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Sovereign Bankruptcy: Why Now and Why Not in the IMF

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SOVEREIGN BANKRUPTCY: WHY NOW AND WHY NOT IN THE IMF

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As the Eurozone sovereign debt crisis that began in 2009 continues to run its course, leaving massive economic dislocation in its wake, and as NML Capital, Ltd. v. Republic of Argentina *makes its way to the U.S. Supreme Court, this Note discusses the timely and persistent problem of sovereign debt crises and the many impediments to their orderly resolution. This Note evaluates various proposals for dealing with sovereign debt–crisis resolution and concludes that a multilateral treaty–based sovereign bankruptcy regime, institutionally independent from the International Monetary Fund, offers the best solution.*

The status quo—messy, inefficient, and unpredictable ad hoc negotiations—has consistently proven inadequate. Ex ante contractual devices and piecemeal statutory fixes in domestic law offer at best incremental solutions that can do little to alter the fundamental problems with the present state of affairs. Just as domestic bankruptcy law complements the law of creditor remedies due to the shortcomings of the latter, so too should a system of international bankruptcy law complement the law of creditor remedies vis-à-vis sovereign debtors. This Note argues that, although this approach may be difficult to achieve, that does not justify abandoning it.

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INTRODUCTION

In 2012, Greece executed a debt exchange and subsequent buyback that earned the distinction of being the largest ever debt restructuring by volume.[1] The debt exchange also involved the largest ever aggregate creditor losses.[2] The restructuring included the near elimination of Greece's sovereign bonds held by private investors, which had a face value of more than 100 percent of Greece's gross domestic product (GDP).[3] The architects of the deal applauded themselves for achieving high creditor participation (97 percent) and significant debt relief for Greece (approximately 50 percent of the country's GDP).[4] But the same dealmakers heralding the success of the restructuring concede that the deal came far too late (more than two years after Greece lost access to capital markets and long after Greece's debt became unsustainable), created large risks for the European official creditors involved, left money on the table for Greek taxpayers, created a terrible precedent by paying holdout creditors in full, and failed to restore Greece to sustainability.[5] And that is what the brokers of the global financial system consider a success?

Lack of experience with sovereign debt crises is no excuse for the international community's current dearth of legal and policy tools to address the serious problems presented by situations like that in Greece. The first recorded sovereign debt default dates back to at least the fourth century BCE, when ten Greek municipalities in the Attic Maritime Association defaulted on loans from the Delos Temple.[6] And sovereign debt difficulties have persisted throughout the subsequent centuries. Charles V's empire relied heavily on short-term and consolidated loans with private bankers, despite earning substantial revenues from its colonies.[7] France defaulted on its debt eight times between 1500 and 1800,[8] while Spain defaulted thirteen times between 1500 and 1900.[9] The Panic of 1837 led to eight U.S. states plus the Florida Territory defaulting

1. Jeromin Zettelmeyer, Christoph Trebecsh & Mitu Gulati, *The Greek Debt Restructuring: An Autopsy*, 28 ECON. POL'Y 513, 515–16 (2013).

2. *Id.*

3. *Id.*

4. COMM. ON INT'L ECON. POLICY & REFORM, REVISITING SOVEREIGN BANKRUPTCY 25 (2013), *available at* http://www.brookings.edu/~/media/research/files/reports/2013/10/sovereign%20bankruptcy/ciepr_2013_revisitingsovereignbankruptcyreport.pdf.

5. *Id.* at 24–26; Zettelmeyer et al., *supra* note 1, at 517.

6. FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 3 (2006).

7. Juan Gelabert, *Castile, 1504–1808*, *in* THE RISE OF THE FISCAL STATE IN EUROPE, C. 1200–1815, at 206–07 (Richard Bonney ed., 1999).

8. Richard Bonney, *France, 1494–1815*, *in* THE RISE OF THE FISCAL STATE IN EUROPE, C. 1200–1815, *supra* note 7, at 147–48, 162 (discussing France's policy of persistent partial defaults in order to maintain a serviceable level of debt during the eighteenth century).

9. Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance*, BROOKINGS PAPERS ECON. ACTIVITY, 2003 No. 1, at 1–2, 6.

on bonds by the time the subsequent recession ran its course.[10] And the more than 600 individual cases of sovereign debt restructurings recorded since World War II reveal that debt defaults and restructurings have been prevalent both across and within countries in the modern era.[11]

That sovereigns will continue to utilize capital markets to finance their expenditures is a given.[12] That at some point any given sovereign will experience a mismatch in maturities of outstanding debt obligations and adequate currency with which to service it—whether due to domestic policy mismanagement, exogenous shocks, or some combination of the two—seems equally certain.[13] Centuries of well-documented financial crises would seem to clearly support these statements.[14] The recent sovereign debt crises in the Eurozone starkly illustrate that the heretofore widely held assumption that advanced economies are immune to sovereign debt crises in the modern era is plainly wrong.[15] Yet under the current international

10. DANIEL WALKER HOWE, WHAT HATH GOD WROUGHT: THE TRANSFORMATION OF AMERICA, 1815–1848, at 502, 508 (2007).

11. Udaibir S. Das, Michael G. Papaioannou & Christoph Trebesch, *Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts* 30 (Int'l Monetary Fund, Working Paper No. WP/12/203, 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf.

12. *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Responsible Sovereign Lending and Borrowing*, 73 LAW & CONTEMP. PROBS. 63, 64 (2010) (explaining that advanced economies rely on borrowing to finance their budget deficits, while developing countries require it to develop); Manuel Monteagudo, *Peru's Experience in Sovereign Debt Management and Litigation: Some Lessons for the Legal Approach to Sovereign Indebtedness*, 73 LAW & CONTEMP. PROBS. 201, 212 (2010) ("History shows that public powers have always demanded financial resources . . . ."). At the end of 2011, the external debt stock of the G-7 countries totaled $42.5 trillion, with an average of 26 percent owed by governments. THE WORLD BANK, INTERNATIONAL DEBT STATISTICS 13 (2013). The stock of developing countries' external debt has continued on an upward trend, rising from $4.4 trillion in 2010 to $4.9 trillion at the end of 2011, with 51 percent of long-term debt publicly guaranteed. *Id.* The general government debt of the seventeen Eurozone countries averaged 76 percent of GDP in 2011, which is more than twice the comparable ratio for the largest borrowers among developing countries. *Id.* The seventeen Eurozone countries are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovak Republic, Slovenia, and Spain.

13. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 39–47; Das et al., *supra* note 11, at 66–82.

14. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 3–29 (providing a detailed discussion of sovereign debt crises since the nineteenth century); Das et al., *supra* note 11, at 30 (noting that more than 600 sovereign debt restructurings have taken place during the last sixty years); *see also supra* notes 6–11 and accompanying text. *See generally* WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 118–52 (Hartley Withers ed., 14th ed. 1915) (1873) (for a classic treatment of financial panics in a broader sense).

15. *Compare* LEX REIFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 50–51 (2003) (asserting the then widely accepted view that "[n]one of the mature democracies in the world have come close to a sovereign default in the Bretton Woods era" and "a default by one of these countries on its foreign debt is almost inconceivable"), *with Euro in Crisis*, FIN. TIMES, http://www.ft.com/indepth/euro-in-crisis (last visited Mar. 25, 2014) (providing news, commentary, and analysis of the Eurozone's ongoing sovereign debt crises unfolding in Greece, Ireland, Cyprus, Portugal, and Spain), *and* Charles Forelle, *Iceland Borrows $2 Billion From IMF*, WALL ST. J. (Oct. 25, 2008, 12:01 AM), http://online.wsj.com/news/articles/SB122486370333666973.

legal regime, in spite of centuries of experience with the problem and the ongoing evolution of international legal institutions, sovereign debt restructurings are handled in a totally ad hoc manner.[16] They are chaotic, messy, unpredictable, and can drag on for many years.[17] The current regime is marked by serious shortcomings—it lacks transparency and legitimacy, is inefficient, and applies inequitable treatment both to debtors and creditors.[18]

From the vantage point of common law, debt (as the term is used herein) is a contract.[19] It is a legally enforceable promise between debtor and creditor.[20] Debt contracts derive their value from the "framework of laws and institutions that support them."[21] Certainty, predictability, and uniformity of result are important values in all areas of the law. But where the parties are likely to give advance thought to the legal consequences of their transactions, as in a contract, these values are at their apex.[22]

Proposals for an international legal framework that provides for creditor remedies vis-à-vis sovereign debtors in an orderly fashion are nothing new.[23] Shortly before World War II, the League of Nations formed a special committee that proposed the creation of the International Tribunal for Debts, which would have had jurisdiction to adjudicate sovereign lending contracts with international private borrowers.[24] Periods of intense intellectual debate in this area have ebbed and flowed since then, particularly since the 1970s.[25] The academic and policy community now finds itself in another period of intense debate.[26]

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16. *See infra* Part II.A.

17. *See infra* Part II.A.

18. *See infra* Part II.A.

19. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 55–63; Ugo Panizza, Federico Sturzenegger & Jeromin Zettelmeyer, *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LITERATURE 651, 651 (2009).

