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MINIMIZING HOLDOUT CREDITORS

Carrots

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1. Introduction

This chapter discusses the methods by which voluntary private sector creditor participation in a sovereign debt restructuring can be encouraged through techniques that reward such participation, structurally or monetarily—the 'carrots'. The next chapter (Chapter 2) addresses the techniques that actively *dis*courage non-participation in these affairs—the 'sticks'. **1.01**

2. The Context

In comparison with their corporate and individual debtor counterparts, sovereign borrowers are both uniquely vulnerable to, and uniquely protected against, creditor legal remedies. **1.02**

A. Sovereign debtors are uniquely vulnerable

Sovereigns are uniquely vulnerable in the sense that a bankruptcy code will not shield an overextended sovereign borrower from hostile creditor actions, nor will it permit such a sovereign to engage in an orderly, court-supervised, reorganization of its financial affairs.[1] Sovereigns are not subject to national bankruptcy codes, their own or anyone else's. Thus, when a sovereign signs a foreign law-governed debt instrument in favour of a private sector creditor, there are only two alternatives: pay the debt according to its terms; or face a potential legal action for enforcement of the instrument. For the sovereign borrower—and for only the sovereign borrower—'seeking the protection of the bankruptcy courts' is not an option. **1.03**

[1] An IMF-led effort to create a form of transnational bankruptcy code for sovereigns in 2002—the Sovereign Debt Restructuring Mechanism (SDRM)—did not garner the necessary political support: *see* Anne Krueger, 'International Financial Architecture for 2002: New Approach to Sovereign Debt Restructuring', Speech at the National Economists' Club Annual Members' Dinner, 26 November 2001, available online at <http://www.imf.org/external/np/speeches/2001/112601.htm>. *See* generally Sean Hagan, 'Designing a Legal Framework to Restructure Sovereign Debt' (2005) 36 Georgetown J Int'l Law 299.

B. Sovereigns are uniquely shielded

1.04 Very little may therefore stand in the way of a creditor intent on obtaining a court judgment against a defaulting sovereign borrower. It is when that creditor seeks to enforce the judgment that the sovereign's unique protections will manifest themselves.

1.05 Although the laws of most countries now embrace the 'restrictive' theory of sovereign immunity (sovereigns can be held legally accountable when they engage in commercial activities outside of their borders), foreign state property is still generally accorded a special immunity status under many legal regimes.[2] Sovereigns typically do not own many assets in their own name outside of their borders. Entities such as a central bank or a state-owned enterprise may hold such assets abroad, but these entities are likely to be treated as having a legal personality distinct from the sovereign, and their property will not normally be available to satisfy claims against the sovereign itself.[3] In addition, the few assets that are frequently held abroad in the name of sovereigns, such as embassies and consulates, will typically be clothed with special immunity from creditor seizure either by statute or pursuant to customary international law.[4]

1.06 A creditor that obtains a court judgment against a sovereign debtor will therefore experience a moment of emotional satisfaction; obtaining financial satisfaction may be a more tedious, not to say exasperating, process.[5]

C. The chemistry of sovereign debt workouts

1.07 Mixing this unique vulnerability to creditor lawsuits with this unique degree of protection against creditor remedies produces the essential chemistry of a negotiated sovereign debt workout. Each side, debtor and creditor, comes to the negotiating table boasting a special advantage and nursing a special weakness. Each side should therefore see merit in pursuing a consensual resolution of the problem.[6]

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[2] Joseph W. Dellapenna, *Suing Foreign Governments and Their Corporations*, 2nd edn (Boston, MA: Brill Academic Publishers, 2003), §§12.1 *et seq*.

[3] Dellapenna (n. 2), §§2.5, 2.6.

[4] Dellapenna (n. 2), §11.7.

[5] *See* Alison Frankel, 'How Argentina Lost Game of Chicken with Renegade Bondholders', *Reuters.com*, 26 November 2012, available online at <http://blogs.reuters.com/alison-frankel/2012/11/26/how-argentina-lost-game-of-chicken-with-renegade-bondholders/>.

