COMMENT

THE RELATIONSHIP BETWEEN INDIVIDUAL RIGHTS AND BOND PRICES: A COMMENT ON *PRICING COLLECTIVE ACTION CLAUSES*

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INTRODUCTION

In their article, *Anticipating Venezuela's Debt Crisis: Hidden Holdouts and the Problem of Pricing Collective Action Clauses*, Professors Bob Scott, Steve Choi, and Mitu Gulati present a pathbreaking empirical study of Venezuelan bonds. They find that enforcement rights, taken on their own, have much less of a price impact than one would have assumed. Rather, they identify "contract arbitrageurs"—typically activist hedge funds—as an important link between enforcement rights and bond prices.[1]

In my view, Scott, Choi, and Gulati's assessment is essentially correct. So, I will use this Comment to expound on the differences between collective and unilateral rights and their expected price impact from a more theoretical perspective and then examine their empirical results in light of these differences.

I. DISTINGUISHING TYPES OF RIGHTS

Scott, Choi, and Gulati distinguish between unilateral and collective rights. In what they call the "bilateral model"—where a single holder owns all bonds—stronger enforcement rights (i.e., unilateral rights) are associated with greater recovery and therefore with a higher price for a bond.[2] Scott, Choi, and Gulati fail to find empirical evidence for this price effect and instead embrace the "collective action model"—where bonds are held by multiple owners—and focus on the presence of a "contract arbitrageur."[3] But I think the "collective action model" could be further refined.

Consider the following types of rights, all of which are mentioned in the article:

- A right of each bondholder to sue for overdue payments of interest or principal (a "unilateral right to sue").[4]
- A requirement that holders of 25% in principal amount of an outstanding issue of bonds must act to take certain steps, such as accelerating the payment of principal (an "acceleration clause") or, as in the case of the Collateral Bond, asking the trustee to enforce the right to the collateral.[5]
- A collective action clause ("CAC"), which permits holders of a supermajority of an outstanding issue of bonds to consent to amendments in the core payment terms (interest rate, maturity, and principal amount) and bind nonconsenting bondholders to the amendment.

[1] *See* Robert E. Scott, Steven J. Choi & Mitu Gulati, *Anticipating Venezuela's Debt Crisis: Hidden Holdouts and the Problem of Pricing Collective Action Clauses*, 100 B.U. L. REV. 253, 253 (2020).

[2] *Id.* at 255 (defining "bilateral model").

[3] *Id.* at 256-57.

[4] *Id.* at 257.

[5] *Id.* at 268.

- A unanimous consent clause ("UAC"), which requires the consent of each affected holder to amendments in the core payments terms.

One would be tempted to characterize a unilateral right to sue and UACs as "unilateral" rights and to characterize acceleration clauses and CACs as "collective" rights. But the issue is not so straightforward. To be sure, acceleration clauses and CACs both envision action by a group of bondholders. But an acceleration clause is an *enforcement* provision where a group wants to take remedial action. By contrast, CACs are, strictly speaking, not enforcement provisions, and nor are UACs. These clauses relate to *amendments* that decrease rights but not to the enforcement of rights.[6]

In addition, acceleration clauses and CACs differ in a more fundamental respect. To see the difference, assume that bondholders are dispersed and that it is impossible—or excessively costly—for bondholders to communicate with each other and for the bond issuer to communicate with bondholders. Under these assumptions, an acceleration clause would be useless because bondholders would never be able to assemble the percentage required to act. That would mean that *bondholders* would not be able to exercise a potentially valuable remedy. Likewise, CACs would be useless because the issuer would not be able to assemble the percentage required to approve an amendment. But, at least as a first approximation, the person harmed by that would be the *issuer* seeking adoption of the amendment.

Put differently, UACs are veto-type provisions: an individual bondholder can veto amendments to the payment terms, at least as far as her own bonds are concerned. But the unilateral right to sue for overdue payments of interest or principal is an affirmative right to take an action. A bondholder does not require the consent of other bondholders to take that action, but the bondholder is not exercising veto power over an action that another group of bondholders wants to take.

As I see it, there are therefore six different types of provisions. Four relate to enforcement: First, a bondholder can have a unilateral right to take an enforcement measure without the need to assemble a group of like-minded bondholders who affirmatively support that bondholder. Second, a group of like-minded bondholders holding a sufficient percentage of bonds can have the right to take an enforcement measure. Third, a group of like-minded bondholders holding a sufficient percentage of bonds can have the right to *prevent other bondholders from* taking an enforcement measure. And fourth, a bondholder can have a unilateral right to take an enforcement measure even if other bondholders affirmatively oppose that measure.

