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Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds

Stephen Choi* and Mitu Gulati**

Abstract

Network externalities may lead contracting parties to stay with a “standardized” term despite preferences for another term. Using a dataset of sovereign bond offerings from 1995 to early 2004, we test the importance of standardization for the modification provisions relating to payment terms. We provide evidence that (a) standardization may lead parties to adopt provisions not necessarily out of preference and (b) standards, nonetheless, may change. The process of change, however, is not necessarily quick or straightforward. In the sovereign bond context, change came by way of an “interpretive shock”. Contracts with modification provisions requiring the unanimous consent of bondholders (UACs) suddenly became vulnerable to change with less than unanimous approval through the unexpected use of exit consents. After the shock, sovereigns and investors did not initially react with a significant shift in contract terms. However, we provide evidence that after this initial lull (once investors and sovereign gained experience on the value of allowing modification of payment terms with less than unanimous consent), large shifts in contract terms followed, moving sovereign bond contracts even further away from UACs toward collective action clauses (CACs). We also report evidence that issuer’s attorneys dealing with a high volume of sovereign offerings were the driving factor behind this delayed large shift in contract terms.

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Note on the Interviews that Served as Background for this paper: The research for this paper required us to conduct numerous interviews with both market participants and policy makers familiar with what went on in the sovereign markets during the 1995-2004 period. Most of these individuals, however, requested that we not directly attribute what was said to them. To the extent possible, therefore, we cite to publicly available documents to make the points in the paper. However, there are some instances where we are unable to provide adequate citations.

For most lawyers, the task of reading and revising a boilerplate contract holds less attraction than a visit to the dentist's office. That is why one of the perks of seniority at a law firm is being able to delegate the "update this old contract for our client" task to the most junior associate. After spending at least one frustrating and sleepless night unsuccessfully trying to decipher what the contract language means, the associate slowly begins to grasp the beauty of boilerplate. And that beauty lies in the realization that there is no need to understand the specifics of what the contract provisions say. After all, it is boilerplate....

I. Introduction

Sovereign bond contracts are a special breed of contract. The parties involved are among the most sophisticated in the world financial markets, the amounts involved are large (hundreds of millions of dollars, in any given issuance), there is an active secondary market, and there is no meaningful regulatory body that interferes with contracting practices. Given the context, one would expect to see an active market response to value reducing contract terms. Contracting sovereigns and investors that do not jointly favor a specific term may simply contract away the term in subsequent contracts. Even where the market reigns, however, such a contracting solution may not be so simple. Network externalities may affect the terms that contracting parties select.¹ Parties may not choose a term that maximizes the value of their contract, instead choosing a suboptimal but standardized term subject to network externalities.² With

¹ The hypothesis that network effects might impact contracting practices has been discussed by a number of legal scholars, most notably Marcel Kahan and Michael Klausner. See Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 *UCLA L. Rev.* 931 (1993); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 *Va. L. Rev.* 757 (1995); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 *Va. L. Rev.* 713 (1997) (henceforth "Standardization and Innovation"). See also Fredrick W. Lambert, *Path Dependent Inefficiency in the Corporate Contract: The Uncertain Case with Less Certain Implications*, 23 *Del. J. Corp. L.* 1077 (1998).

Prominent discussions of network effects from the economics literature include, Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 *RAND J. Econ.* 70, 70 (1985); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 *Am. Econ. Rev.* 424 (1985); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 *J. Econ. Persp.* 93 (1994); S.J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, 8 *J. Econ. Persp.* 133 (1994).

² See Kahan & Klausner, *Standardization and Innovation*, supra note 1, at 725-35. On the other hand, parties may ignore the benefit of choosing a standardized term (e.g., greater legal certainty) has on other parties contemplating a similar contract. Parties may therefore have too great incentives to select diverse contract terms. In

standardized terms, uncertainty levels are lower and the resulting bond contracts are easy for the market to price, thereby reducing contracting costs.³

The claim that suboptimal terms may arise as stable equilibrium solutions in highly competitive markets, of course, has its detractors who argue against the importance of network effects.⁴ Much of the debate in this area has largely focused on whether lock-in to suboptimal terms occurs.⁵ Using a dataset of 155 sovereign bond offerings from 1995 to early 2004, we provide evidence on the importance of standardization. We also report evidence on the related question of how, when a standardized term has been recognized as suboptimal and problematic, the move to a new equilibrium occurs (if at all).⁶

the context of sovereign bonds where the contracts are already heavily standardized, this second concern is less likely.

³ Id. For an prior discussion of standardization in commercial contracts and its effects, see Charles Goetz & Robert Scott, *The Limits of Expanded Choice: An Analysis of Express and Implied Contract Terms*, 73 Cal. L. Rev. 261, 286-89 (1985).

Further, it has been suggested that presence of cognitive biases and agency problems may exacerbate the lock-in to suboptimal terms. See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases*, 74 Wash. U. L.Q. 347, 348 (1996); Russell B. Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 Cornell Law Review, 608 (1998); Russell B. Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 Vanderbilt Law Review 1583-1651 (1998); cf. also Jody Kraus, *Legal Design and the Evolution of Commercial Norms*, 26 J. Legal Stud. 377 (1997) (using a model of cultural evolution to demonstrate how commercial norms need not always evolve towards optimality). For a detailed articulation of the dynamics by which these suboptimal (or “second best”) terms can remain unchanged over long periods of time that focuses on the lawyers’ roles, see Claire Hill, *Why Contracts Are Written in Legalese*, 79 Chicago-Kent L. Rev. 59 (2001).

⁴ For more skeptical inquiries into the presence of these network effects, see Clayton P. Gillette, *Harmony and Stasis in Trade Usages for International Sales*, 39 Va. J. Int’l L. 707, 721-40 (1999); Clayton P. Gillette, *Lock-In Effects in Law and Norms*, 78 B.U. L. Rev. 813 (1998); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 Cal. L. Rev. 479, 570-76 (1998).

⁵ For a discussion of this difference in view between those who view existing contract terms as always efficient or optimal and those who allow for the possibility of suboptimal terms existing in equilibrium, see Marcel Kahan, *Rethinking Corporate Bonds: The Tradeoff Between Individual and Collective Rights*, 77 NYU. L. Rev. 1040, 1077-78 (2002). The Ribstein & Kobayashi paper and the paper by Whincop cited below (infra note 6) are examples of empirical tests of the Kahan & Klausner claims regarding inefficient lock-in. The battle over whether suboptimal lock-in occurs has, of course, been famously fought in arenas other than that of contract practices (such as the optimality of QWERTY typewriter/computer keysetting and, more recently, Microsoft’s operating system). See, e.g., Paul A. David, *Clio and the Economics of QWERTY*, 73 Amer. Econ. Rev. 332 (1985); S.J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J. L. Econ 1 (1990), *Network Externality: An Uncommon Tragedy*, 8 J. Econ. Persp. 133 (1994); S.J. Liebowitz & Stephen E. Margolis, *Winners, Losers, and Microsoft: Competition and Antitrust in High Technology* (1999).

⁶ For examination of this question in the broader research on standardization. See, e.g., Joseph Farrell & Garth Saloner, *Coordination through Committees and Markets*, 19 Rand J. Econ. 235 (1988) (examining how a market obtains explicit coordination through the use of standards committees); Philip Dybvig & Chester Spatt,

Our inquiry into how standardized terms change takes the following course. We examine the modification terms in sovereign bond contracts that many scholars have assumed to be functionally identical (e.g., boilerplate).⁷ From there, we move to an examination of the effects of network externality-related frictions in reducing the incentive on the part of contracting parties to deviate from well-known standardized terms in the market even when viewed as suboptimal. Given the influence of these frictions, we examine the process by which shifts in contract terms actually occur.⁸

Sovereign bonds governed under N.Y. law generally require unanimous bondholder approval for any modification of the principal and interest terms for a bond issue (referred to as “UACs”). In contrast, some sovereigns use English-law to govern their contracts and employ collective action clauses for reduction to payment terms in their sovereign bonds (referred to as

Adoption Externalities as Public Goods, 20 *J. Public Economics* 231 (1983) (discussing how government subsidies can cause the internalization of network effects); Jeffrey MacKie-Mason & Hal Varian, *The Economic FAQs About the Internet*, 8 *J. Econ. Persp.* 75 (describing the effects of government subsidies on the development of the Internet and TCP/IP protocol).

⁷ The assumption of standardization, and in particular the assumption that governing law (New York or English law) corresponds to a set of functionally identical terms, is routinely made both the academic literature and the official sector research in the area of sovereign debt contracting practices. See P. Petas & R Rahman, *Sovereign Bonds – Legal Aspects that Affect Default and Recovery*, Deutsche Bank Global Emerging Markets – Debt Strategy, May, pp 59–78 (1999); K. Tsatsaronis, *The Effect of Collective Action Clauses on Sovereign Bond Yields*, BIS Quarterly Review: International Banking and Financial Market Developments, November, pp 22–23 (1999); Liz Dixon & David Wall, *Collective Action Problems and Collective Action Clauses*, Bank of England Financial Stability Review, 8, pp 142–151 (1999); Barry Eichengreen & Ashoka Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, NBER Working Paper No 7458 (2000); T. Becker, A.J. Richards, & Y Thaicharoen, *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?*, (forthcoming *Journal of International Economics*) (earlier version appeared as IMF Working Paper No 01/92); International Monetary Fund, *Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use*, Washington DC, June (2002) (discussing the empirical research on CACs) (available on IMF website). An exception to this is the paper by Richards and Guggiatti for this symposium that documents that, contrary to the standard assumption, there have been multiple sovereigns that have used CACs in their New York law bonds for some years now. See Anthony Richards & Mark Guggiatti, *The Use of Collective Action Clauses in New York Law Bonds* (forthcoming, *Georgetown Journal of International Law* (2004)).

⁸ For a fuller application of the economic and cognitive theories of standardization to the recent move from UACs to CACs in New York law bonds, see Robert Ahdieh, *Cueing Transition in Sovereign Debt Contracts: Network Effects, Coordination Games, and Focal Points in the Choice of Mandate versus Contract* (forthcoming Emory L. J. (2004)). Ahdieh’s paper on the sovereign contracting practices builds on his earlier work applying research on network effects to understand financial market transitions. Robert B. Ahdieh, [Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets](#), 76 *S. Cal. L. Rev.* 277 (2003); Robert B. Ahdieh, *Law's Signal: A Cueing Theory of Law in Market Transition*, 77 *S. Cal. L. Rev.* (forthcoming 2003).

“CACs”). For countries that eventually ran into financial distress, UACs presented a large roadblock in restructuring the debt to the benefit (ex post) of both the countries and the bondholders. Creative interpretation of exit consent provisions in late 2000 (working through non-unanimous modification terms relating to *non-payment terms* in the otherwise N.Y.-law governed bonds) allowed Ecuador to push through a modification of its payment terms with less than unanimous support from the bondholders despite a UAC agreement.⁹ Angry protests from bondholder groups suggest that the use of this technique had not been previously contemplated (and was thus an “interpretive shock” of the contract terms).¹⁰ Post-Ecuador, previously unimportant exit consent provisions suddenly became an important means of providing non-unanimous modification of payment terms for countries with UAC-sovereign debt issuances in financial distress.¹¹ Starting early in 2003 (with Mexico’s offering of sovereign bonds in

⁹ See Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, *Int’l Fin. L. Rev.* at 17-18, December 2000 (describing Ecuador’s use of Exit Consents). For a more detailed discussion of the restructuring of Ecuador’s sovereign debt, see *Involving the Private Sector in the Resolution of Financial Crises--Restructuring Sovereign Bonds*, (IMF 2000) available at www.imf.org/external/pubind.htm.

¹⁰ See Felix Salmon, *The Buy Side Starts to Bites Back*, *Euromoney*, April 2001, at 46; cf. Anna Gelpert, *Sovereign Debt Crisis: Creditors Rights versus Development (Beyond Balancing: the Interests of Creditors and Developing States)* 97 *Amer. Soc. Int’l L. Proceedings* 221 (2003) (observing that although exit consents are viewed as an usurpation of their rights by many creditors, they have become an important weapon in the arsenal of restructuring techniques). For more on the negative and skeptical reactions to Ecuador’s use of Exit Consents, see Moody’s Investor Service, *What Happens if a Sovereign Defaults* (2000); *Troubled Sovereigns Won't Benefit from Restructuring with Exit Consents*, *MOODY'S REP.*, Mar. 27, 2001; *End of the Line for Exit Consents?*, *Euromoney* Tuesday, April 1, 2003, 2003 WL 11807263, (reporting that “if there is one thing that investors hate as much as SDRM, it is exit consents”).

The negative reaction to exit consents appears to have largely disappeared by the time Uruguay used the technique two years later in what looks to have been a more sophisticated and investor-friendly manner. See *Calm After the Storm*, *Euromoney*, May 2, 2003, 2003 WL 11807313. *Euromoney* reported:

Uruguay has now become only the second country ever to attempt to use a tool known as exit consents in trying to restructure its bonds. The first time this happened, in Ecuador in 2000, the uproar from the investor community was so great that it sparked the formation of a new trade organization - the Emerging Market Creditors Association (Emca). But in the case of Uruguay, Emca couldn't even muster a mildly disapproving press release.

¹¹ For example, see IMF Report, *supra* note 9. To see how normalized Exit Consents have become, one only has to look at the lack of reaction to the use of this technique by Uruguay in 2003. On the Uruguay exchange offer, see Felix Salmon, *Uruguay Closes the Loop*, *Euromoney*, May 2, 2003, 2003 WL 11807300; Felix Salmon, *Uruguay’s Elegant Transformation*, *Euromoney*, February 2004. For fuller discussions of the Uruguay exchange by

February), the market finally made a move away from the UAC standard and toward a new standard around collective action clauses.¹²

We provide three primary results from a dataset of sovereign bond offerings from 1995 to early 2004. First, we provide evidence that network-externality type frictions likely play a role in the persistence of certain sovereign bond contract terms.¹³ Ecuador's use of exit consents in 2000 undermined a long held assumption among investors and issuers that UAC governed bonds were immune from restructuring.¹⁴ If parties preferred the UACs despite the pressure of standardization, they would have moved immediately after Ecuador to eliminate the possibility of exit consents in subsequent bond offerings. This did not happen, consistent with the view that the UACs were dominant prior to Ecuador more due to the effect of standardization than the desirability of the UACs for all parties. Instead, the modification terms in the bond offerings for the two-year period immediately after the Ecuador restructuring did not change appreciably. Despite the uproar against Exit Consents, countries issuing new debt continued to use the new, exit-consent friendly standard – evidence consistent with the gravitational pull of contract term standards in the market.

one of its architects, see Carlos Steneri, *Uruguay's Debt Exchange: Lessons From Experience* (forthcoming *Georgetown Journal of International Law*, 2004).

¹² Discussions of these preconditions are contained in numerous recent articles on the topic of sovereign debt restructuring. For an overview, see IMF, *Collective Action Clauses in Sovereign Bond Contracts: Encouraging Greater Use* (discussing the reasons for resistance to change) (document dated June 6, 2002) (available on IMF website); see also Barry Eichengreen *Restructuring Sovereign Debt*, 17 *J. Econ. Persp.* 75 (2003) (discussing externalities, coordination, first move problems, and time-inconsistency in political preferences as among the different reasons for stickiness in the sovereign bond terms) (citing Franklin Allen & Douglas Gale, *Financial Innovation and Risk Sharing* (1994)).

¹³ For a discussion of the sources of incompleteness in contracts (and statutes), see Scott Baker & Kimberly D. Krawiec, *The Penalty Default Canon*, (forthcoming *George Washington Law Review* (2004)). In addition, with standardized terms, there is the additional problem that because everyone assumes that the “market” understands the meaning of these terms, there is the risk that the meanings of terms that are long unused can simply be forgotten. This process of market memory loss is vividly described in Buchheit & Pam, *Pari Passu*, *infra* note ____.

¹⁴ On this assumption, see Lee C. Buchheit, *Overview: A Quarter Century of Sovereign Debt Management* (forthcoming, *Georgetown Journal of International Law* (2004)).

Second, we examine whether changes are possible despite the influence of standardization. In particular, small changes may help lead to even larger later changes. Parties prior to Ecuador did not deviate appreciably from the UAC-standard. However the Ecuador Exit-Consent shock moved the prevailing standard much closer to the collective action clauses for modification involving payment terms (CACs). This move generated information for parties on the value of more collective-action friendly clauses (and how courts and investors would view such terms in the sovereign bond context), reducing the uncertainty for countries contemplating even greater shifts toward CACs involving payment terms. The Exit Consent shock also introduced a new set of dimensions (dealing with the non-payment term modification clauses) along which parties could modify their contracts. For many of these dimensions, standardized options already existed for contracting parties desiring to make collective action through exit consents more (or less) difficult. Incremental shifts along the spectrum from UACs to CACs then became possible after Ecuador (instead of the binary choice between either UACs or CACs that existed pre-Ecuador), leading potentially to more change in contract terms.

After no appreciable change in contract modification terms after Ecuador, we provide evidence that a large shift in sovereign bond terms occurred several years later with the implementation of collective action clauses in the Mexico sovereign bond offering in February 2003.¹⁵ Standardization limited the initial amount of contract change post-Ecuador. However, eventually market forces resulted in a (delayed) large shift in contract terms toward CACs.

Third, we examine the significant driving forces behind the shift toward CACs commencing with the 2003 Mexico offering. Several repeat players operate in the sovereign

¹⁵ For an early and insightful discussion of the move to CACs by Mexico in 2003, see Anna Gelpern, *Collective Action Shows the Way Forward*, *Int'l Fin. L. Rev.* at 19, May 2003 (reporting on the move by Mexico). For a recent declaration of success on the move to CACs by the U.S. Treasury, see Statement of Under Secretary of Treasury John Taylor Regarding the Decisions By Countries to Issue Bonds with Collective Action Clauses (available at www.ustreas.gov/press/releases/js1144.htm) (February 3, 2004).

bond market, including the issuers, large investors who are repeat buyers of these bonds, investment bank-underwriters of the offerings and attorneys for both the issuers and the underwriters. In addition, there are official sector players, such as the International Monetary Fund (“IMF”), the World Bank, the Bank for International Settlements (“BIS”), the U.S. Treasury, and industry groups such as the Emerging Markets Creditors Association (“EMCA”), the Emerging Market Traders' Association (“EMTA”), and the Institute of International Finance, Inc. (“IIF”), who operate in the background and might also be thought of repeat participants. While these official sector and industry groups certainly influenced the move to CACs, we provide evidence that market forces nonetheless drove the eventual post-Mexico adoption of CACs among a number of sovereign issuers. Informal conversations with market participants as well as prior research suggested to us that it is typically the attorneys for the investment bank who have control of the drafting in a sovereign bond deal.¹⁶ Our data suggests, however, that the issuer’s counsel may also play a significant role under certain circumstances (specifically, big changes in contract terms).

The innovation literature contains at least two competing hypotheses. The first, that draws from Joseph Schumpeter, suggests that actors with significant market share and market power drive innovation.¹⁷ These actors are most likely to overcome the public goods and financing problems associated with unpatentable new ideas (e.g., contract innovations).¹⁸ The counter hypothesis is that it is the smaller firms – the ones who lack market share and market power, but are willing to take risks and invest to gain a foothold – that are most likely to

¹⁶ See Mark Gugiatti & Anthony Richards, *The Use of Collective Action Clauses in the New York Law Bonds of Sovereign Borrowers*, (forthcoming *Georgetown Journal of International Law* (2004) (finding, in the context of their study, that underwriters’ counsel drive contract terms).

¹⁷ Schumpeter’s classic work is Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (3d ed. 1950); see also W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action*, 42 *J. Econ. Lit.* 116, 119 (2004) (discussing the Schumpeterian hypothesis in the context of their survey of empirical research on financial innovation).

