

# **Sovereign debt restructuring: the Judge, the vultures and the future of creditor rights\***

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## **Abstract**

What role did the US courts play in the Argentine debt swap of 2005? What implications does this have for the future of creditor rights in sovereign bond markets? The judge in the Argentine case has, it appears, deftly exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement – to promote a swap with a supermajority of creditors. In the period leading to the swap, our analysis of Argentine debt litigation reveals a ‘judge-mediated’ sovereign debt restructuring which resolves the key issues of Transition and Aggregation – two of the tasks envisaged for the IMF’s still-born sovereign debt restructuring mechanism.

For the future, we discuss how judge-mediated debt restructuring complements the use of collective action clauses; and also how creditor committees (and codes of conduct) can help promote good faith bargaining.

**Keywords:** Sovereign debt crises, debt restructuring, holdout creditors, collective action clauses

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## Introduction

The progressive switch from bank loans to sovereign bonds in lending to emerging markets – and the Brady Plan in particular – triggered a lively debate on bond restructuring and the potential obstacles posed by ‘holdout creditors’<sup>1</sup>. The IMF proposal for a new Sovereign Debt Restructuring Mechanism (Krueger, 2003) to tackle the issue found little favour with creditors or debtors, and this left the US Treasury-backed initiative for putting Collective Action Clauses (CACs) into sovereign bond contracts as the preferred alternative.<sup>2</sup>

Nonetheless, when in 2005 Argentina successfully restructured the majority of its defaulted foreign debt, this was neither mediated by the IMF, nor assisted by clauses to promote creditor coordination. It was effected by a take-it-or-leave-it offer from the debtor, accepted by a supermajority of bondholders despite the substantial ‘haircut’ involved.<sup>3</sup> It is our contention that in the period leading to the swap, the US courts played a major role in promoting the swap by engaging the debtor and aggregating the claims of diverse creditors.. In this paper we give an account of how the process of judge-mediated debt restructuring has operated in this case; and we speculate on future developments.

To some observers, the size of the write-down involved in the Argentine case suggests that “rogue debtors, rather than rogue creditors, are the ones that pose the greatest threat to the integrity and efficiency of the international financial architecture,” Porzecanski (2005, p.331). Despite the waiving of sovereign immunity, it is argued, “the fact remains that it is exceedingly difficult to collect from a sovereign deadbeat [and] the sad truth is that only other governments...can hope to rein in a wayward sovereign debtor and persuade it not to walk away from its lawful obligations.”

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<sup>1</sup> These include vulture funds who buy distressed debt in default and sue for payment in full, Fisch and Gentile (2004).

<sup>2</sup> By 2004, close to 90% of the new international bond issues had CAC’s; and the figure approached close to 100% in the first half of 2005. Helleiner (2006) Mimeo

<sup>3</sup> Creditors who enter the swap suffered a loss of about two thirds in the face value of their bonds; those who did not have, so far, received nothing from Argentina in more than a year after the swap.

Others take a more optimistic view: for Sturzenegger and Zettelmeyer (2005c, p.10) the Argentine swap was “in most dimensions a textbook example of how to do an exchange”. In reviewing recent litigation in international debt markets, however, they found no evidence that sanctions on trade and payments have been imposed in an effective way. Recent developments, they argue, provide support for the assumption made in the seminal paper by Eaton and Gersovitz (1981): that while “creditors cannot impose any sanction on defaulting countries, they can hinder its access to international capital markets”, Sturzenegger and Zettelmeyer (2005b, pp.7, 51).

Careful examination of the Argentine debt swap of 2005 leads us to qualify both views. While Porzecanski concludes that the courts are irrelevant, we note that the judge appears to have exploited creditor heterogeneity – between holdouts seeking capital gains and institutional investors wanting a settlement, in particular – to achieve a swap. Likewise, the simple dichotomy between sanctions and reputation proposed by Sturzenegger and Zettelmeyer (as the only mechanisms to ensure a successful swap) misses a key factor: namely judicial activism. In the context of holdout litigation, an activist judge is one who deals with the issues before him as part of an on-going restructuring process and not as isolated suits by a series of holdout creditors.<sup>4</sup>

In terms of their effectiveness, our analysis of the opinions and orders of Judge Griesa’s court draws a clear distinction between pre- and post-swap phases of judge-mediated debt restructuring. First, in the pre-swap phase, comes the *engagement of the debtor*: the Judge finds in favour of holdouts this encourages the debtor to make an offer. Second is *promoting the swap*: he alternatively refuses *and* threatens attachment long enough to promote a successful debt swap. Once the swap has been accepted by a supermajority, it is time for the courts to threaten the debtor with attachment (effectively denying it access to primary capital markets). Thus the continuing threat of attachment gives the debtor an incentive to settle outstanding creditor claims. At the same time, the judge has expressed his readiness to resolve disagreements between some holdouts, retail investors for example and the debtor, thereby facilitating the settlement of outstanding claims. Currently, the last two aspects of judge-mediated debt

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<sup>4</sup> We thank Anna Gelpert for her insight into contemporary assumptions about the judicial process in the context of sovereign debt.

restructuring prevail simultaneously. The post-swap phase has so far proved unsuccessful in the face of the intransigent stance taken by the debtor.

