Good Faith in a Sovereign Debt Restructuring Sequential Game

BUENA FE EN UN JUEGO SECUENCIAL DE RESTRUCTURACIÓN DE DEUDA SOBERANA

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ABSTRACT

This study explores a legal and economic understanding of breach of good faith. First, it starts with a review of bona fide within the sovereign debt restructuring literature. Then, the study moves into a recent and emblematic case where a breach of good faith was invoked by minority creditors. This case illustrates controversial legal techniques that may be used for enforcing a bond restructuring which in turn rises arguments related to breach of good faith compliance. Next, the research constructs a sequential game for setting the limits of good faith in sovereign debt workouts. The concepts of subgame perfect Nash equilibrium and Pareto optimal are examined in two scenarios: an unsupervised debt restructuring process, and a supervised restructuring process. After this, the article studies how good faith compliance is connected to the subgame perfect Nash equilibrium and Pareto optimality. Finally, the last part briefly discusses how the legal and economic approach to a breach of good faith could be implemented in legal practice.

Keywords: Sovereign Debt Restructuring, Good Faith, Public Debt, Good Faith Breach, Law and Economics.

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RESUMEN

Este estudio explora una explicación jurídica y económica del incumplimiento del deber de actuar buena fe. En primer lugar, el artículo presenta una revisión de la buena fe dentro de la literatura sobre reestructuración de deuda soberana. A continuación, el estudio se adentra en un caso reciente y emblemático en el que los acreedores minoritarios invocaron el incumplimiento de la buena fe. Este caso ilustra algunas técnicas jurídicas controvertidas que pueden utilizarse para forzar una reestructuración de bonos, lo que a su vez evidencia nuevos argumentos relacionados con el incumplimiento de la buena fe. A continuación, el artículo propone un juego secuencial para establecer los límites de la buena fe en las reestructuraciones de deuda soberana. Los conceptos de equilibrio de Nash, subjuego perfecto y óptimo de Pareto se examinan en dos escenarios: un proceso de reestructuración de deuda no supervisado y un proceso de reestructuración supervisado. Después, el artículo estudia cómo el cumplimiento de la buena fe está conectado con el equilibrio de Nash perfecto en subjuegos y con la optimalidad de Pareto. Por último, la última parte discute brevemente cómo el enfoque legal y económico sobre el incumplimiento de la buena fe podría ser implementado en la práctica legal.

Palabras clave: reestructuración de deuda soberana, buena fe, deuda pública, incumplimiento de la buena fe, análisis económico del derecho.

INTRODUCTION

Determining a breach of good faith during a sovereign debt restructuring requires defining when good faith is breached. However, this enquiry has created problems of interpretation for international organisations, adjudicators, and practitioners when they have studied a presumed *bona fide* breach. In light of multiple controversies related to defining a breach of good faith, this paper designs a legal and economic concept of a breach of good faith. This is done using a game theory model of a sovereign bond restructuring that explains the boundary between breach and compliance of good faith.

Good faith has been addressed differently in English and United States case law when dealing with bondholders' rights. In English law, the Chancery Division in *Dennis Edward Myers and Another v Kestrel Acquisitions Ltd and Others* (2015) stated that good faith obligations must be expressly included in commercial contracts and that the Court has no authority to introduce "fairer or more reasonable" provisions (Dennis Edward Myers and Another v Kestrel Acquisitions Ltd and Others, 2015, para. 50); however, the Chancery Division did not address the boundary between breach and compliance of good faith. Whereas, in the U.S. case *Katz v Oak Industries Inc* (1986), the Court of Chancery of Delaware held that good faith was not breached because there was no violation of the reasonable expectations of the bondholders (Katz v. Oak Industries, Inc., 1986, para. 26); nonetheless, the Court did not clarify the extent of reasonableness. These approaches to good faith show that judges from different jurisdictions approach good faith differently. They also show that adjudicators do not use an objective circumstance approach to determine when a breach of good faith compliance occurs.

Additionally, the sovereign debt restructuring framework does not have a legal and financial supervisor which provides an unbiased analysis of a breach of good faith during restructuring negotiations; thus, parties in the restructuring process lack a neutral opinion on the restructured financial terms. Even though the International Monetary Fund (IMF) plays a role in supervising the debt sustainability of member countries, its mandate does not stipulate to supervise countries' debt negotiations with private creditors. Additionally, The IMF Executive Board has assessed good faith under a fourfold criterion but in the context of the Lending into Arrears to Official Bilateral Creditors policy. These four criteria are approach to creditors, substantive and collaborative dialogue towards an agreement, disclosure of relevant information, and consistency between debtor offer and IMF support programs (International Monetary Fund, 2022b, p. 21).

Furthermore, the process is frequently contentious, notwithstanding professional advice to the restructuring parties. When a debtor presents an exchange offer to creditors, the former usually receives financial and legal advice from private firms that are familiar with debt market practices. Moreover, legal and financial experts also advise creditors on debt restructuring matters. The so-called London Club, an informal and ad-hoc group of commercial banks, also played this role, which oversaw restructuring plans for commercial creditors (Kirchner & Ehmke, 2012). However, regardless of professional advice on both debtor's and creditor's sides, parties frequently disagree on the exchange offer terms, thus increasing the probability of litigation in courts.

Under the circumstances above, this article explores a legal and economic understanding of a breach of good faith. First, it starts with a review of *bona fide* within the sovereign debt restructuring literature. Then, the study moves into a recent and emblematic case where minority creditors invoked a breach of good faith. This case illustrates controversial legal techniques that may be used for enforcing a bond restructuring, which raises arguments related to breach of good faith compliance. Next, the research constructs a sequential game for setting the limits of good faith in sovereign debt workouts. Next, the study examines the subgame perfect Nash equilibrium and Pareto optimal concepts in two scenarios: an unsupervised debt restructuring process and a supervised restructuring process. After this, the article studies how good faith is connected to the subgame perfect Nash equilibrium and Pareto optimality. Finally, the last part briefly discusses how the legal and economic approach to a breach of good faith could be implemented in legal practice.

LITERATURE ON GOOD FAITH IN SOVEREIGN DEBT RESTRUCTURINGS

Good faith scope in public international law was adapted to the context of sovereign debt restructurings; however, the explanation of when the principle has been breached remains unaddressed. First, the UN Charter, Article 2(2) has recognised good faith when it comes to the rights and obligations of the Charter. Second, following extensive debates related to good faith obligations, the General Assembly recommended the adoption of good faith in resolution 2526/1970 (XXV). Finally, this trend in consolidating good faith was revalidated in the GA Resolution 69/319, which declared good faith should be a guiding principle for a debtor and creditors for constructive public debt negotiations. However, despite these legal developments in implementing good faith, the objective circumstances under which bona fide is breached have not been explained. Therefore, even though good faith has been evolving to address international public concerns in sovereign debt issues, international law is deficient in defining an outright breach of the principle.