¹⁸ See Frame & White, *supra* note 17, at 119.

innovate.¹⁹ As a recent survey article by Frank and White points out, empirical research testing these hypotheses in the area of financial products has been scarce.²⁰ Further, there has been almost no empirical testing of how the hypotheses play out in the presence of network effects.²¹ The one prominent study in the financial contracting/boilerplate area that we are aware of, however, is in the Schumpeterian vein.²² Marcel Kahan and Michael Klausner both hypothesize and find that it is the high volume underwriters and lawyers who are most likely to be associated with innovation.²³ The rationale being that it is the high volume players who internalize the cost of putting together a significant shift in bond terms because they can spread the cost across their expected future stream of contracts.²⁴ Investors may also view a contract change promulgated by high volume attorneys as more likely to gain widespread use, leading to less resistance to the terms. Our results indicate that big shifts in standardized contract terms are associated with the high volume attorneys (and in particular high volume issuer's counsel). Smaller attorney firms – lacking the economies of scale to justify expending resources in developing new terms and bearing the uncertainty risks associated with such terms – are not as instrumental in pushing forward new terms and instead may simply follow a big shift (often with flawed or inadvertently modified terms). In contrast, we do not find evidence of high volume underwriters as an

¹⁹ See *id.* at 120 (drawing this hypothesis from F.M. Scherer, *Innovation and Growth, Schumpeterian Perspectives* (1994)). Sociologists studying the related question of status and conformity have suggested that initial deviations from existing standards are most likely to be initiated by *both* those at the top and the bottom of the status hierarchy. Those at the top are the most secure in their position and, therefore, feel comfortable experimenting with deviations whereas those at the bottom have the least to lose and the most to gain from deviations. See Damon J. Phillips & Ezra W. Zuckerman, *Middle-Status Conformity: Theoretical Restatement and Empirical Demonstration in Two Markets*, Graduate School of Business (University of Chicago) Research Paper #1598R, February 2001.

²⁰ *Id.* at 116.

²¹ *Id.* at 121-122 (citing to Jeffrey Rohlfs, *A Theory of Interdependent Demand for a Communications Service*, 5 *Bell J. Econ. Manage. Sci.* 16 (1974), on the theoretical front, and to Garth Saloner & Andrea Shepard, *Adoption of Technologies with Network Effects: An Empirical Examination of the Adoption of Automatic Teller Machines*, 26 *Rand J. Econ.* 479 (1995), on the empirical front).

²² . See Kahan & Klausner, *supra* note ___, at 736-40.

²³ *Id.* at 753-760

²⁴ *Id.* at 736-740 (also hypothesizing a coordinating function that high volume bankers and lawyers play in influencing changes in standardized terms)

important factor in contract term change, inconsistent with the Kahan and Klausner hypothesis (and findings).²⁵

Our study provides insight into how market innovation in contract terms may occur even when contracts are boilerplate. Understanding how parties in the sovereign bond market react to changes in the interpretation and uses for bond terms provides a view into whether, more generally, the market alone can generate value-maximizing contracts for all parties. If standardization, for example, is so great an influence that parties are unable to modify contract terms to increase the joint value of such contracts, an argument exists for more formalized, non-contractual procedures to govern sovereign bond deals. Recently, reformers have called for bankruptcy-like workout procedures to govern sovereign bonds and their issuers in times of country financial distress.²⁶ Understanding the ability of private contract to incorporate terms that maximize the joint value of parties – in particular in the area of debt restructuring – is important in determining the need for such non-contractual intervention.

More specifically, we are able to provide preliminary answers to a number of questions that have been as yet unanswered in the literature on financial innovating. For example, Frank and White speculate that changes in markets characterized by network effects are unlikely to be “large”.²⁷ What we find is very much that. Change not only takes time, but also comes in stages (as we describe it, there is first an interpretive shock, then a lengthy period of adjustment, and

²⁵ See Kahan & Klausner, *supra* note __, at 753-60 (finding evidence of large underwriters coordinating contract change, but not small underwriters or law firms).

²⁶ For discussions of the proposals for a sovereign bankruptcy regime at this conference, see the papers by Steve Schwarcz, *The Idiot’s Guide to Sovereign Bankruptcy*, forthcoming Emory L. J. (2004); Robert Rasmussen, *American Bankruptcy Law and Sovereign Debt Restructuring*, forthcoming, Emory L. J. (2004); Patrick Bolton & David Skeel, *Inside the Black Box: How Should a Sovereign Bankruptcy System be Structured* (forthcoming Emory L. J. (2004); Mechele Dickerson, [title] (forthcoming Emory L. J. (2004). Also see Hal Scott, *A Bankruptcy Procedure for Sovereign Debtors*, 37 *Int’l Lawyer* 103 (2003); Michelle White, *Sovereigns in Distress: Do They Need Bankruptcy?* 1 *Brookings Papers on Economic Activity* 21 (2002). For a survey of the precursors to the current round of sovereign bankruptcy proposals and critiques, see Kenneth Rogoff and Jeronim Zettlemeyer, *Early Ideas on Sovereign Bankruptcy: A Survey*, IMF Working Paper dated WP/02/57.

²⁷ See Frank & White, *supra* note __, at 122.

only then a big shift in terms). Frank and White also speculate that changes will come in flurries.²⁸ In other words, that when there is recognition that a new “regime” has arrived, there will be a flurry of innovative activity before the system settles into a new equilibrium.²⁹ Again, this is what we find. The market resists making even minimal changes to boilerplate language for years. But when there is recognition of a regime change, there is a short period of intense innovation, after which the system settles into a steady state again.

The remainder of the article proceeds as following. Part II sets forth the debate over sovereign debt restructuring and the article’s hypotheses. Part III describes our data set of New York law governed sovereign bond offerings. Part IV contains a statistical analysis of the differences in terms of their pricing effects and their correlation with other variables such as the investment banks and lawyers involved in the deals. Part V tests the article’s hypotheses and chronicles recent developments in sovereign bond terms and the implications of this paper’s findings on how bond terms change for these clauses. Part VI takes a different approach to testing the hypotheses through the in-depth examination of contract changes in only one country—Mexico—and an analysis of the rising importance of *pari passu* clauses.

II. Sovereign Debt Restructuring and the Hypotheses

Let us say that a hypothetical sovereign is in financial distress. What does it do? Unlike a corporate debtor, the sovereign cannot liquidate its assets or give up control to the creditors. One could expect the sovereign to contact its creditors and explain to them that the only way that it can repay even a fraction of the debt it owes is for the creditors to give it a break (that is, forgiving some portion of the debt or at least pushing back the maturity of the debt). Given that

²⁸ Id.

²⁹ Id.

the creditors have few mechanisms by which to force the sovereign to pay and have an interest in allowing the sovereign to regain its financial health,³⁰ the creditors will presumably agree to some kind of restructuring. The problem is that the above scenario rarely occurs these days. Sovereigns raise most of their capital through widely dispersed bond issuances, making it near impossible to contact and negotiate individually with the full set of creditors. Even more problematic are the New York-law governed UACs contracts under which most of the sovereigns issue debt. The requirement of unanimous approval not only exacerbates coordination problems, but also produces a holdout problem. Every single bondholder has a veto over the restructuring under a UAC contract and can thereby demand a premium for her vote. The end result is that sovereigns, particularly those with New York-law governed bonds, find it extremely difficult to restructure their debt in times of distress. The inability to restructure quickly and painlessly can cause considerable harm to the sovereign's economy, something that not only hurts the sovereign but also its creditors because the sovereign's prolonged distress inevitably results in a reduced ability to repay debts.³¹

What then explains the long-term use of UAC-type sovereign bonds? Under one theory, some sovereigns may desire UACs as a means of signaling the low probability of default to investors at the time the bonds are issued,³² alternatively, UACs may serve as a means to bond

³⁰ See Bratton & Gulati, *supra* note __ (describing the limited means that creditors have to make sovereigns pay).

³¹ The articulation of the economics of sovereign debt contained in the text is a simplification of a large literature on the subject that has grown exponentially in the last few years. For overviews of this economics, see William W. Bratton, *Pari Passu and the Distressed Sovereign's Rational Choices* (forthcoming Emory Law Journal (2004)); Caroline Gentile & Jill E. Fisch, *Vultures or Vanguard: The Role of Litigation in Sovereign Debt Restructuring*, (forthcoming, Emory L. J. (2004)); William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interests of Creditors*, (forthcoming Vanderbilt L. J. (2004)). For general overviews of the evolution of understanding of the sovereign debt problem by two of the prominent players in this arena, see Daniel K. Tarullo, *Neither Order Nor Chaos: The Legal Structure of Sovereign Debt Workouts*, (forthcoming Emory L. J. (2004)); Lee C. Buchheit, *Overview: A Quarter Century of Sovereign Debt Management* (forthcoming Georgetown Journal of International Law (2004)).

³² UACs make restructuring in times of financial distress both more difficult and costly for issuers. Issuers with a higher probability of facing financial distress therefore suffer a disproportionately higher expected cost from

the country against engaging in moral hazard (e.g., using the borrowed money profligately and then seeking a restructuring).³³ The prevalence of UAC bond terms at least until recently may simply be a reflection of the contracting preferences of sovereign bonds issuers and their investors. Consider the following figure that depicts a range of possible modification provisions ranging from unanimous consent at one end (the UACs) to more collective action friendly modification terms at the other end (e.g., the CACs) and the preferred location of countries if all prefer UACs:



Figure 1

Others, however, argue that use of UACs on the part of sovereigns is simply a reflection of the standardized nature of such terms and the “stickiness” inherent in changing such terms.³⁴ Countries in fact may have varied preferences (see Figure 2 below).

the use of a UAC. Conversely, those issuers with a lower probability of facing distress endure a reduced cost from selecting a UACs. The very selection of a UAC, therefore, provides a credible means for an issuer to demonstrate to the market that the issuer believes it poses only a low risk of financial distress (and thus is willing to bear the bad consequences of facing distress under a UAC contract).

³³ Countries may also not engage in moral hazard to protect their long-term reputation. This reputation, in turn, allows the countries to obtain future financing from the capital markets.

³⁴ For a discussion of the “stickiness” theory, see Bratton & Gulati, *supra* note __ .

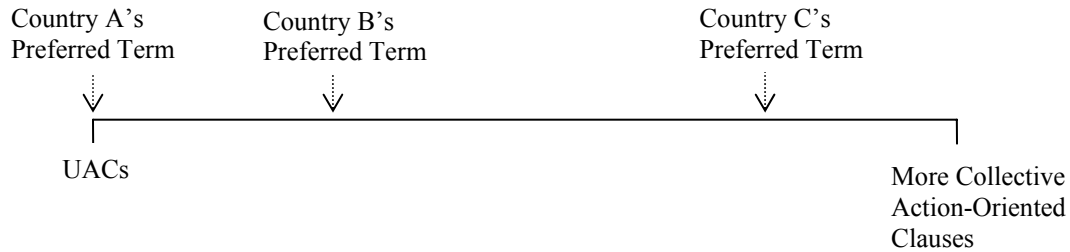


Figure 2

Particularly those calling for implementing bankruptcy-type procedures on top of contractual sovereign bond agreements argue that the UACs simply are an artifact of suboptimal standardization in the market. Existing evidence on whether UACs are preferred by at least some countries (or are simply an artifact of standardization) is mixed. Eichengreen, Kletzer, and Mody (2003) provide evidence that lower credit rating countries may prefer UACs (as opposed to CACs) as a means of bonding their credibility to the market.³⁵ Gugiatti and Richards (2003), in contrast, report evidence that the many CACs (prior to Mexico's sovereign debt offering in February, 2003) were simply due to inadvertence.³⁶ Indeed, Gugiatti and Richards make the claim that most bond investors (and even some of their lawyers) simply were unaware of the presence of CACs.³⁷ We can restate the debate between preferences and standardization as the driving force behind contract terms in the following testable hypotheses:

³⁵ See Barry Eichengreen, Kenneth Kletzer, and Ashoka Mody, *Crisis Resolution: Next Steps* (working paper, 2003) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=445520). Put another way, investors may worry about countries selecting a CAC out of a fear that such a country may engage in moral hazard (borrowing too much or not employing fiscal discipline) because the country realizes that a later debt workout is easier due to the CAC. See also Eichengreen, Barry and Ashoka Mody (2000a), "Would Collective Action Clauses Raise Borrowing Costs?" NBER Working Paper no. 7458 (January) (finding that CACs results in lower interest rate spreads for investment grade issuers but wider spreads for non-investment grade issuers); Eichengreen, Barry and Ashoka Mody (2000b), "Would Collective Action Clauses Raise Borrowing Costs? An Update and Extension," World Bank Research Paper no. 2363 (same).

³⁶ See Gugiatti and Richards, *supra* note 16.

³⁷ See *id.* The Richards and Guggiati story has resonated with at least some other experts in the area. See Robert Gray, *Collective Action Clauses – The Way Forward*, forthcoming, *Georgetown Journal of International Law* (2004).

Hypothesis 1 (the Standardization Hypothesis): At least some sovereign issuers selected the UAC terms prior to Ecuador only because of the standardized nature of the UACs (and would have chosen another modification-related term if the UACs had not been the standard).

A major interpretive shock in how parties viewed the UAC bond terms allows for a test of the importance of standardization in contract terms. Today, because the Exit Consent technique is the primary method of restructuring New York-law governed UAC bonds, these differences are important to investors. But prior to four years ago, it was widely assumed that UAC sovereign bonds were restructuring proof.³⁸ Then, as sovereign financial crises occurred in the late 1990s, lawyers began to look for creative methods of interpreting the existing language of the contracts to allow for restructurings ultimately resulting in the use of exit consents.³⁹

The Exit Consent was a technique already in use by U.S. corporations (for whom the use of UACs in bond covenants were mandated by law).⁴⁰ Ecuador's innovation was in adapting Exit Consents to the sovereign context; an area in which the technique had been assumed to be inapplicable.⁴¹ Contracts are inevitably incomplete because there are always some contingencies that either cannot be foreseen or are too difficult or costly over which to negotiate. This

³⁸ See Buchheit, Overview, supra note ____.

³⁹ Id. at ____.

⁴⁰ The background to the use of the exit consent technique by Ecuador is described in Lee C. Buchheit & G. Mitu Gulati, Exit Consents in Sovereign Bond Exchanges, 48 UCLA L. Rev. 59 (2000). For a more recent treatment of the uses of exit consent technique in the sovereign context, see Kentaro Tamura, The Problem of Sovereign Debt Restructuring: Holdout Problem and Exit Consents, 1 J. Restructuring Finance 1 (forthcoming, 2004).

⁴¹ Given the widespread use of the exit consent technique by corporates, it seems unlikely that the players in the sovereign markets (who, in the law firm context at least, often work side-by-side with the corporates) were unaware of the technique. Yet, as we know from the outrage and surprise that was expressed after the use of the technique by Ecuador, its use in the sovereign context did come as a shock. See infra note ____ (citing articles). The explanation for this, Lee Buchheit tells us, may have had to do with the refusal of the old Bank Advisory Committees (on grounds of gentlemanly behavior and a fear of incurring legal liability) to use an equivalent technique (they called it a "scorched earth" amendment) to motivate holdouts in the restructurings of the 1980s. Subsequent to the rejection of the technique in the 1980s, the sovereign market in the 1990s seemed to have forgotten about this possibility. They were thus "shocked" when Ecuador used the technique in late 2000. For discussions of the foregoing history to the use of exit consents in the sovereign market, see Lee C. Buchheit, Unseating Free Riders, Int'l Fin. L. Rev., Sept. 1989 at 15; Lee C. Buchheit, Making Amends for Amendments, Int'l Fin. L. Rev. Feb. 1991 at 11.

incompleteness allowed Ecuador to take advantage of the ambiguity in the contract language to restructure its UAC-clause sovereign bonds even without unanimous bondholder approval using exit consents modifying the non-payment terms of the bonds. Key to an Exit Consent is the recognition that there is more to a sovereign bond contract than the requirement that unanimous approval be obtained for an alteration of the payment terms. Indeed, the vast majority of clauses (non-payment term-related) in even the N.Y.-law governed contracts can be modified by something less than unanimous consent. There are a few clauses covering ministerial matters that can be modified with permission from the bond's fiscal agent alone. And then there are more important clauses covering matters such as negative pledges, governing law, submissions to jurisdiction, and listing provisions.⁴² Changing these clauses requires a vote of the bondholders, but importantly not a unanimous one even in UAC contracts. Exit Consents exploit the maneuvering room within the clauses that allow changes with less than unanimity for non-payment terms to circumvent the formal unanimity requirement for modification to the payment terms imposed under the UACs. Through exit consents, a subset of bondholders (typically a simple majority) exit the bond for another security, voting to modify a non-payment term of the old bond as they exit (e.g., changing the governing law for the bond or removing the waiver of sovereign immunity on the part of the issuer). The modification to the non-payment term of the old bond then leaves holdouts who do not exit with a reduced value bond (e.g., removing the waiver of sovereign immunity makes it harder to sue the sovereign). Exit consents therefore deter holdouts and encourage collective action, inducing all the bondholders to exchange their

⁴² For a discussion of these clauses and the likely impact of a threat to alter them in the context of an Exit Exchange offer, see Buchheit & Gulati, *supra* note 44, at 81-83. __

old bonds for the new bonds with more favorable terms for the issuer in times of financial distress.⁴³

The sudden shift in interpretation of the modification provisions post-Ecuador toward Exit Consents allows for a test of the importance of these network externalities. If parties selected UACs because UACs were simply the best for their situation and network externalities do not matter then we would expect that parties would react to the Ecuador interpretive shock (Step 1 in Figure 3 below) with an immediate shift back to the old pre-Ecuador interpretation in new offerings post-Ecuador (for example, through the provision of unanimity voting for even non-payment-related terms) (Step 2 in Figure 3 below).

⁴³ Say that a hypothetical sovereign in financial distress has managed to work out a restructuring deal with the majority of its creditors (call them the “Good Guys”). Suppose also that a handful of holdouts refuse to go along with the deal unless they are paid a premium for their votes. Paying a premium to the holdouts however complicates matters with the Good Guys because that means that there is a smaller pie available for them. Plus, they begin to wonder whether or not they should hold out themselves (after all, the holdouts are getting paid more). And once that dynamic starts, it is not long before the entire restructuring unravels. Exit Consents solve this problem by utilizing the “consent” of the Good Guys prior to their “exit” from the old bonds (hence, the term Exit Consent). Through Exit Consents, the Good Guys exchange their old bonds for the new restructured bonds and also consent to changes in the terms of old bonds not covered under the UAC provision. Through changes in the governing law, listing provisions, and other terms, the Exit Consent procedure can then diminish (sometimes dramatically) the value of the old bonds. For example, changing the governing law from that of New York to that of some jurisdiction less sympathetic to holdout behavior (for example, England) would make it harder for the holdouts to sue. Alternatively, Exit Consents may be used to rescind the issuer’s waiver of sovereign immunity or its consent to jurisdiction in New York, both of which would complicate the ability of holdouts to bring suit to enforce their rights under the old bond covenant (again reducing the value of the bonds to holdouts). Rather than obtaining a reward for being a holdout, those who hold out are left with less than the other bondholders, leading fewer (if any) bondholders to be holdouts in the first place. Exit Consents therefore provide a mechanism to ensure collective action on the part of dispersed bondholders. The foregoing is described in Buchheit & Gulati, *supra* note ___. On the use of the exit consent technique more generally, see William A. Klein & John C. Coffee, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U.Chi. L. Rev. 1207, 1214 (1991); William W. Bratton, *Corporate Finance* 263-265 (5th ed. 2003) (discussing the exit consent technique, empirical evidence on its use, and the relevant case law).

