Individual Enforcement Rights in International Sovereign Bonds

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Abstract

Sovereign bonds are notoriously hard to enforce. What little rights bondholders have can be vested either collectively or individually. It seems that investors, particularly in the US market, traditionally had a preference for the latter, which hindered financial market reform projects, such as the universal adoption of collective action clauses in 2003.

This paper uses a range of theoretical approaches to discuss whether it is indeed in the bondholder's collective interest to be allowed to individually sue and attach the debtor country's assets following a default. Furthermore, it examines the landmark case of *Elliott Associates v. Peru* to attempt a quantitative assessment of just how much sovereign bondholders actually value individual enforcement rights. I find that even the single most important event to reinforce creditor rights in recent years had no noticeable impact on bond prices.

Keywords: sovereign debt, collective action clauses, fiscal agency agreements, trustees
JEL classification: F34, K12

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1 - Introduction

Research question

This paper is concerned with the question of whether extensive individual enforcement rights necessarily benefit the holders of international sovereign bonds in a situation of default. At a superficial level, it is not obvious how more rights could possibly hurt creditors. Michael Chamberlin (2002a, p. 4), Executive Director of the Trade Association for the Emerging Markets (EMTA) and as such a chief lobbyist for bondholder rights, argues accordingly:

> Contracts, even sovereign debts, should be enforceable. There is a growing perception in the bondholder community that they are not, and that creditor rights should be strengthened, not weakened. At a bare minimum, rather than overriding the rights of individual bondholders, greater attention should be given to seeking ways to ensure that bondholders are constructively included in the restructuring process.

From a slightly more analytical perspective, the virtues of individual enforcement rights are less evident. Three reasons for this are analysed here. First, enforcement action against a sovereign debtor is impractical for most retail investors due to economies of scale in legal action and the international nature of the contractual relationship. Second, because of the well-known collective action problems among creditors, a group of bondholders whose members have individual enforcement rights may actually be worse off than with collective rights only. Third, depending on which view one takes of sovereign default, the threat of enforcement as a deterrent against repudiation may not work, so that one of the most important arguments for individual enforcement breaks down.

Thus theory is ambiguous about the merits of individual enforcement rights. Empirical evidence, on the other hand, is scarce, at least with respect to sovereign bonds. I examine bondholders' reactions to the famous (or infamous, depending on the perspective) case of Elliott Associates versus the Republic of Peru to add some empirical insights to the debate on creditor rights. A time-series analysis of bond price movements surrounding the settlement date does not support the view that individual enforcement rights, which were arguably strengthened by the case, are a major concern to investors.

Motivation

Sovereign bonds are peculiar instruments. A state whose government does not repay its debts cannot be liquidated, and bondholders have only limited recourse to legal remedies. What bondholders can and cannot do to recover their claims has therefore always been an issue of uncertainty and tension, probably more so than in corporate debt markets. This tension shaped the discussions that eventually led to the most important recent change to the international financial architecture, namely the almost universal adoption of collective action clauses in new sovereign bond issues beginning in 2003.[1]

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[1] Bradley et al (2008) provide detailed figures on the prevalence of CACs in the US market: In 2003, 70% of new issues contained CACs. In the period 2004 to 2007, the share increased to 92%.

Spurred by the Mexican Tequila crisis in 1994, the Group of Ten countries had set up a working party to develop strategies for the more timely and orderly resolution of sovereign debt crises. The resulting Rey Report called for a set of provisions to be introduced into sovereign bond contracts that would later be called *collective action clauses*. Theses clauses had already been a regular feature of bonds issued under the laws of England for many decades but were generally not used for bonds in the other major jurisdiction, New York State. Besides provisions for the improved flow of information, engagement of the debtor and convening of bondholder meetings, collective action clauses most importantly comprise two sets of clauses: First, *majority restructuring (*or *amendment*) *provisions* allow a qualified majority of bondholders, typically 75%, to amend the payment terms of the bond and to make the amendment binding on all bondholders of that particular issue. Thus, an agreement on debt relief is more easily concluded between the debtor and the required majority of creditors, and dissenting bondholders are prevented from disrupting the restructuring by holding out and bringing legal action against the sovereign *after* a restructuring agreement has been reached. Second, *majority enforcement provisions*, although already commonplace in the US market, were to be amended so as to bar lawsuits from individual investors following a default but *before* the restructuring, which was to be achieved amongst other means by requiring any proceeds from litigation to be shared between all bondholders.

Clearly, the planned introduction of collective action clauses in the US market implied a significant curtailing of bondholders' individual enforcement rights - a necessary sacrifice on the way to more efficient sovereign debt markets. It was therefore inevitable that emerging markets investors would resist the initiative - or was it? I will return to this question throughout the paper.

The Rey Report marked the beginning of a steady stream of publications and speeches by both academics and representatives of international financial institutions who praised collective action clauses and tried to disperse the market's fears of impaired creditor rights and, consequently, higher spreads. None of the rhetoric showed any effect until finally in March 2003 Mexico made the first publicly placed bond issue with collective action clauses under New York law and thereby initiated a complete reversal of market practice in the US market. Almost all new issues since then have made use of such clauses.

There has been some speculation as to the reasons for the seven-year delay between the earliest calls for the wider use of collective action clauses and the first sign of action. Gelpern and Gulati (2007) discuss this question in great depth. Undeniably, the scepticism of some bondholders towards a perceived loss of legal rights, as exemplified by the above quote, contributed to the time lag in financial innovation. Part of the motivation for the present empirical investigation therefore is to examine whether that scepticism was justified - in a sense, a purely historical interest.

This paper is, however, also motivated by the fact that financial innovation is not yet complete. While collective action clauses are now ubiquitous in bonds that are issued under New York law, issuers in the German market failed to follow the development. Bonds governed by German law traditionally required unanimous consent for a change in the payments terms. When the pressure to adopt collective action clauses rose, it may have been uncertainty about the legality of majority voting that perpetuated the status quo (Liu, 2002). It seems that public statements by the German federal government about the admissibility of collective action clauses (BMF, 2000) did not fully dispel the doubts of sovereign issuers. The German Central Bank, fearing that missing out on the important developments would hurt the standing of the German financial market, urged the legislator to amend the relevant laws (Deutsche Bundesbank, 2003). The government subsequently reversed its position inasmuch as Finance Minister Hans Eichel said at the 2004 IMF Spring Meeting that a reform of the indenture law was underway (Eichel, 2004), even though new legislation had been considered unnecessary earlier. Four years later, a draft of the new *Schuldverschreibungsgesetz* (indenture law) has finally been completed. It remains to be seen, however, whether the improved legal certainty can actually induce issuers to

face the risk of negative investor reaction to bonds with weaker individual and stronger collective rights.

Lastly, in both the German and the US markets there has still been no change with respect to the administrative structures of sovereign bonds. Many academics and policymakers have called for the increased use of trust structures, which are more conducive to collective action - and hence potentially offensive to bondholders worried about individual enforcement rights - than the more traditional fiscal agency arrangements.

Both of these two pending reforms could, when implemented, meet the resistance of investors - or policymakers may be afraid that they could. In either case, a better understanding of bondholders' views about their enforcement rights would be desirable.

Related literature and structure of the paper

Besides the vast literature on sovereign debt in general, this paper expands on the discussion of bondholders' attitudes towards individual enforcement rights in Häseler (2007). Fisch and Gentile (2004, p. 1106) suggest "measuring the extent to which investors value the litigation option" via yield differences between bonds with different sets of creditor rights. Sturzenegger and Zettelmeyer (2006) propose to use insights about the effectiveness of the litigation threat for the construction of sovereign debt pricing models. In a sense, this is the reverse of the approach taken here. Thus, an interest to get a quantitative handle on the value of litigation against sovereign debtors exists in the literature but empirical evidence is so far sparse. Alfaro et al (2007) are currently engaged in panel data research on the effect of holdout litigation on bond spreads. Their methodology is similar to the one used in this paper but the focus of interpretation differs. Bradley et al (2008) similarly examine the effect of the *Elliott* case on bond yields, but for a longer time horizon. Also, their analysis focuses on holdout risk, rather than on enforcement rights – although it could be said that these are in fact two sides of the same coin.

The remainder of the paper is organised as follows. Section 2 provides some historical and factual background to the current state of individual bondholder rights. Section 3 discusses some of the theoretical approaches to assessing the value of those rights. Section 4 provides the facts of, and reactions to, the *Elliott* case and derives some testable hypothesis. In section 5, the data and methodology are presented and the regression results are discussed. Section 6 concludes.

2 - Some Background

Following a brief history of sovereign debt enforcement, this section presents the current state of individual enforcement rights, describing the difference that the adoption of collective action clauses has made and the difference that the wider use of trust structures, if implemented, could make.

Historical Perspective: Gunboats…

The ability of bondholders to take defaulting sovereigns to court is a relatively recent phenomenon. When especially Latin American countries began to finance their growth increasingly through the bond markets in the 19th century, they were protected from lawsuits by the doctrine of absolute sovereign immunity, which posited that no government could be sued in a foreign court without its consent. In that era, aggrieved creditors' options were restricted to bundling their voices in institutions such as the British Corporation of Foreign Bondholders, and

trying to persuade their national governments to apply political pressure on the debtor country. Common wisdom has it that such pressure regularly took the form of military action, as in the famous case of the joint British, German and Italian blockade of Venezuelan ports in 1902.