In addition to the four types of enforcement provisions, there are two types of amendment provisions: First, there are provisions that permit a requisite majority of bondholders to bind a nonconsenting minority to the amendment, such as CACs or the majority amendment provisions that typically govern

[6] *See* Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. REV. 1040, 1047-52 (2002) (distinguishing between individual enforcement rights and amendment rights).

nonpayment terms. Second, there are UACs, which require the consent of each affected holder for an amendment.

A typical corporate bond indenture contains most of these types of provisions. Thus, the unilateral right to sue is an example of a unilateral enforcement measure that neither requires the affirmative consent of other bondholders nor can be blocked by the affirmative opposition of other bondholders. Acceleration clauses as well as provisions enabling a majority of bondholders to give directions on enforcement to the indenture trustee are examples of enforcement provisions that require the affirmative consent of a prescribed percentage of bonds. But there are also provisions that permit a majority of bondholders to block enforcement. For example, a majority of bondholders can typically revoke an acceleration. As for amendments, the typical corporate bond indenture requires the consent of each affected holder for amendments to the payment terms but only majority consent for most other amendments.[7]

II. THE RELATIONSHIP BETWEEN UNILATERAL AND COLLECTIVE RIGHTS AND BOND VALUE

I now turn to the claim that stronger enforcement rights are associated with greater recovery and therefore with a higher bond price. I will argue that this relationship does not always hold when bond holdings are dispersed and that, in fact, the opposite relationship may sometimes hold. To show this, I will discuss the theoretical pricing of enforcement and amendment rights under different sets of assumptions.

A. *Dispersed Bondholders - Same Opinions, No Conflict, No Rent Seeking*

Let me start off with a very simple case. Multiple bondholders own bonds of a certain issue. Each bondholder owns a relatively small percentage of bonds and organizing bondholders into a cohesive group is costly. Bondholders are homogeneous: their only interest is to increase the value of their holdings and they agree on the course of action that would do so.

In this simple setting, unilateral enforcement rights are preferable to collective enforcement rights (like acceleration clauses) because they entail lower collective action costs.[8] Whether a majority of bondholders has the right to prevent other bondholders from taking an enforcement measure or whether unilateral enforcement rights can be exercised even over the affirmative opposition of other bondholders would not matter since bondholders have the same interests and agree on how that interest is to be furthered. To that extent, stronger unilateral *enforcement* rights are (weakly) associated with greater recovery and thus, presumably, with a higher bond price.

However, when it comes to amendments, collective action costs are reduced if a majority of bondholders can bind a nonconsenting minority to an amendment. In that respect, therefore, stronger unilateral *amendment* rights

[7] *Id.* at 1047.

[8] *Id.* at 1057-58 (discussing collective action costs with respect to enforcement).

should *not* be associated with higher bond values. At least in this simple setting, bonds with CACs should have a higher value than bonds with UACs.

B. *Dispersed Bondholders - Divergent Opinions, No Conflict, No Rent Seeking*

In the next case, bondholders are still dispersed, face collective action costs, and are only interested in increasing the value of their holdings. Because all bondholders share the goal of maximizing the value of their holdings and because no bondholder is engaged in rent seeking (i.e., no bondholder tries to increase the value of her holdings at the expense of other bondholders), a single course of action is optimal for all of them. However, bondholders disagree on what actions will achieve this goal. I will further assume that support for a course of action by holders of a greater percentage of the outstanding bonds makes it more likely that the course will increase the value of the bonds. This assumption should be uncontroversial if only because the opposite assumption—that support from more bondholders makes it *less* likely that a course of action is beneficial—would be hard to justify.

In this setting, unilateral enforcement rights may still be justified because they entail lower coordination costs; however, they now also carry the risk that a small minority of bondholders will embark on enforcement actions opposed by a majority of bondholders. To reduce that risk, it may be desirable to require the support of holders of some percentage of outstanding bonds for some or all enforcement actions. Moreover, it will generally be desirable to permit holders of a majority of bonds to block enforcement actions and to bind nonconsenting and dissenting minority bondholders to amendments. In other words, neither stronger unilateral enforcement rights nor stronger unilateral amendment rights are clearly associated with greater recovery.[9]

[9] A normative case for unilateral enforcement rights not subject to majority control and for restrictions on the ability of the majority to bind dissenting minority bondholders with respect to amendments could be made based on personal autonomy: if a bondholder favors an action that is likely to reduce the value of her bonds, that is her choice, and one should not stand in her way. *See id.* at 1059. A unilateral enforcement right based on that reason, however, would not necessarily be reflected in the market value of the bonds. Moreover, the autonomy-based argument is dependent on one bondholder's actions not affecting her fellow bondholders. Enforcement actions, however, almost always have some effect on bondholders at large. This is most evident for actions such as acceleration, which results in the entire bond issue becoming due immediately. But even more limited enforcement actions—such as suing for payment of amounts due to an individual bondholder—generate some externalities. For example, defending against the suit and making the payment depletes the company's resources to the detriment of other bondholders.

