

Avoiding a Lost Decade --
Sovereign Debt Workouts in the Post-Covid Era

Lee C. Buchheit & Mitu Gulati

Abstract

All sovereign debt restructurings risk undershooting (providing *less* debt relief than is needed to restore the country to long-term sustainability) or overshooting (extracting *more* debt relief from creditors than turns out to have actually been necessary). Of these, undershooting will be the greater risk in sovereign debt workouts in the post-Covid era. Bondholders can be expected to prefer short and shallow debt restructurings that provide near-term debt relief (time enough to sell out of sticky positions). As for the future, creditors will endorse Doris Day's assessment -- *que será será*. For their part, politicians in the debtor country may also prefer a quick restructuring that provides abundant short-term debt relief even if it complicates the life of the next administration. The last time a systemic emerging market sovereign debt crisis was handled through a series of short and shallow debt restructurings was in the 1980s. It bequeathed to the debtor countries what is still called the Lost Decade. Can a similar fate be avoided in the decade that has just begun?

* * * *

Avoiding a Lost Decade --
Sovereign Debt Workouts in the Post-Covid Era

Lee C. Buchheit
Mitu Gulati*

In the late summer of 2020, Ecuador and Argentina each concluded restructurings of their foreign currency bonds. These were not the first post-Covid era sovereign debt workouts; they were the *last pre-Covid* sovereign debt restructurings. Both countries had been in debt distress before the pandemic began and, somewhat ominously, the financial terms of the two debt restructurings may have been framed without regard to the longer-term consequences of the Covid crisis.¹

Many countries entered 2020 with historically high debt stocks, in some cases a legacy of fiscal stimulus programs that followed the 2008 financial crisis. Those countries that could do so have borrowed heavily in the last six months to defray the cost of Covid amelioration and economic stimulus measures. Even taking into account the benign effect of zero (or negative) interest rate policies in developed countries and the colossal amount of liquidity that has been injected into the system by large central banks, many emerging market countries are facing a bleak outlook if the longer term effects of the Covid crisis on the world economy are as grisly as the IMF seems to think they may be.²

Emerging market countries experienced what economists call a “sudden stop” at the outset of the pandemic (March 2020) -- an abrupt cessation of external capital

* The authors are affiliated with the Center for Contract and Economic Organization, Columbia University and the Department of Law, Duke University, respectively.

¹ See, e.g., Agustino Fontevicchia, *Default in the Times of Coronavirus: Argentina's Ticking Time Bomb*, FORBES (Apr. 28, 2020).

² International Monetary Fund, *A Crisis Like No Other, An Uncertain Recovery*, WORLD ECONOMIC OUTLOOK UPDATE (June 2020).

flows. While this proved to be a temporary phenomenon last spring, a recurrence would quickly push a number of countries into unsustainable debt positions.³ Even if the private capital markets remain in their current “risk on” mood a while longer, not all emerging market sovereign borrowers can expect to benefit from their munificence.⁴ In short, there is a chance that we are on the cusp of a systemic emerging market sovereign debt crisis of a kind not seen since the global debt crisis of the 1980s and early 1990s.⁵

The Lost Decade of the 1980s

More than two dozen emerging market countries were forced to reschedule their external debt in the 1980s, more or less simultaneously.⁶ The causes of the global debt crisis are not relevant here. The method by which that sovereign debt crisis was handled during its first eight years, however, offers important lessons. The lenders in that era were exclusively commercial banks. The sovereign debt portfolios of many of the world’s largest commercial banks represented for those institutions a potentially existential vulnerability. And a collapse of the commercial banking systems in the United States, Europe and Japan would have plunged the developed world into a deep crisis.

The debt restructuring technique employed during the period between 1982 (when the global debt crisis began) and 1990 (when the first of the so-called Brady Initiative deals signaled the end of the crisis) was therefore deliberately short-term

³ See Jeremy Bulow, Carmen Reinhart, Kenneth Rogoff & Christoph Trebesch, *The Debt Pandemic*, FINANCE & DEVELOPMENT 12 (Sept. 2020).