Tomz (2006) cites support for this 'gunboat hypothesis' from major authorities such as Rudiger Dornbusch and the Economist magazine. Mitchener and Weidenmier (2005) find that between 1870 and 1913, the exertion of military pressure or political control over a debtor country was a common and successful enforcement strategy. Likewise, Tomz finds a positive and significant correlation between defaults and militarised disputes but goes on to look at the deeper causes of the hostilities. Examining historical political documents, he finds no indication that gunboat diplomacy was ever motivated by the desire to satisfy domestic creditors' claims but rather by other grievances, often involving harm done to the creditor country's assets or citizens in the course of unrest in the debtor country.

According to Tomz, the statistical association between gunboat incidents and default periods is therefore spurious. The author does not attempt to explain this result, even though at least one potential cause of the correlation seems quite obvious. A civil war or similar condition in the debtor country is likely to cause two things: first, a deterioration of the country's ability to repay its debts and hence a higher default risk, and second, adverse effects on the property and citizens of other countries, which in turn may seek compensation through the use of military force. So it is quite natural that defaults and militarised disputes will tend to co-occur. A better test would be to compare two countries' probabilities of sending gunboats, where both countries have been affected by the civil war in the debtor country, but only one of them has an interest in debt collection.

One might think that the era of enforcement by gunboats, if indeed it can be labelled as such, formally ended in 1907 with the signing of the Hague Convention on "The Limitation of Employment of Force for Recovery of Contract Debts". Alfaro et al (2007) would disagree, for they examine a number of militarised interventions by the United States in Central American countries in the period 1905 to 1929, all of which were intended to protect the interests of US bondholders or to pre-empt similarly motivated interventions by European states. But be that as it may, the Great Depression finally put an end to US involvement in debt collection, so with gunboats gone for good and sovereign immunity still firmly in place, the time that followed arguably saw the position of bondholders at its weakest.

The ability of the sovereign bond market to survive in a setting in which an opportunistic defaulter had to fear only loss of reputation was tested when, due to the Depression, all but three Latin American countries fell behind on their debt service. Bondholder committees were formed to negotiate with the debtor countries but the debtors lacked incentives to reach an agreement in a timely fashion and the committees lacked the power to bind all bondholders when an agreement was reached. Thus, as a result of insufficient enforcement mechanisms, the sovereign bond market dried up and private finance was replaced by lending from other governments and international institutions, in particular development banks (Fish and Gentile, 2004).

…and Courts

Two developments then brought bondholders back into play. The first was yet another shift in the composition of lending to developing countries. The oil price shocks of the 1970s sent large sums flowing from the oil exporting countries to commercial banks and then on to Latin American countries that needed to finance their increased expenditures on oil. A number of those countries subsequently defaulted in the following decade. The defaults were cured through what became known as the Brady Plan of 1989: The debtor countries were granted substantial reductions in the face value of the debt, and the banks were able to sell on the syndicated loans to the market in the

form of Brady bonds. As a result, by the late 1990s there was once again an active market for Latin American bond debt.

Secondly, the position of bondholders was strengthened by important changes in the legal environment. The doctrine of absolute sovereign immunity was abandoned in all major jurisdictions between the 1950s and the 1970s. As states and state-owned entities had increasingly engaged in international commercial transactions, immunity gave them an unfair advantage over private sector competitors and was therefore restricted wherever states or their agents acted as commercial players (Alfaro et al, 2007).[2] The relevant legal documents include the Tate Letter by the US State Department (1952), the European Convention on State Immunity (1972), the US Foreign Sovereign Immunities Act (FSIA, 1976), and the British State Immunity Act (1978). So when the 1980s heralded the next wave of defaults in Latin America, sovereign debtors were for the first time vulnerable to suits from creditors.

It was not long before the first creditors began to explore the newly-opened avenues of debt enforcement. Arising out of the Costa Rican default in 1981, *Libra Bank Ltd. v. Banco Nacional de Costa Rica* was the first notable example of creditor litigation.[3] Banco Nacional initially sought defence in sovereign immunity, but the New York court found that immunity had been explicitly waived in the loan contract. Furthermore, the *act of state doctrine*, which says that the courts of one country must not judge on the sovereign acts of another, was raised for defence but to no avail. This first case, although nominally successful, already demonstrated quite clearly the limited value of the litigation remedy. The syndicate of banks surrounding Libra had claims against Banco Nacional amounting to $35 million, however, only $2.5 million worth of assets could be located within the jurisdiction of the New York court, and the sum that the plaintiffs were eventually able to attach was lower still at $800,000 (Fisch and Gentile, 2004).

In 1985, the court once more ruled against Costa Rica in *Allied Bank International v. Banco Credito Agricola de Cartago*. Besides the act of state doctrine, another popular defence was rejected, namely *comity*, a rather vague concept which US courts have tended to interpret to mean that another state's actions are admissible if they are in accordance with US policy. The *Allied* case has been identified as the first instance of *holdout litigation* because at least the later stages of the dispute arose from the unwillingness of Allied's client, Fidelity Union, to agree to the terms of a restructuring that had already been accepted by all other banks in the syndicate. Yet, despite the success in court, Allied eventually settled for the same terms as the other banks and so the holdout strategy did not pay off.

Sovereign immunity lost the last of its sway in *Republic of Argentina v. Weltover* (1992). The case established, in line with earlier judgements, that issuing bonds is a commercial activity in the sense of the FSIA, and the fact that interest payments are made in New York entails that the United States are directly affected so that US courts can exercise unconstrained jurisdiction. A fourth common defence was denied in *CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brazil*. Banco Central invoked the law of *champerty*, which bars litigation based on claims that were purchased with the intent of bringing lawsuit. Once again the court sided with the plaintiff.

The position of creditors was further strengthened in *Pravin Bankers v. Banco Popular del Peru* and *Elliott Associates v. Republic of Panama* (both 1997), where the courts ruled that claims based on debt that was purchased a deep discounts on the secondary market are valid and enforceable. With this history of largely successful – but not always fruitful - creditor litigation against defaulting sovereign borrowers in mind, next I discuss the impact of recent and possible future bond market reforms on individual creditor rights.

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[2] Another interesting justification is that "the U.S. felt uneasy with granting sovereign immunity to Soviet Union state owned companies operating in the U.S." (Sturzenegger and Zettelmeyer, 2006b, p. 37)

[3] More detailed accounts of these important cases are to be found in Fisch and Gentile (2004) and Sturzenegger and Zettelmeyer (2006a), amongst others.

Individual Enforcement Rights

With sovereign immunity out of the way and most of the debtor countries' defences cleared, bondholders during the 1990s enjoyed extensive liberties to pursue their claims in court independently of other bondholders. I will refer to these liberties as individual enforcement rights and will first focus on the conditions for individual enforcement pertaining to bonds governed by the laws of New York before the introduction of collective action clauses in 2003. The relevant clauses in the bond contracts go under the common heading of *majority enforcement provisions* and regulate the initiation of proceedings, acceleration of the principal, and reversal of acceleration.

The right to *initiate legal proceedings* against the debtor country rests with individual bondholders if the bond was issued under a *fiscal agency agreement*, which is still the most widely used administrative structure in the US market. The fiscal agent serves exclusively the debtor, and its duties are primarily restricted to making payments of interest and principal to the bondholders.

Furthermore, to make litigation against a defaulting debtor worthwhile, creditors must have the right, upon an event of default, to sue not just for any missed interest payments, but also to *accelerate* the loan, i.e. to declare the entire outstanding balance payable immediately. Acceleration usually requires a vote by at least 25% of the bondholders of a particular issue, but some bonds afford the owners the right to accelerate their claims individually. A majority vote of 50% or more of bondholders can often rescind a prior acceleration. Acceleration played a pivotal role in the *CIBC Bank* case,[4] whereas reversal of acceleration was crucial to Ecuador's restructuring in 2000 (Buchheit et al, 2001).

Vultures

The combination of extensive individual enforcement rights in at least some bond contracts, the demise of sovereign immunity, and the dismissal of the debtors' most popular defences has resulted in creditor lawsuits "in the hundreds"[5] since the 1980s. Some creditors have become known as 'vulture funds', or, more neutrally, 'distressed debt funds' for their aggressive litigation strategies. These are investment companies that specialise in buying the debt of financially troubled countries in the secondary market and suing for full repayment when at the same time most other creditors are prepared to grant debt relief in a restructuring.

While obtaining a favourable judgement has been comparatively and increasingly easy, the effectiveness of the legal remedy is limited by the availability of assets that belong to the debtor, that are situated within the relevant jurisdiction (usually New York State) and can be attached to satisfy the claim. Diplomatic assets, for example, are still covered by sovereign immunity (White, 2005). "In practice, creditors have little difficulty in securing court judgements ordering the sovereign to repay after a default."[6] However, "[g]oing to court in a G-7 (or similar) country is beneficial only if the lender identifies property of the defaulting sovereign in that jurisdiction (or another jurisdiction willing to levy execution on the first jurisdiction's judgement). And defaulting sovereigns try their best not to leave valuables lying around."[7] Sandoval (2002, p. 4) writes that the "traditional problem of suing a sovereign" is the "practical impossibility of attaching the sovereign's assets in order to obtain payment." Yet, there have been some

[4] Fisch and Gentile (2004). However, the claims in that case were based on bank loans, rather than bonds.
[5] Sturzenegger and Zettelmeyer (2006a, p. 21). In fact, the number of lawsuits against Argentina alone exceeded 200; see Miller and Thomas (2006).
[6] Bedford et al (2005, p. 92)
[7] Bratton and Gulati (2003, p. 11)

spectacular cases of successful vulturing, often thanks to the creditors' inventive strategies for locating attachable payment streams in the relevant jurisdiction. Examples include privatisation revenues, VAT revenues, or aircraft landing fees. Rather than the prospect of losing the actual asset, what often forces the debtors to give in are the imminent follow-up costs that would arise from the 'virtual blockade' on fresh money imposed by the vultures (Alfaro et al, 2007). In some cases, the mere threat of a lawsuit and the nuisance it entails may suffice to induce the debtor to settle.