By contrast, in the context of amendments to payment terms, it is more plausible to envision situations in which a decision by a bondholder not to participate has no detrimental effect on other bondholders. Assume, for example, that a company proposes to shorten the maturity of its outstanding bonds. Most bondholders think this is a good deal and would like to accept. A minority wants to keep its existing, longer-term bonds. If the majority cannot persuade the minority to the change in maturity, the company's proposal can be implemented via an exchange offer in which the bondholders who want to accept it receive the shorter-term bonds

C. *Conflicts Among Bondholders*

We now turn to the setting where bondholders' interests conflict. Bondholders, or their agents, are no longer solely interested in maximizing the value of their bonds but also have other interests that diverge. In the presence of such conflicts, the same course of action is no longer optimal for all bondholders.

Scott, Choi, and Gulati mention several reasons for such conflicts. For example, they note that some bondholders may have sold credit default swaps and would therefore want to block a default declaration regardless of whether a default declaration maximizes bond values.[10] By the same token, of course, a bondholder who has bought a credit default swap may want to generate a default declaration regardless of whether a default declaration maximizes bond values. Elsewhere, Scott, Choi, and Gulati mention the possibility that some bondholders "desire to maintain good relationships with sovereigns" or that institutional investment advisors want to avoid the "burden of justifying large front-end litigation costs to their investors."[11] Maintaining good relationships with sovereigns is yet another extrinsic interest that may lead to conflicts among bondholders. Further, concern over large front-end litigation costs would seem to suggest that agency costs can cause institutional investment advisors to pursue a strategy that does not maximize value for their investors.

As Professor Mark Roe has explained, concern about conflicts of interest was one of the main reasons for the inclusion of Section 316(b) in the Trust Indenture Act.[12] Section 316(b) requires indentures subject to the Act—most corporate bond indentures but not sovereign bond indentures—to provide for two unilateral rights: a unilateral enforcement right to sue for payments of principal and interest after their respective due dates (even if other bondholders affirmatively oppose such suits) and a unilateral amendment right that requires consent by each affected holder to changes in core payment terms (the amount of principal, the interest rate, and the maturity date).[13] According to Roe, the desire of William Douglas, the then-Chairman of the Securities and Exchange Commission (and later Supreme Court Justice),

> to prohibit majority action clauses was partly prompted by a fear that insiders could gain control of a bond issue and destroy it for the insiders' benefit. What the insiders lost by forgoing interest or principal payments, they recouped as stockholders. What the outsiders lost as bondholders, the insiders gained as stockholders. As long as the insiders owned a greater

and the bondholders who do not want to accept it retain the longer-term bonds. In these circumstances, exchanging bondholders should not care that some other bondholders keep their longer-term bonds.

[10] *See* Kahan, *supra* note 6, at 1053-54; Scott, Choi & Gulati, *supra* note 1, at 257.

[11] Scott, Choi & Gulati, *supra* note 1, at 261.

[12] *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 251-52 (1987).

[13] Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp (2018).

percentage of the stock than of the bonds, forgiveness of bond repayment would be profitable for them.[14]

Stronger unilateral rights, according to that account, protect minority bondholders against actions by holders of a majority of bonds who are conflicted and do not pursue maximization of bondholder value. Such conflicts of interest would then provide a basis for the argument that stronger enforcement rights are associated with greater recovery on the bonds and therefore with a higher bond price.

But it is not inevitable that conflicted holders *of a majority of bonds* pursue extrinsic interest at the expense of holders of a minority of bonds. It is also possible that conflicted holders *of a minority of bonds* pursue extrinsic interest at the expense of holders of a majority. For example, in the typical corporate bond indenture, holders of just 25% of the outstanding bonds may issue a notice of default—thereby generating an Event of Default[15]—and holders of just 25% of the outstanding bonds may accelerate the maturity of bonds once an Event of Default has occurred. Generation of an Event of Default or acceleration may benefit certain holders because of extrinsic interests—for example, these holders can hold other instruments that contain cross-default provisions triggered by an Event of Default or an acceleration or they may have bought credit default swaps—even if they do not benefit bondholders at large.

This is yet another reason why holders of a majority of bonds have the rights to revoke an acceleration and to waive most types of defaults.[16] Strengthening unilateral rights by reducing the power of holders of the majority of bonds to control and block the actions of holders of a minority could therefore lead to lower bond values if it is the minority that is conflicted. Of course, if it is the holders of a majority who are conflicted—because they hold shares in the company, because they want to "maintain good relationships," because they have sold credit default swaps, and so on—then strengthening unilateral rights by reducing the power of holders of the majority of bonds to control and block the actions of holders of a minority would increase bond values. Conflicts of interests thus also fail to yield crisp theoretical predictions with respect to the relationship between unilateral enforcement and amendment rights on one side and bondholder recovery and bond prices on the other.

