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Private Bond Restructurings: Lessons for the Case of Sovereign Debtors

Prepared by Marco A. Piñón-Farah 1/

Authorized for distribution by Steven Dunaway

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Abstract

This paper reviews recent experience with both sovereign and private bond restructurings. It also summarizes the literature on private bond restructurings and describes the "typical" process for a voluntary exchange of new bonds for existing obligations. From this information some conclusions are drawn as to the possibility of concluding voluntary restructuring agreements for sovereign bonds within relatively short periods of time.

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Summary

With the sharp rise in bond financing in recent years, developing countries have experienced a substantial increase in the number and in the diversity of their creditors. As a consequence, it is generally believed that a restructuring of sovereign bonds could be a complicated and drawn-out process in the event that a country were to encounter payment difficulties. Nonetheless, some sovereign bonds have been successfully rescheduled in the recent past and voluntary restructurings of private bonds are relatively common.

The lack of a specific, bankruptcy-like mechanism for involuntary reschedulings of sovereign bonds and the difficulty in differentiating the seniority of various types of debts may complicate attempts to restructure these claims. However, given that foreign courts can usually only enforce judgments only on assets held by a sovereign outside its legal territory (which may be a limited amount), the expected recovery of claims through legal proceedings is likely to be more uncertain in the case of a sovereign than in the case of private debtors. Moreover, pursuing legal remedies can be quite costly to creditors.

Since the 1980s, four voluntary bond restructurings have been concluded for sovereign debtors: Costa Rica (1985), Guatemala (1989), Nigeria (1988), and Panama (1993). Over the same period, there have been numerous private bond restructurings in the United States, including such prominent cases as Univision and RJR Nabisco. More recently, Areomexico (Mexico's largest airline) managed a successful exchange of new obligations for some existing Eurobonds.

The picture that emerges from this review is that, in spite of potential obstacles and limited experience with sovereign bond restructurings, it is reasonable to expect that voluntary agreements could be reached within an acceptable period of time, depending on how an exchange offer is tailored in consultation with major creditors. The success of an exchange offer depends critically on whether creditors are convinced that the exchange provides them with a higher and more certain payout on their claims than alternative legal remedies.

I. Introduction

In recent years, there has been a dramatic shift in the composition of external debt of developing countries away from commercial bank loans to bonds. Given the wide variety of investors that are now purchasing these bonds and the likely diversity of their interests, it is generally considered that it would be difficult to restructure this debt in the event a country encountered financial difficulties. In the absence of a well defined and accepted process for accomplishing a rescheduling, it is suggested that mechanisms employed to restructure debts would be ad hoc and might involve "involuntary" solutions. As a consequence, holders of the debts might seek to seize a country's assets or threaten to disrupt its trade and payments system, thereby running the risk that the country's adjustment efforts and attempts to resolve its difficulties in a coordinated fashion would be undermined. Even if a resolution were negotiated with major holders, there is a concern that recalcitrant creditors ("free riders") by trying to enforce their original claims could derail any negotiated settlement. Moreover, involuntary debt restructuring could significantly undermine a country's creditworthiness and might have a more lasting impact on its ability to access international markets in the future.

Despite the difficulties, a few countries have successfully rescheduled sovereign bonds in the recent past. 1/ These experiences may shed some light on the possible means of accomplishing a successful restructuring of bond debt and the problems involved. In addition, similar difficulties exist in restructuring privately issued bonds. Corporate bond restructurings are relatively common, and the growing literature on the subject may provide insights for dealing with possible sovereign bond reschedulings. In particular, a bond rescheduling recently undertaken by a private developing country borrower and the "junk" bond 2/ reschedulings in the United States may provide some relevant lessons.

II. General Approach

1. Private debtors

The restructuring of bonds generally involves the exchange of new for existing securities. In the case of a private debt exchange, the success of the offer depends on whether creditors expect that they will receive a

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1/ For a more complete discussion, see Juan José Fernández-Ansola and Thomas Laursen, "Historical Experience with Bond Financing to Developing Countries," IMF Working Paper, WP/95/27 (March 1995).

