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Reforming Sovereign Lending Practices: Modern Initiatives in Historical Context

W. Mark C. Weidemaier*

Abstract

In response to the Eurozone sovereign debt crisis, policymakers have initiated a range of reforms falling at both poles of the "hard"/"soft" law continuum. One of the most ambitious is the United Nations Conference on Trade and Development's initiative to identify what it calls "Principles of Responsible Sovereign Lending and Borrowing." The Principles aim to transform attitudes about sovereign lending in general, and sovereign loan contracts in particular, through consensus-building, promulgating model contract terms, and other soft law approaches. Principle 15, for example, envisions the use of collective action clauses (CACs) to ensure that debt restructurings occur "promptly, efficiently, and fairly." Public officials agree with this goal, if not the method. Eschewing persuasion and other soft-law techniques, Eurozone leaders have stated their intent to mandate the use of standardized CACs in all euro area sovereign bonds.

This article explores, and ultimately questions, whether initiatives such as the Principles are likely to have a significant impact on bond contracts. Over the past century, other initiatives have pursued the same goal with varying degrees of success. Using a dataset of bonds issued in New York and London, the article demonstrates how contracts responded (or failed to respond) to these initiatives, often in ways reformers did not anticipate. Several lessons emerge. First, initiatives designed to encourage changes to entrenched contracting practices may require significant and coordinated leadership by states and other international actors. Without such leadership, these initiatives may fail. One reasons for this is that reformers often misread market sentiment or fail to appreciate the diverse preferences of market actors. Second, even successful initiatives can have unexpected results. In particular, efforts to encourage the use of uniform contract terms may have the paradoxical effect of provoking greater contract variation. The third lesson, then, is that standardization – assuming that is a desirable (and feasible) goal – may have to be mandated. The paper concludes by exploring other ways in which initiatives like the Principles can influence sovereign lending markets.

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Reforming Sovereign Lending Practices: Modern Initiatives in Historical Context

W. Mark C. Weidemaier

Principles 7 and 15 of the UNCTAD Principles of Responsible Sovereign Lending and Borrowing propose to establish 'commonly accepted principles and practices' for sovereign debt restructuring. The Principles represent an important effort to identify and promote appropriate norms in the sovereign debt markets. Yet this ambitious norm-setting goal is inextricably linked with more prosaic and technical questions about the design of sovereign loan contracts. For example, consider Principle 7, which observes that lenders 'have a duty to behave in good faith and with cooperative spirit' in response to a sovereign's financial difficulty.[1] The sentiment may be universal, but such generalities are not likely to alter market participants' behavior unless translated into more specific rights and duties and embodied in the terms of loan contracts (or imposed as a matter of mandatory law). For that reason, the Principles represent only a first step along the path to reform. Their ultimate ambition is to set a 'global standard for the contracting of sovereign debt, against which to assess the quality of contracts and the sustainability of debt.'[2]

The effort to develop the Principles occurs at what may be a critical juncture in the history of sovereign lending, but it is not unprecedented. Over the past century, a number of other initiatives have pursued similar goals. This paper mines this historical context to unearth lessons relevant to the implementation and ultimate impact of the Principles. The paper begins with three case studies. The first is the informal and largely unsuccessful effort by the League of Nations in the 1920s and 1930s to introduce a range of innovations into sovereign loan contracts, including collective action clauses (CACs) and arbitration clauses. The second involves mid-twentieth century efforts to encourage market participants to rely on formal adjudication, including arbitration, to resolve sovereign debt disputes. The third revisits the late-twentieth century effort to encourage lenders and issuers to plan for restructuring ex ante through the use of model CACs. Drawing on a large dataset of sovereign bonds issued in New York and London, the paper demonstrates how contracts responded (or failed to respond) to these initiatives, often in ways reformers did not anticipate.

Several lessons emerge. First, initiatives designed to change entrenched contracting practices may require coordinated and assertive leadership by governments and other international actors. Less direct methods – such as promulgating model clauses – often fail. One reason for this is that the officials involved may misread market sentiment. As an example, for most of the twentieth century governments tried to steer lending disputes, and other disputes between private investors and foreign sovereigns,

[1] UNCTAD, 'Draft Principles on Promoting Responsible Sovereign Lending and Borrowing', Principle 7 (April 26, 2011) [herein, Principles].

[2] UNCTAD Press Release, 'UNCTAD unveils principles to guide responsible sovereign lending and borrowing' (May 4, 2011).

into arbitration or litigation in national courts. So did the League of Nations, which proffered model arbitration clauses for this purpose. These efforts were premised on the belief that market participants wanted a viable forum for resolving sovereign lending disputes. Evidence from bond prices and contracts, however, suggests that this belief was mistaken. Investors, at least, had little interest in legal enforcement – perhaps because the existence of viable enforcement rights might have relieved some of the pressure on powerful governments to protect bondholder interests. As a result, sovereign bonds almost uniformly omitted dispute resolution clauses until statutory changes late in the century made it impossible to ignore the subject any longer. One implication is that major shifts in contracting practices may require more explicit and coordinated official-sector guidance. It is, of course, a separate question whether public officials should intervene so directly in the terms of loan contracts.

A second lesson is that even successful initiatives can have unexpected results. In particular, efforts to encourage the use of uniform contract terms may have the paradoxical effect of provoking greater variation. For example, the successful effort to promote the use of CACs in bonds governed by New York law seems to have prompted a flurry of innovation in other sovereign debt markets. Bonds governed by English law, which previously had employed standardized CACs, began to depart from this standard. A third lesson, then, is that uniformity in contract terms – assuming that is a desirable goal – may have to be mandated. Encouragement and suasion do not suffice, even when applied by esteemed and influential actors.

The paper concludes by exploring further implications for how the Principles could shape sovereign debt practices. As the case studies highlight, it is hard to predict whether and how the Principles will affect contracts in the long term. Their most lasting impact may arise from the effort to crystallize general norms concerning appropriate borrower and creditor behavior. As just one example, an increasingly diverse group of actors – including national courts, international tribunals, and ad hoc arbitration panels – must confront the question whether creditors are behaving abusively in the context of a sovereign debt restructuring. Regardless of their impact on contracts, the Principles may play an important role in developing consensus on this and other questions.

1. Collective Action Clauses: The First Go-Round (1920-1945)

Contract terms do not usually take center stage in discussions of financial crisis and macroeconomic policy, but CACs are an exception. For at least the past decade, much of the discussion about how to respond to sovereign debt crisis has revolved around CACs,[3] and the discussion continues today with plans to mandate the use of standardized CACs in Eurozone bonds.[4] Although the Principles do not often refer to

[3] For early proposals to use CACs, see Barry Eichengreen and Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (1995), at 34-36; Rory Macmillan, 'The Next Sovereign Debt Crisis', 31 *Stanford Journal of International Law* (1995) 305, at 356.

[4] Eurogroup, Statement by the Eurogroup of November 28, 2010, retrieved from http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf.

specific contract terms, Principle 15 makes an exception for CACs and emphasizes their importance in facilitating restructuring negotiations.[5]

The term 'CAC' actually refers to a variety of clauses designed to ease the coordination problems that may complicate the restructuring of sovereign bond debt.[6] For example, *modification clauses* allow a defined percentage of bondholders to approve a restructuring proposal in a vote that will bind all holders of that bond, and *aggregation clauses* allow for a similar vote to occur across different bond issues.[7] The term 'CAC' often is used as shorthand for one or both of these clauses. On occasion, however, it is used to refer to other clauses. *Trustee clauses*, for example, empower a trustee to make decisions on behalf of bondholders as a group. *Bondholder committee clauses* provide for the formation of a bondholder committee to negotiate with the issuer after a default. *Acceleration clauses* prevent individual bondholders from demanding full payment after a default and instead condition acceleration on approval by a defined percentage of bondholders.[8] Although they work in different ways, these contract terms are functionally similar. Each enables bondholders to decide important questions collectively, thus making it harder for lone or small groups of bondholders to impede a course of action – such as a restructuring – that might benefit the group as a whole.[9]

Given their central place in modern debates, it is tempting to view CACs as recent innovations. But this is not the case. CACs have been around for over a century. What is true is that CACs did not enter widespread use in sovereign bonds until they were introduced into English-law bonds in the mid-1980s.[10] As is widely known, CACs later spread to bonds governed by New York law after a prominent issuer (Mexico) included a

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[5] The implications section to Principle 15 notes that '[c]ollective action clauses can facilitate sovereign debt restructuring; therefore it is recommended that debtors and creditors should include them in multi-party debt instruments.'