D. *Rent Seeking*

Even UACs—the unilateral right that is most central to the analysis of Scott, Choi, and Gulati and one of the unilateral rights enshrined by Section 316(b) of

[14] Roe, *supra* note 12, at 251.

[15] Most covenant violations are mere defaults and become Events of Default only after notice and passage of time. *See, e.g.*, Ad Hoc Comm. for Revision of the 1983 Model Simplified Indenture, *Revised Model Simplified Indenture*, 55 BUS. LAW. 1115, 1135 (2000). Events of Default have more severe consequences for a company than mere defaults. *Id.* at 1136. Bondholders and the indenture trustee may pursue a remedy only if an Event of Default has occurred and is continuing, and it sometimes takes an Event of Default to generate cross-defaults in other agreements. *Id.* at 1136-37.

[16] *Id.* at 1137.

the Trust Indenture Act—could be associated with reduced bond values due to conflicts of interests. Withholding consent to a change in core payment terms can lead to the failure of a restructuring proposal and, as a result, to a corporate bankruptcy filing or a sovereign payment default. A bondholder who failed to consent may benefit from such a filing or default through other investments.

The main concern about UACs, however, is not that bondholders have conflicts of interests due to extrinsic investments but that some bondholders will hold out.[17] The classic bondholder holdout problem runs as follows: A company in financial distress proposes a restructuring involving changes in the core payment terms. The proposed restructuring would resolve the financial distress and be beneficial to bondholders as a group. If a single bondholder held all bonds, that holder would thus accept the restructuring. Bonds, however, are held by dispersed holders. Each dispersed holder would prefer the restructuring to succeed. But each dispersed holder would be best off if the restructuring succeeded with the participation of *all other bondholders* while she retained her bonds with the original payment terms. When holders of a majority of bonds cannot bind the minority to changes in payment terms—that is, in bonds with a UAC—a bondholder may thus decide to hold out and reject the restructuring proposal, hoping that sufficient other bondholders accept the restructuring to allow it proceed. Note that in the holdout problem, unlike in the conflicts case, each bondholder is merely trying to maximize the value of her bonds—but does so at the expense of the value of the bonds of other holders (and of equity holders).

In the corporate debt context, the holdout problem can inhibit out-of-court restructurings and cause companies to file for bankruptcy. In a Chapter XI reorganization, however, a majority of creditors can bind a minority of creditors to a reorganization plan, thereby overcoming the holdout problem. In the sovereign debt context, of course, bankruptcy is not an option, and the holdout problem is therefore more severe. This concern over holdouts, and the fact that sovereign bonds are not subject to the Trust Indenture Act, has led to the inclusion of CACs in sovereign bonds, which permit a supermajority of bondholders to bind the minority to changes in the core payment terms.[18]

1. Country Has Issued Only a Single Bond

To examine the effect of CACs versus UACs on bond values, let us start with a country that has issued a single bond and proposes a restructuring. Assume the bond contains a CAC. Would that bond have a higher value in the counterfactual case where core payment terms could be changed only with the consent of each affected holder?

If the bond contained a UAC instead of a CAC, it is easier to hold out. Such holding out can lead to several results:

[17] Kahan, *supra* note 6, at 1055-56 (discussing holdout problem).

[18] *See* Michael Bradley & Mitu Gulati, *Collective Action Clauses for the Eurozone*, 18 REV. FIN. 2045, 2045 (2014).

- The proposed restructuring may fail because too few bondholders agree to participate;
- the country proposes a revised restructuring that is better for all bondholders, and the holdouts agree to the revised proposal; or
- the country implements a restructuring with the bondholders who agreed and then strikes a side deal with the holdouts involving greater payment to the holdouts.[19]

If the holdouts would cause the restructuring to fail, then bondholders as a group would be better off if the bond contained a CAC. By contrast, if the holdouts would lead the country to make a superior restructuring proposal to all bondholders, then bondholders as a group would be better off if the bond contained a UAC.

If holdouts alone get a superior side deal, who bears the costs of the superior deal: the other bondholders or the country? Assume first that the other bondholders bear the costs—for example, because the country, anticipating the possibility of holdouts and the need to pay them off, offers a worse deal if the bond issue contains a UAC than if it contains a CAC. Bondholders *as a group* are now equally well off, but not all bondholders receive the same payoff. Further, it is not clear whether the market price at which the bonds trade would reflect the payoff received by the holdouts or the value received by the bondholders who participate in the restructuring. As a result, it is unclear whether bonds would trade at a higher price if they have a CAC versus a UAC and whether this relationship would be stable over time.