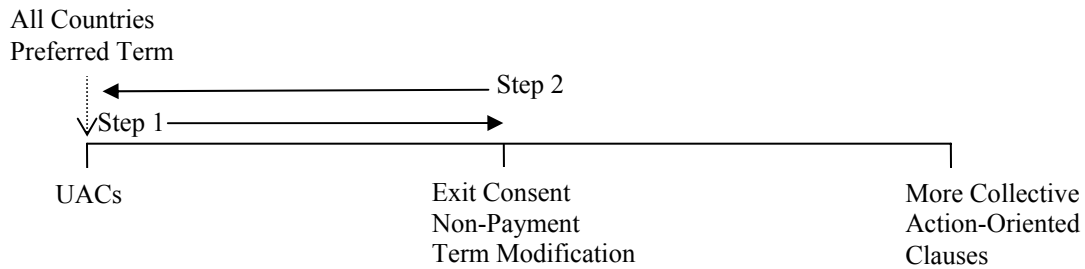


Figure 3

On the other hand, if parties selected the UACs pre-Ecuador primarily because of network externalities (and in fact have a range of preferences as in Figure 2), they will not all shift immediately back to the pre-Ecuador UAC regime. The post-Ecuador shift in the meaning of the exit-consent related modification terms provides a new interpretation for the old standardized terms, creating a new standard in the market (with exit consent-driven modification of payment terms). The lack of a shift back to the pre-Ecuador interpretation of the UACs would provide evidence consistent with the Standardization Hypothesis. In the alternative, countries and investors could have shifted their preferences from UACs to more collective-action friendly terms in 2000. We could therefore view the shift to the Exit Consent interpretation of the UAC-contracts as reflecting this new preference and therefore not supporting the standardization hypothesis.

Assuming countries do not all prefer the pre-Ecuador UACs (and were “stuck” on the UAC contracts due to standardization effects), how will they react after the interpretive shock post-Ecuador? We can imagine at least two possibilities. First, countries may stay with the new standard regardless of what is optimal for their particular situation simply because of network externalities. However, the new standard is unlikely to have the same level of stickiness as the

old pre-Ecuador UACs. The use of Exit Consents, while powerful, was open to some amount of uncertainty after Ecuador, giving it less value as a standardized provision.⁴⁴

Second, countries may shift toward their desired preference point (in the spectrum from UACs toward more collective action oriented terms). It is possible that some countries may shift their terms back toward the pre-Ecuador-understanding of the UACs (even if not all the way to the pre-Ecuador UACs). Other countries may shift toward even more collective-action oriented terms—significantly, after an initial delay.

Ecuador's use of exit consents, in particular, may have—over time—made it easier for countries to move even further toward the collective-action friendly spectrum of possible contract terms. The modification terms-related to the Exit Consents provide sovereigns an expanded set of dimensions along which the sovereigns could vary terms (across well-known alternatives). For example, prior to Ecuador, some of the non-payment term modification clauses provided for a 50% voting threshold while others provided for a 66.67% threshold. Because no one thought the modification of non-payment terms was important prior to Ecuador, these terms got little attention. Instead, pre-Ecuador, many countries likely viewed their choice as simply being between UAC or CAC modification provisions relating to the payment terms. Given such a stark choice, most countries aligned themselves with the UACs. Post-Ecuador, however, these same countries may face lower costs in modifying the existing non-payment modification terms incrementally to provide for more collective-action friendly Exit Consent

⁴⁴ A number of the articles commenting on exit consents that came out subsequent to the Ecuador offering expressed doubt as to the extent to which this technique could be pushed. See Michael M. Chamberlin, *At the Frontier of Exit Consents*, EMTA, November 8, 2001 (at www.emta.org/ndevelop/exitcons.pdf); Anthony Richards et al., *Recent Proposals For Reform of Sovereign Debt Restructuring*, Federal Reserve Bank of Australia Bulletin, 61, 65, August 2002 (noting uncertainty about the extent to which the exit consent technique can be pushed) (at www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_aug02/bu_0802_3.pdf); see also, supra note __ (citing articles commenting on Ecuador's use of exit consents, including reports from Moody's and Goldman Sachs). Skepticism about the extent to which the exit consent technique could be pushed was expressed in at least one of the papers for this conference as well. See Schwarcz, *Idiot's Guide*, supra note __.

provisions (moving therefore gradually toward the CAC end of the spectrum of contract term possibilities).

Post-Ecuador, countries also developed greater experience with the benefits and costs of the exit consent procedure. Investors, similarly, could use the post-Ecuador experience to assess better the value of having collective action procedures in the sovereign bond context, reducing their resistance (in the form of a demand for higher interest rates) to terms closer to the CAC-end of the contract term possibility spectrum. Information also likely developed on how courts would view the use of Exit Consents (and more generally collective-action friendly provisions) applied under N.Y. law.⁴⁵ An indication of this improved understanding and sophistication about Exit Consents was the Uruguay exchange offer conducted in 2003. One danger with Exit Consents is the possibility that issuers may use the procedure to coerce investors into accepting inferior terms even when not in the best interests of the investors as a group. The Uruguay offering was far more creative than the Ecuador offer in terms of providing investors with protections against the possibility of coercion and later opportunistic behavior by the debtor.⁴⁶ The sudden shift in understanding post-Ecuador on the ability of forcing through collective action restructuring through existing contracts therefore may have lead to an eventually larger overall shift in the standardized terms after an initial delay (during which experience and information is generated on the desirability of the Exit Consent procedure).

Other reasons exist for an initial delay in response after an interpretive shock. Issuers and their attorneys may hesitate to modify boilerplate contract terms after an interpretive shock to the

⁴⁵ Although there was no litigation over the use of Exit Consents in either Ecuador or Uruguay, we suspect that, in the post Ecuador period, lawyers for both the creditor and sovereign sides studied the case law from the corporate context so as to gain a greater understanding of the limits of the technique.

⁴⁶ For a descriptions of the bells and whistles in the Uruguay offer, see Lee C. Buchheit & Jeremiah Pam, Uruguay's Innovations 19 *Journal of Int'l Banking L. & Reg.* [] (2003); see also IMF, *Reviewing the Process For Sovereign Debt Restructuring Within the Existing Legal Framework* 32 (August 2003) (at <http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf>).

extent the meaning of the shock is somewhat uncertain (at least initially). Any change the issuers and attorneys make to the contracts may indirectly provide evidence that the older contract terms (contained in the large stock of existing bond covenants) in fact do represent the meaning given them by the interpretive shock (otherwise why change the terms). So, for example, a court may interpret a shift in contracts toward prohibiting exit consents as a tacit admission that the older contracts in fact allow exit consents.⁴⁷ After the initial delay (once the interpretative shock is more definite), parties may then seek to change subsequent contract terms.

Given the necessity of time in developing experience with collective-action friendly clauses under N.Y.-law governed bonds, we put forth the following hypotheses:

⁴⁷ The logic of this explanation (related to us by a number of market participants) was not obvious to us. The explanation for a lack of change posits that there is a significant risk that courts will interpret a change as a sign that the prior language meant something different from the new language. But the question that occurred to us was: Why wasn't it just as likely (if not more likely) that a court would interpret a change in the contract language (in response to the interpretive shock) as a sign of the market's expression of disapproval as to the prior unexpected interpretive shock. Lee Buchheit explained to us that the flaw in our question was in assuming that a full scale coordinated shift to the new language was possible. As a practical matter, however, the individual lawyer proposing that his client alter the term in her contract (in response to an interpretive shock) faces the possibility that no one else will change their terms. If so, the value in engineering the change is unclear. Indeed, if the court sees that some parties change their terms and others do not, it is going to be harder to argue to the court that the market is unambiguous in having an understanding different from that which caused the interpretive shock. Further, and perhaps more important, assuming that any change in the boilerplate language has to be explained and justified to the underwriters (who, as both Ed Bartholomew and Robert Gray explained to us at the conference, do not like deviations from the standard form because they cause costly delays in getting the deal done), it may well be in the individual client's interest to stick with the old term.

Bill Bratton pointed out, however, that the foregoing does not mean that the market does not ever respond to interpretive shocks. If the shock is costly enough to individual clients, and there is a clear and widespread understanding that the interpretation was wrong and needs to be corrected, the market does move. Indeed Bratton documents such a coordinated move to correct the language in bond contracts in the wake of the classic Fifth Circuit case of *Broad v. Rockwell*. See William W. Bratton, *The Economics and Jurisprudence of Convertible Bonds* 1984 *Wis. L. Rev.* 667, n. 75 & n. 111.

In sum, the story seems to be that if the shock is extreme enough, coordinated change can be induced. But if there is ambiguity as to whether the new interpretation is problematic, at least among some contracting parties (as we suspect was the case with Ecuador's use of Exit Consents), then coordination is difficult and parties may continue using the same contract language despite a preference different from the interpretive shock.

Hypothesis 2 (Big Shift Hypothesis): Contracting parties experience higher costs and delay in making larger variations from standardized contract terms even where such a shift is value-increasing. Smaller shifts, nonetheless, can reduce the incremental cost of a subsequent bigger shift in contract terms by reducing the uncertainty surrounding the larger shift (through greater experience on the value of the smaller shift developed over time).

Figure 4 depicts the big shift hypotheses. Step 1 represents the initial shock post-Ecuador to the Exit Consent standard. Step 2 is the range of initial responses around the new Exit Consent standard. Removing the non-payment modification terms is relatively low-cost and thus we hypothesize that countries may move back to the pre-Ecuador UACs if they desire. On the other hand, we hypothesize that countries have only a limited ability to move further toward more collective-action friendly terms past the initial interpretive shock at least initially (due to the high uncertainty costs as to the value of the Exit Consents and how courts will treat even more collective action friendly terms under N.Y. law). Step 3 is the range of larger additional movements away from the original pre-Ecuador UACs made possible with greater information and certainty arising with experience post-Ecuador on the interpretation and use of collective action-related clauses. Step 3 necessarily will occur only after a delay after Step 2.

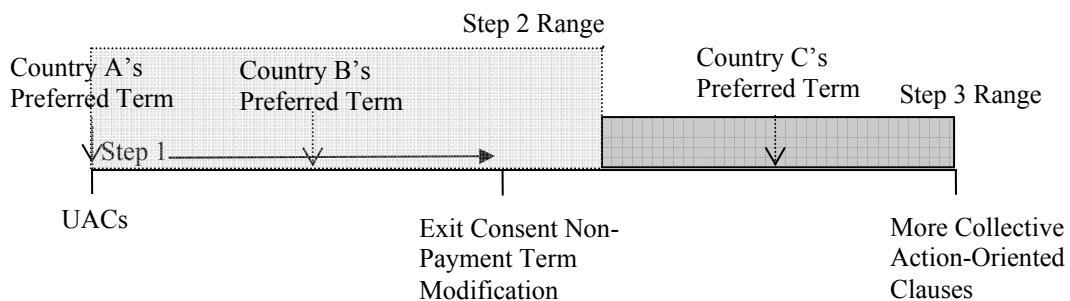


Figure 4

Network externalities giving rise to “stickiness” in standardized terms arise precisely because contracting parties fail to internalize the impact their choice of a particular contracting term has on outside third parties. When Argentina and its underwriters as well as attorneys for both decide to put together a sovereign bond deal, they may fail to take into account the value to future contracting parties of devising new terms. They will however bear the full cost of drafting the new term, assessing the impact of the new term on other terms in the contract, and the risk of uncertainty in how investors and courts will react to the new term. Nonetheless, some of the associated participants in the sovereign bond contracting process may internalize at least a substantial fraction of the benefits from generating new contract terms that increase the overall value. Attorney firms handling a large number of sovereign bond deals in particular act as repeat players in drafting standardized contracts for use with multiple sovereigns as we set forth in the following hypothesis:

Hypothesis 3 (High Volume Attorney Hypothesis): Attorney law firms dealing in a high volume of standardized contracts are the most likely to engage in a big shift in contract terms.

We predict that those attorney firms that handle a large volume of sovereign are most likely to lead the move toward newer bond terms representing a dramatic shift from those in use in the past (the CACs in the post-Mexico era after February 2003).

III. Description of the Dataset

Our dataset consists of 155 New York law governed sovereign bond contracts issued during from January, 1995 to February, 2004. While not comprehensive, we gathered all publicly-available contracts from filings available from the Securities and Exchange

Commission. We supplemented with bond contracts obtained from multiple law firms and investment banks. Even given our efforts, collecting a comprehensive set of sovereign bonds is difficult (and we are likely missing a number of the smaller offerings).⁴⁸ Nonetheless, our sample consists of most of the larger sovereign bond offerings and therefore the more economically important offerings. For each offering we examined the prospectus or registration statement associated with the offering to obtain information on the offering terms and the modification clauses contained in the contracts.⁴⁹

There are 34 countries represented in the sample (we collected multiple contracts for many of the sovereigns involved). Table 1 provides a summary of the countries in our sample.

Table 1: Issuers by Country

<i>Country</i>	<i>Frequency</i>	<i>Percentage</i>
Argentina	4	2.6%
Australia	1	0.6%
Bahamas	1	0.6%
Belize	4	2.6%
Brazil	4	2.6%
Chile	8	5.2%
China	4	2.6%
Colombia	17	11.0%
Costa Rica	7	4.5%
Ecuador	1	0.6%
Egypt	4	2.6%
El Salvador	4	2.6%
Finland	3	1.9%
Guatemala	2	1.3%
Indonesia	2	1.3%
Israel	1	0.6%
Italy	6	3.9%
Jamaica	4	2.6%
Korea	3	1.9%
Lebanon	2	1.3%
Malaysia	1	0.6%

⁴⁸ These difficulties in collecting the actual contracts is also discussed in Gugiatti & Richards, (GJIL paper), supra note 16_.

⁴⁹ These documents typically report the key contract terms in a section titled “Description of the Securities” (or “Description of the Notes”).

Mexico	17	11.0%
Panama	5	3.2%
Peru	4	2.6%
Philippines	10	6.5%
Poland	3	1.9%
Qatar	2	1.3%
South Africa	5	3.2%
Sweden	1	0.6%
Thailand	2	1.3%
Trinidad & Tobago	2	1.3%
Turkey	6	3.9%
Uruguay	12	7.7%
Venezuela	3	1.9%
Total	155	100.0%

In addition, there were 24 law firms (we counted the London-branch of a U.S. law firm as a separate law firm to track the importance of location in determining the particular types of bond terms)⁵⁰ and 17 investment banks involved in the offerings. Tables 2 and 3 provide a summary of the attorneys and the underwriters associated with our sample respectively.

Table 2: Breakdown of Attorneys Associated with the Offerings

<i>Attorney Firm</i>	<i>Issuer Counsel</i>		<i>Investment Bank Counsel</i>	
	<i>Frequency</i>	<i>Percentage</i>	<i>Frequency</i>	<i>Percentage</i>
Allen & Overy	11	7.1%	3	1.9%
Arnold & Porter	22	14.2%	0	0.0%
Cleary Gottlieb	69	44.5%	15	9.7%
Clifford Chance	0	0.0%	6	3.9%
Cravath	0	0.0%	7	4.5%
Cravath (LONDON)	0	0.0%	1	0.6%
Davis Polk	0	0.0%	5	3.2%
Dewey Ballantine	0	0.0%	2	1.3%
Dewey Ballantine (LONDON)	0	0.0%	4	2.6%
Freshfield	1	0.6%	0	0.0%
Government	15	9.7%	0	0.0%
Greenberg Taurig	3	1.9%	0	0.0%
Hogan & Hartson	1	0.6%	0	0.0%
Hunton & Williams	1	0.6%	0	0.0%

⁵⁰ See Gugiatti and Richards, supra note 16 (providing evidence that the London offices of U.S. law firms drove many pre-Ecuador adoptions of CACs).

Latham (London)	2	1.3%	0	0.0%
Shearman & Sterling	1	0.6%	28	18.1%
Sidley & Austin	6	3.9%	0	0.0%
Simpson Thatcher	0	0.0%	4	2.6%
Skadden Arps	0	0.0%	7	4.5%
Skadden Arps (LONDON)	0	0.0%	2	1.3%
Sullivan & Cromwell	3	1.9%	63	40.6%
Thacher, Proffitt & Wood	3	1.9%	0	0.0%
White & Case	7	4.5%	1	0.6%
White & Case (LONDON)	5	3.2%	0	0.0%
Unknown	5	3.2%	7	4.5%
Total	155	100.0%	155	100.0%

Table 3: Breakdown of the Investment Banks for the Offerings

<i>Investment Bank</i>	<i>Frequency</i>	<i>Percentage</i>
ABN AMRO	4	2.6%
Barclays	3	1.9%
Bear Stearns	9	5.8%
CS First Boston	2	1.3%
Chase	6	3.9%
Citigroup	7	4.5%
Credit Suisse	17	11.0%
Deutsche Bank	13	8.4%
Goldman Sachs	25	16.1%
HSBC	2	1.3%
J.P. Morgan	19	12.3%
Lehman Brothers	6	3.9%
Merrill Lynch	10	6.5%
Morgan Stanley	6	3.9%
Salomon Bros	2	1.3%
Salomon Smith Barney	6	3.9%
UBS	1	0.6%
Unknown	17	11.0%
Total	155	100.0%

The modification clauses that we examine can be divided into three broad categories. First, we classify those offerings in the period where all New York issue bonds were assumed to contain UACs and prior to the use of Exit Consents to get around the UACs as in the “Pre-Ecuador” period (in our sample, that is between 1995 and August 2000). News of the Ecuador use of Exit Consents filtered into the market throughout much of 2000. We selected the

publication date of a law review article detailing how to use exit consents to affect a restructuring of even UAC sovereign bonds in October 2000 (co-authored by Lee Buchheit, one of the architects of the Ecuador offering) to mark the end of the Pre-Ecuador period.⁵¹ Second, we classify the period after the news of the Ecuador restructuring hit the market in August 2000 and Mexico’s issuance of a bond offering involving collective action modification clauses in February 2003 as the “Post-Ecuador” period. Third, we classify the period including the Mexico CAC offering in February 2003 and thereafter up to February 2004 (when we stopped collecting data for this piece) as the “Post-Mexico Period”. Table 4 provides a summary of the offerings by year and by designated time period.

Table 4: Sovereign Bond Offerings By Year

Panel A

<i>Year</i>	<i>Frequency</i>	<i>Percentage</i>
1995	2	1.3%
1996	10	6.5%
1997	6	3.9%
1998	9	5.8%
1999	18	11.6%
2000	17	11.0%
2001	22	14.2%
2002	31	20.0%
2003	36	23.2%
2004	4	2.6%
Total	155	100.0%

⁵¹ See Lee C. Buchheit & G. Mitu Gulati, Sovereign Bonds and the Collective Will, 51 Emory L.J. 1317 (2002). For examples of discussions where Lee Buchheit is explicitly credited (or blamed) with devising the exit consent strategy in the sovereign context, see Chamberlin, supra note __ & Report on the Meeting of the Private Sector Discussion Group, HSBC, February 2002 (at <http://www.ids.ac.uk/ids/global/Finance/pdfs/psdg6.pdf>).

Panel B

Pre-Ecuador is defined as including all offerings in the sample up to and including October 2000. Post-Ecuador is defined as including all offerings after October, 2000 until January 31, 2003. Post-Mexico is defined as including the Mexico offering on February 1, 2003 and all offerings thereafter up to February 2004.

<i>Time Period</i>	<i>Frequency</i>	<i>Percentage</i>
Pre-Ecuador	61	39.4%
Post-Ecuador	59	38.1%
Post-Mexico	35	22.6%
Total	155	100.0%

IV. Differences in Modification Terms

The basic UAC clause says something along the following lines:

The terms of the indenture can be changed with the written consent of more than X% of the holders, in aggregate principal amount. No such action may, however, may be taken without the consent of each holder of the securities of the series that alters:

- (i) the times, dates, amounts, and currency of payments of principal or interest on the series (including in the event of an acceleration);
- (ii) any redemption payments and procedures; or
- (iii) the proportion of the principal amount that is required to authorize any action relating to this series.

