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### How CACs Became Boilerplate, or The Politics of Contract Change

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Sovereign Bankruptcy

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# HOW CACS BECAME BOILERPLATE, OR THE POLITICS OF CONTRACT CHANGE

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• Rutgers University School of Law-Newark and Duke University School of Law, respectively. This chapter is adapted from the authors' "Public Symbol in Private Contract: A Case Study," *Washington University Law Review*, vol. 84 (2006), No. 7, pp. 1627-1715 (used by permission). For comments, we owe thanks to Scott Baker, Patrick Bolton, William W. Bratton, Philip G. Cerny, Stephen Choi, Giselle Datz, Kevin Davis, Adam Feibelman, Eric Helleiner, Barry Herman, Claire Hill, Melissa Jacoby, William Klein, Kimberly Krawiec, Stewart Macaulay, Richard Portes, John Pottow, Anthony Richards, Annelise Riles, Kenneth Rogoff, Felix Salmon, Brad Setser, Shari Spiegel, Lawrence H. Summers, Daniel K. Tarullo, George Triantis, Edwin M. Truman, Matthew R. Tubin, Mark Weidemeier, Brittany Wilcox, participants in the 2006 F. Hodge O'Neil Symposium at the Washington University School of Law, the faculty colloquium at Rutgers-Newark, the 2006 Annual Meeting of the Canadian Law and Economics Association, the 2007 Stanford/Yale Junior Faculty Forum, the 2007 CSGR Summer Research Conference at the University of Warwick, and the 2007 Annual Meeting of the Law and Society Association. Special thanks to Nancy Staudt for providing the initial impetus, to Robert E. Scott for motivating our theoretical search, and to John Conley for guidance at every stage of this project. Professor Gelpern thanks the Dean's Fund at Rutgers-Newark for financial support. Most important, thanks to all our "informants," many of whom also commented on drafts of the original article. They made this project possible.

## 1. INTRODUCTION

In 1997, a developing country defied convention. It issued New York law bonds that let 75% of the bondholders change key financial terms.<sup>1</sup> Until then, standard form New York law contracts required unanimous consent. But no one seemed to notice the innovation, and just about no one followed suit.

In 2003, another developing country issued New York law bonds with a 75% amendment threshold.<sup>2</sup> The world of international finance erupted in applause and criticism.<sup>3</sup> Major press outlets, finance ministers and senior executives publicly pondered the shift.<sup>4</sup> Other countries adopted similar provisions under the rubric of “collective action clauses” or “CACs”. Academic study of sovereign debt contracts took on new importance. This chapter reports on an effort to understand what happened and what it means.

Standard – or “boilerplate” – terms in complex financial contracts rarely change.<sup>5</sup> The basic theoretical explanation of boilerplate attributes it to learning and network effects, and associated “switching costs”.<sup>6</sup> Theory suggests that market participants attach value to contract terms solely because they have been used in the past and are well-known (learning effects) or are widely used now and/or are expected to be widely used in the future (network effects). As a result, firms might adopt terms that are suboptimal on their own merits just because they are well understood or widely used. Switching may be costly for a single firm because it takes time and effort to produce a new term that works and to educate the target audience about its meaning. There is no guarantee that investors, analysts and judges will interpret the term in a way that is favorable to its original proponent or – as the example in our opening paragraphs illustrates – that others will adopt the term in the foreseeable future.

Boilerplate change is poorly understood because it happens rarely, slowly and quietly. Contract terms do not normally feature on the editorial pages of the Wall Street Journal, the Economist, or the Financial Times, let alone in dozens of academic articles in law, economics and political

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1 See Offering Circular for the Republic of Kazakhstan, \$350 million, 8.375% Notes due 2002, Issued on October 1, 1997 (on file with authors)

2 See Pricing Supplement and Prospectus for the United Mexican States, \$1 billion, February 2003 (on file with authors) (also available at sec.gov).

3 See e.g., Statement of G-7 Finance Ministers and Central Bank Governors [http://www.g8.fr/evian/english/navigation/news/previous\\_news/ministerial\\_meetings\\_communiques/statement\\_of\\_g-7\\_finance\\_ministers\\_and\\_central\\_bank\\_governors.html](http://www.g8.fr/evian/english/navigation/news/previous_news/ministerial_meetings_communiques/statement_of_g-7_finance_ministers_and_central_bank_governors.html) and Part III infra.

4 Id. An April 25, 2006 Westlaw search in the ALLNEWS database for all articles discussing “Collective Action Clauses” in the sovereign debt context yielded over 400 hits, including many references to official statements.

5 See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261 (1985) and Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 Va. L. Rev. 713 (1997).

6 See Kahan & Klausner, *supra* note 5.

science. Against this background, the dramatic and public shift in sovereign bond documentation beginning in 2003 offers a rare perspective on the contracting process and boilerplate change.

The CAC episode is unusual in another respect. World leaders generally do not know what boilerplate is, much less advocate for it in communiqués reserved for big-picture concerns like global economic imbalances. Yet for nearly a decade CACs had a guaranteed spot in summit statements alongside financial stability and currency regimes.<sup>7</sup> Moreover, boilerplate theory does not usually contemplate a role for the public sector in promoting a switch to optimal private contract terms.<sup>8</sup> But in the case of collective action clauses, governments not party to the contracts got credit for playing a central role in the shift.<sup>9</sup> Judging from recent policy initiatives, the apparent success of the CAC campaign may have created a new model where economic policy proposals are framed in terms of private contract reform. The latest public-sector effort to promote GDP-indexed bonds cites the CAC experience as an inspiration and even adopts some of the organizational features of the earlier initiative, such as the expert contract drafting group.<sup>10</sup>

For all its value as precedent, the public sector's role in the CAC episode remains unexplored. Proponents in the Bush Administration called the shift "market-based" even as market commentary attributed it to government pressure. On the other hand, neither the United States nor any other government in the Group of 7 (G-7) appears to have issued direct threats or bribes, the traditional instruments of "hard power".<sup>11</sup> Financial industry regulators refused to mandate CACs or otherwise promote their inclusion; instead, pressure came in the form of exhortations by economic policy officials.<sup>12</sup> Did the "soft power"<sup>13</sup> of G-7 ideas convince developing countries of the CACs' inherent virtues? No emerging markets official would tell us that they participated in the CAC shift because the clauses could alter the course of a crisis. Even after moving to CACs, borrowers expressed skepticism about the extent of the holdout problem CACs

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7 E.g., U.S. Actions at the G-8 Summit, White House Press Release, June 2, 2003 (available at <http://www.whitehouse.gov/news/releases/2003/06/20030602-10.html>); G-7 Finance Ministers Adopt Financial Crises Action Plan, Department of Finance (Canada) Release, April 20, 2002 (available at <http://www.fin.gc.ca/news02/02-034e.html>); G-20 Finance Ministers' and Central Bank Governors' Meeting: Delhi Communique, November 23, 2002 (available at [http://www.g20.org/Public/Communiques/Pdf/2002\\_india.pdf](http://www.g20.org/Public/Communiques/Pdf/2002_india.pdf)).

8 It does not preclude it either. In their original study, Kahan and Klausner advocate private standard-setting bodies for contracts on the model of the existing standard-setting bodies for industrial products; some of the product standard-setters are state-run. See Kahan & Klausner, *supra* n. 5 at 761-764.

9 See Anna Gelpern and Mitu Gulati, "Public Symbol in Private Contract: A Case Study," *Washington University Law Review*, vol. 84 (2006), No. 7, Section III(i)-(iii).

10 G-24 Seminar on GDP-Indexed Bonds, Friday, April 21, 2006, webcast available at <http://www.imf.org/external/mmedia/view.asp?eventid=577>.

11 One way of exerting economic power is through loan conditionality of the International Monetary Fund, trade or other agreement links.

12 See e.g., Barry Eichengreen, *Restructuring Sovereign Debt*, 17 *J. Econ. Persp.* 75 (2003).

13 The term describes "the ability to get what you want by attracting and persuading others to adopt your goals. It differs from hard power, using the carrots and sticks of economic and military might to make others follow your will." Joseph S. Nye, Jr., *Propaganda Isn't the Way: Soft Power*, *International Herald Tribune*, January 10, 2003.

would solve. Alternatively, scholars have suggested that G-7 governments engaged in informational “cueing” to help overcome network effects, a form of “soft” regulation.<sup>14</sup> Here too, no early mover admitted acting in the expectation of a market-wide shift; few thought the G-7 capable of delivering such a shift and all worried that their country would pay a penalty for innovating.

A final lingering puzzle of the CAC episode is just how few private or public sector participants in it express strong feelings about the clauses as such. We spoke with dozens of actors whose websites and speeches proclaim the seminal importance of the CAC shift (usually as they claim paternity), yet in private, a scant few described the change itself as important in addressing the problem of sovereign debt restructuring or financial crises in the emerging markets. Many were unsure of how the new clauses would work in crisis; most said they were probably good, none said they were clearly bad. More participants volunteered strong feelings about the process that led to the shift – praising cooperation, grumbling about wasted time and official meddling. Was this another instance of wasted lawyering, or runaway process?<sup>15</sup>

If true in part, this description is incomplete and not entirely fair. Most participants suggested that their effort on CACs had less to do with the clauses’ literal purpose (facilitating future contract modification) than with their relative utility in advancing other goals, such as signaling commitment to a new crisis management strategy, currying political favor, or advancing their reputation in the market. Some were successful in achieving these goals; others failed. Their collaboration produced a revealing study in the uses of contract form and ways of governance.

We depart from earlier quantitative and analytical studies of sovereign debt contracts<sup>16</sup> in favor of an interview-based approach. We have collected over 100 accounts of the CAC shift from market participants, officials and others who took part in it, and have supplemented these with our own observations from the daily work of law firms and government offices, conferences and negotiations, press accounts, official documents, and – of course – the debt contracts themselves.<sup>17</sup>

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14 Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 *Emory L.J.* 691, 694 (2004) (“cueing” may include a signal that the term will be widely used).

15 Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *Amer. Soc. Rev.* 55 (1963) (contracts play a marginal role in the business relationships of Wisconsin manufacturers); Annelise Riles, *The Network Inside Out* (2000) at 171-178 (women’s issues “networkers” working for the sake of the Network and its paraphernalia, with the effect of shutting out politics and the women in whose name the networking takes place).

16 See e.g., Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 *Emory L.J.* 929 (2004).

17 Our approach to and use of interviews is similar to that in John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement*, 31 *J. Corp. L.* 1 (2005) (describing “business ethnography” at 9-12) and that of Dezalay and Garth (describing “reflexive sociology”). Yves Dezalay & Bryant G. Garth, *The Internationalization of Palace Wars: Lawyers, Economists, and the Contest to Transform Latin American States* (2002). Earlier work using similar methods includes Macaulay,

Below we first review the contract provisions at the center of the study, and the process that led to the shift in 2003. We then describe the findings from our interviews, conducted against the background of vigorous public and academic debates about the causes of the shift. We conclude with implications for contract change, the uses of contract, and governance.

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supra note 15 and Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes*, 291–92 (1991) (describing interview-based research in a small community).

## 2. MEET THE CLAUSES

Contract terms are rarely named for social science theories. Collective Action Clauses are the exception. Collective action problems in economics and political science describe the circumstances where individuals acting rationally to maximize self-interest generate an outcome detrimental to their interests as a group.<sup>18</sup> Free-riding and prisoner's dilemma are variants of the problem. Collective action clauses in sovereign debt contracts describe provisions that address collective action problems that might arise among creditors, which may in turn trigger a rush to sell the debt, a rush to sue, or cause creditors to hold out and free ride on a restructuring agreement.<sup>19</sup> Creditor coordination failures delay debt restructuring and may reduce recovery for creditors as a group. Other things equal, large groups lacking social cohesion are prone to collective action problems. Hence the move from regulated bank syndicates of the 1970s to more dispersed bondholder constituencies of the 1990s was expected to cause disruption in sovereign debt management.<sup>20</sup>

Bankruptcy regimes address creditor collective action problems for corporate, individual and municipal debtors – but not sovereigns. By the mid-1990s, a chorus of lawyers, officials and academic economists anticipated a sovereign bond crisis and predicted chaos. Academics and economists in the official sector – here the International Monetary Fund (IMF) and its principal shareholders – framed the policy challenge in collective action terms.<sup>21</sup> The presumption that any attempt at bond restructuring would lead to systemic disruption was so strong in 1994 that few were willing to risk amending Mexico's domestic-law dollar-indexed tesobonos – the instruments at the center of that country's financial crisis – even if technically it could have been done by fiat.<sup>22</sup> Mexico's ties to the United States and other factors instead weighed in favor of a \$50 billion U.S.-IMF loan package.

Working groups of officials from systemically important economies assembled in the aftermath of crises in Mexico and throughout Asia in the late 1990s considered and rejected sovereign bankruptcy as a political non-starter. Reports released in 1996 and 1998 advocated widespread adoption of contract terms – some old, some new – to improve creditor coordination and bind

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18 See Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (1971).

19 See Eichengreen, *supra* note 12; Thomas Jackson, *The Logic and Limits of Bankruptcy Law* 11-14 (1986).

20 The description is stylized. Some syndicates include hundreds of banks, while some bond issues are closely held.

21 See e.g., Group of Ten, *The Resolution of Sovereign Liquidity Crises: A Report to the Ministers and Governors Prepared under the Auspices of the Deputies* (1996) (hereinafter the "Rey Report"), available at <http://www.bis.org/publ/gten03.pdf> and Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (1995).

