Individual versus Collective Enforcement Rights in Sovereign Bonds

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1. Introduction

Sovereign bonds are notoriously hard to enforce. Maybe that is exactly why bond holders often guard what little rights they have so fiercely. Among the perceived threats is the apparent inclination of policy institutions to vest these rights collectively rather than with individual bond holders.

This chapter examines alternative creditor rights regimes in the most relevant jurisdictions. We discuss the enforcement of bond contracts alongside amendment of their terms because these two aspects are almost inseparable in the event of default.[1] The main focus of this chapter, however, is on the question as to whether having the option of individually and independently enforcing a sovereign bond contract will indeed be in the investor's best interest. Sometimes the perspective will shift to that of the debtor country and third parties. The discussion centres on the incentives for the parties' behaviour created by different structures of creditor rights. The analysis rests on economic theory as well as on bond market evidence to arrive at the recommendation to embrace collective rights structures.

These issues may be of interest to prospective investors that wish to know which allocation of enforcement rights is likely to effect the largest repayment from a faltering sovereign debtor. The implications become much wider, however, once we realise that the structure of enforcement rights can affect the course of a sovereign debt crisis and restructuring, thus determining not only the distribution of repayment, but also how much value is lost in the process. Given that these effects will be anticipated by the market, the question of individual enforcement rights (IERs) can ultimately influence the amount, and the terms at which, a country can borrow – and therefore that state's prospects for economic development. The structure of enforcement rights thus becomes a matter of interest also for policymakers and academics.

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1 Our analysis is restricted to the payment terms of sovereign bonds, ie, those that bond holders will try to enforce in a default situation. For a discussion of individual versus collective enforcement of non-payment bond terms, see Kahan, M (2002) "Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights", *NYU Law Review* 77(4):1040–87.

2. Individual enforcement

2.1 Collective action clauses and governance structures

At the turn of the century, sovereign bond markets were perceived to be ripe with problems – and little has changed since to improve that impression. The problems revolve around the fact that these markets are ill-equipped to deal with sovereign default in any satisfactory manner. A series of debt crises during the 1990s showed that sovereign bonds are subject to non-payment and rescheduling much like other classes of debt, but that they lack provisions and procedures to cope with such situations in an efficient and orderly way. "At present the only available mechanism requires the international community to bail out the private creditors" said Anne O Krueger, First Deputy Managing Director of the IMF, in November 2001.[2] More than 10 years later, we are again witnessing a series of bail-outs, this time in response to the ongoing European debt crisis.

We must not forget, however, that not all countries can hope to be 'rescued' from their debt problems through cheap additional loans from other countries or international financial institutions. States that are not considered relevant to any economic system or that are not at the focus of geopolitical interests will often be left to their own devices to develop ad hoc procedures for a debt restructuring or to rely on what little guidance the bond contracts have to offer. And it is precisely the structure of enforcement rights that can make the difference between a smooth debt rescheduling and one that drags on for years, unnecessarily damaging the debtor's economy and depressing bond values.

Crisis resolution mechanisms need to improve, not only for the benefit of such 'neglected' countries but also in the event that the current generosity with respect to bail-outs ends when the political will and economic resources for rescue packages are exhausted. Perhaps one day politicians will even heed the economic advice that bail-outs are inefficient because they create the wrong incentives for both lenders and borrowers, and unfair because they shift the burden of the debt problem to third-country taxpayers.

Some progress towards reforming creditor rights in bond contracts for smoother restructurings has already been made. In the late 1990s, policy calls accumulated for the universal adoption of collective action clauses (CACs). The clauses allow a qualified majority of bond holders (typically 75%), to agree with the debtor on debt relief through amendment of the bond's payment terms – eg, a lower interest rate, reduction of principal, or a rescheduling of payments. The amendment then becomes binding also for non-participating bond holders. These provisions had already featured in bonds governed by the laws of England, Japan and Luxembourg, but their effectiveness was limited by the fact that almost all countries continued to issue bonds that required unanimous consent, such as those governed by the laws of Germany and the State of New York. In March 2003, Mexico yielded to political pressure and made the first publicly noted bond issue with CACs under New York law, where this issuing practice has since become the norm. Yet the many bonds still outstanding that require unanimous consent may continue to impede sovereign debt restructurings for some time. Restructuring such bonds can only be done through voluntary bond exchanges, in which some investors are almost certain not to participate. Such 'holdouts' present the debtor with the unpleasant choice of either paying the dissenters in full according to the original terms (which is unfair to those creditors who did tender their bonds), or refusing to service the left-over bonds, which means risking litigation from the holdouts, with dire consequences for the restructuring process.