Collective Action Clauses

To limit the disruptive activities of vulture funds was one of the main motivation behind the efforts to introduce collective action clauses into the US market. The clauses that have been implemented since 2003 have effected some restrictions of individual enforcement rights but are insufficient to eliminate vulturing altogether.

As mentioned in the introduction, *majority action provisions* have been a feature of nearly all newly-issued sovereign bonds under New York governing law since February 2003. In most cases, the required voting threshold for changing payment terms is set at 75% of outstanding bonds (Drage and Hovaguimian, 2004). A debtor's restructuring proposal that is accepted by the necessary majority becomes binding for all bondholders under the same contract. The simple but important implication is that dissenting creditors have no basis for litigation as long as the debtor honours the new contract terms. Thus, collective action clauses effectively prevent holdout litigation, that is, litigation *after* the restructuring has been concluded - the preferred strategy of vulture funds. Several of the cases cited above would have had no basis if collective action clauses had been a feature of (bank) loan contacts earlier on.

Trust structures

What remains largely intact, however, is the scope for litigation after default but *before* a restructuring becomes effective. In a period that may last years, for example if the borrowing country hesitates to approach creditors to engage in negotiations or when a restructuring offer fails to meet the required approval, sovereign debtors under New York law are still vulnerable to creditor suits despite collective action clauses. The likelihood of such litigation has been reduced only somewhat because collective acceleration (by at least 25% of bondholders) has now become the standard.

When the US market finally embraced collective action clauses, it at the same time rejected more decisive steps towards collective enforcement. Policy institutions and academics had been calling since the late 1990s for reforms that would bar lawsuits even before the restructuring and thus prevent a race to the courthouse. The G10 Working Group, amongst others, suggested that new bond issues under New York law should follow the English practice of appointing a trustee to represent the bondholders, rather than for the bond to be issued under a fiscal agency agreement. The establishment of a trust deed is a requirement for listing on the London Stock Exchange. The trustee has the sole power to sue the debtor on behalf of the bondholders if instructed to do so, typically by a vote of 25% of bondholders. Any proceeds from litigation are then distributed among the creditors on a pro rata basis. Thus, trust structures constitute a double defence against vultures: Individual legal action is not possible (unless the vulture holds more than 25% of the debt) and, even if it was, the sharing rule would make it utterly unprofitable.

In contrast to the success of collective action clauses, the years of advocacy for trust structures showed no effect as issuers chose to leave individual enforcement rights untouched in this respect. The vast majority of newly issued bonds in New York since 2003 continue to be governed by fiscal agency agreements, which means that bondholders still have the individual

right to bring action against the debtor, have no obligation to share the proceeds, and in some cases may even accelerate the bonds individually. Of the seventeen bonds issued in the first 18 months since the adoption of collective action clauses, only two had made use of a trust indenture, the American variant of the English trust deed (Drage and Hovaguimian, 2004).

Indeed, the adherence to established structures appears to have been a deliberate choice by market participants. "Of all the proposals to change sovereign bond documentation, the investor community reserved its special wrath for the sharing clause idea. Trade associations representing bond market investors were uniform in their rejection of the proposal to add sharing clauses to sovereign bonds."[8] The Emerging Markets Creditors Association and the Trade Associations for the Emerging Markets actively opposed any sharing mechanism that "unduly restricts the right of individual bondholder action."[9]

To reiterate, whereas new bonds with collective action clauses are no longer prone to holdout litigation *after* a restructuring, the recent change in market practice has made little difference to the enforcement rights of bondholders who wish to pursue their claims individually while others are negotiating with the debtor country.

Given this brief account of the current state of individual enforcement rights, in the next section I will draw on some theoretical considerations before moving on to an empirical assessment of the merits of such rights.

3 - Some Theory

This section deals with some of the theory that can be brought to bear on the question as to whether bondholders as a class of creditors might prefer individual or collective enforcement rights. Focusing on the interest of bondholders, it disregards wider welfare considerations, which are touched upon for example in various publications of the IMF, as well as in Häseler (2007).

It is difficult to approach the question systematically because of the multitude of views and theoretical concepts, most of which are related, though it is not always clear in what manner. I will proceed by discussing in turn three motives for bondholders to pursue individual legal action against the debtor.[10]

Disciplining the debtor

Why do sovereign debtors default?

It is a widely held view that without effective enforcement powers for (individual) bondholders, sovereign debt would be prone to opportunistic default and sovereign debt markets could therefore not exist in their present form. Either outcome would be clearly undesirable for creditors, if not for all parties concerned.

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[8] Buchheit and Pam (2003, p. 16)

[9] Drage and Hovaguimian (2004, p. 5)

[10] An alternative approach would be to discuss both benefits and costs of individual enforcement rights. However, the costs do not make for particularly interesting analysis. As explained in virtually every paper on sovereign debt restructuring, strong individual enforcement rights encourage holdout litigation, which in turn will tend to make the restructuring process lengthy and unpredictable – an undesirable situation for the debtor as well as for the creditors. See, for example, Bradley et al (2008).

Creditor representatives have justified their demand for stronger individual enforcement rights with the concern about repudiation and the future viability of sovereign debt markets. Chamberlin (2002b) warned that any infringement of the "legitimate right of creditors to enforce their claims" could "further reduce the flow of private capital to the Emerging Markets".

Academics, too, have emphasised the role of creditor litigation in disciplining sovereign borrowers. Fisch and Gentile (2004, p. 1051) particularly stress the value of holdout litigation: "[B]y reducing the likelihood of opportunistic defaults, holdout creditors increase capital flows to sovereign debtors… The extent to which holdout creditors provide those values… depends upon the power conferred through judicial enforcement of their claims against sovereign debtors." The authors also cite opinions of the US Justice Department and the New York Clearing House Association which "suggest a clear relationship between the availability of judicial enforcement of loan agreements against defaulting sovereigns and the functioning of the sovereign debt market" (p. 1085).

Sturzenegger and Zettelmeyer (2006a) hold that stronger enforcement rights could improve the welfare of both borrowers and lenders, given that, as can be argued, the amount of lending is currently sub-optimal and the cost of borrowing is excessive compared to a world in which sovereigns cannot repudiate their debts. Alfaro et al (2007) agree that stronger enforcement could reduce the cost of capital for developing countries, which in itself does not benefit the lenders, but which implies more lending and hence greater gains from trade for both sides. In the same vein, Hallak (2003) finds that more borrowing takes place under laws that provide stronger creditor protection.

What underlies all of these statements about the merits of debt enforcement is the assumption that the threat of litigation directly affects borrower behaviour. But does it? This may be quite a bold assumption to make in light of the host of conflicting theories about the factors that cause a sovereign borrower to default. Figure 1 below brings the most important views of sovereign default into a rough order.

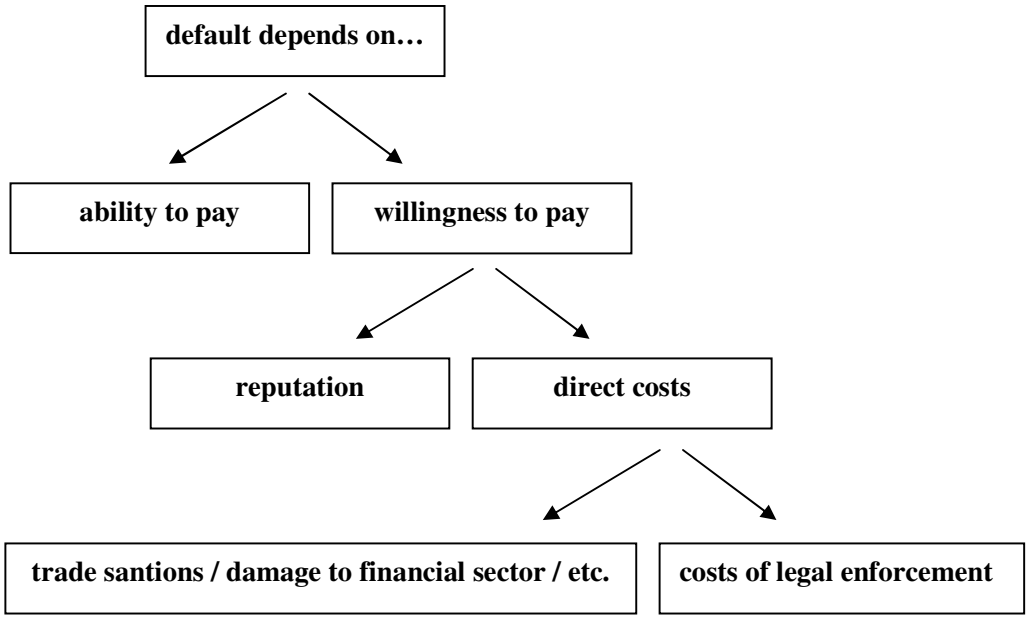

Figure 1: Different views of sovereign default

The simplest and most fundamental assumption which the proponents of individual enforcement implicitly base their demands on is that borrowers actually have a *choice* between servicing and not servicing their debts. The question is whether debt service (or lack thereof) is determined primarily by a country's *ability to pay*, in which case we might speak of distress defaults and – of course – there is no room for considerations of deterrence, or by its *willingness to pay*, in which case defaults may be considered as strategic or opportunistic.