22 An op-ed in *The Financial Times* reflected the prevailing sentiment: "As the Mexican crisis showed, the world financial system desperately needs a mechanism to draw bondholders together to renegotiate foreign government debt." Rory Macmillan, *Personal View: New Lease of Life for Bondholder Councils*, *The Financial Times*, August 15, 1995, at 11. In fact, the Mexican crisis showed little, since the rescue package preempted bondholder mischief by paying them off.

disruptive minorities.<sup>23</sup> In practice, these recommendations targeted New York law bonds, which dominated the sovereign debt market.<sup>24</sup> Issuers and investors dismissed the prospect of coordination failures and rejected official intrusion in their contracts. Contract reform initiative stayed with the academy and the official sector.<sup>25</sup> By 1998, the term “Collective Action Clauses” or “CACs” came to describe the universe of terms they advocated.<sup>26</sup>

Lawyers seem like bit players in this story so far. But neither the officials nor the academics who advocated CACs had intuited the content of the clauses on their own. Trade journals and manuscripts circulating among practitioners by the mid-1990s identified four kinds of terms. Most prominent were modification provisions that would allow a qualified majority of creditors (usually 75% in principal amount) to change payment terms over minority objections. These had been common in English and Japanese law bonds, but not in New York and German law bonds, which required unanimous consent. Second, a related set of terms would restrict an individual creditor’s capacity to demand full repayment (accelerate) or sue the debtor. Clauses that require creditors to share litigation proceeds with their comrades had been used in syndicated loans and were being proposed for bonds, to dampen incentives to sue. Third, collective representation or engagement clauses would help organize bondholders and channel their activities through a trustee or a creditor committee. Deputizing the trustee to accelerate, sue and share the proceeds combines the representative function with the brake on individual enforcement described earlier. Finally, initiation clauses would help the debtor initiate a restructuring, and might sanction a payment suspension and a “cooling off” period.

Mexico’s SEC-registered 12-year global note issue launched in February 2003 tipped the markets in the direction of CACs. Mexico’s sole – momentous – innovation was in the modification provisions. Departing from the unanimity convention under New York law, the notes allowed amendment of financial terms (“reserve matters”) by holders of 75% of outstanding principal. Mexico raised the threshold for amending most other terms from 50% to 66 2/3%; several non-financial terms including status and waiver of immunity were elevated to reserve status and now required 75%.<sup>27</sup>

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23 See Rey Report, *supra* n. 21, and Report of the Working Group on International Financial Crises (October 1998) (hereinafter the “G-22 Report”), available at <http://www.bis.org/publ/othp01d.pdf>.

24 New York law bonds accounted for about seventy percent of all emerging markets paper in 2002. See International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* (December 13, 2002) at 44, available at <http://www.imf.org/external/pubs/ft/gfsr/2002/04/pdf/chp3.pdf>.

25 Clauses had several early prominent supporters in the market; these were the exception. See, e.g., Lee C. Buchheit, *The Collective Representation Clause*, *Int’l Fin. L. Rev.* September 1998; Ed Bartholomew, Ernest Stern & Angela Liuzzi, *Two-Step Sovereign Debt Restructuring: A Market-Based Approach in a World Without International Bankruptcy Law*, 35 *Geo. J. Int’l L.* 859 (2004).

26 The term “collective action clauses” appears to have been used for the first time in the G-22 Report.

27 For one of the many official sector announcements of the Mexico 2003 shift, see <http://www.imf.org/external/np/sec/pn/2003/pn0353.htm>.

This was a tradeoff: even before Mexico, countries constrained by unanimity could still restructure by exchanging old bonds for new ones. However, creditors that did not participate in an exchange retained a claim for full face value of their bonds. To discourage holdouts, borrowers asked participating creditors to vote to amend non-financial terms in the bonds they were exiting to make them unattractive. This practice is known as “exit consents”; on at least one occasion, it left holdouts with claims that were illiquid and essentially unenforceable. A lower amendment threshold for payment terms combined with a higher threshold for most others makes it possible to restructure holdouts’ bonds against their will, but reduces the scope for borrowers to pressure creditors indirectly through exit consents.

Trade association data suggest that since Mexico, more than two dozen countries – including Brazil, South Korea, Turkey, and South Africa – have issued bonds with majority modification provisions under New York law contracts, most using the 75% threshold for reserve matters.<sup>28</sup> Several countries have gone beyond majority amendment and adopted other innovations; these have not caught on as widely.

When we speak of the “CAC shift”, we refer principally to the shift from unanimous to majority modification provisions in New York law bonds, which is virtually complete for new issues. As of February 2006, the stock of bonds with CACs was at 60% of the total outstanding – up from 40% in just three years.<sup>29</sup>

As noted at the start, CACs were introduced twice over the past decade. Mexico’s 2003 issue has attracted virtually all the commentary. But six years earlier, a group of less prominent issuers including Bulgaria, Kazakhstan, Egypt, Lebanon and Qatar used majority modification clauses in their New York law bonds issued in the European market and exempt from SEC registration. These had little market impact, and attracted no official or academic attention until after Mexico in 2003. Here, we focus on the shift that began in 2003; we elaborate on the earlier shift and its implications elsewhere.

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28 EMTA, Sovereign Bond Documentation Charts, available at [www.emta.org](http://www.emta.org). Several countries started with 85% and switched to 75% in subsequent issues.

29 International Monetary Fund, Report of the Managing Director to the International Monetary and Financial Committee on the IMF’s Policy Agenda, April 20, 2006, at 8, available at <http://www.imf.org/external/np/pp/eng/2006/042006.pdf>. The total includes all international bonds, not just ones governed by New York law. Most of the outstanding bonds without CACs were issued before 2003.

### 3. WHODUNIT: THE INTERVIEWS

The Mexico-led shift inspired a host of press releases, public statements, articles in the popular and trade press, and renewed academic activity on the subject of CACs. Most authors tried to explain what caused Mexico and others to change their contracts.

The most common explanation cited fear of the Sovereign Debt Restructuring Mechanism (SDRM), a statutory regime proposed by the IMF to address creditor coordination problems, as the dominant factor in the CAC shift. In this account, clauses prevail because they are the lesser of two evils. Sovereign borrowers and private creditors rejected SDRM as an IMF power grab designed to encourage defaults and reduce demand for official money.<sup>30</sup> Before SDRM, neither group had shown enthusiasm for CACs.<sup>31</sup> With SDRM on the horizon, a contractual solution began to look attractive.<sup>32</sup> Mexico and others then adopted CACs to preempt SDRM.<sup>33</sup>

The other popular theory attributed the shift to U.S. pressure. Beginning in the fall of 2002 Bush Treasury officials appeared to make CACs a centerpiece of their strategy to eliminate public sector bailouts of the sort Mexico received in 1995. The trade and financial press reported that Treasury arm-twisting caused Mexico and others to try CACs.<sup>34</sup> Others suggested the shift came

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30 See Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 *Geo. J. Int'l L.* 299 (2005), *The Economist* explained the CAC shift this way in May 2003:

Why have borrowers changed their minds? One reason is fear. Once the SDRM was mooted – a far worse idea than collective action clauses in borrowers' eyes – the thought that it might be put into effect focused minds on the search for a market based alternative.

*Dealing With Default*, *The Economist*, May 8, 2003.

Paul Blustein's book on Argentina's crisis concludes:

The triumph of CACs over the SDRM offered some depressing insights into the difficulty of making headway on international financial reforms. The idea of introducing the clauses had been proposed years earlier and had stalled amid opposition from Wall Street; only when the more radical SDRM reared its head did private financiers come around to backing CACs as the lesser evil.

Paul Blustein, *And the Money Kept Rolling In (and Out): Wall Street, the IMF, and the Bankrupting of Argentina* (2005) at 230. See also Melvyn Westlake, *Battle of the Heavyweights*, *Emerging Markets*, Sept. 27, 2002, at 16; *A Better Way to Go Bust*, *Economist*, Feb. 1, 2003, at 64.

31 See Hagan, *supra* note 30, at 319-20.

32 "Developing countries are issuing new bonds that should make it easier to clear up or head off defaults," *The Economist*, May 8, 2003; *Deutsche Bank Emerging Markets Daily*, February 26, 2003, at 8,

33 See Hagan, *supra* note 30 at 320 (citing Adam Lerrick & Allan H. Meltzer, *Sovereign Default: The Private Sector Can Resolve Bankruptcy Without a Formal Court*, *Q. Int'l Econ. Rep.*, Apr. 2002, at 2: "With bailouts ruled out, the private sector is confronted with a choice: accept regulation or find its own solution to make restructuring work."). See also Barry Eichengreen et al., *Crisis Resolution: Next Steps* (IMF Working Paper No. WP/03/196, Oct. 2003) (noting that the IIF's embrace of collective action clauses would never have happened in the absence of the SDRM initiative), available at <http://www.imf.org/external/pubs/ft/wp/2003/wp03196.pdf> (last visited Nov. 2, 2004). A nuanced version of this story had Mexico adopting CACs to stop the talk of SDRM, which was harming the asset class regardless of the initiative's ultimate prospects. Nouriel Roubini & Brad Setser, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (2004), at 313.

34 See *Dealing with Default*, *supra* note 30 ("American pressure also played a part. The Treasury made no secret of its preference for the clauses."). More recently, see Blustein, *And the Money*, *supra* note 30, at 230 ("Eventually,

of a Treasury-sponsored change in U.S. law.<sup>35</sup> In a new book, the leading advocate of CACs in the U.S. Government characterizes the efforts as broad-based “diplomacy” and persuasion”.<sup>36</sup> Some in the market pointed to Mexico’s special relationship with the United States, and cited rumors of a *quid pro quo*.<sup>37</sup>

These and other stories served as background for our interviews. We collected accounts of the CAC shift from over 100 participants. We tried to be comprehensive first, by reaching out to everyone involved in the CAC shift (about 200 people) and second, by soliciting different perspective on the same events – for example, interviewing issuers, underwriters, investors and the lawyers on both sides in the early CAC deals. We believe that we contacted over half of all direct participants in the shift. We obtained multiple accounts of every incident we describe, have shared drafts of the article on which this chapter is based with many of our interviewees, and have reflected their comments. This approach also addressed fading memories and hindsight bias, though both remain important concerns. Our contacts spoke to us in the expectation of confidential treatment; we have coded the interviews to preserve anonymity. We avoided statistical survey tactics in favor of free-form interviews that allowed our contacts to frame their accounts in their own terms<sup>38</sup> and produced nuance that we found lacking in prior studies, including our own.<sup>39</sup>

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with U.S. clout working its usual magic, CACs won endorsement from the G-7 and the IMF’s policy-setting committee of member-country finance ministers, and several emerging-market countries began issuing bonds with the clauses in 2003.”); David Skeel, *Why Contracts are Saving Sovereign Bankruptcy*, *Int’l Fin. L. Rev.*, March 2006 at 24-32 (“With some serious arm twisting by the U.S. Treasury, Mexico finally broke the logjam in 2003”).  
35 Alan Beattie, ‘Vulture Funds’ Circle but Debtors Remain a Moving Target, *Financial Times*, February 18, 2007.  
36 John B. Taylor, *Global Financial Warriors: The Untold Story of International Finance in the Post-9/11 World* (2007), at 124-25.

37 Felix Salmon, *Blazing a Trail Down Mexico Way*, *Euromoney*, April 2003. See also John Authers, *Mexico Sends Signal with Bond Clauses*, *Financial Times*, February 26, 2003 (“‘I think Mexico is building up a war-chest of favours to the US Treasury, which it’s going to claim at some point in the future,’ said Walter Molano, of BCP Securities. Molano also said that ‘This deal is going to be an orchestrated success, because there’s an enormous amount of political reputation riding on this, specifically for the US Treasury.’”); Matthieu Wirz, *Mexico Introduces CACs to Rocky Reception*, *International Financing Review*, March 1, 2003 (“Bankers and investors point to the heavy hand of US Treasury and recognition of the inevitability of CAC implementation to explain the decision.”); Fernando J. Losada, *Mexico: Going Nowhere Fast*, *ABN-AMRO Emerging Markets Fortnightly*, March 5, 2003, at 31 (“The authorities in Mexico were apparently persuaded by the US Treasury and some leading Wall Street bankers to attempt to issue such a bond.”).

38 Cf. Yves Dezalay & Bryant Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order* 17 (1996) (hereinafter, “*Arbitration*”) on the value of encouraging interviewees to present their own picture of the relevant legal field: “it serves to identify what they seek to appear to be and what they reject, thereby serving to define the principles of opposition that structure the field and shape change over time”.