When all sovereign bonds are eventually equipped with collective amendment rights, CACs promise to effectively put a stop to holdout behaviour – but only after a restructuring agreement has been reached. From the moment the debtor has defaulted until the resolution of the crisis – a period that may span years

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[2] Krueger, A (2001) "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring", speech at www.imf.org/external/np/speeches/2001/112601.htm.

– bond holders typically remain unconstrained in exercising their enforcement rights. The extent of these rights, and in particular the question whether they are vested in the individual bond holders or in a representative of a majority, depends on what we shall term the governance structure of a bond. Three types of governance structures can be distinguished:

- **Fiscal agents** - first, the simplest arrangement has the debtor country issuing bonds under a fiscal agency agreement. The fiscal agent, typically a bank, performs a set of largely administrative functions. In particular it receives payments of interest and principal from the debtor for distribution to the creditors, but it also distributes and registers the bonds themselves and relays information from the debtor country to the bond holders. The fiscal agent acts only for the issuer and bears no obligation towards the bond holders. Importantly, under a fiscal agency agreement each bond holder retains the right to contractual remedies in the event of a default. This includes the right to accelerate the claims – that is, to declare them repayable immediately, under certain conditions, such as a missed interest payment. In some cases, however, acceleration requires a vote by the holders of a certain proportion of the principal. Importantly, every individual bond holder is free to initiate legal action against a defaulting debtor. There is no obligation to share any proceeds from such litigation.

Instead of, or in addition to the fiscal agent, the issuer may appoint a trustee to represent and protect the interests of the bond holders. The trustee will take over most enforcement powers from the bond holders, the details depending on whether the trust is created under English law (in which case there will be a trust deed) or US law (trust indenture). The trust concept is not recognised or used in most other jurisdictions.

- **Trust deed** - the trust deed under English law is a contract between the issuer and the trustee which specifies the extensive ways in which the trustee is obliged to serve the interests of the bond holders. The trustee has both the power and the duty to monitor the debtor's compliance with the terms of the instrument, and to take remedial measures in case the debtor country fails to meet its obligations. The trustee may act either on its own initiative or when instructed to do so by the required proportion of bond holders. The right to accelerate the bond and to initiate legal proceedings rests exclusively with the trustee, rather than with the individual bond holders, and the proceeds from litigation will be shared among the bond holders. An exception lies in the case where the trustee fails to take action despite being prompted to do so by the bond holders. Only then will the individual bond holders redeem the right to accelerate and enforce their claims as they would under a fiscal agency agreement.

- **Trust indenture** - by contrast, New York-style trust indentures generally follow the requirements of the US Trust Indenture Act of 1939, even though the act applies only to corporate bonds. The act stipulates that "each bond holder has an unqualified right to bring an individual enforcement action to recover her share of any amounts of principal and interest not paid on their respective due dates. Apart from this individual right to recover overdue amounts, however, only the trustee has the right to pursue other remedies, including the important right to sue for accelerated amounts".[3] Unlike the trust deed, the trust indenture does not imply a sharing requirement. In terms of enforcement rights, trust indentures thus constitute a middle ground between the extremes of fiscal agency agreements and trust deeds.

Below we shall discuss, from the bond holders' as well as from a general welfare perspective, the potential advantages of trust structures over purely individual enforcement rights. Many of these

[3] Buchheit, LC and GM Gulati (2002) "Sovereign Bonds and the Collective Will" *Emory Law Journal* 51, pp 15.

benefits have been stressed in the literature since the early 1980s.[4] Policy circles joined in the support for the standard appointment of a trustee in the late 1990s. Yet, market practice with respect to governance structure has been changing only slowly, if at all. In 2009, only 24% and 28% of outstanding bond issues under English and New York law, respectively, named a trustee. The data suggests a very slight upward trend for trustee appointment in new bond issues over the past few years. Another development may have been initiated by bonds issued by Grenada (2005), Belize and the Republic of the Congo (both 2007).[5] These countries assigned trustees to their new securities under New York law; however, the trustees were given full enforcement rights of the type they would traditionally have only under English law. In that sense, we may be witnessing a convergence of the two traditions of bond holder representation.

2.2 Individual enforcement rights

Before attempting to evaluate their desirability, we first need to find a comprehensive definition of individual enforcement rights . The presence of a trustee, with its implications for individual acceleration, initiation of litigation, and sharing, is too narrow. CACs clearly also play an important role. For, if a country manages to negotiate, through the use of CACs, a restructuring agreement with the required majority of its bond holders without defaulting, there is never any scope for legal action. Only a restructuring without CACs – ie through an exchange offer – will almost certainly leave non-participating, dissatisfied bond holders, some of whom may be tempted to try their luck in court. In the future, as CACs are expected to become ubiquitous, and if debtor countries are able to use the clauses in such a way as to avoid default, the governance structure of a bond and the implied modes of legal action will lose much of their relevance.