20. *See, e.g.*, 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 1 (3d ed. 2004); *see also infra* Part I.C. *But see, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 55–63 (discussing limitations on the legal enforcement of sovereign debt contracts, most of which are largely practical and political rather than legal).

21. REIFFEL, *supra* note 15, at 11.

22. *See, e.g.*, Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1314 (N.Y. 1989) (noting that contract law is "an area of the law where certainty, predictability and reliability are highly prized common-law goals"); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 cmt. i (1971).

23. In 1776, Adam Smith wrote:

> When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor.

ADAM SMITH, THE WEALTH OF NATIONS 883 (Edwin Cannan ed., Modern Library ed. 1937) (1776).

24. LEAGUE OF NATIONS, REPORT OF THE COMMITTEE FOR THE STUDY OF INTERNATIONAL LOAN CONTRACTS 5–7 (1939); MICHAEL WAIBEL, SOVEREIGN DEFAULTS BEFORE INTERNATIONAL COURTS AND TRIBUNALS 324 (2011).

25. *See, e.g.*, Das et al., *supra* note 11 (providing an in-depth review of the literature from 1950 through 2010); *see also* Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001*, 49 IMF STAFF PAPERS 470 (2002); Kathrin Berensmann & Angélique Herzberg, *International Sovereign Insolvency*

Commentators who favor the idea of a bankruptcy regime for sovereign debtors have invoked countless reasons—many grounded in economic, policy, social, and moral arguments—to support their position.[27] Opponents have responded with a similarly far-reaching panoply of criticisms.[28] As the discussion of the utility of a sovereign bankruptcy mechanism has reemerged in earnest in the wake of the Eurozone sovereign debt crisis[29] and the *NML Capital, Ltd. v. Republic of Argentina* saga,[30] this Note deigns to enter the fray by elevating one central proposition: from the perspective of contract law, a preagreed framework for the orderly resolution of sovereign debt crises, akin to a bankruptcy mechanism, is desirable for both debtors and creditors. Such a mechanism has the potential to provide certainty, predictability, and uniformity of result in a way that no other existing or proposed solution can. Just as domestic bankruptcy law complements the law of creditor remedies due to the shortcomings of the latter,[31] so too should a system of international bankruptcy law complement the law of creditor remedies in the realm of sovereign debt. As Anna Gelpern aptly stated in a recent commentary, in spite of the formidable practical obstacles to implementing a sovereign bankruptcy regime, the role of the legal academy "is to challenge imaginations until reality catches up."[32] This Note is informed by that valuable insight.

Part I of this Note provides an overview of key features of sovereign debt, sovereign debt crises, and subsequent debt workouts, including key legal issues. Part II introduces and discusses the tools that are on the table, whether in reality or as academic constructs, for dealing with sovereign debt crises. These tools include ad hoc deals (currently the predominate approach), contractual devices, national legislation, and multilateral solutions. Part III takes the position that coordinating sovereign debt restructurings through an orderly preagreed framework, in the form of a multilateral treaty, would be the most satisfactory solution. Part III also suggests the general contours of the form such a treaty mechanism should take, and it concedes some of the key impediments to this approach, namely, political realities.

I. SOVEREIGN DEBT IN DISTRESS: RESTRUCTURINGS, BAILOUTS, AND BAIL-INS

This Note begins by providing context for the debate regarding sovereign debt–crisis resolution. Part I.A sets forth a basic overview of the sovereign

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Procedure—A Comparative Look at Selected Proposals? (German Dev. Inst., Discussion Paper No. 23/2007);.

26. *See infra* Part II.D.1.e.

27. *See infra* Part II.D.1.

28. *See infra* Part II.D.1.

29. *See supra* notes 1–4, 12 and accompanying text.

30. *See infra* Part I.C.4.

31. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 4–19 (1986).

32. Anna Gelpern, *A Skeptic's Case for Sovereign Bankruptcy*, 50 HOUS. L. REV. 1095, 1096 (2013).

debt market and explains fundamental concepts and terminology. Part I.A also discusses the key features that distinguish sovereign debt from other kinds of debt. Part I.B identifies the major distortions in the sovereign debt market. Part I.C discusses various legal issues impacting sovereign debt workouts, including legal doctrines that limit and enable the enforcement of creditor remedies. Finally, Part I.D explains the collective action problems involved in sovereign debt restructurings, including holdout creditors and so-called vulture funds. The problems discussed in this Part invite an international policy response.

A. Sovereign Debt: An Overview

This section introduces the fundamental concepts and distinguishing features of sovereign debt in order to lay the necessary foundation for a fuller discussion of challenges in sovereign debt markets and, ultimately, legal solutions aimed at addressing these challenges.

1. Fundamental Concepts

"Sovereign debt," as the term is used in this Note, refers to a debt instrument issued by a governmental entity.[33] A "debt instrument" is a financial claim that requires one or more payments of interest or principal by the debtor to the creditor at a date, or dates, in the future.[34] The term "sovereign debt restructuring" denotes any change in the profile of contractual payments owed by a sovereign debtor.[35] A restructuring may simply constitute a rescheduling that involves the deferment of principal payments due on maturing debt, without any reduction in the contractual interest rate.[36] Alternatively, a restructuring could involve both a deferment of principal payments and a reduction in the contractual interest rate.[37] A restructuring may also involve a reduction in the face value of a country's debt, which is known as a "haircut."[38] A "refinancing" denotes the conversion of the original debt, including arrears, into a new instrument.[39] The term "workout" is synonymous with "restructuring" in this context.[40] More formal synonyms for "restructuring" and "workout" include

33. *See, e.g.*, RIEFFEL, *supra* note 15, at 9–23 (providing a useful and concise discussion of the fundamental economic concepts underlying debt contracts); Panizza et al., *supra* note 19, at 659–88 (presenting a survey of the economic literature on sovereign debt).

34. *See, e.g.*, INT'L MONETARY FUND, PUBLIC SECTOR DEBT STATISTICS: GUIDE FOR COMPILERS AND USERS 3 (2013), *available at* http://www.tffs.org/pdf/method/2013/psds2013.pdf. The following is a nonexhaustive list of debt instruments: special drawing rights; currency and deposits; debt securities; loans; insurance; pensions; standardized guarantee schemes; and other accounts payable. *Id.*

35. *See, e.g.*, NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? RESPONDING TO FINANCIAL CRISES IN EMERGING MARKETS 3 n.3 (2004).

36. *See, e.g.*, *id.*

37. *See, e.g.*, *id.*; Das et al., *supra* note 11, at 82–87 (discussing the economics of sovereign debt restructurings).

38. *See, e.g.*, ROUBINI & SETSER, *supra* note 35, at 3.

39. *See, e.g.*, RIEFFEL, *supra* note 15, at 23.

40. *Id.* at 20.

"bankruptcy" and "insolvency."[41] All of these terms denote the procedures, both formal and informal, for resolving the settlement of creditors' contractual claims when a borrower is unable to meet its obligations in full.[42]

The following is a brief summary of the fundamental dynamic underlying a restructuring. If creditors agree to take a haircut, reducing the excessive debt burden of a sovereign debtor, the country may be enabled to strengthen its economy, thereby increasing its ability to repay the remaining debt.[43] Instead of absorbing a sizeable loss from a sovereign default, creditors may benefit by restructuring debt in this manner and subsequently bearing a smaller loss.[44] But if creditors renegotiate debt too easily, future debtors will be incentivized to default even when they can feasibly repay.[45]

"Bailouts" involve official sector lending in response to a sovereign debt crisis,[46] while "bail-ins" denote commitments from private sector creditors engaging in various forms of so-called "burden sharing."[47] What is termed the "official" or "public" sector includes the International Monetary Fund (IMF), the World Bank, regional and multilateral development banks, the group of bilateral creditors that comprise the Paris Club, and governmental entities (such as central banks, departments, agencies, and other government-controlled institutions).[48] The finance ministers from the Group of Seven (G-7) countries—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States—assume the primary role in designing the policy framework for sovereign debt workouts, and the IMF is their principal instrument for implementation.[49] Other multilateral institutions undertake a secondary role.[50] The prominent role of the G-7 is directly related to the economic dominance of these countries in the global economy and the political clout of their heads of state.[51] When a crisis leads to an imminent or actual sovereign default, the G-7 architects determine the amounts and forms of official support that will be deployed to mitigate the crisis and to finance the country's recovery.[52]

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41. *Id.*
42. *Id.*
43. Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 134 (2012).
44. *Id.*
45. *Id.*
46. *See, e.g.*, Olivier Jeanne & Jeromin Zettelmeyer, *International Bailouts, Moral Hazard and Conditionality*, 16 ECON. POL'Y 409 (2001); *see also infra* notes 53–57 and accompanying text.
47. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 8–9 (discussing how, in principle, creditor moral hazard can be mitigated by employing official rescue packages that "bail-in" private creditors); ROUBINI & SETSER, *supra* note 35, at 6, 18 (discussing different types of bailouts and bail-ins).
48. ROUBINI & SETSER, *supra* note 35, at 1 n.1; *see also* RIEFFEL, *supra* note 15, at 24–44, 56–94 (providing a useful sketch of the main players involved in sovereign workouts, including the official sector, and a discussion of the Paris Club process).
49. REIFFEL, *supra* note 15, at 24.
50. *Id.*
51. *Id.* at 24–25.
52. *Id.* at 26–27.