39 Our approach, including the use of free-form interviews and withholding attribution in the text, leaves us open to criticism among other reasons, because our study may be difficult to replicate. See e.g., Lee Epstein & Gary King, *Exchange: Empirical Research and the Goals of Legal Scholarship*, *The Rules of Inference*, 60 *U. Chi. L. Rev.* 1, 38-45 (2002). Our response is twofold: first, we spoke to half of all participants in a very small universe. At worst, the information we have gathered may help direct future quantitative inquiry that might improve on the studies we cited in the preceding section. Second, we simply saw no other way to learn and tell what we thought was an

### 3.1. SDRM: The Phantom Menace

The majority of our contacts connected the CAC shift with SDRM. Most market participants offered two basic versions of the explanation. In the first version, the official sector wanted to foist a statutory regime on the market, but backed down in the face of market resistance, settling for CACs as “second best”. According to one investor,

There were enough parties of interest in the world of finance [opposing SDRM] that political forces in Washington stood down. The White House listened to this ... ‘maybe we were making too many enemies, we need a second best.’ CACs were that second best.<sup>40</sup>

In another market view, more common among those familiar with public sector efforts to promote CACs in the 1990s, officials announced SDRM out of frustration with the market’s failure to adopt CACs – or any other fix to the collective action problem that governments foresaw and markets dismissed.<sup>41</sup> SDRM was the nuclear fix, a way to ensure that “the private sector would pay attention finally to what government thinks.”<sup>42</sup>

Our interviews and correspondence confirm that industry representatives tried more than once to trade their acceptance of CACs for the official sector’s commitment to “drop” SDRM,<sup>43</sup> which implies that they had thought such a bargain to be within the power of their official interlocutors. A dozen or so contacts described a particularly contentious gathering of investors, emerging markets issuers, and G-7 officials hosted by the U.S. Treasury in late September 2002 on the margins of the World Bank-IMF Annual Meetings. The parties reportedly tried to reach consensus on CACs, but failed because the United States would not take SDRM off the table.<sup>44</sup> One participant described the meeting as a “debacle”. Mexico’s Finance Minister Francisco Gil Diaz “got up and said forget it, we are never doing CACs!” – a gesture the Minister reprised at

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important story. Compare Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of The Yellow Submarine*, 80 *Tulane L. Rev.* 1161, 1185 and n. 99 (2006).

40 Interview 070206 (This and subsequent such references are to transcripts of the interviews on file with the authors).

41 See Hagan, *supra* n. 30 at 4.

42 Interview 111705

43 See e.g., Letter to Paul H. O’Neill from the heads of EMTA, IIF, IPMA, BMA, SIA, ISMA, and EMCA, dated December 6, 2002 (on file with authors):

We believe that a market-based approach to strengthening crisis management holds the only promise for success. Consequently, we have taken the lead in developing marketable collective action clauses (CACs) that could command the support of both investors and issuers. Regrettably, that effort was set back by the “two-track” approach reinforced in September, an approach which was seen by a number of investors as well as issuers as signaling that a sovereign debt restructuring mechanism (SDRM) could override what is achieved through CACs.

44 Interviews 100605 and 092705. Also, see Paul H. O’Neill, *Keynote Address to the Institute of International Finance, Washington, D.C., September 28, 2002*, available at <http://www.treasury.gov/press/releases/po3077.htm> (where O’Neill refers to the meeting several days earlier but commits to pursue both CACs and SDRM).

international gatherings in the run up to February 2003.<sup>45</sup>

Did the G-7 and the IMF truly aim for a statutory regime, settling for CACs as the face-saving fallback? Or was SDRM a ploy to induce a market fix to collective action problems, after nearly a decade of market resistance to official pleas? And were the G-7 deliberately driving a hard bargain, holding SDRM over the markets to secure unconditional surrender on CACs? Interviews with officials suggest a different story, and raise the possibility that SDRM itself came of a loss of control by the United States and coordination failure among the G-7.

Most accounts of the IMF's initiative<sup>46</sup> start with Argentina. In August 2001, that country secured its last IMF loan before defaulting on nearly \$100 billion in foreign bonds. The Bush Treasury, eager to distance itself from Clinton-era bailouts,<sup>47</sup> was searching for a way to inject market discipline in the Argentine package. Inspired by the financial engineering of the Brady Plan and by faith in market ingenuity, the Treasury team pressed the IMF to set aside \$3 billion out of \$23 billion for a "market-based, voluntary restructuring operation".<sup>48</sup> It soon became clear that restructuring \$100 billion with \$3 billion would take more magic than engineering.<sup>49</sup> But some of the early design meetings introduced Paul O'Neill, the eccentric first Treasury Secretary of the second Bush Administration, to negative pledge constraints in sovereign debt contracts.<sup>50</sup> O'Neill did not take well the prospect that a contract clause might interfere with debt restructuring for an insolvent sovereign. On September 20, 2001, he publicly called for a sovereign bankruptcy mechanism.<sup>51</sup>

Days earlier, O'Neill had hosted a private breakfast for Horst Koehler, the Managing Director of

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45 Interview 100605

46 The intellectual history of sovereign bankruptcy precedes SDRM, tracing at least as far back as Adam Smith. See Kenneth Rogoff & Jeromin Zettelmeyer, *Early Ideas on Sovereign Bankruptcy: A Survey* (March 2002) (available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=879533](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=879533)).

47 See e.g., John B. Taylor, *The Bush Administration's Reform Agenda At the Bretton Woods Institutions: A Progress Report and Next Steps*, Testimony Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, May 19, 2004, available at <http://www.treasury.gov/press/releases/js1662.htm> (describing post-Mexico packages of the 1990s as an example of short-term tactics that risked distorting market incentives).

48 International Monetary Fund, *Transcript of a Press Briefing by Thomas Dawson, Director, External Relations Department* (Aug. 30, 2001), available at <http://www.imf.org/external/np/tr/2001/tr010830.htm> (last visited Jun. 27, 2007).

49 Eichengreen implies that collective action problems were responsible for the failure to deploy the \$3 billion in a preemptive restructuring. Eichengreen, *supra* note 12, at 82. The officials and investment bankers who participated in the discussions on possible financial structures said that the \$3 billion mandate did not reflect financial realities; none reported coordination problems (e.g., Interview 013106). In retrospect, Taylor describes the value of \$3 billion as "strongly signaling that this was in fact the final augmentation." Taylor, *supra* note 36, at 88.

50 A standard negative pledge clause restricts the borrower's capacity to pledge collateral to secure future debts. Most private lenders to sovereigns, as well as the World Bank, require negative pledge commitments.

51 We need an agreement on an international bankruptcy law, so that we can work with governments that in effect need to go through a Chapter 11 reorganization instead of socializing the cost of bad decisions." *The Condition of the Financial Markets and Regulatory Responses Following the September 11 Terrorist Attacks: Hearing Before the Committee on Banking, Housing, and Urban Affairs, 107th Cong. 33* (2001) (statement of Paul O'Neill, Secretary, United States Department of the Treasury).

the IMF, and Anne Krueger, his newly-appointed First Deputy.<sup>52</sup> Several senior staff were in attendance. One participant told us that at breakfast, O’Neill “waxed poetically” about international bankruptcy.<sup>53</sup> Another reported O’Neill saying something like, “We need an international bankruptcy court ... and do it by December.”<sup>54</sup> The IMF had explored sovereign bankruptcy several times in the preceding decade, each time without an action mandate from its major shareholders. For the IMF officials at the Treasury breakfast, O’Neill’s call signaled an institutional boost. Elated, “Horst and Anne sort of floated out of the place.”<sup>55</sup>

In contrast, O’Neill’s deputies took his words as rhetorical gloss. The Secretary had identified a problem – inflexible debt contracts – and commissioned a solution. Statutory sovereign bankruptcy was a solution, but one that was costly (at a minimum, requiring Congressional involvement) and more importantly, too dirigiste for most of the Bush team’s free market sensibilities. One team member, a lawyer by training, suggested that bankruptcy functions could be replicated in a contract. Conversations with staff and outside experts (mostly academic economists) unearthed the earlier CAC initiatives, going back to 1996. Officials became convinced that “not only was it possible, it was smarter to do it contractually.”<sup>56</sup> But by then, the IMF machine was in full gear designing the statutory framework.

Some Treasury participants in the September breakfast say they saw right away that Krueger’s understanding of O’Neill’s marching orders differed from their own. But Treasury officials, still completing transition to the new Administration, thought they had time to bring Fund management “back on the reservation.”<sup>57</sup> They miscalculated. Krueger gave her first speech launching SDRM in November 2001.<sup>58</sup> IMF had sent an advance copy to the Treasury but heard nothing back. Krueger may have assumed she had what “clearance” she needed; Treasury officials assumed more substantive consultations would ensue: after all, she was proposing to amend the IMF Articles of Agreement (Charter) and the United States held the blocking vote.

Market reaction to Krueger’s speech was scathing. One lawyer recalled that the speech “scared the Bejesus out of” some business contacts: “It’s VIII(ii)(b) again, but much, much worse!” – referring to an earlier official attempt to sanction nonpayment under Article VIII(ii)(b) of the

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52 O’Neill mentions the meeting in his September 20, 2001, testimony. He dates it the preceding Monday, which was September 17. *Id.* The IMF’s first deputy is traditionally nominated by the United States. Krueger, a prominent economist, was a Bush White House choice. For the announcement of her appointment, see Stanford Report, Economics Professor Anne Krueger Named to Key Job at IMF (June 8, 2001), <http://news-service.stanford.edu/news/2001/june13/krueger-613.html>.

53 Interview 121605

54 Interview 121405

55 *Id.*

56 *Id.*

57 *Id.*

58 Anne Krueger, Speech at the American Enterprise Institute, International Financial Architecture for 2002: New Approach to Sovereign Debt Restructuring (Nov 26, 2001), available at <http://www.imf.org/external/np/speeches/2001/112601.htm> (visited Mar 22, 2005).

IMF Charter.<sup>59</sup> A money manager summarized market concerns as two-fold: discomfort with “institutionalizing a process by which your contracts would be trumped” and having that process run by an institution like the IMF, controlled by the G-7 and exposed to their shifting policy priorities.<sup>60</sup> Many others suspected Fund motives, and accused it of conflicts of interest: the IMF is often the largest creditor of a sovereign in distress.

Once the idea was out, it proved hard to squash. O’Neill had no problem with CACs, but refused to allow his deputies to end the statutory experiment. A celebrated industry captain before his Treasury stint, he fancied the idea of different groups competing to design solutions to his problem.<sup>61</sup> Competition began to resemble confrontation the following spring when Krueger and John Taylor, Treasury Under Secretary for International Affairs, both spoke at a conference on sovereign debt restructuring at the Institute for International Economics, a Washington think tank.<sup>62</sup> Krueger delivered a modified version of the first SDRM proposal, scaling down the IMF’s role.<sup>63</sup> Taylor endorsed CACs in a speech that was read as dismissing SDRM as a matter for academic speculation.<sup>64</sup> Those involved in preparing the text say that Taylor had never intended to slight Krueger, a former Stanford colleague, and certainly did not mean “academic” as a pejorative. The following account is typical:

He was asked to speak at a conference, he had views to share. Fairly sure he was not doing it to be Machiavellian. He was being analytical. She thought that the U.S. was supporting her ... There was pressure after for John not to be in Anne’s face ... she was ‘slightly’ upset.<sup>65</sup>

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59 Interview 121305. See Daniel K. Tarullo, Rules, Discretion, and Authority in International Financial Reform, *J. Int’l Econ. L.* 613 (2001) at 674.

60 Interview 070206. Many in the market never bought into the IMF’s efforts to distance itself from the actual management of the restructuring process – no technical changes could convince the skeptics that SDRM was anything other than a power grab by the IMF.

61 Interview 121405. In the fall of 2002, O’Neill publicly called for a competition of ideas:

Simply put, our goal is to change the way that debt is restructured, not to tie ourselves to one approach or another. If there were a third approach to consider, we would welcome that opportunity as well. Don’t throw stones at our best efforts to fix this system – throw ideas. The competition of ideas will ensure that we develop the most sensible system to bring predictability to sovereign debt restructuring. We will explore every option, every means to our goal, assess its flaws and strengths, and modify it accordingly.

See O’Neill, *supra* n. 43.

62 The institute has since been renamed Peter G. Peterson Institute for International Economics (<http://www.petersoninstitute.org>).

63 Anne O. Krueger, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking*, Speech at the conference on “Sovereign Debt Workouts: Hopes and Hazards”, Institute for International Economics, Washington, DC, April 1, 2002, available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=454> and Paul Blustein, *IMF Scales Down ‘Bankruptcy’ Plan* *The Washington Post* April 2, 2002, at E1.

64 John B. Taylor, *Sovereign Debt Restructuring: A U.S. Perspective*, Speech at the conference on “Sovereign Debt Workouts: Hopes and Hazards”, Institute for International Economics, Washington, DC, April 2, 2002, available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=455>.

