 30 July 2014, Argentina was in default. Other third parties, such as credit rating agencies[102] and ISDA,[103] also tended to think that the default occurred. Even though their opinions are not legally binding, they help to understand the market's attitude towards the case at hand.

Given this situation, from an economic point of view, it is straightforward that exchange bondholders were deprived of Argentina's payment due on 30 June 2014 and afterwards for almost two years. However, in order to fully understand the situation, it is necessary to turn to the legal component of the financial transaction, as default is not merely an economic concept. Law and contractual obligations provide a basis for the proper distribution of assets and the available remedies in case actors deviate from an agreed transaction. In other words, financial deals are legally constructed to secure recourse to legal vindication.[104]

According to the terms and conditions of the securities, which are an exhibit to the indenture, Argentina could choose between two methods of making payments

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[100] See Ibid, at p 21.

[101] See 'Argentine Default Imminent, Mediator Says', Financial Times (online), Available at: <http://www.ft.com/intl/fastft/188642>.

[102] See 'S&P Puts Argentina on 'Selective Default' ' , Financial Times (online), 31 July 2014, Available at: <http://www.ft.com/intl/fastft/188612/post-188612>; 'Moody's changes Argentina's outlook to negative as default will hasten economic decline', Moody's, 31 July 2014, Available at: <https://www.moodys.com/research/Moodys-changes-Argentinas-outlook-to-negative-as-default-will-hasten--PR_305436>; 'Argentina Downgraded to 'Restricted Default': Fitch', Financial Times, 31 July 2014, Available at: <http://www.ft.com/fastft/2014/07/31/fitch-downgrades-argentina-restricted-default/>.

[103] See ISDA News Release, 1 August 2014, available at: http://www2.isda.org/news/isda-americas-credit-derivatives-determinations-committee-argentine-republic-failure-to-pay-credit-event (ISDA Committee resolved that a failure to pay credit event occurred in respect of the Argentine Republic, which triggered applicable CDSs).

[104] Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315, 317.

on the bonds. Choosing the first option, which represents the payment to the BNYM in the present case study, Argentina makes principal and interest payments to a trustee in Argentina that in turn makes an electronic funds transfer (EFT) to the US-registered exchange bondholders. The EFTs are made from the trustee's non-US bank to the registered holder's US bank, often routed through one or more intermediary banks.[105] The second alternative allows Argentina to make payments directly, or to order the trustee to do so, by mailing a check to the bondholders.[106]

The stumbling block is the end of the abovementioned provision, where, referring to payment by check through the mail, it prescribes:

> 'Notwithstanding anything herein to the contrary, the Republic's obligation to make payments of principal of and interest on the Securities shall not have been satisfied until such payments are received by the Holders of the Securities.'

Some controversy emerged as to whether this provision applies to both payment methods or only to payments by checks through the mail. According to Argentina, there is a reason to condition the fulfilment of Argentina's payment obligations on the actual receipt of such payments by bondholders only when payments are made by mail.[107] Unlike payments made to the trustee, funds sent by mail remain in the Republic's ownership until the check is received and cashed. Therefore, in Argentina's view, the borrower's payment obligations were discharged, and no event of default occurred by timely transferring the funds to the trustee.[108]

However, from the structure of the contractual clause in the indenture, it seems that Argentina did not meet its payment obligations. Also, its wording is identical to what is stated in the prospectus. It seems that Argentina included the provision, making her responsible for the actual receipt of the payments on the bonds, as a sweetener for the creditors. By accepting the clause, the sovereign sent a valuable signal of 'trustworthiness' and willingness to provide special guarantees, and, as a result, presumably achieved a higher participation rate in the bond swap.

At the same time, this clause gives rise to multiple questions as to how Argentina could actually control the whole payment process and the legal and economic appropriateness of such a guarantee. Under the general principle in

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[105] See NML Capital, Ltd., 699 F.3d 246, 253 (2nd Cir. 2012).

[106] The Argentina Indenture 2005, *supra* fn 67, at p C-2.

[107] See *supra* fn 98.

[108] See *supra* fn 97.

contractual relationships, the risk should be allocated to the superior risk bearer.[109] It seems natural that this is the contracting party who has more opportunities to identify and control the risk at the lowest costs. Be it as it may, for the purpose of the analysis it is assumed that Argentina, even though coerced by the pari passu injunctions, infringed the payment procedure described in the indenture and prospectus, triggering an event of default, which imposed higher fiduciary duties on the trustee.[110]

As the trustee represents the bondholders and has collective enforcement rights vested in him, one could expect that the trustee will become active once the funds were blocked by the pari passu injunctions and following the non-receipt of the subsequent bond payments from Argentina and fulfil its obligations provoked by the default situation. However, it is difficult to determine whether the trustee followed the provision of the indenture[111] and notified the bondholders of the event of default. The only hint that such notice was given is the heading of the notice of 31 July 2014 itself: 'Notice […] of the formal default of the Republic of Argentina'.[112] A reference to the formal default does not make any sense from the legal point of view as there is no gradation of the defaults under the trust indenture. Differentiation between different types of defaults, such as technical default, selective default and formal default, is practised by credit rating agencies to provide some characteristics of the particular default. The trustee, for some reason or other, entirely omitted mentioning the word 'default' in the actual text of the notice, nor did it include any references to the event of default as stated in the explicit list of events under the indenture.[113]

Trustee's Actions to Protect Bondholders

While it is part of the bond trustee's business to find itself in an unenviable position balancing between Scylla and Charybdis in a non-payment situation,[114] this case is

[109] See Richard A Posner and Andrew M Rosenfield, 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis' (1977) 6 The Journal of Legal Studies 83, 90 (Defining a 'superior risk bearer' as 'the party that is the more efficient bearer of the particular risk in question, in the particular circumstances of the transaction').

[110] For details see Pustovit, 'Sovereign Debt Contracts: Implications of Trust Arrangements for Financial (in)Stability'.

[111] See the Argentina Indenture 2005, *supra* fn 67, at p 27.

[112] See 'Bank of NY Mellon advises holders of Argentina default', notice by Bank of NY Mellon, dated 31 July 2014.

[113] See the Argentina Indenture 2005, *supra* fn 67, at p 21.

[114] Simile by courtesy of Schwarcz and Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee', 1042.

unusual in many respects. Generally, during the bond default, there is a conflict between bondholders and the borrower over the missed payments, whereas a bond trustee is navigating between them fulfilling the prescriptions of the indenture.

However, in this case, the interest of the exchange bondholders and Argentina were aligned – both parties demanded that the frozen funds are disbursed to the exchange bondholders and hence, were two-headed Scylla. Their antagonist, and Charybdis for the trustee, were holdout creditors who requested the pari passu injunctions and to some extent the US courts which granted them.[115] It seems reasonable to expect in such a situation that a trustee should take sides with the exchange bondholders especially when a borrower, another party to the bond indenture, supports that. Nevertheless, it became a fierce confrontation between the exchange bondholders and Argentina on the one side, and the trustee on the other.

The actions of the trustee and its subsidiaries were critically assessed by the exchange bondholders and the borrower and were even subject to legal suits on three continents. In addition to actions brought by some exchange bondholders in England, Belgium and Argentina, the trustee was subject to multiple administrative proceedings in Argentina.[116] Furthermore, Argentina stopped paying the trustee and even tried to replace the trustee and alter the payment mechanism for the exchange bondholders to escape the long arm of the US judicial system.[117] To sum up, as described by Justice Newey, the pari passu injunctions caused a continuing 'state of paralysis' in the operation of the trust.[118]

It is understandable why the trustee took the position that injunctions were binding and followed them.[119] Under the pressure of sanctions, it is too much to

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[115] See Response of the Bank of New York Mellon to Motion of the Republic of Argentina seeking to vacate Injunctions, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 29 February 2016), Document 900 (The trustee described himself as 'a non-party to these proceedings which has been accused of no wrongdoing and has nonetheless been targeted by both sides in domestic and foreign jurisdictions').

[116] See Ibid fn 115.

[117] Amended and Supplemental Order, NML Capital v Argentina, case 1:10-cv-05338 (S.D.N.Y. 3 October 2014), Document 199 (The court found Argentina in contempt of court and prescribed her to reaffirm the role of the BNYM as the indenture trustee); Letter to the court by the plaintiffs, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 20 August 2014), Document 648; also see supra fn 115.

[118] Knighthead Master Fund LP v Bank of New York Mellon, [2015] EWHC 270 (Ch), 2015 WL 537875 (2015).

[119] NML Capital Ltd v Republic of Argentina 727 F.3d 230 (2013) ('The amended injunctions provide that BNY, as a participant in the payment process of the Exchange Bonds, 'shall be bound by the terms of this ORDER as provided by [Federal Rule of Civil Procedure] 65(d) (2).'); For the trustee's view see supra fn 115.

expect from the trustee to violate the pari passu injunctions and transfer the money to the exchange bondholders. However, there were plausible scenarios for the trustee to defend the interest of bondholders complying with the pari passu injunctions. Notably, this applies to the funds which were envisaged for the Euro-denominated and English law governed bonds.

Due to the novelty of the pari passu injunctions, the question to which extent the trustee is bound by the injunctions, particularly in respect of foreign law and currency bonds, was left open for clarification in previous judgments.[120] It is reasonable to expect that a trustee will try to clarify in front of the court the conflicting actions prescribed by the injunctions and the indenture. Nevertheless, the trustee did not seek to clarify its position and possibility to transfer the funds to the exchange bondholders following the bond documentation.

From the beginning, the trustee unconditionally presumed that it would be exposed to liability from injunctions and regarded the obligations arising from the indenture as inferior. His both proposals to the court to return the funds to Argentina or to retain them are not authorised by the indenture, which is considered to be a bible for the trustee's actions. Furthermore, it took some time before the trustee finally asserted that the funds are held on trust for the exchange bondholders as beneficial owners, and therefore, protected from the attachment.

In the letters to the trustee following the receipt of the funds by the trustee, Euro bondholders were concerned that the trustee being their fiduciary did not transfer the funds to the beneficial owners and instead offered an interpleader action to bring those funds to New York. [121] Furthermore, the bondholders were insulted by the trustee's readiness to cooperate with plaintiffs, NML Capital, in drafting an order for returning the money to the detriment of the bondholders. Similarly, Argentina demanded the trustee to proceed with the payments according to the indenture supporting the motions submitted by the Euro bondholders, Euroclear and

[120] NML Capital Ltd v Republic of Argentina 727 F.3d 230 (2013), (Stating that with regard questions as to who is bound by an injunction '[t]he doors of the district court obviously remain open for such applications.' Also, the court stated that if 'the payment process for [the Euro Bonds] takes place entirely outside the United States, then the district court misstated that … the Exchange Bond payment 'process, without question takes place in the United States').

[121] Letters to the Bank of New York Mellon from the Euro bondholders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 27 June 2014), Document 582-2, Exhibit G.

Clearstream.[122] Also, the memorandum of the Republic of Argentina stated that until such payments are made, the funds should be held in trust for the benefit of bondholders while Argentina is not entitled to those funds.[123]

From the legal standpoint, the most persuasive case for rejecting the pari passu injunctions is related to the funds received by the trustee in euro. The amount of €225,852,475.66, which was blocked at the trustee's account, and the following three transfers of similar sums, which were not transferred by Argentina due to pari passu injunctions, are obligations of the borrower out of the Euro bonds. Those bonds are governed by the laws of England and Wales and paid in euro. Furthermore, the Euro bonds have a distinct payment mechanism from the dollar-denominated and New York law governed bonds.[124] The whole payment flow does not enter the US at any point, and the only connection with the US is that the trustee is incorporated under New York law and has its registered office is in New York.[125] Those facts were used by the Euro Bondholders as arguments for releasing the Euro bonds from the operation of the pari passu injunctions.[126] Their argument was based on the Supreme Court's judgment establishing that the US courts lack jurisdiction over foreign parties for injunctive relief.[127] Another argument was based on the international comity concerns as the injunctions conflicted with the EU Settlement Finality Directive and

[122] Letter to the Bank of New York Mellon from Republic of Argentina, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 3 July 2014) Document 582-2, Exhibit J; Memorandum of the Republic of Argentina, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 21 July 2014), Document 602.

[123] See Ibid. Memorandum of the Republic of Argentina.

[124] Declaration of Kevin F. Binnie of the Bank of New York Mellon regarding the payment process and Declaration of Kevin F. Binnie of the Bank of New York Mellon regarding the payment process, NML Capital v Argentina, case 1:08-cv-06978-LAP (S.D.N.Y. 16 November 2012 and 17 June 2014), Document 579 (Payments on the Euro Bonds are made as follows: (1) The Republic deposit funds to the account of the BNYM at Banco Central in Argentina; (2) the funds are then transferred to Deutsche Bank in Frankfurt, Germany to the account in the name of the BNYM Brussels; (3) the funds are transferred to clearinghouses Euroclear (Belgium) or Clearstream (Luxembourg) for distribution among their participant banks, who then transfer the funds to the beneficial owners).

[125] Knighthead Master Fund LP v Bank of New York Mellon, [2015] EWHC 270 (Ch), 2015 WL 537875 (2015); Memorandum of law in response to non-parties Euro Bondholders' emergency motion for clarification by the Bank of New York Mellon, NML Capital v Argentina, 1:08-cv-06978 (S.D.N.Y. 10 July 2014), Document 581.

[126] 'The Euro Bondholders are Knighthead Capital Management, LLC, Redwood Capital Management, LLC, Perry Capital LLC, VR Global Partners, LP, Monarch Master Funding 2 (Luxembourg) S.à r.l., Silver Point Capital LP, QVT Fund IV LP, QVT Fund V LP, Quintessence Fund LP, and Centerbridge Partners LP (each on behalf of itself or one or more investment funds or accounts managed or advised by it).' From memorandum of law submitted by the Euro Bondholders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 29 June 2014), Document 545.

[127] Daimler AG v Bauman, 134 S. Ct. 746 (2014); see Memorandum of law submitted by the Euro Bondholders, supra fn 126.

national laws of Belgium and Luxemburg, which shielded Euroclear and Clearstream from attempts to enjoin payment transfers.

Moreover, a similar strategy succeeded in the motion for clarification submitted by Citibank N.A. regarding its branch in Argentina, acting as a local custodian for bondholders, concerning the payments on the peso-denominated and Argentinian law-governed exchanged bonds. They were granted exemption from the pari passu injunctions, and the payment transfers to bondholders were allowed.[128] In both cases, the parties that process payments were exposed to liability in their home forums for complying with the injunctions.[129]

Shortly after the motion for clarification was lodged by Euro bondholders, the trustee provided its opinion to the court seeking to contain its liability risks from the actions vis-à-vis received funds from Argentina.[130] In his statement, the trustee neither mentioned any of the arguments submitted by the Euro bondholders to release the Euro bonds from the operation of the pari passu injunctions nor tried to defend bondholders' rights to receive payments in any other way. To the contrary, it was inclined to maintain the funds at the account at Banco Central arguing that it would not prejudice plaintiffs.

Refining his previously stated opinion to the court, in its motion for clarification, the trustee abandoned its previous suggestion of filling interpleader to determine who has a right to the funds but proposed that he has to retain the funds.[131] Furthermore, the trustee reached an agreement with the plaintiffs on a form of the order, which was later endorsed by the court,[132] obliging the trustee to retain the funds and indemnifying trustee from liability for complying with this order.[133] It is important to mention that the trustee claimed that all parties agreed to the trustee's

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[128] Court Order clarifying amended February 23, 2012 Orders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 27 June 2014), Document 547; Court Order, NML Capital v Argentina, case 1:10-cv-05338 (S.D.N.Y. 1 August 2014), Document 159.

[129] Memorandum of law in support of Citibank, N.A.'s renewed motion by order to show cause for clarification or modification, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 19 June 2014), Document 550. See more regarding suits by the Euro bondholders against the trustee in other jurisdictions at p 153.

[130] Letter to the court from the Bank of New York Mellon as indenture trustee, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 1 July 2014), Document 552.

[131] Declaration of Evan K. Farber in support of the motion of non-party Bank of New York Mellon, as indenture trustee, for clarification of amended February 23, 2012 Orders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 10 July 2014), Document 582-2, Exhibits M and N.

[132] Court Order, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 6 August 2014), Document 166.

