REVIEW ESSAY

CAN MAJORITY VOTING PROVISIONS DO IT ALL?

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With another slate of countries—most prominently Argentina and Brazil—uttering on the brink of financial collapse—the question of how best to address sovereign debt default is one of the most pressing issues on the global agenda. Drawing on proposals that first surfaced in the 1980s, the International Monetary Fund (IMF) has proposed a sovereign insolvency framework based in many respects on Chapter XI of the U.S. Bankruptcy Code, and it is expected to roll out a more elaborate proposal in 2003. Other observers—including, as of this writing, the U.S. Treasury—have called for a more minimal, contractual approach.1 If sovereign debtors included majority voting provisions in the bonds they issued, the contractualists argue, the parties could restructure the debts on their own, without the need for a new administrative structure.

Sovereign Bonds and the Collective Will, by Lee C. Buchheit and G. Mitu Gulati,2 does not explicitly take sides in this debate. Their goal, instead, is to conduct a simple but very important thought experiment. Just how much could a sovereign debtor and its lenders do, they ask, though clever adjustments to their bond contracts, together with existing procedural devices such as the class action mechanism? Could voting provisions be used to obtain many or all of the same benefits that the IMF and others anticipate from a statutory framework? Given the political obstacles that stand in the way of a sovereign

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1 See, e.g., Michael M. Phillips, Survivors Build for Plan in Ease Debt Loads of Developing Nations, WALL ST. J., Sept. 17, 2002, at A16 ("The Bush administration has thrown its weight behind the idea of urging borrowing governments to include clauses in future bond contracts that would allow a majority of creditors to agree to a restructuring... ").

bankruptcy regime, the significance of these questions can hardly be overstated.

To answer the questions, Buchheit and Gulati first embark on a fascinating historical tour of the development and use of majority voting provisions by ordinary corporate debtors. Majority voting dates back to 1879 in England, but the practice was stymied in the United States, first by negotiability concerns and later because the Securities and Exchange Commission (SEC) persuaded Congress to prohibit voting on key bond terms. This divergence endured, and it was replicated in the sovereign debt context, where sovereign bonds issued under London law include collective action clauses but New York-based debt historically did not. Yet nothing prevents sovereigns from including voting provisions in their New York debt.7 If voting provision advocates persuade sovereign borrowers to add these clauses to all of their bonds, including those issued in New York, Buchheit and Gulati predict that U.S. courts may (and, as the authors strongly suggest, should)8 police bondholder voting for good faith to prevent strategic behavior. Although American courts rarely intervene in this way when ordinary corporate debt is restructured, Buchheit and Gulati argue that their laissez-faire stance makes far less sense for sovereign debt because, unlike corporate debtors, sovereigns do not have the option of filing for bankruptcy. The authors go on to propose a variety of adjustments the parties could make to standard bond terms to facilitate a subsequent restructuring, then conclude by considering whether existing procedural mechanisms such as the U.S. class action device could be used “to engage the equity powers of U.S. federal courts in the oversight of some sovereign bond workouts.”9

This is a very happy story—a tad too happy, it seems to me; and I will say more about this in a moment. There is also a puzzling indecisiveness in Buchheit’s and Gulati’s arguments. They strongly hint that collective action provisions obviate the need for a more formal sovereign bankruptcy framework, but they never quite come out and say this.

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7 After this response was first drafted, in fact, Mexico did precisely that, apparently after some arm-twisting by the U.S. Treasury. See, e.g., John Authen, Mexico Sends Signal with Bond Clause, FIN. TIMES, Feb. 27, 2003, at 23 (U.S. ed.). Several other countries—including Uruguay and Brazil—have subsequently followed suit.

8 In other important recent work, one of the authors has explicitly advocated “judicial policing of collective and opportunistic use of the collective action provisions in restructuring.” William W. Bratton & G. Mitu Gulati, Sovereign Debt Restructuring and the Best Interest of Creditors, 57 VAND. L. REV. (forthcoming January 2004).

9 Buchheit & Gulati, supra note 2, at 1948.
But let me make clear from the outset that I am a huge fan of this article. Buchheit’s and Gulati’s historical analysis of majority voting provisions, and their defense of importing good faith oversight, is both innovative and enormously important. Unlike the vast majority of academic articles, Sovereign Bonds and the Collective Will may and should influence how the parties and courts approach collective action provisions in the future.