[6] The policy of the US government has been to encourage negotiated solutions to sovereign debt problems. The United States has not wanted to see either side—debtors or creditors—obtain a decisive legal advantage that might erode their willingness to negotiate. This first became apparent in 1985 when the US government intervened on behalf of creditors in a federal court case, arguing that sovereign debtors could not pass laws or decrees that effectively unseated creditors from pursuing their legal remedies in US or other foreign courts. *See* Brief for the United States as *Amicus Curiae*, July 1984, at 6–7, 18, *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir. 1985) (No. 83-7714). The US government's most recent intervention (28 December 2012), this time on behalf of a sovereign debtor, contained the most explicit statement to date of its desire to preserve what would, in nineteenth-century diplomatic parlance, have been termed strategic balance:

> A sovereign's potential resistance to paying non-exchanged debt is a critical tool in its efforts to negotiate broad creditor support for restructuring. This leverage will be lost if creditors believe that a holdout strategy will eventually result in substantial or full payment. If enough creditors adopt this strategy, foreign sovereign debt restructuring will become impossible. While holdouts retain the right to assert legal claims in court and enforce resultant judgments in appropriate circumstances and in a manner consistent with the FSIA [US Foreign Sovereign Immunities Act of 1976], the creation of new rights and new vehicles for enforcement alters and destabilizes the landscape of sovereign debt restructuring.
>
> (Brief for the United States as *Amicus Curiae* in Support of the Republic of Argentina's Petition for Panel Rehearing and Rehearing *En Banc*, December 2012 at 4, *NML Capital, Ltd et al. v. Republic of Argentina* (12-105-cv(L), 2d Cir. 2012))

The logic of a negotiated workout, as it applies to a class of creditors, is invincible. If any significant percentage of a sovereign's lenders resort to their legal remedies, the paucity of attachable assets outside the sovereign's jurisdiction will surely result in most of them going without a recovery. But that logic is less compelling when applied to an individual creditor. When most of a sovereign's other lenders have agreed voluntarily to restructure their claims, this may leave an opening for a small group of determined creditors to extract a preferential settlement by threatening legal action. And if threats alone are not enough to open the sovereign purse strings, perhaps some stray attachable assets can be found to satisfy a small number of judgments. At the very least, the holdouts may reason, the negative publicity occasioned by lawsuits, attachments, injunctions, and other unpleasantries should put pressure on the sovereign to settle on terms advantageous to the holdouts.[7] In short, what is inescapable for the many (a negotiated settlement) may provide a lucrative business opportunity for the few. **1.08**

Apart from creditors who may approach a sovereign debt restructuring with malice aforethought, other debtholders may simply be unpersuaded that the sovereign requires debt relief of the kind or to the degree that it is seeking in the restructuring. This problem will be particularly acute if the debt had originally been placed with retail (individual) investors. The proverbial 'mom and pop' investors are likely to argue that they were beguiled into giving the Republic of Ruritania their retirement nest egg by the presence of sonorous phrases such as 'the full faith and credit of Ruritania is pledged for the repayment of this debt' in the offering documents. Unpersuaded (but not necessarily litigious) and unsophisticated creditors may decline to participate in a sovereign debt workout and find themselves tagged with the epithet 'holdout'. **1.09**

As a class, holdouts may thus include both the opportunistic and the befuddled, the blade runners and the sheep, those trying cynically to score a windfall by exploiting a sovereign's unique legal vulnerability and those just trying to recover their meagre life savings. But one thing will always be true: if the holdout population in a sovereign debt restructuring is too large, the restructuring will fail and years, perhaps decades, of litigation will ensue.[8] Minimizing the size of the holdout population is therefore one of the highest priorities for a sovereign debt restructurer. **1.10**

3. Techniques to Encourage Creditor Participation

A sovereign debtor can dangle a number of inducements in an effort to increase voluntary creditor participation (and proportionally decrease the size of the holdout population) in a sovereign debt restructuring. Unfortunately, the most obvious measure that the sovereign debtor can take—to offer more creditor-friendly restructuring terms—is generally not possible. The sovereign debtor would not have commenced a wrenching operation such as a generalized debt **1.11**