[133] Letter to the court from the Bank of New York Mellon as indenture trustee, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 4 August 2014), Document 630.

retention of the money.[134] However, this claim was rejected by the Euro bondholders who asked to proceed with payments following the bond indenture and appealed the court order about retainment of the funds by the trustee.[135]

What is striking is that the trustee took no position on the merits of the Euro bondholder's motion.[136] At the same time, it did discuss at large the liability risks coming from the exchange bondholders and Argentina for not distributing payments among bondholders.[137] In reply to the plaintiffs' question why the trustee requests to retain the funds the trustee clarified that in this case, he maintains the senior lien on the funds protecting him from potential litigation risks.[138] In her letter to the trustee, Argentina blamed that the trustee 'has placed its interest, and those of the plaintiffs [..,] over those of the Exchange Bondholders, in violation of BNY's duties as Trustee.'[139] This observation is in line with the recurrent statements from scholars and practitioners that sometimes trustees 'devote as much of their energies to avoiding personal liability as to protecting bondholders'.[140]

Eventually, the district court refused to grant the Euro bondholders' motion for clarification stating only that 'to do so would start making important exceptions to the basic ruling and Injunction.'[141]

Furthermore, in response to the trustee's actions, the Euro bondholders initiated a suit against the bond trustee in England. The claimants sought declarations from the Chancery division of the High Court as to the status of funds and the obligations of the trustee to transfer the Euro funds to the registered holder of the

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[134] Letter to the court from the Bank of New York Mellon as indenture trustee, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 6 August 2014), Document 631.

[135] Letter to the court from the Euro bondholders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 6 August 2014), Document 632; Notice of appeal by the Euro bondholders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 15 August 2014), Document 640.

[136] Memorandum of law in response to non-parties Euro Bondholders' emergency motion for clarification by the Bank of New York Mellon, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 10 July 2014), Document 581.

[137] Memorandum of law in support of the motion of non-party Bank of New York Mellon, as indenture trustee, for clarification of amended February 23, 2012 Orders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 10 July 2014), Document 578.

[138] Reply memorandum of law in support of the motion of non-party Bank of New York Mellon, as indenture trustee, for clarification of amended February 23, 2012 Orders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 21 July 2014), Document 599.

[139] Letter to the Bank of New York Mellon from Argentina, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 6 August 2014), Document 635.

[140] Schwarcz and Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee', 1041.

[141] Court order denying 'Emergency Motion for Clarification' filed by the non-party 'Euro Bondholders', NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 25 November 2014), Document 724.

global securities issued in respect of the debt securities.[142] It is reasonable to expect that a prudent trustee would approach the court with the same questions on its own. Unfortunately, the court clarified only that the funds received by the BNYM were held on trust for the beneficiaries leaving open the issue of the trustee's obligations. Nevertheless, while noting that the plaintiffs were critical of the conduct of the trustee in the US proceedings, the English court showed its dissatisfaction with the trustee's conduct in the present litigation describing it as 'outside the reasonable range of possible approaches.'[143] Furthermore, the English court clarified that the pari passu injunctions are not precluding the trustee from liability under English law, and the Commercial Court of Brussels went a step further by obliging BNYM Brussels, paying agent under the Euro bonds indenture, to transfer the payments relating to the Eurobonds that would be made by Argentina.[144]

Finally, once the holdout creditors came to the settlement agreement in principle and there were prospects that the pari passu injunctions, which blocked Argentina's money in the hands of the trustee, could be revoked, the trustee filed a response to the motion of the Republic of Argentina Seeking to Vacate Injunctions. It sought for direction and clarification from the court.[145] The trustee feared to lose the indemnification from liability of the trustee under the indenture or otherwise due to compliance with the court orders. Therefore, the trustee requested that those protections should remain in full force and effect after the revocation of the injunctions. Also, the trustee sought to endorse its senior right to and charging lien securing payment of fees and expenses. The trustee's concern might have been rooted

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[142] Knighthead Master Fund LP v Bank of New York Mellon, [2014] EWHC 3662 (Ch), 2014 WL 5599463 (2014) (Additionally, the Euro bondholders requested for the injunctive relief by way of the distribution of the funds to them).

[143] Knighthead Master Fund LP v Bank of New York Mellon, 2015 WL 537875 (2015) (At the same time, the court kept 'open the position that, because the trustee is subject to the personal jurisdiction of the US courts, it may as a matter of English law be able to rely on the injunction as a proper ground for non-compliance with what would otherwise be its obligations under the trust indenture').

[144] Knighthead Master Fund LP v Bank of New York Mellon, [2014] EWHC 3662 (Ch), 2014 WL 5599463 (2014), ('While, however, that [the pari passu injunctions] may excuse the Bank from any liability to holders of euro-denominated Exchange Bonds as a matter of American law, I find it hard to see how it can do so in the eyes of the English Courts, and the bonds in question are governed by English law').

Knighthead Capital Management LLC v S.A. The Bank of New York Mellon, S.A. Euroclear and S.A. Euroclear Bank, Commercial Court of Brussels, R.G.: 5650/13 (2015), (The Belgian Court provided that, even if BNYM Brussels 'fear[s] the consequences of such a transfer under US law, such a fear does not constitute an insuperable obstacle to the execution of its obligations as paying agent').

[145] Response of the Bank of New York Mellon to motion of the Republic of Argentina seeking to vacate injunctions, supra fn 115.

in previous judgments by the English and Belgian courts and clarification by the US Court of Appeals that the trustee may face litigation.[146]

The Euro bondholders saw the trustee's motion as 'a stealth last-minute request for relief under the guise of a 'response."[147] They claimed that the substance of the motion was not addressing the core issue of whether the injunctions had to be lifted, but rather was an attempt to withhold funds due to exchange bondholders and to secure a 'broad-based exculpation from liability under the Indenture.' In essence, the trustee's motion was seen by Euro bondholders 'as baseless as it is offensive to its role as trustee under the Indenture.'

Nevertheless, in response to the trustee's motion, the court recognised that special consideration to the rights of the financial intermediaries that facilitate payments to the exchange bondholders has to be given.[148] The court ordered that the trustee shall not incur any liability for complying with the court orders even after the pari passu injunctions are lifted. Interesting enough that the court concluded that this order is not binding on any courts outside the US, perhaps learning from the previous conflict with foreign courts.

Besides clarifying the scope of the injunctions, there might have been an alternative route for the trustee to secure the payments to the bondholders. This way of action would have been based on the fact that the trustee, being a centralised enforcer of the bondholders' rights under the indenture, has the exclusive right to initiate a suit against the defaulted borrower. Even though the default on exchange bonds was caused de facto by the US court's injunctions and not by Argentina's unwillingness or inability to pay, the exchange bondholders still retained their rights to sue the borrower for breach of payment.[149]

The trustee could have sued Argentina for missed payments. At first glance, the money judgment regarding missed payments might be seen as another piece of paper for exchange bondholders stating their rights but useless to provide the effect, i.e. actually to receive the money. However, for an exchange bondholder, becoming a judgment creditor could be the way to escape the pari passu injunctions which are

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[146] NML Capital. v Argentina, case 14-2922 (2nd Cir. 22 October 2014), Document 93 (The Second Circuit has recognized that the Injunction 'does not enjoin third parties, such as Euro Bondholders .., from bringing suit against BNY').

[147] Letter to the court from the Euro bondholders, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 29 February 2016), Document 907.

[148] Order NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 19 April 2016), Document 931.

[149] See NML Capital Ltd v Republic of Argentina 727 F.3d 230 (2013).

framed narrowly and apply to payments due on exchange bonds.[150] Once a money judgment is granted, the relationships between the creditor and borrower are framed by this judgment.[151] Payments to fulfil a money judgment should not be seen as obligations under terms of the bonds and hence, would have been beyond the scope of the injunctions.

C. Ecuador's Default of 2008: Protection of Small Investors

In the Argentine case study, we have seen a standoff between the trustee and some bondholders over the course of actions to receive the payments following the sovereign default. Notably, the Euro bondholders were a group of institutional investors which held bonds for €1.06 billion.[152] It is not only cost-efficient for a group which has substantial holdings of the bonds to defend its interests, but it is also a precondition to direct the trustee to perform some specific actions, e.g., to accelerate the bonds or start the enforcement action.[153]

Conversely, the prospects for protecting their rights are much less promising for small investors who neither have resources to withstand a protracted legal battle nor legal standing to direct the trustee. According to anecdotal records, the attorney's fees in sovereign debt disputes in the US courts sum up to the hundreds of thousand dollars per case.[154] The default of the Republic of Ecuador (Ecuador) in 2008 and two separate enforcement actions deriving from an institutional and a retail investor are evidentiary in this regard. These cases exemplify that courts bolstered the

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[150] Order, NML Capital v Argentina, case 1:08-cv-06978 (S.D.N.Y. 23 February 2012), Document 371 ('2.a. Whenever the Republic pays any amount due under terms of the bonds or other obligations issued pursuant to the Republic's 2005 or 2010 Exchange Offers, or any subsequent exchange of or substitution for the 2005 and 2010 Exchange Offers that may occur in the future (collectively, the "Exchange Bonds"), the Republic shall concurrently or in advance make a "Ratable Payment" (as defined below) to NML').

[151] See about merger doctrine at p 121.

[152] Knighthead Capital Management LLC v S.A. The Bank of New York Mellon, S.A. Euroclear and S.A. Euroclear Bank, Commercial Court of Brussels, R.G.: 5650/13 (2015).

[153] See Chapter 4.IV. Collective Enforcement Clauses at p 117.

[154] UNCTAD, 'Box 4.2. Concentrated, Costly and Opaque: Sovereign Debt Restructuring and Debt Litigation', *Trade and Development Report 2019: Financing a Global Green New Deal* (2019), 99; Libra Bank Ltd. v Banco Nacional De Costa Rica, S.A., 570 F.Supp. 870 (S.D.N.Y. 1983), ($425,200 for attorneys' fees. Court reduced the claimed amount by 20%); Commercial Bank of Kuwait v Rafidain Bank, 1993 WL 597380 (S.D.N.Y. 1993) and 15 F.3d 238 (2nd Cir. 1994), (Plaintiff was awarded $225,000.00 in attorney's fees.); Pravin Banker Associates, Ltd. v Banco Popular del Peru, 912 F.Supp. 77 (S.D.N.Y. 1996), (Attorneys' fees and expenses incurred in the prosecution of the action of $191,428.71 were awarded in full amount); Themis Capital v Democratic Republic of Congo, 2014 WL 4379100 (S.D.N.Y. 2014) (The court granted $3.5 million as the reimbursement of attorneys' fees for approximately 5-years litigation).

importance of the trustee as a centralised enforcer by diminishing unconditional enforcement rights of the bondholders.

Ecuador is a frequent object of discussions in the sovereign debt community, as the country was in default for 109 out of the last 184 years.[155] Among those numerous defaults, the one of 2008 has received particular attention in the media and scholarship due to the unusual reasons for non-payment. It is one of a few instances in modern history when a sovereign defaulted as a result of lacking willingness to pay but not of the inability to pay. In essence, Ecuador repudiated the bonds and repurchased them both through the secondary market and directly through a buyback with a substantial discount.[156]

The defaulted bonds in 2008 were the result of the sovereign debt restructuring of 2000 which was itself the restructuring of the Brady bonds, which were issued in 1995 to restructure commercial bank loans. Those bonds were issued under the trust structure and governed by New York law.

Lee Buchheit and Mitu Gulati described the behaviour of the trustee after the default as 'bovinely passive' as the trustee neither accelerated the bonds and started the enforcement on its own volition nor followed the direction of the bondholders' vote to do the same using as an excuse the absence of Ecuador's certification to define the threshold for the effective vote.[157] As suggested by the authors, those actions made it impossible for bondholders to recover their losses through the attachment of the buyback funds used by Ecuador.[158]

However, the story of the remiss trustee continued and recently got new twists. In 2014, GMO Trust, the Boston open-end investment company and the holder of defaulted Ecuadorian 2030 Bonds, sued Ecuador for non-payment. Naturally, following the tradition of the recent copycat suits based on NML Capital v Argentina,[159] the plaintiff claimed a violation of the bonds' pari passu clause.[160] However, a significant distinction between NML Capital and GMO Trust is that the

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[155] Arturo C Porzecanski, 'When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador' (2010) 73 Law and Contemporary Problems 251, 251 (The author provides this metrics for the period from 1826 through 2010).

[156] Ibid (The bond buyback occurred for thirty-five cents on the dollar).

[157] Gulati and Buchheit, 'The Coroner's Inquest: Ecuador's Default and Sovereign Bond Documentation', 24.

[158] Ibid.

[159] E.g. Export–Import Bank of the Republic of China v Grenada, 2013 WL 4414875 (S.D.N.Y. 2013).

[160] The wording of the pari passu clause contained in the 2030 Ecuador Bonds differs from the one which was interpreted in NML Capital's case.

later acquired the bonds upon their issuance, i.e. about nine years before the default, in effect paying a nominal value of the bonds in contrast to a heavily discounted fraction of it on the secondary markets as usually done distressed funds.

The suit was filed almost six years after the default presumably because only by that time the GMO Trust was able to overcome the 25 per cent threshold to direct the trustee to accelerate the entire principal amount of the bonds and commence the enforcement action. The plaintiff's comparatively timid holdings of the bonds in the principal amount of $15,876,000 seemingly became sufficient to satisfy the requirements of the no-action clause for enforcement of the 2030 Bonds, whose issuance volume was $2.7 billion, due to buybacks performed by Ecuador in 2009 and 2014.[161] Nevertheless, the trustee of the 2030 Ecuador Bonds declined to institute an action for collection of the unpaid debt despite the assertions of GMO Trust that all requirements were fulfilled.[162] According to the trustee, the required percentage of outstanding bondholders for direction was not reached.[163] Buchheit and Martos referred to this particular instance as 'a good example of the Abdicating Trustee Scenario' – a circumstance where the trustee despite a valid instruction by the holders and offered indemnity declines to enforce the bonds and a bondholder gains the right to proceed on its own.[164] Also, based on the fact that the case was settled within a few months after the initiation, Ecuador might have been persuaded by the plaintiff's legal position.[165]

A different story unfolded at the same period concerning the same 2030 Ecuador Bonds for a retail investor who filed a similar suit as a pro se plaintiff. Mr Penades, who lived in Uruguay, invested all his capital, including the heritage, into Ecuadorian bonds intending to transfer the capital to Brazil as a part of his relocation and family reunification plan. The default of Ecuador left him without any savings in a state of limbo between his home country and Brazil, which denied him a

[161] Complaint, GMO Trust v the Republic of Ecuador, case 1:14-cv-09844 (S.D.N.Y. 12 December 2014), Document 1.

[162] Ibid. (A vote above the threshold for direction and an indemnity for the trustee).

[163] A letter from the trustee to a bondholder, 23 December 2014, on file with the author (It could be that, similar to the situation described by Buchheit and Gulati, the trustee absent of the information from Ecuador regarding the actual outstanding amount of the 2030 Ecuador Bonds after the 2014 buyback derived its conclusion based on the incorrect information).

[164] Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 463.

[165] 'GMO Settles With Ecuador Over Bonds That Defaulted in 2009,' 1 April 2015, Bloomberg, Available at <http://www.bloomberg.com/news/articles/2015-04-01/gmo-settles-with-ecuador-over-bonds-defaulted-on-six-years-ago>.

residence permit for lack of funds and resulted in physical and mental sufferings bringing him nearly to committing suicide.[166]

In Penades v the Republic of Ecuador,[167] there was no settlement offer coming from Ecuador, the lawsuit was decided on the merits and went through the appeal. The insurmountable obstacle for Penades' claims became the no-action clause of the 2030 Ecuador Bonds and its interpretation by the courts.

As the trustee remained passive for many years since Ecuador's default and did not initiate any enforcement action, the plaintiff took the initiative into his own hands just like the GMO Trust did. It is generally regarded that a bondholder has two exceptions from impediments of the no-action clause under the US-style trust indenture: (i) as discussed previously, the Abdicating Trustee Scenario, which was presumably triggered by GMO Trust; and (ii) concerning claims for due but missed payments, e.g. interest payments in arrears, – the provision imposed on all indentures qualified by the TIA, which is regularly included in sovereign debt issued under New York law.[168] In this regard, Penades sought to recover past-due interest on the bonds and argued that the second type of exception was relevant.

The district court decided that neither of those exceptions applied to Penades.[169] While the requirements to trigger the Abdicating Trustee Scenario were not fulfilled by the plaintiff and could not be fulfilled at least due to small holdings of the bonds, what surprises is the unusual, narrow interpretation of the clause governing the second type of exception, which contains in the indenture under the title 'Unconditional Right of Bondholders to Receive Principal and Interest at Maturity.'[170] Pursuant to the court, which was upheld by the appellate court,[171] 'Section 4.6 unambiguously authorizes suit only if and when Defendant fails to timely fulfil its obligations on the maturity date, which is not until August 15, 2030.'[172] With such an interpretation, the plaintiff is barred by the no-action clause

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[166] See Complaint, Penades v the Republic of Ecuador, case 1:15-cv-00725 (S.D.N.Y. 25 January 2015) Document 2, pp 1-2.