65 Interview 121305

Taylor considered Krueger a friend; he also knew that she was revising the original design – perhaps he had expected their approaches to converge.<sup>66</sup> Looking back, it is hard to see how a U.S. proposal with no role for the Fund could escape being perceived as threatening. In any event, the press reported the speeches as open conflict between the IMF and its largest shareholder.<sup>67</sup> The signal that sent may have trumped the substance of either initiative. To control the damage, Taylor’s new deputy Randal Quarles told the press the United States was for a two-track approach – where the Fund and the G-7 would explore both CACs and SDRM.<sup>68</sup>

Krueger had some support inside the Bush White House. The nature and depth of this support are unclear. Taylor recounts in his book being called to the White House and told to go easy on the Fund.<sup>69</sup> Krueger was friendly with National Security Adviser Condoleezza Rice (both had taught at Stanford). When they occasionally dined together, Krueger would mention the SDRM, and Rice would respond with encouragement.<sup>70</sup> But senior White House staff apparently considered and rejected the idea of elevating either SDRM or CACs beyond the Treasury.<sup>71</sup> A Treasury official characterized White House interest as “discomfort with the press playing up the conflict between Treasury and IMF ... It was an arcane issue at the White House.”<sup>72</sup>

National Economic Adviser Larry Lindsey and CEA Chairman Glenn Hubbard were among the few top White House officials to weigh in on the debate, generally in line with the contractual approach.<sup>73</sup> Hubbard even gave a keynote speech at an IMF conference on SDRM. He proposed a mix of contractual innovation and a voluntary dispute resolution mechanism that echoed some features of the SDRM, combined with restructuring incentives and tighter conditions on IMF lending.<sup>74</sup> Even though in substance Hubbard’s idea was much closer to Taylor’s than to

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66 Interview 061506

67 See e.g., Paul Blustein, *IMF Crisis Plan Torpedoed; Treasury Official Rejects Proposal a Day After It Is Advanced*, *The Washington Post*, April 3, 2003, at E1; *Sovereign Bankruptcies* *The Economist*, April 6, 2002 and Alan Beattie & Raymond Colitt, *US Scorns IMF Plan for Bankrupt Governments: Proposals to Help Countries in Crisis Sort Out Their Debts without Fear of Litigation Have Met a Cool Response*, *The Financial Times*, April 6, 2002, at 7.

68 See e.g., Paul Blustein, *IMF Reform Plan Makes Comeback; U.S. Eases Stand on ‘Bankruptcy’ Idea*, *The Washington Post*, April 9, 2002, at E4 and O’Neill says US view on IMF Debt Restructuring Plan Misinterpreted, *AFX European Focus* April 9, 2002, available on LexisNexis.com.

69 Taylor, *supra* note 36 at 118.

70 Interviews 032306 and 121405. Some Administration insiders suggested to us that Rice was merely being polite without delving into the initiative’s substance.

71 Interview 122005

72 Interview 061506

73 *Id.* and R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Remarks at the Conference on the Sovereign Debt Restructuring Mechanism, International Monetary Fund, January 22, 2003, available at <http://www0.gsb.columbia.edu/faculty/ghubbard/speeches/1.22.03.pdf>. Hubbard delivered nearly identical remarks several months earlier at the American Enterprise Institute. R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Remarks at the American Enterprise Institute Conference on the IMF’s Sovereign Debt Proposal, October 7, 2002, available at <http://www.whitehouse.gov/cea/EnhancingSovereignDebtRestructuringAEIOct72002.pdf>.

74 Hubbard, January 22, 2003, *supra* note 73.

Krueger's, his rhetoric was telling – he called CACs a “Treasury proposal”, as if to distance the rest of the Administration from the controversy. Some Treasury officials saw Hubbard's “third way” as a worrisome diversion.<sup>75</sup> But to IMF staff the speech sounded the death knell for SDRM – they had assumed that the White House was with Krueger.<sup>76</sup> Hours later, things got surreal as Quarles delivered another ritual endorsement of the two tracks, promoting the clauses but encouraging the IMF to keep refining their SDRM proposal. An IMF staffer complained privately that he wished the United States would just end the charade and put his colleagues out of their misery.

Active controversy around SDRM and CACs lasted for about a year and a half from Krueger's first speech. Some senior U.S. and IMF officials suggested quietly it was a no-win battle, and tried to distance themselves from both sides to the extent possible.<sup>77</sup> Their reasons were some combination of believing that neither initiative was likely to succeed, that CACs were inadequate, while SDRM was ill-conceived. Some said that at the Fund, Krueger “owned” the initiative so completely that it left little room for others of her stature.<sup>78</sup> “It was going to be her legacy” and was her battle to fight.<sup>79</sup> On the other hand, our contacts often pointed to a small cohort of “true believers” in SDRM, comprising Krueger and several senior IMF staff, sustained in their design work by encouragement from O'Neill, the desire to boost the role of the IMF, at least acquiescence from the White House, and importantly, by support from European capitals.

By the end of the 1990s, European officials had come to lead the opposition to outsize IMF packages. Germany's insistence on hard lending limits typified this view, as did a joint paper by the Bank of England and the Bank of Canada, advocating debt standstills and lending limits.<sup>80</sup> Unlike the newly minted Bush appointees, many European representatives in the CAC-SDRM

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75 Interview 061506

76 Hubbard's audience was likely unprepared to parse yet another proposal; the big question on everyone's mind was whether the White House was for the SDRM or against it. There is some evidence that Hubbard did indeed intend his speech as a signal against. One guest at a conference luncheon recalls Hubbard asking privately, “Was I clear enough?” – a question that confirmed the impression around the table that the speech sought to end the IMF experiment. Interview 052506. On the other hand, it is not clear that White House officials cared much one way or another about the substance; they just wanted the controversy to end. A prominent academic heading an advisory body, Hubbard may have been testing out yet another theoretical construct that could simultaneously help solve the restructuring problem and end the Treasury-IMF contest.

77 Interviews 121205 and 122005.

78 Interview 052506. A long-time observer of sovereign debt restructuring interpreted Krueger's ownership as the first sign of doom: “When it came out, [SDRM was the] Anne Krueger proposal – not IMF, not Koehler – first clue to me that it was dead on arrival.” Interview 060606

79 Interview 0502506.

80 See Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* 170–74 (2001); Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds*, unpublished paper of the Bank of England and Bank of Canada, November 2001, available at <http://www.bankofengland.co.uk/publications/other/financialstability/boeandboc.pdf>. This staff paper came with the explicit endorsement of the heads of their respective central banks. As the authors note, the paper circulated widely in the official finance circles before being publicly released.

debate were veterans of the “private sector involvement” wars of the late 1990s.<sup>81</sup> Wary of discretion, which had let the United States steamroll over their objections, and weary of the old CAC initiatives that looked in retrospect like a fig-leaf for U.S.-led bailouts, the Europeans wanted firm crisis management rules.<sup>82</sup> SDRM was their chance, thanks to the space created by O’Neill.<sup>83</sup> Europe’s over-representation in the IMF Board made its support impossible to ignore, even if the U.S. alone could have blocked the supermajority vote to amend the Charter.<sup>84</sup>

With the U.S. tied to the parallel tracks for as long as O’Neill was in office, the most vocal resistance to SDRM in the IMF Board came from large emerging market issuers, notably Mexico and Brazil.<sup>85</sup> One official called the SDRM “a wrong idea at the wrong time”, noting flatly that if it had prevailed, his country would have lost all market access.<sup>86</sup> In private, borrowers also worried about losing access to IMF funds; some raised the IMF’s conflict of interest.<sup>87</sup> In public, they framed their resistance in the language of large-volume market issuers, as in this example: “From the point of view of [this issuer], all discussions of default, possibility of making default easier, were not genial. ... Our scenario is not default.”<sup>88</sup>

Mexico’s CAC issue came two months after O’Neill’s stormy departure from office in December 2002.<sup>89</sup> It is hard to speculate whether either event alone was sufficient to shelve SDRM. The IMF conference where Hubbard and Quarles appeared to speak at cross-purposes came between O’Neill’s resignation and the appointment of his successor, John Snow, and may have been a symptom of the interregnum. (Mexico’s spokesman at the conference reiterated his country’s

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81 Roubini & Setser, *supra* note 33, Interview 021706. The term is also known by its acronym, “PSI”. Blustein describes private sector involvement, a term that emerged in the context of the 1990s crises and the accompanying IMF packages, as “a code phrase for inducing banks and investors to accept part of the burden for resolving a crisis by reducing or stretching out their claims.” See Blustein, *supra* note 80 at 174.

82 See generally, Tarullo, *supra* note 59. Tarullo contrasts the European position with the strongest proposal for a rule based system by Meltzer and others; he does not dwell on the disagreements between the Clinton Administration and its European allies. *Id.* at 641. European officials were not against CACs – most came across to us as both supportive and optimistic about their value – merely skeptical of their capacity to reduce bailouts (e.g., Interview 091106).

83 Brad Setser, *The Political Economy of SDRM*, this volume.

84 See e.g., Edwin M. Truman, *Rearranging IMF Chairs and Shares: The Sine Qua Non of IMF Reform* in Edwin M. Truman, ed., *Reforming the IMF for the 21st Century* (April 2006) at 203 (proposing a consolidated European seat). See also Lorenzo Bini Smaghi, *IMF Governance and the Political Economy of a Consolidated European Seat* in Truman, ed., at 233-255 (explaining the paradox of Europe’s nominal over-representation against the lack of coordination among European chairs in the IMF) and Ngaire Woods, *Unelected Government: Making the IMF and the World Bank More Accountable*, 21 *The Brookings Review* 9, Spring 2003, available at <http://www.brookings.edu/press/review/spring2003/woods.htm> (criticizing constituency representation).

85 Because Mexico was part of the Spanish constituency, it could only voice its objections intermittently, when it held the constituency chair. Interviews 121305B, 121205, 061606 and 072406.

86 Interview 080406

87 Interview 121205

88 Interview 061606; Interview 121205 illustrates a similar sentiment. Both CACs and SDRM raised concerns with signaling default; to some, SDRM raised them more starkly.

89 On O’Neill’s resignation, see Ron Suskind, *The Price of Loyalty: George W. Bush, the White House and the Education of Paul O’Neill* (2004); Interview 121605.

opposition to both tracks, suggesting that finance leaders should better focus on building hospitals, not morgues.) Our interviews tie O’Neill’s departure, SDRM and Mexico’s issue together. This statement by a U.S. official is unusual for bringing broader geo-strategic issues to bear on the CAC-SDRM debate:

Of course now we had an alternative, we could see the alternative happening, it is easier to say we do not have to talk about [SDRM] anymore. Maybe it is easier for the U.S. not to support SDRM. Period. Certainly O’Neill had to be gone. With O’Neill’s departure, [the U.S.] could say to the MD, the U.S. will never support this, and you need our vote. At about the same time, there was a big blowup at the UN about Iraq – after that, it became clear the UN process was failing, falling apart ... With those U.S.-European battles, it made no sense to have battles [at the IMF] for no good reason. When Koehler said the U.S. is against, it’s over ... Koehler was never a true believer.<sup>90</sup>

O’Neill’s initial set-up of a competition between IMF staff and his own framed the episode. Taylor put it diplomatically, “The existence of an alternative proposal advocated by the IMF (and in particular by my colleague Anne Krueger) also had bearing on our financial diplomacy plan.”<sup>91</sup> Another U.S. official recalled O’Neill saying, “If SDRM solves it, good, if your way solves it, good. He was very, quite direct. ‘Read my lips – I want the problem solved. Don’t swat Anne down. I’m behind Anne and you will get in line.’ Awkward – ... In the end, I think it was a good thing from the point of view of process that we didn’t swat down the SDRM. ... With O’Neill out of the building ... the heart of Treasury support was gone. ... Mexico moved, others moved ... ‘We said all along, may the best process win, and it did.’”<sup>92</sup> But another official said that keeping SDRM alive may have done more harm than good:

Some people feel that [SDRM] was a forcing factor. I am not sure. Private sector was so alarmed, it ran the risk of scaring [them] away from the whole deal. Did not make much difference. ... The underlying story is O’Neill versus Snow. O’Neill wanted to have it [SDRM] out there. Snow was very comfortable about ending SDRM. The whole thing changed.<sup>93</sup>

The irony of the episode is that SDRM’s ultimate chances of implementation had always been slim to none. The IMF Charter is an international treaty; amending the Charter requires a super-majority vote of its Board and approval by member states, which for the United States would

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90 Interviews 121305, 121605, 121305B.

91 John B. Taylor, *Essential Reform of the International Financial System: Collective Action Clauses*, <http://www.stanford.edu/~johntayl/Essential%20Reform%20of%20the%20International%20Financial%20System,%20CACs.htm> (last visited Mar. 19, 2007).

92 Interview 121405

93 Interview 061506

implicate the U.S. Congress.<sup>94</sup> The leading policy officials in the Bush Administration came to office skeptical of the role of the international financial institutions and the way in which the Clinton Administration had used them to battle international crises. Before his appointment, Taylor had even suggested abolishing the IMF (he later distanced himself from the statement).<sup>95</sup> The idea that this Administration would spend political capital to expand IMF power at the expense of private contracts, and that Congress would blithely go along, verges on inconceivable.<sup>96</sup> One European official involved in early CAC efforts offered a broader view:

I always thought SDRM was dead in the water – because countries just do not cede sovereignty. The Rey Report said as much. It was a waste of the Fund’s time, anyone’s time. It was not a credible alternative.<sup>97</sup>

Other contacts, including investors and emerging markets officials who worked hard to defeat the proposal, said they had always assumed it would die – eventually.<sup>98</sup> But for Mexico and others, eventually may not have been soon enough.