The commentary that follows is divided into two principal parts. In Part I, I revisit Buchheit’s and Gulati’s historical analysis. I suggest alternative historical explanations for several of the patterns they detect, though I am wholly persuaded by the overall thrust of their argument. I then turn, in Part II, to the choice between collective action clauses and a statutory approach. I conclude, in answer to the question in my title, that majority voting provisions cannot do it all. After arguing that majority voting is not a true substitute for sovereign bankruptcy, I sketch out some of the provisions that a sovereign bankruptcy framework should include.

I.

The historical story told by Buchheit and Gulati is simple, elegant, and extremely powerful. In the late nineteenth and early twentieth century, they tell us, as England was developing majority voting provisions, concerns about negotiability stymied American issuers from following the same path. If the terms of the bonds could be altered by majority vote, the debt would not qualify as an “unconditional promise to pay,” and its marketability would be seriously impaired. Rather than majority voting provisions, corporate debtors who needed to restructure their debt were (once large-scale reorganization was codified) channeled into bankruptcy instead. Buchheit and Gulati argue that, because sovereign debtors do not have a bankruptcy option, American courts may police for good faith, much as American courts did in the decades before Congress enacted the first large-scale corporate reorganization law.

Although I find the authors’ conclusions compelling, I suspect that the history may be a bit more complicated (and perhaps even more interesting) than they suggest. In attributing the absence of collective action provisions to negotiability concerns, Buchheit and Gulati are following the standard account. The original source of this account is the leading corporate reorganization

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4 Id. at 178.
5 Id. at 134.
lawyers of the early twentieth century, which suggests that negotiability must be at least part of the story. But majority voting provisions obviously didn’t bring English bond markets scrunching to a halt. At the least, this suggests that the absence of majority voting provisions was not economically inevitable. If majority voting provisions clearly were important to maximizing the value of corporate debt, I suspect that American issuers and underwriters could have found a way around the negotiability concern. They could have attempted to persuade courts to adopt a more flexible interpretation of negotiability, for instance, or better yet, simply lobbied for statutory changes in key states like New York.

Let me suggest several alternative explanations for the divergent history of English and American bonds. Negotiability was not the only difference between the bonds. The history of American bonds was shaped by two other, very practical considerations as well. The first is that, at the end of the nineteenth century—the very time when English financial experts were developing their new-fangled voting clauses—a large majority of American railroad bonds were sold to foreign investors rather than domestic investors. J.P. Morgan first made its name as America’s preeminent bank by scuttling back and forth across the Atlantic to reassure skittish European investors that the American markets could be trusted. The possibility that the bonds could be altered by a majority vote might have made European investors even more hesitant to buy than they already were.

Second, and of particular relevance for the sovereign debt context, the capital structures of the American railroads were notoriously convoluted. Much like telecom companies in the 1990s, the railroads expanded through a dizzying number of mergers in the second half of the nineteenth century. By the time the dust settled, some railroads had dozens of different classes of bonds, each with a mortgage on different railroad assets. It is not clear that collective action provisions would have helped a great deal in this context. With firms that have issued three or four classes of bonds, majority voting provisions can be used to restructure the firm’s obligations outside of

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8 See, e.g., De Forest Blythe, Corporate Mortgage Bonds and Majority Clauses, 57 Yale L.J. 595 (1948); Robert Swaine, Reorganization of Corporations: Certain Developments of the Last Decade, 27 Colu. L. Rev. 901, 917 (1927).


10 Skeel, supra note 9, at 62.
bankruptcy. When the number of different classes hits double digits, the game probably is not worth the candle; it is too late for collective action clauses, and time for a more thoroughgoing reorganization process.

Indeed, by the time majority voting caught on in England after 1879, the American courts had already stepped in and devised the remarkable equity receivership procedure that was used to restructure American railroads (and later, other large companies) that encountered financial distress. The equity receivership is usually traced back to 1845, \(^{11}\) long before majority voting became all the rage in England, and it, unlike majority voting, offered a full service solution to the railroads’ financial woes.

It is interesting to note that U.S. practitioners’ increasing interest in majority voting clauses in the 1930s fits the complexity story. Many of the companies that experimented with collective action provisions were industrial firms rather than railroads, and the railroads themselves had begun to simplify their capital structures by this era. The point, then, is this: even apart from negotiability concerns, collective action provisions may well have made more sense in England than in the United States. Troubled U.S. firms needed full-blown bankruptcy proceedings, or something like them. Most troubled sovereigns do too, or so I will argue in the next Part.