[167] Case 1:15-cv-00725 (S.D.N.Y.).

[168] Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 457.

[169] Opinion & Order, Penades v the Republic of Ecuador, case 1:15-cv-00725 (S.D.N.Y. 2016) Document 57.

[170] Section 4.6. of the Indenture of 23 August 2000 for Global Bonds due 2030 issued by the Republic of Ecuador.

[171] Summary Order, Penades v the Republic of Ecuador, case 16-3617 (2nd Cir. 2017), Document 70-1.

[172] Opinion & Order, Penades v the Republic of Ecuador, case 1:15-cv-00725 (S.D.N.Y. 2016) Document 57.

to initiate any suit to enforce not only the principal amount but also any missed interest payment until the final payment due date in 2030.

Sovereign bond contracts are well known for their boilerplate nature,[173] and contractual clauses governing the unconditional right of bondholders to sue for missed payments, akin to Section 4.6 of the 2030 Bonds, seem to be standardised and used in other sovereign bonds structured under a trust indenture and governed by New York law. One of the examples is the bonds issued by the Province of Mendoza in 1997.[174] Its indenture contains an identical clause to the Section 4.6 of the 2030 Ecuador Bonds, and it was interpreted by courts in Greylock Global Opportunity Master Fund Ltd. v. Province of Mendoza as allowing the plaintiffs to proceed with lawsuits regarding payments in arrears individually.[175] Furthermore, other clauses from the 2030 Ecuador Bonds' indenture which were used by the court to derive the meanings of the terms 'maturity' and 'stated maturity' are practically identical to the terms of the 2007 Mendoza Bonds.[176]

Interesting to note that in the Greylock case a distressed fund, which held out from the debt restructuring, alleged that the exchange offer and consent solicitation[177] contemplated by the Argentine province were unlawful, and even obtained a temporary restraining order precluding the province from consummating the restructuring.[178] The crux of the dispute revolved around the Sovereign Immunity Amendment, which abrogated the province's waiver of sovereign immunity to attachment and execution, provided by the consent solicitation. The parties disputed whether the Sovereign Immunity Amendment requires the unanimous consent of the existing bondholders. The gravamen relied on the logic that the Sovereign Immunity Amendment violates bondholders' rights under Section 4.6 of the Indenture 'to

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[173] See supra fn 79.

[174] See Indenture of 4 September 1997 for Bonds due 2007 issued by the Province of Mendoza (Argentina).

[175] Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 2004 WL 2290900 (S.D.N.Y. 2004); Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 162 Fed.Appx. 85 (2nd Cir. 2006).

[176] See fn 174 (The wording of the clauses used by the courts are identical in sections 3.4(a); 4.1; Exhibit B (8a). Sections similar to 2.4(f) and Exhibit B (4) are missing in the 2007 Mendoza Bonds. None of the sections referred by the court in the 2030 Ecuador Bonds and available in the 2007 Mendoza Bonds have a different wording with regard the use of terms 'maturity' and 'stated maturity').

[177] Consent solicitation is referred to a procedure prescribing that holders consent to amend provisions of the existing bonds by way of participating in the exchange offer. Therefore, in case the majority of bondholders participate in the exchange offer the amendments deemed to be approved.

[178] Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 2004 WL 2290900 (S.D.N.Y. 2004).

'receive payment of' principal and interest, and 'to institute suit for the enforcement of any such payment' from impairment without their consent.'[179] While deciding that the indenture required no more than majority consent for the adoption of the Sovereign Immunity Amendment, the courts provided an interpretation of a clause identical to the clause on the unconditional right to sue contained in the 2030 Ecuador Bonds:

> 'The reasonable way to interpret Section 4.6 is to read it in conjunction with the immediately preceding provision, Section 4.5, the 'Limitation on Suits by Holders.' When read in conjunction with Section 4.5, it becomes clear that the purpose of Section 4.6 is […] a 'savings provision' for individual suits that might otherwise be subject to the immediately preceding limitations.'[180]

Furthermore, in various suits involving bonds with similar clauses, the courts awarded missed interest payments before the bonds became mature contrary to the new reading of the unconditional right to sue clause in the Penades case. [181]

Deliberately or not, the courts grossly constrained the last stronghold of the individual rights of the bondholders for enforcement, and hence bolstered the importance of the trustee as a centralised enforcer.[182] This once again demonstrates the convergence of the US-style trust arrangement with the UK one diminishing unconditional enforcement rights,[183] with the difference that this time it is done at the judicial level through the interpretation of the contractual provisions. The concern arising from these developments is that with power should come accountability.

Those two cases displayed the severity of the situation for bondholders, and especially for small investors when enforcement action concerning defaulted sovereign bonds is required but their guardian who has the right to seek relief – the bond trustee – remains passive. As a result, bondholders whose securities are governed by trust arrangements are at structural disadvantage compared to bondholders governed by fiscal agency agreements. It seems that the trustee's

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[179] Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 2004 WL 2290900 (S.D.N.Y. 2004).

[180] Greylock Global Opportunity Master Fund Ltd. v Province of Mendoza, 2005 WL 289723 (S.D.N.Y. 2005).

[181] Legnaro v The Republic of Argentina, 2006 WL 2462917 (S.D.N.Y. 2006); Rossini v The Republic of Argentina, 2006 WL 2463559 (S.D.N.Y. 2006); Prima v Republic of Argentina, 2006 WL 1211140 (S.D.N.Y. 2006); Moldes v Republic of Argentina, 2006 WL 1211148 (S.D.N.Y. 2006); Botti v Republic of Argentina, 2006 WL 2555984 (S.D.N.Y. 2006).

[182] N.B. While rulings by summary order can be cited by parties, to make an argument in other cases, they do not have a precedential effect. See Federal Rules of Appellate Procedure 32.1.

[183] See supra at p 123.

passivity reaches such a level that makes trust structures unattractive for sovereign bondholders.

Some commentators suggested that the precedent with Ecuador's default on the 2012 and 2030 Ecuador Bonds will increase the standard of the trustee's liability.[184] However, it seems not to be the case more than a decade after the default. In this regard, there are other ways to align the interests of bondholders and trustees, as discussed in the following.

[184] Yuefen Li and Rodrigo Olivares-Caminal, 'Avoiding Avoidable Debt Crises: Lessons from Recent Defaults' in Carlos A. Primo and Gallina A. Vincelette Braga (eds), *Sovereign Debt and the Financial Crisis* (The World Bank 2010), 253.

CHAPTER 6. BOND TRUSTEES AND THE WAY FORWARD

The previous chapter has provided an overview of the critical junctures for corporate bond trustees when their performance was scrutinised and regulated, as well as in-depth case studies assessing the functionality of the trustees in sovereign bond restructurings performed by Argentina in 2016 and Ecuador in 2008. It was shown that bondholders were suffering from the passivity of the trustees in each case. Against its original purpose to preclude only holdout litigation, a trust structure works as an effective barrier against enforcement of the bondholders' rights in general. Under such circumstances, the trust arrangement seems to be unsuccessful in securing a collective best interest of bondholders as a group in sovereign debt restructuring.

Now, Chapter 6 turns to the root of the trustees' passivity that is the agency problem, which is assessed under the law and economics prism. The agency problem is aggravated by the asymmetric relationships between parties in the bond issue, the contract of adhesion nature of the bond contract, and the lack of almost any boundaries imposed by law or courts.

In order to ameliorate the agency problem, there are various ways to incentivise a trustee to act in the best interest of bondholders. Those incentives are classified as competitive, monetary and liability incentives and discussed providing concrete proposals on how to employ them. In respect of liability incentives, the spotlight is brought on fiduciary obligations. It is a core element to restore the balance between parties by prompting an agent to act in the best interest of the principal. Setting a normative benchmark, such as to promote the best interest of the bondholders for the trustee's discretionary actions, provides the necessary flexibility and guidance for the trustee.

Finally, this chapter argues that the best interest of bondholders in sovereign debt restructuring is captured in sovereign debt sustainability. This approach can be further used as an objective in constructing a legal framework for trustees in sovereign bond markets.

I. THE AGENCY PROBLEM AND ITS ROOTS

A. The Notorious Agency Problem and Sovereign Bond Trustees

The promising features of the trust arrangement for Eurobonds,[1] and later also for sovereign bonds, were identified long ago.[2] A bond trustee has formidable firepower to defend the interests of bondholders and be an effective enforcer, especially in the event of default. The array of available remedies at law or in equity depends on the language of the indenture, and apart from the actions to collect due payments may include those concerned with a breach of implied covenants of good faith and fair dealing, tortious interference with contractual relationships and common law fraud.[3]

In this regard, the poor performance of the sovereign bond trustees seems to be dictated by their reluctance rather than incapacity and can be explained through the prism of the agency theory. This theory assumes that each agent and principal is acting in his self-interest.[4] At times, the interests of the agent and principal are not aligned, which may result in the agent's activity to maximise its welfare to the detriment of the principal's interests. This phenomenon is called an agency problem.

The well-known agency problem envisaged by Jensen and Meckling concerns primarily divergent interests of the management and owners of the firm.[5] However, the idea behind the conflicts of interests between the agent, or in legal terms the fiduciary,[6] and the principal applies to many other types of relationships,[7] including those between a bond trustee and bondholders.

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[1] AMH Smart, 'Fiscal Agency or Trust Deed' (1982) 1 International Financial Law Review 18, 19.

[2] IMF (2002) 'Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use', Available at <www.imf.org/external/np/psi/2002/eng/060602a.pdf>, 15.

[3] James E Spiotto, *Defaulted Securities: The Guide for Trustees and Bondholders* (Chapman and Cutler LLP 2018), 152.

[4] Stephen A Ross, 'The Economic Theory of Agency: The Principal's Problem' (1973) 63 The American Economic Review 134, 134.

[5] Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 Journal of financial economics 305.

[6] Austin Wakeman Scott, 'The Trustee's Duty of Loyalty' (1935) Harvard Law Review 521, 521 (While the circle of the fiduciaries is not fixed, traditionally it included trustees, guardians, executors or administrators, receivers, agents, attorneys, corporate directors or officers, partners, and joint adventurers).

[7] Ross, 'The Economic Theory of Agency: The Principal's Problem', 134 ('Examples of agency are universal. Essentially all contractual arrangements, as between employer and employee or the state and the governed, for example, contain important elements of agency.') See also, Barry M Mitnick, 'The Theory of Agency' (1975) 24 Public Choice 27.

In line with Jensen and Meckling's definition of an agency relationship,[8] the trustee performs a service on the bondholders' behalf, who delegate some decision-making authority to the trustee based on the indenture. An agency problem, which is inherent to such relationships, occurs as the trustee's interests may differ from the bondholders' concerns. For instance, trustees can fail to act in bondholders' interests in order to be more attractive for issuers or to reduce their expenses.[9]

Naturally, in order to maximise the principal's welfare, the agency problem should be solved. This problem could be mitigated through proper incentives and monitoring activities, which may align the incentives of the principal and agent.[10] In this regard, agency theory is praising property rights enforcement and contracting to align incentives.[11] It is achieved by allocating costs and rewards through the specification of the individual rights in a contract.[12] However, from an economic standpoint, it is impossible to eliminate all conflicts of interests between the agent and principal unless those roles concur in the same person. Also, it might be unreasonable to mitigate some conflicts of interests due to the higher costs of incentives and monitoring activities relative to the gains for the principal's welfare.

In an environment of highly dispersed creditors, the monitoring activities are greatly suffering from freeriding.[13] Furthermore, monitoring activities can be costly and are based on the explicit stipulations of the trustee's duties, which, by definition, cannot foresee all circumstances with conflicts of interests.[14] Unusually high costs of specification and monitoring are characteristic of fiduciary relations.[15] It is practically an axiom that principals cannot efficiently monitor their fiduciaries.[16]

Therefore, bondholders usually avoid monitoring activities of trustees. As a result, the lack of information to verify the trustee's behaviour can exacerbate the

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[8] Jensen and Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 308.

[9] Yakov Amihud, Kenneth Garbade and Marcel Kahan, 'A New Governance Structure for Corporate Bonds' (1999) 51 Stanford Law Review 447, 482.

[10] Ibid.

[11] Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 Journal of Political Economy 288, 289.

[12] Jensen and Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', 307.

[13] See Chapter 1.II. Coordination Problems in Sovereign Bonds and Implications at p 22.

[14] Morey W McDaniel, 'Bondholders and Stockholders' (1987) 13 Journal of Corporation Law 205, 231.

[15] Frank H Easterbrook and Daniel R Fischel, 'Contract and Fiduciary Duty' (1993) 36 Journal of Law and Economics 425, 427.

[16] Tamar Frankel, 'Fiduciary Duties as Default Rules' (1995) 74 Oregon Law Review 1209, 1212.

conflicts of interest, especially if the agent possesses information about his environment.[17] This may change in the future, and we will see some creditors monitoring the performance of trustees. There are shifts in the enforcement paradigm brought by the spread of activist creditors, also known as hedge funds, who are ready to go for the extra mile and monitor the performance of their agents in order to receive extra returns.[18] Nevertheless, the hedge funds so far aimed their monitoring activities at the borrowers themselves and not at the trustees.[19]

This brings us to the second way of mitigating the agency problem, which is by providing proper incentives to the agent to act in the best interest of the principal. As will be shown, there are various alternatives for mitigating the agency problem by the parties by contractual means. However, while applying those solutions, one should take into account the specificity of the relationship structure and drafting practices of the bond documentation.

B. Contract of Adhesion as the Root of the Problem

The lack of carefully crafted contractual incentives for trustees mitigating the agency problem can be explained by the peculiar relationship structure and the way the bond documentation is drafted and negotiated. Also, in practice, the use of the contractual incentives in bondholder-trustee relationships is further complicated by the standard form nature of the indenture. It is highly challenging to change the regular terms used in the contract or add new provisions.[20]

In contrast to other forms of loans where the lender is directly negotiating with the borrower the provisions of the contract, the terms of publicly issued bonds are drafted by the borrower and the underwriter.[21] As seen from Figure 2, the prospective bondholders and their lawyers are not involved in negotiations. Therefore, the contractual terms, including possible monitoring and incentives, are agreed upon between the issuer and the underwriter, whose primary concern is different from bondholders' interests.

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[17] Sanford J Grossman and Oliver D Hart, 'An Analysis of the Principal-Agent Problem', *Foundations of Insurance Economics* (Springer 1992), 43.

[18] Marcel Kahan and Edward Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay' (2009) Northwestern University Law Review 281, 283.

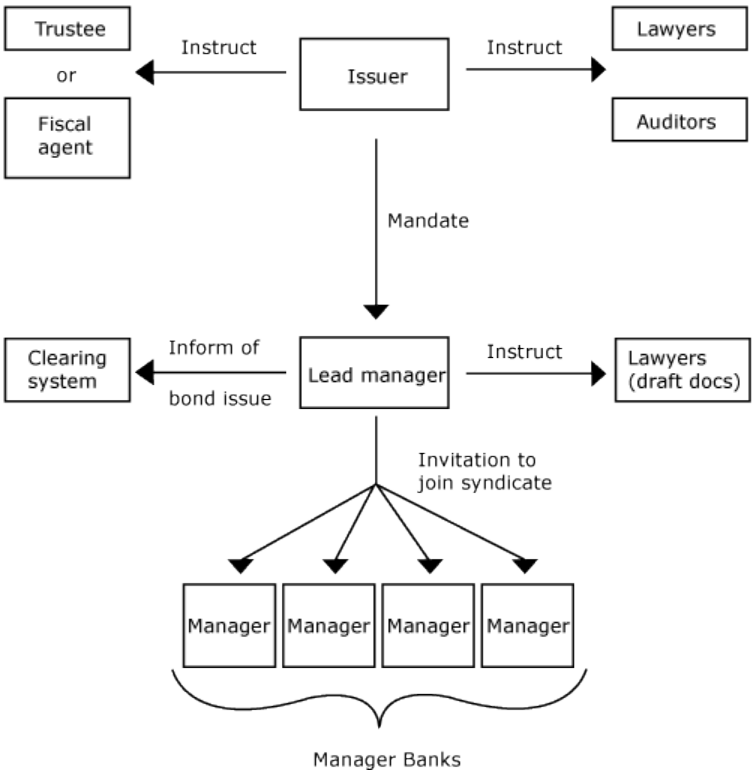
[19] See supra Chapter 1.II.B. Frivolous Litigation at p 29.

[20] For the ABA's explanation see fn 81 in Chapter 1.II.B. Frivolous Litigation.

[21] Philip Rawlings, 'The Changing Role of the Trustee in International Bond Issues' (2007) 2007 Journal of Business Law 43, 44.