2/ Junk bonds are high yielding bonds issued by U.S. corporations with non-investment grade ratings. The credit ratings of these companies are roughly comparable to those of many developing countries.

higher payout from the bond exchange than from bankruptcy proceedings. Creditors are likely to grant concessions (including an amount of debt forgiveness), as long as the expected value of the firm as an ongoing concern--net of the cost of the restructuring and the face value of more senior claims--exceeds the expected liquidation value, net of the value of the more senior claims and the cost of legal proceedings. 1/

A successful negotiation of a debt restructuring agreement is complicated, however, by the possibility that both parties in the negotiation do not possess the same level of knowledge regarding the true profitability of the firm. Often, debtors ("informed" players) may be perceived by creditors ("uninformed" players) as having no incentive to reveal the true profitability of the firm. As a result, creditors may resist accepting the terms of an agreement, which may, in fact be in their best interest. Thus, adverse selection can lead often to insufficient debt relief and unnecessary bankruptcy filings.

Compared with other forms of debt, cases of private bond restructurings face additional difficulties. Firstly, voluntary bond workouts are often viewed as more difficult to achieve, due to the large and diverse number of creditors, which could complicate the task of reaching an agreement on the terms of the restructuring. Furthermore, as out-of-court agreements are not binding on dissenting creditors, hold outs by minority groups can hinder the agreement. Stein (1989), for example, confirms that bank creditors are more likely to favor out-of-court agreements. In spite of these difficulties, corporate bond restructurings are common. Asquith (1991), in a sample of 102 junk bond issuers in financial distress during the 1970s and 1980s, find that 34 companies successfully completed 93 bond exchanges. Moreover, they find that bondholders are more likely to accept terms involving debt relief (lower principal or interest payments) than bank creditors.

A central argument in favor of a voluntary agreement is that its cost is likely to be substantially lower and that major participants have more control and flexibility in the restructuring. For example, some studies (see Nauer (1991)) have estimated that the out-of-pocket expenses of a workout were typically less than 1 percent of a company's market value, while Chapter 11 proceeding could cost up to 5 to 10 percent. Moreover, Gilson (1990) finds that exchange offers are normally completed within two months, while bankruptcy proceedings have a median of 18 months in their sample. Hence indirect costs (including the opportunity cost of management's time being devoted to debt issues instead of the company's business) are also likely to be lower under a voluntary agreement.

1/ In practice, the seniority of claims is not always strictly enforced in legal proceedings. Weiss (1989) find that in 29 of 37 firms studied priority of claims was not fully respected.

Furthermore, since the attractiveness of an exchange offer also depends critically on the expected value of the firm as an ongoing concern, compared with its liquidation value, exchange offers are often made in the context of actions that may increase the profitability of the firm. Such actions might include operational changes and new capital infusions, some of which are made contingent on the acceptance of the exchange offer. New investments signal the shareholders approval of the restructuring effort and the expectation of increased profitability.

Finally, exchange offers are generally tailored to increase the expected payout of the targeted bondholders class. For example, successful bond exchanges often involve swaps of subordinate claims for new notes which are more senior, which entails a higher recovery of investment in the case of a future bankruptcy filing. Also, exchange offers often include equity as part of the swap. Detragiache (1995) has shown that the latter addresses the problem of adverse selection inefficiency.

2. Sovereign debtors

In principle, the discussion of private bond restructuring can be extended to the case of sovereign debt--and more specifically to sovereign bonds. Holders of sovereign bonds can also benefit by reaching voluntary restructuring agreements providing higher net recovery of their investment, particularly when faced with a credible threat of default and an uncertain outcome of costly court proceedings. However, there are some important differences that arise in the case of sovereign bonds. There may be an uncertain expected recovery under the legal route since court actions in jurisdictions outside of the sovereign debtor's can enforce judgments only on assets held by the sovereign abroad, 1/ compared with the full liquidation value of a corporation in the private debtor case. Thus, creditors may be more receptive to reaching agreement on a voluntary workout. At the same time, there is a lack of a specific mechanism for "involuntary" restructurings of sovereign debt (similar to bankruptcy proceedings), and there are difficulties in differentiating the seniority of various types of debt to private creditors. 2/

In principle, the problem of imperfect information discussed in the literature on exchange offers could be addressed in sovereign debt cases through a number of mechanisms. For example, a recovery clause contingent on the evolution of an indicator of the country's capacity to pay could reduce the creditor's concerns. In practice, these indicators are difficult

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1/ The ability to attach assets abroad may be rather limited depending on the law and custom regarding sovereign immunity existing in various jurisdictions and whether the sovereign borrower has waived its immunity.