Before I leave history behind, let me make one more comment about Borchelt’s and Gulati’s historical analysis. The authors’ analysis elegantly underscores the importance of looking not just at the majority voting provisions alone but also at the relationship between these provisions and bankruptcy. Their story suggests that a thriving good faith jurisprudence withered on the vine after Congress codified large scale corporate reorganization in the 1930s because the new bankruptcy framework (complete with majority voting and judicial oversight) \(^{12}\) made it unnecessary. This analysis raises an intriguing question for the sovereign debt debate. Suppose a sovereign bankruptcy framework were created. If it were—a big “if,” to be sure—would this obviate the need for the kind of good faith scrutiny that Borchelt and Gulati propose? I suspect they would say “it depends”—depends, that is, on the kind of bankruptcy framework that was put in place. If the regime were too harsh, sovereign debtors would avoid it, and majority

\(^{11}\) Skeels, supra note 9, at 57-58 (describing the Muirre receivership).

\(^{12}\) The most important innovation added when large scale reorganization was first codified in the early 1930s was majority voting. In the equity receiverships, dissenting creditors could not be bound by the vote of a majority of their peers. See, e.g., Skeels, supra note 9, at 104-06; Buchelt & Gulati, supra note 3, at 135.
provisions would still be where the action was. As it turns out, this was more or less the case in the United States for at least a decade after 1938, when Congress enacted sweeping New Deal bankruptcy reforms. Unfortunately for troubled debtors, Congress also cut off the majority voting option by prohibiting companies from using these provisions outside of bankruptcy. Only later did troubled corporate debtors have a truly meaningful bankruptcy option as a substitute for good faith protection outside of bankruptcy. In the interim, they had to muddle through as best they could, a status that may have discouraged at least some firms from issuing bonds as all.

II.

In the second half of the article, Buchheit's and Gulati's thought experiment takes over. Using the majority voting provision as their base, they imagine how sovereign debt contracts could be restructured to provide all of the benefits that bankruptcy enthusiasts claim for a sovereign bankruptcy framework. The parties could hold maverick bondholders in check by requiring twenty-five percent approval for acceleration or other enforcement. Creditors could facilitate debtor-in-possession financing by voting to subordinate their interests to the new lender. Then, their speculation reaches its most heroic. The parties could use the U.S. class action device, Buchheit and Gulati argue, to effect what amounts to a private receivership.

At this point, I am tempted to say, if it walks like a duck and quacks like a duck, perhaps we should start looking for ducks. The framework Buchheit and Gulati have in mind sounds an awful lot like bankruptcy, so why not just call for that? In a moment, I will do just this, but let me first talk about the limitations of the contractual alternatives they propose.

Start with the majority voting provision itself. Majority voting provisions may be all the sovereign needs to effect a restructuring if it has only issued one or two classes of bonds. But the voting strategy is much less attractive if the sovereign's borrowings are more elaborate. If the sovereign has issued, say,

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13 Chapter 11 of the Chandler Act of 1938 required that the managers of a corporation debtor be replaced with a court-appointed trustee and prohibited the Wall Street bankers and lawyers who had represented a debtor before bankruptcy from continuing to represent the company in bankruptcy. See id., supra note 9, at 16043 (recording the history). Corporate debtors and their lawyers spent the next 40 years trying to evade these rules until Congress enacted the current Chapter 11 in 1978. Id.

14 Buchheit and Gulati briefly acknowledge this concern, Buchheit & Gulati, supra note 2, at 1341, but they go on to consider how voting provisions could be used to achieve a restructuring. The same coordination
a dozen or two separate bonds, holding individual votes on each of the bonds is a much more complicated endeavor.16 Furthermore, the restructuring becomes even more troublesome if some of the bonds have collective action provisions but others do not. As with the nineteenth-century railroads, there comes a point when only a more thoroughgoing restructuring process will do.

Buchheit and Gulati suggest that a more complete restructuring could be effected through a clever manipulation of the U.S. class action device. An obvious problem with this strategy is that the U.S. Supreme Court has shown little stomach for creative use of the class action procedures in recent years. The recent cases have sharply restricted their scope, not expanded it. This is one of the reasons that so many of the major mass tort cases are now handled in bankruptcy rather than under the class action device. Moreover, most other countries do not have procedural devices that are even remotely similar to the U.S. class action, which suggests that the U.S. courts would be the only option for sovereign debt restructuring. An exclusivity that does not seem likely to go over well as a political matter.