In general, the issuer has no interest in advancing bondholders' rights and in imposing additional obligations on himself. Moreover, problems of bondholder coordination and trustee's incentives to protect bondholders' interests being connected to potential default on prospective obligations are shunned above all by the borrower side.

Figure 2: Procedures before and at the launch of the public bond issue



Source: Thomson Reuters, Bond issues: step-by-step guide

Underwriters or primary dealers involved in government securities are financial intermediaries, whose task is to buy and distribute securities performing a market-makers function.[22] It is hard to expect from them to negotiate the bond contract from the position of bondholders because they are usually not the final investors. Moreover, the underwriter is not a party to the indenture and does not have liability towards bondholders for lack of privity.[23] The underwriter has contractual obligations towards the issuer based on an underwriter agreement and is guided by

[22] WB and IMF, *Developing Government Bond Markets: A Handbook* (World Bank, International Monetary Fund 2001), 166.

[23] Klein v Computer Devices, Inc., 602 F. Supp. 837 (U.S. Dist. 1985).

the issuer's desire to have as fewer restrictions in the bond terms as possible.[24] All in all, the underwriter's motivation to act in the interest of bondholders in negotiating the indenture is merely coincident to have such terms being enough to sell the bonds.[25]

In such circumstances, the obvious party which can take part in the negotiations on bondholders' behalf is a bond trustee. However, according to practitioners, the trustees are usually selected at a later stage in the preparation of the corporate bond issue.[26] A comparable situation exists with the US municipal bonds and sovereign debt of foreign countries where trustees are often joining the transaction after the drafting of all the bond documents are completed.[27] Moreover, even if the trustee reviews the terms of the contracts, it lacks the authority to demand changes.[28] Any trustee's effort to advance the bondholders' position will be seen by the issuer and underwriter as an intrusion.[29]

In this regard, the issuer may have a strong influence on the trustee by the fact that the issuer hires and pays the trustee for all costs, except those for enforcement during the default.[30] Paradoxically, a promise of the trustee to serve, including conditions of the service, is made rather to the issuer, a third party, than to the bondholders, the principal. As in any other situation, when wolves are hiring the shepherd, the issuer wants to minimise the activism of the trustee in protecting the bondholders.[31]

To compound the problem, there are concerns that the trustee is mostly preoccupied with limiting his liability in the process of negotiation of the trust

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[24] Martin Riger, 'The Trust Indenture as Bargained Contract: The Persistence of Myth' (1990) 16 Journal of Corporation Law 211, 216.

[25] Anna Gelpern and Mitu Gulati, 'Public Symbol in Private Contract: A Case Study' Available at SSRN 932942, 11.

[26] Sheilah D Gibson, 'The Case for the Expanded Role of Trustees in Securitizations' (2004) 121 Banking Law Journal 387, 403; American Bankers Association, 'The Trustee's Role in Asset-Backed Securities' (2010), 4.

[27] Kyle Glazier, 'Why Bond Trustees Are Often Frustrated, Powerless in Today's Debt Environment' (2016) 1 Bond Buyer 16.

[28] Phil Hall, 'Bond Trustees Reexamine Role' (1989) 81 American Bankers Association ABA Banking Journal 42, 42.

[29] Riger, 'The Trust Indenture as Bargained Contract: The Persistence of Myth', 218.

[30] Clifford W Smith and Jerold B Warner, 'On Financial Contracting: An Analysis of Bond Covenants' (1979) 7 Journal of financial economics 117, 149; Ramon E. Johnson and Calvin M. Boardman, 'The Bond Indenture Trustee: Functions, Industry Structure, and Monitoring Costs' (1998) 8 Financial Practice and Education 15, 22; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 299.

[31] Efrat Lev, 'The Indenture Trustee: Does It Really Protect Bondholders' (1999) 8 University of Miami Business Law Review 47, 71.

contract.[32] It is important to note that the bond trustee does not have fiduciary duties towards prospective bondholders before the trust is formed, i.e., bonds are issued, and looks after its own interest in the transaction.

Translating this situation into legal language, the trust indenture (deed) are contracts of adhesion.[33] Once the bond documentation is finalised, the bondholders join the contract through the purchase of the bonds. This has a remarkable imprint on the terms of the contract as bondholders have no say in drafting the financial and legal terms in dealings with the issuer. The American Bar Foundation mentioned the absence of bargaining as the most crucial characteristic of long-term debt financing.[34]

What is even more bizarre is that by buying bonds, the holder is also automatically entering in complex fiduciary relationships with a trustee. The choice of the trustee and as well as the negotiation of the indenture provisions take place without the involvement of the prospective bondholders. Bondholders are restrained in their indispensable rights to bargain with the trustee independently and to receive information from the trustee, which is also acquired by virtue of the agent's position, in order to make an informed decision.[35] As a result, prospective bondholders are usually excluded from the contracting process aimed to mitigate the agency problem between them and the trustee. As stated by Martin Riger 'the indenture is only a depository of terms fixed by the issuer.'[36]

Strikingly, courts neglect that these particular aspects of the bond financing have a tremendous impact on the incentive structure of the contracting parties. In the respective landmark case, the court while acknowledging the fact that bondholders do not negotiate the terms of the public bond issue blatantly rejected the argument that a bond indenture is a contract of adhesion asserting that bondholders bargained for contractual terms.[37] In justifying the 'strikingly inequitable nature of the parties' respective bargaining positions', the court resorted to the market forces and freedom

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[32] See Argentina case study at p 142; Frederica R Obrzut, 'The Trust Indenture Act of 1939: The Corporate Trustee as Creditor Comment' (1976) UCLA Law Review 131, 135; Jason Grant Allen, 'More Than a Matter of Trust: The German Debt Securities Act 2009 in International Perspective' (2012) 7 Capital Markets Law Journal 55, 77.

[33] Robert I Landau and John E Krueger, *Corporate Trust Administration and Management* (Columbia University Press 1998), 27.

[34] American Bar Foundation, *Commentaries on Indentures* (American Bar Foundation 1971), 1.

[35] Frankel, 'Fiduciary Duties as Default Rules', 1213.

[36] Riger, 'The Trust Indenture as Bargained Contract: The Persistence of Myth', 219.

[37] Metropolitan Life Ins. Co. v RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

of the parties to review the contract before buying bonds and ability to leave by selling their bonds at any time.[38]

The view of the bond indenture by US courts as a bargained contract brings anomaly in applying the principles of contractual construction. It is 'well established' by courts that 'interpretation of indenture provisions is a matter of basic contract law.'[39] The courts are captured in 'a hollow ring' following a fictional proposition of the bargained contract and interpreting the indenture through the fictional intent of the parties, i.e. the issuer and bondholders.[40] Similarly, the trustees are struggling to interpret their tasks out of the bond documentation without knowing the intent of the drafters.[41]

There is no wonder that the bond trustees are notoriously known as passive administrators that have no use in protecting their principal, the bondholders, if one considers the status quo characterised by the asymmetric relationships between parties in the bond issue, the way the bond documentation is drafted and negotiated, and the lack of legal 'counterbalance.' In other words, all bondholder rights are derived from the contract, but bondholders are excluded from drafting the terms of the bond documentation and the parties which are drafting it have acute conflicts of interests with bondholders without almost any boundaries imposed by law or courts.

This results in an acute agency problem restricting the utility of the trust arrangement merely to an insurmountable obstacle for bondholders in accessing legal remedies. Bondholders find themselves almost unprotected in the complex relationships with trustees: on the one hand, trustees are de facto not bound to protect bondholders' rights and, on the other hand, bondholders' individual capabilities to protect themselves are limited. The failure of the trustees to protect the bondholders' interest and facilitate the engagement between the issuer and its creditors is especially evident in sovereign debt markets.[42] As a result, contrary to the logic that bondholders are better-off with the presence of the trustee in the bond issue, the Congo's creditors

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[38] Ibid.

[39] Bank of NY. Trust Co. v Franklin Advs., Inc., 726 F.3d 269, 276 (2nd Cir. 2013).

[40] Riger, 'The Trust Indenture as Bargained Contract: The Persistence of Myth', 222 (Analysing the decision Broad v Rockwell Int'l Corp., 642 F.2d 929 (U.S. App. 1981) and Prescott, Ball & Turben v LTV Corp., 531 F. Supp. 213 (U.S. 1981).

[41] Glazier, 'Why Bond Trustees Are Often Frustrated, Powerless in Today's Debt Environment'.

[42] Anna Gelpern, 'Courts and Sovereigns in the Pari Passu Goldmines' (2016) 11 Capital Markets Law Journal 251; Lee C Buchheit and Sofia D Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?' (2016) 31 Butterworths Journal of International Banking and Financial Law 457, 463.

withstood the borrower's request for a trustee and agreed only in exchange of special rights to have a creditor committee funded by the borrower.[43] Furthermore, absent the creditor side in indenture drafting, Grenada managed to exclude the bondholders' unconditional right to enforce due payments, which is a fundamental right prescribed by the TIA, for the first time in a New York governed indenture.[44] It can be explained by even more degraded legal measures against the agency problem in sovereign bonds due to their exclusion from TIA's scope.[45]

II. WAYS TO THE MITIGATE THE AGENCY PROBLEM

There is a consensus between scholars about an urgent need to provide proper motivation to the trustees through an overhaul of how the interests of the bond trustee are aligned with the bondholders' interests.[46] The current design provides limited incentives for trustees to act on behalf of bondholders.[47]

One of the most notable proposals advocates for establishing a new institution of the 'supertrustees' which will become an active representative of bondholders and provide not only additional incentives to serve bondholders' interests but also increase their powers, such as granting them the ability to monitor, renegotiate and enforce bond covenants on behalf of the bondholders.[48]

An agent, or a bond trustee in our case, can be incentivised to act in the interest of bondholders in various ways. These incentives could be broadly classified as competitive, monetary and liability incentives. Those types of incentives are not mutually exclusive. To the contrary, in order to secure an optimal result, all forms of incentives have to be employed in a complementary manner.

A. Competition Between Bond Trustees and Reputational Incentives

[43] Mark B Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back' (2010) 73 Law and Contemporary Problems 273, 287.

[44] Ibid.

[45] See fn 29 at p 132.

[46] Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 463.; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 300.

[47] Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 297; Marcel Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights' (2002) 77 New York University Law Review 1040, 1060.

[48] Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds'.

One source of incentives is competition among firms. It disciplines the firm and forces it to monitor the performance of its entire team and individual members.[49] Trustees can compete among each other for the appointment by the bondholders. In other words, bondholders could see the appointment of one or another trustee as the quality mark of the bond issue based on the reputation of the trustee. In theory, it should be more comfortable for bondholders to rely on the trustee's reputation, especially if proper monetary and liability incentives are also in place than the issuer's compliance with bond covenants.[50]

The literature on intermediaries' reputation is based on the mechanism of repeat play and market share. The higher the market share and reputation is, the more significant incentives an intermediary has to behave responsibly in the long-term relationships. There are many accounts of the operation of reputational incentives for actors in different modern markets, specifically in financial industries as underwriters, credit agencies, auditors.[51] Moreover, it is fair to say that the trustees are concerned to preserve their reputational integrity by avoiding unfair actions in favour of the issuer, such as closing the eyes on the violation of the debt covenants.[52] However, it seems that trustees do not have strong reputational incentives to provide effective bondholder representation partially due to the relatively rare occurrence of issuer's default which is primarily the situations when trustees by their actions can build up the reputation of bondholder guardians.[53]

Even when the trustees compete for the nomination, what is crucial is that the benchmark for the assessment is the price of their services and performance of the administrative functions, not the previous efficiency of the trustee to represent and defend bondholders' interest.[54] This can be explained by the fact that trustees are

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[49] Fama, 'Agency Problems and the Theory of the Firm'.

[50] Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds'.

[51] See the literature on the effect of intermediary's reputation in financial markets: Sheridan Titman and Brett Trueman, 'Information Quality and the Valuation of New Issues' (1986) 8 Journal of Accounting and Economics 159 (Regarding auditors and investment bankers); Richard Carter and Steven Manaster, 'Initial Public Offerings and Underwriter Reputation' (1990) 45 The Journal of Finance 1045; Marc Flandreau and Juan H. Flores, 'Bonds and Brands: Foundations of Sovereign Debt Markets, 1820–1830' (2009) 69 The Journal of Economic History 646; Marc Flandreau and others, *The End of Gatekeeping: Underwriters and the Quality of Sovereign Bond Markets, 1815-2007* (University of Chicago Press 2010).

[52] Smith and Warner, 'On Financial Contracting: An Analysis of Bond Covenants', 149.

[53] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1064.

[54] Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds', 485.

chosen by the issuer who assesses the trustee from his perspective, which tends to diverge from the bondholders' view.

There are also some impediments for the competition coming from the trustee's appointment process. The competition between trustees can be realised during the initial appointment of the trustee or through the consequent re-election. Also, making parallels to the market of corporate control,[55] the pressure could be applied externally, and the inefficient trustees can be substituted by the more competent rivals if favourable conditions exist.

However, once the trustee is selected, it usually holds its position until the bonds mature; the indenture does not provide for any periodical re-election procedure.[56] Also, the dispersed nature of sovereign bondholders[57] impedes the removal of the trustee.[58] Furthermore, even if it is theoretically possible for the investor to buy enough bonds to substitute the inefficient trustee, it would not make much sense, because the investor with substantial holdings can step-in the shoes of trustee himself, and second, there is a limited upward reward which the investor may receive in investing in fixed income bonds in comparison to the equity of the firm.

There are some contractual attempts to spur the competition and add some pressure on the trustees. For instance, the indenture Congo (Brazzaville) innovatively contains a clause that replaces the trustee with a bondholder representative if the trustee fails to act in a default situation.[59] However, this solution seems inferior as the replacement of the trustee by the bondholder brings back the coordination problem and the question how to incentivise the newly established representative to act in the interest of the whole bondholder community. As a result, at present, trustees do not face fierce competition which would incentivise them to act in the bondholders' interest.

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[55] Michael C Jensen and Richard S Ruback, 'The Market for Corporate Control: The Scientific Evidence' (1983) 11 Journal of Financial Economics 5.

[56] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1062.

[57] Ibid.

[58] Frankel, 'Fiduciary Duties as Default Rules', 1256.

[59] Richards, 'The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back', 299.

B. Monetary Incentives for Bond Trustees

There is a direct link between the scope of responsibilities and remuneration in any commercial relationships. Likewise, in respect of the bond trustees, the fact that they receive remuneration for their services is seen as a reason for applying a higher standard of duties by courts.[60] However, already at the beginning of the 20th century, the legal community was alarmed by the misalignment of the bond trustee's duties, requiring trustees to be an active representative of the bondholders and their compensation.[61] Substantively, the same debate is still open, and the lack of monetary incentives is widely lamented by academics and practitioners.[62]

It is a widespread fallacy that having a trustee in the bond issue is expensive, especially if one considers the breadth of functions performed by a trustee.[63] The trustee receives a small annual fee for its services and is reimbursed for out-of-pocket expenses.[64] Usually, the trustee fees are determined through a competitive bidding process, adding pressure on the trustees to lower the fees.[65] According to the ICMA and NAFMII, the fees charged by trustees in international bond issues are trivial in comparison to the overall expenses for issuing bonds.[66] The trustee's fee for unsecured bonds ranges typically from $1,500 to $15,000.[67] This figure looks modest in comparison to the six-figure the underwriter generally gets from a bond deal.

Moreover, the compensation seems even more disproportionate if the liability risks for trustees from discretionary powers are taken into account. Understandably,

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[60] In Re Magadi Soda Co Ltd (1925) 41 TLR 297.

[61] Francis Lynde Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures* (Some Phases of Corporate Financing, Reorganization, and Regulation, Macmillan 1916), 52.

[62] Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds', 473; Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1063; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 300; Buchheit and Martos, 'Trust Indentures and Sovereign Bonds: Feature Who Can Sue?', 463.

[63] James Gadsden, 'Trust Indenture Act under Attack' (1996) 113 Banking Law Journal 967, 968.

[64] Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures,* 52; Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds', 479; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 299.

[65] Glazier, 'Why Bond Trustees Are Often Frustrated, Powerless in Today's Debt Environment'.

[66] ICMA-NAFMII Working Group, 'International Practices of Bond Trustee Arrangements' (2018) Available at <https://wwwicmagrouporg/assets/documents/About-ICMA/APAC/ICMA-NAFMII-WG-International-Practices-of-Bond-Trustee-Arrangements-031218pdf>, 9.