Moreover, good faith as an emerging soft law principle in sovereign debt restructuring has been part of the principles for guiding these processes. Likewise, in 2005, the Institute of International Finance enacted the principles for stable capital flows and fair debt restructuring in emerging markets (The Institute of International Finance, 2005). The principles focused on transparency and timely flow of information, close debtor-creditor dialogue and cooperation to avoid restructuring, good faith actions, and fair treatment. In 2010, following the Eurozone debt crisis, the principles were applied to mature economies, resulting in the Principles for Stable Capital Flows and Fair Debt Restructuring (Principles Consultative Group, 2010, p. 3). Since 2012, when the applicability of the principles was broadened (The Institute of International Finance, 2012), good faith negotiations have remained a pillar for reaching voluntary debt restructuring agreements to prevent crisis resolution (Principles Consultative Group, 2021, p. 56). Nonetheless, the principles have stated neither how to construct nor analyse a breach of those principles.

Goldman's understanding of what constitutes a breach of good faith in sovereign debt negotiations has been more noticeable than the previous approaches(Goldman, 2014, p. 16). Likewise, he believed that good faith should be essential in sovereign debt workouts(Goldman, 2014, p. 6), provided that this principle is not used to trespass contractual clauses(Goldman, 2014, p. 9). Furthermore, he suggested that good faith in sovereign debt workouts comprises the duty to participate in negotiations for debt workouts and not obstruct negotiations(Goldman, 2014, p. 12). Nonetheless, he pointed out that this obligation raised critical issues related to understanding the legitimacy of an invitation for negotiating, negotiation time framework, negotiation and financial costs. Accordingly, he believed good faith is such a broad concept that its implementation in a sovereign framework pushes the limits of creditors' and debtors' willingness to negotiate(Goldman, 2014, pp. 11-12).

Moreover, Lastra and Bodellini (2018) have suggested that implementing soft law principles such as good faith into a legal instrument could provide law courts with a legal source for interpreting debt restructuring cases (pp. 24-25). For example, they stated that good faith could help to interpret other principles in civil law jurisdictions. However, they pointed out that limitations related to the lack of binding and enforceable effects were a disadvantage. Nevertheless, despite problems related to enforceability, they recognised the potential practical relevance of good faith in sovereign debt restructuring (Lastra & Bodellini, 2018, p. 25).

More recently, Buchheit and Gulati pointed out the complexity of good faith in sovereign debt workouts. As the New York law has been using good faith for regulating opportunistic creditors, they have suggested that good faith clauses should be included in the debt contracts because, in the absence of these contractual clauses, some creditors might try to exploit the inexistence of the good faith clause in the contract. This situation is observed primarily in minority creditors trying to obtain better treatment when debt relief is assigned to a pool of creditors. Additionally, they propose that the implied duty of good faith in debt contracts could be incorporated into written law to obligate creditors to collaborate in debt workouts. (Buchheit, & Gulati, 2021, pp. 12-16; 2022, pp. 10-11).

In sum, public international law, soft law and academic views diverge on good faith: they disagree on the limits of the principle and when a breach occurs. This divergence hinders compliance with this principle. On the whole, sources of law show that international organisations, adjudicators and practitioners provide limited approaches to understanding when good faith is breached in a bond restructuring scenario. These divergences of good faith make it challenging for the legal community to approach a breach of good faith. Likewise, the case of *Contrarian Emerging Markets and others v the Republic of Ecuador,* which took place amid the Covid-19 pandemic, showed obstacles arising from a presumed breach of good faith. The following paragraphs explore the case to show the discussion's relevance.

GOOD FAITH IN *CONTRARIAN*

Contrarian Emerging Markets and Others v The Republic of Ecuador (United States District Court Southern District of New York, 2020) illustrated how parties approached a breach of good faith (Clark, & Lyratzakis, 2021; de la Cruz, & Lagos, 2021) differently in bond restructuring cases. In May 2020, the Republic of Ecuador announced the negative economic impact of Covid-19 on the country (The Republic of Ecuador, 2020a). Following financial difficulties, Ecuador decided to start a debt restructuring process. On July 20, 2020, Ecuador announced an invitation memorandum which contained the exchange offer between eligible bonds and new securities. Moreover, the announcement contained a redesignation provision[2] allowing to redesignate the

2 "The Republic has retained the right, in its sole discretion and subject to the Minimum Participation Condition (as defined below), to (a) re-designate at any time (including after the Consent Deadline) one or more series of Eligible Bonds (other than the 2024 Bonds) that will be subject to the Proposed Modifications on an aggregated basis, (b) consider the Proposed Modifications effective with respect to one or more series of Eligible Bonds if the Republic receives the requisite consents with respect to such series, and (c) re-designate at any time one or more series of the Eligible Bonds (other than the 2024 Bonds) as to which the Proposed Modifications are 'uniformly applicable' (as defined in

voting pool of the eligible bonds. The invitation memorandum stipulated compliance with good faith as follows:

> Throughout its debt restructuring process, Ecuador engaged in good faith with its bondholders, providing information with transparency and seeking to adjust the terms of its outstanding debt while respecting inter-creditor equity (The Republic of Ecuador, 2020c).
>
> (...)
>
> Eligible Holders who do not submit valid consent and tender orders or whose valid consent and tender orders are not accepted by the Republic will have their Eligible Bonds modified pursuant to the Invitation if we receive the requisite consents to the Proposed Modifications with respect to that series of Eligible Bonds. In this event, the economic terms of such holder's modified Eligible Bonds will differ significantly from the economic terms applicable to its Eligible Bonds prior to the effectiveness of the Proposed Modifications (The Republic of Ecuador, 2020c, p. 3).

On July 21, Ecuador stated that the Republic was unwilling to provide concessions to bondholders looking to disrupt the good faith restructuring procedure (The Republic of Ecuador, 2020b, p. 2). Later, on July 24, a new Ecuador press release stated that any allegation of bad faith was a lie as the Republic had been trying to actively negotiate with all creditors to find a joint agreement in the middle of the Covid-19 pandemic and its negative financial consequences(The Republic of Ecuador, 2020d, p. 2). This unconformity was addressed by Ecuador as follows:

> The Minority Committee asserted that the Republic negotiated with them in bad faith and characterised consent process as "coercive". Nothing could be further from the truth. The Republic has been proactively engaged in this process with holders since at least April, eager to find common ground when it became clear that, due to events outside of its control, the Republic would be unable to honour its debt service obligations and that a consensual restructuring, rather than outright default, was in the best interests of all our stakeholders, including bondholders (The Republic of Ecuador, 2020d, p. 2).