In sum, if the SDRM initiative had a role in the CAC shift – and our interviews suggest that it did – then this may be the ultimate story of inadvertence. A brand-new, enterprising U.S. Treasury Secretary, unaware of the old CAC initiatives, got peeved at the negative pledge clause in Argentina’s bonds, and unleashed a statutory alternative that made CACs seem handsome by comparison to the markets. O’Neill’s intervention empowered IMF management (led by another Bush appointee) and long-time European advocates of rule-based crisis resolution, but also energized his own deputies to work hard to preempt them. The White House allowed the space for competition by deeming the controversy too technical and insignificant to intervene. The entire kerfuffle lasted long enough either to convince the markets of the merits of the contractual solution, or to create enough uncertainty about the outcome to make it worth the markets’ while to preempt the debate. The political transition in the United States and the Argentine crisis, bound up in this story, are the salient distinguishing features between the successful shift in 2003 and the failed campaign for CACs in the late 1990s.

### **3.2. Invisible Hands**

Bush Administration officials came up with CACs in the fall of 2001, knowing little or nothing

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94 Articles of Agreement of the International Monetary Fund, Article XVIII, available at [www.imf.org](http://www.imf.org), and The Bretton Woods Agreements Act, 22 USC Sec. 286c.

95 Adios IMF? International Monetary Fund, Uncommon Knowledge (a Hoover Institution video program), December 15, 1998, video and transcript available at <http://www.uncommonknowledge.org/99winter/320.html>.

96 For example, Interview 060606

97 Interview 021706

98 For example, Interview 121205, 060606. The incentive to claim foresight ex-post is obvious. But we heard similar sentiment from scores of officials, investors and observers long before SDRM was shelved.

of the prior life of the initiative in the 1990s. One official implicated in the clauses' comeback described a tinge of awkwardness when learning he had re-invented the CAC wheel: "It's round, it rolls, look what I've discovered!"<sup>99</sup> A staffer privy to both iterations of the CAC campaign was more charitable: "There was a lot of pressure for a radical alternative, and to his credit, John [Taylor] did not yield to the pressure, but dusted off the CACs."<sup>100</sup> The subtlety was lost on some market observers:

I did not pay much attention to the early rounds – it did not make sense to. We thought it would go away. And for a period it seemed they [CACs] vanished ... and then they reemerged. I try to stay away from Washington, I am not a lobbyist – here Washington lobbied us, invaded ... I thought they were on a tear to fix ... but fix the wrong thing. Boy they sure got CACs. Now you can bind 25%.<sup>101</sup>

In this and other accounts, market-based change came courtesy of successive Washington invasions. This explanation raises more questions. If U.S. pressure catalyzed the CAC shift in 2003, what were the ingredients of the winning strategy? Why did U.S. advocacy fail the first time around in the 1990s? Did the early efforts contribute to its eventual success?

Mexico's near-default in 1994 solidified public consensus that the era of bond crises had arrived, and was worse than the 1980s loan crisis, which involved fewer creditors and fewer instruments. By the mid-1990s, emerging market sovereign bonds had acquired a reputation as a sacred asset class partly because they seemed technically difficult to restructure, but also partly for their association with the moral commitment the official sector had made in sponsoring the Brady Plan.<sup>102</sup> The Bradies were meant to be inflexible to instill fear of default in the hearts of wayward debtors. One provision in the bonds turned out in retrospect to be near-comical bluster – a promise that they would never be restructured. Starting in 1995, academic and trade journals began publishing lawyers' bond restructuring proposals; yet more ideas circulated informally.<sup>103</sup>

On the official side, concern about bond restructuring went hand in hand with concern about

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99 Interview 121405

100 Interview 121305

101 Interview 111705

102 The Brady Bonds, which were the predominant model for emerging markets sovereign bond contracts, had been designed as "not market instruments but rather as crisis instruments created specifically by the creditor banks as a prerequisite for agreeing to significant debt and debt service reduction." James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, *Int'l Fin. L. Rev.* March 1996, at 14. See also Rey Report, *supra* note 21; Vincent Truglia et al., *Sovereign Risk: Bank Deposits vs. Bonds*, Moody's Investor Service Special Comment, Oct. 1995 (surveying recent history of selective sovereign default and implications for different instruments); Azmat Zuberi & David Roberts, *Preferred Creditors and the Sovereign Ceiling*, Duff & Phelps Credit Rating Co., Mar. 19, 1996.

103 See e.g., Symposium – *The New Latin American Debt Regime*, in 16 *NW J. Int'l L. & Bus.* (Fall 1995) symposium; Hurlock & Alexander, *supra* note 102; J.B. Hurlock, *Sovereign Bankruptcies: Countries Cannot Always Pay*, White & Case (1995), unpublished, cited in Eichengreen & Portes, *supra* note 21 at 65.

mega-bailouts: many in the finance circles fumed at the \$50 billion Mexico package.<sup>104</sup> Central banks took the lead in making sure it did not happen again. A series of central bank deputies' meetings beginning in February 1995 produced a G-10 working party under the leadership of Jean-Jacques Rey, the Belgian central bank deputy chosen, in the words of one participant, "because he was neutral – not American but not crazy Bundesbank – no bailouts."<sup>105</sup> The Rey group's mandate was "a reaction to what you [the United States] did – there has got to be a better way of handling sovereign liquidity crises."<sup>106</sup> The fruits of the group's work, known informally as the Rey Report, came out in May 1996. It considered and rejected statutory sovereign bankruptcy as neither feasible nor appropriate and proposed a "market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation" between debtors and creditors, as well as among creditors. This specifically included majority modification to improve restructuring predictability.<sup>107</sup>

It is not clear how the contract proposal made its way into the report. Some later commentators credit a volume edited by economists Barry Eichengreen and Richard Portes, commissioned by the British Treasury and the Bank of England in connection with their work in the Rey group.<sup>108</sup> But some of the authors and working party members describe the bond clause proposals as "already out there" and part of the crisis management discussion.<sup>109</sup> Veterans of the 1980s crisis who participated in the Rey effort said that the lengthy, costly and traumatic restructuring delays they attributed to high-majority and unanimity requirements in loan contracts played a role in framing their concerns.<sup>110</sup> Some private practitioners had expressed similar worries several years before the 1994 Tequila Crisis.<sup>111</sup>

In market surveys commissioned for the Rey Report, investors dismissed the contract proposal:

Market participants opposed any change to the present structure of bond contracts. The general view among the respondents was that bonds represent a simple promise by the borrower to pay, and their attractiveness as an investment vehicle reflects their character as easily transferable, unencumbered and difficult-to-restructure securities.<sup>112</sup>

To be fair, investors also dismissed sovereign bankruptcy and bondholder committees – they pretty much wanted to be left alone. We were privy to similar outreach efforts in the late 1990s,

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104 See e.g., Blustein, *The Chastening*, supra note 80.

105 Interview 100705

106 Id.

107 Rey Report, supra note 21.

108 Eichengreen & Portes, supra note 21.

109 Id., Interviews 100705, 021706, 010306 and 081706.

110 Interview 092705

111 Lee C. Buchheit, *Making Amends for Amendments*, *Int'l Fin. L. Rev.* February 1991 at 11.

112 Rey Report, supra note 21 at 35.

which elicited roughly the same market response.

Nevertheless the clause proposal, initially mocked as a “tinny deliverable,”<sup>113</sup> survived for almost five years. After the Rey Report, clauses reappeared in a report on crisis resolution by the G-22<sup>114</sup> in the aftermath of the Asian financial crisis, and as part of the International Financial Architecture Initiative in 1999. One staffer suggested this resilience was due to a combination of intellectual appeal and bureaucratic convenience:

[CACs offered a] very elegant, simple theoretical framing. It worked in the economics world. Collective action problems are a well-accepted category that a legal problem falls into – a well-accepted model of market failures ... Government is only involved if there is a market failure. It is easy to show market failure here. ... Very powerful framing overlapped with the concern in the legal world whether document standards in New York law Brady Bonds made sense – set up in a way – exit – no more restructuring – that made it harder down the line. This simple accepted model of potential problem that worked both in legal and economic world – there was an element of truth to the arguments – got elevated and expanded into a notion that because CACs are not there, there is no market solution; the only option is a bailout. Somehow it went from “absence of CACs makes restructuring harder than it should be” to “there will always be bailouts”.

Jeff Sachs was pushing international bankruptcy<sup>115</sup> – seemed too far. Traded securities difficult to restructure – means a bailout next time – the Mexico problem – not tenable. As always the case, you put the unattractive options as the first bullet and the third; everyone picks the option in the middle. The option in the middle was to do something that makes tradable bonds easier to restructure.<sup>116</sup>

The intellectual appeal story is plausible because of the large number of academic economists involved in CAC policies over time. Lawrence Summers and John Taylor are the best-known of the lot, but the economics PhDs involved over time and at the highest levels numbered in the dozens. It helps explain the search for market failures, and the willingness to commission academic studies in support of the effort.

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113 Interview 092705, 092606

114 The group included the G-7 and Argentina, Australia, Brazil, China, Hong Kong, India, Indonesia, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, South Korea and Thailand.

115 See Jeffrey D. Sachs, *Do We Need an International Lender of the Last Resort*, Frank Graham Lecture, Princeton University (April 1995) (available at <http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf>). For a more recent iteration, see Jeffrey D. Sachs, *Roadblock to a Sovereign Bankruptcy Law*, 23 *Cato Journal* 73 (2003) (available at <http://www.cato.org/pubs/journal/cj23n1/cj23n1-8.pdf>).

116 Interview 112205. This statement sets out for CACs the classic ingredients for dissemination of policy ideas. See generally Peter A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism across Nations* (1989).

The bureaucratic story requires elaboration. The officials who discussed the topic with us made clear that their advocacy of CACs related to a bigger policy objective. If Mexico-style bailouts were no more, bond restructuring was inevitable. In the late 1990s, CACs became part of the effort to signal that the official sector would not stand in the way of sovereign bond restructuring, and in some cases may even demand it. The implications of that judgment translated into two big policy shifts in the late 1990s under the rubric of “private sector involvement in crisis management,” or “PSI”.<sup>117</sup> First, the Paris Club of government-to-government creditors would condition its relief on the debtor’s commitment to seek private bond restructuring terms comparable to the official concessions.<sup>118</sup> Second, the IMF would extend to bonds its willingness to finance countries in default on private debt.<sup>119</sup> Several participants said that at the time, CACs ended up on the laundry list of “things to be for” in operationalizing PSI.<sup>120</sup> Despite three years of market resistance beginning with the Rey Report investor surveys, the clauses still had an inoffensive, vaguely market-friendly ring to the official ear.

But in the late 1990s CACs never quite overcame their status as an adjunct initiative. A former Clinton White House official suggested that Treasury Secretaries Robert Rubin and Lawrence Summers never seemed eager to push hard on the CAC front.<sup>121</sup> Staffers observed that Rubin and Summers had expressed their respective reservations differently:

Rubin was happy to have us talk about it, but would not have supported drafting model clauses. ...“These guys have a problem coming down the pike – [they will have to] restructure bonds – if they can’t do it, this is when it will happen. This will not be solved until they believe it is a problem, and when they do, then they will solve it better than we ever had.” Larry was worried that it would make us look feckless. We publicized it a certain amount, but how they structure contracts is not our business. If this is our primary recommendation and they do not do anything about it, we look feckless.<sup>122</sup>

The delicate state of the global economy weighed heavily against regulation or even heavy

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117 See supra note 81.

118 See Jeffrey Keegan, *Growing Chorus of Regulators Want Sovereign Bondholders to Share the Pain*, *Investment Dealer’s Dig.*, May 3, 1999; Kristin Lindow et al., *Pakistan’s Paris Club Agreement Implies New Official Strategy Regarding Seniority of Sovereign Eurobonds*, *Moody’s Investors Service Global Credit Res.*, Mar. 1999, at 3. Bank loans had been subject to “comparability” since the 1970s.

119 Before 1989, the IMF refused to finance countries in arrears to private creditors. This empowered the creditors to hold up both their own as well as the IMF’s financing. As bank restructurings progressed, the Fund changed its policy to allow lending where the country was in still in default on its loans, provided the country was complying with its policy program. With qualifications, the policy expanded to cover default on bonded debt in the late 1990s. Int’l Monetary Fund, *Fund Policy on Lending into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion 3-9* (July 30, 2002), available at <http://www.imf.org/external/pubs/ft/privcred/073002.pdf>.

120 Interviews 091305, 092705

121 Interview 010306

122 Interviews 091305, 092705

pressure on market participants: “Although we believed that CACs would not in any basic sense change the situation, [they were a] highly charged symbolic political thing since the Rey Report.” Moving precipitously might “screw up fragile equilibrium.”<sup>123</sup> Mulling the CACs’ eventual success, another participant in the Clinton-era debates admitted being torn between feeling “sheepish – they made it happen when we could have done it in 1999-2000 – and what I used to think then ... which is that ... in the hierarchy of priorities ... it is not number one, number two, or number three.”<sup>124</sup>

The overall tone of the PSI effort of the 1990s was more burden-sharing than privatization. CACs were part – even if the mildest part – of a policy package that signaled “we want banks to take a hit.”<sup>125</sup> The official sector was not about to get out of the crisis management business; rather, private creditors that got a subsidy post-Mexico would now be asked to pay their way. In the late 1990s, the official sector was united around bond comparability and lending into arrears on bonded debt. These were measures that governments could and did implement on their own, with minimal cooperation from the private sector. Once they did, officials could wait and see how bond restructurings might pan out. Within two years, Pakistan, Ukraine and Ecuador had secured high participation rates in distressed bond exchanges without significant litigation.<sup>126</sup> Ecuador was especially influential because it restructured New York law Brady Bonds without CACs, thanks in part to another market-generated contractual innovation – exit consents.<sup>127</sup>

The context had changed by the time CACs reemerged in 2002, several years after the Paris Club and IMF policies had been implemented. IMF packages were getting even larger under the new U.S. Administration, which had made opposition to bailouts a plank of its foreign economic policy.<sup>128</sup> The new U.S. leadership framed this opposition as leaving the market to its own devices – getting the public sector out of crisis management, rather than making the private sector pay.<sup>129</sup> In contrast, for many European officials SDRM seemed like a natural next step in escalating the PSI debate.