[67] Simon Hill and Tim Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?' (2010) 5 Capital Markets Law Journal 5, 6 ('The trustee's fees may be in the region of £4,000 per annum for a 'plain-vanilla' corporate Eurobond (plus a small 'acceptance' fee)'); John Hintze, 'Clarity on Trustee Responsibilities Arrives Slowly' (2013) 13 Asset Securitization Report, 9 ('Trustees traditionally have been paid relatively small fees—approximately $5,000 for a $400 million deal');

as a reaction to a small remuneration, bond trustees require fewer responsibilities and broader indemnities from the trustee's duties. This situation was already noted more than a hundred years ago and has not changed since then.[68]

It appears that the monetary incentives for trustees should be carefully revisited because inadequate compensation can even amplify the conflict of interest issues.[69] According to the experts, trustees should be paid multiple times more for being an active guardian of bondholders' interests.[70] It brings in the questions of how monetary incentives for trustees should be constructed and who carries the burden of those expenses.

Agency theory emphasises the importance of the payment structure for mitigating the conflicts of interests. In basic terms, the payment structure could be behaviour-oriented, like a salary. Alternatively, the payment structure can be outcome-oriented and remuneration occurs via commissions or stock options. The general proposition of the positivist agency theory is that outcome-oriented contracts do align the agent's interests closer with the principal's interests.[71]

In this regard, Kahan illustrated that '[t]he trustee has no direct monetary stake in preserving the value of the bonds.' The main issue seems to be that the trustee's reward is not conditional upon the scope of the work. This compensation is constant regardless of whether the trustee performs its administrative functions in due course of the bond repayment or when fulfilling various functions to defend bondholders' interests once the event of default has occurred.[72]

(fn 67 continues) Mark Brown, 'Trustees Face up to Heavier Burdens' (2004) 35 Euromoney 122; Amihud, Garbade and Kahan 1999 'A New Governance Structure for Corporate Bonds', 479; Johnson and Boardman, 'The Bond Indenture Trustee: Functions, Industry Structure, and Monitoring Costs', 27 (The annual costs of having a trustee range from $7,655 to $13,715 per year for issues in the $50 to $100 million range. Monitoring costs (trustee fees) are greater the larger the issue and the lower the quality rating. Although fees are greater the larger the issue, they are smaller per dollar of the issue the larger the issue).

[68] Stetson, *Preparation of Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures, 52*.

[69] Steven L Schwarcz and Gregory Sergi, 'Bond Defaults and the Dilemma of the Indenture Trustee' (2008) 59 Alabama Law Review 1037, 1070; Saptak Santra, 'Bondholders, Fight Back' (2010) 29 International Financial Law Review 26, 27.

[70] Brown, 'Trustees Face up to Heavier Burdens' ('If you want somebody who is prepared to tell the issuer to go to hell, you can't pay them $5,000 or $15,000. You need to pay them $100,000').

[71] Kathleen M Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 The Academy of Management Review 57, 60.

[72] Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights', 1065; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 299.

Amihud et al., in their paper on supertrustees, proposed to positively tie the compensation to changes in the market value of the bonds reflecting the credit risk.[73] They envisage three ways to incentivise the bond trustee such as (i) using a set of derivatives as compensation whose value is decreasing in sync with bonds' value, (ii) bonuses for each payment made by the borrower on time, and (iii) by requiring the trustee to hold a substantial fraction of the bond issue, e.g. 10 or 20 per cent.[74]

It seems that the design and use of those solutions could be overcomplicated. The first and third solutions could be prohibitively costly to set up, while the second solution would not properly align the performance of the trustee to the bondholders' interests as most of the bonds are paid on time without any involvement of the trustee. Instead, one may think about a contingent remuneration based on the received amount by bondholders in post-default situations due to enforcement or settlement initiated by the trustee. In this case, the additional incentives are coming to the fruition at the moment when the trustee is expected to take an active position and aligned to the proportion of the due payments recovered for bondholders.

As a rule, the trustee's ordinary administrative expenses are covered by the issuer, however, should the situation deteriorate, the enforcement actions are funded under a new indemnity by bondholders. Arranging an indemnity among scattered bondholders can be a laborious and time-consuming task precisely at the moment of default when the involvement of the trustee to defend bondholders' interest is the most appreciated. The practice of the ad hoc funding should be changed in the first place to incentivise trustees.

In order to tackle with the disadvantages of the ad hoc funding for the trustee's services, more and more special 'fighting funds' are established by bondholders to pre-fund the trustee from the outset of the corporate bond issue.[75] This solution was already utilised in sovereign debt restructurings. It started with Belize's trust indenture 2013 allocating half a million dollars from the first payment on the new bonds to the 'Contingency Account' to pre-fund the trustee's enforcement actions.[76] A similar fund was established in leu of Grenada's sovereign debt

[73] Amihud, Garbade and Kahan, 'A New Governance Structure for Corporate Bonds', 480.

[74] Ibid.

[75] Andrew Denny and Morgan Krone, 'When Bond Trustees Are Called to Action' (2016) 35 International Financial Law Review 9.

[76] See Trust Indenture between Belize and the Bank of New York Mellon, dated 20 March 2013, U.S. Dollar Bonds Due 2038.

restructuring of 2015.[77] Whether or not such a contingency fund is established, it is highly advisable to contractually grant a priority reimbursement to bondholders providing the funds for trustee's enforcement actions.

Furthermore, it seems that the first-choice solution for funding the activities of the trustee aimed to defend bondholders' interests following the default will be a new insurance product. The development of new insurance has already captivated the practitioners involved in the bond trustee business.[78] This insurance is similar to a legal expenses insurance, which is rather popular in Europe but not in the US.[79] The fundamental difference is that on top of legal costs, the insurance should also cover the costs and expenses of the trustee as a representative of bondholders. The most anticipated problem with such a source of funding for enforcement actions is that the insurer will try to control litigation resulting in conflict with the trustee's fiduciary duties.

Taking into the account that the majority of the sovereign bonds never default the insurance premia should be affordable, and in any case paying an insurance premium will be more favourable than depositing half-million dollars to the trustee's contingency account in every bond issue. Nevertheless, it could be that mere monetary incentives alone are not able to perfectly align the interests of the parties,[80] hence, additional incentives are required.

C. Liability Incentives: Fiduciary Duties as the Core Solution

There is no doubt that a legal environment and in particular potential liability costs have a tremendous impact on the decisions of the business actors.[81] In other words, the imposition of legal liability is a powerful tool for establishing incentives to behave in a certain way. However, liability incentives are a double-edged sword as they can induce both socially desirable and undesirable behaviour and economic

[77] Benu Schneider, 'Sovereign Debt Restructuring: Further Improvements in the Market-Based Approach' (2018) 13 Capital Markets Law Journal 294, 303.

[78] Hill and Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?', 20.

[79] Michael Faure and Jef De Mot, 'Comparing Third-Party Financing of Litigation and Legal Expenses Insurance' (2011) Journal of Law, Economics & Policy 743, 743.

[80] Frankel, 'Fiduciary Duties as Default Rules', 1221; Kahan and Rock, 'Hedge Fund Activism in the Enforcement of Bondholder Rights Essay', 300.

[81] Steven Garber, 'Product Liability, Punitive Damages, Business Decisions and Economic Outcomes Measuring the Shadow of Punitive Damages: Their Effect on Bargaining, Litigation, and Corporate Behavior' (1998) Wisconsin Law Review 237, 239.

effect. Further, the impact of the liability incentives is complicated to predict with high precision ex ante.[82]

In this regard, the liability incentives should be meticulously balanced in order to exclude two opposing but equally undesirable outcomes for economic efficiency such as underdeterrence and overdeterrence. Likewise, any uncertainty existing in legal liability standards precludes the effective control of the behaviour and can bring about undesirable social and economic outcomes, and hence should be averted.[83]

It is a difficult task to balance the duties of the bond trustee in such a way that prospective liability would not preclude the trustee even further from taking action in the interest of bondholders.[84] Overdeterrence, in its extreme form, can even make the business unappealing to trustees.[85] As for any other safety valve, the trust arrangement should be carefully re-assessed on the issue of unambiguous design, concrete allocation of rights and liabilities, as well as on the risks created by the agency problem.[86]

Even if a trust arrangement would not be a contract of adhesion, bondholders had a problem to contractually account for all situations where the performance of the trustee may be influenced by the agency problem in order to deal with it. This is an arduous task by itself and more so in the environment where a bondholder cannot effectively observe or verify the exercise of the trustee's discretion.[87]

The situation is further complicated by the fact that any bond issue involves multiple bondholders which can have conflicting interests imposing additional negotiation difficulties and transactional costs to resolve the agency problem through

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[82] Ibid.

[83] Ibid.

[84] International Law Association (Sovereign Bankruptcy Study Group), 'The Legal Approach to Sovereign Bankruptcies' (2016), 14.

[85] Hill and Beech, 'The Credit Crisis: Have Trustees Lived up to Expectations?', 18 ('It has been suggested recently that one way of addressing the perceived delay in Trustees taking action would be to remove the Trustee's right to be 'indemnified and/or secured and/or pre-funded' prior to being obliged to take any action. For the reasons discussed above, this would never be acceptable to Trustees as it would open them up to massive potential financial liability').

[86] Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315, 329.

[87] Robert H Sitkoff, 'The Economic Structure of Fiduciary Law Symposium: The Role of Fiduciary Law and Trust in the Twenty-First Century: A Conference Inspired by the Work of Tamar Frankel: Panel II: An Interdisciplinary View of Fiduciary Law' (2011) Boston University Law Review 1039, 1042.

contracting.[88] Finally, the boilerplate nature of the bond documentation takes a heavy toll on the mitigation of the agency problem by using contractual tools.[89]

Proper liability incentives are paramount for the efficient functioning of such a sophisticated institution as a bond trustee in order to balance the discretion of the trustee which is necessary to fulfil his role but at the same time should not be abused to the detriment of the bondholders. Since the monitoring and enforcement powers are vested in the bond trustee on behalf of bondholders, it is reasonable to impose duties on the trustee to take full and prompt action.[90]

In this regard, the law offers a solution to mitigate the agency problem through the imposition of fiduciary duties by legislatures and courts. They serve as an alternative or a supplement to costly contracts.[91] The concept of fiduciaries duties is a legal framework of encompassing character, which encompasses various relationships and provide different levels of protection to the principals in dealings with the agents. For a reason, it is named as 'legal polyfilla' placing itself within other legal structures among different fields of law.[92] Fiduciary duties strive to correct the shortcomings of other legal structures in aligning interests of the principals and agents. The common law concept of fiduciary duties is praised for its support of financial markets.[93] The concept is even seen as superior to its civil law analogue in deterring conflicts of interest in dealings of various financial intermediaries as it attempts to sustain the markets instead of replacing them.[94]

In this respect, there is an agreement that there is a need to overhaul the trustee's responsibilities.[95] The flaws in applying duties are hampering the correct application of the safety valve, which is systemically important for the sovereign bond market, and debt restructurings in particular.

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[88] Steven L Schwarcz, 'Fiduciaries with Conflicting Obligations' (2010) 94 Minnesota Law Review 1867, 1874.

[89] See supra at p 27.

[90] Terence Prime, *International Bonds and Certificates of Deposit* (Butterworths 1990), 321.

[91] Daniel R Fischel, 'Corporate Governance Movement, The' (1982) Vanderbilt Law Review 1259, 1264.

[92] Law Commission, 'Fiduciary Duties of Investment Intermediaries' (2014) Law Com No 350, 31.

[93] Steven L Schwarcz, 'Systemic Risk' (2008) 97 Georgetown Law Journal, 245.

[94] Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 Journal of Economic Literature 285, 300.

[95] Lee C Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds' (2017) Available at SSRN 3095768, 5.

In theory, bond trustees should be helpful to coordinate creditors during sovereign debt restructurings, as the bond trustee owes duties to all of the bondholders as a group instead of selective representation.[96] The bondholders are grouped into a class of beneficiaries of the trust based on affiliation to a bond issue. The fiduciary duties secure that bondholders are treated impartially by the trustees. As Lord Justice Turner said in *Re Tempest*:

> It is of the essence of the duty of every trustee to hold an even hand between the parties interested under the trust. Every trustee is in duty bound to look to the interests of all, and not of any particular member or class of members of his *cestuis que trusts* [beneficiaries].[97]

In the domain of bond trustees, the two aspects of the duty mean that (i) holders of the same bond issue, being in the same class of beneficiaries of the trust, ought to be treated equally, and (ii) holders of different bond issues ought to be treated fairly if the same trustee acts on their behalf.

In the end, the trustee has a discretion whether and how to act, but the law can and does impose some legal constraints on the agent's freedom of choice.[98] And when imposed duties work well, they operate alongside regulatory intentions and market structures by aligning the interests of the bond trustee with those of the bondholders as a group, allowing the trustee to act in the best interest of the bondholder community by alleviating the collective action problem. The fiduciary duties go beyond mere fairness and honesty by obliging a fiduciary to act in the best beneficiary's interest and avoiding any situation of conflicts of interests.[99]

This thesis does not have a goal to propose a unified set of rights and duties for a bond trustee. It seems to be a herculean task. Particularly, to define the fiduciary duties of a specific agent, it is necessary to assess concurrently different types of law. While the concept of fiduciary duties has its roots in case law, it can be deeply intertwined with general principles or legislation covering particular financial

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[96] E.g., W Mark C Weidemaier and Mitu Gulati, 'How Markets Work: The Lawyer's Version', *From Economy to Society? Perspectives on Transnational Risk Regulation*, vol 62 (Emerald Group Publishing Limited); David Christoph Ehmke, 'IX. Information, Coordination, and Fence', *Bond Debt Governance: A Comparative Analysis of Different Solutions to Financial Distress of Corporate Bond Debtors* (1st edn, Nomos Verlagsgesellschaft mbH & Co. KG 2018), 180.

[97] (1886) 1 Ch App 485, 487-488.

[98] Lionel Smith, 'Fiduciary Relationships: Ensuring the Loyal Exercise of Judgement on Behalf of Another' (2014), 610.

[99] Deborah A DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' (1988) 1988 Duke Law Journal 879, 882.

intermediary. In case of the bond trustees, the liability incentives are directly coming from the duties prescribed by the case law, statues, or bond contract.

Besides, the proposed rights and duties must be adjusted to the diverse practices in the UK and US jurisdictions.[100] For example, the US utilises a dual standard of care for corporate bond trustees – a lower standard pre-default and a fiduciary standard post-default – while under English law a bond trustee is a fiduciary from the start.[101] Furthermore, given that the US trust indenture for sovereign bonds does not have to be qualified under the Trust Indenture Act,[102] the prudent man standard is not imposed. Also, the standard has been dropped as a contractual obligation[103] without substituting it with any other fiduciary duties, presumably due to the conflict of interest problem.

However, this thesis, in its next part, strives to provide an approach that reconciles the divergent interests of the creditors and a sovereign borrower in sovereign debt restructuring with debt sustainability concept. This approach can be further used as an objective in constructing a legal framework for trustees in sovereign bond markets, giving to fiduciary duties a new role.

III. DEBT SUSTAINABILITY AS THE BEARING POINT FOR BOND TRUSTEES IN SOVEREIGN DEBT RESTRUCTURING

During a journey, a seaman envisions a bearing point which guides him through the journey until the desired land is reached. Likewise, an agent has to stick to a reference point, some benchmark, in order not to be distracted and lost in the open water of discretionary decision-making. The bearing point or throughline of various liability incentives is to induce the agent to act in the best interest of the principal. Those legal incentives, generally known as fiduciary duties, prompt the agent to act in the best interest of the principal by providing after-the-fact liability for breaching fiduciary duties.[104] Sovereign debt sustainability is a bearing point for a bond trustee in

[100] ICMA-NAFMII Working Group, 'International Practices of Bond Trustee Arrangements', 32.

[101] Prime, International Bonds and Certificates of Deposit, 301-303.

[102] See supra p 132.

[103] Gulati and Buchheit, 'The Coroner's Inquest: Ecuador's Default and Sovereign Bond Documentation', 25.

[104] Sitkoff, 'The Economic Structure of Fiduciary Law Symposium: The Role of Fiduciary Law and Trust in the Twenty-First Century: A Conference Inspired by the Work of Tamar Frankel: Panel Ii: An Interdisciplinary View of Fiduciary Law', 1043.

fulfilling the best interest of bondholders in sovereign debt restructuring. This is the main idea of this part.