[6] This is not to say that these CACs are *necessary* to overcome these problems. For a summary of restructurings from 1998-2010 and a comparison exchange offers to CACs, see Ran Bi, Marcos Chamon, and Jeromin Zettelmeyer, 'The Problem that Wasn't: Coordination Failures in Sovereign Debt Restructurings', IMF Working Paper WP/11/265 (2011). Nor is there consensus as to whether CACs are the ideal solution to problems arising in the context of sovereign default. For a review of the issues and proposals for the creation of a sovereign bankruptcy mechanism, see Patrick Bolton and David Skeel, 'Redesigning the International Lender of Last Resort', 6 *Chicago Journal of International Law* (2005), 177; Steven Schwarcz, 'Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach,' 85 *Cornell Law Review* (2000), 101.

[7] If a majority vote were required by holders of each bond issue, then a minority of the issuer's bondholders might block a restructuring if they comprised a majority of a particular bond issue. Aggregation clauses solve this problem.

[8] For further discussion of these clauses, see Michael Bradley and Mitu Gulati, 'CACs for the Eurozone: An Empirical Analysis' (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948534; W. Mark C. Weidemaier and Mitu Gulati, 'How Markets Work: The Lawyer's Version' (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1886435.

[9] *See* Hal Scott, 'A Bankruptcy Procedure for Sovereign Debtors', 37 *International Lawyer* (2003), 103, 116-118 (summarizing holdout problems in sovereign bond lending).

[10] On this point, see Weidemaier and Gulati, *supra* note 8, at 16-21.

CAC in a 2003 bond issuance.[11] Mexico's issuance was preceded by an official sector initiative – often attributed primarily to the US Treasury Department – to encourage the use of CACs, and a widespread (but contested) narrative attributes the adoption of CACs in the New York market to this initiative.[12]

If that is so, then success was a long time coming. Throughout the 1920s and 1930s, a variety of international actors encouraged the use of CACs with little success. Their efforts took two forms: First, acting through the League of Nations, governments included CACs in contracts for loans they guaranteed or arranged after World War I. Second, a committee of the League of Nations promulgated model clauses for sovereign loan contracts incorporating some of these innovations.

A. *The League Loans*

In the aftermath of World War I, reconstruction loans were arranged under the auspices of the League of Nations to a number of European countries that found themselves shut out of global capital markets. These included Austria, Bulgaria, Estonia, Greece, and Hungary.[13] The League's Financial Committee also provided less formal advice and assistance to other countries.[14] League member governments were heavily involved in negotiating the terms of these loans and worked closely with the participating banks to design the contracts.[15] Default on these loans was a very real possibility and would necessarily implicate League member states, which in some cases had guaranteed the loans.[16] As a result, the contracts took pains to address the possibility of a future restructuring. They did so in ways that would be immediately familiar to a modern lawyer.

Modification Clauses: Modification clauses appeared in sovereign bonds as early as 1923 and sometimes were paired with clauses designating an official-sector representative of bondholder interests. For example, bonds issued in New York and London by Czechoslovakia were 'secured' by customs and other revenues[17] but contemplated that the issuer might default if these revenues proved insufficient to service the loan. In that event, the bonds established a process by which the loan might be restructured:

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[11] The most complete analysis of this shift is Anna Gelpern and Mitu Gulati, 'Public Symbol in Private Contract: A Case Study', 84 *Washington University Law Review* (2006) 1627. For empirical documentation of the shift, see Bradley and Gulati, *supra* note 8, at 11-16.

[12] Gelpern and Gulati, *supra* note 11, at 1643-44, 1649-74; Adam Feibelman, 'Contract, Priority, and Odious Debt', 85 *North Carolina Law Review* (2007), 727, 755-57.

[13] The League also arranged loans to the city of Danzig. For history on the League Loans, see Margaret Myers, 'The League Loans', 60 *Political Science Quarterly* (1945) 492.

[14] *See* Myers, *supra* note 13, at 492.

[15] Although it had of course declined to join the League, the United States government also worked closely with participating banks. *See* Melvyn P. Leffler, *The Elusive Quest: America's Pursuit of European Stability and French Security, 1919-1933* (1979), at 58-64.

[16] *See* Myers, *supra* note 13, at 494-505.

[17] It is something of a euphemism to use the term 'secured' in the context of sovereign loans. In general, secured sovereign loans pledge some revenue stream, such as customs duties, to the service of a particular bond issue. For further discussion, and evidence of the prevalence of these clauses in the pre-World War II era, see Mark Weidemaier, Robert Scott, and Mitu Gulati, 'Origin Myths, Contracts, and the Hunt for *Pari Passu*', *Law and Social Inquiry* (forthcoming).

> 13… [T]he Czechoslovak Government further undertakes that in the event it does not fulfil its obligations …, the Council of the League of Nations shall be invited to nominate its Financial Committee or any other Committee or a Representative who shall be empowered to make the best arrangement for the protection of the Bondholders, provided that the previous consent of the majority in value of the Bondholders at a meeting as provided [below], shall be obtained before any arrangement is accepted or the intervention of the Council of the League of Nations is invited.
> …
> 15. Should circumstances arise hereafter in which it may be necessary or expedient to obtain the sanction of the Bondholders to any exercise of their rights or … any proposal which may be made to them by the Czechoslovak Government, … [the bankers may convene a meeting in London] and the decision of the holders of the majority in nominal value of Bonds present at such meeting, either in person or represented by proxy, shall be binding upon all Bondholders…, but such majority must be comprised of not less than fifty per cent. of the Sterling Bonds and not less than fifty per cent. of the Dollar Bonds outstanding.…[18]

These bonds are noteworthy for the extent to which they anticipate modern practices. They allow a majority of bondholders to appoint a representative to act on their behalf and to approve 'any proposal' made to them by the issuer. Any vote had to occur at a meeting – a requirement that remained standard in English-law bonds with modification clauses until at least 2003.[19] And they offer assurance against unequal treatment of similarly-situated bondholders by requiring a majority vote from holders of both New York and London issues.[20]

Acceleration and 'reverse' acceleration clauses: After a default, many sovereign bonds allow each bondholder to accelerate all future payments due under their bonds. This complicates restructuring, for it allows holdout creditors to demand payment in full immediately instead of suing only to recover missed coupon payments. As noted previously, acceleration clauses make the decision to accelerate a collective one by requiring the approval of a certain percentage of bondholders (typically, twenty-five percent). Some modern clauses go a step further and allow a majority of bondholders to

[18] Listing Application for the Czechoslovak State $14,000,000 Eight Per Cent. Bonds (January 11, 1923); Listing Application for the Czechoslovak State $9,250,000 Eight Per Cent. Bonds (February 3, 1925).

[19] Bradley and Gulati, *supra* note 8, at 18-19. The Czechoslovakian bonds, however, differ in that they require holders of at least fifty percent of the outstanding debt to approve a modification. In the modern era, many English-law allow modification upon a much lower vote. *See generally* Weidemaier and Gulati, *supra* note 8, at 21-26; Bradley and Gulati, *supra* note 8 at 16-18.