By contrast, if the country bears the costs of paying for a superior deal, then bondholders as a group are better off for two reasons. First, the aggregate payoff to bondholders would be higher if the bonds contained a UAC, and no set of bondholders would be worse off. Second, the higher costs the country would face ex post if it has to engage in a restructuring may induce the country, ex ante, to pursue policies that make a restructuring less likely to start with.[20] As a result, the market price of bonds should be higher if the bonds contained a UAC than if they contained a CAC. On the whole, however, the effect of these clauses on bondholder recovery and bond prices is hard to predict.

2. Country Has Issued Multiple Bonds - Specialized Holdouts, No Free Riding

We now turn to a case where a single country has issued multiple bonds that differ in their enforcement and amendment provisions. This permits one to

[19] For simplicity, we will ignore the possibility that the country implements the restructuring with the bondholders who agreed and that the holdouts never succeed in getting any payment or have to settle for a lower payment.

[20] Marcel Kahan & Shmuel Leshem, Sovereign Debt and Moral Hazard: The Role of Collective Action and Contractual Ambiguity 3 (Aug. 9, 2017) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3016604 [https://perma.cc/Z4DP-E9FR].

compare the actual market prices of these bonds rather than engage in the counterfactual inquiry, as in the single bond case, of how a different provision would affect the market price. The object of the empirical study by Scott, Choi, and Gulati—the bonds issued by Venezuela—is obviously an instance of such a single country-multiple bonds case.[21]

I will further assume that only some "specialized" bondholders can engage in effective holdouts. As Scott, Choi, and Gulati note, a holdout creditor must have the willingness, and perhaps a special aptitude,[22] to litigate her claims.[23] For simplicity, let us assume that there is a single potential holdout creditor—let us call it Elias Management ("Elias")—who does not yet own any bonds issued by a country in financial distress—let us call it Venezuela. Other than Elias, no bondholders will hold out as long as Venezuela makes a restructuring proposal that is better for bondholders as a group than a sovereign default. Elias must thus decide whether to purchase bonds in order to hold out at all, how many bonds to purchase, and bonds of which issue to purchase.

If Elias decides to become a holdout creditor, the amount of bonds it will want to buy should be neither too small nor too large. Elias will know that it may incur transaction costs in enforcing its rights as a holdout, such as litigating against Venezuela or trying to find assets that can be attached. If its investment is too small, it will not expect to earn enough profits on the investment to cover these costs. On the other hand, if Elias buys too many bonds, it endangers the entire holdout strategy. Recall that a holdout creditor wants other creditors to accept the restructuring proposal and make concessions. These concessions make it easier for the holdout creditor to get a higher payoff.[24] The more bonds Elias holds, the fewer other creditors there are to make these concessions.

Assume that Elias has settled on the total amount of bonds it wants to buy and that the bonds issued by Venezuela do not differ in their enforcement provisions, but assume that they do differ in whether they contain CACs or UACs (and if CACs, in the percentage required to modify core payment terms). Elias clearly would not want to buy bonds subject to a CAC unless it holds a blocking minority. That would seem to suggest that Elias would prefer bonds subject to a UAC. However, once Elias buys a blocking minority in a bond issue subject to a CAC, the CAC no longer presents a threat to Elias, and Elias would be indifferent between more bonds of that issue and bonds subject to a UAC.

But, as Scott, Choi, and Gulati note, the presence of a CAC or a UAC is not the only factor that determines how many bonds of an issue Elias would want to acquire.[25] Rather, whichever bonds Elias decides to buy, it may want to buy a

[21] *See generally* Scott, Choi & Gulati, *supra* note 1.

[22] *See id.* at 256 (noting that activist "hedge funds specialize in unearthing and then enforcing contract provisions that the market may not have fully priced"); *id.* at 261 (noting that some "firms . . . specialize in the close reading of contract provisions").

[23] *Id.* at 261-63 (discussing collective action theory and its effect on bondholder litigation potential).

[24] *See id.* at 263 ("[H]olding out works best if the population of holdouts is relatively small . . . .").

[25] *Id.* at 270-71.

sufficient portion of an issue so that it can not only block amendments of the core payment terms but also block amendments of other terms related to enforcement (such as a choice-of-forum provision), take enforcement actions beyond suing for payment of overdue principal and interest (such as acceleration), and block other bondholders from interfering in these enforcement actions. To do that, Elias would want to purchase a majority of the outstanding bonds of an issue, or at least a 25% stake.

From that perspective, it may not matter much to Elias whether a bond issue is subject to a CAC as Elias would, for other reasons, want to buy sufficient bonds to make it impossible to meet an amendment threshold required by standard CACs without Elias's approval. Rather than the presence or absence of a CAC, factors such as the amount of outstanding bonds of a certain issue, the liquidity of these bonds, or the willingness of blockholders to sell their stakes to Elias may determine which bond issues Elias decides to purchase.