A report by the Inter-American Development Bank (2006) argues that defaults tend to occur after or amid pronounced economic downturns and that debtor countries often undertake great efforts to avoid default even against all odds: "There is little evidence… of strategic sovereign defaults ever occurring" (p. 236). Bratton and Gulati (2003, p. 17) confirm that "sovereigns as a practical matter only default under identifiably bad conditions", indicating that sheer inability to pay is a crucial reason for default.

Yet, it must be admitted that a government almost always has the option to cut expenditures or to increase revenues even at short notice, so that at the limit, a country's ability to repay can in fact be equated to its willingness to accept political costs. Sturzenegger and Zettelmeyer (2006b) provide a reconciliation of the two views: Assuming that a government is willing to bear only a certain level of political costs in order to continue with debt service, a deterioration in the country's ability to repay, for example caused by a sudden drain of reserves or a decline in tax revenues, will push the costs of debt service above the accepted level and thus trigger default. Appealing as this synthesis may be, it does not provide an answer to the question as to which view best describes debtor behaviour – most likely because no definite answer exists. Bratton and Gulati (2003) add that considerations of both types are present in all decisions to default and that it is impossible to tell from an outside perspective whether a default episode should be attributed to the distress or opportunistic category.

Most of the literature on sovereign default has focused on the "willingness to pay" view - not surprisingly because the alternative view does not provide much scope for analysis. According to this perspective, a debtor who can decide freely whether or not to honour his obligations will conduct a cost-benefit-analysis of default. Much has been written about the elusive costs of default. The first theoretical investigation into the question as to why sovereigns repay was the seminal paper by Eaton and Gersovitz (1981) Their model of sovereign borrowing shows that under certain conditions, debt repayment is sustainable even if default entails no costs other than loss of reputation and the resulting exclusion from future borrowing. Exclusion from capital markets is in itself costly because countries are assumed to borrow and lend in order to smooth consumption across business cycles.

The model by Eaton and Gersovitz has been criticised from several angles.[11] First, the threat of permanent exclusion from borrowing, which the model's lending equilibrium depends on, is not credible because both parties could benefit if lending was resumed at a later stage. In other words, the equilibrium is not 'renegotiation-proof'. Second, lending in international capital markets may not be the only way in which countries can dampen income shocks. If other means, such as insurance, are available, the threat of a lending embargo of course loses some of its force. A third attack on Eaton and Gersovitz arises from empirical research which shows that the interest penalty that a defaulter will suffer is so small and short-lived that repudiation may actually pay off.[12] Costs of reputation, then, apparently do not suffice to explain why sovereigns repay.

The subsequent literature has therefore focused on other, more direct costs of default. A prominent theory, which is supported by at least some evidence, is that a defaulting country will lose international trade, either due to explicit embargoes imposed by creditor countries or because

[11] For a more detailed exposition of the literature, see for example Sturzenegger and Zettelmeyer (2006a).
[12] Mitchener and Weidenmier (2005, pp. 4)

firms in the defaulting country experience difficulties obtaining trade credit. Defaults have also been shown to negatively affect the domestic financial sector. If domestic banks invest heavily in government debt, the default will have a devastating impact on their balance sheets, causing the banks to restrict their lending to the private sector with the usual consequences for economic growth. The probability that a banking crisis will follow within two years after a default has been estimated at 14%.[13] Furthermore, a default will also likely carry political costs besides the loss of reputation with creditors.

With the increased threat of creditor litigation in recent years, the list of direct costs of default must be extended to include costs arising from debt enforcement ("legal costs"). At least three sources of costs can be identified. First, the debtor will have to incur legal expenses for the defence against the creditor suit. Second, the country may be forced to devote substantial efforts to the avoidance of attachment, e.g. it may have to redirect its payment flows outside the reach of creditors. Third, and most importantly, the country may lose its access to fresh financing, not just due to the loss of reputation but because of the immediate threat that creditors could attach any revenues from new bond issues (Sturzenegger and Zettelmeyer, 2006a). For instance in the *Elliott* case discussed below, creditor litigation made it impossible for Peru to meets its obligations to other bondholders, causing Moody's to downgrade its credit rating for the country.

This last category of costs brings us back to the starting point of this section: Only if sovereign defaults are viewed as strategic rather than inevitable, only if the costs of default are at least partly of a direct nature rather than consisting purely in reputation costs, and only if those direct costs consist at least in part in the costs of legal sanctions, only then can stronger individual enforcement rights possibly serve to discipline sovereign debtors.

Individual versus collective enforcement

Assuming for the sake of the argument that enforcement rights indeed have a deterrence effect, it may be asked if those rights necessarily have to be vested individually, rather than collectively, to achieve that effect. When a country considers repudiating its debts, does it make a difference for its government to know whether a potential lawsuit will be lodged by an individual bondholder or by a representative, such as a trustee? Granted, the threshold for initiating proceedings seems higher in the case in which at least 25% of bondholders have to instruct the trustee to sue. Yet, in most of the episodes in which a single creditor is able and willing to sue, it is probably possible to mobilise 25% of bondholders to do the same, which means that the deterrence effect is also the same, if not greater.

In fact, collective litigation may actually be more readily forthcoming than individual suits. The conventional story in the economic analysis of bankruptcy law is that individual enforcement rights provide creditors with an incentive to sue which is excessive from a collective perspective. However, the opposite may actually hold for two reasons. First, litigation involves fixed costs and hence returns to scale. Second, the costs are private (they accrue only to the litigant) whereas the expected gains involve some positive externalities to the other bondholders. So if no mechanism for collective action exists, we may actually see each creditor waiting for the others to move first, i.e., the incentives to bring individual suit are suboptimal, rather than excessive.

In that type of situation, a trust structure may be able to bring forward a lawsuit where exclusively individual enforcement rights could not. Collective action helps spread the fixed costs and internalises the externalities. The threat to a potential repudiator may thus be greater than with individual enforcement rights.

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[13] For detailed references on the costs of default, see IMDB (2006).

Adjusting yields

Even if - in spite of all the reservations mentioned above - greater enforcement capabilities reduce the ex ante probability of default, and even if individual rather than collective rights are strictly necessary, it remains to be explained why a lower default probability would in fact be to the advantage of creditors. The question arises from the 'adjusting yields' argument that was already made in Häseler (2007). Assuming that bond yields adjust to fully reflect the different default probabilities of bonds with collective and individual enforcement rights, then bondholders are perfectly compensated for the difference in risk. If, however, for some reason they really wanted to avoid the additional risk, they can always recreate the "safer" type of bond (supposedly those with individual enforcement rights) by holding the riskier type and making a risk-less loan. Either way, bondholders should be indifferent about the deterrence effect of enforcement.

To sum up, ex ante justifications for stronger individual enforcement rights do not appear to stand up to even some superficial theoretical scrutiny.

Eliciting a (better) restructuring offer

Further justifications for stronger individual enforcement rights can be derived from the ex post situation, i.e. after the debtor has declared a moratorium or has actually defaulted.

Once a debtor country has made the difficult decision to default and has accepted the inevitable loss of reputation, there may be no compelling reason for it to approach its creditors to negotiate a restructuring deal, so long as the country has no immediate need for additional capital from the financial markets. The IMF's 'lending into arrears' policy requires the debtor to negotiate with the creditors in good faith, but again this requirement is not compelling for countries that do not depend on IMF loans. One of the main objectives of the Group of Ten model collective action clauses was "to foster early dialogue, coordination, and communication among creditors and a sovereign caught up in a sovereign debt problem"; however, *engagement provisions*, which could have brought the promise of timely consultations with the debtor, were generally not adopted. So in some situations, the threat of litigation can be only device that bondholders have at their disposal to force the debtor country to the negotiating table. All the costly consequences of creditor suits that were mentioned in the context of deterrence come into play again in the ex post perspective – if nothing else, the prospect of legal battles with hundreds of bondholders should persuade the defaulting country that it is in its own interest to make a restructuring offer. Miller and Thomas (2006) stress the function of litigation for engaging the debtor in the case of the Argentine default. According to their interpretation, the court used the threat of granting attachment orders to ensure that the defaulting country negotiated in good faith with creditors.

Besides the timing, the quality of the restructuring offer itself can also be seen in relation to enforcement rights. "Litigation may also operate as a check on the terms of the proposed restructuring, giving creditors recourse against a restructuring that provides insufficient value…"[14] Clearly, the better the exchange offer, the less likely it is that the debtor will have to bear to nuisance of creditor suits. A lower threshold for (individual) litigation thus translates into greater bargaining power for creditors. Accordingly, Sturzenegger and Zettelmeyer (2006a, p. 3) hypothesise that "the threat of litigation may be an obvious candidate to explain the large recovery values obtained by creditors in some recent debt restructurings…"

Similarly to the first motive discussed above, if the objective is to receive a better and timelier restructuring offer, stronger *individual* enforcement rights appear to be in line with the *collective* interest of bondholders. Again one may ask if the same goal could not be achieved with

[14] Fisch and Gentile (2004, p. 1055)

collective enforcement procedures, e.g. through a trustee. As mentioned before, it is unclear which of the two regimes provides stronger incentives to bring suit. It is obvious, however, that when the trustee initiates litigation – backed by at least 25% of bondholders - the effect on borrower behaviour is likely to me much larger than with individual action. In sum, for the purpose discussed here, individual enforcement rights may be useful, but whether they are indeed necessary or superior to collective rights remains questionable.