[20] Modern aggregation clauses often contain similar protections. They allow a supermajority of all bondholders (say, 85 percent) to bind holders of every bond issue, but only if a certain percentage of bondholders in each issue (say, 66.7 percent) vote favorably. *See* Bradley and Gulati, *supra* note 8 at 21.

reverse a decision to accelerate. Thus, even if a holdout creditor obtained a twenty-five percent stake, the majority could override its decision to accelerate the loan.[21]

As with modification clauses, these seemingly modern innovations have been used sporadically for nearly a century. Consider the following clause from a 1923 issuance by the Kingdom of the Serbs, Croats, and Slovenes, which conforms almost exactly to modern acceleration and 'reverse' acceleration clauses:

> In case [of default] … the Bankers shall, if requested so to do by a writing signed by the holders of twenty-five per cent. in amount of the bonds then outstanding, declare the principal of all the bonds then outstanding to be due and payable immediately…. This provision, however, is subject to the condition that if within one year after such declaration the default on the part of the Government shall have been made good to the satisfaction of the Bankers, then and in every such case the holders of a majority in amount of the bonds then outstanding, by written notice to the Bankers, may waive such default and rescind and annul such declaration of maturity….[22]

Similar clauses appear in bonds issued in foreign markets by provinces, municipalities, and other sub-sovereign entities.[23] These provisions are curious; the standard justification for an acceleration clause is that the clause prevents holdout creditors from using litigation to disrupt restructuring efforts.[24] But when these bonds were issued, both the United Kingdom and United States recognized the absolute theory of sovereign immunity, under which foreign sovereigns were immune from suit in national courts.[25] The presence such clauses in bonds issued in the 1920s implies that, even in a world without strong legal enforcement rights, there may be benefits to treating the decision to accelerate as one to be made by the bondholders collectively.

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[21] For discussion of these clauses, see Bradley and Gulati, *supra* note 8 at 24.

[22] Listing Application, Kingdom of the Serbs, Croats, and Slovenes, Forty-Year Eight Per Cent. Secured External Gold Coupon Bonds (April 9, 1923).

[23] *See, e.g.,* Listing Application, Province of Upper Austria (Land Oberosterreich) External Secured Sinking Fund Six and One Half Per Cent. Bonds (April 16, 1928); Listing Application, Hungarian Consolidated Municipal Loan (September 21, 1927)

[24] Sergio J. Galvis and Angel L. Saad, 'Sovereign Exchange Offers in 2010', 6 *Chicago Journal of International Law* (2005), 219, 226-227. Whether the clause does so effectively is another question. For a skeptical view, see Hal S. Scott, 'A Bankruptcy Procedure for Sovereign Debtors?', 37 *International Lawyer* (2003), 103, 120-121.

[25] In some European countries, by contrast, the principle of absolute immunity began to break down as early as the mid-nineteenth century. French, German, and Swiss courts, for example, enforced ex ante waivers of state sovereign immunity under some circumstances, though typically only when the loan had some connection to the forum. *See* Harvard Law School Research in International Law, 'Competence of Courts in Regard to Foreign States', 26 *American Journal of International Law Supplement* (1932), 473, 548-80; Georges R. Delaume, 'Jurisdiction of Courts and International Loans: A Study of Lenders' Practice', 6 *American Journal of Comparative Law* (1957), 189, 203-04.

Trustee clauses: Some modern bonds provide for a trustee to make important decisions on behalf of bondholders, including whether to accelerate the loan and whether to sue. These clauses, too, have historical roots dating back at least to the League Loans. For example, unable to tap global capital markets on its own after World War I, the Austrian government issued bonds guaranteed by a number of League of Nations member governments. The bonds called for the appointment of a trustee responsible both for ensuring that bondholders were paid out of Austrian customs duties set aside for that purpose and for enforcing the guarantee, if necessary.[26] Similar clauses appeared in bonds issued by Estonia,[27] Hungary,[28] and by Germany in connection with the Dawes (1924) and Young (1930) reconstruction plans.[29]

B. *The Committee for the Study of International Loan Contracts*

League of Nations officials likely played a significant role in introducing these innovations into sovereign bond contracts. League officials, after all, were intimately involved in negotiating and documenting the loans and in ensuring their marketability.[30] But during the 1920s, they made no concerted effort to encourage widespread use of CACs in any form. By the mid-1930s, however, League officials had responded to the growing financial crisis by launching a more formal campaign to reform the terms of sovereign loan contracts. A 1935 resolution sponsored by the Netherlands created the Committee for the Study of International Loan Contracts, which was expressly charged with 'examin[ing] the means for improving contracts relating to international loans issued by Governments … and, in particular, to prepare model provisions … which could, if the parties so desired, be inserted into such contracts.'[31]

The Committee was comprised of leading figures from central banks, international financial institutions, and private bondholder associations.[32] Much of the Committee's attention was focused on the possibility of creating a system of international arbitration for resolving sovereign debt disputes.[33] Yet the Committee was clearly aware that loan contracts could be improved by facilitating bondholder coordination. Its report, released

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[26] Listing Application, Austrian Government Guaranteed Loan, 1923-1943 (May 29, 1924). Guarantor states deposited their own bonds into an account in the trustee's name. After a default, the trustee was entitled to demand payment from each guarantor in exchange for surrendering bond coupons of equivalent value. *Ibid.*

[27] *See* Listing Application, Republic of Estonia (Banking and Currency Reform) 7 Per Cent. Loan (October 29, 1928).

[28] *See* Listing Application, Kingdom of Hungary Seven and One-Half Bonds (February 4, 1925).

[29] *See* Listing Application, German External Loan 1924 (October 14, 1924); Listing Application, German Government International 5 1/2% Loan 1930 (March 6, 1931).

[30] For contemporaneous history, see Sir Arthur Salter, 'The Reconstruction of Austria', 2 *Foreign Affairs* (1924), 630; Sir Arthur Salter, 'The Reconstruction of Hungary', 5 *Foreign Affairs* (1926), 91-102. For a retrospective history, see Gustavo Adolfo Olivares Marcos, *The Legal Practice of the Recovery of State External Debts* (2005), at 125-130.

[31] League of Nations, *Report of the Committee for the Study of International Loan Contracts* (1939), at 5 [herein, *Report on Loan Contracts*].

[32] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 5.

[33] On the committee's activities generally, see Michael Waibel, *Sovereign Defaults Before International Courts and Tribunals* (2011), at 324-326.

in 1939, extensively discussed the potential benefits of trustee clauses and bondholder representatives[34] and proffered a mechanism for obtaining bondholder assent to a restructuring.[35] The Committee also was explicit about its concern that individual bondholders might undercut the collective good, especially through litigation: 'Too many lawsuits would be a bad thing; not only would they be unpleasant for the debtors, but their Stock Exchange effects would be disastrous.'[36] To limit this risk, the Committee discussed the merits of centralizing the power to initiate litigation in the hands of a bondholder representative.[37]

The report did not provide model clauses appointing a trustee or bondholder representative, but it did include a model clause providing for ad hoc arbitration.[38] In the Committee's view, its model clause neatly solved a recurring problem in the sovereign debt markets: the difficulty finding a tribunal 'whose decisions will have legal and moral force in cases of dispute.'[39] The lack of such a tribunal, the Committee suggested, was what had kept previous sovereign debt disputes from being 'easily settled.'[40] Reflecting the Committee's fear of '[t]oo many lawsuits,' the model clause provided that an arbitration could be initiated only by a bondholder representative or by a bondholder or group of bondholders holding at least ten percent of the outstanding debt.[41]

C. *The Market's (Lack of) Response*

As these early bond issues make clear, many 'modern' innovations in the sovereign debt markets are not especially modern. Modification, acceleration, and trustee clauses have been in use for nearly a century, along with a range of other clauses that facilitate collective bondholder action. Many of these clauses appeared in loans arranged by the League of Nations to high-risk countries otherwise unable to access the capital markets. Major international banks – such as Rothschilds, Barings, and JP Morgan – were involved in these loans and were thus well aware of the benefits supposedly attributable to CACs. Furthermore, although the Committee for the Study of International Loan Contracts had only provided one model clause concerned primarily with arbitration, the League Loans themselves provided plenty of other models. Banks were not shy about borrowing clauses found in League Loan documentation and putting them to use in other loan contracts. For example, Rothschilds, JP Morgan, and other banks appear to have

[34] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 17-21, 32-37.