Bailouts are controversial.[53] The United States and other G-7 architects often choose to provide bailouts for countries where they have strategic and financial interests at stake.[54] Absent an established international framework for dealing with distressed sovereign debtors in an orderly fashion, the decision by the official sector as to whether or not to provide rescue financing to a sovereign in crisis is consequential. The economic and financial losses resulting from an unabated crisis will often wreak havoc on a crisis country (including bank panics, capital flight, and the loss of access to credit markets for households and private businesses),[55] and these economic losses often spill over beyond the borders of the crisis country.[56] Furthermore, policy choices for dealing with a sovereign debt crisis will influence expectations about how other countries will act and how the international community will respond when they find themselves in trouble.[57]

53. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 8 (explaining the idea that overborrowing on the part of sovereigns might be the result of moral hazard linked to bailouts since creditors may have incentives to lend recklessly because official bailout packages may enable repayments that are above the socially optimal level, with the resulting bill footed by local taxpayers who end up repaying even when it would have been better to restructure); Michael D. Bordo & Anna J. Schwartz, *Under What Circumstances, Past and Present, Have International Rescues of Countries in Financial Distress Been Successful?*, 18 J. INT'L MONEY & FIN. 683, 705–06 (1999) (concluding that since 1973, bailouts have involved relatively large transfers of wealth "from the less wealthy to the wealthier" and that bailouts during the 1990s have increased moral hazard, which "weakens incentives for lenders to monitor the performance of both the private and public sectors where they invest"); Jeanne & Zettelmeyer, *supra* note 46; Devesh Kapur, *The IMF: A Cure or a Curse?*, FOREIGN POL'Y, Summer 1998, at 114, 125 (1998) (discussing moral hazard experienced by the IMF due to the fact that the Fund is almost always repaid). *But see* RIEFFEL, *supra* note 15, at 53–55 (discussing the term "bailout" in this context and why that term may be misleading). Broadly speaking, "moral hazard" refers to situations where actors do not fully internalize the consequences of their actions. *See, e.g.*, Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 961 (1963); Joseph E. Stiglitz, *Risk, Incentives and Insurance: The Pure Theory of Moral Hazard*, 8 GENEVA PAPERS ON RISK & INS. 4, 5 (1983).

54. ROUBINI & SETSER, *supra* note 35, at 5; Jeffrey D. Sachs, *The Roadblock to a Sovereign Bankruptcy Law*, 23 CATO J. 73, 74 (2003) [hereinafter Sachs, *Roadblock*] ("Managing sovereign insolvency is all politics—whose favored pupil or geopolitical ward you are, or perhaps whose enemy you are."); Jeffrey D. Sachs, Do We Need an International Lender of Last Resort 2 (Apr. 20, 1995), *available at* http://www.earth.columbia.edu/sitefiles/file/about/director/pubs/intllr.pdf [hereinafter Sachs, International Lender of Last Resort] ("[A] country's ability to secure debt relief depends much more on its pecking order in international politics then [sic] it does on financial merit.").

55. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 52–58; Panizza et al., *supra* note 19, at 674–82; Das et al., *supra* note 11, at 60–65.

56. *See, e.g.*, ROUBINI & SETSER, *supra* note 35, at 5; Choi et al., *supra* note 43, at 137 (explaining that third-party countries may by harmed by the default of a neighboring sovereign because (1) banks and citizens in the third-party countries may own the debt and (2) the default of one country can lead to a domino effect resulting in a regional or global economic downturn).

57. ROUBINI & SETSER, *supra* note 35, at 5.

2. Distinguishing Features of Sovereign Debt

Sovereign debt involves peculiarities that distinguish it from corporate debt in at least three important ways. First, because a sovereign cannot be liquidated and no formal bankruptcy for sovereigns exists, a country facing a debt crisis can never get a fresh start in the way that an individual or corporation can by undergoing an insolvency proceeding.[58] Second, due to practical and legal constraints, contract enforcement is more difficult to achieve where the debtor is a sovereign.[59] The practical reason for this is that compelling a government to pay against its will can be difficult since most of its assets or income (including tax revenue) that could be used for repayment are located inside the sovereign's territory.[60] The primary legal constraint on recovery is the doctrine of sovereign immunity, which limits the ability of sovereigns to be sued in foreign courts absent the sovereign's consent.[61] Sovereign immunity and other key legal characteristics of sovereign debt are discussed more fully in Part I.C. Finally, discerning when a sovereign is actually insolvent can be difficult.[62]

Notably, creditor panics are more likely to occur in the context of international or external sovereign borrowing—as opposed to domestic sovereign borrowing, where a treasury issues debt denominated in domestic currency in a transaction that is governed by local law.[63] International sovereign borrowing involves a government borrowing foreign currency in

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58. *See, e.g.*, Gelpern, *supra* note 32, at 1098; Anna Gelpern, *Odious, Not Debt*, 70 LAW & CONTEMP. PROBS. 81, 100 (2007) (discussing the impossibility of a fresh start despite successive debt relief initiatives for poor countries). As Thomas Jackson explained in the context of individual bankruptcy:

> The principal advantage bankruptcy offers an individual lies in the benefits associated with discharge. Unless he has violated some norm of behavior specified in the bankruptcy laws, an individual who resorts to bankruptcy can obtain a discharge from most of his existing debts in exchange for surrendering either his existing nonexempt assets or . . . a portion of his future earnings.

Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1393 (1986) (citations omitted).

59. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 55–56; Panizza et al., *supra* note 19, at 652–659; *see also infra* Part I.C.

60. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 55–56; Panizza et al., *supra* note 19, at 653.

61. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 56; Panizza et al., *supra* note 19, at 653–54; *see also infra* Part I.C.1.

62. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 6 ("[D]ebt crises cannot be neatly separated into excusable defaults driven by fundamentals and inexcusable repudiations."); Choi et al., *supra* note 43, at 132–33 (explaining that it can be difficult for outside investors to tell when a country is able to repay its debts (by, for example, raising taxes, liquidating assets, or diverting revenues from other projects), and when a country is truly not able to repay its debts (due to shocks, including economic downturn, natural disaster, civil war, or lack of political will to engage in painful policies necessary to make debt service feasible)); Das et al., *supra* note 11, at 71 (noting that any debt sustainability analysis involves judgment and making projections of key variables that are inherently difficult to predict).

63. Sachs, International Lender of Last Resort, *supra* note 54, at 5; *cf.* Das et al., *supra* note 11, at 52–53 (discussing the key differences between domestic and external debt restructurings).

international capital markets.[64] Such a transaction involves foreign currency risk for the sovereign debtor,[65] while protecting creditors against, for example, the risk of opportunistic pursuit of inflationary policies on the part of the sovereign debtor.[66] It also means that the domestic central bank will be unable to act as a lender of last resort, since the central bank is only able to control the money supply of domestic currency.[67] Any financing the sovereign debtor is able to obtain to service international bonds may need to be accompanied by conditionalities on the behavior of the government, and such conditionality may be difficult to negotiate in a timely manner.[68] Thus, a solvent but illiquid sovereign borrower may find it difficult to obtain necessary financing in international capital markets to service outstanding debt, and may be pushed into an unnecessary default as a result.[69]

3. (Un)Sustainability of Sovereign Debt

Whether a sovereign's debt profile is sustainable is not simply a matter of the size of a country's debt in relation to the size of its economy.[70] Other key variables include the average interest rate payable on the debt, the maturity dates, and the proportion denominated in foreign currency.[71] Many of these factors tend to be correlated with the overall debt level.[72] Countries with large debts relative to the size of their economies usually can borrow only at high rates for short periods, and they usually must promise investors protection from exchange rate movements in order to attract funds (i.e., debt contracts will not be denominated in local currency).[73] The political support to pay also tends to decrease as the amount of effort required to pay increases.[74]

The restructuring process begins when the debtor has insufficient foreign exchange reserves to cover scheduled external debt service payments and payments for essential imports.[75] The legal effect of directing public and private sector borrowers within a country to suspend payments of principal

64. Sachs, International Lender of Last Resort, *supra* note 54, at 5.

65. *See, e.g.*, Das et al., *supra* note 11, at 52–53 (noting that exchange rate considerations and currency mismatches play a lesser role in domestic debt).

66. Choi et al., *supra* note 43, at 149 ("If a country borrows in its own currency, and then devalues that currency, then the burden of repayment and the value of the debt are reduced.").

67. Sachs, International Lender of Last Resort, *supra* note 54, at 5.

68. *Id.*

69. *Id.*

70. ROUBINI & SETSER, *supra* note 35, at 20 n.24.

71. *Id.* Emerging market countries tend to issue long-term debt in foreign currency and short-term debt in both domestic and foreign currency, while advanced countries mostly issue long-term debt in domestic currency. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 36. The debt structures of emerging market countries contribute to debt crises. *Id.*

72. ROUBINI & SETSER, *supra* note 35, at 20 n.24.

73. *Id.*; *see also supra* notes 63–67 and accompanying text.