After the above discussion, on July 29, the minority committee (Complaint. United States District Court Southern District of New York, 2020) filed a federal securities class action against the Republic of Ecuador before the District Court Southern District of New York asking for restraining Ecuador from conducting the exchange offer (The Republic of Ecuador, 2022, p. 1). Here, the plaintiffs argued that Ecuador had refused

the respective indenture) and consider the Proposed Modifications effective with respect to such re- designated series if the Republic receives the consent of not less than 75% of the aggregate principal amount of all such re-designated series at the time outstanding."

to negotiate in good faith because the offer had been coercive, non-transparent, and had violated the non-less favourable treatment.

According to the plaintiffs, the offer was coercive because if the minority committee had not accepted the tendering offer, the Republic intended to redesignate the voting pool until they reached the necessary majority to change the threshold to approve a change in reserved matters necessary for accomplishing the tender offer (Complaint. United States District Court Southern District of New York, 2020, para. 46). Accordingly, they argued that the consent and tender offer were coercive as the redesignation had limited the minority consent. Moreover, because non-tendering offers would have received less value than tendering offers (Complaint. United States District Court Southern District of New York, 2020, paras. 55-56), the bonds' no less favourable treatment provision would have been breached (Complaint. United States District Court Southern District of New York, 2020, paras 24-26).

Finally, the plaintiffs argued that Ecuador's proposal had not been transparent because the statement "the Republic was committed to a transparent process" was false because by the time this proposal was made, the country had already decided what to do, thus making the statement futile. Therefore, the plaintiffs concluded that Ecuador's announcement was a *material misstatement* equal to security fraud (United States District Court Southern District of New York, 2020, paras 13, 15).

Following the lawsuit, on July 29, Ecuador issued a press release stating that Contrarian and GMO were looking to extract more debt service than the negotiated in good faith with the majority committee.

> In short, Contrarian and GMO seek to interfere with the decision of a majority of Ecuador's investors, seeking to extract debt service from the Republic of Ecuador above and beyond what was negotiated in good faith with a majority of and its largest creditors through legal proceedings and delaying tactics (The Republic of Ecuador, 2022, p. 1).

Finally, on July 31, Judge Caprioni found for Ecuador. First, concerning the connexion between bad faith and coercion, the judge decided that there was no such coercion because the tender offer had been presented to all bondholders, and they were free to choose whether to accept it (United States District Court Southern District of New York, 2020, p. 30). Moreover, regarding the violation NLFT, the Court stated that bondholders could amend and change the clause through supermajority action (United States District Court Southern District of New York, 2020, p. 29). Furthermore, the Court specified that to stipulate that CACs could not amend the NLFT clause, the NLFT clause would need to clearly stipulate its exception from any CACs modification, or the CACs would have to include its impossibility to change the terms of the NLFT clause (United States District Court Southern District of New York, 2020, para 29).

Finally, Judge Caprioni emphasised concerning transparency that the plaintiff's view of an unfair result did not mean that Ecuador was not committed to a transparent process; thus, the content of the tender had not been false (United States District Court Southern District of New York, 2020, para. 28). In other words, the judge stated that when an aspiration does not become a fact, this does not violate transparency, according to *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*(2014). Finally, judge Caprioni indicated that securities law should be analysed as a reasonable investor who is aware of the financial position of Ecuador (United States District Court Southern District of New York, 2020, 25ff), and he supported Ecuador's position provided that the approach to restructuring was reasonable (United States District Court Southern District of New York, 2020, 32ff).

After this legal controversy, Clark and Lyratzakis, from White & Case LLP, which represented the plaintiffs, published their views on the redesignation provision. First, they argued that the redesignation strategy, which permitted to change the voting pool in Ecuador's restructuring offer, could trigger problems related to the debt restructuring procedure(Clark & Lyratzakis, 2021, p. 37). Furthermore, they said that if the voting procedure was unclear regarding how votes were cast, problems of voting integrity and procedural fairness were triggered. Therefore, they believed the CACs redesignation procedure caused doubts about the integrity of the voting procedure(Clark & Lyratzakis, 2021, pp. 37-38).

Contrarily, de la Cruz and Lagos (2021, pp 226-236) from Cleary Gottlieb Steen & Hamilton LLP which represented Ecuador, argued that the invitation to redesignate was based on the body and the spirit of CACs. They pointed out that redesignation was not only in the Ecuadorian indentures but also that assuming it was impossible to redesignate, it would have remained an "all or nothing proposal". Moreover, they explained that even though previous sovereign restructurings had not considered redesignation, the International Monetary Fund staff knew re-designation was in the body of ICMA CAC. Consequently, de la Cruz and Lagos asserted the legitimacy of the re-designation strategy.

Even though the judge supported Ecuador's proposal's reasonability, the question of a breach of good faith remained unclear. The following ideas study different scenarios and incentives around *bona fide* to emphasise how the principle could make restructuring more complex.

PROBLEM ANALYSIS: BREACH OF GOOD FAITH WITHIN SOVEREIGN BOND RESTRUCTURINGS

The problem with a breach of good faith is that its interpretation could be inconsistent when dealing with complex restructuring cases, thus making it difficult to determine when precisely a breach occurs. In addition, an extensive interpretation of the breach also contributes to increasing legal uncertainty(Bratton & Gulati, 2004, pp. 65–66) because its understanding could be inconsistent. Moreover, good faith subjectivity allows parties to make biased interpretations of the principle's scope, thus, triggering doubts about transparency within the restructuring process (Thomas & Garcia-Fronti, 2007, pp. 13-17). Eventually, uncertainty and transparency questions result in inter-creditor tensions and debtor-creditor conflicts (Bratton & Gulati, 2004, p. 73).

Inter-creditor equity issues frequently cause free riding, which in turn increases transaction costs (Abbas *et al.*, 2019, p. 329). Expecting the debtor restructure their debt, creditors are aware of potential changes in the principal's extension or the interest rate; however, not all creditors are willing to give the same concessions to the debtor, so inter-creditor problems arise(Abbas *et al.*, 2019, pp. 329-342). In short, when a creditor provides too little concessions to the debtor, another creditor would have to fill this gap with extra concessions for the debtor to achieve a sustainable debt agreement (Li, 2015, p. 74). As each creditor from the creditor community wants to provide as little concession as possible, free riding becomes more attractive to protect their financial position (Abbas *et al.*, 2019, pp. 344-346) resulting in a potential breach of good faith. In other words, good faith controversies are usually exacerbated by an inefficient allocation of debt relief (Trebesch *et al.*, 2012, p. 28).