[35] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 33-34 (proposing mechanics for conducting a meeting to vote on a restructuring proposal negotiated by the issuer and a bondholder representative).

[36] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 33.

[37] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 32.

[38] For extensive discussion, see Waibel, *supra* note 33, at 324-25.

[39] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 24.

[40] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 25.

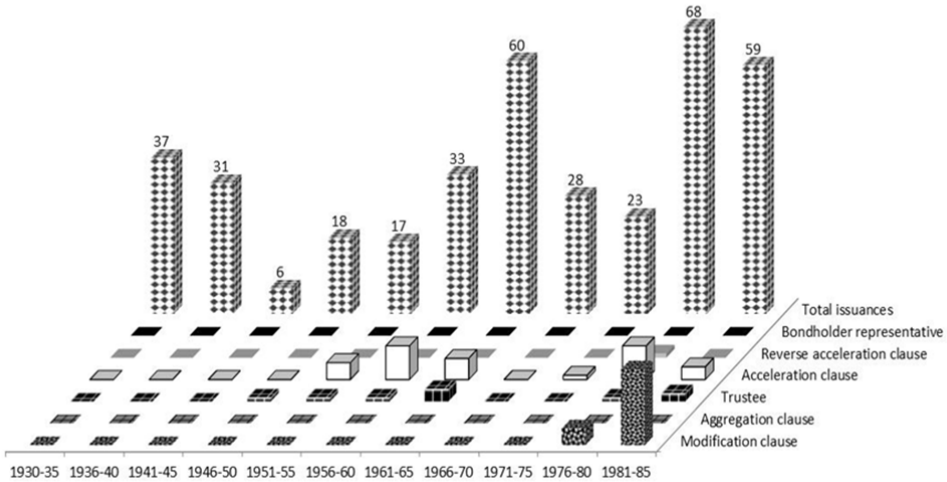
[41] League of Nations, *Report on Loan Contracts*, *supra* note 31, at 26. The debtor government could also initiate an arbitration. *Ibid.*

copied arbitration clauses from some League Loan contracts nearly verbatim in other loan contracts.[42]

With respect to CACs, however, the League Loans seemingly had little impact on general market practices. In the course of other work, I and others have compiled a dataset of over eighteen hundred contracts and disclosure documents for sovereign bonds issued between 1823 and 2011.[43] The dataset consists primarily of bonds issued in London and New York and thus only permits inferences about these markets. Nevertheless, it provides little reason to believe these early CACs ever spread beyond a small subset of issues.

Compared to their heyday in the nineteenth and early twentieth centuries, the bond markets were relatively dormant between 1930 and the mid-1980s.[44] Nevertheless, sovereigns continued to issue bonds during this era, and the dataset includes 380 issues between 1930 and 1985. As Figure 1 indicates, the number of bonds in this era that included any form of CAC was extremely small both as an absolute number and as a proportion of total issuances.

Figure 1. Use of CACs in Sovereign Bonds, 1930-1985



[42] For example, an arbitration clause was included in the contract for a loan to Czechoslovakia in 1922. *See* Agreement Between the Czechoslovak State and Baring Brothers & Co. (April 5, 1922), par. 19. Very shortly thereafter, a nearly identical clause appeared in the contract for a loan to Brazil. *See* Agreement Among the Government of the Republic of the United States of Brazil, NM Rothschild & Sons, Baring Brothers & Co., and J. Henry Schroder & Co. (May 2, 1922) par. 21. The clause, or a variant of it, was then repeated in contracts for loans to Argentina (in 1925) and Hungary (in 1926). *See* Agreement Among the Government of the Argentine Nation, JP Morgan & Co., and the National City Company (May 25, 1925), sec. 5; Agreement Among the Government of the Kingdom of Hungary, NM Rothschild & Sons, Baring Brothers & Co., and J. Henry Schroder & Co. (July 23, 1926), par. 30.

[43] For more detailed description, see Weidemaier, Scott, and Gulati, *supra* note 17; Bradley and Gulati, *supra* note 8 at 30-31.

[44] Youssef Cassis, *Capitals of Capital: A History of International Financial Centres, 1780-2005* (2006), at 192-93; Rory Macmillan, 'Towards a Sovereign Debt Work-Out System', 16 *Northwestern Journal of International Law and Business* (1995), 57, 80-84.

Figure 1 includes only bonds issued by countries in foreign markets. By contrast, CACs made occasional appearances in bonds issued by sub-sovereign entities, such as cities and provinces, as early as the 1920s.[45] But they did not appear with any frequency in bonds issued by countries until bonds governed by English-law began to adopt modification clauses in the mid-1980s.[46]

2. The (Mostly Ignored) Effort to Facilitate Legal Enforcement

This section examines efforts to promote the use of adjudication to resolve sovereign lending disputes. The previous section discussed efforts by the Committee for the Study of International Loan Contracts to promote arbitration as a means of solving sovereign lending disputes. That early effort was followed by two important mid-century initiatives. The first is the effort to create multilateral treaty regimes to promote the use of international arbitration. The second is the gradual relaxation of the formerly strict approach to foreign sovereign immunity in the United Kingdom and United States. Despite the predictions of reformers, however, the evidence suggests that participants in the sovereign debt markets viewed these developments as largely irrelevant.

A. *The Mid-Century Effort to Promote Arbitration and Litigation*

If the report issued by the Committee on the Study of International Loan contracts had no perceptible impact on the use of CACs, it had an equally negligible impact with respect to its primary goal of encouraging arbitration. As noted previously, the Committee seemingly viewed its model clause as a sensible and uncontroversial solution to a problem that had bedeviled market participants: how to find an adjudicatory forum whose decisions would have 'legal and moral force.' If that were true, one would have expected market participants eagerly to embrace the model clause prepared by the Committee or to adapt for their own purposes one of the arbitration clauses used in the League Loan contracts in the 1920s.[47]

In the nineteenth and early twentieth centuries, arbitration was used to resolve a number of sovereign debt disputes, and arbitration clauses made rare appearances in sovereign bonds.[48] As I have noted elsewhere, however, many of these arbitration agreements were not genuine efforts to facilitate arbitration between bondholders and the

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[45] *See, e.g.,* Listing Application, Province of Buenos Aires 6% Loan (July 31, 1928) (including a clause permitting acceleration and reversal by a majority of bondholders).

[46] See Weidemaier and Gulati, *supra* note 7, at 17-21.

[47] On several occasions, in fact, banks did adapt League Loan arbitration clauses for use in new contracts. Examples are cited in footnote 42. They often did so, however, only to resolve disputes between the banks and the issuer. In those cases, the arbitration clause appeared in the loan contract between these parties, rather than in the bond itself, and referred only to disputes involving the banks.

[48] See Waibel, *supra* note 33, at 157-62. For an argument in favor of establishing an arbitration mechanism for managing sovereign restructurings, see Kunibert Raffer, 'Debt Workout Mechanisms: Debt Arbitration' in F. Cheru and C. Bradford, Jr. (eds), *The Millennium Development Goals, Raising the Resources to Tackle World Poverty* (2005), 156-180.

borrower government.[49] Instead, many were designed to provide a legal pretext for the United States to intervene in the borrower's affairs – by force if necessary – in the event of a default.[50] But the United States and other capital-exporting countries grew increasingly unwilling to intervene so directly to protect their citizens' foreign investments. This fact goes some way towards explaining their newfound interest in legal enforcement. By encouraging creditors to rely on arbitration or litigation, these countries may have hoped to deflect pressure to intervene in more direct and costly ways.[51]

In fact, over the course of the twentieth century, the United States and other governments adopted policies designed to channel their citizens' foreign investment disputes into arbitration or litigation.[52] Some of these efforts were multilateral, such as the New York Convention on arbitration in 1959 and the 1966 creation of the International Center for the Settlement of Investment Disputes.[53] Governments also tried to facilitate litigation against foreign sovereigns in national courts. Most notably, the United States and United Kingdom abandoned the doctrine of absolute sovereign immunity in favor of the restrictive theory of immunity. As a result of this change, national courts gained limited power to hear lawsuits and enforce judgments against foreign sovereigns. In the United States, the shift to the restrictive theory of immunity began in 1952, when the Department of State announced that, as a matter of Department policy, foreign sovereigns would no longer enjoy absolute immunity from suit in US courts.[54] Later in the century, both the United Kingdom (1978) and United States (1976) formally adopted the restrictive theory of immunity by statute.[55]

For present purposes, several aspects of this (truncated) history are noteworthy.[56] First, governments actively promoted arbitration and litigation as methods of resolving disputes between private parties and sovereign entities. Second, they did so in part to insulate themselves from pressure to intervene more directly in these disputes. Third, although debates at the time were not focused on sovereign loans, government officials were aware that sovereign lending disputes might be resolved through litigation or

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[49] W. Mark C. Weidemaier, 'Contracting for State Intervention: The Origins of Sovereign Debt Arbitration', 73 *Law and Contemporary Problems* (2010), 335.