In their discussion of sovereign debt restructuring, Fisch and Gentile (2004) emphasise the role of holdout litigation in the enforcement of sovereign obligations. We too see creditor litigation continuing to be important: but only in the period of transition to CACs do we consider that vultures play a pivotal role. In a future where CACs are widespread, it may well be litigation by an *ex ante* Creditor Committees that triggers the debtor to come up with an offer with CACs cramming down potential holdouts. In the event that there is judge-mediated debt restructuring in the future,<sup>5</sup> the Argentine experience may well dissuade creditors from holding out.<sup>6</sup> (This is the case even when it is relatively easy for a large creditor to buy a majority stake in a single bond to block other creditors from restructuring the bond.<sup>7</sup>)

The paper is organised as follows: section 1 briefly reviews the literature on why sovereigns pay and indicates where our analysis fits in. In the next section we outline the salient features of the Argentine case (with a bargaining interpretation of the swap in an Appendix). The next two sections, 3 and 4, analyse the opinions and decisions of the New York courts: encouraging the debtor to make the first offer (in Dubai, September 2003); promoting the ensuing debt restructuring process (from Dubai to the final offer in March 2005); and acting to help resolve the holdout problem. Section 5 indicates how the widespread adoption of CACs will reduce the role of vultures in future and sketches the role that courts and creditor committees will play. The last section concludes.

## **1. Why do sovereigns pay?**

How does the analysis in this paper relate to the existing literature on the incentives for sovereigns to repay debt? What role have these incentives played in the Argentine case? The academic literature has stressed the role of ‘direct’ sanctions, ‘policy conditionality’ and ‘reputational’ sanctions imposed by creditors, as indicated in Table 1, lines 1 to 3a.

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<sup>5</sup> To solve the aggregation problem, for example.

<sup>6</sup> In the absence of creditor coordination, in contrast with traditional holdout litigation, there is still the possibility that class action suits allow for judicial intervention to engage the debtor and aggregate the votes of recalcitrant creditors.

<sup>7</sup> This was the strategy unsuccessfully adopted by the Darts against Argentina. (Roubini and Setser 2004b)

But such mechanisms played a minor role in the Argentine case: they were “the dogs that did not bark”, to make an analogy with Arthur Conan Doyle’s *The Hound of the Baskervilles*. Before outlining the role of the courts in helping to achieve the swap (see line 3(b) of the table), we discuss in more detail the failure of the other mechanisms.

**Table 1. Why do sovereigns honour their debts?**

	Loss of	Comment	Agent/ Institution	Mechanism	The case of Argentina
<b>1. Sanctions</b>	Exports	Transfer to creditors	‘Gunboat’(1)		Illegal under WTO
	Output	Transfer to creditors	‘Gunboat’(2)		Illegal under international law
		Deadweight loss	Crisis(3),	Creditor panic	Yes ( including anticipatory crisis (4))
	Trade credit		Banks(5)	Deny rollovers to business	Yes, short term
	Collateral Assets	Transfer to creditors	Court as enforcer(6)	Attachment	Unsuccessful
<b>2. Policy Conditionality</b>	Sovereignty over policy	Explicit	IMF as enforcer(7)	Program conditions	Yes, but IMF repaid in Dec 2005
	International Goodwill	Implicit	Hegemon, G7(8)		
<b>3. Market access</b>  (a) denied by banks  (b) denied by courts	Reputation with leading banks		“Anarchy”(9)	“Cheat the cheater”	Not evident from sovereign spreads
	Access to primary capital markets		Court as gatekeeper(10)	Threat of attachment pending	A cautionary tale for holdouts in the future

*Notes to Table*

1. Esteves (2005)

2. Bulow and Rogoff (1989)

3. Dooley (2000), Gai et al. (2004), Irwin et al. (2006), Jeanne and Ranciere (2005)

4. Levy-Yeyati and Panizza (2005)

5. Kohlscheen and O’Connell (2003)

6. *E.M.LTD v. The Republic of Argentina* (12 Sept 2003)

7. Sgard (2004)

8. Kaletsky (1985), Aggarwal(1998a,b)

9. Eaton and Gersovitz (1981), Kletzer and Wright (2002)

**Sanctions**

The use of direct military threats to enforce debt contracts may have been relevant in the nineteenth century when ‘gunboat diplomacy’ was common, but not now: WTO rules

prohibit trade intervention for purposes of debt collection, and seizures not authorised by a court are, by definition, illegal. But as capital markets have become increasingly globalised, the waiving of sovereign immunity – often required as a precondition for issuing debt in London or New York – has allowed for the *attachment of collateral assets* under court procedures: specialist vulture funds have developed litigation strategies to exploit these possibilities. In the case of Argentina, however, efforts by holdout creditors to attach assets post-swap, have so far failed to protect their rights as indicated in column 5 of Table 1. (But as indicated in the last column of the table, this aspect of Argentine litigation may prove to be a cautionary tale for holdouts in the future.)

Another feature of modern capital markets is the ease with which creditors can exit; so sovereign debtors are exposed to creditor panic with associated financial and exchange rate crises, Ghosal and Miller (2002). Reducing or avoiding the *output losses* that can be triggered by capital flight is now regarded as a strong incentive for sovereigns to honour their debts, at least *ex ante* as the references in note (2) to the Table make clear.<sup>8</sup> In the Argentine case, severe output losses have of course occurred but – since default was widely anticipated – they ensued well before default: and, while the debt was being restructured, recovery got well under way. (A sanction that may have played a role in this case is the *denial of trade credit*, a device commonly used to put pressure on defaulting sovereigns, Kohlscheen and O’Connell, 2003).

### **Policy conditionality**

Since the IMF policy of ‘lending into arrears’ initiated during the Latin American debt crises of the 1980s, the Fund has had to insist on explicit *policy conditionality* to avoid undermining debtors incentives to repay. Signing the Letter of Intent that embodies such conditions is a precondition for obtaining IMF programme assistance. In the cases of Korea in 1997 and Brazil in 2002, indeed, prospective presidents were persuaded to endorse targets for fiscal prudence before elections took place, an illustration of the loss of sovereignty mentioned in the Table. Conditions for rolling over IMF lending to

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<sup>8</sup> As with bank-runs there is a risk of self-fulfilling crisis occurring: schemes to reduce this risk include Cohen and Portes (2004) and Cordella and Levy-Yeyati (2005).