74. ROUBINI & SETSER, *supra* note 35, at 20 n.24.

75. Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-creditor Relationships*, 1988 U. ILL. L. REV. 493, 515.

or interest on their external borrowings (i.e., an announced general moratorium on debt service) is to compel those borrowers to default[76] under their separate credit instruments.[77] The key legal consequence of a debt default is that it empowers individual creditors to pursue remedies against the borrower(s).[78]

B. Distortions and Failures in Sovereign Debt Markets

This section identifies and discusses important distortions and failures in sovereign debt markets that provide some of the primary justifications for a policy response. Part I.B.1 discusses key explanations for countries' propensity to overborrow. Part I.B.2 discusses problems associated with sovereigns restructuring too late, and Part I.B.3 discusses problems resulting from restructuring too little.

1. The Overborrowing Problem

Traditional theories of sovereign debt hold that the costs associated with a default limit the ability of a sovereign to borrow.[79] These models tend to illustrate "underborrowing," that is, borrowing at a level that is "suboptimally low from a social perspective."[80] But this view seems to be inconsistent with actual sovereign borrowing observed across countries and over time.[81] Advanced economies tend to have higher debt levels than emerging market countries, but variations of borrowing levels among countries grouped by economic development are so significant that it is highly unlikely that most of the these countries' debt levels are at or approaching their upper limit.[82] Similarly, dramatic swings in the borrowing level of some countries observed during short periods of time are not likely to result from changes in borrowing constraints.[83] It is more likely that countries borrow below their debt limit most of the time and that changes in debt levels are attributable to policy choices and economic shocks.[84] If most countries' debt levels are attributable to policy choices over time, it is possible (and perhaps likely) that many countries are overborrowing.[85]

Overborrowing may be the result of three key distortions. First, political leaders frequently have incentives to borrow above socially optimal

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76. A simple definition of default is "any failure to meet the contractually stated servicing obligations on time and in full." Herschel I. Grossman & John B. Van Huyck, *Sovereign Debt As a Contingent Claim: Excusable Default, Repudiation, and Reputation*, 78 AM. ECON. REV. 1088 n.1 (1988).

77. Buchheit & Reisner, *supra* note 75, at 515.

78. *Id.* at 503.

79. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 7; STURZENEGGER & ZETTELMEYER, *supra* note 6, at 48.

80. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 7.

81. *Id.*; *see also* Panizza et al., *supra* note 19, at 668–70.

82. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 7–8.

83. *Id.*

84. *Id.*

85. *Id.*; *see also* Panizza et al., *supra* note 19, at 666–67.

levels.[86] Second, overborrowing may be linked to moral hazard resulting from bailout packages and other forms of official sector support.[87] The presence of bailout packages may induce creditors to lend at reckless levels since official bailout packages enable repayment that is beyond a socially optimal level.[88] The taxpayers of the debtor country pay the price for this overpayment because debtor countries tend to repay what they borrow from official lenders.[89] Third, overborrowing may result from the absence of seniority rules for sovereign debtors because new lending dilutes the claims of existing creditors.[90] Debt dilution can enable excessive debt accrual because the marginal interest rate does not reflect the increased risk presented by the issuance of new debt.[91]

It may very well be that "[d]istorted incentives . . . drive a wedge between the maximum that a sovereign *can* borrow—the borrowing limit—and what it *should* be borrowing—the socially optimal amount of borrowing."[92] If this is indeed the case, there may not be a social cost associated with reducing the costs of crises.[93] To the extent making debt restructurings easier leads to increased borrowing costs, the higher cost of capital would actually improve overall welfare for countries that "overborrow" above the socially optimal amount.[94] Furthermore, while overborrowing is clearly problematic once sovereign debt levels become unsustainable, empirical studies indicate that public sector borrowing may have a "crowding out" effect on private sector borrowing and other productive investments.[95]

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86. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 8; *see also* BARRY EICHENGREEN ET AL., INT'L CTR. FOR MONETARY AND BANKING STUD., PUBLIC DEBTS: NUTS, BOLTS AND WORRIES 15–17 (2011).

87. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 22; *see also* Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103 (2003) (summarizing key arguments regarding bailouts and moral hazard and resulting market discipline problems); Jeanne & Zettelmeyer, *supra* note 46, at 411–12 (emphasizing the problem of bailouts creating moral hazard that facilitates bad domestic policies at the expense of domestic taxpayers); *supra* notes 47–54 and accompanying text.

88. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 8; Jeanne & Zettelmeyer, *supra* note 46, at 411–12.

89. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 8; Jeanne & Zettelmeyer, *supra* note 46, at 410–11.

90. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 9; Patrick Bolton & Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of a Bankruptcy Regime*, 115 J. POL. ECON. 901, 913–18 (2007).

91. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 9; Bolton & Jeanne, *supra* note 90, at 412.

92. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 6.

93. *Id.*

94. *Id.* at 6; Reinhart et al., *supra* note 9, at 5. This argument directly counters objections to a formalized sovereign bankruptcy mechanism based on the idea that such a policy response would subsequently increase capital costs. *See infra* notes 332–36, 395 and accompanying text.

95. *See, e.g.*, Fernando Broner et al., *Sovereign Debt Markets in Turbulent Times: Creditor Discrimination and Crowding-Out Effects* 20 (Nat'l Bureau of Econ. Research, Working Paper No. 19676, 2013) (showing that the increased probability of default raises spreads on sovereign debt, thereby providing incentives for domestic creditors to purchase sovereign debt and creating inefficient "crowding-out regions"); Şenay Ağca & Oya

Furthermore, an overindebted sovereign may be unable to attract voluntary new lending for productive investment since any new borrowing will have to be used to pay off existing debt.[96] According to Paul Krugman, if a country is unable to meet its debt service obligations, creditors have two choices: (1) they can *finance* the country, lending at an expected loss with the hope that the sovereign will eventually be able to repay its debt; or (2) they can *forgive* existing obligations, reducing the sovereign's debt level to one that the country can repay.[97] Under the first option, if the sovereign turns out to do relatively well, creditors will not have written down their claim unnecessarily.[98] But the burden of debt distorts the sovereign's incentives, since the creditors, rather than the sovereign itself, mainly realize the benefits of good economic performance.[99]

2. The Restructuring-Too-Late Problem

Some commentators emphasize the risk that a sovereign debtor may default on a debt obligation simply because it is unwilling to make the required payments, and not because it *cannot* make such payments.[100] Others, however, emphasize the deterrent effect resulting from the fact that a default typically leads to a major loss of confidence in all of the country's other financial assets, including the sovereign's local debt and currency, which in turn is likely to trigger a severe loss in output following a default.[101] Furthermore, legal and reputational costs have deterrent effects

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Celasun, *How Does Public External Debt Affect Corporate Borrowing Costs in Emerging Markets?* (Int'l Monetary Fund, Working Paper No. WP/09/266, 2009) (finding that an increase in the external debt of emerging market governments significantly raises the borrowing costs of the domestic corporate sector); M. Shahe Emran & Subika Farazi, *Lazy Banks? Government Borrowing and Private Credit in Developing Countries* 15 (Inst. for Int'l Econ. Policy, Working Paper No. IIEP-WP-2009-9, 2009) (utilizing panel data from sixty developing countries to estimate that a $1 increase in government borrowing reduces private credit by about $1.40).

96. Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253, 254 (1988); *see also* Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-sovereign Debt*, 121 YALE L.J. 888, 926–30 (2012).

97. Krugman, *supra* note 96, at 254, 267.

98. *Id.* at 254.

99. *Id.*

100. *See, e.g.*, ROUBINI & SETSER, *supra* note 35, at 96–97; Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1048–51 (2004) (explaining why political factors unique to sovereign debtors may contribute to an opportunistic default); Hal S. Scott, *Sovereign Debt Default: Cry for the United States, Not Argentina* 1 (Wash. Legal Found., Working Paper Series No. 140, 2006) (arguing that "[t]he root of the sovereign debt problem is that sovereigns overborrow . . . in excess of their institutional capacity to efficiently employ the borrowed capital" and that such "[o]verborrowing results from the fact that sovereigns face few consequences as a result of default").