[50] Weidemaier, *supra* note 49, at 347-50.

[51] Weidemaier, *supra* note 49, at 350; Waibel, *supra* note 33, at 163.

[52] For a version of this argument, see W. Mark C. Weidemaier, 'Changing the Law to Change Contracts' (2012) (unpublished manuscript on file with author).

[53] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 3; Convention for the Settlement of Investment Disputes Between States and Nationals of Other States, Art. 55 (Oct. 14, 1966). Neither convention purports to address all of the issues that arise in the context of legal enforcement against sovereign states, and indeed the New York Convention does not address the subject of sovereign immunity.

[54] See Tate Letter, 26 *Department of State Bulletin* (1952), 984.

[55] *See* Foreign Sovereign Immunities Act, 28 U.S.C. § 1602 *et seq.*; State Immunity Act, 1978, c. 33 (U.K.).

[56] For an extensive treatment of these developments and their impact on loan contracts, see Weidemaier, *supra* note 52.

arbitration and viewed that as a positive development.[57] In this sense, these government policies were a natural extension of the efforts made by the Committee for the Study of International Loan Contracts. In each case, government officials and international actors acted on the belief that participants in the sovereign debt markets would embrace an adjudicatory process that could provide decisions with 'legal and moral force.'

B. *Again, Contracts Do Not Respond*

As with CACs, however, market participants seemingly viewed these new innovations with indifference. It is true that sovereign loan contracts occasionally have included arbitration and other dispute resolution clauses.[58] But it is easy to overstate the frequency with which these clauses appeared, at least in bonds issued in New York and London. Until relatively late in the twentieth-century, in fact, most sovereign bonds issued in these markets ignored the subject of dispute resolution altogether.[59]

Focusing on each decade from 1930 to the present, Figure 2 shows the total number of bond contracts in the dataset, the number that included waivers of the issuer's immunity from suit in foreign courts, and the number that included arbitration clauses. As the figure indicates, arbitration clauses have never been common, and clauses submitting to the jurisdiction of foreign courts did not appear with any frequency until the 1970s, when both the United States and United Kingdom embraced the restrictive theory of sovereign immunity by statute. (Recall that the United States had embraced the restrictive theory as a matter of policy by 1952.)

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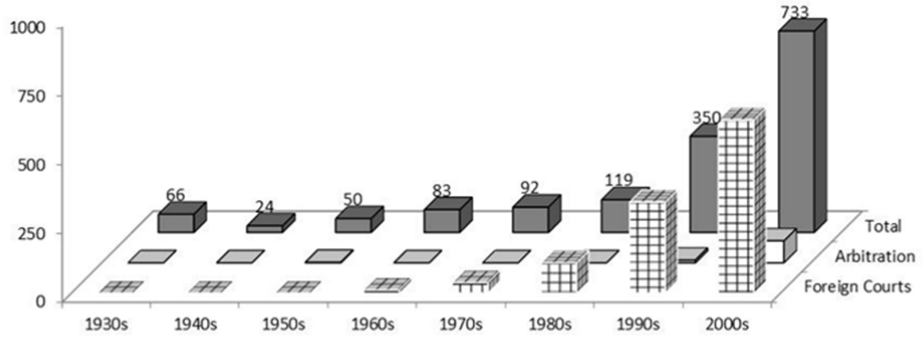
[57] For example, the State Immunity Act permits lawsuits against foreign sovereigns arising out of their commercial activities and includes in its definition of commercial activity 'any loan or transaction for the provision of finance.' State Immunity Act, 1978, c. 33, § 3(3). And while early drafts of the Foreign Sovereign Immunities Act proposed to retain immunity in cases arising out of a foreign sovereign's 'public debt,' this was controversial and these provisions were removed. Explaining the decision to remove them, the relevant report of the House of Representatives flatly states that sovereign loans 'are activities which are of a commercial nature … [and] would not otherwise give rise to immunity.' House Report (Judiciary Committee) No. 94-1487, 1976 U.S.C.C.A.N. 6604, 6609. The Report also states the authors' belief that loan contracts would immediately adopt contract terms waiving the borrower's immunity from suit. *Ibid.*

[58] *See* Waibel, *supra* note 33, at 160-68.

[59] Moreover, some early arbitration clauses were limited to disputes between the underwriting banks and the issuing government; bondholders themselves could not invoke the clause.

Figure 2. Dispute Resolution Clauses, 1930-present



It is not surprising that arbitration clauses rarely appear in sovereign bonds. Cross-border commercial loans, for example, rarely include arbitration clauses, a fact sometimes attributed to lenders' fear that arbitrators will not rigorously enforce loan obligations.[60] When modern sovereign bonds do include arbitration clauses, it is often because there is some reason to doubt the enforceability of foreign court judgments in the borrower's domestic courts.[61] Figure 2 is perhaps most noteworthy, then, for what it reveals about pre-1970s efforts to encourage sovereign bond contracts to include dispute resolution terms: They did not work.

In a private loan, the possibility of legal enforcement helps assure the lender of repayment. Because sovereigns have traditionally been immune from suit and even now enjoy a variety of practical immunities, legal enforcement plays a much lesser role.[62] Nevertheless, sovereign bonds evolved in the late-1970s to include terms designed to facilitate litigation in national courts. How and why this evolution came to pass is discussed extensively elsewhere.[63] For present purposes, two aspects of the evolution are noteworthy. First, despite efforts to promote the use of arbitration clauses in sovereign bonds, and despite efforts to facilitate litigation against foreign sovereigns in national courts, very few bonds addressed the subject of dispute resolution until after major enforcement jurisdictions *codified* the restrictive theory of sovereign immunity.[64] The report issued by the Committee for the Study of International Loan Contracts; the adoption of the New York and ICSID Conventions promoting international arbitration; the 1952 adoption in the United States of the restrictive theory of sovereign immunity as

[60] *See* W. Mark C. Weidemaier, 'Disputing Boilerplate', 82 *Temple Law Review* (2009), 1, 14.

[61] *See* Weidemaier, *supra* note 60, at 29-32.

[62] Ugo Panizza, Federico Sturzenegger & Jeromin Zettelmeyer, 'The Economics and Law of Sovereign Debt and Default', 47 *Journal of Economic Literature* (2009), 1, 2-9 & 20.

[63] See Weidemaier, *supra* note 52.

[64] Because the Figure includes only bonds issued in New York and London, the United States and United Kingdom would have been the primary (but not exclusive) sites of enforcement litigation.

a matter of policy – these developments had no discernible impact on the terms of sovereign bonds.[65]

Second, after the restrictive theory of immunity was codified in the United States and United Kingdom, bonds issued in these jurisdictions almost uniformly incorporated terms waiving the sovereign's immunity from suit in national courts. But this change did *not* correspond to a major shift in lenders' dismissive attitude towards legal enforcement. In the United States, for example, bond prices did not react to the introduction or enactment of the Foreign Sovereign Immunities Act, suggesting that investors did not believe these statutes materially improved their position in the event of a default.[66]

Twentieth-century efforts to promote the use of arbitration and litigation were premised on the belief that investors wanted legal enforcement rights, or at least would take advantage of these rights once they were granted. But for much if not all of the century, this seems not to have been true. Sovereign bonds ignored the subject of dispute resolution despite decades of encouragement. It took major statutory changes to produce change in the terms of sovereign bond contracts, and there remains little evidence to suggest that bondholders viewed their newfound enforcement rights as meaningful.