⁴ Jubilee Debt Campaign reckons that 32 countries are currently at risk of a private sector debt crisis. See <https://data.jubileedebt.org.uk> (last visited, September 25, 2020); see also Jonathan Wheatley, *Emerging Economies Tap Debt Markets But Risks Pile Up Ahead*, FIN. TIMES (Sept. 28, 2020) (“. . . a capital flows tracker by Capital Economics suggests that emerging markets suffered net capital outflows of \$30bn in August [2020], their biggest outflows since the \$55bn the consultancy registered in March at the height of the market panic.”)

⁵ See Bulow et al., *supra* note 3.

⁶ See Jeffrey Sachs, *Managing the LDC Debt Crisis*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 397 (1986).

and assiduously ruled out any reduction in the size of the debt stocks. Maturing principal amounts of the loans were serially rolled over for short periods of time throughout the decade. Interest rates actually went *up* during the early years. Any mention of the need for a reduction in the principal amount of the debt was anathema: a full bucket of scorn would be poured over the head of any commentator reckless enough to suggest otherwise.⁷ Many countries repeated this process three or four times during the decade. This debt restructuring technique had one overriding objective — to protect the balance sheets of the commercial banks in the developed world until such time as the possibility of deeper debt relief would not threaten the solvency of those institutions.⁸

It all looked rather different from the debtors' side of the fence. The serial rescheduling of the principal amount of a country's debt left that debt stock hanging like a miasmatic cloud over the country's economy. Foreign investment and voluntary capital flows into the economy were effectively blocked by that cloud. Rampant capital flight bred ubiquitous capital controls. Economies shriveled. Citizens of the debtor countries increasingly fell into extreme poverty. The statistical indicia of human misery -- infant mortality, life expectancy, educational levels, health care standards -- told a grim story. It was aptly called the "Lost Decade." The crisis did not begin to abate until the commercial banks were compelled by a change in government policy starting in 1989, mainly in the United States, to write off a portion

⁷ See Lee C. Buchheit, *You'll Never Eat Lunch in This Conference Room Again*, 11 INT'L FIN. L. REV. 11 (April 1992) ("In 1982, the acceptable word for all aspects of this situation was 'temporary'; the taboo phrases were 'medium-term' and the unthinkable 'long-term'."); Karin Lissikers, *BANKS, BORROWERS AND THE ESTABLISHMENT* 190 (1991) ("Commentators who dared to suggest that the debt problem was more than temporary and that big losses lay ahead for the banks were dismissed as Cassandras by Citibank chairman Walter Wriston"). Lissikers provides an astute assessment of the reasons why "a majority of banks [insisted] that this was a short-term problem in the face of strong evidence to the contrary." *Id.* at 192-195.

⁸ "The perceived vulnerability of some large banks was one of the principal, though unpublicized, arguments made by U.S. Federal Reserve Chairman Paul Volcker and others as to why the borrowing-lending game must go on even under duress." Lissikers, *id.* at 208.

of their sovereign debt portfolios and to stretch out the balance for 30 years -- the Brady Initiative.⁹

Could It Happen Again?

A bad-case, though not necessarily the worst-case, scenario for the coming decade envisions a world in which the effects of the Covid pandemic force multiple emerging market countries into unsustainable debt positions. Financial assistance from the International Monetary Fund and other official sector institutions will require the staff of the Fund to be able to certify that the countries' adjustment programs are likely to restore sustainability and this, in turn, will almost certainly entail sovereign debt restructurings.¹⁰

This will not, however, be a simple replay of the 1980s. Private capital market flows to these countries in the post-Brady era have come mostly from non-commercial bank institutional investors in the form of bond issuances. While multiple sovereign debt restructurings may occasion an audible creaking of the balance sheets of some of these institutions,¹¹ the financial system of the developed world should not again be hanging in the balance.¹² Does this mean that a global

⁹ See Lee C. Buchheit, *The Background to Brady's Initiative*, 9 INT'L FIN. L. REV. 29 (April 1990).