In this section, we parse the modification clauses in our dataset of contracts for differences that might impact the ease of using the Exit Consent technique to effect a restructuring. Small differences in the language of the modification clauses in these contracts, that we suspect were not given much importance by the market in the pre-Ecuador period, all of a sudden took on great importance after Ecuador's use of the Exit Consent technique in 2000. In what follows below, we describe the key differences in the contract modification clauses as they relate to the use of Exit Consents.⁵²

⁵² The material in this section of the paper is drawn from Stephen Choi & Mitu Gulati, Why Lawyers Need to Take a Closer Look at Exit Consents, *Int'l Fin. L. Rev.*, 15-18, September 2003 (2003). Although that paper was written on the basis of an analysis of fifty contracts only, the differences we found there were largely representative of the differences in the full 160 contract data base.

A. The Pre and Post-Ecuador Periods

To assess the degree of variation that exists in the modification terms, we coded four dimensions for each offering along which modification terms may vary:

1. the voting percentage required for a change to the payment terms (principal and interest) and if the voting percentage is 100% (e.g., unanimity) exactly what group of bondholders are included in this unanimity requirement (VOTEBY);
2. the voting percentage required for a change to the terms of secondary importance—e.g., the non-payment terms (such as the governing law, negative pledge, waiver of sovereign immunity, place of payment, and *pari passu*) (THRESHOLD);
3. whether the terms that required a higher vote threshold (generally, unanimity) for change were specifically enumerated or, alternatively, broadly prohibited unenumerated changes to something like “payment terms” (ENUMERATED);
4. whether there was a prohibition on modifying the “right to institute suit” for failure to comply with the terms of the contract (RIGHT TO SUE).

These four dimensions represent the most important of the differences from the basic UAC clause that we found in our examination of sovereign bond issuances under N.Y. law. We describe each more fully below.

(1) *VOTEBY*

On first reading, it appeared to us that every bond issuances in our sample for the pre and post-Ecuador period required the vote of *all* the holders of the bonds of a series for a change to any of the enumerated payment terms covered under the UAC clauses. Upon closer scrutiny, we discovered some potentially important differences in wording of these clauses. There were at least three different versions, each of which was present in significant numbers:

Version One: The vote of *all the holders* of notes of the debt series is [required for a change to any of the following payment terms].

Version Two: The vote of *all holders* of the notes *affected thereby* is [required for a change to any of the following payment terms].

Version Three: The vote of *all holders of the notes of such debt series affected thereby* is [required for a change to any of the following payment terms].

Version Three looks to be a combination of the language from one and two and a clever litigator could probably argue it either way (although it looks more like One than Two to us). We will focus on the implications of the difference between Versions One and Two. Version One is simple. It requires a vote of all the holders of the notes for any change to the payment terms. This is the commonly-held understanding of the standard modification clause. And, indeed, although both Ecuador and Uruguay had outstanding bonds with Version Three language, those Exit Consents were done using the technique that one would use for Version One.⁵³ Version Two is the interesting one (approximately a fifth of the bond issuances in our sample had Version Two in them). It appears to require only a vote of the holders of the notes *affected by the change*. Read that way, Version Two requires something *less than unanimity* for a change to the *payment terms* (at least if not all the bondholders are deemed as “affected thereby”). But what does this mean in practical terms?

Suppose that a sovereign faces financial distress and restructuring the sovereign’s debt obligation is in the best interests of the group of all bondholders. A problem with the standard Exit Consent route to restructuring is that the bondholders who agree to the restructuring (call these bondholders the “Good Guys”) exit. More specifically, they vote to change the old bond as they exit, but then they are no longer in the old bond. Now they have new bonds. The only

⁵³ In other words, in both Ecuador and Uruguay, the bondholders who agreed to the exchange *exited* the old bonds. The implication of their not exiting is explained in the pages that follow.

holders left in the old bonds are the holdouts. If that is so, then those holdouts are now going to constitute a majority of the old bond issue. That, in turn, means that they now have the votes to do things like accelerate the debt owed (something that generally takes a vote of 25% of the holders in aggregate principal amount). Once the debt is accelerated, the holdouts may then sue the sovereign for payment of the entire principal amount, giving the holdouts a big stick with which to attack the sovereign. Despite the use of an Exit Consent, bondholders may therefore benefit more from holding out even when restructuring is in the best interests of bondholders as a group. Under Version Two, however, there is a solution.

Under Version Two, the Good Guys do not have to exit. They can agree a reduction in the payment terms for themselves and, arguably, stay as holders of the existing bond (remember, in Version Two, we only need the approval of those holders “affected thereby” by the change in payment terms). Instead of the Good Guys exiting the old bonds and having to take entirely new bonds as a result of the requirement of unanimity for any changes to the payment terms of the old bonds, they could agree to take a reduced amount and still stay in the old bonds while allowing the holdouts to remain with their original amounts. But why would anyone agree to do this? Put differently, wouldn't everyone hold out? The deterrent to holding out would be an additional set of amendments that would permit the trustee or fiscal agent to direct payments to the Good Guys according to a new preferential schedule. These amendments, which would include giving the issuer the authority to notify the trustee or the fiscal agent that a particular payment is destined for the Good Guys or the holdouts, would only require majority approval (or two-thirds) because they are not changes to the interest or principal amounts (or scheduled times of payment). The holdouts will fear that the issuer will give instructions for only the Good Guys to be paid. The holdouts, of course, could sue for payment (after all, they still are owed interest under the

original bond contract). The power of the holdouts to hurt the issuer through the filing of suit nonetheless will have been diminished by the continued presence of the Good Guys in the old bonds. The continued presence of the Good Guys in the old bond issue creates a barrier to the holdouts accelerating the remaining debt (for which they typically need a 25% vote; something typically not possible if the Good Guys do not exit). And even if the holdouts have the votes to accelerate, the Good Guys will likely be able to reverse the acceleration (something that typically requires but a 50% vote). Without the ability to accelerate, all the holdouts can do is to sue on their small individual payments as they come due. And that is but a small stick with which to threaten the sovereign.⁵⁴ Version Two therefore works to curtail the problem of holdouts, making collective action to reduce payment terms for issuers facing financial distress more feasible.

But what about the task of persuading the Good Guys to do nasty things to the contract terms if they are themselves going to be affected by them? The answer is that there no longer is a need to do the same types of nasty things. The very presence of the Good Guys in the old bonds and the possibility of resorting to a modification in payment terms under Version Two protects against the primary threat that the holdouts have, thereby leading to few (if any) holdouts. Hence, there is little need to threaten the holdouts with value reducing changes to their contract terms. The potential for the bifurcation of payment streams and the continued presence of the Good Guys should, in theory, be enough of a threat.

(2) THRESHOLD

⁵⁴ This is a small stick because of the expense of litigating. That expense is not going to be worthwhile if the holdout is only able to litigate for one small coupon payment at a time.

The most prevalent difference among sovereign bond modification covenants is in the voting thresholds for modification to the non-payment terms. In a number of the bond issuances done by Ecuador and Uruguay, for example, the vote requirement for modifications was a simple majority. In the majority of the other sovereign issuances examined, and this includes a number of the outstanding Argentine issuances, 66.67% of the outstanding bonds are required for modification of the non-payment terms. Obtaining the approval of bondholders and, therefore, using Exit Consents, is easier when one is faced with the lower voting threshold.⁵⁵

(3) *ENUMERATED*

As with the sample clause described above, the majority of clauses enumerate with specificity those matters that require unanimous approval for a change (for example: the times, dates and currency of payments of principal or interest). All other matters require only a majority (or supermajority) approval. A handful of the issuances, however, do not have this enumeration features. Thailand, Indonesia, Australia, and Sweden, for example, have all issued bonds without enumeration. Instead of enumerating specifically those clauses that required unanimous approval for a change, these bonds instead say something broader along the lines of:

If any modification would change the *terms of payment* of the principal amount of (and premium, if any) or interest or affect the rights of holders of less than all the securities, the consent of all the holders of the securities is required.

⁵⁵ These voting differences can be parsed further in terms of the vote thresholds required at a physical meeting as opposed to vote required without a meeting. For the majority of contracts, we found the two numbers to be the same (for example, 50% of notes outstanding or 50% of those present at the meeting (given that the quorum requirement was met)). However, there were some that did not have a separate requirement relating to a physical meeting. We do not report these finer distinctions, so as to be able to focus on the primary vote differences (and also because our conversations with those in the market suggested that it was impractical to consider having physical meetings in most of these cases). In addition, there are also small differences in quorum requirements that we do not parse for the same reason mentioned above.

This clause is arguably broader in scope than the standard one that specifies that matters like “the times and dates of payments of principal and interest cannot be changed without unanimous approval”. With this broader “terms of payment” clause, the argument can be made that an alteration to something like the governing law clause (as is done through the Exit Consent method), that makes it harder for the holdouts to sue, is really a change to the “terms of payment.” If so interpreted, the broader terms of payment clause then requires unanimity instead of the lower non-payment term voting threshold, undermining the use of Exit Consents. It may be that the argument will be rejected by a judge—she may conduct an investigation into the customary understanding of the clause and find that it means the same as the enumerated one. However, this obviously is not a risk that a distressed sovereign will be happy to assume. Ambiguity elevates the risk level (and cost) in using the Exit Consent technique for countries that fail to enumerate specifically those items that require unanimity for modification.

(4) RIGHT TO SUE

The modification clauses in sovereign bonds governed under N.Y. law are commonly assumed to have been derived from U.S. domestic bonds. One explanation for the unanimity requirement for changes to payment terms is therefore that the language was merely copied from the U.S. domestic bonds where that particular term was mandatory. But one of those mandatory provisions in the domestic bonds that does not appear to have made it into the majority of sovereign issuances is the one that subjects any alteration or impairment of the holders’ “right to sue” to unanimous consent.⁵⁶ Nonetheless, we did find a handful of issuances where among

⁵⁶ It is interesting to ask why this particular portion of the Trust Indenture Act (“TIA”) language was not borrowed by the sovereign debt contracts. The fact that some portions of the TIA language was not copied in the majority of sovereign debt contracts does seem to suggest a problem with the pure path dependence story as to the initial emergence of the UAC language in the sovereign context. See, e.g., Lee C. Buchheit & G. Mitu Gulati,

those matters enumerated as requiring unanimity was the holders' right to sue. For example, Chile did at least two issuances in recent years that specified that unanimity was required to "impair the right to institute suit for the enforcement of any payment." One also sees such language in the issuances by Trinidad & Tobago.

Requiring unanimity among the bondholders to impair the right to sue complicates the matter of Exit Consents. A number of the most potent modifications with which holdouts might be threatened—changes to governing law, rescinding the consent to jurisdiction, rescinding the waiver of sovereign immunity, and altering the votes needed for acceleration—might well be read by a judge as falling within the ambit of a "impair the right to institute suit for the enforcement of any payment" clause and therefore require unanimous approval of the bondholders. Indeed, in the corporate context, we have seen at least one case, *Federated Strategic Income Fund v. Mechala Jamaica Ltd*, where a judge who was faced with an especially harsh use of Exit Consents (one that essentially drained the company of its assets and left little for the bondholders to collect from) read similar language to bar the transaction.⁵⁷

The foregoing are the four contracting dimensions that we are most confident would make an Exit Consent offer significantly easier or harder (depending on what specific term is adopted) to effectuate. There are in addition a set of what we see to be less important, but arguably relevant differences. Because the relevance of these differences is not as clear as those listed above, we do not analyze the variations here (and leave this to future research).⁵⁸

Sovereign Bonds and the Collective Will, 51 Emory L. J. 1317 (2002) (hypothesizing that the initial adoption of UACs may have been the product of "drafting inertia")

⁵⁷ 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).

⁵⁸ The additional variations worth noting are as follows:

(a) *Additional Amounts*

It is standard for sovereign bond contracts contain a provision governing "additional amounts." What this clause refers to are taxes that a sovereign might, at some point, decide to impose on income from bonds. In the case of borrowing by the sovereign, the tax is a method by which the sovereign can force a reduction of its debt. Understandably, therefore, the contracts protect against this type of strategic behavior by the sovereign by saying

that the sovereign has to compensate the lenders for any taxes that it imposes. And for most sovereigns, this protection against sovereign overreaching can only be altered with the unanimous consent of the bondholders. In a small subset of contracts, however, the additional amounts clause is not subject to the heightened voting prohibition. In theory, then, the additional amounts clause can be removed through the use of exit consents.

The matter is not that clear cut though. For the sovereign to unilaterally impose a tax on its bonds is, in effect, to alter its payment obligations. With bond contracts, especially those negotiated by sophisticated parties, courts are more willing to privilege form over substance. But this may be too much even for the most deferential of courts.

(b) Redemption Conditions and Procedures

Some sovereign contracts do not allow changes to redemption conditions without unanimous consent. These redemption conditions might include a penalty that the sovereign has to pay if it wishes to redeem or prepay some portion of the bonds earlier than contemplated in the contract. At first cut, the restriction on redemptions seems like it would be an important one to both the sovereign and the bondholders. After all, a drop in the interest rate that the sovereign can borrow at would make redemption an attractive option for the sovereign (and, conversely, an unattractive option for the lenders). The flaw in the foregoing, at least in terms of relevance to the use of the Exit Consent technique, is that a sovereign that is in financial distress and, therefore, in need of using the Exit Consent technique is hardly concerned about a drop in its interest rates. Indeed, given the distress situation, its borrowing rate is likely sky high (and its lenders would dearly love for the sovereign to want to do a redemption at the old interest rate).

Still, the threat to remove the anti redemption language might be a minor annoyance, that in combination with a number of more painful changes, could produce an effective exchange offer. By itself though, we don't see this difference in language as being especially important.

(c) Agent For Service of Process

As noted earlier, the right to sue (especially the right to sue for accelerated amounts) is one of the primary weapons that hold out creditors have in their arsenal. In order to sue someone though, one has to first be able to serve them (in the case of a sovereign, their agent) with papers. One of the pinpricks that a sovereign might be able to impose on the hold outs is to remove the agent for service of process. The holdout's lawyers will undoubtedly be able to find other methods to serve the sovereign with papers, but there will be additional costs to doing so (first, they have to find a substitute agent and then, second, they have to argue in court that this entity or person is indeed a proper agent for service of process). Most of the contracts in our sample arguably allow for the obligation to maintain an agent for service of process to be removed with a less than unanimous vote. There are some contracts, however, such as that for Trinidad and Tobago, that subject the obligation to maintain an agent for service of process to a unanimous vote.

(d) Place of Payment

A number of the sovereign contracts, in addition to subjecting changes to principal and interest amounts to unanimous consent, also subject any change of the place of payment to the unanimity requirement. On its face, this seems like another small pin prick. After all, the sovereign could annoy the hold out by changing the place of payment to some obscure location. But so long as the payments are still made, the annoyance value is likely to be small (especially given the relative ease of doing banking transfers in the modern era).

The relevance of this restriction, and its absence from a number of contracts, has to do with the steps the U.S. government took in the wake of the Iran hostage crisis in the 1970s. One of the things that the U.S. government did was to put a hold on any payments from the Iranian government. This restriction, however, only applied to payments made within the U.S. Being able to change the place of payment quickly, therefore, became important and a number of the subsequently issued contracts allowed for the place of payment to be changed relatively easily. Some contracts, however, did not make the change. And given that the Iran type of situation did not arise again, there was no impetus for the second set of contracts to change.

(e) Portion of Principal Payable on Acceleration

In addition to the standard restriction on changes to principal and interest amounts, a number of contracts also restrict changes to the portion of the principal that is payable on acceleration. A general restriction on changes to the principal amounts due appears to encompass changes to the portion of principal due on acceleration. We are inclined to say, therefore, that the additional language regarding payments due on acceleration is superfluous. Nevertheless, the presence of this extra language suggests at least the possibility that there was some restructuring that was done in the past where the sovereign argued that changes to the principal payable on acceleration, as opposed to that payable generally, was not subject to the requirement of unanimous approval.

B. The CACs Among the UACs (Post-Mexico Period)

In February 2003, after almost a decade of exhortation from the official sector, Mexico led the move to CACs in New York law governed bonds in a more systematic manner. Other scholars have observed that there have already been at least six sovereigns that had issued CAC bonds under New York law in prior years.⁵⁹ But these were generally thought to have been aberrations.⁶⁰ The issuers were Bulgaria, Lebanon, Egypt, Qatar, Kazakhstan, and the Thai National Power Company. In other words, the modification clauses in these issuances allowed payment terms to be modified with less than unanimity among the bondholders (a 75% vote with all except Egypt, which required an 85% vote). The explanation given was that the issuances for Bulgaria, Lebanon, Egypt, Kazakhstan, and Qatar were by the London branches of New York firms who had used London CAC boilerplate as precedent without realizing the implications of what they were doing.⁶¹ And the Thai Power company issuance (where the underwriter's counsel were located out of the Hong Kong and New York and the issuer's counsel were located out of Singapore and New York), was simply an outlier.⁶²

⁵⁹ See Anthony Richards & Mark Gugiatti, *Do Collective Action Clauses Influence Bond Yields? New Evidence From Emerging Markets*, 6 *International Finance* 415 (2003); Mark Gugiatti & Anthony Richards, *The Use of Collective Action Clauses in the New York Law Bonds of Sovereign Borrowers*, (forthcoming *Georgetown Journal of International Law* (2004)).

⁶⁰ Along these lines, Anthony Richards has discussed how market participants have generally seemed unaware of the extent to which CACs were already being used by sovereign lenders. See Anthony Richards, *The Usage and Pricing of Collective Action Clauses in International Bond Issues*, Background Note for G-20 Seminar on Sovereign Debt Restructuring, Mexico City, (draft dated May 2003).

⁶¹ See *id.*

⁶² We are grateful to Anthony Richards for information on the Thai issuance (email correspondence between Gulati and Richards, dated February 4, 2004) (the two firms in question being Cleary Gottlieb (for the underwriters) and White & Case (for the issuer). To add to these differences, we found two that were even more extreme. For Finland, the modification clause allowed the sovereign to modify any of the terms of the contract at its will. And, with Austria, there simply was no modification term to be found (which, in theory, should mean that no modifications of any sort are permitted). In addition, it has been reported that there are certain contracts for Nigeria that prohibit the use of Exit Consent type techniques altogether. See Goldman Sachs, EMEA Economics Analyst, Jan 25, 2002, <https://www.gs.com/fi/ge/Rdisplay.gscgi/1162352/a.pdf>. We have ourselves, however, been able to track down the actual Nigerian contracts.

Post-Mexico, in contrast, a whole new range of contract terms differences arose for the first time in the sovereign bond market in a systematic manner. In particular, countries began using CACs directly for payment related terms. What started as an indirect method of obtaining collective action among bondholders in Ecuador through Exit Consents utilizing modification of non-payment terms transformed in a matter of years (and seemingly all at once) to outright and direct use of CACs directly on the payment terms.

Table 5 summarizes the various bond terms we collect in the Pre and Post-Ecuador and Post-Mexico periods. We rank the bond terms in the VOTEBY, THRESHOLD, ENUMERATED, and RIGHT TO SUE categories based on the ease with which they allow for bondholder collective action (on a scale from 1 = easiest to 3 = hardest). Because CACs represent a dramatic shift in the VOTEBY (relating to payment terms) category, we code CACs as a 0. While our coding scheme is not exact, it corresponds roughly to the magnitude of importance of these contract variations.

For the bankers and lawyers seeking to implement a restructuring using Exit Consents, at the very least the diversity of terms surrounding the modification provisions require a careful parsing of the modification clauses in the sovereign's various issuances is required. In some cases, as with a Qatar or a Lebanon, they may discover that they do not need Exit Consents at all (but instead can rely directly on CACs). Assuming that there is a need for Exit Consents though, the text of the contract shapes the technique.

Table 5: Contract Provisions

Pre-Ecuador is defined as including all offerings in the sample up to and including October 2000. Post-Ecuador is defined as including all offerings after October, 2000 until January 31, 2003. Post-Mexico is defined as including the Mexico offering on February 1, 2003 and all offerings thereafter.