3. CACs, Reprised.

This section returns to efforts to promote the use of CACs – in particular, modification clauses allowing bondholders to amend payment-related terms without a unanimous vote. Despite the failure of early-twentieth century efforts to introduce these clauses, official-sector efforts resumed late in the century. As noted,[67] bonds governed by English law began to incorporate modification clauses in the mid-1980s, but bonds governed by New York law typically required unanimous assent to any modification. Beginning in 2003, a major shift occurred in which New York-law bonds shifted to incorporate modification clauses.

The story of this shift is widely known. As Gelpern and Gulati have documented, a prominent narrative attributes the shift to a combination of official sector pressure, the desire to preempt the introduction of a statutory sovereign bankruptcy regime, and innovation by leading market players.[68] In what follows, I accept the validity of that narrative, including its emphasis on the official sector's role in producing the change. I focus primarily on sovereign bond contracts after 2003.

The years leading up to the shift encompassed not only official-sector initiatives to promote the use of modification clauses, but also a range of efforts to promote the use of standardized CACs. These efforts went beyond modification clauses and encompassed

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[65] Some sub-sovereign issuers agreed to waive their immunity from suit and submit to the jurisdiction of foreign courts. So did Malaysia in 1965. *See* Weidemaier, *supra* note 52, at 23. But these were the rare exceptions.

[66] *See* Weidemaier, *supra* note 52, at 23-25.

[67] *See* text, *supra* page 3.

[68] *See* Gelpern and Gulati, *supra* note 11, at 1649-73; Anna Gelpern and Mitu Gulati, 'Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003', 4 *Capital Markets Law Journal* (2009), 85, 86-90.

trustee and bondholder representative clauses, acceleration clauses, and others. For example, at the behest of governments comprising the Group of Ten, a working group of bankers, finance officials, and prominent lawyers proposed model clauses to be used 'as a package' in sovereign bonds.[69] An industry trade group, the International Capital Markets Association (ICMA), also proposed model clauses.[70] These models differed, but they reflected the widespread belief that CACs should be standardized rather than 'a source of competition.'[71]

Yet bond contracts are hardly standardized in their use of CACs. After 2003, to be sure, virtually all bonds issued under New York and English law include modification clauses. Almost all bonds governed by New York law, moreover, impose the same voting threshold for modifying payment-related terms. A modification must be approved by holders of 75 percent in aggregate principal amount of the outstanding debt, and this vote need not take place at a meeting.[72] In the wake of this relatively uniform shift in New York-law bonds, however, bonds governed by English law began to adopt new voting thresholds. Before 2003, virtually all English-law bonds allowed modification upon a much lower vote – typically 18.75 percent.[73] After 2003, however, English-law bonds have adopted a much wider range of voting thresholds, as Figure 3 shows. It is as if the shift in New York destabilized the standard that had prevailed in English-law bonds, although of course the causation remains unclear.

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[69] *See* Group of Ten, *Report of the G-10 Working Group on Contractual Clauses* (2002), available at http://www.bis.org/publ/gten08.pdf.

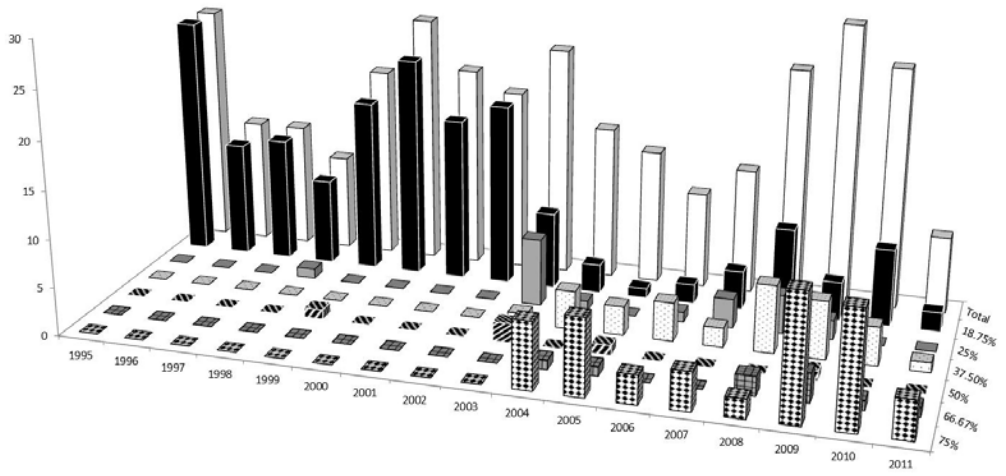
[70] *See* International Primary Market Association (now ICMA), *Standard Collective Action Clauses (CACs) for the Terms and Conditions of Sovereign Notes, English Law, Fiscal Agent Structure* (2004), available at http://www.icmagroup.org/ICMAGroup/files/3c/3cc80d90-da99-4562-8ef2-f604a8e5963e.PDF.

[71] Robert B. Gray, Chairman, International Primary Market Association, *Remarks Prepared for Delivery at UNCTAD Fourth Inter-Regional Debt Management Conference* (2003), available at http://r0.unctad.org/dmfas/pdfs/Gray_Dammers.pdf.

[72] *See* Bradley and Gulati, *supra* note 8; Weidemaier and Gulati, *supra* note 8.

[73] *See* Bradley and Gulati, *supra* note 8; Weidemaier and Gulati, *supra* note 8. This low voting threshold only applied when the vote was taken at an adjourned meeting, at which a lower quorum requirement applied.

Figure 3. Minimum vote to modify payment terms in English-law bonds



In part, the change in English-law contracting practices reflects the presence of new issuers in the market.[74] But a number of established issuers also adopted new voting thresholds.[75] Figure 3, moreover, focuses on only one source of variation: the vote required to modify payment-related bond terms. Additional variation persists in how sovereign bonds employ CACs. Recall that the term 'CAC' encompasses a variety of contract terms. These include, among others, modification clauses, aggregation clauses, trustee clauses, acceleration and reverse acceleration clauses, and clauses allowing for the appointment of a bondholder committee or representative. As a rough measure of how comprehensively sovereign bonds address collective action concerns, one can ask how *many* of these terms a given bond incorporates.

Using that measure, Figures 4 and 5 track the evolution over the past decade in bonds governed by New York and English law. As Figure 4 shows, before 2003, many bonds issued under New York law contained none of these terms ('No CAC'). Those that had CACs generally included only a restriction on the right of individual bondholders to accelerate the loan ('Acceleration Clause Only').[76] The few remaining bonds had modification clauses but did not include any other CAC ('Modification Clause Only'). After 2003, many bonds incorporated modification clauses but did not otherwise address collective action concerns. In many other cases, however, bonds addressed these concerns more comprehensively, often incorporating two, three, or even four of the CACs listed above.