Additionally, during a sovereign bond restructuring, the debtor's scarcity of liquid assets creates tensions in the creditor community(Li, 2015, pp. 25-26), especially within the private commercial creditors such as institutional investors and distressed debt fund. While the former usually buy bonds at or near par value to hold them until maturity, the latter sometimes buy defaulted bonds at large discounts to get a remarkable recovery. To achieve higher returns, the distressed debt fund may challenge a restructuring process looking for total principal and interest payments (Abbas *et al.*, 2019, p. 332). This is not always the case for institutional investors, who are frequently more cooperative with a distressed sovereign looking for a debt restructuring. Accordingly, understanding the distressed debt fund strategy within the context of debt restructuring is critical for addressing debt restructuring controversies.

In financial terms, from the distressed debt fund's point of view, looking for full payment could be profitable as long as the expected outcome of enforcing the bond's full terms before a court exceeds the expected outcome of an exchange offer. Let us take the case of a litigation analysis where a creditor has bought a bond at a high discount and is considering whether to accept an exchange offer or go before a court to enforce the full terms of the bond. First, a creditor studies if *litigation fees* (L) minus the *initial bond investment* (I) times the *probability of getting a favourable judgment* (P)($L - I \times P$) is lower than the *Net Present Value of the bond* ($NPVb$)[3]. If $NPVb > L - I \times P$, a creditor should go before a court to enforce the full terms of the bonds provided that $NPVb$ is greater than the exchange offer[4]. As a result, a distressed debt fund may hold out a

3 LIP< NPVb then creditor should go before court provided that NPVb>Exhange Offer.
Where:
LIP=(Litigation fees – initial bond investment) * probability of getting a favourable judgment.
NPVb= Net Present Value of the bond.

4 The case between NML and Argentina with a settlement in 2016 where NML obtained 2.28 billion for its investment of about $177 million is a good reference for this strategy. For further details on this case see: NML Capital, Ltd. v. Republic of Argentina, 144 F. Supp. 3d 513 (S.D.N.Y. 2015);

restructuring settlement to try to enforce the full terms of the bond if their financial and legal analysis concludes so.

Furthermore, holding out creates legal and economic tensions in the restructuring process. Should a creditor withhold their consent when there is a majority decision on accepting an exchange offer, he endangers the financial position of the creditor majority because the majority would not accept a less favourable financial treatment than the treatment given to holdouts(Lastra & Buchheit, 2014, paras. 1.25-1.27). Because holdouts may be financially better off by trying to enforce the bond's full terms before a court than accepting the restructuring terms, they might not have incentives to participate in the restructuring process. Accordingly, these conflicts create a paradox for the holdout, he could deviate alone from a majority decision and eventually get outstanding financial terms from his bond, but he will also reveal a self-interested and non-cooperative behaviour, which not only makes the restructuring process more complex but also increases the uncertainty of the financial position of the other creditors and the debtor(Lastra & Buchheit, 2014, pt. 1).

To neutralise the holdout's behaviour, the debtor could modify the holdout's right of payment by a broad interpretation of CACs which may trigger doubts about good faith compliance. From a legal viewpoint, a holdout has a legitimate expectation of receiving payment of principal and interest in accordance with the contract. Despite legitimate rights, the debtor may try to use CACs strategically by changing the original payment agreement, to make an exchange offer mandatory without the holdouts' consent(de La Cruz & Lagos, 2021, pp. 235–243). The holdout could not have anticipated the strategic interpretation of CACs; therefore, they may argue that such a strategy breaches good faith. In fact, as shown in *Contrarian v. Ecuador*, good faith has been related to a breach of the NLFT, coercion, transparency, or reasonable expectations.

In sum, even though the debtor and creditors could argue a breach of good faith under different circumstances, there is no joint agreement on what constitutes an outright breach of the principle. Arguably, the principle could be breached on the creditors' side when a dissenting creditor refrains from a restructuring settlement because he leaves the remaining creditors and the debtor worse off. Conversely, on the debtor side, good faith could be breached when they push the legal understating of CACs to make a restructuring binding to all creditors because unusual CAC interpretation could be seen as abusive. Because it is unclear what constitutes a breach of good faith in a creditor-debtor debt restructuring process, the following section explores good faith in the context of a debt restructuring using game theory analysis.

Alexandra Stevenson, 'How Argentina Settled a Billion-Dollar Debt Dispute With Hedge Funds (New York Times, 2016) <https://www.nytimes.com/2016/04/25/business/dealbook/how-argentina-settled-a-billion-dollar-debt-dispute-with-hedge-funds.html> accessed 14 September 2021.

SUBGAME PERFECT NASH EQUILIBRIUM AND PARETO OPTIMALLY IN A DEBTOR-CREDITOR RESTRUCTURING NEGOTIATION

A Bond Restructuring under the Sequential Game

A bond restructuring situation responds to a coordination problem. For example, suppose that a sovereign debtor needs to restructure a bond because the debtor is not in the capacity to pay the initial debt terms. From the debtor's point of view, he may have two options: he could restructure the bond or decide not to pay the bond. If the debtor decides to restructure, he could do it with or without external legal and financial supervision. Next, from the minority creditor's viewpoint, they could either accept the terms of the restructuring offer or not accept these terms.

Subsequently, when the debtor decides to restructure and the minority creditors do not accept the restructuring terms, two outcomes are possible. CACs reach a predefined threshold to make a restructuring binding to 100% of the bondholder community, or CACs do not reach the threshold, and both the debtor and the minority creditors stay in the same situation they were at the beginning of the game. The decision tree in Figure 1 represents the previous scenarios. In this game, the debtor acts first, and minority creditors' decisions would depend on the debtor's decision.

The first scenery is as follows: the debtor decides to restructure without external legal and financial supervision, and the minority creditors accept the restructuring terms. Here, the sovereign debtor would get 2 because not only do they restructure the bonded debt smoothly, but also, they maintain access to the debt market. However, the minority creditors would get -2 because, despite financial concessions on interest, principal, or maturity date, the debtor might not have offered optimal bond terms as an external supervision did not scrutinise the new instruments; thus, debt relief could have been excessive or even confiscatory(Buchheit, et al, 2020, p. 369). Moreover, debt instruments which do not represent creditors' financial needs might have been given to them.

In the second scenery, the debtor decides to restructure the debt, but the minority creditors decide not to accept these restructuring terms. Under this circumstance, CACs trigger a complete restructuring. Here the sovereign debtor gets 1 because they restructure the debt and maintain access to debt markets. However, he gets one point less than the first scenario because triggering a restructuring through CACs costs financial and legal fees, not to mention trade, financial and political costs(Borensztein & Panizza, 2009, p. 683). Moreover, he also gets a negative reputation due to enforcing debt restructuring terms without entire creditors' support. Finally, minority creditors receive -3 because they provided financial concessions to an uncertain and unsupervised debt restructuring and invested uselessly in essential financial and legal advice to try to block the majority creditors' decision.