Getting the money

When creditor representatives argue for stronger individual enforcement rights, they naturally appeal to some noble cause, such as the viability of the sovereign debt market or the necessity to protect financial flows to emerging market economies. At the heart of statements like the one by Michael Chamberlin quoted in the introduction, however, appears to lie but the simple desire to enforce the contract, i.e. to get the money that has been promised. As legitimate as this desire may be, the objective here is to discuss whether it is in the common interest of creditors to be able to pursue this motive. I will in turn examine the individual and the collective perspective.

Individual perspective

If an individual bondholder considers only the costs and benefits that accrue to herself, then the option to litigate at her own initiative can at worst have a value of zero. In fact, zero may just be what it is to the vast majority of bondholders. In all of the major cases against defaulting sovereigns, the claimants were fairly large companies, institutional investors, specialised vulture funds, or all three.[15] The average return they received on the litigation is unknown. Elliott Associates has a track record of achieving full repayment in almost every case, but certainly not all legal action is as successful. If litigation is not always profitable for large, specialised creditors, the expected net present value of suing is much less likely to be positive for small retail investors. As exemplified in the *Elliott/Peru* case outlined in the next section, successful completion of a lawsuit may require innovative strategies, legal action in several jurisdictions, and most of all deep pockets.

The Argentine default of 2002 was the first to have provoked a number of retail investors going to court. However, as of 2006, none of the judgements that creditors were awarded had enabled them to satisfy their claims. It is particularly because of the difficulty to attach the debtor's assets that "agreeing to a reasonable restructuring offer - one that reflects the country's capacity to pay - may be the best option available to mainstream creditors…"[16] Getting the money (i.e. full repayment) is a hope that only very few bondholders may entertain realistically.

Collective perspective

When the welfare of bondholders as a group is considered, the paradoxical possibility arises that individual enforcement rights, which are again just an option whose value by definition cannot be negative, can actually make the group worse off. The solution to the paradox lies in externalities, i.e. the case in which the actions of one bondholder negatively affect the others' welfare. These *collective action problems* have been discussed in depth elsewhere.[17]

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[15] Table 3.1 in Sturzenegger and Zettelmeyer (2006b) presents an overview of litigation against sovereign debtors and the associated outcomes.

[16] Sturzenegger and Zettelmeyer (2006a, p. 31)

[17] See, for example, Dixon and Wall (2000), Sturzenegger and Zettelmeyer (2006b), White (2002), or Häseler (2007).

Still, a numerical example may be helpful to illustrate the concept of collective action problems. Assume a country owes ten creditors ten units of debt each. The country has a capacity to repay only 30 units. Enforcement costs are 40 for a trustee or four units for each individual creditor. The trustee would not sue for full repayment but rather accept the 30 units that the country can offer in a restructuring. If, however, individual enforcement were possible, a race to the courthouse would result in full repayment for the first three creditors and a compete write-off for the other seven creditors. The latter result is not only grossly unfair but also inefficient from the collective perspective of bondholders. Collective enforcement – or rather restraint from enforcement – yields a total payoff of 30 units, as compared to only 18 units with individual enforcement rights.[18]

In more practical terms, suppose a country was forced to default on its bonds and is now trying to obtain additional funding from financial markets to roll over its existing debt or at least to be able to offer an attractive restructuring proposal. If the right to initiate legal action rested with a trustee, it is unlikely that the trustee would be instructed to litigate because no sufficiently large group of bondholders can hope to be repaid in full, given the debtor's current situation.

By contrast, an individual creditor may well hope to satisfy her claims by trying to attach any fresh money that the country can obtain. With her lawsuit pending, however, the markets will be very reluctant to extend new loans to the country. In this situation the majority of bondholders will want to restrain individual members of the group from making use of their rights.[19] Given a choice, they may prefer collective over individual enforcement rights. In the words of Sturzenegger and Zettelmeyer (2006a, p. 19), collective action problems do "not necessarily imply that creditors will be worse off relative to a situation in which they had less rights, but [they open] the door for institutional mechanisms [such as] contracts that force creditors to act collectively."

So much for theory; the next two sections offer some evidence as to how bond markets view the exertion of individual enforcement rights in practice.

4 - The Case

The settlement of the case *Elliott Associates v. Peru* in September 2000 provides an ideal testing ground to study the market's reaction to an event that arguably shaped views about individual enforcement rights. Such a case study is by no means the only possible approach to assessing the value of the enforcement option. Alternative ways include the evidence summarised in Häseler (2007): Since one of the main differences between bonds with and without collective action clauses lies in the extent of individual enforcement rights, a test of the yield difference between the two types of bonds can also be interpreted as a test of enforcement. It has been demonstrated that no systematic yield difference exists. The presence of collective action clauses is of course only an imperfect proxy for enforcement rights because the two types of bonds also differ in a

[18] These numbers are obviously based on the assumption that enforcement merely redistributes the available funds among creditors, rather than extracting payments that would not otherwise have been used for debt service.

[19] The possibility that, rather than creating negative externalities, an individual litigant may also be providing a service to fellow investors has already been mentioned. For example, in the *Allied* case, other creditors demonstrated their support for the holdout by filing an amicus brief (Sturzenegger and Zettelmeyer, 2006a). Yet again, if, by suing, an individual creditor acts in the interest of a larger group, then enforcement rights might as well be vested collectively.

number of other respects. The present case study presents an alternative, perhaps more direct approach to getting a quantitative handle on the meaning of individual bond enforcement.

The significance of the *Elliott* case is easily demonstrated. Anne Krueger, First Deputy Managing Director of the IMF, used the case in one of her first speeches about the Sovereign Debt Restructuring Mechanism to demonstrate the shortcomings of the international financial architecture. Her counterpart at the time, Michael Chamberlin (2002b, p. 3), refers to the case as "the most widely cited (and possibly only) example of roguish behaviour." The paper by Sandoval (2002) begins, "One of the most important cases of the last decade, in the sovereign debt arena, was that involving the New York-based hedge fund named Elliott Associates, LP… against the Republic of Peru…"

Course of events[20]

In October 1995, the Republic of Peru announced its intention to restructure defaulted commercial but officially guaranteed bank loans into Brady bonds. Three months later and, more importantly, only two weeks after the successful litigation by Pravin Bankers against Peru, Elliott Associates began purchasing a total of $20.7 million in face value of the debt at just over 50 cents on the dollar. As the Brady exchange progressed, Elliott predictably refused to participate and instead on October 8th, 1996, filed suit against Peru and its instrumentality, Banco de la Nacion, hoping to attach the collateral to be used in the exchange. However, the motion for attachment was denied.

The Brady exchange closed on March 7th, 1997, backed by Peru's verbal promise that no preferential treatment would be given to holdouts. In August 1998, the New York Southern District Court ruled in response to renewed litigation from Elliot that the claims in question had been acquired with the intention of bringing suit, thus violating § 489 of the New York Judiciary Law. This was the first time the "champerty" defence had worked for a sovereign debtor. Yet, on appeal Elliott succeeded in having the first judgement reversed. The Court of Appeals for the Second Circuit decided that the fund's "primary goal was 'to satisfy the debt' and not necessarily to litigate".[21] The decision came with an attachment and restraining order over any commercial property held by the defendants in New York. However, this was of little value to Elliott as virtually no such property could be located within the jurisdiction.

One June 22nd, 2000, the Southern District Court authorised Elliott to recover a sum of more than $55 million. While immediate attachment was impractical, the award nevertheless posed formidable problems to Peru, which was now forced to rearrange all of its financial flows to avoid interference by Elliott in New York. The situation was further aggravated by Elliott's successful attempts to obtain attachment orders in other financial centres.

A major opportunity for Elliott arose as Peru's Brady coupon payment date on September 7th approached. The vulture sought and received restraining orders directed against Chase Manhattan Bank acting as Peru's fiscal agent, as well as against three clearing houses through which Peru was going to make the payments. The sovereign was thus forced to find other routes to service its debt and in fact missed the payment date, thereby marking the start of a 30-day grace period. Consequently, the Peruvian government had to find a way to make the interest payment before October 7th. Failing to meet this deadline would have implied a formal incident of default, triggering cross-default clauses which would have given Peru's bondholders the right to accelerate almost $4 billion of outstanding debt. Peru's investigations into the possibility of arranging the payments through the Bank of International Settlements yielded no solution to its pressing problems.

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[20] This account is based primarily on Sandoval (2002). See also Buchheit and Pam (2003).
[21] Sandoval (2002, p. 11)

The pace of events increased towards the end of September. On 21st and 22nd, two New York courts granted Elliott further restraining orders. On the latter day, Elliott also sought an injunction from the Commercial Court of Brussels to prevent the Morgan Guaranty Trust Company as operator of the Euroclear settlement system from accepting funds from Peru to be distributed to the Brady bondholders. The motion was rejected, Elliott appealed, and on September 26th, the 8th Chamber of the Brussels Court of Appeals finally granted Elliott's request. Facing the imminent danger of outright default, Peru settled on September 29th for $58.45 million. All restraining orders were lifted and the interest payments were eventually made on October 5th, two days before the deadline.