101. *See, e.g.*, ROUBINI & SETSER, *supra* note 35, at 27; STURZENEGGER & ZETTELMEYER, *supra* note 6, at 49–52 (providing a useful discussion of the empirical evidence of default costs); Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default*, 56 IMF STAFF PAPERS 683, 690–97 (2009); Panizza et al., *supra* note 19, at 667–71, 674–88 (surveying the economic literature on sovereign debt defaults and subsequent costs).

on the possibility of sovereign default.[102] And policymakers may delay default due to self-interest and short political horizons.[103]

In fact, the weight of the evidence seems to indicate that policymakers' reluctance to restructure their debts leads to suboptimal postponement of inevitable defaults.[104] In turn, delayed defaults are costly to the international financial system.[105] Delayed defaults lead to the loss of value since a prolonged period prior to an anticipated default or crisis may lessen a country's capacity and willingness to pay.[106] Capacity to pay is reduced because the delay prolongs uncertainty, high interest rates, and restrictive fiscal policies that deepen output contractions.[107] Willingness to pay is reduced because after suffering through lengthy periods of economic austerity, constituents are less likely to support a debt restructuring on creditor-friendly terms.[108] When the restructuring does finally take place, residual creditors will recover less of their investment than they might have otherwise, because a smaller group of creditors will have to absorb the burden.[109]

3. The Restructuring-Too-Little Problem

When debt restructurings do occur, all too often they fail to restore the sovereign to debt sustainability and market access, which in turn leads to unnecessary costs and repeated restructurings.[110] The current system of ad hoc sovereign debt restructurings may produce two bad equilibria.[111] In the first, restructurings are creditor-friendly and have the advantage of being negotiated quickly, but the disadvantage of failing to solve the debt sustainability problem.[112] In the second equilibrium, sovereigns can achieve greater debt relief, but the trade-off is lengthy negotiations and

102. *See, e.g.*, Borensztein & Panizza, *supra* note 101, at 697–707.

103. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10; Borensztein & Panizza, *supra* note 101, at 716–22.

104. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10; INT'L MONETARY FUND, SOVEREIGN DEBT RESTRUCTURING—RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FUND'S LEGAL AND POLICY FRAMEWORK 15–27 (2013); Borensztein & Panizza, *supra* note 101, at 716–22; Eduardo Levy Yeyati & Ugo Panizza, *The Elusive Costs of Sovereign Defaults*, 94 J. DEV. ECON. 95, 103–04 (2011).

105. *See, e.g.*, INT'L MONETARY FUND, *supra* note 104, at 20.

106. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10; INT'L MONETARY FUND, *supra* note 104, at 20.

107. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10; INT'L MONETARY FUND, *supra* note 104, at 20.

108. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10.

109. INT'L MONETARY FUND, *supra* note 104, at 20.

110. *Id.* at 24–25 (acknowledging this phenomenon and the IMF's own role in contributing to it through overly optimistic assessments and forecasts of debt sustainability); *see also infra* note 217.

111. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 11; Andrew Powell, *Bipolar Debt Restructuring: Lessons from LAC*, VOX LACEA (Feb. 24, 2011), http://vox.lacea.org/?q=node/61.

112. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 11; Powell, *supra* note 111.

prolonged litigation.[113] "Myopic policymakers" may exacerbate these problems if they prioritize regaining access to capital markets quickly and thus push for implementation of swift, creditor-friendly restructurings, leaving others to deal with the costs of future defaults.[114]

C. Limitations on Enforcement of Creditor Remedies and Other Legal Issues

As mentioned above in Part I.A.2, the ability of creditors to enforce claims against sovereign debtors is more limited than in the corporate debt context.[115] Much of the academic literature on sovereign debt emphasizes this fact and assumes that creditors have little or no legal recourse against defaulting sovereigns[116] and that the sovereign debt market only works at all because of various nonlegal mechanisms (including reputational concerns and political pressures).[117] But several high profile cases demonstrate that legal enforcement of sovereign debt obligations is indeed possible.[118] This section outlines the key legal doctrines limiting enforcement of creditor claims against sovereign borrowers, which are sovereign immunity, the act of state doctrine, and international comity. This section concludes by discussing pari passu clause interpretation, which, conversely, enables creditors to recover against sovereign borrowers.

1. Sovereign Immunity

The principle of absolute sovereign immunity traditionally protected sovereigns from suit in foreign courts absent their consent.[119] Following World War II and against the backdrop of the Cold War, the United States began to adopt a more restrictive view of sovereign immunity because it disliked the idea of conferring sovereign immunity to Soviet Union state-owned enterprises conducting business in the United States.[120] This restrictive view was embraced in the Foreign Sovereign Immunities Act of 1976 (FSIA), which provides that a sovereign is not immune from jurisdiction in suits arising from acts that the sovereign performs in

113. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 11; Powell, *supra* note 111.

114. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 12.

115. *See supra* notes 59–61 and accompanying text.

116. *See, e.g.*, Jonathan I. Blackman & Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna*, 73 LAW & CONTEMP. PROBS. 47, 48 (2010) (arguing that foreign sovereign immunity rules function "as a rough, sometimes inadequate, proxy for insolvency laws").

117. *See supra* notes 102–03 and accompanying text.

118. *See infra* Part I.C.4; *infra* notes 185–97 and accompanying text.

119. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 56; Panizza et al., *supra* note 19, at 653.

120. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 56; Panizza et al., *supra* note 19, at 653.

connection with commercial activity.[121] The United Kingdom adopted a similar law in 1978, and many other jurisdictions have done the same.[122]

In *Republic of Argentina v. Weltover, Inc.*,[123] the U.S. Supreme Court determined that the issuance of debt in the United States by a sovereign fell squarely within the ambit of the FSIA because such a transaction met all of the Act's required elements.[124] Thus under U.S. law, international bonds issued by a sovereign and any subsequent default are generally considered commercial activities under the FSIA, regardless of the purpose of the issue or the reason for the default.[125] Furthermore, any remaining protections for sovereigns under U.S. law can be waived contractually (and routinely are), which is also the case in many other jurisdictions.[126] Therefore, sovereign immunity no longer protects sovereign issuers from being haled into courts in the United States and elsewhere by creditors.[127]

However, sovereign immunity remains important in attachment proceedings.[128] Most of a sovereign's assets located outside of its territory, such as military or diplomatic property, do not fall within the commercial exception to sovereign immunity.[129] Furthermore, under the FSIA and

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121. 28 U.S.C. § 1605 (2006). The relevant language from the statute provides:

> (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case—
>
> (1) in which the foreign state has waived its immunity [and]
>
> (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.

122. Lee C. Buchheit, *Sovereign Immunity*, 7 BUS. L. REV. 63, 64 (1986); Lee C. Buchheit, *The Sovereign Client*, 48 J. INT'L AFF. 527, 529 (1995).

123. 504 U.S. 607 (1992).

124. *Id*. at 617–20 (holding that (1) the issuance of bonds was a "commercial activity" under the FSIA; (2) the unilateral rescheduling of the bond payments had a "direct effect" in the United States, the designated place of performance for Argentina's contractual obligations; and (3) Argentina's issuance of negotiable debt instruments denominated in U.S. dollars and payable in New York, and its appointment of a financial agent in New York, was sufficient purposeful availment to satisfy due process minimum contacts requirements).

125. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 56–57; Panizza et al., *supra* note 19, at 654.

126. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57; Panizza et al., *supra* note 19, at 654.

127. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57; Panizza et al., *supra* note 19, at 654.

128. *See* 28 U.S.C. § 1610(a)(1)–(2) (2006). The Second Circuit has explained:

> [T]he execution immunity afforded sovereign property is broader than the jurisdictional immunity afforded the sovereign itself. For example, while a foreign state is not immune from suit for its commercial activities . . . a plaintiff who prevails against the sovereign in such actions can generally execute the judgment only upon assets with respect to which the foreign state has waived immunity, or that the foreign state used for the commercial activity upon which the claim was based.

Walters v. Indus. & Commercial Bank of China, Ltd., 651 F.3d 280, 289 (2d Cir. 2011) (citations omitted); *see also* STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57; Panizza et al., *supra* note 19, at 654.

129. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57.

similar laws, central bank assets are typically immune from attachment.[130] And a sovereign can attempt to impede access to attachable assets by positioning them beyond the reach of foreign courts.[131] For example, sovereigns have held their assets with the Bank for International Settlements in Switzerland, which provides legal protections against attachment proceedings.[132]

2. Act of State

Another potential limitation on creditor recovery from sovereign debtors is the act of state doctrine, which prevents U.S. courts from judging the validity of a foreign sovereign's acts performed within its own territory.[133] The act of state doctrine, unlike sovereign immunity, is not jurisdictional. Instead, it confers presumptive validity on the acts of foreign sovereigns within their territories by rendering nonjusticiable claims that challenge such acts.[134] Furthermore, the act of state doctrine cannot be waived.[135]

However, U.S. courts have declined to find that the act of state doctrine protects sovereign debtors from creditor actions for recovery.[136] In the leading case *Allied Bank International v. Banco Credito Agricola de Cartago*,[137] the Second Circuit held that the act of state doctrine would only be applicable to that suit if the situs of the property in question was in Costa Rica.[138] The court was considering a collection action brought by a creditor bank syndicate to recover on promissory notes issued by Costa Rican banks

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130. *Id.*; Panizza et al., *supra* note 19, at 654.

131. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57; Panizza et al., *supra* note 19, at 654.

132. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 57; Panizza et al., *supra* note 19, at 654.

133. The classic American statement of the act of state doctrine is found in *Underhill v. Hernandez*, 168 U.S. 250, 252 (1897):

> Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory.

The modern statement of the act of state doctrine is articulated in *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 428 (1964):

> [T]he Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government, extant and recognized by this country at the time of suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law.

See also Phillip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2732–38 (1996).

134. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 520 (2d Cir. 1985); RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 428 cmt. e (1987).

135. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 443 cmt. c ("Since the act of state doctrine is a judicial policy of self-restraint, the application of the doctrine cannot be 'waived' by the foreign state."); *see also* Michael J. Bazyler, *Abolishing the Act of State Doctrine*, 134 U. PA. L. REV. 325, 345 (1986); Power, *supra* note 133, at 2732.

136. Power, *supra* note 133, at 2734–38.

137. 757 F.2d 516.

138. *Id.* at 521.

directly controlled by the Central Bank of Costa Rica.[139] The notes were payable in U.S. dollars in New York City.[140] The court concluded that the situs of the property was the United States, and thus the act of state doctrine was not applicable.[141] Because sovereign debt contracts in default often provide for repayment in a foreign currency and consent to foreign jurisdiction,[142] the Second Circuit's decision in *Allied Bank* implies that essentially any action to collect debts under these types of agreements in a U.S. court will not be barred under the act of state doctrine.[143]

3. Comity

Comity is the recognition a sovereign grants within its territory to the legislative, executive, or judicial acts of another sovereign.[144] Unlike sovereign immunity or the act of state doctrine, comity "is not a rule of law, but one of practice, convenience, and expediency. . . . [I]t is a nation's expression of understanding which demonstrates due regard both to international duty and convenience and to the rights of persons protected by its own laws."[145] In the context of creditor actions against sovereign debtors, international comity allows a U.S. court to respect the actions of a foreign sovereign to the extent "they are consistent with law and policy of the United States."[146] Unlike the act of state doctrine, which applies only to foreign acts outside of U.S. territory, comity may apply even to acts of foreign governments on U.S. soil.[147] Thus sovereign debtors have invoked comity as an alternative defense from the act of state doctrine.[148] Reviewing courts must then determine whether the default in question is consistent with U.S. policy.[149] However, courts have declined to extend

139. *Id.* at 518.

140. *Id.* at 518–19.

141. *Id.* at 521–22 (reasoning that (1) the purported taking in question did not come to complete fruition in Costa Rica since the Costa Rican banks' obligation was to pay Allied, the designated bank syndicate, in New York and (2) that New York was also the situs under interest analysis).

142. *See supra* notes 64–68, 73 and accompanying text.

143. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 58; Christopher C. Wheeler & Amir Attaran, *Declawing the Vulture Funds: Rehabilitation of a Comity Defense in Sovereign Debt Litigation*, 39 STAN. J. INT'L L. 253, 266–67 (2003); Power, *supra* note 133, at 2737–38.

144. Hilton v. Guyot, 159 U.S. 113, 163–64 (1895).

145. Somportex Ltd. v. Phila. Chewing Gum Corp., 453 F.2d 435, 440 (3d Cir. 1971); *see also* Wheeler & Attaran, *supra* note 143, at 266–67; Power, *supra* note 133, at 2738.

146. *Allied Bank*, 757 F.2d at 522 (citing United States v. Belmont, 301 U.S. 324, 332–33 (1937)) (finding that acts of foreign governments having extraterritorial effect—and consequently falling outside the scope of the act of state doctrine—should nevertheless be extended comity to the extent that "they are consistent with the law and policy of the United States"); Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp. 660, 664 (S.D.N.Y. 1995), *aff'd*, 109 F.3d 850 (2d Cir. 1997).

147. *Allied Bank*, 757 F.2d at 522; *Pravin Banker*, 895 F. Supp. at 664 & n.4.

148. *See, e.g.*, *Pravin Banker*, 895 F. Supp. at 664 & n.4.

149. In *Allied Bank*, for example, the Second Circuit initially found for the defendant Costa Rican banks on comity grounds because it concluded that Costa Rica's exchange controls were fully consistent with the law and policy of the United States. *Allied Bank*, 757 F.2d at 519. On rehearing, the U.S. Department of Justice joined the litigation as amicus

comity to defaulting sovereigns imposing exchange controls or experiencing domestic economic crisis.[150]

4. Pari Passu Clause Interpretation

While sovereign immunity, the act of state doctrine, and comity have not proven to be particularly effective defenses in actions to recover on defaulting sovereign debt, the ratable payment interpretation of the pari passu clause[151] in the recent Second Circuit decision *NML Capital, Ltd. v. Republic of Argentina*[152] further empowers creditors to recover against defaulting sovereigns.[153] In 2001, Argentina defaulted on more than $80 billion in external debt, then the largest sovereign debt default in history.[154] Argentina subsequently initiated an exchange offer allowing bondholders to exchange their defaulted bonds for new unsecured and unsubordinated

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curiae and clarified its position that Costa Rica's attempted unilateral restructuring of private obligations was inconsistent with U.S. policy. *Id.*

150. *See, e.g.*, Lightwater Corp. Ltd. v. Republic of Arg., 02 CIV. 3804, 2003 WL 1878420, at *5 (S.D.N.Y. Apr. 14, 2003) (rejecting the argument that international law would bar plaintiffs from suing on bonds at a time when the issuer, the Republic of Argentina, was having a severe economic crisis); Nat'l Union Fire Ins. Co. of Pittsburgh v. People's Republic of the Congo, 729 F. Supp. 936, 945 (S.D.N.Y. 1989) (noting that the court was "mindful of the fact that enforcement of this default judgment is likely to cause financial difficulties for the Congo," but the court was "not the appropriate government institution to weigh the harm to the Congo of paying a valid judgment, against the harm to [plaintiff] that would flow from its being denied its legal right to enforcement of the judgment"); A.I. Credit Corp. v. Gov't of Jam., 666 F. Supp. 629, 633 (S.D.N.Y. 1987) (recognizing the court had been advised that its holding could have a "devastating financial impact on the Government of Jamaica" but concluding that "it is not the function of a federal district court . . . to evaluate the consequences to the debtor of its inability to pay nor the foreign policy or other repercussions of Jamaica's default"); *see also* Power, *supra* note 133, at 2738–42.

151. The Latin phrase pari passu means "by equal step" or "[p]roportionally." BLACK'S LAW DICTIONARY 1225 (9th ed. 2009). Pari passu clauses are a standard term contained in most cross-border lending agreements that memorialize a "borrower's promise to ensure that the obligation will always rank equally in right of payment with all of the borrower's other unsubordinated debts." Lee C. Buchheit & Jeremiah S. Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 870 (2004); *see also* Blackman & Mukhi, *supra* note 116, at 55–57; Rodrigo Olivares-Caminal, *Understanding the* Pari Passu *Clause in Sovereign Debt Instruments: A Complex Quest*, 43 INT'L LAW. 1217, 1226–27 (2009).

152. 699 F.3d 246 (2d Cir. 2012), *cert. granted*, No. 12-842 (Jan. 10, 2014) (granting certiorari on the question of the permissible scope of postjudgment discovery), *petition for cert. filed*, No. 13-990 (Feb. 18, 2014) (petitioning for certiorari again following a denial of rehearing by the Second Circuit and posing the questions of (1) whether a court may enter an injunction that effectively forces a sovereign to pay money damages with assets that are immune from attachment under the FSIA and (2) whether the "Court should certify to the New York Court of Appeals [the question of w]hether a foreign sovereign is in breach of a *pari passu* clause when it makes periodic interest payments on performing debt without also paying on its defaulted debt").

153. *See* W. M. C. Weidemaier, *Sovereign Debt After* NML v. Argentina, 8 CAP. MARKETS L.J. 123, 126–29 (2013); Romain Zamour, Note, NML v. Argentina *and the Ratable Payment Interpretation of the* Pari Passu *Clause*, 38 YALE J. INT'L L. ONLINE 55, 56 (2013), http://www.yjil.org/docs/pub/o-38-zamour-nml-v-argentina.pdf.

154. CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 10, 12 (2009); *Argentina's Debt Default: Gauchos and Gadflies*, ECONOMIST, Oct. 22, 2011, at 91.

external debt at a rate of twenty-five to twenty-nine cents on the dollar.[155] Approximately three-quarters of the bondholders took part in a debt exchange in 2005.[156] Another debt exchange under similar terms took place in 2010, bringing the participation rate up to 91 percent.[157] Hedge funds specializing in trading distressed sovereign debt, such as Elliott Associates,[158] purchased large amounts of Argentine debt at a significant discount on the secondary market, refused to join the restructurings, and sought full collection of their debt.[159]

In February 2012, Judge Thomas Griesa of the Southern District of New York issued orders enjoining Argentina from making payments on its restructured 2005 and 2010 debt without making ratable payments to NML Capital, a hedge fund affiliated with Elliott Associates.[160] A unanimous panel of the Second Circuit substantially affirmed the district court's order in October 2012.[161] The effect of this order was that Argentina was prohibited from making full payment on its restructured debt without also making full payment to the holdout plaintiffs. This interpretation of the pari passu clause, known as the ratable payment interpretation, means that not only must equally ranking debt be paid equally when the debtor promises in a pari passu clause to maintain the equal ranking, but also that if there is not enough money to pay all equally ranking creditors in full, each holder of equally ranking debt must receive a ratable share.[162] And these principles are enforceable by a court-ordered injunction against both the debtor *and* the recipients of nonratable payments.[163]