In the third scenery, the minority creditors do not accept the restructuring terms, and CACs do not obtain the necessary majority threshold to enforce the debt restructuring.

In this case, the debtor gets -3 because the restructuring fails, the country's financial position in the debt markets weakens, and investments in legal and financial fees for enforcing a restructuring employing CACs are useless. Conversely, the minority creditors get 1 because they do not have to accept the debtor's offer, and eventually, they would have an opportunity to enforce the bond terms before a court, or they could get better financial terms from the debtor by blocking the restructuring by financial pressure.

A Restructuring Game Without Legal and Financial Supervision

FIGURE 1. SEQUENTIAL RESTRUCTURING GAME WITH NEITHER LEGAL NOR FINANCIAL SUPERVISION

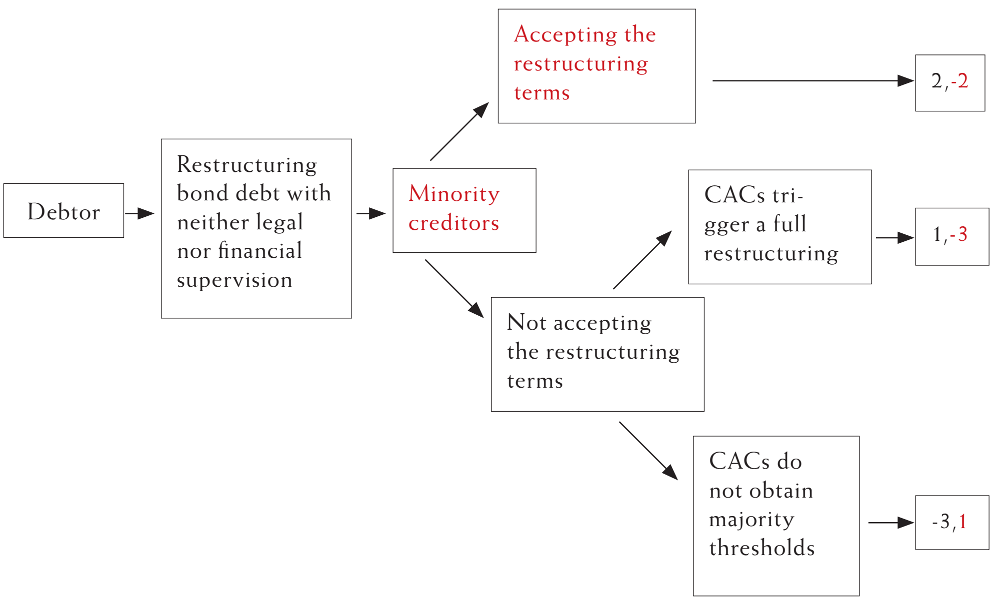


FIGURE 2. GAME WITH NEITHER LEGAL NOR FINANCIAL SUPERVISION

		Debtor	
		CACs trigger a full restructuring	CACs do not obtain majority thresholds
Minority creditors	Accept the restructuring terms	-2,2	-2,2
	Do not accept the restructuring terms	-3,1	1,-3

If parties have perfect information, using backward induction shows that the strategy profile for each player differs according to their optimal outcomes. Likewise, If the minority creditors think that the debtor will not trigger CACs, then the minority creditors would prefer not to accept the restructuring terms. Moreover, if the minority creditors think that the debtor will trigger CACs, then the minority creditors would prefer to accept the restructuring terms. Contrarily, on the debtor's side, if he believes that the minority creditors will not accept the restructuring terms, he would prefer to trigger CACs; additionally, if the debtor believes that they would accept the restructuring terms, he would be indifferent. Therefore, these responses show that even though some outcomes lead to an opposite outcome, there is a subgame perfect Nash equilibrium (SGPNE).

A closer view of the previous strategies shows that both parties have incentives to push the limits of CACs to reach their optimal outcomes. While the optimal outcome for the debtor is minority creditors accepting the restructuring proposal, on the creditors' side, the optimal result is that CACs do not get a blocking position. Accordingly, the debtor will push the procedural limits of CACs; if succeeding, dissenting creditors will argue that the debtor is acting in bad faith because the debtor wants to enforce the restructuring terms coercively. Moreover, the minority creditors will try to achieve a blocking position on the CACs thresholds. Likewise, suppose the minority creditors achieve a blocking threshold in the vote counting. In that case, the debtor may argue that the minority creditors act in bad faith as they put both the creditor majority and the debtor in financial difficulties. As a result, this situation ends in a two-party zero-sum game because the payoff to one party is the negative payoff to the other.

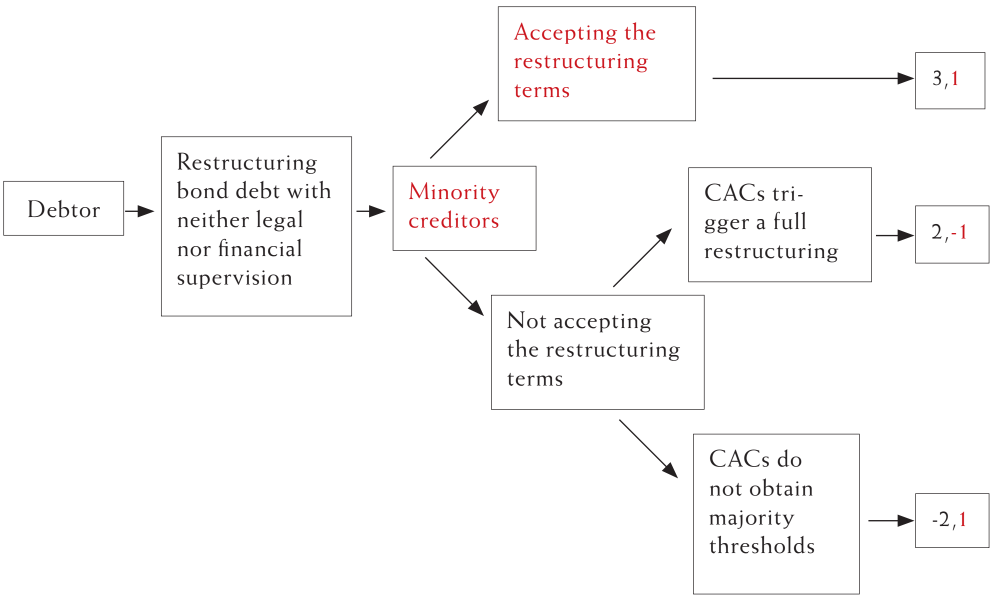
In this game, a SGPNE occurs when the minority creditors accept the restructuring terms because, otherwise, the debtor would have triggered the CACs. Moreover, using backward induction shows that the debtor would always prefer to trigger CACs which would be non-optimal for the minority creditors. However, SGPNE is not Pareto optimal as there is an outcome which could make the creditors better off; this is outcome 1,-3, where creditors do not accept the restructuring terms, and CACs do not obtain a majority threshold. Accordingly, the game shows that the SGPNE is not Pareto optimal on the one hand and that parties' optimal strategies are different; therefore, a cooperative outcome is not achievable (from now on the cooperative problem) on the other hand.