Reactions

The settlement of the case appears to have stirred sentiments of unprecedented intensity, which naturally varied in flavour across different groups of commentators. It provoked an outcry from Jubilee 2000, an international organisation promoting relief for highly indebted countries: "These people are trading in human misery. Elliott Associates, L.P., are picking over the bones of the Peruvian economy like a pack of vultures."[22] According to Sturzenegger and Zettelmeyer (2006a, p. 27), the "Elliott/Peru case led to much consternation in policy circles". The British Prime Minister Gordon Brown later said, "We particularly condemn the perversity where vulture funds purchase debt at a reduced price and make a profit from suing the debtor country to recover the full amount owed – a morally outrageous outcome."[23] Anne Krueger also articulated her displeasure with the outcome, but with a different perspective in mind. She "denounced the fund, alleging that it has undermined the entire structure of sovereign finance."[24]

This paper is, however, more concerned with the impact the case had specifically on the position of bondholders and the implications for the value of individual enforcement rights. There seems to be a consensus that, at least in the direct aftermath of the settlement, the chances of holdouts were perceived to have increased. To quote again Anne Krueger, "The more recent success of an aggressive legal strategy employed against Peru by a vulture company called Elliott Associates underlines the power that holdout creditors retain."[25] Sandoval (2002, pp. 5) writes, "it has been suggested that [the Brussels decision] will definitely strengthen the position of holdout creditors… Commentators have suggested that such a decision is one of the most important weapons given to holdout creditors to defend against sovereigns…" According to Bradley et al (2008, p. 4, FN), "[t]here is a good deal of evidence of market participants characterizing *Elliott Associates* as both unexpected and seismic." Elliott has also been described as the "high water mark for creditor's rights".[26]

An article in the Bradynet forum[27] comments on the settlement from an investor's perspective. It regards Elliott's victory as an event that "gave power back to creditors" after "creditors have been beaten up recently". Furthermore, the "Elliott case is now seen giving investors more faith in the legal system" and, "it's a situation where the legal rights of creditors were reaffirmed". Yet, even this investor-oriented source recognises the ambiguity in the meaning of the case: "While some investors see the Elliott case as spearheading creditor rights, others see it giving vulture funds more ammunition for legal attacks."

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[22] Quoted in Alfaro et al (2007, p. 22).
[23] ibid, p. 1
[24] Salmon, F. (2004) "Elliott Associates' aggression captures low-risk returns" in *Euromoney*, available at www.euromoney.com/Article/1001988/Title.html
[25] Quoted in Alfaro et al (2007, p. 22).
[26] Hal S. Scott, quoted in Bradley et al (2008, p. 9, FN)
[27] The article is available at www.bradynet.com/bbs/latam/100069-0.html

It appears that the academic literature has identified two ways in which the course and outcome of the *Elliott* case could improve the standing of individual creditors wishing to enforce their claims. One such aspect of the case concerns the fact that the plaintiff soon abandoned the traditional strategy of attempting to attach the debtor's assets and instead adopted an alternative, arguably novel approach. In the words of Zettelmeyer and Sturzenegger (2006a, pp. 27), the case

> appeared to open a powerful new channel for the enforcement of the claims of holdouts who had successfully obtained a judgement. Rather than engaging in the difficult and tedious process of attempting to attach debtor assets abroad, holdouts could ask courts to interfere with cross-border payments to mainstream creditors that had previously agreed to a debt restructuring. This seemed to be an almost foolproof enforcement channel, since it effectively gave holdouts a veto over the regularization of a country's relations with mainstream creditors, and hence over its return to international capital markets. Hence, Elliott/Peru appeared to catapult holdouts from their previous status of either a minor nuisance (at worst) or champions of creditor rights (at best) to a formidable obstacle to orderly sovereign debt restructurings.

Secondly, Elliott Associates was able to obtain the final and decisive judgement from the Brussels Court of Appeals based on a most unusual argument. The argument was built on the *pari passu* clauses, which is routinely included in international unsecured credit contracts but had never before played a role in sovereign debt litigation. The covenant had traditionally been interpreted to mean that the debtor may not subsequently issue debt that is senior to the instrument that contains the clauses. Elliott, by contrast, presented the interpretation that the clause required Peru to make payments to all its foreign creditors on a ratable basis. In other words, the plaintiff claimed that Peru was violating the debt contract by trying to make interest payments to the Brady bondholders without satisfying Elliott's demand at least proportionally. Commentators have expressed surprise not only about the new "ratable payments" interpretation of the *pari passu* clause (Buchheit and Pam, 2003), but also at the Brussels court's willingness to accept the argument.[28] Bradley et al's (2008, p. 5) interpretation of the case is a combination of the two meanings discussed here: "*Elliott* gave the *pari passu* clause legal significance by empowering creditors to invoke the clause as a means for holding up the sovereign's restructuring of its debt. This was a bargaining chip that heretofore was not possessed by the holders of sovereign debt."

While it seems that in the immediate aftermath the Elliott/Peru settlement was indeed seen by many commentators as potentially strong precedent for future creditor suits, Zettelmeyer and Sturzenegger (2006a) explain why over the longer run it became clear that the influence of the case was not so large after all. First, the Elliott decision rested heavily on the peculiar interpretation of the *pari passu* clause. Most subsequent litigants failed to obtain a similar ruling in comparable cases. Second, possibilities exist for debtor countries to safeguard their payment flows by redirecting them outside the reach of holdouts. Third, the legal environment began to change in response to *Elliott*. Belgium soon afterwards adopted laws to prevent the use of the Euroclear system for strategies such as Elliott's.

In summary, this review of scholarly and public reactions to the Elliott case has shown that the vulture's success has been widely seen to underpin individual enforcement rights and thereby to improve the position of holdout creditors, at least in the short run. Whether the events gave mainstream bondholders reason to celebrate is, however, an open question. Thus the conclusion is similar to the one that was suggested in the review of the relevant theoretical considerations.

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[28] For a more detailed discussion of Elliott's argument, see for example Sandoval (2002), Buchheit and Pam (2003), or any of the large number of articles on the case.

Testable hypotheses

Section 3 elaborated on a number of reasons why bondholders might or might not benefit from more extensive individual enforcement rights. We have seen that the balance of arguments is more likely to be positive for potential holdouts than for mainstream creditors. The Elliott/Peru case discussed in this section is an excellent opportunity to test the market reaction to what was probably one of the most important events to strengthen the position of individual creditors in the recent history of sovereign bond enforcement. Of course market behaviour is always a mixed result of the actions of different groups of participants, so unfortunately it is not possible to distinguish empirically between the response of mainstream bondholders and vultures.

The next section nevertheless presents an approach to quantifying the impact of the case, not just for Peru itself but also for the sovereign bond indices of a number of other countries. For if indeed the events in court bore significance for creditor rights in general, then the effects should be felt in any country that has only the slightest probability of default.

Given the ambiguity of the theoretical arguments and of the opinions on individual enforcement rights and the Elliott/Peru case that this paper has presented, there can be no clear prior expectation about the sign of the effect that the settlement had on bond prices. For a country that is not directly affected by the events, ex ante considerations (the possibility that the government will be deterred from defaulting) are probably more important in determining bond prices than ex post considerations, such as the possibility that the Elliott/Peru outcome could increase the danger of harmful litigation in the future. Thus, if anything, one might expect the effect on countries that are not directly affected to tend more towards the positive than the effect on the Peruvian bonds.

Speaking about possible results it should be mentioned that several different outcomes are observationally equivalent. A lack of effect of the settlement on bond prices could have at least four meanings:

- Either enforcement rights simply are not a major concern to bondholders,
- or perhaps bondholders do feel strongly about them but are unsure whether individual or collective enforcement rights are to be preferred,
- or perhaps the lack of price movements is the result of offsetting effects from two groups of bondholders - those who welcome Elliott's victory (vultures?) and those who think of it more as a threat (mainstream creditors?),
- or the settlement was not seen as making a difference for the future of bond enforcement, but this would be grossly inconsistent with the opinions cited above and throughout the literature.

Before launching into the empirical analysis, it has to be mentioned that the discussion of the Peruvian case is somewhat complicated by a historical coincidence. It just so happens that the events in court discussed here were immediately preceded by the "most serious political crisis in a decade"[29] in Peru. On September 14th, 2000, a video was broadcast on Peruvian national television that showed Vladimiro Montesinos, head of the national intelligence service and right-hand man of President Alberto Fujimori, handing over a bribe of $15,000 to an opposition congressman for his defection to Fujimori's party. The resulting public outrage forced Fujimori to announce on September 16th elections for the next year in which he would not stand again for President. Shortly afterwards, Fujimori fled the country and was impeached by Congress. The political crisis can quite clearly be expected to depress bond values. "The increased political uncertainty will depress investment, raise financing costs, and slow the economy", commented the deputy head of the sovereign ratings group at Standard & Poor's.[30] Furthermore, a change of

[29] *Euromoney*, October 2000, issue 378, p. 20.
[30] "Credit firms lower rating on Peru debt" *The Houston Chronicle* on September 20, 2000.

government is always associated with the risk that the new administration will use the opportunity to repudiate old debts.

Whether from the perspective of the analysis this coincidence of the two sets of events is a curse or a blessing is hard to say. On the one hand, the effects of the political events may be assumed to have lasted for a number of weeks and thus to have overshadowed the events in court. An attempt will be made to model the prolonged repercussions of the political crisis in the regressions. On the other hand, the political events can be used as a point of reference to gauge the strength of the impact of the events in court.

5 - The Evidence

Methodology

The basic methodology is a time-series study of sovereign bond index returns for Peru and other countries, with special attention given to the effects of the settlement episode. Daily bond index data for the years 1999 to 2001 are divided into 93 periods of eight trading days each. The rationale for this perhaps slightly unusual breakdown of the sample lies in the nature of the event under scrutiny. The most important developments in the Elliott/Peru case span a period of seven trading days, from the first of the final two court judgements for Elliott in New York on September 21st to the settlement on September 29th. Since it is not clear whether the market was able to fully evaluate all information about the settlement on that day, the event window also encompasses the next trading day. Within those eight days, investors witnessed a milestone legal victory by an individual creditor and presumably drew their conclusions about the meaning of this event for enforcement rights and the attractiveness of Peruvian and other government bonds. The enforcement event is assigned the dummy variable D_EA (for Elliott Associates), which takes the value one for t=55 and zero in all other periods. The coefficient on the dummy variable thus tells us by how much bond returns differed during that particular period from what they would have otherwise been, keeping constant all other variables that are included in the regression.