For the time being, however, IERs must be defined with respect to both CACs and governance structure. Table 1 lists the four possible combinations of these two characteristics in a bond contract.[6]

Scope for individual enforcement?	**CACs**	**no CACs**
Trustee	essentially none (21% / 2%)	severely restricted (6% / 12%)
no Trustee	severely restricted (46% / 29%)	mostly unlimited (27% / 57%)

Table 1: The scope for individual enforcement with and without CACs and trustees, and relative frequencies under New York/English law.

The scope for individual legal action by bond holders is at best 'severely restricted' whenever the contract contains CACs. When we add central enforcement through a trustee, independent action is possible only under fairly rare circumstances. Where both CACs and trust structures are absent – a situation we might characterise as 'full individual enforcement rights' – bond holders are free to pursue independent remedies, unless acceleration requires a collective vote.

Looking at the information on market practice in Table 1, we see that the proportion of English law bonds with strong IERs (no CACs, no trustee) is greater than the proportion of New York law bonds in

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[4] For more details, see Häseler (2012).

[5] Buchheit, LC (2007) "Supermajority Control Wins Out" *International Financial Law Review* 26(4): 2.

[6] Estimates of relative frequencies are based on data from Häseler (2012), accurate for 2009.

the same category. The reverse holds true for bonds with the opposite features, ie those with the least scope for individual enforcement. This pattern runs counter to a picture sometimes drawn in the literature, according to which the US market has traditionally tended towards individual action and unconstrained enforceability of bond contracts.

3. Desirability of individual enforcement

We have depicted the issuer's decision on the contractual details of a bond as a menu of choice along the individual-to-collective scale of enforcement rights. But should there really be a choice? Or is perhaps one type of creditor rights' regime preferable – from the bond holders' and from an economist's or policymaker's perspective, respectively? At a superficial level, one might think that the bond holders' interests are best served in the case where they are unconstrained in the exercise of what little enforcement rights they have. Voices from the market certainly suggest so. Next, we provide a survey of theoretical arguments as to why, quite to the contrary, collective enforcement might be beneficial even from an investor's point of view, and even more so from a policymaker's.

3.1 Debtors' incentives – opportunistic defaults and restructuring offers

In the absence of a legal and institutional framework akin to corporate bankruptcy, the very existence of sovereign bond markets depends on some mechanism that will induce the debtor country to honour its obligations. The more frequently debtors default, the more reluctant investors will be to lend, therefore the higher the spreads and the lower the amount of borrowing. Mutually beneficial trade is lost to both borrowers and lenders in consequence. Acting as a deterrent against default, legal enforcement of sovereign bonds may help to reduce the borrower's inherent temptation not to repay (moral hazard). Whether one believes that deterrent to be effective depends on one's view of sovereign default. Whether any such deterrent is stronger with individual – as has been maintained[7] – or with collective enforcement rights is equally unclear. Each question is addressed in turn below.

The plausibility of any deterrence effect crucially depends on our view of sovereign default. Figure 1 maps the most important perspective on default discussed in the literature. Fundamentally, if the threat of enforcement is to have any effect on borrower behaviour, borrowers must have a choice between servicing and not servicing their debt. The question is whether defaults are better described as the consequence of a country's inability to repay, in which case we might speak of distress defaults, or as resulting from an unwillingness to repay, in which case defaults are considered strategic or opportunistic.

Which of these two descriptions better fits a given default episode will depend on the specific circumstances. It has been said that "there is little evidence [...] of strategic sovereign defaults ever occurring"[8] and that "sovereigns as a practical matter only default under identifiably bad conditions."[9] This was, however, written before Ecuador's default in 2008. The country set a precedent when it asked its bond holders to forgive 65% of their claims even though it enjoyed an "enviably manageable external

[7] See, eg, Fisch, JE and CM Gentile (2004) "Vultures or Vanguards? The Role of Litigation in Sovereign Debt Restructuring", *Emory Law Journal* 53(1043):1047–116.

[8] Inter-American Development Bank (2006) *Economic and Social Progress Report 2007*, www.iadb.org/res/ipes/2007, p 236.

[9] Bratton, WW and GM Gulati (2003) "Sovereign Debt Restructuring and the Best Interest of Creditors" Georgetown University Law Centre, Working Paper No 387880, p 17.

debt profile".[10] In this striking example of unwillingness to repay, Ecuador did not even cite financial necessity to legitimise the default. At the other extreme, one of the clearest cases of inability to repay is Grenada in 2004.[11] Hurricane Ivar had altogether wrecked the country's capacity for debt service. No enforcement regime could have deterred this default.