¹⁰

More prolonged macroeconomic and financial impacts [of the Covid-19 pandemic] would raise the potential for the pandemic to be followed by a wave of sovereign debt problems in [Emerging Market and Developing Economies]. The potentially large impact of the pandemic on the solvency of these borrowers may require deep restructurings, implying large losses for creditors and potentially involving protracted and difficult negotiations. In extreme scenarios, these impacts could also have financial stability implications.

International Monetary Fund, *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors — Recent Developments, Challenges, and Reform Options* 43 (Sept 23, 2020) (hereinafter, "IMF 2020 Report").

¹¹ See Matt Wirz, *Ashmore Fund Tripled Down, Then International Trouble Tripped it Up*, WALL STREET JOURNAL (Nov. 21, 2019).

¹² See IMF 2020 Report, *supra* note 10 at note 76.

sovereign debt crisis in this decade will produce financially adequate sovereign debt workouts that will quickly return the debtor countries to sustainable debt positions and avoid the 2020s being called the Second Lost Decade? We fear it may not.

Although the solvency of systemically important lending institutions ought not to be in jeopardy, there will be several other factors pulling sovereign debt restructurings in this decade in the direction of providing only short and shallow debt relief. Unless checked, these tendencies could result in debt workouts that are perceived by potential new investors as insufficient. Such a perception would -- as it did in the 1980s -- inhibit economic growth and greatly increase the risk of another lost decade.¹³

Short and shallow debt workouts in the post-Covid era will exert a strong gravitational pull for these reasons:

Uncertainty. The known unknowns surrounding this pandemic are many. When will the pandemic abate? How much damage will have been inflicted on the world economy when it does? How long will it take for tourism, remittances and tax revenues to recover? Where will commodity prices settle? Will private capital markets be prepared to finance countries facing these uncertainties? Will multilateral financial institutions have exhausted their financial resources fighting the pandemic with little left over to repair the damage left in the wake of the crisis? In

¹³ Serial debt restructurings have been a regular feature of sovereign finance over the past 40 years. The IMF reports that for the 99 sovereign restructurings of private foreign debt between 1980 and 2012, only a third resulted in durable cures (the rest were inadequate, producing the need for additional restructurings). Between 1980 and 2020, multiple countries -- including Ecuador, Argentina, Jamaica, Brazil, Poland and Mexico -- have restructured their external private debt a half dozen or more times. See International Monetary Fund, *The Fund's Lending Framework and Sovereign Debt – Annexes 34-37* (June 2014). A few of these workouts resulted from external shocks such as natural disasters, and some from recurring fiscal mismanagement, but it is hard to avoid the conclusion that in many cases the financial terms of the debt restructurings themselves were insufficient to achieve a durable solution to the country's problem. See International Monetary Fund, *Recent Developments and Implications for the Fund's Legal and Policy Framework* (April 26, 2013); see also Ugo Panizza, Frederico Sturzenegger & Jeromin Zettelmeyer, *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LIT. 651 (2009) (describing the "too little, too late" phenomenon commonly seen in sovereign restructurings).

the face of all these shrieking uncertainties, some may argue, why should creditors be compelled to provide permanent, substantial debt relief? After all, things may not turn out as badly as the pessimists now fear.

Speculative DSAs. Debt Sustainability Analyses (“DSAs”) are the principal analytical tool used to calculate whether a country’s debt load can be serviced without undue pressure on the economy. When a DSA flashes a red warning light of unsustainability, however, the DSA becomes the blueprint for an eventual debt restructuring. Even in normal times -- and these are not normal times -- a DSA that predicts a country’s debt servicing capacity two or three years out represents an educated guess. Projections seven or eight years out are speculative. And after about ten years, a DSA is for all practical purposes an exercise in occult divination.