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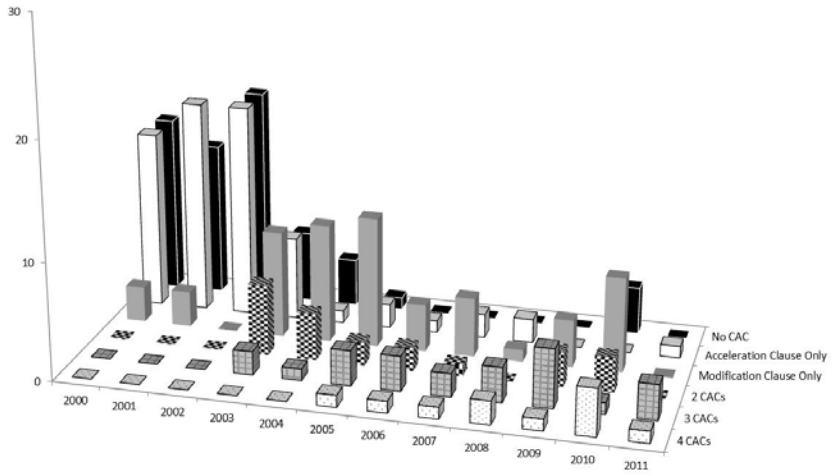
[74] *See* Gelpern and Gulati, *supra* note 68, at 92.

[75] This often was accomplished by eliminating the mandatory meeting requirement. Under the new bonds, the voting threshold must be satisfied by bondholders holding the requisite percentage of the outstanding debt, whereas the old bonds allowed modification if approved by the requisite percentage of bondholders *present or represented at a meeting*. The latter percentage is, of course, must lower, as only a subset of bondholders will attend or give proxies for a meeting. *See* Bradley and Gulati, *supra* note 8, at 17-19.

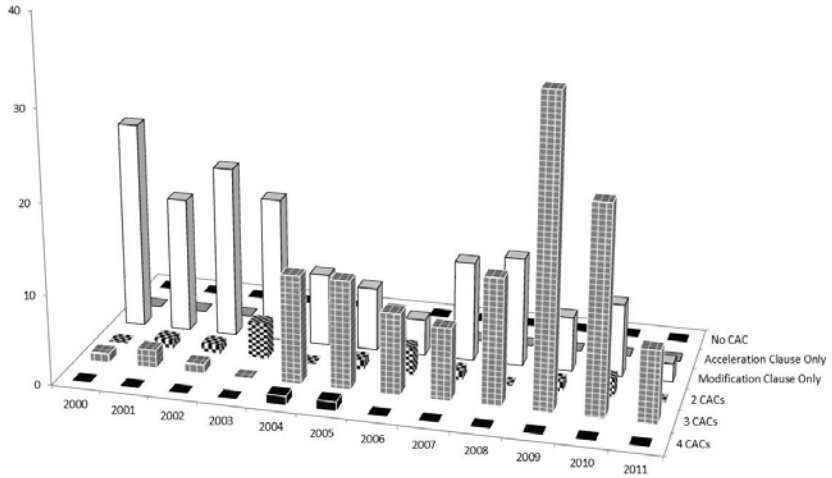
[76] The 'Acceleration Clause Only' category includes bonds with acceleration clauses as well as bonds that also include a 'reverse' acceleration clause.

Figure 4. Different types of CAC; number of New York law bonds (2000-present)



Bonds governed by English law follow a similar pattern. Before 2003, most included modification clauses (unlike bonds governed by New York law), but only a handful contained other terms designed to address bondholder collective action problems. After 2003, however, bonds often combine several of the CACs listed above.

Figure 5. Different types of CAC; number of English law bonds (2000-present)



Admittedly, Figures 4 and 5 paint with broad strokes. They show that bonds issued after 2003 often include multiple terms designed to address bondholder collective action problems. Much of the attention in the sovereign debt world has been focused on the post-2003 shift to modification clauses in bonds governed by New York law. But in fact, what took place was more significant and had ramifications outside of New York. In both markets, bonds began to more comprehensively address bondholder coordination

problems. One issuance, for example, might include a modification clause that allows for aggregation across all of the issuer's bonds, provide for a trustee, and allow for collective decisions on whether to accelerate the loan and whether to reverse a decision to accelerate. Yet contracts did not conform to any of the available standards – such as the G-10 or ICMA model clauses. Instead, drafters adopted a range of approaches. Indeed, Figures 4 and 5 understate the variance by collapsing different approaches into a single category. Thus, the '3 CACs' category includes every bond that uses *any* three of the CACs listed above. After 2003, in fact, English-law bonds have employed at least eleven different combinations of these terms, while New York-law bonds have employed at least sixteen.

It is not clear why sovereign bonds have adopted such varied approaches or whether bond prices are sensitive to all of these differences. The evidence does indicate that bond prices are sensitive to CACs, although the results sometimes point in different directions.[77] In light of this evidence, it is plausible to assume that market participants have heterogeneous preferences with respect to these clauses. Certainly there is no obvious preference for standardization. And if that is so, it is not surprising that efforts to promote standardization have not succeeded.

4. The Long-Term Impact of UNCTAD's Principles

This section returns to UNCTAD's present effort to develop principles and best practices for the sovereign debt markets. As noted at the outset, the long-term impact of the Principles will be judged in part by whether they have a significant impact on loan contracts. This is not by any means the best or only way to judge their success. The Principles also aim to shape the behavior of market participants in ways that might not be directly reflected in the terms of loan contracts. For example, if the Principles induce lenders to more seriously assess the ability of sovereign borrowers to repay (Principle 4), they will have had a profoundly positive impact.

It is clear, however, that the Principles also aim to influence contracts. Sovereign bonds vary in significant ways, but in many respects they remain standardized and resistant to change. Efforts to prompt change must therefore overcome the natural inertia that characterizes such contracts.[78] A sizeable body of contract theory suggests ways this might happen. Of particular relevance here, some theories emphasize that governments and official sector actors can play an important role in overcoming barriers

[77] Bradley and Gulati, *supra* note 8, find generally that CACs are associated with lower borrowing costs for higher-risk issuers, while earlier studies reach contrary results or find no association. Earlier studies include, among others, Barry Eichengreen and Ashoka Mody, 'Do Collective Action Clauses Raise Borrowing Costs', 114 *Economic Journal* (2004), 247-264, and Mark Gugiatti and Anthony Richards, 'Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets', 6 *International Finance* (2003), 415-447.

[78] Omri Ben-Shahar and John Pottow, 'On the Stickiness of Default Rules', 33 *Florida State University Law Review* (2006), 651.

to innovation.[79] As this paper has demonstrated, the history of sovereign lending is filled with such initiatives.[80]

This history does not yield definitive lessons. It suggests, however, that efforts to build consensus, or to provide model terms for market participants to adopt, may have only minimal impact. As examples, consider the range of initiatives to introduce new terms into sovereign bonds. The Financial Committee of the League of Nations introduced CACs into loan contracts in the 1920s – arguably legitimizing their use and providing a model for others to follow. Somewhat later in the century, the Committee for the Study of International Loan Contracts – a group comprised of esteemed lawyers and finance officials – lent its imprimatur to these clauses. The Committee also sought to encourage the use of arbitration clauses and proffered a model clause for that purpose. Its efforts were aided by a range of government efforts to promote arbitration and litigation in national courts. Yet none of these efforts had an appreciable effect on loan contracts. It took heavy-handed government pressure (in the case of CACs in New York) and formal statutory change (in the case of dispute resolution clauses) to prompt the introduction of new terms.[81] Efforts to encourage the use of standardized contract terms have also had limited impact.

What explains the limited impact of these initiatives? Without offering a full explanation, I offer several observations. First, official sector actors have sometimes misread market sentiment. The assumption underlying many contract initiatives is that market participants would prefer a different set of terms but cannot overcome barriers to innovation.[82] If true, this would offer a compelling basis for intervention. In some cases, however, market participants do not *want* the term being offered. This seems to explain investors' historic indifference to legal enforcement rights, which investors seemingly dismissed as having no material impact on the likelihood of default.[83] A similar explanation may explain resistance to CACs. Some investors may prefer terms that increase the likelihood of a taxpayer-funded bailout if the sovereign encounters financial difficulty, and CACs often are seen as bailout substitutes.[84]

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[79] *See generally* Robert B. Ahdieh, 'Between Mandate and Market: Contract Transition in the Shadow of the International Order', 53 *Emory Law Journal* (2004), 691.

[80] *See* Feibelman, *supra* note 12, at 757 (noting that 'the official sector … can play an instrumental role in prodding market participants to embrace new contractual approaches').