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123 Interview 010306. For a sense of the international economic environment and public perceptions of the role of the U.S. economic policy team, see Joshua Cooper Ramo, The Committee to Save the World, Time Magazine, February 15, 1999, at <http://www.time.com/time/magazine/article/0,9171,990206,00.html>.

124 Interview 102105

125 Interview 010306

126 For example, Interview 091106 suggested that the Paris Club was reasonably satisfied with the market’s “practical, pragmatic” response to bond comparability.

127 Lee C. Buchheit, How Ecuador Escaped the Brady Bond Trap, Int’l Fin. L. Rev. December 2000, at 17; Lee C. Buchheit & G. Mitu Gulati, Exit Consents in Sovereign Bond Exchanges, UCLA L. Rev. 59, 83-84 (2000).

128 Roubini & Setser, supra note 33 at 8-9 and Tarullo, supra note 59 at 651.

129 Taylor contrasted the Bush Administration’s approach to their predecessors’: “They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government-induced bail-ins of the private sector.” Taylor, The Bush Administration’s Reform Agenda, supra note 47. Whether this market focus went beyond rhetoric and the extent to which it made for sound policy is much debated. See e.g., Roubini & Setser, supra note 33, at 8-9, 368-69.

The free-market contingent at the U.S. Treasury needed an alternative that promised to reduce bailouts, empower market forces, and look credible enough to preempt SDRM. CACs – long rejected by Wall Street – were arguably the worst candidate. On the other hand, once SDRM was out of the box, the time constraint was real, especially if one believed as some did that the debate itself was harmful to the markets. No other palatable alternative had materialized. Republican officials may have found philosophical appeal to a fix that literally “came from the markets” in the form of standard English-law contracts, and bonus bureaucratic appeal to a fix that looked familiar and essentially harmless to the finance officials in the major industrial countries and even some emerging markets countries that had to buy into CACs to make the shift happen. Within two years, CACs went from being a symbol of “bail-ins” to being a symbol of market-friendly reasonableness.<sup>130</sup>

Taylor noted the early history of CACs in his public statements and private outreach.<sup>131</sup> Several officials specifically credited the education efforts of the 1990s with the initiative’s quick progress in the 2000s, speculating that if CACs had first sprung up on the eve of Argentina’s default, they would have taken another decade to adopt.<sup>132</sup> Most of our interviews with investors and emerging markets officials suggest little knowledge of the history. Some of this may be due to personnel changes. One executive prominent in the 2003 shift speculated that he was too junior to have been included in the CAC conversations of the 1990s.<sup>133</sup> (A Washington team met with the head of his operation in 1999.) Another investor privy to both iterations of the initiative described a subliminal learning process: “People were worn out ... also knew that the public sector lived for that stuff and would never wear out.”<sup>134</sup> In retrospect, early advocacy increased the volume and sharpened the focus of CAC information in the public domain; the drumbeat also raised awareness of bond contracts among some creditors and helped frame the mandate for groups like the Emerging Markets Creditors Association (“EMCA”).

For European officials, the life of CACs between 1995 and 2003 looked more like a continuous effort ten years in the making,<sup>135</sup> even if it proceeded in fits and starts and in distinct phases:

As for the two iterations, there are clear distinctions. I do not think they are completely and absolutely distinct – they [led] into one another. Excuse the analogy, it is like the process of labor – one contraction leading into another. But they were significantly different. ... People who think of success or failure in the international domain bring up the idea of a hegemon. The fact that the U.S. was behind this was necessary but wasn’t sufficient. The U.S. was certainly behind

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130 Interview 010306

131 Taylor, *Essential Reform*, supra note 91.

132 Interview 102705

133 Interview 030306

134 Interview 070206

135 Interviews 021706, 091106, and 071006

the first phase as well.<sup>136</sup>

This official divided the policy push into three phases – the 1995-1996 Rey Report, which was essentially a G-10 only exercise notwithstanding, the 1998 G-22 report on crisis resolution, authored by a group of officials from major industrial and emerging market economies in equal numbers, and the “Taylor-Quarles” phase, which mobilized an even broader range of actors, including lawyers and diverse members of the investor community.<sup>137</sup> Another European described a more diffuse process:

I do not particularly subscribe to individuals make a difference school of thought. If the Rey report had not been written, if Eichengreen-Portes hadn't produced the report, if O'Neill hadn't encouraged Krueger to give her SDRM speech ...the Quarles working group, Taylor's advocacy, Buchheit's advocacy (and these people were important advocates) ... would have taken place in a vacuum.<sup>138</sup>

On balance, even if market outreach had limited visible effect, it seems fair to trace the education and buy-in process among officials to 1995, and for a small but important subset, even further back to the restructurings of the late 1980s. There is some irony to the fact that CACs' most important and powerful proponents in the official sector – Deputy-level Bush Treasury officials – were also the last to arrive on the scene. It helped that their career staff were familiar with the clauses, and that their principal international interlocutors knew about them and were in principle open to them. The accretion of press and academic studies that made CACs look harmless at worst, and often helpful, boosted the officials' rhetorical arsenal and increased their comfort with advocating new terms.<sup>139</sup>

The way in which the new team pursued CACs is instructive. As Under Secretary for International Affairs, John Taylor was head of Treasury's international division; Quarles was his deputy. They oversaw an organization of 150 or so staff, organized into “functional” and geographic offices.<sup>140</sup> Functional offices are responsible for policies that span geographic regions, such as international debt, development, trade, terrorist finance, and U.S. participation in institutions such as the IMF and the World Bank. “Country” offices are responsible for policy with respect to specific countries and regions, and generally maintain staff-level communications with other finance ministries and central banks. The functional office responsible for U.S. policy in the IMF and the G-7 process had the “lead” in staffing the CAC initiative, with input from in-house lawyers and the office of the U.S. representative at the IMF.

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136 Interview 021706

137 Id.

138 Interview 071006

139 Interviews 100705, 061506.

140 <http://www.treas.gov/organization/org-chart-122005.pdf>

Between Krueger’s first speech in November 2001 and the summer of 2002, the lead office collected research on the clauses, and consulted with academics, some emerging markets issuers, and selected market participants (mostly trade groups and researchers at large investment banks). Early efforts focused on including CAC advocacy in important policy signaling documents, such as G-7 communiqués, speeches and other public statements by senior U.S. officials, meetings with foreign counterparts, and market outreach. This was similar to the late 1990s tactics.

In April 2002, the G-7 Finance Ministers and Central Bank Governors adopted an “Action Plan” to strengthen crisis prevention and resolution.<sup>141</sup> G-7 ministers’ meetings usually yield statements and communiqués, broader-brush documents meant to signal economic trends and policy intentions. An Action Plan signaled urgency and specificity – an emphasis on results reflecting the public style of the new U.S. team. “Contingency clauses” were the first item in the plan, followed by limits on IMF lending, greater transparency in official decision-making, and further work on SDRM (which “would take time”). The one-page plan described the clauses in detail, tracking Taylor’s speech a few weeks earlier. CACs also appeared in G-7 statements in the 1990s, but their prominence in this “action” document meant a promotion.

One official described the plan as a U.S.-British compromise to diffuse European support for SDRM and present a united G-7 front for CACs. Shortly after giving the speech that launched the CAC campaign, Taylor traveled to Russia. On the way back, he stopped for a G-7 meeting in London. There, Taylor and his U.K. counterpart Gus O’Donnell agreed to frame CACs as a predicate for limiting IMF lending in crisis—a policy long advocated by the Europeans.<sup>142</sup> For the Clinton Treasury, CACs were marginal and strict limits were unacceptable (and in any event not credible); for their successors, both CACs and limits sent a message against bailouts. Concerned that the other G-7 members would see any U.S.-British deal as suspect, Taylor and O’Donnell asked the Canadian deputy to present what became the Action Plan.<sup>143</sup>

Everyone reports that Treasury’s CAC strategy shifted either in the summer of 2002, or following the disastrous meeting with issuers and investors in September. Staff in “country”

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141 Action Plan, April 20, 2002, available at <http://www.treasury.gov/press/releases/po3015.htm>. See Blustein, *The Chastening*, supra note 80 at 34-36 for a discussion on the role of the G-7 Finance Ministers’ meetings and G-7 Deputies’ channels in international economic policy.

142 Taylor, supra note 36, at 119–20. The Clinton Treasury had a powerful ally in U.S. Federal Reserve Board Chairman Alan Greenspan. Greenspan, Rubin, and Summers were loath to tie their own hands, and in any event had viewed hard IMF lending limits as not credible. Taylor suggested that CACs gave lending limits credibility in Greenspan’s eyes. Taylor, supra note 36, at 120. Others who knew Greenspan speculated that he went along with the deal because the new limits were still plenty flexible, while the clauses did no harm. Interview 100705.

143 Taylor, supra note 36, at 120. Canada chaired the G-7 process that year. The Canadian finance ministry welcomed the new approach as reflecting ideas Canada had been pressing for years to reform international financial architecture. A chronology accompanying the Canadian press release dates the architecture reform effort to the start of Mexico’s Tequila Crisis in December 1994, and features Canada’s advocacy of CACs and its own CAC issue in 2000. Press Release, G-7 Fin. Ministers, Can. Dep’t of Fin., Adopt Financial Crises Action Plan (Apr. 20, 2002), available at <http://www.fin.gc.ca/news02/02-034e.html>.

offices were charged with learning the issuance pipeline for their region in the last quarter of 2002 and early 2003, working with in-house lawyers and using informal market contacts. The lead functional office put together a composite log and coordinated an intensified outreach plan with calls from Taylor, Quarles, and other officials to finance ministers, deputies, and debt managers in the issuing countries. With issuers' permission, U.S. officials and staff also contacted the lawyers and investment bankers involved.

Our official sector contacts stressed that there was no “arm-twisting”, no threats were made and no rewards were promised. Taylor and others have described an exercise in persuasion;<sup>144</sup> the briefings and reports we have seen do nothing to refute this characterization. It is difficult to ascertain how the conversations were perceived on the other end. While none of our investor and emerging markets contacts would admit to having their own arms twisted, many seemed certain that twisting was going on elsewhere. U.S. officials and staff involved in the calls describe the response as mixed – some ministers knew nothing of the clauses; others said they had heard issuing with CACs would be costly. Everyone was polite, but no one volunteered. Smaller, shakier issuers said they could not afford to jeopardize their market access; others said they had no plans to default, did not need new clauses, and would not risk paying a penalty for no good reason.<sup>145</sup> The outreach log from January 2003 records lots of “broadly supportive” and “maybe next time” sentiment. Issuers pointed to the bankers, bankers pointed to the issuers, everyone pointed to the investors. One U.S. official painted this picture:

Don't think any of them saw it as in their own interest. Lawyers – why should they change? They have a template, they are making good money. Countries risk the yield going up. Imagine a finance minister [who is] responsible for spreads going higher. Investment community saw it as taking power away from them...<sup>146</sup>

Against this background, broadening investor outreach was a key aspect of the new strategy. As noted, in the first half of 2002, officials were in frequent contact with trade associations and research analysts at investment banks (the “sell-side”). End investors (the “buy-side”) were usually represented in these discussions by members of EMCA, a group that emerged out of Ecuador's Brady default in 1999.<sup>147</sup> EMCA had been vocal in opposing any contract change that would diminish investor protections.<sup>148</sup> By the end of 2002, U.S. officials engaged with a broader cross-section of the buy-side, including large investors who reached out to the Treasury and tried

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144 Taylor, *Essential Reform*, supra note 91.

145 Interviews 061506, 121305.

146 Interview 061506

147 Background on EMCA is available at <http://www.emcreditors.com/about.html>

148 For the EMCA response to Mexico's February 2003 issuance with CACs, see [http://www.emcreditors.com/pdf/EMCA\\_Press%20Release\\_2\\_26\\_03.pdf](http://www.emcreditors.com/pdf/EMCA_Press%20Release_2_26_03.pdf).

to distance themselves from EMCA positions.<sup>149</sup> On the sell-side, the team shifted focus from research to bankers “actually doing deals”:

After we really got down into the dirt [in late 2002], making calls to the debt managers in the countries and to the real live investment bankers actually doing the deals, these people knew very little about the whole CAC debate. It was quite astonishing. The people doing the deals hadn't been going to the conferences, could have cared less, hadn't heard much from the conference goers, and didn't know much at all. They just knew how to generate fees. So, the private sector talking heads weren't worth much.<sup>150</sup>

By late 2002, outreach to issuers suggested that no single country was willing to go first. As an alternative, the U.S. Treasury and its allies in the investor community tried to get a group of highly rated issuers, potentially including Mexico, Korea, Poland and South Africa, to announce together their intention to issue with CACs. The announcement would not be linked to any particular issue that might fail. To set the stage, they planned a meeting with the target issuers in late February, a week or so before John Snow's first G-7 Finance Ministerial. The objective was to have large investors reassure the countries that they were willing to buy their debt with CACs and did not expect to charge a penalty.