The uncertainties surrounding the effect of the Covid epidemic on the world economy, for which history offers no good precedents, will render post-Covid DSAs even more conjectural than usual. Asking creditors to provide medium to long term debt relief on the basis of such fragile DSAs may be difficult.

Expedition. If sovereign debt restructurers in the coming decade were barbers, they would starve. Above all else, bondholders loathe haircuts -- permanent reductions in the principal amount of their claims.¹⁴ Even the recent Ecuador and Argentine deals achieved most of their debt relief through maturity extensions and interest rate adjustments; principal haircuts were minimal in both cases. Sovereign debtors that ask for significant reductions in the size of their external liabilities in the coming decade should therefore expect debt negotiations that are longer, more

¹⁴ There is a logic to this position. A bondholder participating in a sovereign debt workout hopes that the country’s economic prospects will improve once the deal closes. If prospects improve, the discount rate that the market uses to determine the current value of the stream of future payments under a debt instrument issued by that sovereign will shrink. Shrink the discount rate and the current market value of the instrument will increase. But if the bondholder is asked to write off a significant portion of the face amount of the instrument as part of the debt restructuring, there won’t be much left upon which this increase in present value can operate.

contentious and leave in their wake far more holdouts than would have been the case had the countries limited their demands to simple maturity extensions and interest rate relief.¹⁵

Political frailty. All sovereign debt crises are crises. Every rightly-constructed politician in a debtor country will therefore want the problem to be over quickly, if at all possible, well before the next election. A shallow treatment of the country's debt, with heavily front-loaded debt relief during the term of the current administration, will instinctively appeal to most politicians, even if it is likely to leave the next administration in difficulties when that debt service holiday runs out.

Liquidity. A modern investor in a sovereign's bonds need not worry about the country's medium and long-term economic outlook. This is a benefit conveyed by a liquid financial instrument: the investor can easily exit its position at the first sign of trouble. It is the *next* owner of the bond, or the one after that, or some other remote holder of the instrument who will have to fret about the future. For an investor that marks its positions to market -- as most now do -- the focus will be on the market value of the bond this quarter, this week, today, this morning in fact. As we saw in the Argentine and Ecuador debt workouts earlier this year, such investors will be obsessed with the "recovery value" of their bonds in a debt workout; that is, the anticipated market value of the bonds on the day that the deal closes. If a shallow debt restructuring produces a satisfactory recovery value today, little creditor sleep

¹⁵ Commercial creditors are not the only ones who find principal haircuts distasteful. Although the Paris Club of bilateral creditors commendably accepted significant haircuts for the very poorest countries as part of the Highly Indebted Poor Countries (HIPC) Initiative commencing in the late 1990s, the Paris Club has shown a marked preference for simple "flow" reschedulings of principal payments for the middle income countries that come before the Club. Principal haircuts ("debt stock treatments" in the patois of the Paris Club) for middle income countries are not unknown in the Paris Club, they are just very rare and usually betray the application of intense geopolitical pressure. The 80 percent principal haircut given by the Paris Club to Iraq's Saddam-era debt in November 2004 is perhaps the best example. See Lex Rieffel, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 82-85 (2003) (providing a description of Paris Club terminology and policies regarding debt stock reduction). The view of the world's largest bilateral creditor, China (not an official member of the Paris Club), toward significant haircuts in a sovereign debt workout is unclear but is generally thought not to be welcoming.

will be lost over whether the terms of the deal are likely to bestow on the country a durable financial position down the road. Today's bondholder does not expect to be there for tomorrow's debt restructuring.