<i>Type of Provision</i>	<i>Rankings</i>	<i>Pre-Ecuador Frequency</i>	<i>Percentage</i>	<i>Post-Ecuador Frequency</i>	<i>Percentage</i>	<i>Post-Mexico</i>	<i>Percentage</i>
Voteby	0 = Less than unanimity voting (CAC)	1	1.8%	5	8.9%	20	62.5%
	1 = Each holder affected thereby (Unanimity)	13	22.8%	13	23.2%	2	6.3%
	2 = Each of the affected series (Unanimity)	6	10.5%	10	17.9%	3	9.4%
	3 = Each or All (Unanimity)	37	64.9%	28	50.0%	7	21.9%
	Total	57	100.0%	56	100.0%	32	100.0%
Threshold	1 = 50% voting rule	17	28.8%	18	32.7%	10	29.4%
	2 = 50% of outstanding or 66.6% of votes cast	1	1.7%	0	0.0%	0	0.0%
	3 = 66.6% voting rule	41	69.5%	37	67.3%	24	70.6%
	Total	59	100.0%	55	100.0%	34	100.0%
Enumerated	1 = Enumerated	52	89.7%	56	96.6%	33	100.0%
	3 = Not Enumerated	6	10.3%	2	3.4%	0	0.0%
	Total	58	100.0%	58	100.0%	33	100.0%
Right to Sue	1 = No "Impairment" provision	58	95.1%	54	91.5%	35	100.0%
	3 = Impairment of right to sue provision	3	4.9%	5	8.5%	0	0.0%
	Total	61	100.0%	59	100.0%	35	100.0%

V. How Contract Terms Change

In this section we provide evidence on the importance of standardization and on how contract terms change in the face of network externalities. We also provide evidence on the role of law firms dealing in a high volume of contracts in affecting changes in standardized terms in the sovereign bond context.

A. Standardization Hypothesis

In this section we test how countries with different preferences reacted initially to Ecuador's use of Exit Consents in 2000. If countries all chose UACs prior to Ecuador due to preference (and not because of standardization), we expect that there should have been a wholesale move to eliminate Exit Consents in offerings subsequent to the Ecuador restructuring in 2000. On the other hand, if standardization explains the use of UACs, then we would not expect to see such a large reversion back to the pre-Ecuador interpretation of the UAC terms.

Indeed, we expect that a range of preferences may exist among countries for collective-action oriented modification terms. Some countries may desire UACs without possibility of modification as a means of convincing investors of the countries' low-risk of default. Put another way, investors may fear (and demand a much higher interest rate from) countries with a high background risk of default that also include collection-action-oriented clauses in the sovereign bond contracts. Moral hazard risks for investors (that the country may simply take the money and then demand a restructuring) may become prohibitively high. Other countries, however, may value the ability to engage in relatively low-cost restructuring and pose a

relatively low moral hazard risk for investors (perhaps because of the countries financial strength or long-term reputation for keeping their promises).⁶³

As a proxy for the different preferences countries may have toward collective-action oriented clauses, we group countries into three categories based on the exogenous risk of default they present investors. We focus in particular on the Moody's and Fitch ratings for each country at the time of each of the country's bond offerings. For each offering with a Moody's rating we assigned the following number: 1=Aaa; 2= Aa1 to Aa3; 3= A1 to A3; 4=Baa1 to Baa3; 5=Ba1; 6 = Ba2 to Ba3; 7=B1 to B3; 8= any C. For each offering with a Fitch rating we assigned the following comparable number: 1=AAA; 2=AA+ to AA-; 3=A+ to A; 4=BBB+ to BBB-; 5 BB+; 6 = BB to BB-; 7 = B+ to B-; 8= any C. For each offering, we then calculate an average Moody's and Fitch rating. We then assign the offering one of three categories based on the following breakdown in Table 6:

Table 6: Breakdown of Offerings by Exogenous Bond Rating

<i>Category</i>	<i>Definition</i>	<i>Number of Offerings</i>	<i>Percentage</i>
High Rating	Moody's-Fitch rating of < 5 (Investment Grade)	73	48.7%
Medium Rating	Moody's-Fitch rating of 5 (Non Investment Grade)	59	39.3%
Low Rating	Moody's-Fitch rating of < 5 (Speculative/Substantial Risk)	18	12.0%
Total		150	100.0%

As we discussed above, even in the pre-Ecuador period, variations already existed across a number of different dimensions of the modification terms. To examine the shift in the use of

⁶³ See supra notes 35-37 and accompanying text (citing debate between Gugiatti and Richards (2003) and Eichengreen, Keltzer, Mody (2003) on whether countries price CACs).

modification terms from the pre and post-Ecuador period, we construct a composite measure of the modification-related terms as follows:

$$\text{COMPOSITE} = \text{VOTE} \text{BY} + \text{THRESHOLD} + \text{ENUMERATED} + \text{RIGHT TO SUE}$$

Where (as defined in Table 5):

VOTE BY ranges from 0 (CACs) to 3 (UAC for “each or all”)

THRESHOLD ranges from 1 (50% voting rule) to 3 (66.6% voting rule)

ENUMERATED is equal to 1 (if enumerated) and 3 (if not enumerated)

RIGHT TO SUE is equal to 1 (if can impair) or 3 (if unanimity for impairment)

Table 7 reports a comparison of the use of the individual modification terms and the composite modification variable for the pre and post-Ecuador periods. If the standardization hypothesis is correct, we would not expect to see countries in all three rating groups shifting post-Ecuador to eliminate (or at least make more difficult) the use of Exit Consents.

Table 7: Contract Provision Comparisons

Pre-Ecuador is defined as including all offerings in the sample up to and including October 2000. Post-Ecuador is defined as including all offerings after October, 2000 until January 31, 2003. Post-Mexico is defined as including the Mexico offering on February 1, 2003 and all offerings thereafter. Composite ranking is equal to the sum of the Voteby, Threshold, Right to Sue, and Enumerated term rankings as given in Table 5 (ranging from 3=easiest to modify to 12=hardest to modify). The High, Medium, and Low Ratings are based on the average Moody's and Fitch ratings (see Table 6 for definition).

Pre-Ecuador versus Post-Ecuador

<i>Type of Contract Term</i>	<i>Pre-Ecuador High Rating</i>	<i>Post-Ecuador High Rating</i>	<i>p-value</i>	<i>Pre-Ecuador Medium Rating</i>	<i>Post-Ecuador Medium Rating</i>	<i>p-value</i>	<i>Pre-Ecuador Low Rating</i>	<i>Post-Ecuador Low Rating</i>	<i>p-value</i>
VOTEBY	2.21	1.65	0.050**	2.70	2.59	0.627	2.50	2.29	0.758
THRESHOLD	2.07	1.77	0.274	2.78	2.82	0.842	2.50	3.00	0.242
ENUMERATED	1.28	1.15	0.449	1.17	1.00	0.155	1.00	1.00	.
RIGHT TO SUE	1.19	1.36	0.368	1.00	1.00	.	1.00	1.00	.
COMPOSITE	6.67	5.89	0.108	7.65	7.43	0.465	7.00	7.67	0.447

*** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Note from Table 7 that while countries in all risk categories shift their use of modification terms toward slightly more easy-to-modify provisions, most of the shifts are statistically insignificant. High rating countries (investment grade) experience the only significant overall move toward the collective-action end of the contract term spectrum (significant at 5% for the VOTEBY term and at only the 20% level, however, for the COMPOSITE measure).

Two important consequences flow from Table 7. First, at a summary statistic level, the countries in the three risk categories did not on average move toward eliminating the possibility of collective action through exit consents or other means after the Ecuador restructuring, consistent with the Standardization Hypothesis. If countries had viewed the pre-Ecuador UACs as optimal and contracting for new terms occurred costlessly, one would expect that post-Ecuador the countries would have shifted back toward unanimity only provisions. Such a shift does not occur. Indeed, for higher rating countries, a further shift in the VOTEBY term toward the CAC end of the spectrum occurs.

Second, in the post-Ecuador period, little evidence of significant shifts in any of the risk groups of countries (aside from the VOTEBY term for high rating countries) is evident away from the new Exit Consent standard. Either all three sets of countries are already at their optimal set of modification-related contract terms post-Ecuador or else standardization around the new post-Ecuador interpretation of the old UACs acts as a deterrence to major change (at least initially).

The timing of Ecuador's use of Exit Consents in the alternative could have coincided with a shift in preferences among sovereigns and investors from UACs to CACs. Thus, the shift may not support the standardization hypothesis but instead simply reflect a change in the bargain

among sophisticated contracting parties. We are skeptical of this alternative explanation for several reasons. First, Ecuador's use of Exit Consents did not come after a deliberative discussion among sovereign and investors about the value of collective-action friendly clauses but instead as a shock to the market. Moreover, many investors viewed Ecuador's shift with outrage. Second, if preferences did in fact shift to more collective action-friendly terms suddenly, we would expect a more definite move in the contract language itself. As we discuss more fully in the specific context of Mexico below in Part VI, the actual contract language changed little (and indeed, did not change at all in the case of Mexico) in the post-Ecuador period. Instead, Exit Consents merely changed the how parties interpreted and made use of the existing contract language. Change in the contract terms (incorporating bona fide Collective Action Clauses (CACs) did finally occur. However, the major change arrived only after a three year delay, with little warning, in Mexico's sovereign bond offering in February 2003.

B. Big Shift Hypothesis

For almost a decade, the official sector had been urging, even pleading, with market actors to move from UACs to CACs.⁶⁴ The move would be value creating for all parties involved (except the holdouts perhaps), it was argued.⁶⁵ Yet, the market refused to budge. Indeed, the market's unwillingness to move was perhaps one of the reasons why, in the wake of the Argentine crisis, the IMF, in 2001, was pushed to propose a statutory bankruptcy-like restructuring solution (the Sovereign Debt Restructuring Mechanism or "SDRM").⁶⁶ In effect, the IMF proposed contractual change through external mandate. The private sector though,

⁶⁴ See Bratton & Gulati (describing what occurred between 1995 and 2003 in the sovereign debt markets).

⁶⁵ Id. at ___.

⁶⁶ See *infra* note 78 (citing to Anne Krueger's speech in November 2001, unveiling SDRM)..

resisted all attempts at change.⁶⁷ And then, in February 2003, Mexico came out with a New York-law governed bond that contained CACs. As best researchers have been able to tell, investors imposed no significant penalty (in the form of higher interest rates) on the Mexico offering.⁶⁸ After Mexico, the floodgates opened with offerings containing CACs by, among others, Uruguay, Brazil, Bahamas, South Korea, Guatemala, South Africa, Turkey, Poland, and Italy. The move to CACs appeared to have finally occurred.⁶⁹ And, in that move, there also came changes to the Exit Consent and *pari passu* provisions of the contracts. When change finally came, it came in bunches. The move to CACs post-Mexico, however, was not uniform. There are countries that are still wary about the move (Israel, China, and the Philippines, have all utilized the old UACs in recent issuances).

Table 8 provides a comparison of the modification contract provisions in the Post-Mexico period compared with both the Post-Ecuador (but Pre-Mexico) period and the Pre-Ecuador period.

⁶⁷ Id. at ___.

⁶⁸ See Richards & Gugiatti, (International Finance article), supra note 65_ (describing the yield curves for both Mexico and Brazil after the issuance of their CAC bonds in early 2003). In addition, Brazil, that initially utilized an 85% approval threshold (as opposed to the 75% used by Mexico), has shifted to 75%, explaining that the market did not appear to provide a discount for those issuers choosing the 85% threshold. See Reuters, Brazil to Make New Bond Terms More Flexible, April 1, 2004.

⁶⁹ For articles discussing the move and what lies ahead, see Elmar Koch, Collective Action Clauses – The Way Forward (forthcoming, Georgetown Journal of International Law (2004)); Robert Gray, Collective Action Clauses – The Way Forward (forthcoming, Georgetown Journal of International Law(2004); Galvis, infra note ___.

Table 8

Pre-Ecuador is defined as including all offerings in the sample up to and including October 2000. Post-Ecuador is defined as including all offerings after October, 2000 until January 31, 2003. Post-Mexico is defined as including the Mexico offering on February 1, 2003 and all offerings thereafter. Composite ranking is equal to the sum of the Voteby, Threshold, Right to Sue, and Enumerated term rankings as given in Table 5 (ranging from 3=easiest to modify to 12=hardest to modify). The High, Medium, and Low Ratings are based on the average Moody's and Fitch ratings (see Table 6 for definition).

Post-Ecuador versus Post-Mexico

<i>Type of Contract Term</i>	<i>Post-Ecuador</i>			<i>Post-Mexico</i>			<i>Post-Ecuador</i>			<i>Post-Mexico</i>		
	<i>High Rating</i>	<i>High Rating</i>	<i>p-value</i>	<i>Medium Rating</i>	<i>Medium Rating</i>	<i>p-value</i>	<i>Low Rating</i>	<i>Low Rating</i>	<i>p-value</i>	<i>Low Rating</i>	<i>Low Rating</i>	<i>p-value</i>
VOTEBY	1.65	0.75	0.022**	2.59	1.67	0.021**	2.29	0.00	0.000***			
THRESHOLD	1.77	2.43	0.043**	2.82	2.08	0.011**	3.00	3.00	.			
ENUMERATED	1.15	1.00	0.308	1.00	1.00	.	1.00	1.00	.			
RIGHT TO SUE	1.36	1.00	.	1.00	1.00	.	1.00	1.00	.			
COMPOSITE	5.89	5.25	0.239	7.43	5.67	0.000***	7.67	5.00	0.000***			

*** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Pre-Ecuador versus Post-Mexico

<i>Type of Contract Term</i>	<i>Pre-Ecuador</i>			<i>Post-Mexico</i>			<i>Pre-Ecuador</i>			<i>Post-Mexico</i>		
	<i>High Rating</i>	<i>High Rating</i>	<i>p-value</i>	<i>Medium Rating</i>	<i>Medium Rating</i>	<i>p-value</i>	<i>Low Rating</i>	<i>Low Rating</i>	<i>p-value</i>	<i>Low Rating</i>	<i>Low Rating</i>	<i>p-value</i>
VOTEBY	2.21	0.75	0.001***	2.70	1.67	0.009**	2.50	0.00	0.000***			
THRESHOLD	2.07	2.43	0.266	2.78	2.08	0.014**	2.50	3.00	0.292			
ENUMERATED	1.28	1.00	0.152	1.17	1.00	0.287	1.00	1.00	.			
RIGHT TO SUE	1.19	1.00	0.238	1.00	1.00	.	1.00	1.00	.			
COMPOSITE	6.67	5.25	0.007**	7.65	5.67	0.000***	7.00	5.00	0.092*			

*** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Note two things from Table 8. First, between the initial post-Ecuador period and the later post-Mexico period, a significant overall shift occurs in the VOTEBY term for all three rating categories of countries. In addition, the THRESHOLD term shifts for both high and medium rating countries. While the THRESHOLD term becomes more collective-action friendly for medium rating countries, it becomes less so for high rating countries (both shifts significant at the 5% level). Looking at the overall movement in terms, the COMPOSITE measure indicates a significant shift toward collective-action permissive terms for the medium and low rating countries, but not the high rating countries from the post-Ecuador to post-Mexico time periods. Where the high rating countries shifted somewhat earlier in the move from the pre-Ecuador to post-Ecuador periods, the medium and low rating countries lagged in their eventual shift.

Second, comparing the pre-Ecuador period and the post-Mexico period provides a view of the overall shift in terms after the initial delay period immediately after the Ecuador restructuring in 2000. For all three rating categories of countries, a significant shift occurs between the pre-Ecuador and post-Mexico periods as indicated by the COMPOSITE measure. The most significant overall shift occurs for medium rating countries (where the change is significant at the 1% confidence level).

The comparison of contract terms across the different time periods provides evidence consistent with the big shift hypothesis. For medium and low rating countries, the only significant shift in the COMPOSITE terms does not occur immediately in the post-Ecuador period but only after a lag in the post-Mexico period. While high rating countries do shift somewhat toward collective-action friendly clauses in the post-Ecuador period, the shift in the COMPOSITE term is only significant at the 20% level for such countries. After a lag, high rating countries shift again (driven primarily by the adoption of CAC clauses in Mexico and

other investment grade countries), resulting in a significant overall change in the COMPOSITE term between the pre-Ecuador and post-Mexico periods (at the 5% level).

We, nonetheless, cannot rule out the alternative explanation that countries may have changed their underlying preference for collective action friendly terms in the late 1990s and early 2000s due to repeated sovereign financial crises (starting with the Asian economic crisis to the more recent financial problems in Argentina and other countries) and pressure on the part of the official sector for a move toward more collective action friendly terms. Rather than reflect a delay, the move to collective-action friendly terms in the post-Mexico period may simply reflect a response on the part of countries to official sector pressure.

The importance of official sector pressure and the Asian financial crisis in 1997 in affecting the development of sovereign bond contract terms nonetheless is unclear. If the Asian financial crisis really changed the preference of investors and issuers for collective action terms, why did it take until 2003 for the first CACs to appear with the Mexico offering in February 2003. Likewise, the official sector initially pushed for CAC terms in the aftermath of the Asian financial crisis.⁷⁰ Anne Krueger, First Deputy Managing Director of the IMF, however, appeared to publicly give up on CACs in 2001.⁷¹ Instead, Krueger and the IMF switched to pushing the SDRM bankruptcy-type regime. Importantly, the U.S. Treasury never endorsed the SDRM (instead pushing for a contractual solution) and the proposal faced a torrent of criticism from both sovereigns and bondholders.⁷² Moreover, by 2003 (again, before Mexico's shift to a CAC contract), the IMF began to consider both contractual solutions as well as making elements

⁷⁰ See Bratton & Gulati, *supra* note __ (describing this history of the efforts to push for CACs, that started with the issuance of the Rey Report in the mid 1990s).

⁷¹ See Anne Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*, IMF, November 26, 2001; *see also* Anne Krueger, *A New Approach to Sovereign Debt Restructuring*, IMF, December 20, 2001.

⁷² See John Taylor, *Sovereign Debt Restructuring: A U.S. Perspective*, Department of Treasury, Washington D.C. (April 2, 2002); *see also* Bratton & Gulati, *supra* note __ (reporting on the heated and widespread criticisms of the IMF's SDRM proposal emanating from the private sector).

of the SDRM more voluntary (depending on creditor consent).⁷³ Nonetheless, the official sector undoubtedly played some role in the move to CACs. The G-10 working group that drafted model CAC clauses prior to the Mexico offering likely played a non-trivial role coordinating the important private sector actors; although the role of the G-10 group should not be overstated because the eventual clauses that Mexico, Uruguay, and Brazil came out with all had significant differences from the G-10 group's proposed clauses.⁷⁴ Plus, immediately before the 2003 Mexico offering, the U.S. Treasury did indicate that it was not as hostile to the IMF's SDRM position as had previously been thought, suggesting that it might even support some version of SDRM if the private sector did not fall into line by adopting CACs.⁷⁵ At bottom though, while we think that official sector efforts likely played a role, there is not enough to suggest that it was *the* causal factor in inducing the eventual shift. Moreover, as we discuss in the next section, the shift to collective-action friendly terms in the post-Mexico period took a decidedly market approach. The shifts only occurred for certain risk rating countries (primarily medium and low rating countries—e.g., below investment grade) and, at least initially, only where the attorneys associated with the bond covenants had sufficient economies of scale to make drafting new contractual language worthwhile.

C. Multivariate Tests and the High Volume Attorney Hypothesis

Our summary statistic analysis above partitions countries based on the time period (Pre-Ecuador, Post-Ecuador, and Post-Mexico) and the risk rating of the countries at the time of their offerings. Other factors nonetheless may affect why a country may choose particular contract

⁷³ See IMF PIN No. 03/06, Jan. 7, 2003; International Monetary Fund, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations* (Nov. 27, 2002).

⁷⁴ See *infra* note 115 (discussing the clauses proposed by the G-10's working group).