2/ In the case of sovereign debt, seniority may be effectively established by collateral arrangements--especially the earmarking of certain types of foreign exchange receipts. Such actions, however, may create difficulties with official creditors.

to define and are unlikely to fully anticipate or reflect changes in a country's payments capacity. As a result, adverse selection could pose more of a complication in sovereign debt cases, but it might be addressed by the involvement of a credible third party.

Given the limited access to bond financing by developing countries during the post-War period until the early 1990s, there are only a few cases of payment difficulties which have resulted in defaults. However, although believed to be less complicated than bond restructurings, the resolution of the commercial banks debt crisis of the 1980s and 1990s may provide some insights as to the valuable role of third parties. 1/ In particular, the undertaking of an IMF supported program is generally expected to reduce the adverse selection problem arising from the asymmetry of information. Moreover, since 1989 the IMF has allowed outright approval of an arrangement before the conclusion of negotiations on an appropriate package with commercial banks, and together with the World Bank and other institutions, has contributed to the financing of commercial bank debt restructurings. Therefore, although not necessarily binding in national courts, countries received some limited form of protection from creditors actions while receiving new disbursements and undertaking adjustment efforts. This result in part reflected the sharing clauses in most commercial bank loan agreements. Under the terms of these clauses, all creditors share with each other any recovery of claims. 2/ In addition to reducing information asymmetry, IMF-supported programs have been seen by creditors as improving the prospects for the recovery of their claims, making them more receptive to debt restructuring agreements.

III. Recent Experience

1. Sovereign bonds

During the 1980s, four countries were able to restructure sovereign bonds through unilateral debt-for-debt exchange offers. In 1985, as part of an overall restructuring of its obligations, Costa Rica asked creditors to accept a rollover of $90 million in bonds falling due in that year. Maturing obligations were to be exchanged for new U.S. dollar notes with a three-year grace period and an average maturity of 5 1/2 years, and carrying a floating rate of LIBOR plus 1 1/4, compared to a rate of LIBOR plus 7/8 on

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1/ Financial contributions from third parties, however, may introduce moral hazard problems by altering the expected recovery of the outstanding debt but also by enhancing the perception of implicit payment guarantees.

2/ Not all commercial claims have been resolved through out-of-court agreements. For example, Plenum Financial and Investments LTD and Camdex International pursued their claims against Zambia through the British courts after a restructuring agreement was reached with other creditors and in 1995, they won judgements against the country and some assets were attached. In these cases, however, Zambia had waived its sovereign immunity.

the original obligations. Banks and other financial institutions were given the option of tendering maturing bonds for conversion to debt under the country's 1985-86 bank refinancing agreement, where the terms were a three-year grace period and an average maturity of 7 1/2 years at an interest rate of LIBOR plus 1 5/8. Interest arrears totaling $22 million that accrued in 1984 were cleared prior to the exchange. More than 90 percent of creditors accepted the bond offer within a year.

In February 1989, Guatemala offered to restructure $500 million in bonds maturing in 1989-90, with interest rates ranging from 11 to 12.5 percent. Although Guatemala was current in servicing these obligations, a bunching of maturities meant that the country would be repaying two thirds of its external public sector debt by 1991. Under the exchange offer, existing bonds could be replaced by either dollar bonds with a fixed interest of 10 percent and 10 1/2 years maturity with a 4 1/2-year grace period or local currency-denominated bonds with a fixed interest rate of 16 percent and a 7 1/2 year maturity. The principal amount of the new bonds was issued at a premium to compensate for any reduction in interest rates compared with the old bonds. The offer was accepted by roughly 95 percent of bondholders within a year.