Overshooting and Undershooting

Given the uncertainties about the outlook for the world's economy, sovereign debt workouts in the immediate post-Covid era will involve an enhanced risk of either overshooting or undershooting the amount of debt relief needed to restore the debtor country to a sound financial footing. Of these, overshooting -- asking for more debt relief than turns out to have been necessary -- is the lesser risk. In cases where creditors worry about overshooting they may ask for the debt restructuring to include some form of value recovery instrument. These are instruments that call for additional payments by the sovereign if, for example, the market price of the main commodity export of the country exceeds a pre-established benchmark price. Most of the oil exporting countries that issued Brady bonds in the 1990s (Mexico, Venezuela, Nigeria) were required to issue "oil warrants" as part of their Brady debt restructurings.¹⁶ In more recent sovereign debt workouts (Ukraine and Greece are examples), the debtor countries issued warrants linked to their future gross domestic product.¹⁷

Apart from value recovery instruments, there is an inherent structural cushion for mark to market bondholders against the damage caused by overshooting in a sovereign debt workout. Overshooting implies that things have gotten better in the debtor country sooner and/or to a greater extent than had been foreseen when the financial terms of the restructuring were struck. If and when that happens, all mark to market holders of the sovereign's bonds should benefit from the resulting increase

¹⁶ See Lee C. Buchheit, *No Easy Route to Recovering Value*, 10 INT'L FIN. L. REV. 7 (Sept. 1991).

¹⁷ See IMF 2020 Report, *supra* note 10, at paragraphs 8 & 45; see also Marc Jones, *Ukraine to Look at its GDP-Linked Bonds*, REUTERS (Oct. 9, 2017).

in the market value of those securities; a prospect all the more pleasant for being unexpected.

Undershooting will be the more serious risk in post-Covid era sovereign debt workouts. When investors perceive a debt restructuring as inadequate to restore the country to medium-term debt stability, they will view today's debt workout as just an admission ticket to the next debt restructuring. It then becomes a self-fulfilling prophecy. Investors sense that another debt restructuring will be needed. They accordingly refrain from making the investments that would have allowed the country to *avoid* another debt restructuring. The prophecy then is fulfilled: another debt restructuring does indeed follow. And if that second workout proves to be similarly insufficient, the process begins again.

The staff and management of the IMF have sometimes been the main bulwark against debt relief undershooting. The staff must certify to the Executive Board of the Fund whether a proposed program is likely to restore debt sustainability for the country. If the terms of a proposed debt restructuring are viewed by the staff and management as making an insufficient contribution to that objective, they may refuse to recommend the program to the Executive Board. In the recent Argentine restructuring, for example, the IMF staff publicly signaled that significant further concessions by the Argentine authorities in their private sector debt negotiations would be inconsistent with the goal of debt sustainability.¹⁸ That said, relying exclusively on the stiff vertebrae of IMF staffers to arrest undershooting in sovereign debt workouts may be incautious. Political pressure on Fund economists, and sometimes even on the Executive Board itself, can occasionally result in a willingness to view a debtor country's economic prospects with excessive

¹⁸ “[A] person with direct knowledge of the IMF’s thinking cautioned that it would be ‘very hard’ to improve the value of the deal beyond a net present recovery value of 50 cents on the dollar while maintaining a sustainable debt burden.” Benedict Mander & Colby Smith, *IMF Officials Say Argentina Can Improve Debt Restructuring Offer*, FIN. TIMES (June 2, 2020).

optimism.¹⁹ The result can be a Fund program that tacitly accepts less debt relief than a more sober analysis might have indicated was needed.

Bondholders of a certain age may even remember instances in which the IMF's own crystal ball clouded up. In Uruguay's 2003 debt restructuring, for example, the IMF staff strongly encouraged the Uruguayan authorities to pursue a principal haircut in the country's international bonds as part of the workout.²⁰ The Uruguayans demurred. They argued that a simple five-year stretch-out of maturities, without even a coupon adjustment, should be sufficient. Subsequent events proved the Uruguayan assessment to be correct; debt sustainability was restored without a reduction of principal, and the country has never again needed to seek debt relief from its bondholders.