A. Fiduciary Duties of Bond Trustees in a Larger Debate between Creditors and Debtor States

Already in 1999, the IMF warned that fiduciary agents representing large numbers of private creditors, such as trustees of bonded debt, are likely to have no instructions from creditors and due to potential legal liability will be very cautious about acting on their own resulting in delays to the sovereign debt restructuring.[105] It was noted that the legal uncertainty, attributable to the fiduciary agent's obligations to protect the investor's interest, may adversely limit the room for actions of the agent.[106]

Despite numerous calls for changes and acknowledgements of the importance of providing bond trustees with proper liability incentives,[107] the topic persists to be under-researched with no comprehensive study covering the relationship between duties of the bond trustees and their passivity in acting in the bondholders' best interest in corporate debt restructurings. The lack of understanding is even more acute for the more esoteric field of sovereign debt restructurings, which has its peculiarities in regulating trust arrangements. Most of the available studies premise their assessments on the assumption that trustees always act in the best interest of creditors.[108] This, however, seems to be misleading. There are numerous instances where a trustee's actions manifestly run counter to the interest of the bondholders.[109]

Coming from the premise that the trustee's actions should correspond to the best interest of the bondholders, a benchmark imposed on the fiduciary by law,[110] one should ask first what the fiduciary duty does to act in the best interest of the

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[105] IMF, *Involving the Private Sector in Forestalling and Resolving Financial Crises* (Executive Board Meeting 99/28 from March 17, 1999), 52 (The potential role of fiduciary agents in bond restructurings was highlighted by the Russian default of 1998).

[106] Ibid.

[107] Buchheit, 'Trustees Versus Fiscal Agents for Sovereign Bonds', 5; Sönke Häseler, 'Individual Enforcement Rights in International Sovereign Bonds' (2011) Available at SSRN 1299114, 25.

[108] Häseler, 'Individual Enforcement Rights in International Sovereign Bonds', 25.

[109] See case studies in Chapter 5.II. Sovereign Bond Trustees at p 138, and Mitu Gulati and Lee C Buchheit, 'The Coroner's Inquest: Ecuador's Default and Sovereign Bond Documentation' (2009) International Financial Law Review 22; Häseler, 'Individual Enforcement Rights in International Sovereign Bonds', 25 Frank H. Easterbrook and Daniel R. Fischel, 'Limited Liability and the Corporation' (1985) University of Chicago Law Review 89, 100.

[110] Lionel Smith, 'Understanding the Power' in W. Swadling (ed), *The Quistclose Trust: Critical Essays* (Hart Publishing 2004), 70.

bondholders mean. The common law fiduciary duties, having a relational nature, provide a performance standard in the most general terms as uncertainty and complexity of relationships makes parties unable to specify obligations.[111] This ambiguity leads to different interpretations of the requirement to 'act in the best interests of the beneficiaries.'

The requirement can be seen as a particular duty imposed on the agent, creating much disagreement about what it means and how should it be applied.[112] Alternatively, the best interest requirement is described as an 'umbrella duty' embracing a large combination of existing duties to promote the purpose of the trust.[113] In this regard, it can be a normative goal helping to understand the course of the desirable actions required from a bond trustee.

The coordination problem among bondholders requires to bestow a trustee with a discretionary authority to act in ex-ante unknown circumstances as predefining precise actions for every situation in a sovereign debt crisis is unfeasible. In this context, setting a normative benchmark for the discretionary actions such as to promote the best interest of the bondholders can provide the necessary flexibility and guidance as to which actions are reasonable to expect from the trustee.

While the contours of the trustees' actions are defined as monitoring, acting as an information conduit and enforcing,[114] the specific actions are left to the trustees' discretion with the qualification that those decisions should be in the best interest of all bondholders. One way to define the bondholders' interest in respect of the specific task is to follow the broad intentions of the parties and see it as something that the parties would have agreed if the particular contingency had been negotiated.[115]

This approach sees the fiduciary law as a gap filler imposing a default rule on those contingencies which were not defined by the parties. For instance, if a

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[111] McDaniel, 'Bondholders and Stockholders', 232.

[112] David Pollard, 'The Short-Form 'Best Interests Duty' – Mad, Bad and Dangerous to Know: Part 2 - the Problems and a Suggested Better Formulation' (2018) 32 Trust Law International 176, 176 (Showing that much of case law and commentaries portrays it as an overarching duty).

[113] Geraint W Thomas, 'The Duty of Trustees to Act in the Best Interests of Their Beneficiaries' (2008) 2 Journal of Equity 177, 202; JRF Lehane, 'Delegation of Trustees' Powers and Current Developments in Investment Funds Management' (1995) 7 Bond Law Review 38, 38; Lord Nicholls, 'Trustees and Their Broader Community: Where Duty, Morality and Ethics Converge' (1996) 70 Australian Law Journal 205, 211.

[114] See Chapter 4. Bond Trustees and the Restructuring of International Sovereign Bonds at p 101.

[115] Sitkoff, 'The Economic Structure of Fiduciary Law Symposium: The Role of Fiduciary Law and Trust in the Twenty-First Century: A Conference Inspired by the Work of Tamar Frankel: Panel Ii: An Interdisciplinary View of Fiduciary Law', 1046.

sovereign debtor is experiencing financial distress and is on the brink of default, it is clearly in the best interest of the bondholders that the situation is identified swiftly, and necessary actions are taken to minimise the potential damage to bondholders.[116]

On the practical level, the fiduciary duties should ensure that a bond trustee is an effective representative of the bondholders in such problematic areas where the trustee is faced with a conflict of interests or remains passive despite the bondholders' interest dictating the necessity of actions.[117] Further, fiduciary duties are necessary to restore the balance between parties because the trustee assumes no credit risk in sovereign debt restructuring.

However, the best interest requirement without specific content is an empty shell – a concept without meaning. Therefore, it is crucial to have an appropriate understanding of bondholders' best interest in a specific context, especially during a sovereign debt restructuring. While the desirable outcome for bondholders is a normative goal for bond trustees in exercising their discretionary authority on behalf of bondholders, the peculiarities of sovereign debt restructuring encapsulated in the public interest of a borrower state bring in crucial considerations.

In this regard, the best interest of bondholders in sovereign debt restructuring in simplified terms is a question of the distribution of funds between creditors and a state which embodies its citizens. There are two competing principles of distribution in the political economy of postwar democratic capitalism described by Wolfgang Streeck as market justice and social justice.[118] Those principles have different approaches and yardsticks to define fair distribution outcomes, including in sovereign debt restructuring, and consequently different understanding of the best interest of creditors.

B. Market Justice and Sovereign Debt Restructuring

Market justice is premised on the assumption that markets are efficient. Hence, what emerges from the markets is considered to be just. In the sovereign debt context, market justice is characterised by a private law paradigm requiring fulfilment of the

[116] Prime, *International Bonds and Certificates of Deposit, 321*.

[117] Ibid.

[118] Wolfgang Streeck, *Buying Time: The Delayed Crisis of Democratic Capitalism* (Verso Books 2014), 58.

relevant debt contract which was voluntarily agreed between creditors and a state in an ideally free market.

The respective principle of distribution is generally shared by a corresponding group united by a common interest. In the case of market justice, it is so-called the Marktvolk or the people of the market.[119] They are the creditors of the state having a relationship with the state based on an economic rationale of profit maximisation and shaped through contractual claims. Crucially, the creditors do not have to be physically present or have any cultural or political ties with the state they finance. In practice, most of the creditors are coming from a few developed nations with accumulated wealth, and the United States is the frontrunner. It means that the creditors are mostly detached from the political and social developments in the borrowing state, especially emerging countries, exacerbating an ignorance of relevant political and social factors by creditors in time of crisis.

The clash between market and social justice for the distribution of funds in sovereign debt restructuring becomes tougher as more money is placed at stake. Specifically, the role and amount of debt for state budget purposes has dramatically increased almost for every nation in recent decades, generally corresponding to the decreasing tax burden.[120] These developments are even seen as a game-changing transformation of the tax state to the debt state, meaning that a state is more dependent on the debt than tax revenues in fulfilling its functions.[121] The COVID-19 crisis will only accelerate this trend as additional public spending is used to support economies. As a result, the exclusion of the state from the debt markets results in increasingly negative consequences, such as lower growth, unemployment and various austerity measures.

At the same time, the significance of debt for state budgeting means that in a crisis, the restructuring of debt becomes a crucial factor for rebalancing the state budget and further economic recovery. Consequently, an increased risk of default and restructuring spurs the creditors to protect their claims. The Marktvolk is eager to exercise its power on the government to minimise the competing claims of its citizens for the distributions of funds collected through taxation or further

[119] Ibid.

[120] See Figure 1 at p 5.

[121] See Christopher Green, 'From "Tax State" to "Debt State"' (1993) 3 Journal of Evolutionary Economics 23.

borrowing.[122] Furthermore, similar to private debt, the creditors could screen a potential debtor on risks before granting credit or require some contractual protection in fulfilment of the debt repayment.

Before the disbursement of money, the creditors 'compel' the state to account for its economy and political life. The creditors are using the derived information for financial modelling, predicting a growth trajectory akin to investment decisions regarding private companies.

There is no document issued by a state other than a prospectus for a bond issue which would provide such a comprehensive information about the state to public. In particular, the risk factors section of a prospectus provides an outlook for possible negative economic or financial developments of the state, its major trading connections, produced commodities and potential disruptions, political events prone to uncertainty, such as ongoing investigations into corruption. With respect to the later, the bond issues by Brazil and Mozambique are a vivid example.[123]

Further, the bond contract itself provides various protective clauses such as negative pledge, acceleration, cross-default, pari passu clauses. They serve to secure the repayment and mitigate losses in case of default by a sovereign debtor. None of the standard clauses in sovereign debt documentation account for potential necessity to relax borrower's obligations in times of crisis.[124]

Likewise, the case law of leading jurisdictions for sovereign debt markets are dominated by market justice considerations that the debt contract should be fulfilled no matter what happens. There are two leading English cases where the substance of the bondholders' interest received judicial scrutiny.[125] Both cases took a narrow approach and defined that bondholders have 'the economic interests and the rights ancillary to the economic interests of the bonds,' meaning that bondholders' interest

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[122] Streeck, *Buying Time: The Delayed Crisis of Democratic Capitalism,* 79.

[123] Prospectus of 21 July 2016 for 5.625% Global Bonds due 2047 issued by Federative Republic of Brazil (Describing among the risk factors an investigation into corruption known as 'Lava Jato'); Prospectus of 15 April 2016 for 10.25% Global Bonds due 2023 issued by the Republic of Mozambique. For a bizarre case where corruption intertwined directly with sovereign debt see Matthias Goldmann, 'The Law and Political Economy of Mozambique's Odious Debt' (2019) Available at SSRN 3513651.

[124] As a rare exception some debt instruments are linked to the performance of the sovereign's economy. However, those instruments are still novelty and compose a fraction of the total outstanding debt.

[125] Law Debenture Trust Corporation plc v Acciona SA [2004] EWHC 270 (Ch); Law Debenture Trust Corporation plc v Elektrim Finance BV [2005] EWHC 1999 (Ch).

lies in the contractual entitlements to receive full and timely payments, and additional rights protecting those payments.[126]

Departing from this definition, the bond trustee is acting in the best interest of bondholders if he promotes their economic interests by securing full and timely payments. Obviously, it will not be possible to fulfil this goal to the full extent if the sovereign borrower experiences financial difficulties and some readjustments of the debt burden are necessary for the recovery of the debtor. In the case of corporate bonds, the best interest of bondholders to receive full repayment in normal times is overridden by the bankruptcy procedures in crisis; however, it is not a case for sovereign bonds.

This generates multiple questions. The problematical question for the trustee is what actions should be done in extraordinary situations of imminent default and after its occurrence. How to understand that the bondholders' best interests were secured by the trustee when the sovereign defaults and full repayment is unlikely? Should the trustee be guided by the economic interests only? What haircut is sufficient enough to promote the bondholder's best interest? How does the bondholder's best interest correspond to the objective of the sovereign debt restructuring? Could one say that sustainable debt restructuring is also in favour of the bondholders' economic interests?

In this regard, sovereign debt restructuring itself should not be seen as something negative for bondholders, by renegotiating and reducing the debt burden, bondholders allow the economic recovery of the debtor state faster and to repay the creditors if not more in the long run, then at least with more certainty than if the debtor was left under the pressure of its original debt and without an infusion of new money which usually follow a debt restructuring. It means that a debt restructuring, if properly managed, can create a surplus for both debtor and creditors. And this surplus can be allocated in different proportion between debtor and creditors as a whole but also between creditors themselves.

Based on the premises that sovereign debt restructuring can create a surplus for both debtor and creditors, Bratton argues that the terms of sovereign debt restructuring represent the best interest of creditors if they decided to restructure the

[126] Ibid.

debt induced by the fair division of the surplus.[127] It is certain that the best interest of the creditors in sovereign debt restructuring is the one defined by them through an unfettered majority vote by consent or rejection of the restructuring offer or actions leading to it, such as litigation.[128] However, even in the case of the majority vote, some bondholder groups can dominate and coerce other bondholders.

Moreover, the majority vote provides little guidance for a bond trustee where the whole purpose of the trusteeship is to transfer some decision-making processes from bondholders to their principal, a bond trustee, to solve creditor coordination problems. The bond trustee needs defined criteria to understand how his exercise of discretion would reflect the best interest of bondholders. Further, what should be considered as a fair division of the surplus between a debtor and creditors.

C. Social Justice and Sovereign Debt Restructuring

Social justice, in contrast to market justice, is based on socio-political ideas of democracy. It is not about strict adherence to the letter of contract or economic rationale – social justice is much more abstract. It is based on the shared understanding of fairness, correctness and reciprocity of the community.[129] When it comes to wealth distribution, economic performance and productivity benchmarks give way to different elements such as political decisions and inalienable civil and human rights for dignity, freedom, health, security, education. It is a complex, at times even controversial, fusion of everchanging elements which develop together with a society. Moreover, these elements can have a different meaning from time to time leading to different outcomes. For instance, human rights can provide different benchmarks for wealth distribution. As portrayed by Moyn, they can be seen as a foundation for egalitarian-like wealth distribution or, presently dominant, provision of the subsistence minimum.[130] In the context of sovereign debt restructuring, human

[127] William W Bratton and Mitu Gulati, 'Sovereign Debt Reform and the Best Interest of Creditors' (2004) 57 Vanderbilt Law Review 3, 37.

[128] James W M Moore and Edward H Levi (eds), *Gilbert's Collier on Bankruptcy* (4th edn, Matthew Bender and Company 1937), 260 ('The approval of the majority of the creditors is evidence, prima facie, that the composition is for the best interests of the creditors and the burden is upon those who attack it to show the contrary').

[129] Streeck, *Buying Time: The Delayed Crisis of Democratic Capitalism,* 58.

[130] Samuel Moyn, *Not Enough: Human Rights in an Unequal World* (Harvard University Press 2018), 9.

rights are predominantly used from the sufficiency standpoint, which is especially evident in austerity debates.[131]

The community or Staatsvolk (the general citizenry) is the population of the country having citizenship rights and responsibilities like paying taxes. Although their rights and their fulfilment can vary from country to country, the Staatsvolk is involved in the socio-political life of the country primarily through elections of public servants who are delegated to represent the Staatsvolk on behalf of the state.

The different views on justice shared by Markvolk and Staatsvolk inevitably lead to different outcomes in distributing the funds between creditors and a state. There is a constant competition between Markvolk and Staatsvolk for the share of the pie named a state budget, and this rivalling exacerbates in a crisis as a pie itself becomes smaller. One of the examples is an increasingly strong and complex link between sovereign debt and pensions. Sovereign debt restructuring of 2005 in Argentina has adversely affected pension-policy decisions tilting them from long-term concerns about the stability of the social security system to short-term objectives of the vehicle for sovereign debt financing.[132] Although this confrontation between the Marktvolk and Staatsvolk is most vivid in emerging countries due to more fragile economies and extremes of crises, developed nations are experiencing similar processes, albeit in a more subtle way.

At present, market justice, with Friedrich von Hayek as its most prominent advocate,[133] to the larger extent has excluded social justice and related considerations from sovereign debt restructuring domain.[134] It seems to be the consequences of the trend towards liberalisation of financial markets and the 'neoliberal re-education of citizens' imposing the supremacy of the markets over politics and decreasing the influence of the electoral outcomes on the economic policy.[135]

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[131] Matthias Goldmann, 'Contesting Austerity: Genealogies of Human Rights Discourse' (2020) Max Planck Institute for Comparative Public Law & International Law (MPIL) Research Paper No 2020-09, 27.

[132] Giselle Datz, 'The Inextricable Link between Sovereign Debt and Pensions in Argentina, 1993–2010' (2012) 54 Latin American Politics and Society 101 (Showing that at the midst of crisis the main Argentine pension funds held sovereign bonds as much as 75.30% of the total assets in their portfolios).

[133] Friedrich A Hayek, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy* (Routledge 2013), see Volume 2 The Mirage of Social Justice.

[134] In contrast to private sector, public financial institutions such as the World Bank and the IMF improved their compliance with social rights over time. See Matthias Goldmann, 'Chapter 26: Financial Institutions and Social Rights: From the Washington Consensus to the Lagarde Concord?' in Christina Binder and others (eds), *Research Handbook on International Law and Social Rights* (Edward Elgar Publishing 2020).