According to many observers, Judge Griesa's adoption of the ratable payment interpretation of the pari passu clause is highly problematic and does not comport with market participants' expectations.[164] When the

155. *NML Capital*, 699 F.3d at 252.
156. *Id.*
157. *Id.* at 252–53.
158. *See infra* notes 180–84 and accompanying text.
159. *Argentina's Debt Default*, *supra* note 154; *see also infra* Part I.D.2.
160. NML Capital, Ltd. v. Republic of Arg., No. 08Civ.6978 (TPG), 09Civ.1707 (TPG), 09Civ.1708 (TPG) (S.D.N.Y. Feb. 23, 2012).
161. *NML Capital*, 699 F.3d 246.
162. Buchheit & Pam, *supra* note 151, at 877–83.
163. *Id.*
164. *See, e.g.*, Weidemaier, *supra* note 153, at 126–29; G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 639–50 (2001). According to Lee Buchheit and Jeremiah Pam:

> [E]qually-ranking debts must be paid equally—that's the theory. By the debtor['s] openly announcing its agreement (in a registration statement filed with the U.S. Securities and Exchange Commission, for example) to maintain the equal ranking of this bond with other debts, have those other creditors been given the power to enjoin a payment under this bond, regardless of whether the instruments evidencing those other debts contain their own *pari passu* covenants?
>
> And if there is even the remotest possibility of this outcome, why would the purchasers of such a bond agree up front to decline to accept payments under their instrument unless every other equally-ranking lender to that borrower was also being paid in full? Analyzed in this way, a *pari passu* covenant is a positively dangerous clause to include in any debt instrument.

Second Circuit affirmed Judge Griesa's orders, many commentators vociferously criticized the decision and announced the end of sovereign debt restructuring.[165] Resumption of payment only to restructured bondholders is central to any sovereign debt restructuring, and the ratable payment interpretation of the pari passu clause makes this selective resumption of payment impossible.[166] The decision, if left intact by the Supreme Court, would effectively end consensual sovereign debt restructuring because it would incentivize holding out for full repayment[167] and exasperate collective action problems.

D. Collective Action Problems

Developments and innovation in capital markets during recent decades have diversified risk associated with holding sovereign debt while exacerbating collective action difficulties. This section discusses problems arising from coordinating diffuse creditors in a sovereign debt restructuring. Part I.D.1 discusses the characteristics of creditors holding sovereign debt, and Part I.D.2 addresses holdout litigation and vulture funds.

1. Dispersion and Heterogeneity of Creditors

Since the mid-1990s, holders of sovereign debt instruments have predominantly been widely dispersed bondholders with diverse institutional characteristics—sophisticated hedge funds, pension funds, individual retail investors, and everything in between.[168] For example, the Argentine bonds restructured in 2005[169] were held by a particularly fragmented group of creditors: institutional investors held 56.5 percent of restructured bonds, and retail investors held 43.5 percent.[170] The creditor group was also dispersed geographically: 38.4 percent of the bonds were held domestically, 15.6 percent in Italy, 10.3 percent in Switzerland, 9.1 percent

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Buchheit & Pam, *supra* note 151, at 886. Monteagudo argues that this interpretation of the pari passu clause

> would make impossible the continuity of financial operations of a debtor breaching a contract . . . and would render unnecessary the mere existence of bankruptcy-law principles [since a]ccording to those principles, under a debtor's petition, the State prohibits any individual creditor's recovery outside of an orderly and proportional payment to all creditors.

Monteagudo, *supra* note 12, at 210.

165. *See, e.g.*, Weidemaier, *supra* note 153, at 131; Zamour, *supra* note 153.

166. *See, e.g.*, Weidemaier, *supra* note 153, at 131.

167. *Id.*

168. *See, e.g.*, REIFFEL, *supra* note 15, at 190–93; Panizza et al., *supra* note 19, at 671; Das et al., *supra* note 11, at 21–22. Prior to the creation of the secondary debt market during the late 1980s, the vast majority of holders of distressed debt were banks, which had an incentive not to declare a borrower in default because they would then be required to write down their loans. *See, e.g.*, Panizza et al., *supra* note 19, at 655–56. This situation began to change in the late 1980s with the creation of a secondary market in securitized loans, *id.*, and with the implementation of the Brady Plan, which involved exchanging bank loans into sovereign bonds. *See, e.g.*, Das et al., *supra* note 11, at 18.

169. *See supra* notes 154–57 and accompanying text.

170. Das et al., *supra* note 11, at 24.

in the United States, 5.1 percent in Germany, and 3.1 percent in Japan.[171] The 43.5 percent retail investor group was comprised of more than 600,000 individuals (450,000 Italians, 35,000 Japanese, and 150,000 Germans and Central Europeans).[172] However, sovereign creditor structures are not always as fragmented as Argentina's. For example, in 2007, Belize restructured debt owed to a concentrated creditor group involving mostly institutional investors from the region.[173] During the Belize restructuring, a creditor committee was formed and was composed of thirteen financial institutions from the Caribbean, representing more than 50 percent of outstanding debt.[174]

Multicreditor debt instruments, such as bonds and syndicated bank loans, are legal arrangements that present archetypal common pool problems when an issuer runs into financial difficulties.[175] Once an issuer's financial problems emerge, the actions of any one bondholder can significantly impact the interests of all the other creditors.[176] For example, if each holder has absolute discretion to accelerate its bonds following an event of default, to commence an action for debt collection and attach the borrower's assets, or to force a foreclosure on collateral, then the other bondholders may find that their own options are significantly diminished.[177] Thus, as observable financial strains on the bond issuer appear, grabbing a borrower's assets ahead of fellow bondholders may be a sound business decision because usually little will remain for the slowest acting creditor.[178] This dynamic is especially pronounced in the context of a sovereign debt crisis because no formal bankruptcy regime exists to provide for a predictable, orderly, and timely restructuring based on a preagreed equitable framework.

2. Holdout Creditors and Vulture Funds

Because participation in a sovereign debt restructuring is voluntary, creditors may "hold out" instead of participating in an effort to obtain better repayment terms or even the full value of their claims.[179] During the late 1980s and early 1990s, a secondary market for distressed sovereign debt developed as banks sold rescheduled sovereign debt at a significantly discounted price in order to get it off their balance sheets.[180] This secondary market attracted investors known as "vulture creditors" or

171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.*
175. *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1320 (2002).
176. *See id.*
177. *See id.*
178. *Id.*; *see also infra* notes 302–04 and accompanying text.
179. *See, e.g.*, Fisch & Gentile, *supra* note 100, at 1045; Panizza et al., *supra* note 19, at 656.
180. *See, e.g.*, Ronald J. Silverman & Mark W. Deveno, *Distressed Sovereign Debt: A Creditor's Perspective*, 11 AM. BANKR. INST. L. REV. 179, 185 (2003); *see also* Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401, 402.

"vulture funds"[181] that specialize in the strategic purchase of sovereign debt trading at a deep discount as a result of the sovereign's financial distress.[182] Vulture creditors may "free ride" by holding out during a restructuring for better terms than those already agreed to by other creditors, or they may attempt to sell their claims to other creditors eager to complete the restructuring.[183] If this strategy is unsuccessful, a vulture creditor may seek to collect the full face value of its claim from the sovereign through "holdout" litigation.[184]

One of the most commonly cited examples of successful holdout litigation is the suit brought by Elliott Associates, L.P. (Elliott), a vulture fund, against Peru.[185] Elliott paid approximately $11 million on the secondary market for letter agreements with a face value of approximately $20 million, issued by Banco de la Nación and Banco Popular del Peru, and guaranteed by Peru.[186] At the time, Peru was in the process of negotiating a restructuring of its debt.[187] Elliott refused to participate in the restructuring and was ultimately awarded more than $55 million.[188] While holdout creditors often face difficulties successfully enforcing judgments against sovereign debtors,[189] in this case, the Brussels Court of Appeal authorized its execution through an order to block any payment in favor of Brady-bond creditors.[190] Peru subsequently settled for $56.3 million rather than continuing the legal battle or risk defaulting on its other debt.[191]

Besides haling sovereign governments into court and requiring them to expend resources on costly litigation, the aggressive collection strategies of vulture fund creditors in some instances have at least temporarily impeded sovereign debtors' ability to carry out fundamental governmental functions. On October 2, 2012, the Ghanaian Commercial Court granted NML Capital an injunction to prevent the *ARA Libertad*, an Argentine Navy cadet-training ship, and its crew from leaving the Ghanaian port of Tema until Argentina honored U.S. judgments awarding NML Capital approximately $1.6 billion.[192] Following a two-month standoff, on December 15, 2012,

181. *See, e.g.*, Diana B. Henriques, *The Vulture Game*, N.Y. TIMES, July 19, 1992, § 6 (Magazine), at 18 (explaining that the term "vulture" comes from the analogy that these investors "get rich by feeding on the carcasses" of insolvent debtors).

182. *See, e.g.*, Fisch & Gentile, *supra* note 100, at 1088.