At the present state of the sovereign debt restructurer's art, there are no good contractual techniques for mitigating the risk of debt relief undershooting. Some commentators have promoted the issuance of "contingent" sovereign bonds that would automatically adjust payment terms in the event that the debtor country falls into renewed debt distress.²¹ These instruments would incorporate a feature that automobile designers call a "crumple zone." For an automobile, this means designing the vehicle so that a front-end collision will not result in the engine landing inconveniently in the lap of the driver. A crumple-zone feature in a sovereign bond would automatically adjust payment terms to cushion the shock of a future adverse event, as manifested and measured by a decline in the debtor country's gross domestic product below a pre-established level. The theory is that such a crumple

¹⁹ See International Monetary Fund, *Greece – Ex-Post Evaluation of Exceptional Access Under the 2012 Extended Arrangement* (Feb. 7, 2017) ("In the event, macro outcomes were far below the baseline and while some of this was due to exogenous factors, the baseline macro projections can also be criticized for being too optimistic.")

²⁰ See Felix Salmon, *Uruguay's Elegant Transformation*, EUROMONEY 86-91 (Feb. 2004).

²¹ See James Benford, Thomas Best & Mark Joy, *Sovereign GDP-Linked Bonds*, Bank of England Financial Stability Paper #29 (2016); Yannis Manuelides, *GDP-Linked Bonds: A Comment on a Termsheet*, 12 CAP. MKTS L. J. 125 (2017); see also IMF 2020 Report, *supra* note 10, at paragraphs 43-44.

zone would convey debt relief to the borrower when needed and might thus avoid the need for a full-scale restructuring of the instrument.

In theory, a contingent bond that automatically adjusted payment terms up or down depending on the country's future economic performance could address, within certain bounds, the risks of both overshooting and undershooting in sovereign debt workouts. As sensible as the idea of contingent bonds may be, however, it has not yet attracted a quorum of converts. Creditors fear that sovereigns could manipulate the GDP benchmarks.²² The crumple zones embedded in such instruments may turn out, in practice, to be less or more than the sovereign actually needs at the time -- itself a variation of the overshooting/undershooting dilemma. For their part, sovereign debtors fear that the market will exact a basis point penalty at the time of issuance of a contingent instrument as the price of including a crumple-zone feature that may never be used.

A Covid Codicil

There may be an alternative.

Most sovereign bonds issued in the international markets today contain some version of a collective action clause ("CAC"): a provision allowing the supermajority of holders of the instrument to modify its terms in a manner that binds all holders. The voting threshold to activate these clauses for changes to the payment terms of an instrument are typically high. Depending on the clause,²³ holders of 85%, 75%, sometimes 66 $\frac{2}{3}$ % of the outstanding principal amount of the instrument must affirmatively consent to the modification. In the ordinary case, this makes sense. If an issuer wishes to alter the terms of its contract, the issuer carries the burden of

²² See *Warranting Attention*, THE ECONOMIST (Sept. 26, 2013) (describing Argentina's manipulation of official statistics, which then risked triggering the GDP-indexed warrants).

²³ See Lee C. Buchheit & Mitu Gulati, *The Argentine Collective Action Clause Controversy*, CAP. MKTS L. J. (forthcoming 2020) (describing four generations of collective action clauses).

persuading the preponderance of its creditors that the change is necessary and appropriate.

Sovereign bonds issued in a generalized debt restructuring, however, are not ordinary. The financial terms of such bonds will, or at least should, reflect a judgment about the country's future debt servicing capacity. But this is at base a prediction about the course of future events and is thus inescapably speculative. An assessment of the Republic of Ruritania's debt servicing capacity will be influenced by predictions about future conditions in Ruritania, about geopolitics, about the future of the global economy, about the financial markets and about the vicissitudes of the natural world (pandemics, hurricanes etc.). Any assessment of Ruritania's future debt servicing capacity will thus be highly elastic. Add a dollop of optimism to that assessment, sweeten with a respectful reference to a Merciful Providence, and Ruritania's prospects can begin to look plausibly peachy.