[135] Streeck, *Buying Time: The Delayed Crisis of Democratic Capitalism,* 61.

The dominance of the market justice paradigm is translated into the current framework for sovereign debt restructuring by an attempt to stretch contractual postulates that are designed for normal times to special needs of the crisis, which requires a bankruptcy regime and more flexibility. The use of the private paradigm of full enforcement of claims in sovereign debt restructuring is a gross mistake specifically for the reason that a state fulfils a public interest function and strive to correct market failures. And if a state becomes insolvent, it usually means that the state is under immense pressure trying to sustain the basic needs of citizens and underpin the local markets which failed in the first place.

In this regard, it is improper to compare a sovereign debt restructuring to a corporate debt restructuring as a state could not be liquidated or dissolved, and it is in the public interest to allow it to recover rather than be overwhelmed under the debt pressure. Furthermore, sovereign debt serves a crucial role in providing public goods. As concluded by the ICSID tribunal in the Poštová banka case:

> 'sovereign debt is an instrument of government monetary and economic policy, and its impact at the local and international levels makes it an important tool for the handling of social and economic policies of a State. It cannot, thus, be equated to private indebtedness or corporate debt.'[136]

For this reason, the necessity to have a bankruptcy regime for sovereigns is even more pressing than for corporations. Specifically, a bankruptcy regime is designed to balance the demands of the creditors and borrowers in a way that the best interest of creditors is recognised according to circumstances of the case.

In the absence of the bankruptcy regime for sovereigns, the collective action clauses and the trust structure are helpful to balance those competing demands by reflecting the wider social norms in the regulation of sovereign debt restructuring in line with Polanyian ideas about market and society interactions.[137] In particular, the contractual terms can limit the power of the Marktvolk by keeping the opportunistic behaviour of the individual bondholder in check. Furthermore, it occurs that the views of the Staatsvolk on social justice intersects with the collective best interest of

[136] Poštová banka, a.s. and Istrokapital SE v Hellenic Republic, ICSID Case No. ARB/13/8, Award 324 (April 9, 2015).

[137] Weidemaier and Gulati, 'How Markets Work: The Lawyer's Version'; Further see Dania Thomas, 'Sovereign Debt Restructuring in the Eurozone: A Polanyian Reading of Private Law Enforcement', *From Economy to Society? Perspectives on Transnational Risk Regulation* (2018).

bondholders, which should be a guiding principle for a bond trustee who represents them.

D. Sovereign Debt Sustainability Equals the Best Interest of Bondholders

Notwithstanding how paradoxically it can sound, sovereign debt sustainability equals the best interest of bondholders and a debtor state and its citizens in sovereign debt restructuring. A bond trustee guided by the IMF and WB debt sustainability analysis in restructuring and remedial proceedings against the debtor will advance the collective bondholders' interest within the scope of its mandate. Having clarity and certainty regarding their actions will increase the likelihood and speed of achieving a sovereign debt restructuring which is aimed towards restoring debt sustainability. It is a win-win situation for both Marktvolk and Staatsvolk because it strives to solve the agency problem between a trustee and bondholders and the coordination problem among creditors in sovereign debt restructuring at the same time.

What is missing is a direct link between sovereign debt sustainability and the best interest of the creditors in debt restructuring. It is crucial to connect the dots between sovereign debt sustainability and the best interest of the creditors.

Chapter 9 of the US bankruptcy code could be instrumental in this regard. It comes as close as it gets to the sovereign debt context by providing the rules for the reorganisation of municipalities, which includes cities and towns as well as villages, counties, taxing districts, municipal utilities, and school districts.

This bankruptcy regime recognises the importance of the Staatsvolk's claims for avoiding distorting effect on the economy, and pursues to balance them with the claims of the Marktvolk.[138] It provides that a plan for the readjustment of the municipality's debt has to be in the best interests of creditors and feasible.[139] The best interests of creditors test provide a floor for payments to creditors in the restructuring, while the feasibility test stipulates the ceiling.[140] In principle, a similar approach is used by the IMF and WB in assessing sovereign debt sustainability. While the IMF

[138] Martin Guzman and Joseph Stiglitz, 'Creating a Framework for Sovereign Debt Restructuring That Works' in Martin Guzman, José Antonio Ocampo and Joseph Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press 2016), 9.

[139] 11 U.S.C. § 943(b)(7) (2005).

[140] Henry J Sommer and Richard Levin, *Collier on Bankruptcy*, vol 6 (16th edn, LexisNexis 2020), P 943.03.

and WB debt sustainability analysis does not mention the best interests of creditors and feasibility tests explicitly, it seems to encompass them implicitly.

The plan for the readjustment of the municipality's debt is feasible if in the eyes of the judge, it 'offers a reasonable assurance of success' while the municipality can still maintain its operations and provide essential services to its citizens.[141] And the idea behind the best interests of creditors is that a judge as a mechanism against strategic default by a debtor prevents illegitimate wealth transfers from creditors to the debtor in restructuring by reviewing the plan.[142] It does not mean that creditors could not be forced to reduce their contractual entitlements. What it means is that they receive 'all that could reasonably be expected in all the existing circumstances.'[143] Furthermore, the best interest of creditors reflects a collective interest of all creditors rather than focusing on the claims of individual creditors, which would make it harder to agree to the restructuring.[144]

Understanding the specificity of dealing with municipalities, the Chapter 9 test for the best interests of creditors is starkly different from the Chapter 11 of the US bankruptcy code, which requires that creditors receive under a restructuring plan not less than the amount that they would so receive if the debtor company was liquidated. Apparently, a municipality, similar to a sovereign state, cannot be liquidated and the restructuring plan should be compared to a different alternative for creditors than liquidation. In case of reorganisation of municipalities, this alternative is a dismissal of the Chapter 9 case allowing the creditors' race to the court to recover

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[141] Kane v Johns-Manville Corp., 843 F.2d 636, (2nd Cir. 1988); In re Mount Carbon Metropolitan District, 242 B.R. 18, 34 (D. Colo. 1999) ('there is no purpose in confirming a Chapter 9 plan if the municipality will be unable to provide future governmental services.'); In re City of Detroit, Michigan, 524 B.R. 147, (Bankr. E.D. Mich. 2014) (finding that the City of Detroit 'will be able to sustainably provide basic municipal services to the citizens of Detroit and to meet the obligations contemplated in the Plan without the significant probability of a default'); Franklin High Yield Tax-Free Income Fund v City of Stockton (In re City of Stockton), 542 B.R. 261, 286, 2015 Bankr. LEXIS 4155, Bankr. L. Rep. (CCH) P82,900 (B.A.P. 9th Cir. December 11, 2015).

[142] Michael W. McConnell and Randal C. Picker, 'When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy' (1993) University of Chicago Law Review 425, 466; Bratton and Gulati, 'Sovereign Debt Reform and the Best Interest of Creditors', 38.

[143] West Coast Life Ins. Co. v Merced Irr. Dist., 114 F.2d 654, (9th Cir. 1940); In re Hardeman Cnty. Hosp. Dist., 540 B.R. 229, 241 (Bankr. N.D. Tex. 2015) ('The Plan is in the best interests of Creditors because it provides creditors, as a whole, with a better alternative than dismissal of the Chapter 9 Cases and indeed provides all that Creditors can reasonably expect under the circumstances').

[144] Franklin High Yield Tax-Free Income Fund v City of Stockton (In re City of Stockton), 542 B.R. 261, 286, 2015 Bankr. LEXIS 4155, Bankr. L. Rep. (CCH) P82,900 (B.A.P. 9th Cir. December 11, 2015).

under state law remedies.[145] The practice shows that once the situation escalates to the point of default 'the right to enforce claims against the city through mandamus is the empty right to litigate.'[146] Similarly, in the sovereign debt context, while creditors can receive a money judgement against a sovereign borrower, the collection of the award is a daunting task due to sovereign immunity.

The court by applying the best interest of creditors test requires a reasonable effort by the municipal debtor that is a better alternative to its creditors than the dismissal of the case.[147] The objective is to find a compromise between the conflicting interests of the creditors and municipal debtor.

In two different cases assessing the claims of holdout creditors in 1940, the United States Court of Appeals for the Ninth Circuit, based on the best interests of creditors and feasible assessment, came to different conclusions on the viability of municipal debt adjustment plans. The court decided that 51.501 on the dollar is all that could reasonably be expected to be paid by Merced Irrigation District based on its ability to levy for bond service.[148] And in case of Newport Heights Irrigation District, the restructuring plan proposing 62.50 on the dollar of the principal amount was rejected by the court as failing to be 'equitable' and 'fair' and for the 'best interest of the creditors' due to availability of assets owned by the municipality and taxing power that can be used to pay more to the bondholders.[149] Apparently, the decisive factors for approving a restructuring plan are fairness and debt sustainability concerns but not the scale of the haircut per se.

In Kelley v Everglades Drainage District, the Supreme Court of the United States confirmed a unitary standard for appraising the best interest of creditors and feasibility of the restructuring in cases of municipal bankruptcy.[150] The standard is based on the assessment of the probable future revenues, including tax increases,

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[145] In re City of Detroit, 524 B.R. 147, (Bankr. E.D. Mich. 2014) ('The issue, therefore, is primarily whether the available state law remedies could result in a greater recovery for the City's creditors than confirmation of the plan'); In re Hardeman Cnty. Hosp. Dist., 540 B.R. 229, 241 (Bankr. N.D. Tex. 2015) ('The Plan is in the best interests of Creditors because it provides creditors, as a whole, with a better alternative than dismissal of the Chapter 9 Cases and indeed provides all that Creditors can reasonably expect under the circumstances').

[146] See Faitoute Iron & Steel Co. v City of Asbury Park, 316 U.S. 502, 62 S. Ct. 1129, 86 L. Ed. 1629 (1942).

[147] Henry J Sommer and Richard Levin, *Collier on Bankruptcy*, vol 6 (16th edn, LexisNexis 2020), P 943.03.

[148] Ibid (West Coast Life Ins. Co. v Merced Irr. Dist., 114 F.2d 654, (9th Cir. 1940).

[149] Fano v Newport Heights Irr. Dist., 114 F.2d 563, (9th Cir. 1940)

[150] Kelley v Everglades Drainage Dist., 319 U.S. 415 (USSC 1943).

available for the satisfaction of creditors.[151] The court can refuse to accept the municipal's restructuring plan if the city instead of defaulting is capable of performing actions benefiting the creditors, such as cutting spending, selling a property or raising taxes.[152] Recent cases have followed the same rationale.[153]

In principle, a similar approach is used by the IMF in assessing sovereign debt sustainability, defined as 'a situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure.'[154] In essence, the sovereign debt sustainability analysis encompasses both the best interest of creditors and feasibility tests.

The IMF judgement about debt sustainability hinges on the baseline and stress projections of the future revenues and expenditures of the country based on its outstanding liabilities, while the key aspect of assessment is fiscal policy behaviour. It is agreed that debt sustainability provides a higher bar than a solvency test, and, besides, it covers liquidity problems.[155]

Sustainability assessment is the basis for the IMF's Article IV surveillance activity and a key factor for IMF lending and in deciding whether to condition IMF lending on a debt restructuring.[156] It seems that similar to the best interests of creditors and feasibility requirements of the Chapter 9 bankruptcy procedure, the DSA functions as a tool in sovereign debt restructuring against strategic default by a debtor.[157]

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[151] Ibid fn 150.

[152] McConnell and Picker, 'When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy', 474.

[153] In re Sanitary & Improvement Dist. No. 7, 98 B.R. 970 (Bankr. D. Neb. 1989) (It is another example where the restructuring plan was denied due to failure to comply with the best interest of the creditor); In re City of Detroit, Michigan, 524 B.R. 147, 239 (Bankr. E.D. Mich. 2014) (finding that the restructuring was in the best interest of creditors and feasible); In re City of Detroit, 524 B.R. 147, 149–170 (Bankr. E.D. Mich. 2014) (finding that the plan was in the best interests of creditors and feasible).

[154] Geithner, 'Assessing Sustainability', 4.

[155] Xavier Debrun and others, 'Chapter 4. Public Debt Sustainability (Draft)', *Sovereign Debt: A Guide for Economists and Practitioners (Forthcoming)* (2018), 6.

[156] IMF, 'Sovereign Debt Restructurings–Recent Developments and Implications for the Fund's Legal and Policy Framework' (2013), 10.

[157] Debrun and others, 'Chapter 4. Public Debt Sustainability (Draft)', 41.

In contrast to Chapter 9, the DSA is based on a solid technical framework.[158] In simple terms, there are two different frameworks. One is for low-income countries (LIC), which focuses on external public and publicly guaranteed debt, introduced and used jointly by the IMF and the World Bank since April 2005. The objective of this IMF-WB debt sustainability framework is to support efforts by LICs to achieve their development goals, reflected in the Sustainable Development Goals (SDGs) while minimizing the risk that they experience debt distress.[159] Another one is for countries with market access (MAC), which takes into account total public debt and used for emerging market and advanced economies, developed and employed by IMF staff since 2002.

While being a solid framework, the DSA as any other economic model has some flaws and attracts widespread criticism.[160] However, the conceptual difficulty of the DSA is at least partially explained by unfeasibility to have a one-size fit all approach for forward-looking assessments of numerous countries with different fundamentals. Besides, from the institutional point of view, the abstractiveness of the concept brings flexibility to the IMF's actions. Nevertheless, the DSA represents a great shift from simplistic evaluations based on the debt-to-GDP ratio used previously. Moreover, the DSA's methodology is constantly evolving. This is especially true for the updated LIC-DSF, introducing among other reforms a composite measure based on a set of economic variables and realism tools, in 2018.[161]

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[158] It is worthwhile to add that the courts in a Chapter 9 procedure are empowered to examine revenue and expenses projections which should match the payment obligations under the restructuring plan. See, In re Corcoran Hosp. Dist., 233 B.R. 449, 453 (Bankr. E.D. Cal. 1999) (Plan based upon projections which reasonably anticipated income and expenses); In re Mount Carbon Metropolitan District, 242 B.R. 18, 37–38 (D. Colo. 1999) (debtor failed to project future expenses; the debtor's projections were 'inflexible, overly optimistic and based upon unreasonable and conjectural assumptions'; 'They represent an ideal scenario and fail to anticipate any fluctuation, deviation or upset in development momentum which historically has been manifested in cyclical boom/bust cycles in the Denver metropolitan area').

[159] IMF, 'Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries' (2018), 5.

[160] Lucio Simpson, 'The Role of the IMF in Debt Restructurings: Lending into Arrears, Moral Hazard and Sustainability Concerns' (2006) G-24 Discussion Paper No 40 ('Since debt sustainability analysis is not robust enough, debt service capacity should be estimated taking into account that the margin of error may be large'); Ugo Panizza, 'Debt Sustainability in Low-Income Countries: The Grants Versus Loans Debate in a World without Crystal Balls' (2015) Fondation pour les études et recherches sur le développement international Working Paper 120; Danny Cassimon, Karel Verbeke and Dennis Essers, 'The IMF-WB Debt Sustainability Framework: Procedures, Applications and Criticisms' (2017) 3 Development Finance Agenda (DEFA) 4.

[161] See IMF, 'Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries' (2018).

Practically, any sovereign debt restructuring is occurring in the shadow of the IMF's assessment as the IMF is acting as the lender of last resort for sovereigns. While the IMF does not directly decide on the conditions of the sovereign debt restructuring as a bankruptcy court, its debt sustainability analysis is de facto a roadmap for negotiations between private creditors and the sovereign borrower. Furthermore, the Paris Club bilateral creditors rely on the DSA in debt restructurings with non-HIPC countries.[162] Similarly, OECD Working Group on Export Credit and Credit Guarantees uses the DSA to provide official credits.[163]

Private creditors and a debtor country are incentivised to strike a debt restructuring with a haircut based on the DSA because a reduction of the current debt is usually one of the conditions for the IMF-supported programs.[164] Both creditors and a sovereign borrower understand that without a lifeline from the IMF, the speed of recovery and their financial situation are worse off. Furthermore, IMF's policy on 'lending into arrears' provides some reassurance to the sovereign borrower that its creditors cannot press for better terms of restructuring than envisaged by the IMF program using the leverage that the IMF conditions its financing on a conclusion of the debt restructuring.[165] Moreover, history shows that in time of crisis, the effectiveness of private law protections has always been subordinated by the imperative to achieve debt sustainability.[166]

Therefore, it seems that sovereign debt restructuring, which restores debt sustainability is in the best interest of bondholders as they get a maximum amount available in actual circumstances. Furthermore, the bondholders benefit from the creation of the surplus by prompter borrower's recovery supported by the IMF programs.[167] Protracted situations with unsustainable debt levels are costly to the debtor, creditors and the international monetary system.[168]

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[162] The Paris Club, *The Evian Approach* (2007).