Argentina after default did include the requirement that steps be taken to settle with holdout creditors: but, for the IMF, Argentina was effectively “too big to fail”; and in any case it freed itself from any such policy conditionality by early repayment of all its borrowing in 2006. Kaletsky (1985) stresses the role of international pressure from G7, but this does not seem to have played a decisive role in the Argentine case. (Aggarwal (1998a,b) stresses the hegemonic interests of the US as a critical factor in successful debt swaps : could this play a role in resolving the present stand-off with holdouts?)

### **Market access**

An alternative incentive to repay debts would be fear of losing *reputation*, with consequent widening of the bonds spread from normal junk bond levels<sup>9</sup> to what might be described as rogue-debt levels. Despite Porzecanski’s characterisation, this does not appear to be the case for Argentina – where spreads are close to those of Brazil. Kletzer and Wright (2000) analyse a self-enforcing mechanism – ‘cheat the cheater’ – that could sustain equilibrium in debt markets with a limited number of creditors, see Table 1, line 3a.<sup>10</sup> Their analysis, however, is explicitly related to bank lending as in the original Eaton and Gersovitz (1981) paper: how, if at all, it might be extended to a world of anonymous bondholders is unclear.

The argument of this paper is that in the period leading up to the swap, *the courts* have played a key role in the Argentine case: initially by threatening the debtor with attachments to prompt a credible offer, and reining in the holdouts to promote the swap. After the successful swap, the threat of attachment has effectively denied the debtor access to primary capital markets, namely London and New York.<sup>11</sup> As indicated in line 3(b) of Table 1, denial of access to these markets is one way of pressuring a defaulting debtor to settle pending claims against it. By undertaking to resolve disagreements between the debtor and holdouts, the court also provides a mechanism to ensure successful settlements. It appears that the effectiveness of judicial intervention is limited to the period preceding the swap however, litigation in the post-swap phase has so far

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<sup>9</sup> As it is prone to restructuring, corporate debt in the US is often referred to as junk bonds.

<sup>10</sup> It should be noted, however, that not only Venezuela but also New York banks are happily lending into serious arrears by Argentina : is this consistent with the Kletzer/ Wright equilibrium?

<sup>11</sup> In case of Argentina, it appears that creditors are willing to take a chance and continue lending under Argentine domestic law.

proved ineffective in that the debtor repeatedly asserts that the matter is closed (denying the holdouts any possible restitution).

We conclude that whatever pressure there is on Argentina to finalise the swap it is not coming from self-enforcing reputation mechanisms which operate in an institutional vacuum as suggested by Kletzer and Wright. Court denial of access to New York for the issue of new bonds may not impose immediate hardship on the country or its finances: but it is surely not credible that a middle-income country like Argentina will wish forever to be excluded from the leading capital markets of the world.

## 2. Key aspects of the Argentine debt restructuring

The Argentine case is notable for being the largest-ever sovereign debt default and for being conducted without decisive intervention by international institutions. Before providing our account of role of the US courts in this case, four salient features of the Argentine swap may be discussed with the aid of Table 2: namely, the heterogeneity of creditors groups, the absence of creditor coordination, the size of the write down, and the long delay before it was accepted.

**Table 2. Comparison of Recent Sovereign Debt Restructurings**  
(Porzecanski, 2005)

	ARGENTINA 2005	ECUADOR 2000	PAKISTAN 1999	RUSSIA 1998-2000	UKRAINE 1998-2000	URUGUAY 2003
Per Capita Income (\$)*	11,586	3,363	1,826	6,592	3,841	8,280
Scope (\$ Billions)	81.8	6.8	0.6	31.8	3.3	5.4
Number of Bonds	152	5	3	3	5	65
Jurisdictions Involved	8	2	1	1	3	6
Months in Default	38+	10	2	18	3	9
Principal Forgiveness	Yes	Yes	No	Yes	No	No
'Haircut' in Discount Bond (%)	66.3	40	0	37.5	0	0
Participation Rate (% of Eligible)	76	97	95	98	95	93

*Note: N/A stands for not applicable*

*\* Adjusted for purchasing power, latest (2003) data for Argentina, otherwise data corresponds to year(s) of debt restructuring as noted.*

*Source: IIF IMF, World Bank, A. C. Porzecanski's calculations.*

### **(i) Pronounced creditor heterogeneity**

Argentine debt in default contained a significantly higher number of bond issues than all the other cases listed in the table: it involved many thousands of creditors in eight different legal jurisdictions. The sheer numbers posed a major obstacle to effecting a swap. Perhaps more significant, however, were the conflicting incentives affecting different groups.

As Fisch and Gentile (2004, p.26) note ‘[o]nly certain *large institutional investors*, particularly commercial banks and investment banks have ongoing relationships with the sovereign debtors... [this] may drive these institutional investors to support restructuring plans that are unlikely to be acceptable to smaller investors, notably *retail investors*, who do not expect to gain from future transactions...’ In addition, there are a specialised class of *holdout litigants* popularly known as ‘vulture funds’ who purchase distressed debt at substantial discounts and seek capital gains either through the restructuring process or by holding out and seeking additional payments from the debtors. (The 24% creditors still holding defaulted Argentine bonds include both vultures and retail investors, with vultures holding 1-2% of the outstanding debt.)