Once Elias has settled on potential bond issues, it will try to accumulate the desired stake. Again, the desired stake will depend both on the fraction of the bond issue that Elias needs to purchase to ensure its control over amendment and enforcement measures and the overall amount of bonds that Elias wants to purchase to maximize its payoffs from holding out.

While Elias is accumulating bonds in an issue, the buying pressure will tend to raise the market price of the bonds relative to other Venezuelan bonds. Elias, of course, will try to accumulate bonds in an issue where its purchases would have the least effect on the market price.[26]

Once Elias has accumulated its desired stake, the relative market price should revert to the price, or close to the price, at which other Venezuelan bonds trade. To be sure, it is possible that Venezuela would offer more favorable restructuring terms for the bond issue in which Elias holds a stake. To that extent, the value of all bonds of the issue would exceed the value of other Venezuelan bonds. However, both Venezuela and Elias would benefit from striking a side deal—either before the restructuring is consummated or sometime thereafter—in which Elias, but not other bondholders of that issue, gets paid off. And of course it is also possible that Venezuela will simply refuse to pay Elias at all, just as Argentina for many years refused to pay its holdout creditors.[27] For these

[26] If Elias did not try to accumulate a stake high enough to block other amendments or pursue remedies such as acceleration, it could spread its purchases over multiple bond issues: all Venezuelan bonds subject to a UAC as well as all Venezuelan bonds subject to a CAC where it is relatively easy to accumulate a stake sufficient to block amendments to the core payment terms. In that case, buying pressure for any particular bond issue may be so diluted that it would have only an attenuated effect on bond prices.

[27] *See* Michael Smith, *Why Argentina Consistently, and Unapologetically, Refuses to Pay Its Debts*, BLOOMBERG (July 17, 2015, 12:01 AM), https://www.bloomberg.com/news/features/2015-07-17/-no-why-argentina-refuses-to-pay-its-debts (noting that Argentina refused to pay its holdout creditors for 12 years).

reasons, Elias's accumulation may not have a permanent effect on the value of bonds not held by Elias.[28]

In conclusion, in this scenario the presence of holdouts may generate a temporary price increase in the bond issues in which holdout creditors try to accumulate a stake. However, whether bonds are subject to amendment of their core terms through CACs is probably not a significant factor in determining the bond issue in which holdout creditors try to accumulate a stake.

3. Country Has Issued Multiple Bonds - Specialized Holdouts, Free Riding

In the final case, we consider the possibility that some (nonspecialized) creditors may try to free ride on the efforts of the (specialized) holdout creditor. As before, we assume that there is only a single potential specialized holdout creditor—Elias Management. If Elias does not decide to buy bonds for the purpose of holding out, no other creditors will hold out either. However, as explained by Scott, Choi, and Gulati, certain other institutional investors (which they term "passive creditors") would not on their own "view pursuing a sovereign in court as a viable option;"[29] but if an activist investor, such as Elias, is "motivated to hold out from restructuring offers and aggressively litigate their position,"[30] then these "passive creditors may free ride on the activists' litigation efforts"[31] and also refuse to accept the restructuring proposal. I will assume, along with Scott, Choi, and Gulati,[32] that effective free riding requires not just that Elias decides to pursue a holdout strategy but also that the free riding creditors hold bonds of the same bond issue as Elias does.

From Elias's perspective, such free riders are problematic for two reasons. First, they will make it more expensive for Elias to accumulate the requisite stake of bonds in general and in specific bond issues in particular. Second, by decreasing participation in the restructuring by other creditors, they either force Elias to acquire fewer bonds or endanger the entire holdout strategy (which requires that most creditors participate in the restructuring), in either case reducing Elias's expected profits.[33] As a result, as Scott, Choi, and Gulati note,[34] Elias will have strong incentives to conceal the fact that it is acquiring bonds in order to hold out and to mislead the market (both by concealing its actions and by planting false leads) about the bond issue in which it accumulates a stake.

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[28] Note that, to the extent that holdouts increase the likelihood of the restructuring failing or generate ex ante effects to pursue policies that are less likely to make a restructuring necessary, there should be no effect on *relative* bond prices because all the bond issues of the issuing country would be similarly affected.

[29] Scott, Choi & Gulati, *supra* note 1, at 109.

[30] *Id.* at 262.

[31] *Id.*

[32] *Id.*

[33] *Id.* at 263 ("[H]olding out works best if the population of holdouts is relatively small . . . .").

[34] *Id.* ("[T]he strategy that generates the highest expected payoff . . . depends on [the holdouts] remaining hidden from the market . . . .").

This creates risks for potential free riders. If Elias in the end decides not to pursue a holdout strategy at all or if potential free riders hold bonds of the wrong bond issue, potential free riders may suffer losses.