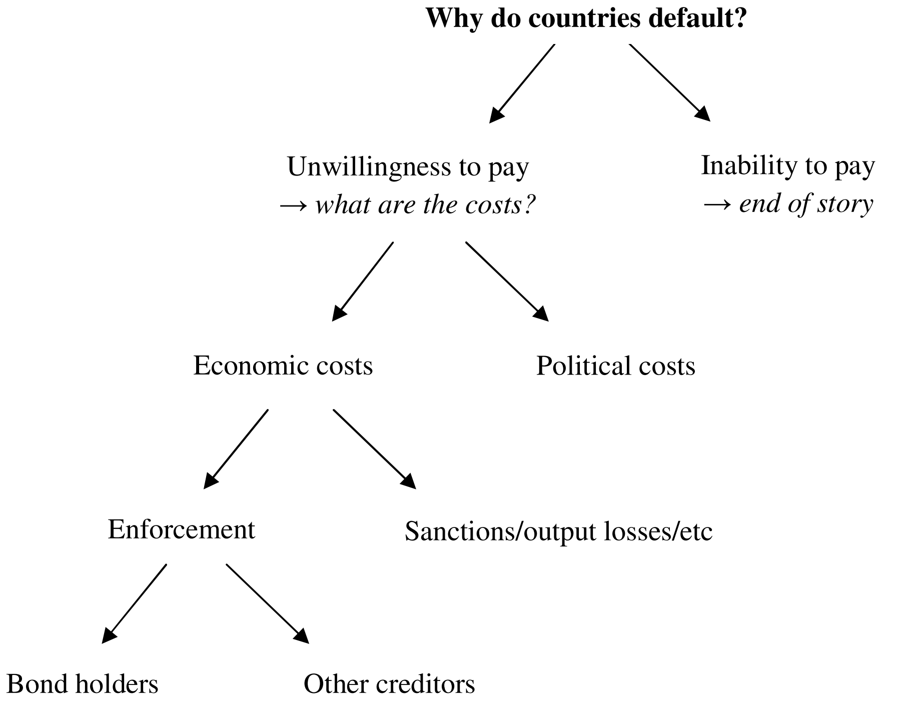

Figure 1: Various views of sovereign default

In instances where a country does have a choice between defaulting and honouring its debt obligations, it will decide on the basis of a cost-benefit analysis. Much has been written about the elusive costs of default, without which sovereign bond markets could not exist. The debtor country will experience substantial political costs, both domestically – ranging to political unrest and revolution – and internationally, including partial loss of sovereignty. In any event, there is a significant probability of top politicians losing office in the course of the events.

Additionally, the country will experience a number of different economic costs, depending on the specific default episode. Default will always hurt the debtor's reputation with the markets, produce a sharp increase in borrowing costs, and may ultimately result in a temporary loss of market access. Other sources of costs are: exclusion from international trade; possibly direct sanctions; damage to the domestic banking sector; a decline in foreign direct investment; and, more generally, loss of economic growth.

Since the demise of sovereign immunity in the 1970s and a series of creditor-friendly court decisions in the 1980s and 1990s, a potential defaulter must also increasingly consider the costs to be expected from its creditors' attempts to enforce their claims. Such 'enforcement costs' may arise in at least five contexts:

[10] Buchheit, LC and GM Gulati (2009) "The Coroner's Inquest" *International Financial Law Review* 29(9), p 22.

[11] Buchheit, LC and E Karpinski (2006) "Grenada's Innovations" *Journal of International Banking and Regulation* 4:227–31.

- The debtor will have to mount a legal defence against the creditors.
- Creditor litigation may trigger hostilities from other parties.
- The debtor will have to incur expenses to safeguard its assets from attachment by the creditors.
- The debtor may nevertheless lose such assets to, or be forced to settle with the creditors.
- Most importantly, creditor litigation may result in the borrower's exclusion from additional funding, eg, because new investors will hesitate to lend given the risk of the fresh funds being attached by the creditors.

To the extent that countries tend to default on all or most of their obligations simultaneously, the expected size of enforcement costs will depend on the structure of enforcement rights in each type of debt. Given all these other potential influences, how plausible is it then that the shape of bond holders' enforcement rights will have a noticeable impact on the country's decision – if a decision it is – to default? Any such effect must obviously be small.

Assuming for the sake of the argument that a deterrence effect does exist, we turn to the second question: does it matter for a potential defaulter to know whether it will have to face the wrath of individual bond holders, rather than a trustee? Deterrence in this context can be formulated as the probability of legal action occurring, multiplied by the costs that such action would impose on the debtor.

The second factor is easily evaluated. When legal action does arise, it is almost certainly a greater nuisance to the debtor coming from a trustee than coming from an individual bond holder. A suit brought by a trustee will typically be backed by at least 25% of the bond's outstanding principal. It is not common for such a large share of a bond issue to be in the hands of an individual creditor.