### **(ii) Absence of creditor co-ordination**

Due in part to the aggressive negotiating stance taken by the sovereign, Argentina’s creditors participated in the swap in the absence of either formal or informal creditor organisations. One exception was the short-lived Global Committee of Argentine Bondholders (GCAB). The GCAB was set up in 2003 to pool negotiating leverage and demand a better deal claiming to represent US, European and Japanese creditors holding about \$40 billion. But at the time of the swap, the GCAB had lost most of its institutional constituents and a majority tendered in the exchange. This attempt at creditor organisation failed as each seemed to act in their own self-interest and took the opportunity to cut their losses and make short-term gains, Gelpern (2005).

### **(iii) Significant debt write-down**

On a total outstanding principal of \$81.8 billion, the Argentine swap involved a 66.3% ‘haircut’ (column 1). This is considerably larger than the other haircuts shown, namely 40% for Ecuador and 37.5% for Russia: whether it is consistent with bargaining theory we consider in the Appendix. The 76% participation rate in the swap is by far the lowest shown and implies that Argentina is still in default with 24% of its creditors by value.

### **(iv) Long Delay**

It took over three years for Argentina to restructure its debt – more than twice as long as it took Russia for example. In part, the reasons were political, as the interim administration of President Duhalde had no mandate to negotiate a swap. Economic reasons for delay are also analysed in the Appendix.

## **3. Judge-mediated debt restructuring: from default to swap**

### **Historical precedents**

In 1976, the US (and, soon after, the UK) imposed statutory constraints on absolute sovereign immunity from suit in foreign courts, Buchheit (1995). In the two decades that followed, creditors developed innovative litigation strategies to maximise the benefits of restricted sovereign immunity. In the absence of statutory regulation of sovereign debt, however, the litigation strategies have had mixed results - with common law decisions influenced by the political and economic conditions in which the litigations were pursued.

Even in the absence of enforcement, restricted sovereign immunity has significantly improved the leverage of creditors in the restructuring process. In the case *Elliot & Associates v. Banco de La Nación* (Perú) decided in 1999, for example, the claimants were vulture funds who threatened the debtor with enforcement and consequent delay of the imminent swap: the debtor settled their claims out of court to avoid this outcome. Similarly, in the case *Elliot & Associates v. Panamá* decided in 1997, the threat of

enforcement would have interfered with a new bond issue and consequently impaired Panama's ability to access capital markets. Again, the case was settled out of court, in favour of the vultures.

Moreover, in the case *Pravin Banker v. Banco Popular del Perú* decided in 1997, the court went as far as to lay down the guidelines that they would follow in sovereign litigation. The first guideline was to encourage orderly debt restructuring initiatives that involved the use of Brady bonds. The second guideline was to ensure the enforcement of contracts executed between American investors and sovereign debtors. In line with U.S. foreign policy at the time, in most cases the second guideline dominates the first: thus in a situation where ongoing debt- restructuring negotiations were at the cost of the claims of U.S. creditors, the courts were bound to concede to the latter.

### **The court's role in the Argentine swap**

Our examination of the Argentine debt litigation reveals an unexplored aspect in the literature on sovereign debt: judicial activism. Such activism is made possible firstly because of the absence of statutory regulation of sovereign debt, and secondly because New York courts are not so closely bound by the doctrine of precedent as is the case in the UK, for example.<sup>12</sup> We argue that the courts have been instrumental in promoting the swap because the judge has dealt with the issues before him as part of an on-going restructuring process and not as isolated suits by a series of aggrieved creditors.<sup>13</sup> In an unprecedented move, the judge has also registered class action suits. The changed judicial role and the possibility of aggregating creditors through class action suits taken together minimises the disruptive potential of holdout litigation.

The Argentine swap was successfully concluded against the backdrop of over 200 law suits – (including 15 class action suits) filed in New York, Italy and Germany: and in Table 3 we summarise the actions taken by Judge Griesa to promote restructuring.

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<sup>12</sup> Judicial activism, (i.e departures from precedent) has been well documented in comparative examinations of common law traditions (especially in contract law) adopted by courts in the UK, and the US, Whitford (2003), Jaffe (1969). A comparative examination of the common law traditions in the context of sovereign debt litigation is a topic deserving further investigation.

<sup>13</sup> We thank Anna Gelpern for her insight into contemporary assumptions about the judicial process in the context of sovereign debt.

**Table 3. Judge Griesa’s Actions to Promote Restructuring**

<b>Event</b>	<b>In favour of holdout creditors</b>	<b>In favour of restructuring</b>
Rush to court house	Summary judgements in favour of creditors	Stays execution
Class action to coordinate creditors	Accepts in principle	<ul style="list-style-type: none"> <li>• encourages tighter definition of a ‘class’</li> <li>• keeps <i>pari passu</i> pending</li> </ul>
Grab race: for old bonds	Orders creditor attachment (of Argentina’s right to receive old bonds)	Order to attach overturned in view of its negative impact on the ongoing swap
Grab race: for new issues	Maintains the threat of enforcement	

Column one describes the events, while columns two and three distinguish court orders on the basis of whether Judge Griesa favours the holdout creditors or promotes the restructuring. In the first instance (row one), the creditors who “rush to court” on the election of President Kirchner, successfully obtain summary judgements: Judge Griesa has no option but to allow such claims [e.g. *E.M.LTD v. The Republic of Argentina* (12 Sept. 2003)] (column two). This is only part of the story, however, as successful claimants have to enforce their judgements against the debtor by attaching its assets. This is where Judge Griesa exercises his discretion, dismissing pleas to attach specific assets of the debtor (final column).

In addition in 2003, relatively early on in the debt restructuring process, the creditors seek to certify class action suits (row two). Judge Griesa accepts certain claims encouraging creditor coordination [*H.W.Urban GMBh v. Republic of Argentina* (30 Dec. 2003)] (column two). However, in his orders rejecting some class action suits, [e.g. *Alan Applestein TTEE v. The Republic of Argentina* (May 12, 2003)], he encourages tighter definition of class: he also keeps *pari passu* pending<sup>14</sup> (column three).