But even if free riders can correctly determine that Elias will pursue a holdout strategy and decipher which bond issue Elias will choose, attempts to free ride entail downsides. As mentioned before, there is no reason that Elias's efforts will produce a better deal for all bondholders of an issue. To the contrary, Venezuela and Elias will have strong incentives to minimize any benefits to free riders who, without Elias, would be helpless. Venezuela and Elias could, for example, agree that Venezuela or a party friendly to Venezuela purchase Elias's bonds at an attractive price, leaving the free riders in the cold. Similarly, any collection efforts pursued by Elias may be brought only on behalf of Elias and not on behalf of the free-riding bondholders. More generally, the same factors that equip Elias—but not the free riders—to become a holdout creditor[35] will also equip Elias to appropriate for itself and to the exclusion of the free riders the benefits of the holdout strategy. As a result, it is unclear whether and to what extent nonlitigating creditors would attempt to free ride.

If free riding is nevertheless attempted, it is likely to have the following effects: It will temporarily raise the market price of bonds that the specialized holdout creditor accumulates by more than in the absence of attempted free riding; but it will also tend to temporarily raise the market price of bonds that free riders wrongly believe the specialized holdout creditor is trying to accumulate. Moreover, to the extent that the market believes that free riding is profitable, free riding may lead to a more permanent increase in the price of bonds that the specialized holdout creditor accumulates.

E. *Summary*

Upon closer inspection, there is no monotonous theoretical link between stronger unilateral rights as to enforcement and amendments on one hand and higher bond values on the other hand. The relationship between stronger unilateral rights and bond values depends on the rights at issue, on the size of collective action costs, on whether bondholders share the same views as to what course of action maximizes bond values, on the presence of conflicts of interests, and on whether there are opportunities for—and bondholders who will want to engage in—rent seeking.

In a sovereign restructuring context, there is some theoretical link between *holdouts* and bond values. In particular, when a sovereign has issued multiple bonds, holdouts may generate a temporary price increase in bonds of the issue that holdout creditors try to accumulate relative to other bond issues. But while the degree of unilateral enforcement and amendment rights in the aggregate may have some bearing on which bond issue holdout creditors try to accumulate, the

[35] *Id.* at 256 (noting that activist "hedge funds specialize in unearthing and then enforcing contract provisions that the market may not have fully priced"); *id.* at 261 (noting that some "firms . . . specialize in the close reading of contract provisions").

presence of CACs (as opposed to UACs) on their own, as Scott, Choi, and Gulati correctly note,[36] is likely to have at most a tangential effect on that choice.

III. THE EMPIRICAL TESTS AND THEIR RESULTS

Scott, Choi, and Gulati conduct several empirical tests to determine whether and when enforcement and amendment provisions are priced. I will now discuss the results of these tests and how they relate to the foregoing theoretical discussion.

A. *The Collateral Bonds and the Hunger Bonds*

Scott, Choi, and Gulati identify two bond issues with special features: the Collateral Bonds and the Hunger Bonds. The Collateral Bonds are secured by a 51% stake in the shares of Citgo.[37] The value of the collateral appears to exceed the amount due under the Collateral Bonds by a substantial amount.[38] To enforce the rights to the collateral, holders of 25% of the principal amount must ask the trustee to act.[39] But Ashmore Capital held, and was known to hold, the requisite amount of bonds.[40]

The Hunger Bonds were acquired by Goldman Sachs Asset Management ("GSAM") in 2017 at a steep discount below their face value.[41] If GSAM acquired these bonds from Venezuela in a primary market transaction—and there are facts suggesting that it may have done so—the bonds would be subject to some unique legal infirmities that any individual holder of another bond issue could raise.[42]

Scott, Choi, and Gulati find that the Collateral Bonds traded at a lower yield and that the Hunger Bonds traded at a higher yield than otherwise comparable bonds.[43] They attribute this pricing differential to the fact that enforcement of the rights required no collective action—in the case of the Collateral Bonds, because Ashmore Capital held the requisite 25% and, in the case of the Hunger Bonds, because any bondholder could raise the infirmity.[44]

But the results of their empirical tests do not quite support this conclusion. What the tests show is that the legal features at issue (the valuable collateral and the legal infirmities) were priced when no collective action to capitalize on these features was required. What we do not know, however, is whether these features would have also been priced if some collective enforcement action had been required. At least for the Collateral Bonds, it is plausible that, even if no holder

[36] *Id.* at 269.

[37] *Id.* at 273.

[38] *See id.* (noting reports that Citgo's value exceeds the principal amount of the Collateral Bonds).

[39] *Id.*

[40] *Id.*

[41] *Id.* at 274.

[42] *Id.*

[43] *Id.* at 287.