⁷⁵ See e.g., R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, IMF Conference on Sovereign Debt Restructuring Mechanism, Jan. 22, 2003.

terms. To control for these other factors, we construct an ordered logit model with the COMPOSITE measure of the level of collective action terms in the sovereign bond contract as the dependent variable (ranging from 3=easiest to 12=hardest to modify through collective action). The ordered logit assumes that the coefficient on each independent variable is independent of any particular COMPOSITE category. We include a number of explanatory variables in the model.

First, dummy variables for high (investment grade) and medium rating countries are included in the model to control for the effect of risk on the selection of collective-action related terms (based on the average of the Moody's and Fitch ratings as described above in Table 6 and assumed exogenous to the selection of modification bond terms).⁷⁶ Particularly in the late 1990s, the financial crisis facing many sovereigns may have significantly altered the risk new offerings from such sovereigns posed for investors. We use dummy variables for different rating categories to capture any non-linearities in the relationship between risk levels and the use of collective-action related terms. Interaction terms are also included for Post-Ecuador x High Rating, Post-Ecuador x Medium Rating, and Post-Ecuador x Low Rating as well as Post-Mexico x High Rating, Post-Mexico x Medium Rating, and Post-Mexico x Low Rating to determine whether countries in a specific risk grouping shifted their toward (or away from) collective-action oriented modification terms in the Post-Ecuador or Post-Mexico periods.

Second, the model includes the offering amount (in millions of U.S. dollars). The offering amount acts as a proxy for the degree of expected collective action problems. Countries

⁷⁶ The Moody's and Fitch ratings are for the credit risk of the entire country and unlikely to depend on the presence of CACs in any particular bond issue. We also had our research assistant call the rating agencies on multiple occasions to verify that what we were using were country ratings and not any sort of individual bond ratings that might be based on the presence of one of the other type of clause. For discussions of various aspects of the Moody's rating processes for sovereigns, see Moody's Investor Service newsletters dated October 1995 ("Sovereign Risk: Bank Deposits versus Bonds"); March 2003 ("The Implications of Highly Dollarized Banking Systems for Sovereign Credit Risk"); June 2001 ("Revised Country Ceiling Policy").

offering a larger amount of securities typically will sell to more investors, leading to a larger potential collective action problem should the country later experience financial distress and need to restructure the country's obligations. We predict therefore that larger offerings should employ more collective action friendly provisions all other things being equal.

Third, the model includes a dummy variable for whether J.P. Morgan or Deutsche Bank, the two underwriters engaged in the largest number of sovereign debt offerings after Ecuador's use of exit consents, is involved in the offering.⁷⁷ We also include a crude proxy for the reputation of the underwriter associated with the offering, using Carter and Manaster's rating of underwriter quality based on initial public offerings (as updated by Professor Jay Ritter).⁷⁸ Our use of the Carter-Manaster rating assumes that underwriters who have a high reputation in the IPO market enjoy a similar reputation for sovereign bond offerings.

Fourth, the model includes variables related to the attorneys associated with each sovereign bond offering. In particular, we are interested in testing the high-volume attorney (as change agents, that is) hypothesis. To do so, we include dummy variables for the presence of the highest volume issuer's attorney (Cleary Gottlieb) and the highest volume underwriter's attorney (Sullivan & Cromwell) in the period after Ecuador's use of exit consents. We define high volume based on the total number of sovereign debt offerings in which an attorney firm participates.⁷⁹ We include interaction terms for Post-Ecuador x Top Issuer Attorney (Cleary Gottlieb) and Post-Ecuador x Top Underwriter Attorney (Sullivan & Cromwell) as well as Post-

⁷⁷ J.P. Morgan participated in 14 offerings and Deutsche Bank participated in 12 offerings after Ecuador's use of exit consents. Combined, J.P. Morgan and Deutsche Bank participated in 28.6% of the offerings after Ecuador's use of exit consents.

⁷⁸ See Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 *J. Fin.* 1045 (1990). The Jay Ritter-Carter-Manaster data is available at <http://bear.cba.ufl.edu/ritter/Rank.HTM> (last visited on January 13, 2004).

⁷⁹ Clear Gottlieb participated in 28 offerings as issuer's counsel (30.8% of the offerings) and Sullivan & Cromwell participated in 32 offerings (35.2%) as underwriter's counsel in the period after Ecuador's use of exit consents.

Mexico x Top Issuer Attorney and Post-Mexico x Top Underwriter Attorney to test for the importance of either type of attorney firm in generating new terms different from the prevailing standard. We also include a dummy variable for the presence of a London-based branch of an attorney firm to account for the possibility that more collective-action friendly terms may enter into a sovereign bond contract simply because London-based firms may have greater familiarity with such terms.

Lastly, we include country-specific dummies for all countries with at least 10 offerings in our dataset to control for the possibility that a country may pick a particular contract and then simply cut and paste that contract for all subsequent bond offerings. Dummy variables for Colombia, Uruguay, Mexico, and Philippines are included (but are not reported).

Table 9 reports the results of three variations of the ordered logit models. Model 1 is for the Pre-Ecuador and Post-Ecuador only periods. Model 2 is for the full sample. Model 3 is based on Model 2 with additional interaction terms for Post-Ecuador x Top Underwriters (J.P. Morgan and Deutsche Bank) and Post-Mexico x Top Underwriters to assess the importance of underwriters in modifying contract terms.⁸⁰

⁸⁰ Not reported, we also estimated Model 3 without interaction terms between Post-Ecuador x Top Underwriter Attorney and Post-Mexico x Top Underwriter Attorney. The coefficients on the Post-Ecuador x Top Underwriters and Post-Mexico x Top Underwriters are again statistically insignificant.

Table 9: Ordered Logit Model of Collective Action-Related Modification Provisions

Dependent variable is the COMPOSITE collective-action contract term ranking equal to the sum of the VOTEBY, THRESHOLD, ENUMERATED, and RIGHT TO SUE rankings (ranging from 3=easiest to modify to 12=hardest to modify). Pre-Ecuador is defined as including all offerings in the sample up to and including October 2000. Post-Ecuador is defined as including all offerings after October, 2000 until January 31, 2003. Post-Mexico is defined as including the Mexico offering on February 1, 2003 and all offerings thereafter. Model 1 is for the Pre-Ecuador and Post-Ecuador only periods. Model 2 is for the full sample. Model 3 is a variation on Model 2 with interaction terms for Post-Ecuador x Top Underwriters and Post-Mexico x Top Underwriters. Dummy variables for countries with at least 10 offerings in the dataset are included in the models (for Colombia, Uruguay, Mexico, and Philippines) but are not reported. The High, Medium, and Low Ratings are based on the average Moody's and Fitch ratings (see Table 6 for definition).

<i>Independent Variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>
Offering Amount (U.S Mill).	-0.001** (-2.520)	-0.001** (-2.270)	-0.001** (-2.210)
Top Issuer Attorney Dummy (Cleary Gottlieb)	0.976 (0.980)	0.764 (0.830)	0.789 (0.840)
Top Underwriter Attorney Dummy (Sullivan & Cromwell)	1.782* (1.870)	1.808** (2.030)	1.837** (2.050)
London-Based Attorney Dummy	-2.461** (-2.140)	-2.847*** (-2.740)	-2.823*** (-2.720)
Top Underwriter Dummy (Deutsche Bank and J.P. Morgan)	0.297 (0.450)	0.253 (0.420)	-0.268 (-0.220)
Carter-Manaster	-1.573** (-2.440)	-1.394*** (-2.630)	-1.402** (-2.530)
High Rating	-1.496 (-0.920)	-1.230 (-0.770)	-1.218 (-0.760)
Medium Rating	-0.207 (-0.130)	-0.136 (-0.090)	-0.129 (-0.080)
Post-Ecuador x High Rating	-1.075 (-1.090)	-1.501 (-1.490)	-1.545 (-1.530)
Post-Ecuador x Medium Rating	-0.657 (-0.540)	-0.835 (-0.710)	-0.884 (-0.750)
Post-Ecuador x Low Rating	0.662 (0.330)	0.922 (0.470)	0.750 (0.380)
Post-Mexico x High Rating		-1.624 (-1.430)	-1.620 (-1.420)
Post-Mexico x Medium Rating		-2.936** (-2.120)	-2.894* (-1.890)
Post-Mexico x Low Rating		-5.019* (-1.810)	-4.934 (-1.610)

Post-Ecuador x Top Issuer Attorney (Cleary Gottlieb)	1.006 (0.940)	1.424 (1.360)	1.283 (1.170)
Post-Mexico x Top Issuer Attorney (Cleary Gottlieb)		-3.665** (-2.520)	-3.713** (-2.550)
Post-Ecuador x Top Underwriter Attorney (Sullivan & Cromwell)	0.229 (0.200)	0.390 (0.340)	0.367 (0.320)
Post-Mexico x Top Underwriter Attorney (Sullivan & Cromwell)		-0.951 (-0.630)	-1.002 (-0.670)
Post-Ecuador x Top Underwriters (Deutsche Bank & J.P. Morgan)			0.759 (0.530)
Post-Mexico x Top Underwriters (Deutsche Bank & J.P. Morgan)			0.466 (0.260)
N	96	117	117
Pseudo Adj R2	0.316	0.338	0.339
Log Likelihood	-99.342	-123.254	-123.111

z-statistics in parentheses.

*** significant at the 1% level, ** significant at the 5% level, * significant at the 10% level.

Note from Table 9 that the coefficient on the offering amount coefficient is both negative and significant at the 5% level in all the models. Larger offering amounts correlate with an increased likelihood of a more collective-action oriented contract (as proxied through a lower COMPOSITE score).

Turning to the country ratings, observe from Table 9 that prior to the Ecuador restructuring, no significant difference exists in the tendency of different rating countries to use collective-action related terms (e.g., the coefficients on the High Rating and Medium Rating variables are statistically insignificant). This result is consistent with the lack of importance (at least according to Richard and Gugiatti (2003)) of non-payment-related modification terms Pre-Ecuador.⁸¹

⁸¹ See Gugiatti and Richards, *supra* note 16. While we begin with the assumption that the differences in non payment related modification terms were widely considered of de minimus importance, the assumption made in much of the literature is actually stronger in that even differences in payment related modification terms are

What did the interpretive shock from Ecuador's use of exit consents do to subsequent bond offerings up until Mexico's February 2003 offering (the Post-Ecuador period)? The models confirm that no major statistically significant shift occurs. Only the coefficient for the Post-Ecuador x High Rating interaction term is significant (and only at the 20% confidence level in Models 2 and 3). The multivariate model's results are therefore supportive of the summary statistic finding that immediately post-Ecuador, despite the shock to how parties viewed the standardized terms, little change occurred – consistent with the Standardization Hypothesis.

Eventually change did occur and Models 2 and 3 confirm the Big Shift Hypothesis. For both medium and low rating countries, the interaction terms with Post-Mexico are negative, indicating a shift toward more collective-action friendly clauses (significant at the 5% level for Post-Mexico x Medium Rating and 10% for Post-Mexico x Low Rating in Model 2 and significant at the 10% level for Post-Mexico x Medium Rating and 20% level for Post-Mexico x Low Rating in Model 3). Despite the fear that non-investment grade countries (the Medium and Low Rating countries) may abuse collective-action friendly terms with actions leading to a higher default rate, these countries moved significantly into such terms in the post-Mexico period.

Who were the agents of change? Note that the coefficient on Post-Mexico x Top Issuer Attorney (Cleary Gottlieb) is negative and significant at the 5% in Models 2 and 3. The presence of Cleary Gottlieb—the law firm handling the largest number of deals for issuers—as the issuer's attorney is significantly correlated with the overall post-Mexico shift toward easier collective action clauses, consistent with the High Volume Attorney Hypothesis. In contrast, as reported in

perceived to be of de minimus importance. See Gugiatti & Richards, (GJIL paper), *supra* note 16 (noting the commonly held view that de minimus importance is attached by market participants to differences in contract terms). This view strikes us as being at odds with notions of efficient pricing and, in particular, the finding in the literature on bonds more generally that covenants in bond contracts are priced. See Michael Bradley & Michael R. Roberts, *Are Bond Covenants Priced*, draft dated November 20, 2003, available on ssrn.com.

Models 2 and 3, neither the top underwriter's attorney (Sullivan & Cromwell) nor the top underwriters (J.P. Morgan and Deutsche Bank) are significantly correlated with a shift toward more collective-action related terms. While official sector undoubtedly played some role in the shift toward CACs in the post-Mexico period, the significance of the high volume issuer's counsel as well as certain risk rating countries (below investment grade) in the shift provides evidence on the ability of the market forces to engineer changes in boilerplate terms.

As a robustness check, we re-estimated Model 2 with dummy variables for countries with at least 5 offerings (Colombia, Uruguay, Mexico Philippines, Italy, Chile, Costa Rica, South Africa, Turkey, and Panama). Unreported, the same qualitative relationships as in the original Model 2 remain between: (a) larger offering amounts and collective action-related terms; (b) the Post-Mexico presence of Cleary Gottlieb as the issuer's attorney and collective action-related terms; and (c) Post-Mexico medium and low rating (non-investment grade) countries and collective action-related terms. One difference in the re-estimated model is that in the *Pre-Ecuador* period (before the interpretive shock involving exit consents), high rated countries (investment grade) are significantly more likely to have collective-action friendly terms compared with lower rated countries, consistent with Eichengreen, Keltzer, and Mody (2003).⁸²

D. New Differences

⁸² See Eichengreen, Keltzer, and Mody, *supra* note 35. Our results therefore do not provide any definitive evidence on the question (not the focus of this article) of whether collective action-related terms are priced prior to the Ecuador restructuring.

As an additional test of robustness, we replaced the independent dummy variables in Model 2 related to country risk rating with a variable for the range of possible ratings based on the average Moody's-Fitch score we discuss earlier ranging from 1 to 8 (RATING). We also include interaction terms for Post-Ecuador x RATING, and Post-Mexico x RATING. From this variation of Model 2, we obtain the same qualitative results as in the original Model 2. We then add a variable for Ratings and again obtain the same qualitative results (although the coefficient on the post-Mexico x Cleary Gottlieb interaction term is now significant at only the 10% level).

Our empirical tests are crude in the sense that we categorize all the post-Mexico CACs in one category (the 0 ranking in the VOTEBY category). We should note, nonetheless, that among the Post-Mexico sovereign bond offerings in our dataset employing some form of CAC, significant differences exist. At least two possible explanations exist for the differences in post-Mexico contracts: (a) attorneys in competition with one another generated further innovation in contract terms post-Mexico or (b) attorneys simply made mistakes in drafting the contracts. Our conjecture, from the limited data, is that *both* innovation and inadvertence are evident in the Post-Mexico CAC contracts. While we perform no additional statistical test on these differences, we discuss some of these differences below.

First, consider the initial move to CACs by Mexico in February 2003. Mexico's issuance was special in that it was the first of the new CAC bonds issued under New York law. Mexico though, did not immediately become the standard for everyone. At least a handful of emerging market countries continued to issue the old UAC bonds. More important, among those countries moving toward the new CAC bonds, Brazil, Guatemala, Belize, and Venezuela chose a 85% vote threshold for its payment terms as opposed to the 75% threshold in the Mexico CAC contract.⁸³ A requirement that approval of 85% of the outstanding bonds has to be obtained before a

⁸³ In addition, when the move to CACs came, so did accompanying restrictions on the Exit Consent technique. For every sovereign that moved from UACs to CACs for payment terms, there was a corresponding change in the modification provisions for non-payment terms. While allowing for the payment terms to be modified by less than unanimous consent (75% or 85%), the new CAC contracts also moved up the voting threshold for modification to non-payment terms up from their prior 50% or 66.66% levels to the 75% or 85% levels. And the non-payment terms that were moved up were the ones most likely to be altered in an Exit Consent offer – clauses governing the following matters: Governing Law, Waiver of Sovereign Immunity, Events of Default, Agent for Service of Process, and *Pari Passu* (we discuss this last elevation in detail later in the paper). Conversely, for the sovereigns that did not move to CACs in the post-Mexico period (Israel, China, and the Philippines), the contracts did not make Exit Consents more difficult.

restructuring can be effectuated—while easier than the 100% threshold in a UAC—is more difficult to satisfy than a 75% vote.⁸⁴

Uruguay then issued its own CAC contract with the same 75% vote threshold used by Mexico, but with an additional set of terms aimed at protecting against debtor opportunism. Take the following example of abuse given by the architects of the Uruguay clauses:

The sovereign solicits creditors to exchange their existing bonds for new bonds with new financial terms (say a 12-year term and 7% coupon). Alongside, however, is an exit amendment that, using the CAC in the old bonds, would change the payment terms of the old bonds to, say, a term of 30 years and a coupon of 2%. No investor could decline that exchange offer without running the risk of being left with 30 year, 2% paper.⁸⁵

To combat this scenario (involving exit consents applied directly on payment-related terms), Uruguay implemented a number of additional restrictions in its post-Mexico offering. Uruguay promised it would not issue new securities with the intention of placing them in the hands of investors expected to vote in favor of the amendments that the sovereign wants. In theory, this provision gives creditors a basis to challenge the placement of bonds with entities sympathetic to the sovereign that goes well beyond the protections against votes by entities “owned or controlled” (directly or indirectly) by the sovereign.⁸⁶ Such a provision protects investors otherwise fearful that the “owned or controlled” restriction can be easily circumvented by placing the bonds with sympathetic entities that fall outside the definition. Indeed, sovereigns

⁸⁴ As things stand, it is not clear that the market is assaying those with the 75% threshold a penalty for being more restructuring friendly. See Sergio J. Galvis, *Collective Action Clauses: Recent Progress and Challenges Ahead* (forthcoming, *Georgetown Journal of International Law* (2004)). While this article was in the editorial stages, the Reuters news agency reported that the lack of a penalty for the use of the 75% vote had resulted in Brazil switching from 85% to 75%. See Reuters report, *supra* note 75.

⁸⁵ We take the discussion of Uruguay’s anti manipulation innovations directly from Buchheit & Pam, *Uruguay’s Innovations*, *supra* note ___. In addition to the anti manipulation innovations, there were other elements of the Uruguay contracts, such as the trust structure, that were also innovative. See *id.*

⁸⁶ This particular protection against vote manipulation by the sovereign debtor by placing bonds with institutions it controls is discussed *supra* (note 96 and accompanying text).

are potentially subject to an open-ended challenge under the provision presumably every time there is a vote in favor of the sovereign. Any disgruntled creditor could simply challenge the vote saying that the sovereign engineered the placement of bonds with investors sympathetic to its interests. The vulnerability to challenge deters the sovereign from seeking a vote (to modify contract terms) in the first place.⁸⁷

All three of these post-Mexico contract variations (UACs, CACs at the 85% voting threshold, and Uruguay) when first occurring were widely reported by the press, scrutinized by the investor community, and under the guidance of law firms engaged in a high volume of sovereign bond issuances and often in competition with other similar law firms (Cleary Gottlieb as the issuer's counsel in the cases of Uruguay and Mexico and Arnold & Porter as the issuer's counsel for Brazil).⁸⁸ The widespread public scrutiny and the participation of high volume issuer's attorneys provide support for the hypothesis that these contract changes represented

⁸⁷ In addition, Uruguay's offering requires the debtor to identify to the trustee, before the vote, those bonds that are disenfranchised as a result of this restriction. This requirement is meant to put in place a self-monitoring mechanism for the creditors. (As an aside, it is not clear to us how exactly this would work, since the mechanism relies on sovereigns (who, in this situation, are presumably intent on manipulating the vote) to inform the trustee voluntarily of the creditors participating in the manipulation. In other words, the disclosure strikes us as unlikely to happen.) Lastly, Uruguay's version of the CAC attempts to eliminate the possibility of mischief by the sovereign by requiring that any modifications to the payment terms of old bonds proposed in the context of an exchange offer not make those terms less favorable than the corresponding features of the new bonds offered in the exchange. See Buchheit & Pam, *Uruguay's Innovations*, supra note ____.