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<sup>14</sup> With the US administration supporting Argentina’s reading of the clause, see Miller and Thomas (2006, Appendix).

In the context of the class action suits, Judge Griesa's observations (*obiter dicta*) are instructive. At one point, he observes that

an important channel for attempting to resolve the Argentine debt problem will undoubtedly be the effort to negotiate a debt restructuring plan.' He continues: 'judging from past national debt crises, these negotiations will be carried on largely, if not entirely by debt holders who do not choose to engage in litigation. To the extent that the other debt holders whether few or many wish to pursue litigation, the litigation should be well defined and its participants should be reasonably identifiable. One reason for this is that those involved in the debt restructuring process should have a clear idea of who has chosen litigation and thus may not be candidates for participation in a voluntary restructuring plan.

In early 2005, just before completion, the vultures attempt to stymie the swap. In the first instance, they succeed in their bid to obtain an order to attach the contractual right of the debtor to receive old bonds [*NML Capital Ltd. v. The Republic of Argentina* (13 Mar. 2005)]. In response to Argentina's submission that this would make it abort the swap, Judge Griesa overturns his own judgement. In contrast with precedent, the Judge is motivated by a concern to promote restructuring and not only to enforce the claims of holdout litigants. Judge Griesa's decision is affirmed by the Second Circuit who find '[t]hat restructuring is obviously of critical importance to the economic health of the nation.' The findings (in the decisions to vacate the attachment orders) assure the creditors who may wish to participate in the swap that the court will ensure its successful conclusion.

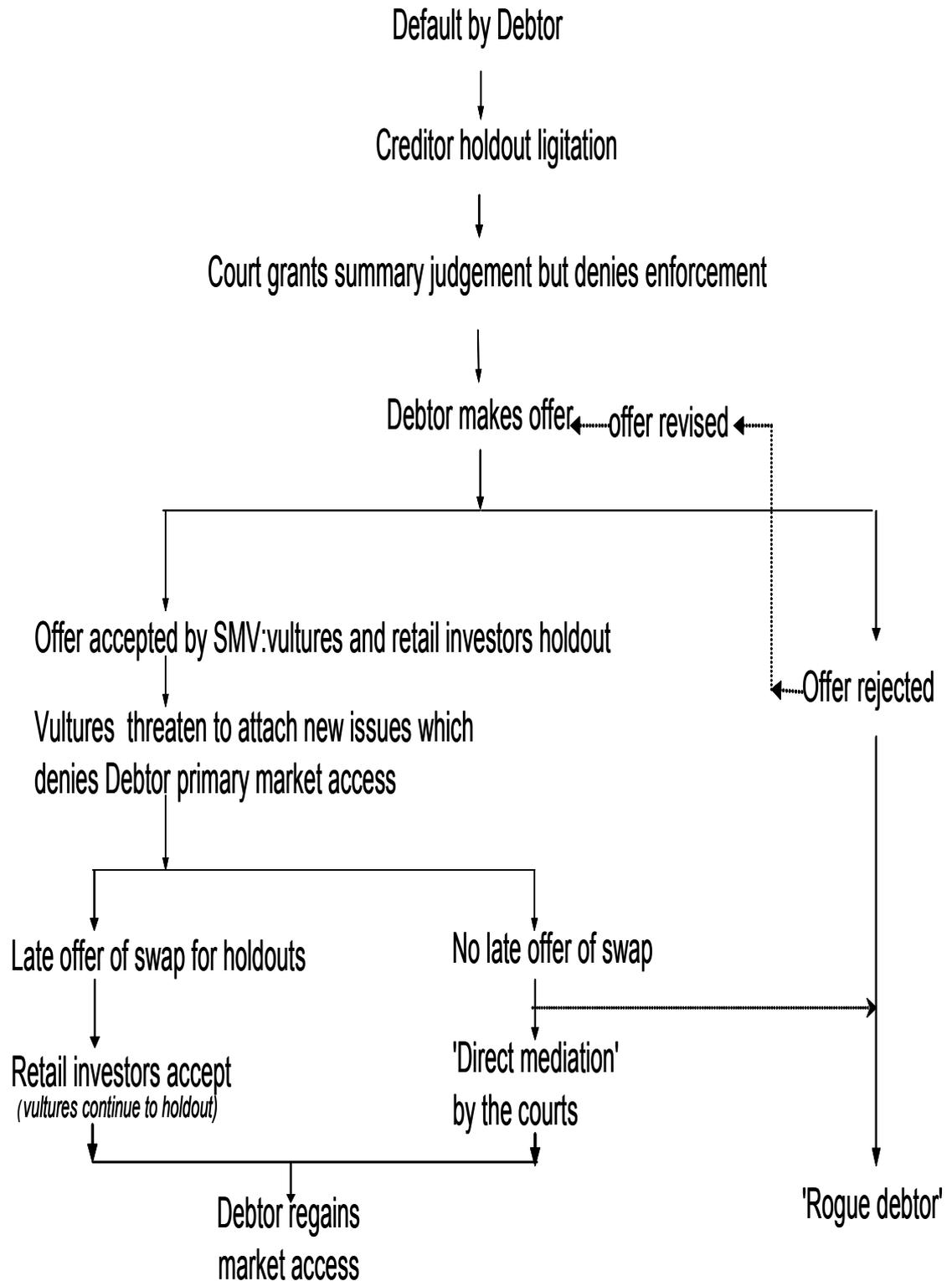
Chart 1 illustrates this process of judge-mediated debt restructuring, with the events described above summarised in the upper part of the Chart.<sup>15</sup> Following default by the debtor, the court grants summary judgements in favour of holdout creditors as a means to prompt the debtor to make an offer. Then, in marked contrast to earlier sovereign debt cases, Judge Griesa reins the holdout creditors in so as to promote a settlement. The judge is concerned with the reasonableness of the swap and the percentage of creditors who consent to the amendment. Finally the offer is accepted by a Super Majority Vote (SMV) but this leaves a fraction of creditors outside the swap -- and there are no CACs to ensure their compliance. (This leads to the next phase, the post-swap outcomes analysed in the next section.)