A comprehensive solution to the cooperative problem should create conditions where not only a SGPNE is possible but additionally where the SGPNE coincides with a Pareto optimal outcome. The following arguments support this idea: first, if a SGPNE is possible, parties should stick to one course of action; therefore, they would not have incentives to deviate from such a course. Second, if this course of action is Pareto optimally, then any party could have been better off without making the other party worse. However, making SGPNE and Pareto optimally outcomes coincide in a single result requires changes of the outcomes shown in figure 1.

A Restructuring Game with Legal and Financial Supervision

Constructing a SGPNE which coincides with a Pareto optimally outcome in a creditor-debtor restructuring process requires designing a sequential game where each party has an optimal strategy which is also the best response to the other strategy. Accordingly, this study speculates that an external legal and financial supervisor could create the conditions to achieve it (this supervisor would be the equivalent of an International Sovereign Debt Restructuring Tribunal). Therefore, the following game explores a restructuring scenario where an external legal and financial supervisor plays an active role in supervising the restructuring process:

FIGURE 3. SEQUENTIAL RESTRUCTURING GAME WITH LEGAL AND FINANCIAL SUPERVISION



In the first scenery, the debtor decides to restructure, and the minority creditors accept the restructuring terms. Here, the sovereign debtor gets 3 because he may be able to stabilise their economy and maintain access to the international debt market. Moreover, the outcome is higher than figure 1, because, in this scenario, the external supervision is a good signal to the market of a neutral analysis of the new bond terms. The minority creditors get 1 because even though they make some concessions regarding principal reduction, interest rates or maturity extensions, they will have new debt instruments that better represent their financial needs. Using backward induction shows that when the minority creditors decide to accept the restructuring terms, the debtor gets 3.

In the second scenery, the debtor decides to restructure the debt, but the minority creditors choose not to accept the restructuring terms. Following this, CACs make a majority decision binding to all creditors. Under this situation, the debtor receives 1 point more than Figure 1 because the external supervision is a positive signal of a reliable negotiation to the capital markets. On the other hand, the minority creditors get -1, which is 2 more points than Figure 1, because even though they have made some financial concessions to the debtor, these concessions had been made under neutral external scrutiny. This case shows a higher grade of certainty than an unsupervised restructuring process.

Third, the debtor decides to restructure the debt with external supervision, and the minority creditors do not accept the restructuring terms. In this case, if CACs are not able to make a majority decision binding to the minority creditors, then they would get 1 because by endangering the restructuring, they could put financial pressure on the debtor side to look for better financial terms. The debtor, by contrast, would get -2 because, unable to restructure the debt terms, the country's financial distress would deteriorate.

FIGURE 4. GAME WITH LEGAL AND FINANCIAL SUPERVISION

		Debtor	
		CACs trigger a full restructuring	CACs do not obtain majority thresholds
Minority creditors	Accept the restructuring terms	1,3	1,3
	Do not accept the restructuring terms	-1,2	1,-2

In this game, from the minority creditors' viewpoint, if they believe the debtor will trigger CACs, they will prefer to accept the restructuring terms as they will get 1 instead of -1. Moreover, if the minority creditors believe that the debtor will not get the majority voting to trigger CACs, then creditors would be indifferent between accepting or not accepting the restructuring terms. Contrary, from the debtor's point of view, thinking that the minority creditors would accept, they would be indifferent between using or not using CACs because both 1,3 and 1,3 are the best responses. Additionally, if the debtor thinks the minority creditors will not accept the restructuring terms, he will trigger CACs.

In this game, there are two SGPNE. First, because the debtor could trigger CACs, minority creditors would accept the restructuring terms. This is logical because, having imagined the success of triggering CACs, the minority creditors would be better off by accepting the initial restructuring terms. Second, when the debtor is sure that creditors will not be able to get a blocking position on the CACs, they would be better off by accepting the restructuring terms from the beginning. In sum, these two strategies constitute a Nash Equilibrium in every sub game.

In Figure 3, Pareto optimally is possible because when the debtor decides to restructure, minority creditors can only choose one strategy, which leaves the debtor and the minority creditors with the highest payoff. Likewise, when the debtor decides to restructure the debt terms, the best strategy for the minority creditors is to accept them. This is the best response because the debtor gets 3, and the minority creditors get 1. Conversely, not accepting the restructuring terms results in either (i) triggering a restructuring by using CACs which would end in 2 to the debtor and -1 to the minority creditors; or (ii) not carrying out a restructuring due to a failure of the collective procedure which gives -2 to the debtor and 1 to the minority creditors. In these cases (i and ii), there is a zero-sum game because one party's payoff is the other's negative payoff.

In this case, both SGPNE coincides with Pareto optimally; thus, not only is there one course of action that both parties would choose, but also this course of action will leave both parties better off without making the other party worse off. The previous idea set the basic idea of the boundary for determining when a breach of good faith could happen. Likewise, assuming that a restructuring game makes obtaining both a SGPNE and a Pareto optimal result possible, any party who deviates from such an outcome would breach the best course of action; thus, this breach would be tantamount to a breach of good faith.

In other words, SGPNE and Pareto optimal in the debtor–minority creditors game are possible provided that parties do not start a procedural controversy of CACs, but they negotiate the restructuring terms and get an outright outcome 3;1 of figure 3. When CACs cannot make a majority decision binding due to a blocking minority, this ends up in legal and economic tensions, which endanger the financial position of creditors and the debtor. From the debtor's viewpoint, this holdout behaviour breaches good faith because it makes the restructuring more complex. Contrary, from the minority creditors' viewpoint, when CACs are used successfully by a strategic clause interpretation, the debtor breach good faith because he arguably could use contract loopholes to get a majority voting on CACs. Accordingly, in this game, a SGPNE and a Pareto optimal outcome are the strategies that set the boundary between breaching and compliance of good faith.

An in-depth analysis of the outcome -2,1 (figure 3) illustrates when a minority creditor has breached good faith. After a supervised debtor restructuring proposal, the minority creditors chose between accepting the restructuring terms and therefore getting an optimal result or not accepting the terms and obtaining a suboptimal result. As an optimal result make minority creditors and the debtor better off than a suboptimal result, the decision which led to the suboptimal outcome is a breach of good faith. This case shows that CACs lead to sub-optimal results compared to when both parties agree on a supervised restructuring (3,1).