[44] *Id.* at 290.

at present owned a 25% stake, the value of these bonds would have exceeded the value of otherwise identical bonds unsecured by highly valuable collateral.

B. *The Threshold Required for Amendments to Core Terms*

Scott, Choi, and Gulati compare bonds with UACs to bonds with CACs, and they compare bonds with CACs with an 85% threshold to adopt amendments to core payment terms to bonds with CACs with a 75% threshold for such amendments. They find no significant price differences.[45] But as I discussed previously, the "bilateral model" does not posit a clear relationship between unilateral and collective amendment rights.[46] Moreover, to the extent that collective action is required for effective enforcement or that important enforcement provisions can be modified subject to a lower consent threshold, the greater ability to block amendments to bonds subject to UACs relative to bonds subject to CACs may not be a significant factor in the "bilateral model" even if—in principle—unilateral amendment rights would be preferable.

C. *The Rumor Bonds*

Finally, and most interestingly, Scott, Choi, and Gulati examine the prices of two sets of "Rumor Bonds." The first rumor that a specialized holdout creditor had taken a position pertained to the 9.25% bonds due 2027.[47] The rumor started in January 2016 and dissipated later that year.[48] Scott, Choi, and Gulati find that the 9.25% bonds due 2027 traded at a lower yield in the first half of 2016.[49] The second rumor, which pertained to the 9.375% bonds due 2034, started in January 2018 and was confirmed in May 2018.[50] Scott, Choi, and Gulati examine the pricing of the bonds in the period starting four weeks before and ending four weeks after the last week of January and find that the yield decreased after the rumor started.[51]

Because the first rumor dissipated within a few months and the empirical test regarding the second rumor runs only up to four weeks after the rumor started, one cannot determine whether the price increases found by Scott, Choi, and Gulati were just temporary or also had a permanent component. The results of their tests confirm that an activist taking a position in a bond issue or rumors to that effect can have an effect on bond prices. This is an important and notable empirical result. Without more, however, one cannot determine whether bond prices increased because of buying pressure or because the activist involvement conferred benefits on other bondholders.

It is also instructive to consider why the activist got involved (or may have gotten involved) with the 9.25% bonds due 2027 and the 9.375% bonds due

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[45] *Id.* at 276.

[46] *See supra* Part I (distinguishing between amendment and enforcement rights).

[47] *See* Scott, Choi & Gulati, *supra* note 1, at 290.

[48] *Id.* at 275.

[49] *See id.* at 291.

[50] *See id.* at 292-93.

[51] *Id.*

2034. Scott, Choi, and Gulati quote a press report stating that the alleged activist that took a position with the 9.25% bonds due 2027 was a holdout creditor.[52] But by January 2016, no default had occurred and no restructuring proposal had been made.[53] Even if an activist had taken a position in these bonds, it is unclear what strategy the activist would have planned to pursue.

Fortunately, we have more information about the 9.375% bonds due 2034. According to *Caracas Capital*, several hedge funds had settled on these bonds because, given the total principal amount outstanding and the price at which these bonds traded, it would cost less than $100 million to acquire a 25% stake.[54] This points to the importance of factors beyond the legal terms in determining in which bonds activists will take a stake. Moreover, again according to *Caracas Capital*, the funds were planning to accelerate the maturity of the bonds, which required a 25% stake.[55] So these activists who took a position in the 9.375% bonds due 2034 were not, strictly speaking, *holdout* creditors. And the stakes required to accelerate bonds (25%) would be sufficient to block amendments to the core payment terms for any of the Venezuelan bond issues (the bond issues easiest to amend required consent by 75% of the holders).[56] This points to the fact that the differences between CACs and UACs may in practice not be important because activists would, for other reasons, want to acquire a sufficient stake in a bond issue. All of this is, of course, consistent with the collective action theory that Scott, Choi, and Gulati present in their article.

CONCLUSION

Scott, Choi, and Gulati identify collectivizing agents, often activist hedge funds, as important players in restructuring and provide empirical evidence that even rumors that such entities may take a position in a bond issue affect bond prices. This presents an important contribution to our understanding of pricing dynamics.

In other empirical tests, Scott, Choi, and Gulati fail to find evidence that bond issues with different amendment terms—UACs versus CACs or CACs with different amendment thresholds—trade at different prices. There are multiple possible reasons for this result. In particular, theoretically, stronger individual amendment rights could increase or reduce bond values, amendment rights interact with enforcement rights, and factors besides amendment and enforcement rights can affect the choice of the bond issue in which a collective agent decides to take a position. While Scott, Choi, and Gulati's empirical analysis of UACs and CACs is an important first step, more work needs to be done to further our understanding of how and when these clauses affect bond prices.

[52] *Id.* at 290.

[53] *Id.* at 292.

[54] *Id.* at 294.

[55] *Id.*

[56] *Id.* at 267.