Three aspects of this particular process are worth highlighting. First, that Judge Griesa views holdout litigation as an opportunity to restructure the debt and to protect creditor rights - and by so doing he engages the debtor to prompt an offer; second that effectively aggregates across creditors in the swap by treating the debt as a consolidated whole; third that, he keeps the claims of the holdouts distinct from those of creditors involved in the ongoing swap.

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<sup>15</sup> This chart clarifies the judge-mediated debt restructuring as it occurred in Argentina and is specific to the context of the Argentine debt crisis. It is not meant as a template for all sovereign debt litigation.

Chart 1 Judge-mediated debt restructuring: The court's role in the Argentine swap



#### **4. Judge-mediated debt restructuring: a speculative analysis of post-swap outcomes**

So far, the post-swap phase of Argentine bond litigation has involved unsuccessful attempts by professional holdouts to attach the assets of the sovereign and forthright denials by the debtor of any compensation for creditors outside the swap. For Porzecanski (2005), the latter constitutes the actions of a ‘rogue debtor’ – defined as a sovereign who can pick and choose the claims it wishes to satisfy and ignore the rest. This pessimistic assessment of the situation is not borne out by low post-swap, sovereign spreads paid by the debtor in secondary markets for its existing debt i.e. the market does not appear to share Porzecanski’s dire predictions (Sturzenegger and Zettelmeyer, 2005c, p.10). Our view of post-swap developments is more nuanced: what we observe are judge-mediated efforts to engage the debtor and complete the swap in the absence of CACs.

The lower part of Chart 1 indicates future developments, sketching two possible outcomes in the Argentine debt swap- other than the ‘rogue-debtor’ scenario. First on the far left, the debtor makes a late offer of a swap (consistent with the “most-favoured-creditor” commitment made to those who accepted the swap). We reckon that this is highly likely to be accepted by retail investors since the bonds involved in the swap have increased substantially in value. In the interests of their reputation, however, vultures may *not* be inclined to accept a substantial haircut; and they have the patience and skill to hold out for years trying to prevent Argentina from accessing primary capital markets. Once a late offer is accepted by other holdouts, however, it is doubtful that vultures alone can continue to deny a debtor access to primary capital markets (Roubini and Setser, 2004b,p.303): for historical evidence see Esteves, 2005.

Should Argentina choose not to make a late offer, it might have to accept direct mediation by the courts (as shown in the centre of Chart 1): in an unprecedented development, Judge Griesa has indicated the court’s readiness to mediate a settlement *directly* should this prove necessary to complete the swap. Specifically, in one of many similar summary judgements [*Vanina Andrea EXPOSITO v. The Republic of Argentina* (17 Feb. 2006)] he directs that

Judgement will be entered for the principal amount of the bonds plus accrued interest. The parties shall consult with one another concerning the form of the judgement and the amounts of interest that should be awarded in the judgement. If the parties are unable to reach an agreement on those subjects, they shall jointly submit an agreed proposed judgement to the court. If the parties are unable to reach agreement on those subjects, plaintiff shall submit a proposed judgement to the court, and the Republic shall submit any objections to plaintiff's proposed judgement within five business days thereafter. The court will then resolve any remaining disagreements.<sup>16</sup>

This may never happen – but it illustrates the readiness of the courts to settle outstanding claims by continuing to engage the debtor. In the absence of a late offer by the debtor or of direct mediation by the courts, Argentina may come to earn Porzecanski's soubriquet of 'rogue debtor'. The current IBD report on 'Living with Debt' provides a characterisation of such debtor behaviour:<sup>17</sup> a government lacking the will to cap expenditure overloads the country with debt and precipitates economic instability and repeated default. So far, however, Argentina does not face the high sovereign spreads that this theory predicts.

## **5. CACs, courts, creditor committees and codes**

We have emphasised the role that courts (prompted by holdout litigation) have played, and are still playing, in the orderly resolution of a major sovereign debt crisis. Study of the opinions and orders of Judge Griesa's court suggests three distinct judicial functions – engaging the debtor to make an offer, promoting a successful debt swap and finally dealing with holdouts – which together protect creditor rights. We have shown that judicial intervention was effective in the pre-swap phase but so far it has afforded holdouts little help.

But the new bonds include CACs, as is now common with new issues of sovereign debt. The future, it seems, belongs to CACs. How will this affect the role of holdouts and of the courts?

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<sup>16</sup> So far, however, this has proved an empty threat as the debtor continues to treat the issue of holdouts as closed.

<sup>17</sup> Based on Rochet (2006).

## **Debtor engagement: Class action suits and bondholder organisation**

The historical record provides evidence of the effectiveness of formal and permanent bondholder committees like the British Corporation of Foreign Bondholders in the early part of the 20<sup>th</sup> century (Eichengreen and Portes, 1995; Esteves, 2005). Mauro and Yafeh (2003, p.26) point out that, "... one of the roles of the Corporation of Foreign Bondholders (CFB) [was] to protect small bondholders from large bondholders who might otherwise arrange for a separate, advantageous deal for themselves in exchange for the promise to provide the country with new lending."