[7] Argentina's flagship navy vessel, the *Libertad*, was detained in Ghana on 2 October 2012 after Elliott, a US fund, secured an attachment order to collect on its Argentine-defaulted bonds. The vessel was ultimately freed, but not until the UN's International Tribunal for the Law of the Sea issued an order on 15 December 2015. *See The Economist*, 'Caught Napping', 13 October 2012, available online at <http://www.economist.com/node/21564542>; Jude Webber, 'Argentina to Call on UN over Seized Ship', *Financial Times*, 12 November 2012, available online at <http://www.ft.com/cms/s/0/f51d20ee-2ce6-11e2-9211-00144feabdc0.html#axzz2cECPVVKX>.

[8] The most prominent sovereign debt litigation involves Argentina's decade-long fight with holders of Argentine bonds that went into default in 2001. *See The Economist*, 'Argy-Bargy', 1 December 2012, available online at <http://www.economist.com/news/finance-and-economics/21567386-argy-bargy>.

restructuring had its existing debt burden been supportable. The entire point of the exercise is to return the country to a sustainable, manageable debt position and that will inevitably require a degree of creditor discomfort. Offering generous financial terms in the restructuring that are the product of a yeasty optimism about the country's economic prospects will no doubt plough the road for this restructuring, but that road will quickly lead to the *next* restructuring.

1.12 The techniques for encouraging voluntary creditor participation (as opposed to *dis*couraging non-participation, the subject of Chapter 2) break down into the following broad categories:

(a) a menu of options;
(b) structural and documentation improvements to the debt instruments;
(c) financial sweeteners;
(d) loss reinstatement features;
(e) parity of treatment assurances; and
(f) value recovery instruments.

A. Menu of options

1.13 The sovereign can offer creditors the ability to choose from a menu of restructuring options, all of which can be calibrated so as to have an equivalent net present value at the time the restructuring closes. This caters to the differing preferences of creditors, the idiosyncrasies of the regulatory and accounting regimes in the jurisdictions where the creditors operate, and conflicting assessments of future interest rate movements. Some lenders, for example, will abhor taking a discount to the principal amount of their claim; they will trade a lower coupon and a longer maturity in a par exchange instrument to avoid such a 'haircut' to principal. Others will be prepared to give up a portion of principal in return for a higher coupon and shorter maturity. Others may want an instrument benefitting from collateral security, even if this means a lower rate of interest. Some lenders will be prepared to capitalize a portion of the interest payable on the new instrument; some will not. Some prefer a floating rate of interest; others, a fixed rate.

1.14 Menus of this kind were a hallmark of the Brady bond debt exchanges of the early 1990s.[9] They are not, however, without cost. Multiplying the number of new instruments issued in a sovereign debt exchange, wholly apart from the additional transaction cost and complexity, may limit the size and thus the liquidity of each instrument. Also, some sovereigns may, for political or optical reasons, need to show a debt stock reduction resulting from the transaction. A heavily subscribed par exchange option will obviously thwart this objective. Each menu option may be equivalent in a net present value sense, but this does not translate into equal cash flow consequences for the debtor. In some of the Brady bond exchanges—Brazil in 1995 is the best example—the sovereign started off by telling creditors that they were perfectly free to choose among a menu of options on offer, only later to command a mandatory 'rebalancing' that forced creditors to take an allotment of one of those options, the discount bond.[10]

B. Structural/documentation improvements

1.15 As an inducement to joining a restructuring, the sovereign can offer an improvement in the structure or in the documentation of the new (restructured) instruments in comparison with the paper that the creditor may currently be holding. Perhaps the classic example of

[9] *See* John Clark, 'Debt Reduction and Market Reentry under the Brady Plan' (1993–94) 18(4) FRBNY Quarterly Rev 41.