As to the first factor, conflicting influences come to mind. At first glance, it must be that trustees stifle enforcement action. This is their stated purpose. Under a fiscal agency agreement, any bond holders can initiate legal proceedings, and there is a well-known temptation to 'race to the court house', suggesting that the debtor must fear immediate and multiple lawsuits. At a second glance though, the answer likely depends on the dispersion of bond ownership and the nature of the creditors. Take a bond issue that is entirely held by small retail investors. Litigation involves returns to scale. It may be that a sufficiently large group of bond holders would favour legal action, but only if it could be channelled through a trustee. Individually, none of them have a large enough claim to make litigation worthwhile.

If deterrence has failed, it can be argued that the shape of bond holders' enforcement rights also has a role to play *ex post*. Once the difficult decision to default has been made and the associated costs have materialised, there may be no compelling reason for the debtor country to approach its creditors and to negotiate a restructuring deal so long as it has no immediate need for additional capital (as may be the case with a truly opportunistic default). In some situations, the threat of litigation can be the only device available for bond holders to force the debtor country to the negotiating table. If nothing else, the prospect of legal battles with hundreds of bond holders should persuade the defaulting country to make a restructuring offer. For example following the Argentine default, the court used the threat of granting attachment orders to ensure that the defaulter negotiated in good faith with its creditors.[12]

Not only the timing of a restructuring offer, but equally its quality may depend on the enforcement regime. "Litigation may also operate as a check on the terms of the proposed restructuring, giving creditors recourse against a restructuring that provides insufficient value…"[13] Clearly, the better the exchange offer, the lower the risk that the debtor will have to face creditor suits. A lower threshold for individual litigation thus translates into greater bargaining power for creditors. Accordingly, "the threat of litigation may be an obvious candidate to explain the large recovery values obtained by creditors in some

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[12] Miller, M and D Thomas (2006) "Sovereign Debt Restructuring: the Judge, the Vultures and Creditor Rights", *The World Economy* 30(10).

[13] Fisch and Gentile, 2004, p 1055.

recent debt restructurings … ."[14] It may of course be questioned why a diligent trustee could not be just as effective as individual bond holders in eliciting a timely and valuable restructuring offer.

3.2 Trustees' incentives: due diligence

We have so far assumed, at least implicitly, that the trustee's incentives to take action are aligned with the bond holders'. Of course they are not. This is a principal-agent relationship in which the trustee, different from US corporate trust indentures, owes no fiduciary duties to the bond holders (Buchheit and Gulati, 2009). It has no incentives to please the bond holders other than to avoid liability (Kahan, 2002) and, perhaps, to maintain at least a decent reputation. Trustee passivity is widely lamented by academics and practitioners alike.[15] Ideally, the trustee will use its discretionary power to pursue remedies against the defaulter without instruction from the bond holders. Given its lack of incentives, however, the trustee is more likely to grudgingly follow the bond holders' orders, which clearly diminishes the chances of success in court. Accordingly, the number of lawsuits by trustees against defaulting sovereigns is far exceeded by the number of suits from bond holders against the trustee for failing to take action. The shortcomings of trust structures were observed in practice following the 2008 Ecuadorian default, where the lack of initiative by a "bovinely passive trustee" cost the bond holders dearly.[16] Such events are facilitated by the noted tendency of bond drafters to dilute the standard of care that the trustee must exercise in representing the bond holders and the adverse consequences for debt enforcement.[17] Trustee passivity reduces deterrence against default and jeopardizes the bond holders' hopes of repayment if default has occurred. Tighter, internationally uniform contractual standards are needed.

3.3 Bond holders' incentives: excessive litigation

From a welfare perspective, IERs entail the risk of excessive litigation by bond holders, which gives rise to three types of inefficiencies:

- multiplicity of action;
- maverick litigation; and
- holdout litigation.

This section shows how the welfare perspective largely aligns with the bond holders' best interests.

Consider first a situation in which most if not all bond holders would agree that a defaulting sovereign should be sued (perhaps Ecuador in 2008) so that there is no conflict of interest among bond holders. And yet even in this situation enforcement through a – sufficiently diligent – trustee should be the preferred option for bond holders and all other parties: IERs would potentially open the door to thousands of lawsuits, all of which are based on the same type of claim, are accompanied by the same

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[14] Sturzenegger, F and J Zettelmeyer (2006) "Has the Legal Threat to Sovereign Debt Restructuring Become Real?" working paper, http://econpapers.repec.org/paper/udtwpbsdt/legalthreat.htm, p 3.

[15] eg, see Goodall, CP (1983) "Eurobonds Issued with the Benefits of Trust Deeds", *International Financial Law Review* 2, p 2: "[I]nvestors often complain that trustees do not act positively enough." On the practical side, Michael Chamberlin, Executive Director of the Trade Association for the Emerging Markets, said in correspondence with the author: "Trustees are notable for their caution, occasional incompetence and being subject to institutional constraints (need indemnities, may have conflicts of interest or be subject to political suasion) that make them less effective as litigants than individual holders."