This is relevant to the Argentine case where many small creditors sold out to institutional investors at prices of less than 30 cents. Esteves (2005) suggests that enhanced creditor organisation will substantially increase creditor payoffs: but, because institutional investors acted to coordinate creditors and to negotiate with the debtor, the payoff to creditors as a whole would probably not have risen much – as the economic analysis of the swap in Dhillon et al (2006) shows.

Even without bondholder committees, class action suits may prove a valuable aggregation device. Buchheit and Gulati (2002) argue that class action suits could be used to involve courts in sovereign debt restructuring. According to them creditors have a basic "class" interest<sup>18</sup> which is distinguishable from the interest of an individual creditor. With CACs including SMV this class interest is better defined.<sup>19</sup> Class action procedures would engender the formation of ex-post, ad hoc creditor committees that would prompt the debtor into making an offer. In the latest judgement in the existing (and only) certified class action, Judge Griesa granted the motion of the class for summary judgement [*H.W.URBAN GMBH, Individually and on behalf of all others similarly situated v. The Republic of Argentina* (9 March 2006)]. This favourable judgment increases the chances that class action suits may be used in the future.

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<sup>18</sup> A class interest is one in which creditors as a class can achieve a settlement more effectively than individual creditors.

<sup>19</sup> While Sturzenegger and Zettelmeyer (2005) may dismiss class action procedures as ineffective for solving holdout problem, with CACs this is no longer an issue.

## Promoting the swap and handling holdouts

Given that CACs are designed to reduce the profit opportunities available to holdouts, it should be easier for creditors to initiate early dialogue, coordination and communication amongst themselves and the sovereign debtor ('engagement'); and it should be easier for creditors to organise a swap, with a SMV requirement of 75% as the industry standard.<sup>20</sup> As the IMF has warned, however, aggregation will remain a problem: the clauses only operate within a single bond issue, Krueger (2002).<sup>21</sup> This is especially true where sovereigns like Mexico have not adopted a trustee structure like that adopted by the UK, for example.<sup>22</sup> Without a trustee structure, creditors and the debtor must initiate debt restructuring before any individual bondholder will get a favourable judicial order in its favour. In this fails to happen, judge-mediated debt restructuring provides a viable alternative to long drawn out and costly restructuring and disruptive holdout litigation.<sup>23</sup>

The judge in the Argentine case viewed the debt as a consolidated whole thereby effectively aggregating a majority of the creditors (76%) that participated in the swap. Despite the requirement for unanimity in the bond contracts, the courts promoted a swap influenced by economic, political and financial factors at the time. Similar action may be called for in future. With CACs, however, the issue of recalcitrant holdouts should disappear: subject to the necessary majority for a swap, they will be impelled to accept the same terms. The fate of holdouts in this case should give creditors an incentive to form a creditor committee *ex ante* and not hold out *ex post* should the judge intervene in the interests of aggregation across creditors.

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<sup>20</sup> Even though CAC's are issued these clauses may not be used - as was the case in the NY- law bond issues of Egypt, Lebanon, Qatar and Kazakhstan.(Roubini and Setser, 2004b, p.311)

<sup>21</sup> There are proposals to insert clauses that facilitate the aggregation of majority action provisions over a number of different issues to facilitate restructuring. Drage and Hovaguimian (2004). This has been adopted by Uruguay where the votes of all the sovereign's outstanding external bonds are pooled in an 'aggregated vote'; and the threshold for amending the financial terms of any individual bond issue is lowered to two-thirds so long as 85% of all the holders of Uruguay's external bonds support the restructuring.(Roubini and Setser, 2004b, p.311)

<sup>22</sup> The UK for instance has issued new debt under a trust deed where a trustee acts as a permanent representative of bondholders. The Trust deed also includes features to limit disruptive legal action by restricting individual holders from initiating litigation and providing for any litigation proceeds to be distributed pro rata across holders.

<sup>23</sup> Judge-mediated debt restructuring can be initiated by a class of creditors through a class action lawsuit and not necessarily through individual creditor suits.

The widely accepted IIF Code of Conduct for debt restructuring is another significant development following the Argentine crisis. This code (though voluntary) could be an important first step in preventing future crises. Evidence that market actors, debtors and creditors, are using the code to guide their behaviour<sup>24</sup> bodes well for good faith bargaining in the engagement and initiation phase of restructuring CACs in the future. The code thus enhances the prospect of good faith bargaining as a viable litigation strategy in judge-mediated debt restructuring.

To conclude, we see the vulture-initiated strategies for debt resolution as important principally in the period of transition to CACs, mainly in the pre-swap phase. Unlike Fisch and Gentile (2004), who emphasise the continuing role of the vultures, we assume that SMV under CACs will reduce the threat of holdout litigation as we know it, but will nonetheless leave an important lesson for creditors attempting to use the litigation route to mitigate the effects of a sovereign debt crisis in the future.<sup>25</sup>

Thus instead of the largely ineffective threat of attachment by specialist creditors, it will hopefully be CACs, courts, creditor committees and codes that will prompt the debtor into making an offer to successfully restructure its debt.

## **Conclusions**

Our interpretation of the Argentine litigation is that Judge Griesa used creditor heterogeneity to promote the swap – encouraging holdouts to bring the debtor to the negotiating table but restraining them when they threaten the swap itself. Following this interpretation, we believe that as far as Argentina goes the judge will encourage the holdouts to threaten its access to primary credit markets unless and until it deals satisfactorily with creditors outside the swap. Our conclusions differ from those of Sturzenegger and Zettelmeyer (2005) who are inclined to dismiss the role of holdout litigation in favour of reputational models. Our interpretation can also be contrasted

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<sup>24</sup> IIF Press Release (2006)

<sup>25</sup> The incentives for vultures to litigate will arise from issues in which they have a SMV. They will use the courts to enforce hundred percent claims against the debtor. In the absence of unanimity however, these claims will be isolated at the margin and will not affect the entire debt.

with the view that holdout litigation represents a lasting solution to sovereign debt crises, Fisch and Gentile (2004). We agree with them that holdout litigation is ‘part of the solution and not the problem’ (Roubini, 2002), but believe that to be true *only in the period of transition to CACs and in the pre-swap phase of a sovereign debt restructuring*.