After failing to meet the first amortization payment due in 1986 and interest payments due in 1987 on government guaranteed promissory notes, Nigeria offered to restructure $4.9 billion of these notes (including capitalized interest). The notes had been originally issued to refinance trade arrears with uninsured suppliers after the country ran into financial difficulties in 1982-83. The notes had a six year maturity, including 2 1/2-years grace period and an interest rate of LIBOR plus 1 percent. In January 1988, a settlement was reached at a large bondholders meeting which restructured these notes over 16 years (including a two-year grace period) at a 5 percent interest rate.

Panama in 1993 began discussions with major creditors on restructuring $450 million in obligations (including past-due interest) on bonds that had not been serviced since 1987. These bonds consisted of U.S. dollar floating rate bonds with maturities of five to 12 years and interest rates ranging from LIBOR plus 5/8 to LIBOR plus 1 3/4; ECU denominated bonds carrying five year maturities and a fixed interest rate of 8 1/4 percent; and yen-denominated bonds carrying five year maturities and a fixed interest rate of 7.6 percent. Efforts were particularly intense on reaching an understanding on yen bonds because there was no precedent for a bond default and restructuring in the Samurai market. On January 31, 1994, Panama made an offer that included a 25 percent downpayment on past-due interest and the exchange of principal and remaining interest arrears at par. New notes were denominated in U.S. dollars or Japanese yen with a maturity of eight years (including a 1 1/2-years grace period) and interest rates of LIBOR plus 1 on U.S. dollar bonds or a fixed rate of 3 3/4 percent on yen bonds. By May 1, 1994, the exchange was completed with the participation of more than 97 percent of creditors.

In each case, the exchange of old bonds for new did not involve a reduction in principal (or a reduction in interest rates), with the exception of Costa Rica's where higher interest rates than on the original obligations were used as an inducement for creditor participation. Also, settlements required the debtors to make up-front cash payments on interest arrears. Costa Rica and Guatemala remained current on their bonds and were successful in reaching agreements to roll the bonds over before they matured. Panama and Nigeria, in contrast, were successful in restructuring their bonds with the participation of virtually all creditors, after the bonds were in default for a prolonged period.

A distinctive feature of these restructurings was that no official bondholder committees were involved in the settlements. Rather, terms of the exchange offers were formulated based on contacts with the main groups holding the securities. Bondholders signaled their approval by exchanging the old instruments for the new. While the formulation of workable settlements was complicated (especially in the case of Panama) by the diverse group of creditors involved and the different currencies of denomination of the bonds issued, settlements were reached with participation by virtually all creditors. The high level of participation in these exchanges suggests that, despite their diverse interests, creditors generally viewed the exchange offer as providing a better and more predictable outcome than attempting to collect payments on the original obligations through legal action.

All settlements were final and included negative pledge clauses, providing for the bondholders to receive any advantage granted to new or outstanding obligations. In addition, some settlements included early redemption options and allowed for debt conversions into equity. In all of these cases, agreement on the terms of the rescheduling was reached within six months to a year.

2. Private bonds

a. Voluntary exchanges--typical process

Many of the well-known recent cases of defaults in corporate bond markets followed the boom years of the "junk" bond market in the late 1980s. As a result, exchange offers have generally been aimed at reducing cash debt service, frequently requiring bondholders to accept a discount on their claims. Bond exchange offers typically have been presented in the context of broader restructuring efforts, often involving agreements with banks and other creditors, the liquidation of assets, and changes in the operation of the firm.

The specific terms of each offer were generally designed in consultation with at least some of the major bondholders and, typically, include debt-for-debt exchanges, debt-for-equity exchanges, buyback operations or a combination of all three. To encourage bondholders to tender their old bonds, new instruments were often more senior in payment

and/or matured sooner. Moreover, most offers were conditioned on acceptance by a critical mass of at least 85 percent of bonds outstanding. A sufficient critical mass was important because out-of-court agreements are not mandatory on dissenting bondholders in the United States 1/ and because any elimination of protective covenants of the old bonds requires a two thirds majority vote.