On the contrary, from the debtor's side, good faith would be breached when they make a restructuring proposal without a legal and financial supervision authority, like in the case of Figure 1. In this case, Nash equilibrium was impossible because an optimal choice for the debtor and the minority creditors was not achievable. Moreover, this case was where minority creditors could have argued that the collective procedure violated good faith due to coercion, violation of the NLFT, transparency or reasonability. Consequently, making an unsupervised proposal ends up in creditors trying to get a blocking position in the collective action procedure which enhances the probability of litigation and suboptimal outcomes.

EVALUATION OF SUBGAME PERFECT NASH EQUILIBRIUM AND PARETO OPTIMALLY IN THE RESTRUCTURING GAME.

Incentives of the Subgame Perfect Nash Equilibrium and Pareto Optimally Approach to a Breach of Good Faith

Setting a breach of good faith from SGPNE and Pareto optimally increases legal certainty in a debt restructuring. Reaching either a majority decision for making a restructuring binding to the creditor community or a robust minority for blocking such restructuring creates tensions in the collective procedure. This procedure, moreover, ends up in a zero-sum game, and it causes the parties to make CACs strategic interpretations to protect their positions. However, suppose either party could choose an optimal strategy given the other party's choice. In that case, the collective tension could be reduced because the parties do not have to protect their positions with innovative CACs interpretations. As a result, when a SGPNE and PO are an alternative to a Zero-Sum game, both parties could achieve optimal results, making CACs unnecessary and the restructuring process less controversial.

Additionally, when SGPNE and PO are used as a boundary to determine a breach of good faith, parties are incentivised to stay in SGPNE and PO; thus, making a successful restructuring more likely. If a party knows that deviating from a SGPNE and PO course of action will make them liable for a good faith breach, they will realise their probability of paying damages will increase. Therefore, they may prefer to stay at a SGPNE and PO situation to avoid paying damages. Consequently, staying in SGPNE and PO creates an incentive to negotiate a restructuring amicably.

Furthermore, using the SGPNE and PO approach to good faith in a restructuring negotiation incentivises reasonable behaviour from minority creditors. For example, if a minority creditor is considering to free ride on an optimal restructuring, a court would determine that holding out is against the optimal negotiation; therefore, making him responsible for breaching good faith. Because a minority creditor would rather prefer to accept the optimal restructuring offer than be responsible for breaching good faith, the creditor would stick to a course of action where SGPNE and PO are possible; therefore, the probability of holding out reduces.

Moreover, the SGPNE and PO approach to a breach of good faith would weaken holdouts' probability of succeeding in enforcing the full terms of the bond because the probability of getting a favourable judgment reduces. Remember that in Section IV we said that a creditor studies if , then if this is the case, the creditor should go before a court to enforce the full terms of the bonds provided that . The SGPNE and PO approach to a breach of good faith would decrease , because a judge would consider that the creditor is deviating from the optimal agreement. As the creditor notices that reduces their probability of getting full payment of principal and interests, they should decide not to sue the debtor.

In addition, the SGPNE and PO approach to a breach of good faith incentivises reasonable behaviour from the debtor. Firstly, the debtor's restructuring financial offer under external supervision may be more reliable than an unsupervised offer. Secondly, the debtor will know that an unsupervised restructuring offer will automatically breach good faith, thus making the debtor responsible for paying damages to creditors. Accordingly, the SGPNE and PO approach to a breach of good faith would reduce the probability of making unreasonable financial proposals.

Furthermore, accepting that a deviation from SGPNE and PO triggers a breach of good faith would reduce the probability of controversies related to CACs. When SGPNE and PO are possible in a sequential game, any party who deviates will breach good faith because they would be moving aside from an optimal agreement. Remember that while the debtor could be responsible for trying to push the understanding of CACs, the creditor could be responsible for endangering an optimal result for both parties. Subsequently, as any party would prefer not to be responsible for a breach of contract, they would prefer not to initiate legal proceedings related to CACs.

Finally, including a SGPNE and PO approach to good faith in a debt contract could incentivise creditors to provide financial assurances when the IMF requires them to provide financial assistance. The Fund's financial assistance in critical cases, like Sri Lanka(International Monetary Fund, 2022a, p. 2) and Zambia(International Monetary Fund, 2022c), were conditioned to financing assurances from private creditors, thus making it crucial that the debtor reaches an agreement with such creditors for a successful debt restructuring. Accordingly, if a SGPNE and PO clause is included in the contract terms, the IMF may be more willing to lend to the country because private creditors will show a precommitment towards a restructuring. Therefore, the SGPNE and PO approach to good faith could thoroughly deal with incentives to stay in an optimal agreement.

Subgame Perfect Nash Equilibrium and Pareto Optimally Approach to Good Faith in Courts

Adjudicators could use the SGPNE and PO approach to determine a breach of good faith. Likewise, in *Contrarian v. Ecuador*, the Judge could have checked if a financial oversight had supervised the Ecuadorian debt restructuring terms. If the financial and legal supervisor had supported the restructuring terms, the Judge could have concluded that the restructuring outcome could have been optimal for the parties. Conversely, had any party chosen a way of play that made the other party worse off, the adjudicator could have concluded that such party were looking for a suboptimal result, making both parties worse off. Even though it would be a matter of local law whether the Judge could consider the supervisory oversight in his judgement, he could have an objective understating of what constitutes reasonable behaviour by the parties. As a result, eventually, the Judge could argue that hindering an optimal negotiation was tantamount to a breach of good faith.

Moreover, the SGPNE and PO approach to a breach of good faith avoids ex-ante controversies associated with procedural fairness, such as the redesignation and Pac-Man strategies. Because a SGPNE and PO approach to a breach of good faith incentives creditor's support to a restructuring, creditors may approach the negotiation more confident about the financial terms of the exchange offer. For example, casting votes in *Contrarian* was related to the expected good faith behaviour by the sovereign. Had the SGPNE and PO approach to good faith been used, creditors might have shown a cooperative attitude towards the debtor's offer. However, the controversy ended up in court because the exchange offer did not have a boundary between what constituted a breach or good faith compliance. As a result, the SGPNE and PO approach to good faith would reduce debtors' necessity of creating CACs strategic understandings to enforce financial proposals to non-cooperative creditors.

Additionally, the SGPNE and PO approach to a breach of good faith contributes to the judicial scrutiny of CACs before English courts. Likewise, *in Myers*, the Chancery Division stipulated that good faith obligations must be expressly included in commercial contracts and that the Court has no authority to introduce "fairer or more reasonable" provisions(Dennis Edward Myers and Another v Kestrel Acquisitions Ltd and Others, 2015); however, it did not address its scope. Accordingly, *Myers* serves for showing the limitation of good faith when defining the scope of fair or reasonable provisions in practice. Had a breach of good faith been analysed from a sequential game perspective, the judge may have been able to assert a breach of good faith.