[10] Clark (n. 9), 45.

a structural enhancement was the full collateralization of the principal due at maturity of Brady bonds issued in the 1990s.[11] Other possible structural improvements include a co-financing feature (see paragraphs 1.16–1.17) or a partial guarantee from a multilateral financial institution (see paragraph 1.18). Examples of documentary improvements may include a listing of the new instrument on a securities exchange, a shift of the specified governing law from that of the sovereign's own jurisdiction to a foreign governing law, tighter financial covenants, a broader waiver of sovereign immunity, eligibility to use the new instruments in a debt-for-equity or debt-for-privatization programme, and so forth.

A good example of a structural enhancement for a new instrument being offered in a sovereign debt exchange is a co-financing feature. The creditors' perspective on this technique is simple enough: sovereign borrowers have (almost invariably) continued to pay certain types of lender, such as the World Bank and other multilateral financial institutions, even while the sovereign may have been busily restructuring its commercial bank creditors, bondholders, and bilateral (government-to-government) creditors. If the payments due under a new instrument being issued in a debt restructuring can be linked to loans from one of these 'preferred' creditors, the argument goes, the new instrument will benefit from the aura of that preferred status. The trick, of course, is to ensure that the linkage cannot be broken or circumvented. A failure by the borrower to make a full payment under the private sector instrument *must* trigger a proportional default on the loan by the traditional preferred creditor; otherwise, the arrangement misfires. Only in this way can the sovereign borrower be forced into the position of having to alienate the affections of one of its multilateral lenders if ever it seeks to default or restructure the new instrument being issued to private sector creditors. **1.16**

Co-financing techniques of this kind became popular in the late 1980s as sovereign debtors caught up in the debt crisis of that era found it increasingly difficult to borrow the money they needed to remain current on the interest payments due under their commercial bank indebtedness.[12] The technique then seemed to pass out of mind and memory until the massive Greek restructuring of early 2012. As an inducement for creditors to participate in that restructuring—a particularly savage one that imposed a 53.5 per cent principal haircut—the new Greek bonds were linked by a co-financing agreement to Greece's payments under a €30 billion credit facility granted by the European Union's bailout mechanism, the European Financial Stability Facility (EFSF).[13] The theory was that Greece would never wish to anger its European partners by defaulting on an EFSF loan. The co-financing feature was thus intended to bring the new private sector bonds under this protective umbrella. **1.17**

Another possible structural enhancement is a partial guarantee of the new debt instruments by a multilateral financial institution. The Republic of the Seychelles, in 2010, obtained a partial guarantee from the African Development Bank for the new notes issued in connection with the Seychelles' debt restructuring. The Federation of St Kitts and Nevis used a similar enhancement—a partial guarantee from the Caribbean Development Bank—in its debt restructuring in 2012. **1.18**

[11] *See* generally Charles Collyns and Mohamed El-Erian, *Restructuring of Commercial Bank Debt by Developing Countries: Lessons from Recent Experience*, IMF Paper on Policy Analysis and Assessment (June 1993).
[12] *See* Lee C. Buchheit, 'Alternative Techniques in Sovereign Debt Restructuring' [1988] U Ill L Rev 371, 384–5.
[13] Allen & Overy, *How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency* (September 2012), available online at <http://www.allenovery.com/SiteCollectionDocuments/AO%20-%20Greek%20debt%20reorganisation%20of%202012.pdf>, 28.

1.19 Documentation improvements will have no immediate basis point cost to the sovereign at the time of the restructuring; that is their charm. Their significance (and cost) may become apparent down the road only if some further treatment of the new instruments is required. Any feature that makes those instruments more difficult to restructure in the future, such as a shift to a foreign governing law in lieu of local law, may then be regretted, but for politicians facing the need to conclude a debt restructuring successfully this year, the operative words in this description are 'down the road' and 'in the future'.

C. Financial sweeteners

1.20 Sovereigns are sometimes advised to blend a drop or two of honey into the restructuring medicine in order to make the mixture go down the lenders' throat more easily. Such *douceurs* come in several varieties. For example, up-front cash payments can be made to those creditors joining the debt restructuring, sometimes labelled 'participation fees', 'consent fees', or 'goodwill payments'. A bit of camouflage can be added by styling the sweetener an 'early bird fee' available only to those who commit by a specified date (a very popular technique in the restructurings of commercial bank loans in the 1980s). In situations in which the sovereign has suspended interest payments on its existing instruments in the lead-up to a restructuring, the sweetener may involve nothing more than an undertaking to pay all accrued interest in cash on the closing date of the restructuring rather than to capitalize those amounts.