John Taylor (2002), then Under Secretary of Treasury for International Affairs, identified three main possibilities for debt restructuring: a decentralised, market-led approach; a centralized statutory approach, and a combination of the two where clauses are inserted into new debt instruments and a panel or court is created to deal with aggregation and other issues not captured in the clauses.<sup>26</sup>

While the second centralised approach has since been sidelined for the indefinite future, the first market-driven alternative favoured by Taylor has become the norm. But the process of restructuring Argentine debt leads us to favour the third possibility, that of combining CACs with judicial process. It may be that, in theory, bonds with CACs can be restructured to ensure engagement and to secure aggregation: in practice it seems that the courts can do a great deal to help. This is why we look to a future with CACs and courts, aided by creditor committees and codes of conduct.

Stiglitz (2006) makes a similar point when he argues:

The fact that every advanced country has found it necessary to have a bankruptcy law reinforces the conclusions of economic theory, that collective action clauses will not suffice; some judicial process is required.

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<sup>26</sup> Taylor (2002)

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## APPENDIX

### **The size of the write-down and the long delay: a bargaining approach**

It is clear from Table 2 that lenders to emerging markets may be exposed to substantial losses and to prolonged delay in restructuring in some cases. In addition, the Argentine case challenged the idea that the IMF must play a central role in arranging sovereign debt swaps: stymied by conflict of interest and criticised by both debtor and creditors for its earlier handling of Argentina's affairs, the Fund had to withdraw to the sidelines and let creditors and the debtor sort things out themselves.<sup>27</sup>

With the IMF *hors de combat*, the New York Court had perforce to play a greater role. But the court does not carry the same big stick as the Fund: its role is to promote negotiations between sovereign and the creditors to achieve a fair outcome, and to preserve the sovereign debt market. In this spirit, Dhillon et al. 2006 apply a bargaining approach to explain both the final settlement and the delay in achieving it, assuming implicitly that the court is holding the ring. The authors follow the approach of Merlo and Wilson (1998) where the size of the pie is uncertain and 'efficient delay' can occur as creditor and debtor wait for economic recovery - fearing that early settlement will lock in the recession. (The Rubinstein model of alternating offers, applied to sovereign debt negotiations by Bulow and Rogoff (1989), is not used because it predicts prompt settlement.)

Based on the creditor response to the initial Argentine offer at Dubai in 2003 Dhillon et al. (2006) estimate that the "pie" to be divided between debtor and creditors was worth almost 3% of GDP. Allowing for the "first mover" advantage for the debtor as proposer, the bargaining model implies that creditors receive a little under half the pie. On this basis, the predicted recovery rate on debt without interest is 41 cents – a little better than the final settlement (estimated to be worth about 34 cents in Table 2).

As for the prolonged delay, the authors note that political factors played a critical role until 2003 when President Duhalde – appointed earlier by Congress as interim office-holder – was replaced by President Kirchner after a general election. Because the expected annual rate of economic recovery in 2003 exceeded the time rate of discount<sup>28</sup>, it is claimed that further postponement was economically 'efficient'. An alternative

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<sup>27</sup> "Argentina has become a test case for a vastly reduced role for the IMF and the official sector more broadly in the sovereign debt restructuring process", Roubini and Setser (2004a).

<sup>28</sup> Estimated to be 4% for both parties

account for delay under President Kirchner is explored by Ghosal and Miller (2006). There it is noted that, if the debtor is aware of the constraints imposed by sustainability while the creditor is not, the former may have an incentive to make a low offer leading to delay in order to act as a *signal* to the creditor (that sustainability is a serious cause for concern). On this reasoning, the Argentine government would *not* have expected creditors to accept the offer made at Dubai in 2003; but the final settlement reached in 2005 - broadly in line with Argentina's sustainability guidelines - would reflect a successful signalling strategy by the President and his finance minister.<sup>29</sup>

The observed delay and the write down are, it seems, broadly consistent with a bargaining approach. Moreover, according to Porzecanski (2005), the fall of the currency rendered the government insolvent because of the large debts contracted by previous administrations. He notes in his introduction that “[a] sinking currency rendered the government instantly insolvent; the net government debt, which at the one peso per dollar exchange rate was equivalent to three times tax revenues and 50% of GDP, virtually tripled once the currency sank to around three pesos per dollar, becoming unaffordable to service”: and he also observes that policy prior to 2002 involved the authorities then in power “betting the ranch” by borrowing almost exclusively in dollars and other foreign currencies to finance a string of budgetary deficits, even though their revenues were due and collected only in pesos.<sup>30</sup> (Porzecanski, 2005).

If Argentina was insolvent for reasons to do with previous administrations, why should it be treated as a rogue debtor? In our view, it all depends on how creditors outside the swap are dealt with. The bargaining model assumes that all creditors get parity of treatment (as they might with under CACs). So far, however, those outside the swap have received nothing. How the sovereign might deal with the holdouts so as to avoid been treated as rogue debtor is discussed in section 4 of the paper.

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<sup>29</sup> Roberto Frankel, an economist who was a close observer of the swap, reckoned that the finance minister deserved a bronze statue in the Plaza de Mayo for his negotiating tactics! (Liascovich, 2005, p.257 )

<sup>30</sup> For an interesting analysis of how a government which cannot pre-commit to control spending may expose the country to recurrent crises, see Rochet (2005).