[81] I do not mean to imply that government pressure is required before sovereign bonds will introduce new terms. As just one example, English-law bonds began to incorporate modification clauses in the mid-1980s. *See* Weidemaier and Gulati, *supra* note 8, at 16-21. The point, rather, is that official sector efforts to introduce new terms are often unsuccessful.

[82] They have been abetted in this assumption by a body of contract theory emphasizing the stickiness of standardized terms. For a discussion of relevant theories, see Ben-Shahar and Pottow, *supra* note 78. For discussion in the context of sovereign bonds specifically, see Ahdieh, *supra* note 79.

[83] See the discussion on pages 12-13.

[84] Many observers, of course, believe that CACs are inadequate to solve the problems associated with sovereign default. *See, e.g.,* Patrick Bolton and David Skeel, 'Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?' 53 *Emory Law Journal* (2004), 763; Schwarcz, *supra* note 6.

I am not suggesting that official sector actors should refrain from attempting to influence bond contracts. As the CAC example suggests, investors may prefer a world of bailouts to a world where investors bear the cost of improvident loans.[85] There is no reason why official sector actors should respect that preference. The point, rather, is that encouragement, suasion, and other noncoercive methods often will fail to dislodge entrenched contracting practices. To put it starkly, we should not be surprised when market participants do not eagerly embrace model clauses that achieve unwanted results. In such cases, change must be mandated – a fact that Eurozone leaders appear to recognize in their stated plan to mandate the use of standardized CACs.[86]

The second observation relates to efforts to standardize bond contracts. Many debates in the sovereign debt world begin with the assumption that sovereign bonds are standardized in all material ways.[87] The assumption is valid to a degree, but if accepted uncritically it obscures the fact that bond contracts also vary in significant ways.[88] Despite a professed aversion to 'competition' in bond terms,[89] investors seem to have heterogeneous preferences. As a result, efforts to promote standardization – such as the introduction of model contract terms – may have limited impact.

Third, contract change – when it occurs – often follows some disruptive event. In many cases, the event is a financial crisis. For example, Choi, Gulati, and Posner document the introduction of new terms into sovereign bonds in the wake of financial crises from the 1980s to the present.[90] In other cases, the event may be the passage of a law making a particular contract term salient – as appears to have been the case with the passage of statutes adopting the restrictive theory of sovereign immunity in the United Kingdom and United States.[91] After enactment in each jurisdiction, bonds quickly incorporated waivers of sovereign immunity, even though these clauses arguably did little to improve enforcement prospects.[92]

More broadly, contract change itself may be a disruptive event, one that begets more contract change. When contracts are standardized, parties who wish to depart from the standard may fear that they will send an unwanted signal if they bargain for their preferred term.[93] Before 2003, for example, an issuer who was considering adopting a non-standard CAC might have worried that investors would conclude that it posed an increased risk of default. After all, why else would it modify a term whose primary function is to facilitate a restructuring? By the end of 2003, however, contracts were in

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[85] Bolton and Skeel, *supra* note 18, at 765.

[86] Statement by the Eurogroup, *supra* note 4.

[87] Examples include, among others, Jill Fisch and Caroline Gentile, 'Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring', 53 *Emory Law Journal* (2004), 1043, 1111; Robert Ahdieh, 'The Role of Groups in Norm Transformation: A Dramatic Sketch, in Three Parts', 6 *Chicago Journal of International Law*, 231, 231.

[88] *See supra* pages 14-17.

[89] Gray, *supra* note 71.

[90] Stephen Choi, Mitu Gulati, and Eric Posner, 'Political Risk and Sovereign Debt Contracts' (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1962788.

[91] Weidemaier, *supra* note 52.

[92] Weidemaier, *supra* note 52.

[93] *See* Ben-Shahar and Pottow, *supra* note 78, at 657-59.

flux in one major market – New York – and this may have reduced the barriers to innovation in other markets. The post-2003 variation in English-law CACs is consistent with this explanation. The introduction of modification clauses in New York was a significant and disruptive event, and it was quickly followed by innovation in the English-law market.

These observations suggest that the Principles may have only a limited impact on bond contracts unless they receive substantial support from the official sector. If the goal is to directly influence contracts, it will first be necessary to identify the concrete implications of the Principles' general, normative language. Even if a consensus on this difficult question is reached, experience with past initiatives teaches that bond contracts will not adjust automatically and that methods of 'soft' persuasion – such as promulgating model clauses – will have little effect. To the contrary, change may require fairly assertive, official-sector intervention. Such an intervention, moreover, might have the effect of provoking other changes in bond contracts. As it turns out, the relatively near future may offer a test of this prediction. Eurozone officials plan to mandate the use of standardized CACs – perhaps in the belief that other markets will follow. If the post-2003 experience with CACs is any guide, however, it is also possible that this intervention will prompt experimentation in other markets.

Of course, the Principles may have a significant impact even if they do not directly influence bond terms. Their primary aspiration is less concrete, if no less important: to 'identif[y], harmoniz[e], and systematiz[e] the basic principles and best practices applied to sovereign lending and borrowing,' with the ultimate goal of preventing 'undisciplined, ineffective, abusive or non-cooperative behavior' by borrowers and creditors alike.[94] This aspiration can be pursued without altering the language of bond contracts. Principle 7, for example, reflects deep skepticism about investors who buy a distressed sovereign's debt for the purposes of demanding preferential payment terms. Such a creditor, the 'Implications' section declares, is 'acting abusively.'[95]

Holdout litigation may take place before many different courts and tribunals – including national courts, international tribunals, and ad hoc arbitration panels. Although the doctrinal questions may differ, each of these tribunals may confront arguments that creditors are behaving abusively in the context of a sovereign debt restructuring. For example, although most so-called vulture funds have reportedly avoided buying Greek bonds,[96] certain aspects of potential Greek restructuring plans could prompt litigation before the European Court of Human Rights, before national courts in creditor countries, and before arbitration tribunals (assuming there are arbitration clauses in Greece's bilateral investment treaties).[97] In particular, a decision by Greece to

[94] UNCTAD, 'Preamble: Second Draft Principles on Promoting Responsible Sovereign Lending and Borrowing' (2011).

[95] UNCTAD, 'Second Draft Principles on Promoting Responsible Sovereign Lending and Borrowing' (2011), at 8.

[96] *See* Financial Times, 'Hedge Funds Give Greek Bonds Wide Berth', January 24, 2012.

[97] *See* New York Times, 'Hedge Funds May Sue Greece if it Tries to Force Losses', January 18, 2012 (noting possibility of suit before European Court of Human Rights).

retroactively impose collective action clauses on its local law contracts could prompt legal challenge.[98]

By itself, the assertion that holdout creditors who demand preferential payment terms are 'acting abusively' cannot resolve these disputes. But if the Principles succeed in garnering widespread support, they may prove influential in less direct ways. For instance, governments who accept this view of creditor behavior may wield significant influence over national courts, causing them to view some creditor claims with skepticism. As an example, an amicus brief filed in 2004 on behalf of the US government is widely credited with reducing the perceived risk associated with holdout litigation.[99] (The risk had been caused by fear that US courts would adopt a Belgian court's unexpected interpretation of a commonly-used contract term, the *pari passu* clause). One can imagine the principles having a similar, indirect impact on any litigation arising out of a Greek restructuring. If that were to happen, the Principles would have succeeded in rewarding restructuring negotiations conducted 'in good faith and with cooperative spirit,' even if they do not succeed in changing the terms of bond contracts.

[98] *See* Lee Buchheit and Mitu Gulati, 'How to Restructure Greek Debt' (2010), at 10-13, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304. For an analysis of the issues involved in such a restructuring, see Melissa Boudreau, 'Restructuring Sovereign Debt Under Local Law: Are Retrofit Collective Action Clauses Expropriatory?' (2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1979238.

[99] *See* Michael Bradley, James Cox, and Mitu Gulati, 'The Market Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market', 39 *Journal of Legal Studies* (2010), 289.