At the last minute, Mexico canceled. It later turned out that Mexican officials were meeting with their bankers and lawyers to plan for the country's first CAC issue. By many accounts, U.S. officials found out about the issue shortly before the launch. According to Mexican officials, the Finance Minister broke the news casually at the end of a lunch with the new Treasury Secretary.<sup>151</sup> One senior U.S. official describes intense coordination leading up to the launch, where Treasury pledged and delivered a public statement of support and procured similar backing from the G-7; others describe a compressed process following Mexico's surprise revelation.<sup>152</sup> Within days of Mexico's announcement, at Snow's first G-7 meeting, the United States signaled the end of the two tracks. SDRM was officially shelved in April.<sup>153</sup>

Just as SDRM was identified with Anne Krueger, in 2002-2003 many saw CACs as John Taylor's initiative. Observers familiar with early CAC efforts said Taylor's voluntary contractual initiative was doomed on arrival. Comments from the audience at his April 2002

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149 Interviews 100605 and 030306

150 Interview 121605

151 Interview 121205

152 Interviews 061606, 121605. While the precise form and timing of the issue appear to have been a surprise, file memos indicate that Mexican officials told their U.S. counterparts that they were ready to move in principle as early as January. See also U.S. Treasury Statement Regarding Decision by Mexico to Issue Bonds with Collective Action Clauses (February 24, 2003), available at <http://www.treasury.gov/press/releases/200322418171120575.htm>.

153 G-7 Action Plan Implementation, April 2003, April 12, 2003, available at <http://www.treasury.gov/press/releases/200341213252315778.htm>

speech predicted nothing would happen without a government mandate; hallway chatter bordered on disparaging – but Taylor seemed undaunted.<sup>154</sup> In less than a year, he proved them all wrong. For a non-lawyer, Taylor had an impressive grasp of how key clauses worked; he missed no opportunity to raise CACs in speeches and testimony, and asked for frequent progress reports on the initiative. He was invested in the targeted, intensive outreach. Contacts at all levels described encounters where Taylor – a mild-mannered man – showed visible frustration with the slow progress to CACs, most notably in late 2002. One person remembered getting a call while Christmas-shopping at Target – “Nothing is happening, we need to do something!”; another only tangentially involved with CACs recalled Taylor’s reaction to a CAC-less bond issued without Treasury’s knowledge – “There is no excuse, we should be calling everyone!”<sup>155</sup>

Some suggest CACs made sense as a defensive move on Taylor’s part – “the principal aim was to stop SDRM and his mad boss.”<sup>156</sup> Yet among all U.S. participants in the CAC episode, only academic economists (of which he is one) expressed Taylor’s level of enthusiasm for the clauses’ substantive value and their potential importance in crisis. Taylor’s website puts CACs among his most important accomplishments at the Treasury, under the headline “Essential Reform of the International Financial System: Collective Action Clauses”, and alongside Iraq’s reconstruction, terrorist financing, and China’s exchange rate. In speeches, he has credited the success of the CAC effort partly to the post-9/11 spirit of international cooperation. We have no way of knowing whether this conviction was genuine; if it were, we can only speculate on the reasons. But we cannot help wondering whether a cooler, more pragmatic approach to CAC advocacy in 2002 might have failed as its predecessors had in the late 1990s: “History needs a midwife in this situation. John was the midwife.”<sup>157</sup>

### 3.3. The Ultimate Market Story

Our first two stories suggest that the CAC shift was driven by the authorities in major financial markets, often in the face of vehement protests on the part of the very emerging market officials the clauses were meant to benefit.<sup>158</sup> In our third story, we pull together the different interview strands that address Mexico’s motives for moving first.

SDRM was malingering at the IMF, the U.S. Treasury had lobbied Mexico for months, and clause drafting efforts were proliferating, sponsored by the G-10 and creditor associations. These factors weighed against what seemed like unwavering resistance at the highest levels in the Mexican government. The core Mexican team responsible for making the decision consisted

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154 Interview 010306.

155 Interviews 121405, 121605

156 Interview 010306, Taylor, *supra* note 36 at 116.

157 Interview 092705

158 See Setser, this volume.

of three officials led by the Finance Minister. The Minister went so far as to write a scathing 13-page letter to O'Neill in November 2002, expressing his intractable opposition to both CACs and SDRM.<sup>159</sup> What changed minds so drastically that (apparently, on a weekend) Mexican officials called their lawyers down to Mexico City to implement CACs?

We heard two explanations. Market participants, both lawyers and bankers, told of a rumor that a small country was going to launch an offering using creditor-friendly clauses with a high amendment threshold. Such unfavorable CACs risked becoming market standard if Mexico did not preempt this unnamed country. Others focused on Mexico's leading role in opposing SDRM. A trade press account of the CAC shift suggested that taking SDRM off the table was the quid pro quo that Mexico extracted out of the United States.<sup>160</sup>

Both stories are problematic, even though we heard them from multiple sources. Not one of our contacts had a clue as to the identity of the country in the "small country-bad clauses" rumor, raising the possibility that it was just that – a rumor. In public and in private, Mexican officials expressed only a general desire to preempt bad precedent, and concern about proliferating public and private initiatives that threatened to destabilize the boilerplate. Bankers and lawyers involved in the deal echoed the sentiment.

As for fear of SDRM and the quid-pro-quo theory, it rings only partly true. It is unlikely that a U.S. Treasury under John Snow would have continued the two-track charade much beyond the spring of 2003. Hubbard's keynote at the IMF conference on January 22 signaled to a spectrum of interested parties that White House support was not there. On the other hand, even after Mexico's debut, a market-wide shift looked far from certain. Mexico's issue was a hopeful sign and a new argument for the contract contingent, but not mission accomplished. And in any event, even wholesale adoption of CACs was never an adequate substitute for statute in the SDRM camp. Almost two years and two dozen CAC issues since Mexico, one U.S. contact speculated that if a vote were held on the day of our interview, a majority of the IMF Board would have supported SDRM.<sup>161</sup>

So, what moved Mexico? Mexican officials tell the ultimate market story – an issuer with significant market power that perceived a threat to this power from a mix of official meddling and bondholder activism:

For us, the issue was our role as issuer. We were concerned about the state of discussion on the markets ... What generated the change? We didn't like the fact

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159 Interview 100605, 121405

160 Salmon, *supra* n. 37. Like Salmon, we found no evidence of other tradeoffs, for example, on immigration or trade policy. The fact that the White House was uninterested in CACs makes these kinds of tradeoffs unlikely.

161 Interview 121305B. The figure of 70% was widely circulating in late 2002-early 2003. Interview 013106

of being pushed around by international initiative where our fate was not very clear.<sup>162</sup>

This is not so much a story of Mexico eager to get the best possible clauses into its debt, or Mexico worried that SDRM would come to pass, but of Mexico worried that talk of SDRM – *and* clauses – would not stop. The talk got everyone thinking about default (the morgues), threatened to create uncertainty in the markets about G-7 and IMF behavior in crisis, and to increase the cost of capital for the very countries supposed to benefit from the initiatives.

We have no way of knowing whether the story of market and political leadership that we read in the press and heard from Mexican officials in fact reflects their true motives for using CACs. Virtually all the lawyers, bankers and investors involved in the first CAC deal, as well as the G-7 officials who lobbied Mexico, stress reputational factors and U.S. pressure and de-emphasize the CACs' substantive value. The narrow scope of Mexico's CACs as a technical matter supports the point.

To the extent Mexico wanted to use the CAC incident to create a perception of autonomy and leadership, it was wildly successful. A European official put it this way:

Mexico may have been ahead of the curve ... They not only earned the respect of the official sector (that didn't mean anything to the Mexicans) – they showed the markets that they were ahead of the markets. ... They are too intelligent, too sophisticated to have believed SDRM was a realistic possibility.<sup>163</sup>

Market participants and officials alike were effusive about the Mexican debt managers' intelligence, sophistication, financial acumen, and investor relations style. Mexico, they said, was not like any other emerging markets issuer. Observers spoke of a "revolutionary experience", a "transformation of mentality between 1994 and 2000", of getting "out of the victim mentality" that plagues the emerging markets.<sup>164</sup> Reacting to an early draft of this study, one U.S. official mused that his Mexican counterparts "may well have been the only adults in the whole crowd":

[Mexico's Deputy Secretary of Finance Agustín] Carstens had been Mexican ED at IMF. He was always very open minded and into modernizing the IMF – he was ok on transparency etc, which put him in contrast with many of his EM colleagues on the Board. In FinMin, he worked a lot with markets. I actually think Agustin was being internationalist minded at the time and believed that he

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162 Interview 121206

163 Interview 021706

164 Interview 060606

thought Mexico should be internationalist to show that it was playing a greater role as a responsible player on the global scene. He and Alonso Garcia should be mega-stars of the article.<sup>165</sup>

While Mexico's circumstance and leadership indeed stood out at the time, many of our contacts also noted that the shift conceived in the turmoil of the 1990s finally happened under unusually benevolent market conditions, when interest rates in mature market economies were at all-time lows and investors flocked to emerging market debt.<sup>166</sup> Mexican debt was investment grade, and attracted growing numbers of crossover investors. The government had pre-financed for the year, and did not need the money from the CAC issue (it used the proceeds to retire more costly Brady Bonds). It was difficult to envisage a better time.<sup>167</sup> But in the mind of a key Mexican participant, the experiment was not riskless:

At the time, Mexico could issue \$1 billion on a day's notice; everyone knew our contracts. [Issuing with CACs] disturbed it a little bit without an immediate benefit for Mexico. ... Push [to] strengthen international financial system. ... Instead of opening the book in the morning and closing six hours later oversubscribed, three days working the phones. Some committed clients surprised, some sensed betrayal – [because Mexico had] not consulted them.<sup>168</sup>

The same official described CACs as beneficial, but suggested that their principal benefit in 2003 was to let business people return to business:

Both debtors and creditors like having a set of contracts, and proceed to issue. Impractical to make the issue of contracts ... [Settling procedural terms] allows to focus on the substantive issues of the transaction – issues, rights, options – this is what the market participants want.<sup>169</sup>

In this framing, which we also heard from other emerging markets contacts, government debt managers are first and foremost market participants, whose goal is to minimize borrowing costs.

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165 Interview 121605. At the time of this writing, Carstens is the Finance Minister of Mexico. ED stands for Executive Director.

166 A biweekly sell-side research note a few weeks before Mexico's launch described the market conditions: EM debt has soared in recent days in moderate volume, allowing the asset class to deliver a year-to-date return in excess of 2%. The rally in the US Treasury market, where 10-year yields have dropped from 4.20% two weeks ago to below 4.00% at present, is creating a hothouse effect for investors in EM bonds. Portfolio managers in the US and Europe continue to receive inflows of funds looking to be invested in EM bonds.

ABNAMRO Emerging Markets Fortnightly, February 9, 2005, at 1. For example, Interviews 060706, 070206 and 070706.

167 For example, Interview 030106

168 Interview 121206. Note this official's use of "clients" to denote investors in his country's debt.

169 Interview 121206

We got the distinct sense that when these officials spoke of a disequilibrium that prompted the CAC shift, they referred to the flurry of public sector crisis resolution initiatives. For them, public good and international prestige came by way of being market actors *par excellence*.<sup>170</sup>

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<sup>170</sup> Here it is useful to contrast Mexican and U.S. accounts of the months leading up to the first CAC issue. Mexican officials and their advisers stress the fact that the decision was made independently and all but sprung on the U.S. Treasury, even as they express gratitude for U.S. and G-7 support. U.S. officials emphasize long-term, painstaking coordination.

#### 4. CONCLUSIONS

Public explanations of the rapid market-wide shift in sovereign bond amendment provisions reflect a traditional understanding of contracts. In the official accounts of the CAC episode, contract terms matter because they regulate the actions of contract parties: they facilitate or impede debt workouts, motivate decisions to pay, default, hold out or restructure, and serve as vehicles for contingency planning and risk allocation between the sovereign and its bondholders. Absent statutory bankruptcy, a sovereign constrained by unanimity might refrain from launching a debt restructuring, while bondholders might leverage unanimity to extract side payments. When negotiating new contracts, a sovereign that expects to restructure (arguably a defining feature of the emerging market asset class<sup>171</sup>) might seek lower amendment thresholds. Bondholders would seek amendment thresholds high enough to control “rogue” borrowers, but not so high as to invite holdouts and deadweight losses. A reasonably high majority amendment clause in emerging market bonds seems desirable and attainable from this perspective.

Why did it take so long to break the unanimity habit in New York? Literature on boilerplate would point to learning and network externalities. These in turn underlie many of the public explanations for the shift: governments, investors, lawyers, official and private groups variously get credit for helping market participants overcome switching costs associated with learning and network effects.<sup>172</sup> Collective action problems and switching costs also help justify government involvement in private contracts. SDRM makes sense both as an alternative means of promoting collective action, and as a stick to push the markets to switch to CACs—a way of altering the calculus for switching costs.