1.21 The problem, as always in these affairs, will be money. The sovereign must either raise the funds required for the sweetener by suspending payments on its existing loans from the very same creditors who will be receiving the sweetener when they join the restructuring, or else borrow the money from an official sector source. The former smacks of pilfering someone's car keys and then offering to give them back to the owner in return for a ride to town. The latter requires a broad-minded and indulgent official sector lender prepared to use its taxpayers' money to raise the saccharine content of a settlement with private sector lenders.

D. Loss reinstatement features

1.22 At base, a sovereign debt restructuring is as much an implicit bargain between the debtor and its creditors as it is an explicit contract. The creditors are asked to provide debt relief in the form of lower interest rates, a reduction of principal, and/or a stretch-out of maturities. In return for these concessions, the borrower promises to service the new (restructured) instruments on their amended terms. But what happens if the borrower cannot, or will not, continue normal debt servicing of the new instruments and another restructuring—a 're-restructuring'—is proposed? The creditors come to that next restructuring permanently impaired; they are clutching instruments with a lower face amount, a reduced interest rate, and/or a delayed maturity in comparison with the paper they held at the time of the first restructuring. The implicit bargain of 'debt relief now for full performance later' will have been shattered, with lasting prejudice to the creditor side of the table.

1.23 A technique to redress this balance was first used by Ecuador in its debt restructuring of 2000 and dubbed 'principal reinstatement'.[14] Ecuador had inflicted a 45 per cent loss on it bank creditors as part of its Brady bond restructuring in 1995—the most generous terms that had

14 *See* Lee C. Buchheit, 'How Ecuador Beat the Brady Bond Trap' (2000) 19 Int'l Fin L Rev 17, 19. A very similar clause was employed in Belize's debt restructuring of 2013. *See* Belize, *Offer to Exchange*, Offering Memorandum, 15 February 2013, 127–8.

been given to a Latin American sovereign borrower up to that point. Exactly five years later, however, Ecuador defaulted on its recently issued Brady bonds and requested yet another round of restructuring. To assuage creditor concerns that such serial restructurings would relentlessly erode the face amount of their claims, Ecuador promised that if it were to default again within the first ten years after issuance of its new bonds in 2000, a portion of the previously forgiven principal would automatically balloon back, returning creditors (more or less) to the status quo ante of the prior debt restructuring. Naturally, another default within that period would most likely entail yet another round of restructuring, but the theory was that the creditors would come to that future negotiating table with the principal amount of their claims reinstated.

A loss reinstatement feature modelled on the Ecuador clause was also included in the Seychelles restructuring of 2010 and the St Kitts and Nevis restructuring of 2012, although in both of these cases the trigger for the principal reinstatement was a failure by the debtor country to implement its International Monetary Fund (IMF) programme. The St Kitts and Nevis Principal Reinstatement Clause reads as follows: **1.24**

> If the Relevant Event has not occurred by 31 March 2014, the Issuer shall deliver Par Bonds to the holders thereof on the next Payment Date. Such Par Bonds shall be in an amount equal to 40 per cent of the face amount of the Bonds issued on the Issue Date . . . having the same terms and conditions as the Par Bonds in all respects except that interest shall only accrue from the date of such further issuance and no scheduled payments (including the Goodwill Payment thereunder) under the Par Bonds falling on or prior to the date of such further issuance will be made. . . . '**Relevant Event**' means that a press release has been issued by the International Monetary Fund (the '**IMF**') confirming that the IMF Executive Board has approved the sixth review under the IMF Stand-By Arrangement with the Issuer existing at the time of the issue of the Bonds.