[16] Buchheit and Gulati, 2009.

[17] *ibid.*

circumstantial facts, and should therefore have the same merits in court. Such multiplicity of action unnecessarily burdens the creditors, the debtor, and the courts. Either a class action or enforcement through a trustee can achieve a better outcome at much lower social costs.

Yet, such a uniform appetite for action will rarely occur. In the more likely event, the majority of bond holders will realise that their best bet is to hope for an acceptable restructuring offer, while a small number of creditors may be tempted to use their IERs. Each such 'maverick' creditor will strive to be the first to initiate legal action since any hesitation might enable other potential mavericks to lay their hands on the debtor's sparse assets or give the debtor time to shield the assets from the creditors' reach. A race to the courthouse can be the result. Maverick litigation is almost surely socially inefficient as the individual creditor's gains are dwarfed by the losses that accrue to the majority of creditors and to the debtor and third parties.

Finally, 'holdout' litigation refers to the strategy of not accepting a restructuring offer in the hope of achieving a better outcome later. IERs form the basis of any such hope. Holdouts will typically retain their old bonds until a restructuring has gone through. When the sovereign is once again solvent, thanks to the debt relief granted by the majority of bond holders, the holdouts will press for full repayment by threatening or initiating legal action. Holdout behaviour is individually rational but socially detrimental: IERs can create a prisoners' dilemma situation among bond holders. The danger of preferential treatment for holdouts will reduce the mainstream creditors' willingness to participate in a restructuring, which in turn aggravates the crisis, with negative consequences for all parties concerned. This problem will, however, disappear if and when all restructurings are done through the use of CACs, rather than exchange offers.

If we leave behind the welfare perspective and consider for a moment exclusively the bond holders' primary objective to retrieve their investment, we must note the discrepancy between *de jure* and *de facto* enforcement rights. The costs and efforts required to obtain a judgment against a defaulted sovereign imply that individual bond enforcement is not worthwhile for small retail investors. To turn a judgment into cash by locating attachable funds or pursuing other, more innovative legal strategies is more difficult still and utterly beyond the capacity of all but the most professional and specialised investors. Accordingly, in all of the major cases against defaulting sovereigns, the claimants were fairly large companies, institutional investors, specialised vulture funds, or all three.[18] With IERs, retail investors with small stakes are paradoxically cut off from meaningful access to enforcement measures. The Argentine default of 2002 was an exception in that it provoked lawsuits from a number of retail investors. However, four years later, none of the judgments that creditors were awarded had paid off.

This scenario, in which IERs seem to strengthen the position of specialised investment funds but leave mainstream bond holders empty-handed, is compatible with the willingness-to-pay view of sovereign default, where enforcement actually shifts value from the debtor to (a few) creditors. Under the ability-to-pay perspective, by contrast, the amount available for debt service is fixed and litigation therefore yields only a costly reallocation of funds between different types of creditors. A shift from collective to individual enforcement would thus result not in a shift of power from the debtor to creditors, but rather away from an equal distribution of power among bond holders towards a situation where essentially only vultures may enjoy meaningful enforcement rights. Taken one step further, the ability-to-pay view also implies that any expenses the sovereign incurs in the defence against enforcement action are funds that then become unavailable for debt service, making enforcement a negative sum game. If this is an accurate description of reality, individual action must be suppressed. It is both sufficient and more efficient to vest enforcement rights in the trustee for use in the rare case that legal action is in the bond holders' common interest.

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[18] See Table 3.1 in Sturzenegger, F and J Zettelmeyer (2006b) *Debt Defaults and Lessons from a Decade of Crises,* Cambridge, MA: MIT Press.

4. Market views

Having presented and evaluated various theoretical arguments on the merits or otherwise of IERs, we now turn to some empirical evidence of investor opinion. If bond holders take a stance on IERs this information should be reflected in bond prices. We summarise two studies that try to elicit such views.

4.1 Case study

In 2000, a settlement following the decision of a court in Brussels in favour of a vulture fund and against the Republic of Peru appeared to set a precedent that was regarded as highly controversial in academic and policy circles and as a reason to celebrate by at least some representatives of the investor community.[19] If bond holders indeed prefer individual over collective enforcement rights, we should expect to see an appreciation of bond prices on or shortly after the settlement date. The case evolved as follows.[20]

In October 1995, the Republic of Peru announced its intention to restructure officially guaranteed bank loans into Brady bonds. Three months later, the vulture fund Elliott Associates purchased $20.7million in face value of the debt at just over 50 cents on the dollar. As the Brady exchange progressed, Elliott refused to participate and instead, in October 1996 filed suit against Peru. A four-year legal battle ensued, in the course of which Elliott tried a range of strategies but was unsuccessful until September 2000, when the fund was able to persuade the commercial court of Brussels of a rather unusual interpretation of the *pari passu* clause contained in the debt contract. The court found that Peru must not disburse interest payments to its regular Brady bond holders without simultaneously satisfying the claims of Elliott at least on a rateable basis. Peru, in order not to be forced into default on its huge stock of Brady debt, settled on September 29 for $58.45million.