⁸⁸ The differences between the Mexico 75% vote threshold (coming initially out of Cleary Gottlieb) and the Brazil 85% were widely noted by observers of these markets, as were the differences in investor protections in the Uruguay contracts and those of the other post-Mexico CAC contracts. These differences and others (such as the difference in de acceleration thresholds) are highlighted in the recent IMF report on progress on the CAC front. See IMF, *Progress Report to the International Monetary and Financial Committee on Crisis Resolution*, September 5, 2003 (noting that although the market paid intense attention to the specific contract provisions used in the first few issuances with the new CACs, attention soon moved away from the contract terms to risk levels for the sovereign more generally) (<http://www.imf.org/External/NP/pdr/cr/2003/eng/090503.pdf>). Along these lines, the Emerging Markets Creditors Association appears to have a web site that ranks the bonds in terms of their provisions (<http://www.emta.org/ndevelop/>) (note, however, that the site is password protected for members); see also John Barham, *Cooking Up a New Solution*, *Latin Finance*, June 2003, at 10 (discussing the move to CACs and the question of whether the market would move to a 75% or 85% standard); Felix Salmon, *Brazil Goes off on a CACs Tangent*, *Euromoney*, June 2003, at 156.

More than the firms themselves, the individual lawyers responsible for these contracts were all major players in the world of sovereign debt and, in particular, in the debate over the move to collective actions clauses. Based on our conversations with participants in this arena, the names we have heard as being closely associated with the innovations in these contracts are Mark Walker (Cleary Gottlieb – Mexico contract), Lee Buchheit (Cleary Gottlieb – Uruguay contract), and Whitney Debevoise (Arnold & Porter – Brazil contract).

value-increasing innovations (for issuers and investors jointly). Our findings suggests that lawyers, while reluctant to alter standardized forms as a general matter, become competitive when there is a period of flux or disequilibrium. In other words, there appear to be benefits that accrue to the lawyers who end up setting the new standard. But these benefits are significant enough only during periods of flux, when it is clear that the standard is going to change (as occurred immediately in the post-Mexico period).

Second, consider the more low visibility differences that show up in the contracts done by lower volume, lower profile issuer counsel in the post-Mexico period. One low-visibility change involves the term “outstanding” appearing as part of the voting threshold in modification clauses. So, for example, the vote required for a change to the payment terms of a post-Mexico CAC bond issuance is “75% of the aggregate principal amount of *outstanding* Notes”. That begs the question of which bonds count as outstanding. From the perspective of the side that is attempting to obtain the 75% votes, the larger the set of bonds that qualifies as “outstanding” the harder it is to obtain the “75% of outstanding bonds” threshold. Creditors might be especially concerned that debtors may try to manipulate the definition of the term “outstanding” so as to make it easier to force a reduction in payment obligations. One typically sees protections against debtor opportunism on this score with provisions making it hard to change the meaning of the term “outstanding”. Unlike most terms in the contract that require either a 50% or 66.67% approval for a change, it typically takes a 75% or 85% vote to change the meaning of the “outstanding” term. It is also standard for contracts explicitly to exclude bonds “controlled, directly or indirectly” by the sovereign or one of instrumentalities from the meaning of “outstanding”. A handful of contracts in our dataset, however, did not contain one or the other of these protections in the post-Mexico period. Specifically, the sovereign bond contract for the

Bahamas did not require the higher vote threshold for changes to the term “outstanding” and the contracts for Belize and Guatemala did not have the extra paragraph excluding sovereign issuer controlled bonds from the meaning of “outstanding.”⁸⁹ All the other post-Mexico CAC contracts had these protections against debtor opportunism.⁹⁰

Rational explanations may exist for even the low-visibility differences. Belize, the Bahamas, and Guatemala may have all consciously negotiated to give their creditors lower protections compared with other sovereigns. But we suspect not for several reasons. First, these were low visibility differences. In other words, the lawyers did not tout them in the press as special. The lawyers who came up with these innovations would have wanted to promote them and take credit for them, just as the attorneys for Mexico, Uruguay and Brazil did with their post-Mexico variations. Second, there was no explicit discussion or disclosure of these differences in the introductory sections of the prospectuses. We assume that investment banks and securities disclosure lawyers would have advised the sovereigns to flag the innovations (just as almost all the issuers of post-Mexico CACs flagged the presence of the new CACs at the outset of the prospectuses). Third, and perhaps most telling, the low-visibility differences noted above correlate with issuer’s counsel who are relatively low volume players in the sovereign debt

⁸⁹ One caveat is that all of these observations are based on the descriptions of the contract terms in the prospectuses. It may be that for these countries, the differences we observed in the prospectuses may have been corrected for in the fiscal agency agreements or elsewhere. If so, however, that would be a different kind of deviation from the conception of these all being boilerplate contracts.

⁹⁰ Another low-visibility difference involved the *pari passu* or “status” clause. This previously obscure clause rose to international prominence in 2000 thanks to a surprisingly broad interpretation from a court in Brussels. The result was to put a potent weapon in the hands of holdout creditors. And the effect of that, in turn, was to make it harder for a country to do a restructuring. One of the most interesting aspects of the post-Mexico CACs, that we discuss in detail later in the paper, was that one of the give-backs in exchange for agreeing to make payment terms easier to modify was to make it more difficult for the sovereign to modify the *pari passu* clause. So, as the CACs made it easier to modify the payment terms (and harder to hold out), the elevation of the *pari passu* clause made holding out a more potent strategy. Specifically, what happened was that the *pari passu* clause got moved from the prior 50% or 66.67% vote required for a modification (in the UAC contracts) to the higher 75% or 85% level (in the new CAC contracts). At least three of the contracts in our post-Mexico CAC data set – Poland, Italy, and the Bahamas -- however, do not have this added protection for the *pari passu* clause.

issuance market (at least for the offerings in our data base). In contrast, the Mexico, Uruguay, and Brazil contracts were all the products of high volume players.

Table 10 details the issuer’s and underwriter’s counsel for the high-visibility change offerings (involving Mexico, Uruguay, and Brazil) and the low-visibility change offerings (involving Bahamas, Belize, Guatemala).

Table 10: Attorneys Associated with Select Post-Mexico Offerings

Volume of the issuer attorney corresponds to the fraction of the offerings in the dataset in which the particular attorney acts as the issuer attorney. Volume of underwriter counsel corresponds to the fraction of the offerings in the dataset in which the particular attorney acts as the underwriter counsel. (See Table 2).

<i>Sovereign</i>	<i>Issue Date</i>	<i>Issuer Attorney</i>	<i>Volume of Issuer Attorney</i>	<i>Underwriter Counsel</i>	<i>Volume of Underwriter Counsel</i>
Mexico	2/1/2003	Cleary Gottlieb	44.50%	Sullivan & Cromwell	40.60%
Uruguay	4/10/2003	Cleary Gottlieb	44.50%	Shearman & Sterling	18.10%
Brazil	6/19/2003	Arnold & Porter	14.20%	Sullivan & Cromwell	40.60%
Bahamas	7/24/2003	Hogan & Hartson	0.60%	Shearman & Sterling	18.10%
Belize	6/1/2003	Hunton & Williams	0.60%	Allen & Overy	1.90%
Guatemala	7/29/2003	Sidley & Austin	3.90%	Cleary Gottlieb	9.70%

Observe the volume of the issuer attorneys associated with the offerings containing high-visibility first-mover changes compared with the low-visibility change offerings in Table 10. Cleary Gottlieb and Arnold & Porter—the two most active issuer’s attorneys—represented Mexico, Uruguay, and Brazil. The change in contract terms in Mexico, Uruguay, and Brazil toward CACs in 2003 is consistent with the high-volume *issuer’s* attorney driving innovation in contract terms. On the other hand, Hogan & Hartson, Hunton & Williams, and Sidley and Austin—among the least active issuer’s attorneys—represented Bahamas, Belize, and Guatemala respectively. Changes occur for such countries in the post-Mexico period, but the presence of low-volume attorney’s support the notion that these changes are more out of mistake. The

Bahamas did enjoy a high volume underwriter's counsel (Shearman & Sterling). And Cleary Gottlieb acted as the underwriter's counsel for Guatemala. Nonetheless, the results from the ordered logit regression reported in Table 9 call into question the role of the underwriter's counsel in driving change in sovereign bond terms in the post-Mexico period. Anecdotally, evidence exists that Cleary Gottlieb, acting as issuer's counsel, preferred a 75% voting threshold for modification to payment terms in the CACs employed post-Mexico.⁹¹ Significantly, Guatemala's contract employed a 85% voting threshold despite the presence of Cleary Gottlieb as the *underwriter's* counsel.

VI. Additional Tests

In the following two sections we attempt to shed further light on some of the hypotheses by examining in greater detail two narrow slices of the data. First, to examine the standardization and big shift hypotheses, we look at the specific case of Mexico's bond issuances between 1995 and early 2004. Second, for insight on the matter of the market's speed in reacting to interpretive shocks, we look at the one other interpretive shock that occurred in the sovereign debt markets in the 1995-early 2004 period; the case of the *pari passu* clause.

A. A Further Test of the Standardization Hypothesis: The Case of Mexico

In prior sections, we used standard econometric techniques to examine whether patterns in the aggregate suggest a lock-in effect. Specifically, we examined whether contracting practices respond to exogenous interpretive shocks. In this section, we use a test of the standardization hypothesis that was suggested to us by lawyers working in the area. Their suggestion was that we look at contracts in greater detail for a single country, instead of

⁹¹ Our conversations with a number of market participants suggest that Cleary (or at least some of its attorneys) was active in promoting the 75% threshold.

aggregating the data across the different countries.⁹² While there were reasons for market-wide standardization (that would show up in the aggregate data), the lawyers contended that even stronger forces may push for standardization within a single country's contract. In particular, the market may take a suspicious view of country's that attempt to vary the contract terms in their sovereign bond deals. The data on Mexico bears out this single-country standardization hypothesis.

The reason we chose Mexico was that it was the country for which we were able to obtain the largest number of contracts for the time period of this Article. As we discuss later, however, the Mexican experience may not be representative and a fuller test would need to look at the data for a larger number of countries. Caveats aside, however, this case study produces interesting results. First, it suggests that the with-in country lock-in effects, at least for Mexico, are significantly stronger than revealed by the econometric tests. Second, we no longer see an effect dependent on the size of the offering; the contracts remain identical regardless of the size of the offering. Third, we find a dynamic between the issuers, the issuers' counsel, the underwriters, and the underwriters' counsel that may shed light on a new reason for the contractual stickiness or standardization.

Table 11 below reports the data for 18 debt issuances by Mexico primarily during the time period of our main dataset.⁹³ At the top and bottom of the table, we report the results for the contract language for one contract in 2003 (that is, the contract that set off the "big shift" toward CACs) and one contract in the pre-1995 period (that is, prior to the peso crisis in 1995 and before

⁹² While the multivariate ordered logit model reported in Table 9 does include country dummies with countries with at least 10 offerings in our dataset, focusing on the actual contract language within a single country provides added insight into standardization effects as we discuss in this section.

⁹³ In order to construct this table, we supplemented the data for Mexico that we had in our original database (for which we report results in the prior sections), with [x] additional contracts that we obtained from the SEC's database.

the start of our dataset). A couple of things are striking about the results. The first has to do with the degree of lock-in and the second has to do with the reasons for standardization.

Table 11: Sovereign Contracts for Mexico From 1995 to 2003 (up to the “Big Shift” to CACs)

Issue Date	Amount	Interest Rate	Due	Moody's Rating	Fitch's Ratings	Issuer Counsel	Inv. Bank Counsel	Inv. Bank	VOTEBY	THRESHOLD	ENUMERATED	Extra Provisions--at Higher Vote level (No Impairment of RIGHT TO SUIT for all contracts)	Pari Passu
2/1/2003 (the “Big Shift”)	\$1 Billion	N/A	N/A	Baa2	BBB-	Cleary	Sullivan & Cromwell	Goldman Sachs	75%	66.667%	Yes	*governing law *submission to jurisdiction *waiver of immunities *place of payment *change the meaning of "outstanding" *agent for service of process *redemption procedures *event of default *STATUS or <i>Pari Passu</i>	Will rank equally
12/4/2002	\$2 Billion	6.375%	1/16/2013	Baa2	BBB-	Cleary	Sullivan & Cromwell	J.P. Morgan	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
11/28/2001	\$1 Billion	8.30%	8/15/2031	Baa3	BB+	Cleary	Sullivan & Cromwell	J.P. Morgan	Each	66.667%	Yes	*Place of payment *Redemption *Portion of principal payable on acceleration	Will rank equally
8/9/2001	\$1.5 Billion	8.30%	8/15/2031	Baa3	BB+	Cleary	Sullivan & Cromwell	Goldman	Each	66.667%	Yes	*Place of payment *Redemption *Portion of principal payable on acceleration	Will rank equally
3/23/2001	\$3.3 Billion	8.125%	12/30/2019	Baa3	BB+	Cleary	Sullivan & Cromwell	Credit Suisse	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
3/29/2000	\$500 Million	8.625%	3/12/2008	Baa3	BB	Cleary	Sullivan & Cromwell	Chase	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
3/29/2000	\$500 Million	8.625%	2008	Baa3	BB	Cleary	Sullivan & Cromwell	Chase	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
3/23/2000	\$500 Million	9.875%	2010	Baa3	BB	Cleary	Sullivan & Cromwell	J.P. Morgan	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
10/6/1999	\$425 Million	10.375%	2/17/2009	Ba1	BB	Cleary	Sullivan & Cromwell	Goldman Sachs	Each	66.667%	yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally

Issue Date	Amount	Interest Rate	Due	Moody's Rating	Fitch's Ratings	Issuer Counsel	Inv. Bank Counsel	Inv. Bank	VOTEBY	THRES-HOLD	ENUM-ERATED	Extra Provisions--at Higher Vote level (No Impairment of RIGHT TO SUIT for all contracts)	Pari Passu
10/4/1999	\$425 Million	10.375%	2/17/2004	Ba1	BB	Cleary	Sullivan & Cromwell	Goldman Sachs	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
8/2/1999	\$400 million	11.375%	9/15/2016	Ba2	BB	Cleary	Sullivan & Cromwell	Solomon Smith Barney	Each	66.667%	yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
8/2/1999	\$400 Million	11.375%	9/15/2016	Ba2	BB	Cleary	Sullivan & Cromwell	Solomon Smith Barney	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
8/2/1999	\$425 Million	10.375%	2009	Ba2	BB	Cleary	Sullivan & Cromwell	Goldman Sachs	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
8/2/1999	\$400 Million	11.375%	2016	Ba2	BB	Cleary	Sullivan & Cromwell	J.P. Morgan	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
4/16/1999	\$500 million	10.375%	2/17/2009	Ba2	BB	Cleary	Sullivan & Cromwell	J.P. Morgan	Each	66.667%	yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
3/25/1999	\$1 Billion	9.750%	4/6/2005	Ba2	BB	Cleary	Sullivan & Cromwell	Morgan Stanley	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
4/1/1998	\$400 Million	11.375%	2016	Ba2	BB	Cleary	Sullivan & Cromwell	Solomon Smith Barney	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
3/5/1998	\$1 Million	8.625%	2008	Ba2	BB	Cleary	Sullivan & Cromwell	Morgan Stanley	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
9/24/1996	\$1 Billion	11.375%	9/15/2016	Ba2	BB	Cleary	Sullivan & Cromwell	Goldman Sachs	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally
[Pre 1995]	\$1 Billion	N/A	N/A	N/A	N/A	N/A	N/A	N/A	Each	66.667%	Yes	*Portion payable on acceleration *Place of payment *Redemption procedures	Will rank equally

First, prior to the big change in February 2003, the key contract terms stay identical, regardless of fluctuations in the country's risk ratings, fluctuations in the size of the offering, and Ecuador's Exit Consent interpretive shock in late 2000. These contract terms stay identical not only in terms of the primary provisions that we ran the econometric tests on – that is, the VOTEBY, THRESHOLD, ENUMERATED, and RIGHT TO SUE provisions discussed earlier that would have an obvious impact on any attempt to use the exit consent technique – but also on three less important provisions that Mexico as reported in the “Extra Provisions” column in Table 11.⁹⁴ The single country data reveals lock-in effects that are much stronger than what was revealed in the aggregate data discussed in the prior sections. Regardless of what happens externally, there is no fluctuation at all in the language of the modification term; at least until the big shift to CACs occurs in February 2003.

Second, and potentially more interesting, is the relationship between the issuers and underwriters' counsel. From deal to deal, the lead underwriters change. But the issuer's and underwriter's counsels remain the same. It makes sense that the issuer's counsel (Cleary, Gottlieb, in Mexico's case) remains the same because the issuer is the same for every deal. But what we also see is that the underwriter's counsel remains the same even though the lead underwriter changes. So, even though the lead underwriter for one deal may be Goldman Sachs and the lead for another deal may be Credit Suisse and the lead for a third deal may be Barclays, the underwriter's counsel remains the same (Sullivan & Cromwell, in Mexico's case). Put differently, the primary relationship of the underwriters' counsel seems to be with the issuer (or the transaction) as opposed to with their purported clients, the underwriters. This puzzling

⁹⁴ These three less important provisions are: (i) restrictions on altering the place of payment; (ii) restrictions on altering redemptions procedures; and (iii) restrictions on altering the portion of principal payable on acceleration. Mexico's contracts specified that these restrictions could only be lifted with unanimous approval of the bondholders. The importance of these three additional restrictions is discussed in note __, *infra*.

pattern raises at least two questions. First, can it really be true that underwriters' counsel is determined by the issuer and not the underwriter? (This pattern certainly does not suggest the kind of adversarial relationship where the underwriters' counsel is looking out for the interests of the ultimate purchasers of the bonds, the investors). Second, does this unusual correlation help explain the strong lock-in effects that we were seeing?

The lawyers and investment bankers to whom we spoke did not find the patterns we describe to be unusual or problematic in the least. The reason for the correlation between the issuer and the underwriters' counsel that we found, they explained, had to do with the speed with which these deals tended to be done. These bond issuances tended, inevitably, to be shelf offerings.⁹⁵ Because of the need for speed in what everyone viewed as a routine transaction, there was a need to have counsel on both sides who were familiar and comfortable with the deal documents. To hire a new set of lawyers on either side would mean that these lawyers would necessarily have to take time to get comfortable with the documentation. The choice of lead underwriter faces no such constraint and typically different underwriters bid to take the lead position for any particular offering. But it was in everyone's interests to use the same underwriters' counsel who had already gotten comfortable with the documents. What assured investors that underwriters' counsel would look out for their interests (despite being, in effect, chosen by the issuer)? Reputation (and the potential of losing high profits if the investors' view of the underwriter's counsel diminished) provides one answer. Reputation then provides a reason why so few law firms operate effectively as underwriter's counsel in such a market (e.g., more concentration in the market of legal services ensures higher profits and thereby a larger penalty—lost profits—for those firms that diminish their reputation).

⁹⁵ For a description of the background on shelf offerings, see Stephen J. Choi & Adam C. Pritchard: Securities Regulation: Cases and Materials (draft materials on file with authors, dated 2004).

The foregoing story bears directly on the question of why there appears to be unusually strong lock-in effects when one looks at country specific data. If the lawyers for the deal are chosen because they are comfortable with the deal documents then little incentive will exist on the part of the lawyers to change the documentation – that is, unless something major happens. Changes in the country’s risk ratings do not seem to qualify as a large enough change that merits altering documentation and neither did the exogenous shock of Ecuador’s use of exit consents.⁹⁶ To articulate the point differently, the importance of getting these transactions done quickly seems paramount and that goal trumps concerns with contract language.