E. Assurances of parity of treatment

Creditors caught up in a sovereign debt workout fear two things. First, they detest being made to look like incompetent debt negotiators—something that would obviously happen if another group of creditors were to secure a better deal for themselves after the first bunch had signed on to more severe restructuring terms. Second, they do not want to see the cash savings that accrue to the sovereign borrower as a result of their own generosity being diverted into the pockets of other lenders who refused to join the restructuring. **1.25**

These sentiments can prompt a call for inclusion of contractual provisions in the new debt instruments that assure a parity of treatment with other creditors.[15] The clauses come in two varieties. The first, best illustrated by the so-called 'comparable treatment' provision included in all agreed minutes signed with Paris Club creditor countries, explicitly forbids the sovereign debtor from granting more favourable restructuring terms (expressed in a net present value sense) to any other group of creditors, including private sector creditors. A Paris Club Comparable Treatment Clause reads as follows: **1.26**

> In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Republic of Ruritania commits to seek promptly from all its external creditors debt reduction and reorganization arrangements on terms comparable in net present value to those set forth in the present Agreed Minutes for credits of comparable maturity. Comparability of treatment for debt reduction in net present value is assessed not only on the basis of the reduction in the face value of the debt but also on the terms of repayment of the debts not cancelled. Consequently, the Government of the Republic of Ruritania

[15] *See* Lee C. Buchheit, 'The Search for Intercreditor Parity' (2002) 8 Law & Bus Rev Am 73.

> commits to accord all categories of creditors—and in particular creditor countries not participating in the present Agreed Minutes, commercial banks and suppliers—a treatment not more favorable than that accorded to the Participating Creditor Countries.

1.27 The second, sometimes called 'most favoured creditor' provisions, mandate that if ever the sovereign gives a better deal to any other similarly situated lender, it will make the same offer to all those who accepted the original debt restructuring. Most favoured creditor provisions are designed to assure participating creditors simultaneously that they will not be embarrassed by a future settlement with other creditors on more favourable terms and to dispel any hope on the part of non-participating creditors that a better offer may follow this one. In this way, they serve an *in terrorem* function vis-à-vis the holdouts.[16] It should be obvious that the sovereign lacks the resources to offer a much improved deal to *all* of its creditors. The prospective holdouts are therefore expected to absorb the message that a preferential payout to them will effectively be blocked by the operation of the most favoured creditor clause, because that clause would require any improved terms to be offered to all other creditors as well. Belize's Most Favored Creditor Clause, for example, reads as follows:

> Belize shall not enter into any arrangement to pay or to settle an Untendered Material Claim on terms more favorable to the holder thereof (in a net present value sense) than the terms offered in the Offering Memorandum to the holders of tendered Eligible Claims, without simultaneously making those more favorable terms available to each holder of a tendered Eligible Claim.

F. Value recovery rights

1.28 One of the most popular techniques for encouraging private sector participation in a sovereign debt restructuring has been to offer participating creditors a value recovering right (VRR) as part of the restructuring package. Value recovering rights were originally intended to mimic the 'equity kickers' frequently used in corporate debt workouts. In those situations, creditors are asked to grant debt relief to a corporate borrower, but have no way of recouping their losses if the reorganization succeeds in returning the debtor company to financial health. The solution is to give creditors an equity stake in the company as part of the restructuring. If the company prospers in the future, the value of that equity will rise and allow creditors to recover some of the forgone principal or interest on their loans.

1.29 The obvious problem in transposing this technique to a sovereign debt setting is that sovereigns do not have shareholder's equity that can be distributed to indulgent creditors. When commercial banks were asked to take outright losses on their sovereign loan portfolios starting in 1990 with the Mexico Brady exchange, they argued that the price of oil—Mexico's main primary commodity export—would be a reasonable indicator for predicting Mexico's future economic prosperity. If the price of oil were to increase beyond a specified benchmark, the creditors argued, this would be a sure sign that the country could afford to recompense them for a portion of the sacrifices that the Brady initiative had inflicted on Mexico's creditors.