Peru

The revelation of the bribery scandal and subsequent announcement of new elections fall into the period immediately before the court event. I construct a variable for the political event, D_POL, to capture any abnormal returns that can be attributed to the scandal. In the simplest formulation (D_POL_1) it equals one for t=54 and zero in all other periods. However, it is likely that the political turmoil depressed bond returns for some time after September 16th. After all, Alberto Fujimori had managed to remain in power in seemingly hopeless situations before. The political crisis in Peru only started to be resolved in November 2000. Moser (2007) finds that political instability tends to depress bond prices for as long as 40 days after the event. Accordingly, D_POL_2 models the impact of the event as lasting for five periods (see figure 2 below).

	t=53	t=54	t=55	t=56	t=57	t=58	t=59
D_POL_1	0	1	0	0	0	0	0
D_POL_2	0	1	0,5	0,333	0,25	0,2	0
D_POL_PRESS	39	149	263	64	0	0	0

Figure 2: Different ways of modelling the political event

Both D_POL_1 and D_POL_2 are simplistic and, which is more concerning, arbitrary ways of modelling the course and effect of the political crisis. D_POL_PRESS takes a different approach.[31] This variable counts the number of US press releases on LexisNexis Business that contain the search term "Fujimori" in each period. Figure 3 graphs the number of articles as returned by the search on a day and per period basis.

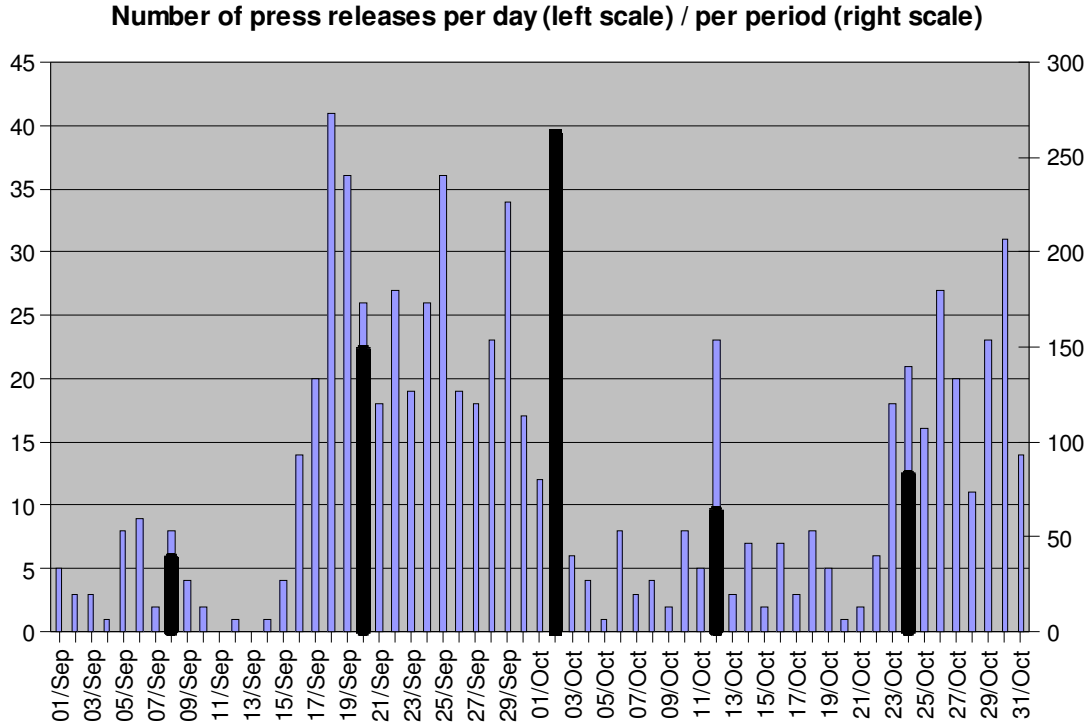

Figure 3: Number of articles per day in the US press that mention "Fujimori", from LexisNexis

The political crisis is clearly represented by the bulk of articles in the second half of September. D_POL_PRESS reverts back to zero after t=56 because the resurgence of press releases towards the end of October was already due to the next, separate set of events.[32] This is of course again an arbitrary decision, but to proxy the impact of the political crisis through the attention it received in the media is surely an improvement over the purely theoretical formulations of D_POL_1 and D_POL_2.[33]

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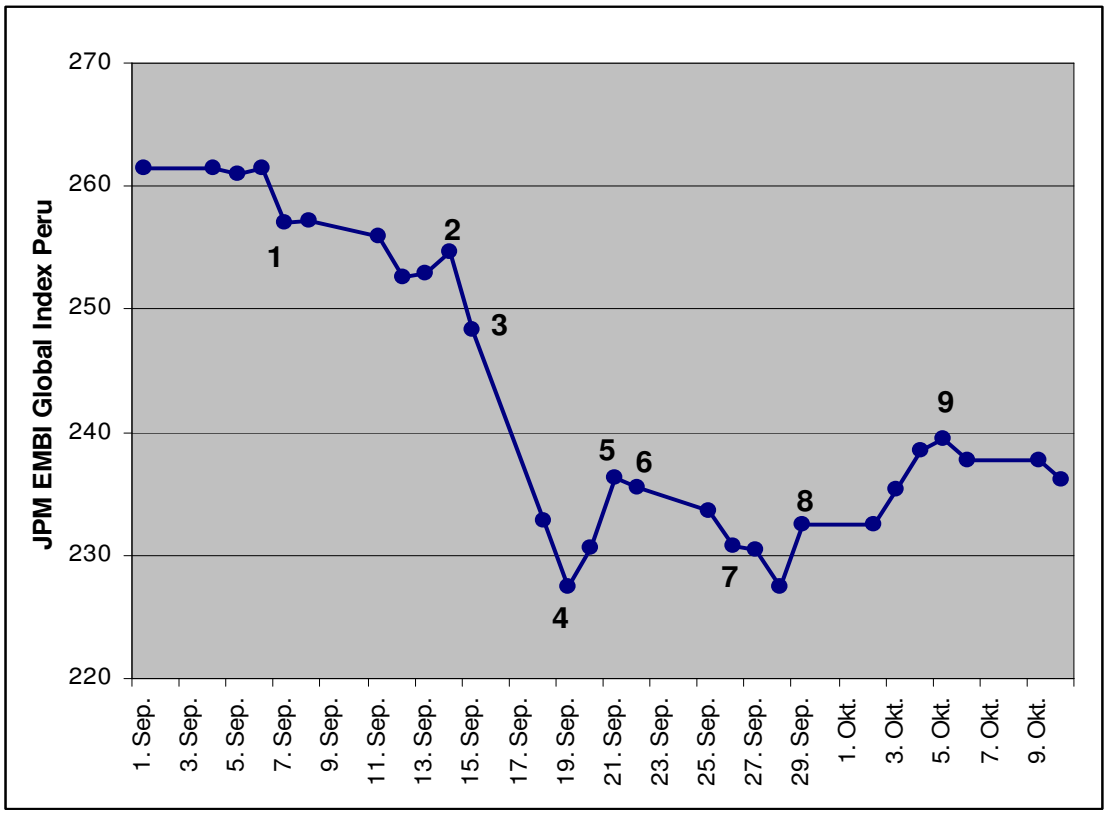
[31] I am most grateful to Jonathan Klick for this suggestion.

[32] From October 23rd onwards, the news of Vladimiro Montesinos returning to Peru and Vice President Francisco Tudela resigning in consequence received a lot of media coverage.

[33] Only two of the articles in t=55 mention Elliott Associates. This means that D_POL_PRESS is able to make a clear distinction between the events in court and in parliament.

As dependent variable, in accordance with Moser (2007), I use JP Morgan's Emerging Market Bond Index Global (EMBIG). The data were obtained from Thomson's Datastream service. To be more precise, the dependent variable consists in the percentage change in the index value over the eight-trading-day periods. Figure 4 plots absolute EMBIG values for Peru during the relevant weeks. It is evident that the political events (marked 2 and 3) had a large negative impact on the index value, whereas events related to interest payments and enforcement had no systematic effect.



No.	Date	Event
1	07.09.2000	missed Brady interest payment
2	14.09.2000	corruption scandal becomes public
3	15.09.2000	new elections announced (16th)
4	19.09.2000	S&P rating downgrade
5	21.09.2000	NY court decision for Elliott
6	22.09.2000	NY court decision for Elliott and motion filed in Brussels -> denied
7	26.09.2000	appeal in Brussels granted
8	29.09.2000	settlement
9	05.10.2000	Brady interest payment made

Figure 4: EBMIG index values and some important dates

Besides the dummies[34] for the political and enforcement event, a number of other explanatory variables were considered.

[34] D_POL_2 and D_POL_3 are admittedly not dummy variables in the usual sense.