This concern with speed is related to the reasons for contractual lock-in discussed at the outset of the paper – such as learning externalities. So, for example, market familiarity with standardized contract terms reduces the delay and cost to investors of pricing a sovereign bond offering. In addition to network externality-related effects, the importance of deal-to-deal continuity for a single issuer may also drive standardization. The willingness of a sovereign issuer to stick to the same documents provides the market with some assurance that the issuer is not trying to act opportunistically to take advantage of the investors. Where a contract term suddenly changes, for example, investors may worry that the issuer is attempting to take advantage of some unobservable shift (e.g., perhaps the issuer is now higher risk and the issuer therefore is seeking to impose terms more favorable to debt restructuring). The lack of any change helps the deals get done faster. This story about the need for speedy transactions then helps explain why there is essentially perfect standardization within the individual country data, but imperfect standardization (although still a high level of similarity) across countries.

⁹⁶ The *pari passu* terms also remain the same, despite the shock to the interpretation of this term in 2001; something we discuss in sub section F, *supra*.

As a skeptic might point out though, there are a variety of reasons why the Mexican experience may not be representative. Among other things, Mexico is unique in terms of its proximity to the U.S. and its importance to the U.S. economy. If Mexico defaults, this may cause negative spillovers into the U.S. and the fear of those spillovers may mean that Mexico expects a high likelihood of a bail out should Mexico face financial distress. Consequently, creditors may view Mexico's sovereign debt contract terms as irrelevant. Also, the pattern of contracting may be different for a country that does not come to the international debt markets quite so often or has a lower credit rating (Mexico was either investment grade or in that vicinity all through the 1995-early 2004 period of the Article). As Ashoka Mody points out, high risk countries that are relatively new entrants to the private credit markets may need to use contractual terms to demonstrate their commitment or credibility to investors in a degree greater than an experienced participant, such as Mexico.⁹⁷

B. A Second Interpretive Shock: The *Pari Passu* Clause (Once Again, Little or No Response Until the Point of a Big Change)

Simultaneously in the post-Mexico period, we also observed a change to the *pari passu* provision in many of the sovereign bond contracts in our dataset. But not in the direction we expected.

As discussed above, the Exit Consent technique was devised by sovereign lawyers to deter holdout creditors. Within a few months of Ecuador's use of Exit Consents, lawyers for the holdouts countered with their own creative technique to hurt the defaulting sovereign despite the

⁹⁷ See Ashoka Mody, What is an Emerging Market?, forthcoming, Georgetown Journal of International Law (2004).

possibility of Exit Consents. In devising their technique, the holdouts used the now infamous *pari passu* clause.⁹⁸ Typically, a *pari passu* clause says something along the lines of:

“These Notes rank, and will rank, equally (or *pari passu*) in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the Issuer.”

In the domestic corporate context, the clause had a clear meaning. In the event of a bankruptcy or insolvency, any legally senior obligations would have a priority against the corporation’s assets in a liquidation or reorganization. None of the unsecured creditors would have a priority over the others. But what does this clause mean in the sovereign context? Sovereigns, unlike corporations, do not liquidate or go through Chapter 11-type reorganizations. Instead, they simply stop paying their obligations. For decades, it had been assumed that creditors had no real method of forcing the sovereign to pay (aside from reputational concerns on the part of sovereign issuers interested in future financing).

In 2001, in a case against the Republic of Peru, a holdout creditor came up with a creative method of imposing real costs on the defaulting sovereign.⁹⁹ The holdout, a vulture fund named Elliott Associates, argued that the *pari passu* clause barred Peru from making payments on its restructured Brady Bonds without making ratable payments on all its other debt (Elliott Associates held an interest in an older loan agreement that had a *pari passu* clause). At first cut, the interpretation had some appeal. It made sense that any set of creditors would not want the debtor to be able to pay another set of creditors without paying it an equivalent share. And a

⁹⁸ The debate over the meaning of the *pari passu* clause that we recount in this section is described in detail in the following articles. See William W. Bratton, *Pari Passu and the Rational Creditor* (forthcoming, Emory L. J. (2004)); Lee C. Buchheit & Jeremiah Pam, *The Pari Passu Clauses in Sovereign Debt Instruments*, Harvard Law School Program in International Financial Systems Working Paper, Nov. 21, 2003 (forthcoming, Emory L. J. (2004)); Philip Wood, *Pari Passu Clauses—What Do They Mean?*, Butterworths J. Int’l Banking and Financial L. 371-72 (November 2003); Mitu Gulati & Kenneth Klee, *Sovereign Piracy*, 56 *Business Lawyer* 635 (2000). For a treatment of the clause predating the current battle, see Lee C. Buchheit, *The Pari Passu Clause Sub Specie Aeternitatis*, *Int’l Fin. L. Rev.*, Dec. 1991, at 11-12.

⁹⁹ See Buchheit & Pam, *supra* note _ (describing the Elliott versus Peru litigation in Brussels).

court in Brussels accepted this interpretation and granted Elliott the injunction against Euroclear that it had requested. Peru then settled the case, paying Elliott an amount far in excess of what Elliott had paid for the distressed debt. The problem with the interpretation though was that it put, in the hands of the holdout creditors, the power to bring the sovereign to its knees. Among other things, it restricted the sovereign from making preferential payments to its more important creditors (for example, the IMF or vital suppliers) during times of financial distress. Without such an ability to make preferential payments, a sovereign in financial distress may lack the ability to obtain new financing to bridge its financial crisis, to the detriment of the sovereign and potentially to all bondholders as a group.

The expressions of outrage and shock at the Brussels interpretation were even louder than those with the Exit Consents.¹⁰⁰ Numerous articles were written, working groups to study the issue were formed, and the action was even used as a justification for the need to create an international bankruptcy court to tackle sovereign insolvencies.¹⁰¹ In the meantime, the Brussels interpretation spawned a plethora of lawsuits by holdouts against sovereigns. The lawyers for the sovereign issuers (at least for some time), however, did not have a good explanation for what the *pari passu* clause did mean in the sovereign context. Undoubtedly, there had been a reason for including the clause at some point in history. But that understanding appeared to have been lost over the decades. And it was that gap in the market's collective memory that allowed the holdouts the space to create their new interpretation.¹⁰²

¹⁰⁰ Details as to the foregoing are described in the articles cited in note 10, *supra*.

¹⁰¹ See *supra* note 27 (citing materials). The Elliott versus Peru litigation famously made its way into one of Anne Krueger's initial speeches arguing for the need for a sovereign bankruptcy regime. See IMF, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (November 26, 2001) (speech at the American Enterprise Institute) (<http://www.imf.org/external/np/speeches/2001/112601.htm>).

¹⁰² Buchheit & Pam, *Pari Passu*, *supra* note __, attempt to go back in time and reconstruct that history so as to glean the meaning of the clause.

Given the negative response to the Brussels interpretation of the *pari passu* clause, one would expect to see the *pari passu* clause either stricken or drastically revised in every sovereign lending contract subsequent to the decision. Alternatively, if the reverse was true and the market's understanding was more consistent with the holdout view, the clause should at least have been clarified so as to eliminate the need for litigation over the new contracts. Instead, as with the Exit Consents, nothing happened initially after the Republic of Peru case. The new contracts issued in the wake of the Brussels interpretation all contain the same *pari passu* language as before. And this is even though no one on the sovereign issuer side seemed to have a clear understanding of what value the clause provided (other than now providing the holdouts with a potent weapon). What we have then is additional evidence that contract language does not respond very quickly to what we have called "interpretive shocks."¹⁰³

Similar to the change in terms related to Exit Consents though, change did eventually come for the *pari passu* clause, occurring concurrently with the move from UACs to CACs in the post-Mexico period (as part of the "big change"). But the change that came was not the clarification of the meaning of the *pari passu* term itself. But, instead, it was the elevation of the importance of the term. As noted earlier, in all but three of the new contracts, the vote required to change the *pari passu* term was elevated from a 50% or 66.67% vote required threshold to the heightened 75% or 85% threshold. So, the *pari passu* term that no one seems to understand and provided for a heightened risk of holdouts, instead of getting clarified or eliminated in the new contracts, got elevated thereby further increasing the risk of holdouts! Put differently, the sovereigns (and the potential holdouts) voluntarily subjected themselves to the risk that a judge will rule against them on the interpretation of the *pari passu* term. And the risk is immediate

¹⁰³ For a discussion of the reasons for the delay in response to interpretive shocks see supra text accompanying notes 44-47.

because there are, at the time of this writing, multiple court proceedings around the world where the meaning of the term is being litigated.¹⁰⁴

While the shift in the *pari passu* clause in the post-Mexico is consistent with the big shift hypotheses, it still leaves us with a couple of puzzles. Why did the shift occur in a direction increasing holdout problems? Perhaps, as Bill Bratton suggests, countries more at risk of default purposefully increase the holdout problem to reduce the likelihood that successful restructurings will occur upon default (reducing the moral hazard problem that the country may end up in default in the first place). The bigger puzzle for us though is that the parties seem to embrace uncertainty and ambiguity – things that rational agents are supposed to loathe – in the contract drafting process, as opposed to using the opportunity for change to clarify what the ambiguous terms means.¹⁰⁵ While changes did occur in the threshold vote provisions for modification to the *pari passu* term, sovereign issuers failed to provide any contractual language clarifying the meaning of the *pari passu* term in the first place.

VII. Concluding Observations

This final section puts together the implications of our study for sovereign debt in particular and the general theory of boilerplate contracts. At least one caveat is in order. We only have evidence on one particular type of boilerplate contract term, the modification terms in sovereign bond contracts. While we think that the experience of sovereign bonds likely generalizes to other bond contracts, further study is necessary.

¹⁰⁴ The current state of the *pari passu* litigation is described in Buchheit & Pam, *Pari Passu*, supra note ___ & in Bratton, supra note ___.

¹⁰⁵ Although the standard view in the law and economics literature on contracting practices is that rational parties desire certainty in the meaning of their contract terms and seek to avoid the uncertainty inherent in judicial interpretation, there have been those who have observed that sophisticated commercial transactors do sometimes choose vague and uncertain terms. See George Triantis, *The Efficiency of Vague Contract Terms*, working paper 02/07 dated May 2002 (available on ssrn.com).

How Boilerplate is Boilerplate? In comparing contracts governed by English law versus New York law, previous studies have commonly made the assumption that these contracts were identical in all meaningful ways other than the UAC versus CAC difference with respect to payment-related terms. The assumption was that the English contracts were significantly easier to restructure than the New York ones and the question many posed was whether this additional ease of restructuring translated into a pricing premium.

Our examination of sovereign bond contracts suggests that it is problematic to lump all the New York contracts together as being identically situated in terms of the ease of restructuring them. Instead, some New York-governed contracts are easier to restructure than others. The following question remains nonetheless: are the differences that we observe aberrations – as others who had observed earlier differences contend¹⁰⁶ – or are they more systematic and widespread. Our study provides evidence that there are indeed meaningful and widespread differences among the New York contracts in the ease with which they can be restructured (particularly through Exit Consents).

The Market's Ability to Adjust Standardized Terms. Standardization matters – and our study supports this proposition. The interpretive shock that accompanied Ecuador's use of Exit Consents—in the absence of network externalities and standardized sovereign bond contracts—should have resulted in countries readjusting their contracts to their desired optimal point (e.g., back to the UACs dominant prior to Ecuador). Instead, countries simply stood still—at least initially—in their offerings, keeping substantially the same terms despite the new interpretive mean (allowing for Exit Consents). While some small shifts occurred in the initial post-Ecuador period, none of them were statistically significant.

¹⁰⁶ See Gugiatti and Richards, *supra* note 16.

When Change Comes, it Comes in Bunches. After a couple of years experience with the exit consents, a major shift finally occurred – toward the introduction of CACs involving payment related terms. We conjecture that the initial interpretive shock paved the way for this eventual shift. No longer stuck in the previous UAC-only standardized term equilibrium, countries had time to judge the value of the Exit Consents post-Ecuador. New information (including what happened with the *pari passu* clause) may have then led countries (and investors) to take a more favorable view toward collective action-oriented clauses. The Exit Consents also opened up new dimensions — previously unavailable in the previous binary UAC or CAC choice pre-Ecuador — along which parties could incrementally provide for increased collective action friendly terms – e.g., the VOTEBY, THRESHOLD, ENUMERATED, and RIGHT TO SUE dimensions. Lastly, reluctance on the part of attorneys and issuers to weigh in with new contract terms shortly after an interpretive shock out of a fear that the very act of drafting new terms may influence how courts view the interpretive shock (particularly where the exact meaning of the shock is ambiguous) may also explain the initial delay in response to Ecuador’s use of exit consents.

The Importance of Attorneys. We finally provide evidence consistent with the hypotheses that the issuer’s law firm dealing with the largest number of offerings (Cleary Gottlieb) is an important force behind large shifts in standardized terms. Attorneys handling smaller numbers of offerings may simply lack the economies of scale to absorb the fixed costs of generating a new term, researching the impact of the term, and bearing the risk if the term turns out poorly for the clients. Firms handling large numbers of offerings, on the other hand, internalize a greater fraction of the benefit from devising a new term and thus are better positioned to absorb the costs. It is interesting that neither the underwriters nor the

underwriters' counsel appear to play a significant role in inducing change in standardized terms. Prior research (consistent with our informal conversations) suggested that it is the underwriter's counsel who is primarily responsible for the choice of contract form.¹⁰⁷ But what we find suggests that that story might be different during a period of flux or disequilibrium. Then, it is the large issuer's counsel who takes over (at least for sovereign bonds). Not only that, but there is active competition among these lawyers to devise the boilerplate terms that will become the new standard.

How Should We Deal With Boilerplate? Our analysis reveals that there are lock-in effects, but that they are not insurmountable. Where policymakers have a clear sense that standard boilerplate terms are not optimal for the market, policymakers may take actions to lessen the amount of lock-in. The official sector played (and continues to play) a key role in the move from UACs to CACs. So, for example, we suspect that the U.S. Treasury and perhaps the other G-7 countries were instrumental in pressuring Mexico, Brazil, and Uruguay (and their lawyers and bankers) to make the initial move to CACs.¹⁰⁸ And the IMF sitting in the

¹⁰⁷ Becker et al (2003) and Gugiatti & Richards, (forthcoming GJIL) supra note__ both report significant correlations between the governing law in the contracts in their sample and the nationality of either the lead underwriter or that of the law firm advising the underwriter. And Richards & Gugiatti cite Cliff Dammers for the proposition that the choice of governing law (and, therefore, the CAC versus UAC choice in the pre Mexico period) was likely simply a function of the standard form used by the lead underwriter's lawyers. See Richards & Gugiatti, (International Finance article), supra note 16, at n.29 (citing Cliff Dammers, Remarks at a Panel Discussion in the Reinventing Bretton Woods Committee Conference, New Rules of the Game in Global Finance: An International Bankruptcy Regime for Sovereign Debtors? May 2002).

¹⁰⁸ For example, one of the news reports on Chile's recent issuance of CAC bonds had the following caveat (somewhat humorous to those of us who have suspected that the U.S. Treasury was doing a lot of arm twisting in inducing the move to CACs):

The fact that the new bond includes a CAC does not suggest that Chile is likely to default on the paper. It merely means that the Chilean authorities are bowing to pressure from the US Treasury, which has been pushing for all emerging-market issuers to include such clauses.

Nick Ashwell, Chile Places First Sovereign Bond With Collective Action Clause, World Markets Research Centre, January 27, 2004.

There is also the question of what influence, if any, the G-10 committee's draft clauses that were released shortly prior to the Mexico issuance had on the clauses that were adopted there and the ones that were adopted subsequently. We don't discuss the impact of the G-10 draft clauses because the two aspects of the post-Mexico contracts that we look at, the anti exit consent elevation of certain clauses and the pari passu elevation, were not part of the G-10 proposal. Those latter aspects of the new contracts were, however, contained in the terms proposed by

background with its proposal for a statutory scheme for sovereign bankruptcy to displace contract—the Sovereign Debt Restructuring Mechanism (SDRM)—probably also placed pressure on countries to move to CAC terms (if only to avoid the SDRM). At the very least, expert groups and government officials may have played a role in coordinating market participants around new contracting standards (ensuring for example that a large proportion of the market shifts at once toward CACs, reducing the penalty imposed by underwriters for the use of a new standardized contract term). The waning impetus behind the SDRM at the time Mexico put together its CAC offering in February 2003 coupled with the importance of issuer’s counsel in driving the actual change to CACs post-Mexico (e.g., change did not occur across the board but only where the market viewed change favorably and attorneys had sufficient deal volume flow to make change cost effective) nonetheless provides evidence of the equal (if not greater) importance of market forces. A full attempt to understand how the change from the UACs to the CACs finally occurred would necessarily have to unpack the dynamics of the interaction between the various official sector players and the private participants. And based on our informal conversations with the various participants during the course of this study, we suspect that such a study would reveal that the official sector plays a key role “seeding” the market with new contract terms to break the hold standardized terms may have on contracts.¹⁰⁹

The presence of lock-in effects also means that the market will find it hard to respond to a shift to a new standard even where the change is not in the best interests of market participants.

the expert group of the Gang of Seven (a collection of the seven major creditor groups). In other words, there appears to have been some give and take between the G-10 group’s proposed clauses and those of the creditors’ groups. For a detailed account of which terms were contained in the G-10 proposals and which in the Gang of Seven proposals, see Elmar Koch, *Collective Action Clauses – The Way Forward*, (forthcoming *Georgetown Journal of International Law*). The G-10 clauses are available at <http://www.imf.org/external/np/g10/2002/cc.htm>

¹⁰⁹ See Klausner, *Standardization and Innovation*, *supra* note 1, at 837-41 (arguing for a menu of contract defaults to network lock-in effects). In the sovereign context, it is likely that the many official sector efforts at supporting research on new contract terms, in organizing conferences, and setting up drafting committees, all played an important role in producing change. When we say that we find an effect by the issuer’s counsel on the change from UACs to CACs that occurred then, what we mean is a marginal effect.

In the sovereign context, upon the move toward exit consents (away from UACs), the market did not initially respond. Only after a several year delay, the market finally shifted toward CACs in the February 2003 Mexico offering. Not all boilerplate terms are suboptimal – many in fact are preferred by a majority of contracting parties. Unexpected shocks to the meaning of a contract in such cases can have large and enduring costs on the contracting parties. Where no clear sense exists that existing boilerplates are problematic, courts (and other regulators) should proceed with caution and a heightened attention to market understandings in adjusting the meaning of boilerplate terms.

We end with a caveat. This study has but scratched the surface in understanding the dynamics of how boilerplate contract forms change. We see that there are long periods during which there is no change, despite the significant shocks to the system. Then, when the change occurs, it occurs with rapidity and normal behavior patterns are inverted. This pattern of behavior bears similarity to the types of phase transitions that network theorists in numerous other areas have described.¹¹⁰ But it is too early, and our knowledge base on network theory is too limited, for us to conclude that we have observed similar dynamics in the bond contract market. One important question left unanswered is whether the new standards appearing in the Post-Mexico era are in fact optimal for all different types of countries. Or are countries with different risk ratings once again forced into a one-size-fits-all contract solution (only now centered on CACs). Our study is therefore only a first step.

¹¹⁰ For three recent and relatively accessible treatments of the developments in network theory, see Albert-Laszlo Barabasi, *Linked: The New Science of Networks* (2002); Mark Buchanan, *Nexus: Small Worlds and the Groundbreaking Science of Networks* (2002); Duncan J. Watts, *Six Degrees: The Science of a Connected Age* (2003). In legal academia, we are aware of only a couple of scholars who have talked about the complex dynamics of phase transitions. See J.B. Ruhl, *The Fitness of Law: Using Complexity Theory to Describe the Evolution of Law and Society and its Practical Meaning for Democracy*, 49 *Vand. L. Rev.* 1407 (1996); Thomas E. Geu, *Complexity and Coevolution: The Web of Law, Management Theory, and Law Related Services at the Millenium*, 66 *Tenn. L. Rev.* 137 (1998) & 65 *Tenn. L. Rev.* 925 (1998).