Elliott is easily the most influential and widely-cited case of sovereign debt enforcement in recent history. Commentators have variously interpreted it as at the same time heralding the end of, and also rescuing sovereign bond markets. To see whether market participants felt equally strong about the events, we need to look at the price movements of Peruvian bonds for abnormal returns during the relevant period.

The analysis is complicated by a historical coincidence. In September 2000, just before the events in Brussels, Peru experienced the most serious political crisis in a decade. Late on September 14, a video was broadcast on Peruvian national television that showed the Head of the national intelligence service handing over $15,000 to an opposition congressman for his defection to President Alberto Fujimori's party. The resulting public outrage forced Fujimori to announce on September 16 elections for the next year in which he would not stand again. How does the impact of the political scandal on bond prices compare to any effect of the settlement and, by implication, the strengthening of IERs?

The solid line in Figure 2 shows the development of JP Morgan's Emerging Markets Bond Index Global for Peru over the relevant period, normalised to a value of 100 for September 1. The political events, marked by the two bars in dark grey, are associated with a sharp decline in the index. By contrast, the various stages of the legal battle with Elliott (light grey bars) do not appear to have affected bond prices. The only exception is a rating downgrade on September 19 which is unexpectedly followed by an appreciation of the index. Notably, the index line is flat on the settlement day.

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[19] The precedent was in fact reversed already in 2004, when the same Brussels court ruled the opposite in a similar case. The following year, new legislation in Belgium put a definite end to enforcement strategies of the type employed by the vulture fund.

[20] For a full exposition of the case, setup, data sources, and results, see Häseler, S (2008) "Individual Enforcement Rights in International Sovereign Bonds", working paper, www.bepress.com/gwp/default/vol2008/iss1/art17

The dotted line represents an attempt to render any influence of *Elliott* more visible. Its values were calculated by ‘removing’ from the index a number of influences reflecting changing market and political conditions: movements in the interest rate, in an index of financial market volatility, in global sovereign bond markets and the Peruvian exchange rate; and two indices of the number of daily news items in the global press containing search terms intended to capture the political mood in the country. As a result, the movements in the index are less pronounced. There is still no visible reaction to the settlement.