The creditors caught up in a sovereign debt restructuring will have every motivation to be sanguine about Ruritania's future. The higher the assessment of future debt servicing capacity, the lower the amount of debt relief that the incumbent creditors will need to swallow in the current debt restructuring. For its part, the sovereign debtor will have mixed feelings. At one level, of course, it will want as much debt relief as can be extracted from the lenders without inflicting lasting bruises on the country's credit reputation. In theory, this should counsel stone cold sobriety in forecasting Ruritania's future debt servicing capacity. Pulling in the other direction, however, the sovereign will want to reach a deal with its creditors, preferably a quick deal. And if that means embracing an optimistic view of Ruritania's future, well then... *Viva Ruritania!* As noted above, the convergence of these sentiments often exerts a gravitational pull toward short and shallow sovereign debt workouts. The uncertainties of a post-Covid environment will, we believe, only increase that gravitational force.

By succumbing to this gravitational pull, however, both sides of the negotiating table in a post-Covid sovereign debt restructuring will be consciously assuming a

risk of debt relief undershooting. The incumbent crop of lenders caught up in the restructuring will be making a clear-eyed choice to minimize the quantum of debt relief they will accept today at the risk that they (or their successors in title) may need to provide supplemental relief down the road.²⁴ As the beneficiaries of that bargain, we believe that the current creditors can reasonably be asked to relax the CAC voting threshold that would apply if the need for a subsequent debt restructuring materializes. Such an operation would, after all, really just be the second phase (let's call it "Phase Two") of the initial restructuring ("Phase One").

In Phase One of the debt restructuring, traditional CAC voting thresholds will apply to potentially sensitive issues such as the nature of the debt instruments that will be issued in the workout, the designation of which creditors will receive which instruments and the value of those instruments relative to each other. The Phase One CAC voting thresholds will also protect against the risk of "ganging up" on minority bondholders.²⁵ As long as the Phase Two process respects the tactical decisions that had been made in Phase One, and limits itself to seeking additional debt relief proportionally across all instruments issued in Phase One, there should be no need to apply the traditional CAC voting thresholds in Phase Two. A simple majority vote should suffice. Moreover, if all holders of all instruments are being treated proportionally in Phase Two, there should be no obstacle to a fully aggregated vote by holders of those instruments.

²⁴ Felix Salmon describes this assessment by Uruguayan bondholders in 2003 in these terms:

The insertion of CACs [in Uruguay's restructured bonds] . . . was clearly a way of making any future debt restructuring easier. But the market approached the CACs maturely, and didn't seem to worry that Uruguay was sending a signal that it was going to go through the whole process all over again once the new bonds started coming due in five years' time. Everybody understood, it seemed, that the lack of a haircut this time around meant a higher debt burden, and therefore a higher marginal probability of future default. But certainly on a net present value basis, it is better to get cashflows for another five years and then worry about default than to suffer a default today in the hope of minimizing the chances of another later.

Salmon, *supra* note 20.

²⁵ Buchheit & Gulati, *supra* note 23.

We shall call a provision lowering the CAC voting threshold in a Phase Two debt restructuring a “Covid Codicil” to the collective action clauses in the sovereign’s restructured bonds. Such a provision should have these features:

- It should be time bound. The more time that passes after the Phase One debt restructuring, the greater the chances that events that could not have been foreseen at the time of the first restructuring will be the cause of the sovereign’s later debt distress. And when the need for a Phase Two debt restructuring cannot reasonably be attributed to insufficient debt relief in Phase One, the justification for relaxed CAC voting thresholds diminishes. Five years strikes us as a reasonable period. If another debt restructuring for the country is required within five years of an initial restructuring, it seems fair to conclude that the first restructuring suffered from debt relief undershooting.
- There must be an objective assessment of unsustainability. A lower CAC voting threshold of a simple majority will obviously make the Phase Two debt restructuring easier. It therefore cannot be left in the discretion of the sovereign borrower to decide whether a second round of restructuring is needed. The only body with both the technical competence and political legitimacy to make such an assessment is the International Monetary Fund. For a Covid Codicil to be activated, we believe the IMF staff would need to certify that the country was again facing an unsustainable debt position in the absence of supplemental debt relief and other adjustment measures.
- Proportional relief should be sought from all series of bonds. The Phase One debt restructuring (with normal CAC voting thresholds) will have established both the series of the new bonds issued in the workout and the relative value of those series in relation to each other. There is no need to revisit those features in what amounts to an adjustment of financial terms in Phase Two. Accordingly, a

proportional amount of additional debt relief -- probably expressed in net present value terms -- should be sought from each series of bonds issued in Phase One, thus preserving the tactical and relative value choices made in the negotiation of Phase One. To secure the needed majority support, bondholders may also insist that proportional debt relief be sought from other creditor groups such as bilateral creditors.

- Fully aggregated voting. Assuming proportional terms are applied to all series in Phase Two, there should be no reason why all series could not vote in Phase Two on a fully aggregated basis.

In an ideal world, the very existence of a Covid Codicil in a country's restructured bonds permitting, if necessary, supplemental debt relief with the consent of only a bare majority of bondholders, would be enough to assuage the concerns of future investors about the country's prospects. Were a Covid Codicil to have that effect, it would break the self-fulfilling prophecy curse of shallow debt restructurings. Once convinced of the likelihood that the debtor could obtain additional relief from legacy creditors if needed, new investors may be prepared to support the country's economy in a manner that would ensure that no such additional debt relief is in fact needed.

A sovereign borrower's return to a state of debt distress within five years of a debt restructuring may be wholly attributable to undershooting in the restructuring but probably won't be. The country's failure to implement, or to persevere in, necessary fiscal adjustment policies may well be a contributing factor. How then can bondholders be sure that by accepting a Covid Codicil in the country's restructured bonds they will not just be encouraging post-closing fiscal indiscipline through the provision of supplemental debt relief? Two reasons. First, the triggering of a Covid Codicil would require the IMF to certify that the country is once again facing an unsustainable debt position. As is customary in such assessments, the Fund will determine the extent to which the situation can be addressed through reasonable fiscal adjustment measures and the extent to which it will call for supplemental debt

relief. Second, the sovereign debtor still carries the burden of persuading at least a majority of its bondholders that the requested debt relief is necessary and is proportional to the contribution expected from additional fiscal adjustment and debt relief from other creditor groups. The majority of affected creditors will always have the final say in the matter.

Conclusion

If the trend in post-Covid sovereign debt workouts is toward short and shallow debt relief (a trend already visible in a number of pre-Covid sovereign debt restructurings), some mechanism will be needed to address the risk of debt relief undershooting in these transactions.²⁶ An automatic adjustment to payment terms through a contingency feature may be one option if sovereign debtors and bondholders are prepared to embrace such a feature. A Covid Codicil may be another alternative: it will not avoid the need for a second round of debt restructuring but would make that second round easier and more predictable. The objective, however, should be to avoid a scenario in which countries are forced to undergo serial sovereign debt restructurings, none of which is adequate to persuade new investors that the debtor country has indeed regained a sound financial footing. We lived through such a decade in the 1980s and we know its unfortunate consequences.

* * * *

²⁶ Argentina provides a vivid example. Within weeks of that country's bond restructuring in August 2020, its debt was again being discounted by the market in anticipation of yet another restructuring. See Colby Smith & Benedict Mander, *Argentina Bonds 'Back in Hot Water' Just Weeks After Restructuring*, FIN. TIMES (Sept. 27, 2020).