The modalities and the terms of exchange offers, however, have differed across cases significantly, highlighting differences in the capacity of firms to pay and the importance of appropriately tailoring agreements on a case-by-case basis to ensure that a high participation rate was achieved. Some restructurings were only successful after significant modifications to an offer's initial terms in line with creditors' expectations. The terms of the offers ranged from steep discounts on claims to exchanges at-par with added enhancements, with one key enhancement being to make new notes senior in payment.

Exchange offers, however, have been complicated since 1990 by changes in U.S. tax law and by a court ruling in one case which established a precedent favoring bondholders who refuse to participate in an exchange. According to this ruling, bondholders who surrendered their bonds are entitled only to the market value of the new instruments, while holdout bondholders could be entitled to the full value of the original instruments. This ruling might discourage bondholders from participating in future reschedulings because, even after carrying out successful exchange offers, some companies have ended up in bankruptcy proceedings at a later stage.

b. Selected cases in the U.S. junk bond market

One illustrative case involved Univision, a Spanish-Language broadcast network. In mid-1988, Hallmark Corporation and First Chicago Corporation purchased the company for $600 million. The operation was financed roughly half through bank debt and half through two issues of junk bonds. In March of the following year, however, Univision missed an interest payment. Citing severe financial difficulties owing in part to its debt service burden, the company offered to buyback its junk bonds for 45 cents on the dollar. After some initial resistance, 92 percent of bondholders agreed to participate in the operation when the offer was raised to 55 cents on the dollar.

One of the most famous junk bond cases involved RJR Nabisco. After the leveraged buyout of the company by Kohlberg Kravis Roberts in February 1989, the consolidated debt of the company was approximately $29 billion. Through a number of steps, including the sale of various businesses, the company was able to reduce its debt by approximately $11 billion by March 1991.

1/ Under the Trust Indenture Act of 1939, a firm can change the core terms of a bond (principal amount, interest rate and maturity) only if every bondholder agrees.

Nevertheless, the company continue to face steep debt-servicing costs. It was able to avoid a default on its obligations and a formal debt exchange by raising new funds to retire a portion of its original junk bond debt. In addition to a new issue of stock, the company made a $1.5 billion offering of 10 1/2 percent seven-year notes. These notes were explicitly designated by the company to be senior in right of payment to existing junk bond debts.

After an effort to branch out from distribution to manufacturing copying equipment, Savin Corporation faced severe payment difficulties in the late 1980s. Facing imminent bankruptcy proceedings the company's bondholders agreed in 1988 to an exchange of $167 million of debt for equity, including in-kind preferred stock. The exchange reduced drastically the company debt service and set the stage for a subsequent sale of over half of its stock to HCS Technology. In August 1992, the company filed for Chapter 11 protection, and in April 1995, Savin was acquired by Ricoh Corporation.

In the case of Seaman Furniture Co., a year after the 1980 purchase of 80 percent of the company's stock for $360 million by Kohlberg Kravis Roberts, the company was unable to meet its debt service obligations. After a long period of growth, sales declined in 1989 and cash flow was insufficient to cover interest payments. Bankruptcy proceedings were avoided when an exchange offer was accepted by creditors in November 1989. As part of the exchange, bondholders and bank creditors, coordinated by Manufacturers Hanover Trust Co., traded their claims for half-ownership in the company, while Kohlberg Kravis Roberts & Co. agreed to invest an additional $35 million. Despite the debt service relief provided by the exchange, the company filed for Chapter 11 protection in January 1992.

In a period of about 15 months, Oak Industries Inc. was able to successfully carry out two bond exchanges. In February 1985, the company offered to exchange its outstanding bonds for a package of new bonds, warrants, and common stock. The new bonds matured some 10 years earlier than the original bonds but carried a lower coupon rate and allowed interest to be paid in common stock; 79 percent of bondholders accepted the offer. Subsequently, in late 1985, as part of the restructuring effort, the company sold an operating division and common stock to Allied-Signal. The sale of common stock was made conditional on acceptance by bondholders of a new exchange offer consisting of a package of cash and common stock for the company's remaining outstanding bonds.