The percentage change in the JP Morgan EMBIG index for Asia (JPMGASI, also obtained from Datastream) is used to proxy for all sorts of factors that influence sovereign bond markets globally. The expected coefficient sign of this proxy is positive. In accordance with Moser (2007), another explanatory variable consists in the percentage change in the 10-year US Treasury Bill rate (UST), as obtained from Yahoo Finance. Finally, I use the percentage change in the Peruvian exchange rate (NUEVO_SOL). Theses data are taken from www.oanda.com. The expected sign is negative for the following reasoning: An improvement in a country's capacity to service its debt should, besides raising the price of its debt, boost the value of its currency and thus reduce the exchange rate as measured in local currency units per dollar.

Estimation and results

All estimations were done using straightforward OLS regression in EVIEWS. First a parsimonious equation for Peru was estimated without the dummies. The results are presented as model 1 in figure 5. The model has a good overall fit and passes the usual tests for violations of the classical assumptions. The US Treasury Bill rate proved to be largely uncorrelated with Peruvian government bond prices, so the variable was dropped, even though it was attributed great explanatory power in the study by Moser (2007). By contrast, the coefficients on JPMGASI and NUEVO_SOL are highly significant and of the expected sign. The latter result is somewhat unexpected as the Peruvian exchange rate was effectively a managed float at the time so that changing economic fundamentals could drive the value of the currency only to a degree.

Dependent variable: JPMGPER	t-statistics			
Variable	model 1	model 2	model 3	model 4
C	-0.238	0.17	0.37	0.303
JPMGASI	5.753	5.696	5.551	5.478
NUEVO_SOL	-4.913	-4.886	-4.919	-4.917
D_EA	-	-0.865	0.448	1.752
D_POL_1	-	-3.045	-	-
D_POL_2	-	-	-2.956	-
D_POL_PRESS	-	-	-	-2.584
Adjusted R-squared	0.4477	0.4926	0.4898	0.4787

Figure 5: Various specifications to predict JPMGPER

The introduction of D_POL and D_EA in models 2 to 4 makes little difference to the coefficients of the control variables. The political event appears to have had a strong negative impact on bond returns, not just in the period in which it occurred, but also when the effect is modelled as diminishing only gradually over time, as in the last two columns.

The sign change of D_EA between model 2 and models 3 and 4 is quite informative. It is exactly the outcome one would expect if the political event had a prolonged effect and the enforcement event had none. In model 2, D_POL_1 most likely captures the politically-motivated depression of returns in t=54, and D_EA mostly captures the continuing negative effect of the political event in t=55, rather than any effects of the settlement. When D_POL is modified in model 3 to allow for an extended impact of the scandal, D_EA is "relieved" of the burden wrongly attributed to it in model 1 and promptly changes sign. Model 4, which arguably represents the best way of incorporating the political event, returns a t-value for D_EA that is relatively large but still not significant. Yet a different specification of D_POL could easily cause the coefficient of D_EA to be zero. This would not be the case if investors had taken the Elliott/Peru case to have either a positive or negative general meaning for the position of

creditors. Restricting the sample to 53 observations as a robustness check yields very similar estimates for the event dummies.

Other countries

To test whether the *Elliott* settlement influenced bond prices of countries that were not directly affected, I ran a series of regressions of the form

$$EMBIG_{i,t} = c + \alpha_i * UST_t + \beta_i * D\_EA + \varepsilon_i$$

for 19 countries of moderate and poor credit ratings.[35] The coefficient estimate on the event dummy measures the abnormal return in each country's bond index during the settlement period. The t-values of that coefficient range between -0.43 and 1.49, so none of the countries experienced significant abnormal returns. The average of 0.31 is again not significantly different from zero.

Given the lack of effect for Peru and the ambiguity as to the merits of individual enforcement rights, this result was to be expected. A possibility, however, is that even though the settlement event had no effect on third countries on average, the impact on individual countries might vary with their probability of default. Figure 6 below shows that this is not the case.

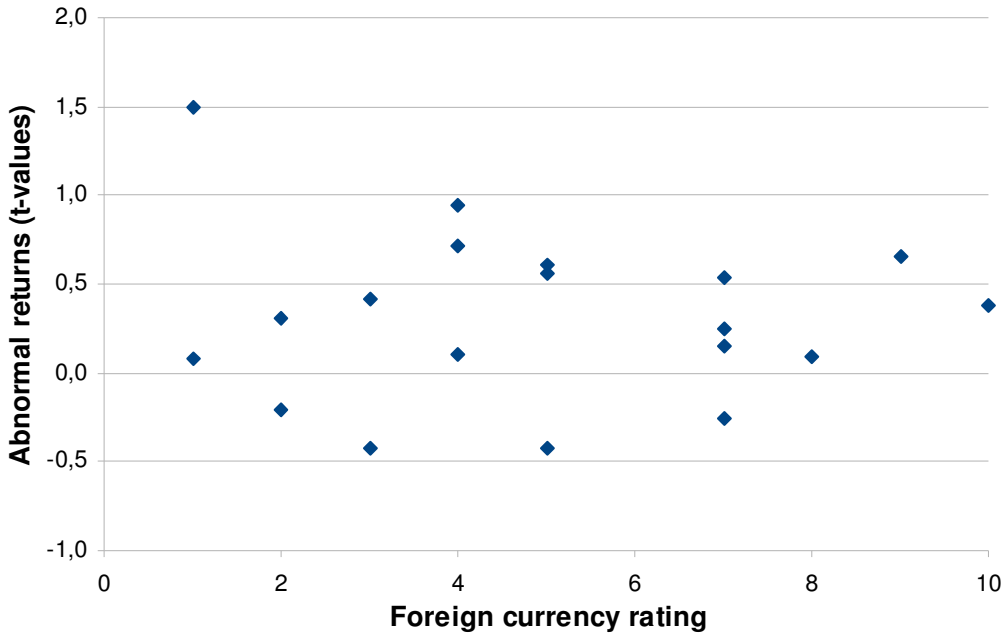


Figure 6: Sovereign credit ratings and abnormal returns during the settlement period

Standard and Poor's foreign currency credit ratings were transformed into numerical values such that the lowest default risk in this group of countries (BBB+) is assigned the value 1 whereas the highest default risk (SD) is assigned the value 10. The abnormal returns (scaled by their standard deviations to obtain t-values) bear no correlation to default risk, neither their absolute values nor

[35] This is the universe of countries for which data on the Emerging Market Bond Index Global is available from Datastream for the period 1999-2001.

their variance. Thus, there is no evidence to suggest that investors around the world took much notice of the *Elliott* case, or at least they did not appear to have a clear view of whether the outcome improved or harmed their position.

6 – Conclusion

This paper has presented a critical view of individual enforcement rights in international sovereign bonds as seen from the perspective of overall bondholder welfare. It has been demonstrated that, whichever may be the primary motivation for some bondholders to insist on individual enforcement rights, the aims could be equally well achieved if the powers to enforce the claims rested with a trustee. Where collective action problems play a crucial role, the ability to initiate legal action individually can be detrimental to the common interest of creditors.

The analysis of market reaction to the Elliott/Peru settlement fits in well with the theoretical considerations. Compared to the effects of the political turmoil, the market seems to have taken hardly any notice of what has been described as the greatest boost to creditor rights in the decade. Given the observational equivalence of different results, though, this lack of abnormal returns has to be interpreted carefully. What can be said under the assumption that the outcome of the case was indeed perceived as a triumph for individual enforcement is that there must be a large fraction of investors who are at best sceptical of the merits of individual enforcement rights.

Remarkably, that fraction has never raised its voice, for example in the debates about collective action clauses. Arguments in favour of collective enforcement have come forward from academics and public sector representatives, but not from bondholders themselves, even though the present analysis suggests that there must be supporters of trust structures among the ranks of creditors. Public choice theory may help to explain this puzzle. The negative externalities caused by individual litigation are borne by a large group of bondholders and are therefore not material to any of them. The benefits, by contrast, accrue almost exclusively to the plaintiff. The 'usual suspects' for maverick litigation are probably a relatively small number of vulture funds, who have a strong incentive to lobby for the preservation or expansion of individual enforcement rights. The potential opposition, however, is widely dispersed, anonymous, and therefore less well organised and less effective in influencing public opinion.

One should think that organisations such as EMTA would take a balanced stance on individual enforcement, one that reflects the diversity of the creditor community. Why then did its chairman assert that creditors want unrestricted individual enforcement rights? Part of the answer may be found in public choice theory. Part of the answer is also that EMTA's membership is comprised solely of institutional investors, and Elliott Associates is one of them.

It may be speculated that the opposition to collective action clauses before 2003, which was justified by concerns about enforcement rights, was unrepresentative of the views of most bondholders. Only potential holdouts and vultures stood to lose from collective action clauses and the associated (slight) restriction of individual enforcement rights. If that is so, policymakers need not have hesitated to apply pressure on issuers to effectuate the change in market practice.

Looking ahead, a better understanding of the meaning of enforcement can pave the way for the speedy adoption of trust structures outside of England. Other financial centres should follow the example of the London Stock Exchange and make the appointment of a trustee a listing requirement. Any remaining protest from bondholders probably reflects individual rather than collective interests and can therefore be disregarded. Being able to say that bondholders are at worst indifferent about relinquishing their remaining individual enforcement rights would also open the door for some tentative welfare analysis of individual versus collective rights. Most likely, sovereign debtors would prefer to deal with the latter – lower negotiation costs, more

predictable outcomes. The public sector, too, has made its preference for trust structures quite clear. Again, authorities should press for what promises to be a Pareto improving reform.

Further research should continue to refine our understanding of bondholders' attitudes towards individual enforcement rights. A simple survey of investors' opinions could be quite informative. Alternatively, one could test for yield differences between bonds governed by fiscal agency agreements versus trust deeds.

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