1.30 Mexico was thereby persuaded to issue oil recovery warrants as part of its Brady bond exchange. The warrants were free-standing instruments that entitled the holder to receive a

[16] Anna Gelpern, *After Argentina*, Rutgers School of Law Newark Research Paper No. 011/Institute for International Economics Working Paper No. 2005-PB05-2 (September 2005), available online at <http://ssrn.com/abstract=880794> or <http://dx.doi.org/10.2139/ssrn.880794>, 5 and 6.

cash payment in respect of any period (starting in 1996, five years after the Mexican Brady exchange closed) in which the inflation-adjusted price of a barrel of Mexican crude oil exceeded US$14.[17] Virtually all other oil-exporting countries that implemented a Brady exchange in the 1990s, such as Venezuela and Nigeria, were obliged to issue oil warrants of a similar nature. Ecuador in 1995 was the visible exception.

For Brady countries that lacked a principal export like oil, the creditors had to look for other benchmarks that could reliably signal whether the country had returned to financial health. The most popular benchmark was gross domestic product (GDP). A GDP warrant will call for a cash payment if the debtor country's GDP in a future year exceeds a baseline projection for that year. There were other variations as well. Uruguay, for example, opted to issue a warrant whose payments were linked to the price of a basket of traditional Uruguayan exports. **1.31**

Value recovery rights have had a chequered career in sovereign debt restructurings. They are typically designed to be well 'out of the money' (that is, below the point at which the benchmark would require cash payments to be made on the instrument) at the time of issuance, but for this reason they are utterly misprized by the market when first issued. The sovereign debtor consequently gets little or no credit, in the sense of more favourable restructuring terms, when the VRRs are included in a debt restructuring package. If the debtor were to ask its creditors 'What restructuring terms will you give me in a package *with* a VRR and what terms with*out* a VRR?', the answer from the lenders would likely be 'The same terms'. **1.32**

Many of the VRRs issued as part of the Brady bond restructurings of the 1990s have subsequently come into the money and the issuing countries have been making quarterly cash payments, even after the underlying Brady bonds have been retired (the VRRs are usually detachable from the underlying bonds and will continue to trade in the market). Rarely, however, are those payments made to the creditors who actually granted debt relief by accepting Brady bonds in the 1990s. Because VRRs are typically formatted as free-standing, freely tradable instruments, most have long since passed into the hands of investors who, if they recognized the phrase 'Brady era' at all, would assume that it was roughly coterminous with the Peloponnesian War. **1.33**

Value recovery rights have also featured in more recent sovereign debt restructurings. Argentina issued a GDP-linked warrant as part of its bond restructuring in 2005 and has been paying on it (heavily) ever since.[18] Greece included a GDP-linked warrant in its €206 billion bond restructuring in early 2012.[19] **1.34**

4. Implications

A. The 'floats all boats' argument

For obvious reasons, sovereign borrowers would prefer not to have to offer carrots to entice creditors to join a debt restructuring. All such features involve either cost or risk to the **1.35**

[17] *See* Lee C. Buchheit, 'No Easy Route to Recovery Value' (1991) 10 Int'l Fin L Rev 7.

[18] *See Euromoney*, 'Argentine GDP Warrants', 25 January 2006, available online at <http://www.euromoney.com/Article/1014876/Argentine-GDP-warrants.html>.

[19] *See* Ministry of Finance of Hellenic Republic, 'PSI [private sector involvement] Launch Press Release', 21 February 2012, available online at <http://www.minfin.gr/portal/en/resource/contentObject/id/7ad6442f-1777-4d02-80fb-91191c606664>; *see* also Allen & Overy (n. 13), 35.

sovereign. Sweeteners such as consent fees require an immediate diversion of scarce cash; VRRs may require such a diversion in the future. Structural/documentation inducements, such as tougher legal terms in the new debt instruments or co-financing links to official sector loans, will make it more difficult to seek additional debt relief from those instruments if this becomes necessary in the future.