There is another problem as well: the contractual strategy does not provide for an adequate "stay" while the restructuring is being negotiated. To be sure, the stay is not as self-evidently necessary for sovereign debt restructuring as for ordinary corporate reorganization. Sovereign creditors' enforcement options are limited if a sovereign decides not to pay. Based on this reasoning, some commentators have argued that the stay is unnecessary.16 But to say that creditors' options are limited does not mean that there is no threat to the sovereign's financial well-being while the restructuring plan is being hammered out. Most sovereigns have at least a few importat assets—the places flown by the country's public airline, for instance—that could be at risk in the absence of a stay. Buchheit and Gulati describe how the risk of rogue creditors could be reduced (most importantly, by requiring a twenty-five percent vote for bondholder action), but once again, these provisions only work for creditors who are subject to them.

16 Recent work by Barry Eichengreen and Ashoka Mody seems to undermine this conclusion. Eichengreen and Mody find that the aggregation clause defined in the provisions over what risk-free debt would count—increase as the number of debt instruments issued by a sovereign increases. Barry Eichengreen & Ashoka Mody, Is Aggregation a Problem for Sovereign Debt Restructuring? (Jan. 2003) (unpublished manuscript), on file with the authors.

I should emphasize that Buchheit and Gulati do not claim that their contractual approach is a complete substitute for bankruptcy. Their thought experiment is exactly that, a thought experiment. But once we look at the test tubes and petri dishes, it seems even clearer that we really do need a sovereign debt restructuring mechanism if we are serious about addressing the sovereign debt crisis. This is not the place to explore in detail what the framework should look like, but we have already been discussing the essential attributes, so let me briefly summarize several of the key provisions.17

The first is binding majority voting provisions. This, of course, is the point of including collective action provisions in bonds. The beauty of bankruptcy’s voting provisions is that they apply even to bonds that lack a voting provision and to other creditors whose claims do not provide for any form of voting.18

Second, the sovereign debt restructuring mechanism needs to provide for at least a limited stay (such as a stay on asset seizures), as I discussed earlier.19

The third is debtor-in-possession financing. Like troubled corporations, financially distressed sovereigns need additional capital to fuel their restructuring effort. For private corporate debtors, the U.S. Bankruptcy Code addresses this concern by giving special priority to the new lender.20 An effective sovereign bankruptcy framework would also need to address the financing issue. The simplest solution is to adopt the same strategy as the U.S.21

18 There is also a cost. I should quickly add if requiring unanimous consent has a desirable disciplining effect on the sovereign ex ante, bankruptcy’s voting provisions override it. My own view is that the disciplining effect of unanimity isn’t likely to function very effectively with sovereigns. For a similar view, see Patrick Bolton, Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Around the World 33-35 (Nov. 2002) (unpublished manuscript, on file with author). The empirical evidence thus far is mixed and inconclusive.
19 A sovereign bankruptcy framework would also include limited currency restrictions in order to address the related problem of capital flight. One possible strategy, recently suggested by Patrick Bolton, is to permit investors to withdraw their cash if they wish, but require them to take it back in the sovereign’s currency after the filing of a sovereign debt restructuring proceeding. Id. at 32.
Bankruptcy Code, and to hold out the promise of priority treatment for the IMF or a private lender that supplies new financing.

The efficacy of a sovereign bankruptcy framework obviously would depend on how effectively it balances the rights of creditors with the interests of the sovereign debtor. Critics worry that the existence of a sovereign bankruptcy framework would make it too easy for debtors to default on their obligations. But the reality is that it is very difficult for creditors to create enforceable priorities under the existing regime, and a sovereign bankruptcy framework could be structured in such a way as to provide more—not less—protection for creditors’ priority rights.21

I do not mean to suggest that the adoption of a sovereign bankruptcy framework should preclude the use of voting provisions. To the contrary, the parties might still decide to use voting provisions in many contexts. The point is simply that a sovereign bankruptcy framework would bring benefits that cannot be replicated through contractual provisions in bonds.

III.

I have spent much of this commentary arguing for a sovereign bankruptcy framework, the principal alternative to collective action provisions, so let me conclude by underscoring Buchheit’s and Gulati’s achievement in their remarkable article. For my money, Sovereign Bonds and the Collective Will is the single most important analysis to date of majority voting provisions—and indeed, of sovereign debt issues generally—thus far in the legal literature. Not only do Buchheit and Gulati explain why London and New York adopt precisely the opposite approaches to collective action provisions, but, drawing on the same historical analysis, they make a compelling case for good faith scrutiny of bondholder interactions in the restructuring context.

The political obstacles to putting a sovereign bankruptcy regime in place are formidable. This will make majority voting provisions all the more important in the meantime, and Buchheit and Gulati outline some extraordinarily valuable ways to make them more effective.

21 For a much more detailed discussion of these points, see BISChem & Steel, supra note 17.