Finally, in US courts, the SGPNE and PO approach to a breach of good faith could help to clarify views on the meaning of reasonability in bond restructuring cases. For example, in *Katz*, the Court held that there was not a good faith breach because there was not a violation of the reasonable expectations of the bondholders(Katz v. Oak Industries, Inc., 1986). The breach of good faith is too broad and subjective that the parties and the judge frequently have a different views on when the principle has been breached. Accordingly, if the deviation from SGPNE and PO had been used, parties could have objectively understood when the breach occurred.

Academic Impact of Subgame Perfect Nash Equilibrium and Pareto Optimally on Good Faith

The SGPNE and PO approach could deepen Goldman's idea that good faith is a duty not to obstruct negotiations(Goldman, 2014, p. 12). According to Goldman, good faith could be interpreted as behaviour that does not hinder a negotiation; nonetheless, it does not define a limit that sets *when* and *how* the principle has been breached. Likewise, an obstruction to an unsupervised exchange offer could have been legitimate because creditors did not benefit from a neutral supervisor. Therefore, SGPNE and PO in a restructuring sequential game expands Goldman's idea on what constitutes obstruction of a sovereign debt negotiation, and when such obstruction happens.

SUBGAME PERFECT NASH EQUILIBRIUM AND PARETO OPTIMALLY APPROACH TO GOOD FAITH IN PRACTICE

The Condition of a Legal and Financial Supervisor

The boundary for determining a breach of good faith depends on an appointment of a supervisor. A financial and legal supervisor in the restructuring is a condition for creating a situation where both SGPNE and PO are possible; accordingly, if the supervisor is unwilling to participate, the game would return to figure 1, where Pareto optimal was not possible. Consequently, external supervision is essential to construct a negotiation where both SGPNE and PO are possible.

Ideally, the parties should appoint a supervisor to increase the legitimacy of the financial and legal advice. When parties appoint the surveillance authority, they may be more willing to accept the financial terms of the restructuring. Conversely, suppose the supervisory authority is only appointed by one party. In that case, the non-participating party may not entirely support the financial advice on the restructuring terms, thus creating tensions concerning advice objectivity. Consequently, the supervisory authority should address both parties' interests.

The supervisory authority should be different from the IMF because this international organisation is frequently a creditor (with a *de facto* preferred creditor status) of sovereign states, thus creating a potential conflict of interest with the restructuring parties. Usually, the IMF serves as a lender of last resort to insolvent sovereign debtors who need financial assistance; thus, making this organisation another creditor who will eventually be part of the restructuring process. Arguably, a party being simultaneously a creditor and supervisor may have a biased approach to what could be financially appropriate to the sovereign state. For example, while acting as a supervisory authority, the IMF may care about the amount of necessary debt relief for debt sustainability; as a creditor they may also verify that their right of payment is guaranteed. In 2021, the IMF Executive Board Assessment published an ex-post evaluation of Argentina's Exceptional Access Under the 2018 Stand-By Arrangement which showed that their financial assistance should have incorporated realistic assumptions(International Monetary Fund, 2021, pp. 1-3). Therefore, if a credit line is based on limited information, the outcome of the restructuring could be heavily affected. As a result, IMF creditor (preferred) status could compromise their judgment on supervising a restructuring negotiation.

In addition, if debt relief is essential for a successful restructuring process, the financial supervisor should guarantee that debt relief is efficiently allocated; otherwise, SGPNE and PO would not be possible in the sequential restructuring game. For example, debt relief given in the form of principal reduction, maturity extension, change in interest rate, or new debt instruments -among others- should be given to creditors in such a way which maximises the value of each debt relief form. Moreover, debt relief represented in maturity extension should be given to creditors who value it the most because if this is given to a creditor who does not value maturity extension as much as another, it will create a loss of value in the debt relief distribution. As a result, the more efficiently debt relief is distributed, the less pain creditors could experience.

Moreover, the supervision should take into account the financial position of both parties in order to reduce problems connected to asymmetric information. Likewise, because parallel debt negotiations with other creditors – such as bilateral creditors, multilateral organisations, or domestic creditors – are typical, the supervision should approach the restructuring with full awareness of the conditionalities and constraints of the sovereign to negotiate. For example, it would be crucial to study, if available, a Debt Sustainability Framework for Market access countries or an IMF- World Bank Debt Sustainability Framework for Low-Income Countries. Additionally, the supervisor should evaluate whether restructuring financial terms may hinder the financial stability of commercial banks or non-bank financial intermediaries. Accordingly, evaluating a breach of a legal and economic approach to good faith requires disclosure of financial constraints to be potentially helpful.

Finally, because SGPNE and PO are only possible when a financial supervisor oversees the restructuring proposal, it is necessary to find a way to pre-commit to a line of play where the outcome is 3;1 like in figure 3. This precommitment is essential for the theory's success because if not possible, the result would be one of figure 1 where SGPNE and PO are not possible. For example, legally binding precommitments could be an amendment to the bonds clauses; precommitment clauses in new bonds terms; a model law stipulating a restructuring supervisor authority; or possible ways to agree on a supervisor authority for restructuring purposes.

How can a Subgame Perfect Nash Equilibrium and Pareto Optimal Good Faith be Included in the Restructuring Process?

The SGPNE and PO approach to good faith could be included in the bond terms as a clause. First, this clause would facilitate an objective interpretation of a good faith breach because this analysis would use a clause in the contract rather than a subjective understanding of how good faith is breached. Second, the clause would avoid biased interpretations on the merits of the breach because the analysis would focus on whether any party deviate from an optimal outcome given the optimal outcome of the other party. Third, the clause would benefit both parties because the debtor would breach good faith when they try to enforce a restructuring without a mutually agreed financial supervisor, and the creditor would breach good faith when they try to hinder a supervised restructuring. Thus, including a clause which regulates SGPNE and PO equilibrium is practical for restructuring purposes.

Even though the principle's objective is to overcome the obligatoriness and enforceability problems of good faith, the SGPNE and PO approach could also be a soft law instrument for addressing bond restructuring issues. Likewise, an international instrument could include economic-good faith as a guiding principle for dealing with inter-creditor or creditors-debtor tensions during a restructuring. Organisations like the International Capital Market Association, The Hague Conference on Private International Law or the United Nations Commission on International Trade Law could enact the economic good faith approach as a soft law principle. Moreover, states could pass this into local law for adopting economic-good faith.

Moreover, this theory makes a steep forward on sovereign debt principles because it expands the current understanding of a breach of good faith. This study accomplishes limiting the extent of the principle; nonetheless, in some cases, it may be more convenient to stick to a subjective approach to good faith as there are complex cases requiring broad interpretations. In sum, the SGPNE and PO approach to a breach of good faith opens a new door for addressing its compliance.

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