1.36 The sovereign borrower's strongest argument to resist calls for the inclusion of such enticements in a debt restructuring is straightforward: if the restructuring (coupled with the sovereign's economic adjustment measures) succeeds in returning the country to a sound financial footing, then everyone wins. Most holders of sovereign bonds are institutional investors that mark their positions to market each day. The mark-to-market value of those positions will decline as the sovereign enters its debt restructuring, but will, everyone hopes, be restored to robust value once a successful debt restructuring closes. It is in this way, the sovereign will argue, that palpable value can be returned to participating creditors, at least in comparison with the depressed levels at which the debt was trading before the restructuring closed. Ancillary inducements to participation of the kind discussed in this chapter will, if the debt restructuring is successful in restoring the borrower to economic health, be viewed in hindsight as trivial or even silly. But if the sovereign does *not* recover its financial footing for some reason, such features are unlikely to be of much comfort to the afflicted creditors. In short, the sovereign's argument is that restored prosperity is the rising tide that will float all boats.

B. Utility

1.37 Hanging over all discussions about adding carrots to a sovereign debt restructuring package is the question 'Do they really matter?'; in other words, will the decision of even a single creditor about whether to participate in the restructuring turn on the presence or absence of these features? Or, as the sovereign borrower might suspect, are these features being proposed by creditors merely as a way of squeezing some extra value out of a deal that they know they will accept with or without the carrots? No one can prove the counterfactual, so these concerns are likely to remain in the realm of suspicions.

C. Futility

1.38 All vendors of Christmas trees will attest to the truth of the following proposition: no matter how many ornaments you hang on the tree, if the customer is not in the Christmas spirit, you are unlikely to make a sale. Or, if you prefer a mammalian to an arboreal analogy, no matter how large the dangling carrot, a donkey without an appetite is unlikely to move forward.

1.39 As applied to a sovereign debt restructuring, the lesson of these truisms is that no matter how succulent or how numerous the ancillary enticements that may be added to a debt restructuring package, a creditor who acquired the underlying paper with the express intention of staying out of the deal and pursuing a preferential recovery at the sharp end of a litigation is unlikely to be dissuaded from this path by the presence of those inducements. The addition of sweeteners such as those discussed in this chapter may—repeat, *may*—operate at the margin to bring into a debt restructuring creditors who are otherwise predisposed to being seduced (and to that extent the holdout population may be reduced), but they will not melt the flinty heart of the deeply dyed holdout.

1.40 The sovereign debtor may therefore reasonably ask whether the inclusion of such carrots in a restructuring package is an exercise in futility—and a damnably expensive exercise at that. The answer to this question turns on the significance of the relative size of a holdout population. The goal, express or implied, in most sovereign debt restructurings is to achieve a creditor participation rate at a level (usually higher than 90 or 95 per cent) that renders the holdouts no more than an irksome nuisance.

A negligible holdout population, even if one assumes that they will all eventually succeed in obtaining a full recovery, will not threaten the sovereign's future debt service capacity. On the other hand, leaving behind a sizable holdout community may undermine the financial predicates of the entire restructuring, possibly presaging another debt crisis in the near future. **1.41**

So it boils down to this: how many marginal creditors will join a deal that includes one or more inducements of the kind discussed in this chapter when they would reject a deal bereft of those enticements? This is always a judgement call. For the advisers/arrangers in a sovereign debt restructuring, this judgement will require close and accurate market soundings. For the sovereign borrower, it is usually a straight cost–benefit analysis: are the marginal, seducible creditors numerous enough to justify the cost and risks of giving the inducements to *all* participating lenders? **1.42**

D. The political dimension

Finally, there is the political dimension. Before a sovereign ever gets to the point of proposing a debt restructuring, its citizens will have borne the pain of an economic collapse accompanied by a heavy dose of fiscal adjustment and austerity. The debt restructuring, when it eventually comes, is therefore likely to be perceived by those citizens as an equitable sharing of the burden with the country's other stakeholders—that is, its creditors. No one will begrudge seeing the mark-to-market value of the portfolios of the participating creditors inflate if and when prosperity returns to the country. But why, domestic critics of the debt restructuring package may ask, should these other stakeholders need to be induced, coaxed, and sweet-talked into bearing their fair share of the misery? **1.43**