[163] OECD Working Party on Export Credits and Credit Guarantees, *Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to Low Income Countries* (TAD/ECG(2008)1, 2008).

[164] IMF, 'Involving the Private Sector in the Resolution of Financial Crises - Restructuring International Sovereign Bonds' (2001), 1.

[165] Simpson, 'The Role of the IMF in Debt Restructurings: Lending into Arrears, Moral Hazard and Sustainability Concerns', 9 (However, this policy is not without some flaws such as its inconsistent application).

[166] Thomas, 'Sovereign Debt Restructuring in the Eurozone: A Polanyian Reading of Private Law Enforcement'.

[167] Bratton and Gulati, 'Sovereign Debt Reform and the Best Interest of Creditors', 25.

[168] IMF, 'Sovereign Debt Restructurings–Recent Developments and Implications for the Fund's Legal and Policy Framework', 20.

E. Sovereign Debt Sustainability as the Bearing Point for Bond Trustees

Once an overarching best interest of bondholders in sovereign debt restructuring is defined as restoration of debt sustainability, it is possible to answer how a trustee can promote the best interest of bondholders. The inquiry should be performed in connection to the scope of the bondholders' relations with a bond trustee.[169] In other words, the bond trustee has a duty 'to act for the benefit of the other party to the relation as to matters within the scope of the relation.'[170] In this regard, the trust arrangement is designed to address the coordination problem and produce an overall result in the best interest of the bondholders as a group.[171]

A bond trustee in exercising its discretion prior and during sovereign debt restructuring should rely on the IMF and WB debt sustainability analysis aiming to restore debt sustainability of the sovereign borrower as it corresponds to an overall result in the best interest of the bondholders as a group of prudent investors. In this regard, prudent bondholders are those having long-term investment horizon and more importantly whose strategy is not defined by buying deeply discounted bonds and pressing for the enforcement of the face value.

It is well-known that trustees have a right to rely on expert opinions in exercising their discretion.[172] Although it should be tested in a courtroom, it seems that the DSA can be seen as an expert opinion and help trustees to shield themselves from liability in case their actions are contested. In particular, the US courts are lenient to the IMF's role and procedures for sovereign debt restructuring.[173]

What is more, the DSA recognises the social and political factors involved in the context of sovereign debt restructuring.[174] During the recent decade, debt sustainability became a nexus of economic and human rights concerns in sovereign

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[169] Chapter 4. Bond Trustees and the Restructuring of International Sovereign Bonds of this thesis is indicative regarding the scope of the bondholders' relations with a bond trustee.

[170] Austin Wakeman Scott, *The Law of Trusts* (Little, Brown and Co 1939), 34.

[171] Prime, *International Bonds and Certificates of Deposit, 301*.

[172] This right is usually encapsulated in bond indenture having its roots from the Trust Indenture Act.

[173] Allied Bank Int v Banco Credito Agricola Cartago, 757 F.2d 516, (2nd Cir. 1985) (Stating that restructurings should be done under the auspices of the IMF and cooperative in nature); Pravin Banker Associates Ltd v Banco Popular, 165 B.R. 379, (S.D.N.Y. 1994); Pravin Banker Associates, Ltd. v Banco Popular del Peru, 109 F.3d 850, (2nd Cir. 1994).

[174] Timothy Geithner, 'Assessing Sustainability' (2002) International Monetary Fund, Policy Development and Review Department 1, 5.

debt restructuring. Seemingly, it has risen to the status of a principle of international law comprehending a public interest in sovereign debt practices.[175]

Besides the IMF and WB, sovereign debt sustainability is recognised by all other major multilateral institutions dealing with sovereign debt, including the UN agencies and even the Paris Club. Specifically, much of the progress in promoting the importance of sovereign debt sustainability as a guiding principle is owed to UNCTAD and its initiatives: Principles on Responsible Sovereign Lending and Borrowing of 2012, and the Roadmap and Guide on Sovereign Debt Workouts of 2015.[176] Likewise, the UN Human Rights Council stressed that debt sustainability is important to promote social development and to provide basic services, to create the conditions for the realisation of economic, social and cultural rights.[177]

While a recent ambitious initiative of the General Assembly of United Nations to adopt a multilateral legal framework for sovereign debt restructuring has reached an impasse,[178] it nevertheless fruited to the adoption of the Basic Principles on Sovereign Debt Restructuring Processes.[179] One of the nine basic principles is sustainability requiring that:

> 'sovereign debt restructuring workouts are completed in a timely and efficient manner and lead to a stable debt situation in the debtor State, preserving at the outset creditors' rights while promoting sustained and inclusive economic growth and sustainable development, minimizing economic and social costs, warranting the stability of the international financial system and respecting human rights.'[180]

Those recent developments demonstrate a strong trend towards the recognition of sovereign debt sustainability as the objective of sovereign debt restructuring to

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[175] Juan Pablo Bohoslavsky and Matthias Goldmann, 'An Incremental Approach to Sovereign Debt Restructuring: Sovereign Debt Sustainability as a Principle of Public International Law' (2016) 41 The Yale Journal of International Law 13.

[176] UNCTAD, *Principles on Promoting Responsible Sovereign Lending and Borrowing* (Available at <https://unctadorg/en/PublicationsLibrary/gdsddf2012misc1_enpdf>, 2012); UNCTAD, *Sovereign Debt Workouts: Going Forward Roadmap and Guide* (Available at <http://unctadorg/en/PublicationsLibrary/gdsddf2015misc1_enpdf>, 2015).

[177] Human Rights Council, *Resolution on the Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of All Human Rights, Particularly Economic, Social and Cultural Rights* (A/HRC/RES/20/10 from July 18, 2012).

[178] United Nations, *Towards the Establishment of a Multilateral Legal Framework for Sovereign Debt Restructuring Processes* (GA Res 68/304 from September 9, 2014).

[179] United Nations, *Basic Principles on Sovereign Debt Restructuring Processes* (GA Res 69/319 from September 29, 2015).

[180] Ibid 179.

promote economic development and human rights enjoyment. Following the Polanyian insight that legal institutions are historically contingent and ideologically determined, the domination of the private law paradigm in sovereign debt restructuring need not be a fact of life.[181]

Adopting the principle of sovereign debt sustainability as the normative centre provides a robust framework – incremental approach – to overcome the undue supremacy of market justice, i.e., private law paradigm, on all levels of decision-making related to sovereign debt restructuring.[182]

In this regard, a recognition of debt sustainability, being in substance the IMF and WB debt sustainability analysis, as the best interest of bondholders in sovereign debt restructuring is beneficial from multiple aspects. It not only enables a bond trustee to excel in its designated role by following this bearing point in exercising its discretion but also fosters an equilibrium between the interests of Marktvolk and Staatsvolk. It is a small yet crucial link in the chain of implementing the incremental approach to sovereign debt restructuring.

[181] Thomas, 'Sovereign Debt Restructuring in the Eurozone: A Polanyian Reading of Private Law Enforcement' (The author argues that the private law enforcement paradigm in sovereign debt restructuring, being an embodiment of self-regulating markets, is sustained by political intervention).

[182] Bohoslavsky and Goldmann, 'An Incremental Approach to Sovereign Debt Restructuring: Sovereign Debt Sustainability as a Principle of Public International Law'.

CONCLUSIVE REMARKS

The trust arrangement has great potential to facilitate the sovereign debt restructuring process. Mitigating the coordination problem, the trust arrangement fulfils the purpose of a safety valve by allowing quicker and organised renegotiation of the contractual commitments in times of crisis.[1] In contrast to sovereign bonds issued under the fiscal agency agreement, which vests nearly all enforcement rights in bondholders, the trust arrangement theoretically allows undertaking timely restructuring beneficial for both issuer and bondholders avoiding frivolous litigation.

According to the IMF, the statutory sovereign debt restructuring mechanism should be based on four main features, such as (i) deterring disruptive litigation, (ii) protecting creditor interest, (iii) availability of the debtor-in-possession financing, and (iv) allowing a restructuring agreed by the majority creditors.[2] Based on the previously described role and functions of the trust structure,[3] it is capable of fulfilling the former two features and facilitating the latter two features.

Moreover, the empowerment of creditors by the recent New York court's pari passu judgement[4] seems to be a proper instrument once a trust structure is utilised. In such case, an injunction in the hands of a diligent trustee will be used for the benefit of the bondholders as a class in case of opportunistic default or unreasonable restructuring terms diverging from debt sustainability analysis, but not to exert a preferential treatment by a holdout creditor.

Further, one may think about trustee committees which will operate akin to the London Club operates for banks involved in debt restructuring. Trustees can organise a group with a lead trustee to represent bondholders with other types of creditors. It seems that trustees have the professional expertise to fulfil this duty, and courts of the US and the UK will encourage such practice.

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[1] Unitary Training Programs on Foreign Economic Relations, Doc 1, Sovereign Debtors and Their Bondholders (2000), 4 (Arguing that the use of the bondholders' representative in negotiating new terms with the issuer increases the chances of successful acceptance of those terms by bondholders).

[2] Anne O Krueger, 'International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring' (2001)

[3] See Chapter 4. Bond Trustees and the Restructuring of International Sovereign Bonds.

[4] See details at p 32.

Last but not least, a trust structure could be used to impose consistent collective action clauses with aggregate effect for multiple series of sovereign bonds. As noted by the IMF, the collective action clauses could be contained in a trust contract functioning as a master agreement for all of the individual bond issuances.[5]

All in all, thanks to the inherent capabilities of the trustee to exercise collective rights, the scope for application of the trust arrangement is broad and have many virtues for the sovereign debt restructuring. In contrast to the majority action clauses (aka CACs),[6] which are essentially only a voting mechanism, a bond trustee is a sophisticated institution with discretionary powers. However, the flaws caused by the agency problem preclude the optimal application of the trust arrangement.

As discussed in Chapter 6, a bond trustee can be incentivised to act in the interest of bondholders by various competitive, monetary and liability incentives. It is important to stress that those types of incentives are not mutually exclusive. To the contrary, in order to secure an optimal result, all forms of incentives have to be employed in a complementary manner.

Absent of the statutory sovereign debt restructuring mechanism, there is no easy fix for the debt restructuring process nor for the role of the trustees in it. However, what is crucial that the solution lies in the best aggregate outcome for involved parties. Both interests of private creditors and a debtor state should be balanced through the prism of the sovereign debt sustainability.

In this regard, a recognition of the debt sustainability, being in substance the IMF and WB debt sustainability analysis, as the best interest of bondholders in sovereign debt restructuring is beneficial from multiple aspects. It enables a bond trustee to excel in its role as a guardian of bondholders by following the best interest of bondholders in exercising its discretion. Furthermore, it fosters an equilibrium between the interests of private creditors and a state taking into account its socio-political aspects.

While the IMF and WB debt sustainability analysis is evolving and had experienced tremendous changes in its methodology, there are still many efforts required to address future problems in sovereign debt governance and restructuring. One of the main challenges for the DSA brought by the COVID-19 pandemic is

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[5] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring' (2014), 25.

[6] For the description and differentiation between CACs and MACs see Chapter 4.II. The Impact of the Legal Framework on Sovereign Debt Restructuring.

extreme uncertainty impacting already tentative projections and shock scenarios used to assess debt sustainability of the economies. There are numerous factors for uncertainty caused by COVID-19, including (i) the path of the pandemic within the territory of the country and beyond, (ii) the depth and length of the fall in global economic growth, (iii) the projected path of inflation, interest rates, and commodity prices (above all for oil), and (iv) the future behaviour of global financial markets.[7] The exact trajectory of the pandemic is very uncertain, but it is likely to span over several years, and its economic and social impacts differ across countries.

In the environment of such an extreme uncertainty, there is a risk that creditors will ubiquitously dispute the justification of the DSA pushing to deal with the problem on a short-term horizon in debt restructuring and provide as smaller relief as possible with the hope that most of the medium and long-term negative projections will not materialise. However, if these shocks will materialise, then the only solution will be another sovereign debt restructuring. This can lead to a cascade of 'too little, too late' restructurings dragging the growth and development for years if not decades, especially in low-income countries.

Reforms are necessary to enhance the DSA, which in turn will mitigate the impact of COVID-19 and provide better guidance for the parties involved in debt restructuring, including a bond trustee. There is a long-standing debate that the DSA and consequently sovereign debt restructurings are skewed towards the creditors.[8] This results in inadequate provision of debt relief for development goals of debtor countries and increases the risk of 'too little, too late' restructurings, what actually jeopardise the IMF's resources as well.

The reforms can be conditionally grouped as econometric and normative. From the econometric perspective, further actions have to be taken to enhance debt transparency. In particular, the DSA can benefit from better data on collateralised debt and external debt of state-owned enterprises. Further, there are calls to account

[7] Anna Gelpern, Sean Hagan and Adnan Mazarei, 'Debt Standstills Can Help Vulnerable Governments Manage the COVID-19 Crisis' in Maurice Obstfeld and Adam Posen (eds), *How the G20 Can Hasten Recovery from COVID-19*, vol PIIE Briefing 20-1 (Peterson Institute for International Economics 2020), 46.

[8] Lucio Simpson, 'The Role of the IMF in Debt Restructurings: Lending into Arrears, Moral Hazard and Sustainability Concerns' (2006) G-24 Discussion Paper No 40, 22; Sean Hagan, 'Sovereign Debt Restructuring: The Centrality of the IMF's Role' (2020) Peterson Institute for International Economics Working Paper 20-13, 4.

for political risk factors, which are not part of the current DSA framework even though they can severely impact the projections under the DSA.[9]

On the normative level, criticisms focus on the very concept of debt sustainability used in the DSA.[10] The idea is to embed the human development perspective into debt sustainability. In this regard, the DSA frameworks for market access countries (MAC) and low-income countries (LIC) have different approaches.[11] The MAC-DSA does not account for development goals what seems to be explained by the fact that it is used for both advanced and emerging market economies.[12] It seems flawed to disregard the development financing needs of the emerging market economies and use the same framework for assessing debt sustainability of such emerging countries, according to the IMF,[13] like Angola, Libya, Pakistan, Ukraine, Venezuela and advanced countries including Germany, Switzerland, the UK and the US.

As for the debt sustainability analysis for low-income countries, it has an objective to support the development goals of the LICs while minimising the risk that they experience debt distress.[14] However, the determination of whether the debt is sustainable is based on a country's capacity to carry debt and its projected debt burden.[15] This benchmark, similar to the corporate finance standards, assesses the capacity of the borrower to repay being blind to the actual impact of debt levels on fulfilment of the development goals, let alone distributive considerations. It is important to look for mechanisms from the human development perspective that may

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[9] Andrea Consiglio and Zenios Stavros, 'Incorporating Political Risks into Debt Sustainability Analysis' (*Bruegel,* 2020) <https://www.bruegel.org/2020/01/incorporating-political-risks-into-debt-sustainability-analysis/> accessed August 9, 2020 ('Clearly, ignoring the political risks can lead to excessive optimism and wrong decisions').

[10] Eurodad, *Putting Poverty Reduction First. Why a Poverty Approach to Debt Sustainability Must Be Adopted* (European Network on Debt and Development, Brussels, 2001); Denis Cassimon, Blanca Moreno-Dodson and Quentin Wodon, 'Debt Sustainability for Low-Income Countries: A Review of Standard and Alternative Concepts' in Blanca Moreno-Dodson and Quentin Wodon (eds), *Public Finance for Poverty Reduction: Concepts and Case Studies from Africa and Latin America* (World Bank 2008); Danny Cassimon, Karel Verbeke and Dennis Essers, 'The IMF-WB Debt Sustainability Framework: Procedures, Applications and Criticisms' (2017) 3 Development Finance Agenda (DEFA) 4.

[11] See details regarding the WB and IMF DSA frameworks at p 194.

[12] IMF, 'Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries' (2013).

[13] IMF, 'Methodological and Statistical Appendix to IMF Fiscal Monitor: Policies to Support People During the Covid-19 Pandemic' (2020).

[14] IMF, 'Guidance Note on the Bank-Fund Debt Sustainability Framework for Low Income Countries', 5.

[15] Ibid.

link debt sustainability to the spending necessary to reach social and poverty-reduction goals.

‘Though these young men unhappily fail to understand that the sacrifice of life is, in many cases, the easiest of all sacrifices, and that to sacrifice, for instance, five or six years of their seething youth to hard and tedious study, if only to multiply ten-fold their powers of serving the truth and the cause they have set before them as their goal – such a sacrifice is utterly beyond the strength of many of them.’

Fyodor Dostoevsky, The Brothers Karamazov

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