But the view of contracts we got in most of our interviews differed from the one that underpins these explanations. Despite the apparent risks of holdouts under unanimity, and the equally apparent merits of majority amendment as a fix, participants in the CAC shift consistently refused to cite these as motivating factors for their efforts. Early movers asserted that amendment terms had no bearing on a sovereign’s decision to default or restructure, were routinely ignored by investors buying sovereign bonds, and while potentially helpful at the margins, may not function as expected in crisis. Whether or not this is the case, the interviews give us no basis to conclude that parties adopted CACs to improve their contracts, and therefore provide no basis to assess the learning and network explanations.

Instead, the participants’ attitude to contracts evokes Stewart Macaulay’s classic 1963 study of

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171 See Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance*, 2003 *Brookings Papers on Econ. Activity* 1 (2003).

172 Taylor was among those who suggested paying countries to switch. Taylor, *supra* note 64.

Wisconsin manufacturers.<sup>173</sup> Macaulay found that contracts often played a bit part in the business relationships they purported to govern.<sup>174</sup> This conclusion was at odds with the prevailing contracts literature, which was built on the presumption that contracts mattered in a very literal sense for their stated technical function. Macaulay's findings raised three kinds of questions for contracts scholarship. First, how should courts interpret terms left vague or apparently ignored by the parties? Second, if contracts (or, for that matter, the law) did not govern business relationships, what did? Third, why would anyone spend time and money on contract terms that were, in the parties' own words, beside the point?

Answers to the first two questions are the subject of a distinguished literature.<sup>175</sup> The third question has drawn increasing attention from scholars.<sup>176</sup> While our project did not start out trying to answer the third question, our findings point in its direction. We studied sophisticated market actors who deliberately changed their contracts in an apparent attempt at contingency planning. But most of them told us that they were not worried about the contingency the new terms addressed, and insisted that these terms were at best marginally useful in managing risks associated with default. They said they adopted the terms in their private contracts primarily to send a public message to non-parties—other governments, international institutions, and the broader markets—in the hope of getting political, reputational, and economic benefits.

Law scholars and economists have written about the use of contracts to send messages. In 1941, Lon Fuller described what he called a “channeling function” of the contract form.<sup>177</sup> According to Fuller, parties write their contracts, he says, not only to serve as evidence in court or to constrain one another's commercial behavior, but also to communicate something about their

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173 Macaulay, *supra* note 15.

174 *Id.* at 57–67.

175 See, e.g., Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 *Va. L. Rev.* 1089 (1981) for a classic treatment of the first question. Macaulay's own study focused on answering the second question. Although it addresses statutes and ordinances more than contracts, Ellickson's research on economic relations among cattle ranchers offers critical insights into the second question. Ellickson, *supra* note 17. Lisa Bernstein's work is an example of the first two questions joined: she identifies private commercial norm systems, but argues against judicial reliance on commercial custom in contract interpretation. See Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 *Mich. L. Rev.* 1724 (2001) and Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 *U. Chi. L. Rev.* 710 (1999). See also Richard Craswell, *Do Trade Customs Exist?* in Jody S. Kraut & Steven D. Walt, eds., *The Jurisprudential Foundations of Corporate and Commercial Law* (2000) at 118-148 (arguing that judges bring their experience and biases to bear in identifying custom).

176 Mark C. Suchman, *The Contract as Social Artifact*, 37 *L. & Soc'y Rev.* 91 (2003), offers the broadest theoretical framework for answering the third question. The literature on the “boilerplate” phenomenon (see Goetz & Scott and Kahan & Klausner, *supra* note 5; Omri Ben-Shahar and John A.E. Pottow, *On the Stickiness of Default Rules*, 33 *Fla. St. U. L. Rev.* 651 (2006)) addresses one aspect of the question: why parties fail to reform suboptimal terms. Few legal studies offer an affirmative case for including contract terms for reasons other than their mechanical function. But see, e.g., Claire A. Hill, *A Comment on Language and Norms in Complex Business Contracting*, 77 *Chi.-Kent L. Rev.* 29, 56 (2001) (suggesting that the signaling value of contract terms may be distinct from their mechanical function).

177 Lon L. Fuller, *Consideration and Form*, 41 *Colum. L. Rev.* 799, 801–03 (1941).

relationship to the outside world.<sup>178</sup> Contract theorists in economics have described instances where the contract form itself serves as a signal, conveying information to would-be parties.<sup>179</sup> More recently, Mark Suchman proposed the notion of “contract as artifact,” where a contractual device serves not only as a technical solution but also as a symbol and gesture.<sup>180</sup>

The function of CACs and of the contract form more broadly that emerges from our interviews resonates with these strands of the contracts literature. But it is not an easy fit. For example, our interviewees frequently described their use, non-use, support of, or opposition to CACs as “signaling.”<sup>181</sup> Yet CACs look ineffective as an economic signaling device—a way to tell good borrowers or instruments apart from bad ones in the face of information asymmetries.<sup>182</sup> Before 2003, all emerging market sovereigns issuing bonds in New York, regardless of credit quality, used contracts with unanimity. To the extent unanimity was meant to signal that bonds would not be restructured, exchange offers (especially Ecuador’s) made it meaningless.<sup>183</sup> After Mexico, Brazil, and Uruguay changed their bond contracts in 2003, adopting CACs in New York became effectively costless for sovereigns, again, regardless of their credit rating. The precise formulation of an issuer’s CACs, including the voting threshold, also seemed to lose significance almost immediately as a means of conveying the likelihood of default or restructuring.<sup>184</sup>

In our contacts’ accounts of the CAC shift, “signaling” (in the broader sense of using contract terms to communicate) was often done by and directed at non-parties – people and institutions outside the contract. The same contract form conveyed different messages depending on who was communicating and with whom; it became a medium of communication. For example, CACs may have communicated both Mexico’s status as a market leader and the Bush administration’s desire to stop bailouts. At some point between 1996 and 2005, CACs in New York law bonds went from standing for economic weakness, reduced willingness to pay, and official coercion of private creditors, to standing for strength, of market and political leadership,

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178 Id.

179 See, e.g., Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 *Am. Econ. Rev.* 388 (1987), for a domestic commercial example; Joseph Stiglitz, *this volume*], for a related argument in the sovereign context; see generally Patrick Bolton & Mathias Dewatripont, *Contract Theory* 100–27 (2005).

180 Suchman, *supra* note 176, at 108–15. See also Hill, *supra* note 176, at 56.

181 Participants used similar language in public statements. For example, Taylor observed, “I did look for opportunities to take some immediate actions that would signal change, in particular, that we wanted to move in the direction of ‘rules’ or ‘limits’ [on official lending] . . . .” Taylor, *supra* note 36, at 108. Mexican officials said the CAC move was meant “‘to send a signal’ to the markets, and that . . . there was almost no chance of a debt restructuring within the next 12 years.” Authers, *supra* note 37.

182 A. Michael Spence, *Job Market Signaling*, 87 *Quarterly J. of Econ.* 355 (1973) (describing a mechanism by which good employees can distinguish themselves from bad ones by acquiring costly but otherwise useless education).

183 Cf. Choi & Gulati, *supra* note 16, describing Ecuador’s restructuring as a shock that reduced the value of unanimity as a device to discipline debtors. Regardless of its technical efficacy, unanimity’s value as a signal that bonds could not be restructured would have been lost. Cf. discussion of “moral commitment” in Brady bonds, *supra* note 102 and accompanying text.

184 For example, lawyers for a leading trade association observed that their contract analysis product was most interesting to academics; members paid little attention. Interview (June 4, 2007).

and market-friendly policies.<sup>185</sup>

Our interviews also raise new questions about the role of governments in the incident. Market forces and official conspiracy are equally implausible as stand-alone explanations for the shift. That said, much of the credit for the CAC shift goes to newly appointed U.S. officials anxious to distance themselves (at least symbolically) from their predecessors' crisis management strategy. They invested unprecedented time, prestige, and intellectual resources in promoting an increasingly familiar and inoffensive contract term under historically favorable market conditions. The campaign proceeded in tandem with a statutory alternative, which came to look viable almost accidentally, thanks to the intervention of a maverick U.S. Treasury Secretary. The official sector encouraged drafting efforts and pricing studies whose principal value appears to have been rhetorical and political. The G-10-sponsored drafting group in particular implicated leading private sector lawyers in the official effort, spurred competition with trade associations seeking a different market standard,<sup>186</sup> and ultimately created an implicit benchmark for countries' clauses.

For issuers and bondholders alike, all this activity did not reduce, but exacerbated uncertainty about future crisis management. It also destabilized sovereign bond boilerplate, dislodged settled meanings, and opened a range of contract terms to variation. Mexican debt managers described this as a threat; others saw an opportunity.

This pattern of official activity does not look like regulation, even of the soft "cueing" variety. Despite persistent misperceptions to the contrary,<sup>187</sup> the U.S. government did not preempt private contracting in the CAC episode, as it had in the Trust Indenture Act's unanimity requirement for U.S. corporate bonds. Officials' adoption of private contract terms as a symbol of their free-market agenda, and especially their deep involvement in drafting and negotiating substantive content, resemble the behavior of a party.

This observation is consistent with Bulow and Rogoff's view of sovereign debt as a three-party relationship. Creditor-country taxpayers have a vested interest in the resolution of sovereign-debt crises (for example, to maintain mutually beneficial trade), and are willing to make side

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185 This fits well with Suchman's "symbolic" accounts of contract formation and contract regimes. He borrows from anthropologists, describing contract terms deployed as "signs" and "gestures" that change meaning over time and depending on who is using them, and perform legitimating functions for specific actors and actions. Suchman, *supra* note 176 at 110-114, 126-128.

186 Creditors sought to control debtor moral hazard, pointing to Argentina as the "rogue debtor". Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 *Chi. J. Int'l L.* 311 (2005). For the role of associations in producing boilerplate, see Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate* 104 *Mich. L. Rev.* 1075 (2006).

187 See, e.g., Beattie, *supra* note 35.

payments to debtors and creditors to make the deal happen.<sup>188</sup> The long history of official involvement in sovereign debt matters may have led debtors and creditors to believe they had a contingent claim on the official sector. Taking Bush II Treasury officials at their word, they saw themselves as unwitting third parties to sovereign bond contracts, committed to provide financing in the event the parties failed to restructure in crisis. The CAC initiative was presented as a way to push the private sector to write the official sector out of the boilerplate, eliminating or reducing the scope for a bailout. According to Taylor, “a rules-based reform of the IMF was inseparably linked to a reform of the process for sovereign debt restructuring.”<sup>189</sup> The strategy would work only if CACs in fact facilitated restructuring without official intervention.

Here the communicative and technical functions of contract terms blend: a quasi-party, such as the U.S. government, seeks to use amendment provisions to remove itself from the contract. U.S. advocacy of CACs *both* told the world about the policy shift and tried to accomplish the policy shift via contract change. In another example of blending, the investment community and Mexico deployed CACs to preempt official initiatives, notably SDRM. Preemption was an instrumental use of clauses, albeit not one readily discernible from reading their language. Adopting CACs sent the message that the market solved the collective action problem on its own; the contractual solution obviated the need for SDRM.

These examples raise the question of how the technical and communicative functions of contract relate to each other. For example, if CACs did not, as a technical matter, make a material difference in a debt workout, were they less credible as a gesture on the part of the Bush II Administration? On the other hand, did CACs’ success at preempting official initiatives reflect their efficacy at solving collective action problems?

Answers to these questions are beyond the scope of this chapter. No one knows for sure how CACs will work in the next crisis.<sup>190</sup> Our study does not stand for the proposition that they in fact do not or could not matter, or should be ignored. Our interviews reveal only that CACs had a communicative function apart from and in addition to any actual or potential technical function, that this communicative function had both public policy and private market dimensions, and that in 2003, CACs’ value as a communication device, more than their technical merits, was instrumental in the market-wide boilerplate shift. At this writing, one small issuer, Belize (a Buchheit client), has used New York-law CACs to restructure a bond. The transaction concluded

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188 Jeremy Bulow & Kenneth Rogoff, *Multilateral Negotiations for Rescheduling Developing Country Debt: A Bargaining-Theoretic Framework*, 35 IMF Staff Papers 644 (1988). Similarly, a U.S. cabinet official we interviewed referred to the public sector’s predicament as “the realtor squeeze”—an analogy to real estate brokers who sacrifice part of their commission to close home sale. Interview 121906.

189 Taylor, *supra* note 36, at 110.

190 This does not mean, of course, that sophisticated market participants could not calculate amendment thresholds, but rather that none was willing to predict how the presence of CACs might affect issuer and investor behavior in a restructuring, or bet against a maverick litigator forcing a small debt issue out of a restructuring notwithstanding the presence of CACs.

without incident – as did most of the CAC-less restructurings before it.<sup>191</sup> Just about everyone we interviewed agreed that in the next big crisis, CACs might help on the margins, but will not change the policy response or the economic outcome. Perhaps the next crisis will have nothing to do with New York-law bonds. Do Ghanaian-law bonds have CACs?<sup>192</sup>

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191 Participation rates were in the high 90s, about on par with Ecuador and Uruguay. Interview 092205. See generally Federico Sturzenegger & Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (2006), for other restructuring outcomes.

192 Kathryn Wells, *Sovereigns Look Abroad: G8 Debt Relief Package Will Not Constrain Issuance Plans*, *Euromoney*, Aug. 9, 2006, at 54.