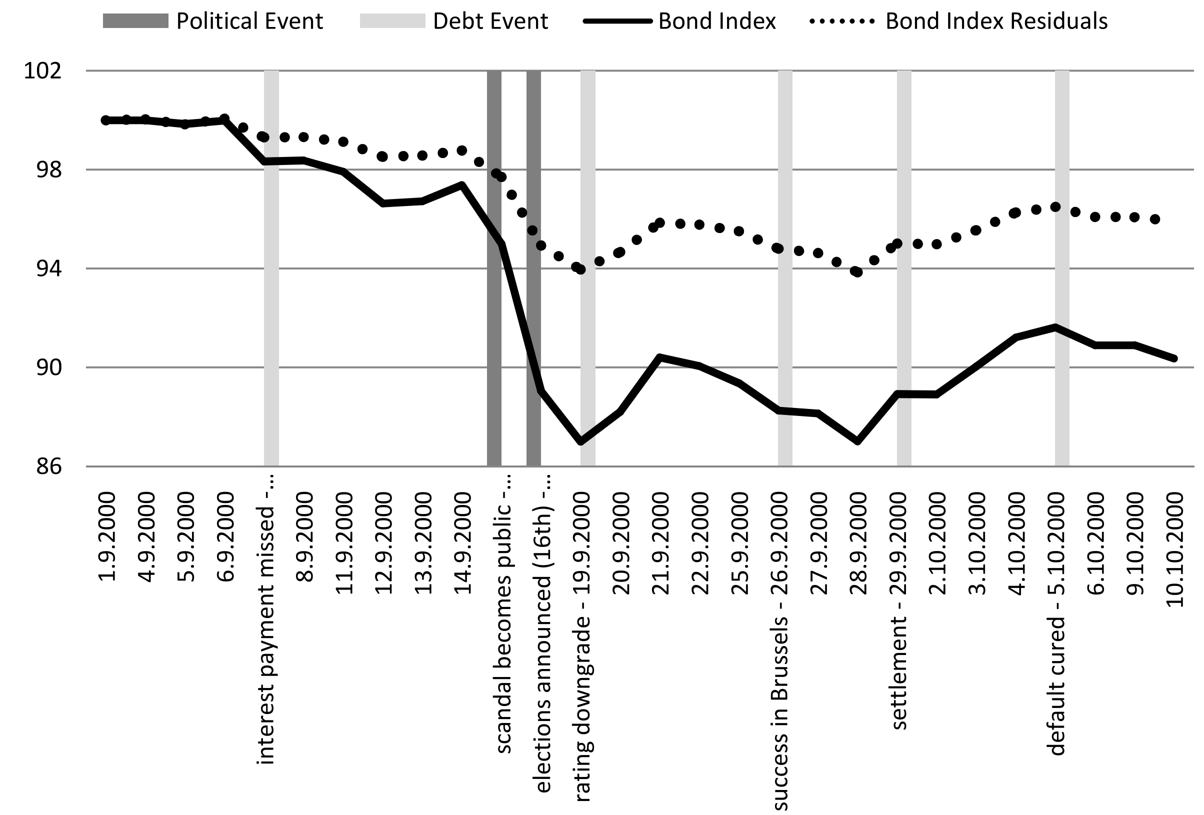

Figure 2: Peruvian bond index before and after ‘removing’ the influence of political and market

Figure 2 is essentially just a graphical representation of the slightly more formal statistical analysis conducted in the study. Time-series regression confirms the optical impression that the Peruvian bond index exhibits no abnormal returns on or immediately after the settlement day. The same goes for the indices of several other countries that were at the time also likely targets of vulture funds: Ecuador, Uruguay, Russia and Argentina. We interpret the results to mean that investors, on average, do not care for IERs quite as much as some commentators have suggested.

4.2 Cross-section study

In addition to looking at the movement of a single bond or index in response to an important event, insights into investors’ attitudes may be gained by comparing the values of bonds with different enforcement terms at one point in time. Such cross-section studies were instrumental in convincing bond issuers that investors think no less of securities with collective amendment, ie CACs. However, in the parallel debate on collective enforcement, ie bonds with trustees, such evidence was entirely lacking.

Häseler (2012), replicating the methodology of the empirical literature on CACs, analysed a large sample of bonds to test whether markets perceive securities with collective enforcement as riskier, for example because of the arguably lower deterrence effect. If that were the case, then the added risk would translate into higher yields, ie higher borrowing costs for debtor countries, which might explain their reluctance to appoint trustees for new bond issues. The results indicate, however, that bonds with collective enforcement rights neither carry a systematic yield premium, nor are they more likely to be in default at any given moment. The same hold true for bonds with CACs.

5. Conclusion

This chapter has presented the contractual conditions under which sovereign bond holders can exert their wills individually and independently of other bond holders in an event of default, as opposed to being bound to a majority in the amendment (CACs) and enforcement (trust structures) of the bond's payment terms. We have sketched out the policy debates regarding the universal adoption of CACs, where much progress has been made, and the universal appointment of a trustee, which sovereign borrowers seem slower to embrace.

A review of theoretical arguments yields the fairly sound conclusion that collective enforcement rights regimes are to be preferred from a social welfare perspective, given the large external costs of individual legal action which accrue to the debtor, other bond holders and third parties. The only major argument against collective rights – the potentially lower deterrence against opportunistic defaults – is not overly convincing, given the complexity of the debtor's decision whether or not to default.

Theory gives us less guidance on the desirability of IERs from an investor's perspective. It is therefore fitting that the evidence of two empirical studies summarised here shows no significant abnormal returns in response to the creditor-friendly outcome of the *Elliott* case and no significant yield premium for bonds with trustees, respectively.

While the type of enforcement regime may indeed make little difference to bond holders on average, we have argued that there are strong distributional effects between different types of bond holders. The extraordinary difficulties of de facto enforcement against a sovereign debtor imply that IERs will benefit, if at all, only specialised investment funds, whereas most retail bond holders are probably better served by a trustee.

What is a policymaker to do, given that collective enforcement appears to be the way forward for anyone concerned with social welfare and smooth sovereign debt restructurings? So far, sovereign issuers in all major jurisdictions are free to choose the governance structure of their bonds. They hesitate to break with established market practice, which favours fiscal agents in most segments, for fear of being punished by investors and they want to save the moderate extra fees for a trustee so as not to be put at a disadvantage in the competition for funds.

If the appointment of a trustee were required by law, both concerns – market practice and competitive disadvantage – would disappear. Issuers would be no worse off than before, nor would, as the evidence suggests, the bond holders. The necessary legislative or regulatory steps appear to be quite straightforward. The US Trust Indenture Act could be extended to sovereign bonds. The New York Stock Exchange could follow the example of London and make the appointment of a trustee a listing requirement. Whatever the best policy response, international coordination is paramount to achieve a uniform issuing practice.