Petro Lewins Corporation was able to conduct two successful exchanges in less than a year. In the first offer, 80 percent of one bond issue and 58 percent of preferred stock issues were exchanged for new bonds and common stock. Subsequently, 50 percent of bondholders agreed to exchange four other bond issues for a package of new secured bonds (with a lower face value but higher coupon rate), common stock, and cash. A third exchange offer in 1986 was later called off. Towards the end of 1986, the company

avoided bankruptcy proceedings when Freeport-McMoRan Inc. acquired the company through a tender offer for all of the outstanding bonds and common stock.

c. Aeromexico

In June 1995, Aeromexico (Mexico's largest airline) asked the holders of $100 million in Eurobonds and $37.5 million in Euro commercial paper maturing in June 1995 to accept an exchange of these obligations for new five-year notes. The new issue would carry the same annual interest rate as the original bonds (9 3/4 percent, payable semi-annually). The company set a July 10, 1995 deadline for holders to accept the offer. To encourage creditors to accept the offer, Aeromexico indicated that the final interest payment on the existing obligation would not be forthcoming unless 95 percent of the bondholders accepted the restructuring plan. The company also announced that if debtors did not agree to the new terms, the company would seek bankruptcy protection in Mexican and foreign courts.

Although bondholders had the option of legal proceedings (the bonds were governed by New York law), by mid-July over 95 percent of debt holders had agreed to swap their obligations. The high participation rate reflected confidence in a restructuring plan that was presented to shareholders at a June 30, 1995 meeting. Implementation of this plan was made conditional on the success of the exchange offer. A majority of the company's creditors were reported to be willing to convert their debt into equity and a bank consortium (which took effective management control of Aeromexico in October 1994) was willing to inject new capital in preparation for a sell off of the company.

IV. Conclusion

Although the experience with sovereign bond restructurings is limited and the amounts involved have been small thus far, the picture that emerges from this review suggests that it may be possible to work out voluntary agreements for sovereign bonds within relatively short periods of time.

For an exchange offer to be successful, it should lead creditors to expect a higher recovery of their investment by accepting the offer. Thus, a credible risk of default, accompanied by an expectation of a less favorable and/or more uncertain outcome from pursuing legal means, has to be linked with a debt exchange offer consistent that is consistent with creditors perceptions of the payment capacity of the debtor. The experience both in the cases of sovereign debtors and companies issuing junk bonds indicates that the acceptance of an exchange offer is likely to be higher if the terms of the offer are appropriately tailored through consultations with creditors and part of a more general restructuring/adjustment effort.

In cases of perceived illiquidity, such as those resulting from a bunching up of maturities, holders of the claims are likely to expect an offer under terms at least comparable to those of the original bonds. In

other cases, bondholders may be willing to accept discounts; however, a perception on the part of creditors that debtors may lack an incentive to reveal their true capacity to pay could lead creditors to resist sufficient discounts and invite legal action.

The adverse selection problem arising from this asymmetry in information between debtors and creditors might be dealt with by the intervention of a credible third party that could provide an informed judgment as to the payments capacity of the debtor, a role essentially played by the IMF in the past. Moreover, economic policy and structural reforms implemented as part of an IMF-sponsored adjustment program could be expected to improve a debtor's payment capacity and prospects for creditors to recover their claims, providing an incentive for creditors to agree to a restructuring.

The scope for legal action in the case of sovereign borrowers rests on which country is designated in the bond contract to have legal jurisdiction in the case of disputes 1/ and that country's laws and practices regarding sovereign immunity. The ability of creditors to enforce judgments won against debtors also depends on the laws and practices regarding sovereign immunity and what assets of the debtors are available for seizure. Uncertainty over legal outcomes and their enforcement might provide significant incentive for creditors to accept voluntary restructuring offers.

More generally, given all of the potential difficulties involved in restructuring bonds, a sovereign debtor would not find this to be a useful course of action unless bond debt represented a substantial share of the country's outstanding and/or maturing obligations.

1/ Eurobonds generally are covered by the laws of the United Kingdom or the United States.

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