183. *Id.*

184. *Id.*; *see also supra* Part I.C.4. For useful discussions of many key holdout litigation cases, see STURZENEGGER & ZETTELMEYER, *supra* note 6, at 62–76, and Panizza et al., *supra* note 19, at 655–59.

185. Elliott Assocs., L.P. v. Banco de la Nación, 194 F.3d 363 (2d Cir. 1999).

186. *Id.* at 366–67.

187. *Id.* at 368.

188. *See* Elliott Assocs., L.P. v. Banco de la Nación, 194 F.R.D. 116, 119–20 (S.D.N.Y. 2000).

189. *See, e.g.*, Panizza et al., *supra* note 19, at 659 ("[F]ull repayment has remained the exception, and many holdouts have received nothing.").

190. Gulati & Klee, *supra* note 164, at 635–38.

191. Panizza et al., *supra* note 19, at 657–58.

192. Shane Romig, *Argentine Navy Ship Remains Impounded in Ghana*, WALL ST. J. (Oct. 11, 2012, 8:42 PM), http://online.wsj.com/news/articles/SB10000872396390443749204578051231734377620; *see also supra* Part I.C.4.

the International Tribunal for the Law of the Sea ordered Ghana to release Argentina's frigate.[193] The incident caused a significant international controversy because the Ghanaian ruling, even if temporary, effectively allowed a U.S. hedge fund to interfere with the most fundamental of sovereign powers—the operation of a military vessel consistent with well-established international law.[194]

Argentina's 2001 default has resulted in extensive litigation in addition to the dispute with NML Capital. Besides a large number of suits filed in Argentine courts, by 2005 almost 140 lawsuits had been filed against Argentina in New York, Italy, and Germany.[195] Many of the creditor plaintiffs in these suits successfully obtained judgments, including a $725 million judgment in favor of EM Ltd., a fund controlled by the Dart family.[196] The legal battle for enforcement of these judgments is still playing out at the time of this writing.[197]

Holdout creditors like Elliott and the Darts have been subject to widespread criticism. They have been charged with delaying the restructuring process, thereby imposing unnecessary burdens on the citizens of the sovereign debtors, and they have been denounced for seeking payments for themselves at the expense of other creditors and at the risk of jeopardizing the restructuring.[198] The often-cited Peru-Elliott example is illustrative of the inequities that can arise from successful holdout litigation at the expense of creditors that have consented to restructuring. The perception of unfairness results when a holdout creditor recovers an amount exponentially greater than the recovery in voluntary restructuring realized by pari passu creditors[199] and the price such holdout creditor paid to purchase the debt instrument on a secondary market.[200]

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193. The "ARA Libertad" Case (Argentina v. Ghana), Case. No. 20, Order of Dec. 15, 2012, ¶ 108, http://www.itlos.org/fileadmin/itlos/documents/cases/case_no.20/C20_Order_15.12.2012.corr.pdf.

194. *See, e.g.*, *Argentine Navy Chief Replaced Amid Libertad Row*, BBC NEWS (Oct. 15, 2012, 21:01 EST), http://www.bbc.co.uk/news/world-africa-19957762.

195. Panizza et al., *supra* note 19, at 658.

196. EM Ltd. v. Republic of Arg., No. 03 Civ. 2507 (TPG), 2003 WL 22454934 (S.D.N.Y. Oct. 27, 2003), *aff'd*, 382 F.3d 291 (2d Cir. 2004). Dart, through CIBC Bank as the debt holder of record, had previously sued the Central Bank of Brazil in a high-profile case that resulted in a settlement for $25 million in cash and $52 million in Eligible Interest Bonds. CIBC Bank & Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995); *see also* Panizza et al., *supra* note 19, at 656.

197. *See supra* Part I.C.4.

198. *See, e.g.*, Buchheit & Reisner, *supra* note 75, at 504 (noting that most of the international banking community "probably regret[s] that potentially 'maverick' lenders can exert a disproportionate influence on the course of events by threatening to withhold consent to a restructuring program"); Wheeler & Attaran, *supra* note 143, at 259–63 (describing criticisms of holdouts as disrupting the restructuring process); Das et al., *supra* note 11, at 28–29.

199. For example, creditors that participated in the Greek debt exchange suffered a 59 to 65 percent "haircut," while the holdouts were repaid in full. Zettelmeyer et al., *supra* note 1, at 516.

200. In the Peruvian example discussed above, for instance, Elliott Associates received a reported settlement amount of $56.3 million on debt they had purchased in the secondary market for approximately $11 million. Panizza et al., *supra* note 19, at 657–58. Similarly, in

II. STRATEGIES FOR RESOLVING SOVEREIGN DEBT CRISES: AD HOC DEALS, EX ANTE CONTRACTUAL TOOLS, AND MULTILATERAL ARRANGEMENTS

From the perspective of debtors and creditors alike, it is uncontroversial that predictability, consistency, and transparency are important policy objectives for designing a framework to deal with distressed sovereign debtors.[201] But the manner of achieving such predictability, consistency, and transparency has and continues to be vociferously debated.[202] Part II of this Note discusses several solutions, either already on the table or advocated by experts and commentators, for handling sovereign debt crises. These tools include ad hoc deals (currently the dominant approach), contractual devices, national legislation, and multilateral arrangements, including a formal sovereign bankruptcy regime.

A. Ad Hoc Deals

Sovereign debt crises are generally resolved by deals negotiated on an ad hoc basis, which may or may not involve bailouts. A restructuring commences with a default on debt payments or an announcement of a debt restructuring.[203] Negotiations between the defaulting sovereign and its creditors subsequently begin.[204] The primary aim of the debt renegotiations is to agree on the terms of a debt exchange that will provide debt relief to the sovereign, bringing the sovereign's debt burden to a sustainable level.[205] The negotiations may last for months or even years.[206] During this time period, an evaluation of the debtor's financial situation is done and the

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Elliott Associates, L.P. v. Republic of Panama, 975 F. Supp. 332 (S.D.N.Y. 1997), Elliott successfully obtained judgments for the full face value of debt it had acquired at a substantial discount, and subsequently settled for close to the judgment amount. Panizza et al., *supra* note 19, at 657. However, some observers have defended the role that vulture funds play in the sovereign debt market. *See, e.g.*, Fisch & Gentile, *supra* note 100, at 1048–51 (defending the value of vulture creditors as providing liquidity in the secondary sovereign debt market and emphasizing the important and legitimate role of holdout litigation as a check on opportunistic default). *See generally* Broner et al., *supra* note 95, at 5 (summarizing recent literature demonstrating how secondary sovereign debt markets restrict governments and enforce debts efficiently).

201. *See, e.g.*, ROUBINI & SETSER, *supra* note 35, at 23.

202. *See, e.g.*, *id.* at 335 ("[T]he hardware of the international financial system is in better shape than is commonly assumed [since t]he tools needed to respond to a wide range of crises by and large already exist, [and that i]t is the software of the international financial system—the policies and practices that determine how the existing toolkit is used—that is in most need of an upgrade."); STURZENEGGER & ZETTELMEYER, *supra* note 6, at 267–95 (evaluating several reform proposals); Das et al., *supra* note 11, at 87–95 (summarizing the debate and discussing key proposals).

203. *See, e.g.*, Das et al., *supra* note 11, at 12.

204. *Id.*

205. *Id.*

206. Data compiled by David Benjamin and Mark Wright demonstrates that, on average, sovereign defaults take close to eight years to resolve. David Benjamin & Mark L. J. Wright, *Recovery Before Redemption: A Theory of Delays in Sovereign Debt Renegotiations* 6 (Australian Nat'l Univ. Ctr. for Applied Macroeconomic Analysis, CAMA Working Paper No. 2009-15, 2009), *available at* http://cbe.anu.edu.au/research/papers/camawpapers/Papers/2009/Benjamin_Wright_152009.pdf.

debtor country often undertakes a macroeconomic adjustment program.[207] One of the first steps is the verification of total debt claims, including evaluating the characteristics of the sovereign's debt stock and debt-service profile.[208] The next key step is a comprehensive debt sustainability analysis, which demonstrates the financing gap, the necessary structural adjustments, and the magnitude of needed debt relief.[209] Defaulting sovereigns and their advisors then develop various restructuring scenarios and prepare a final restructuring proposal.[210] Once the restructuring offer is presented to creditors, they must decide whether to accept the offer. A successful exchange generally requires a specified minimum threshold of creditor participation.[211] Creditor coordination problems and holdout risks are especially problematic during this period.[212] This process is subsequently repeated within a few years if the adjustment program is flawed in design, execution, or due to exogenous factors.[213] Bilateral loans are handled separately under the Paris Club process,[214] and the Bank Advisory Committee, known as the London Club, coordinates debt owed to commercial banks.[215] Suppliers and trade creditors are also handled separately through an ad hoc process.[216]

The current ad hoc regime for coordinating and resolving sovereign debt crises is unpredictable, messy, inefficient, and it lacks legitimacy.[217] Debt workouts tend to be lengthy and have uncertain, and sometimes unfair, outcomes.[218] Because it often takes many years before a distressed sovereign achieves any debt relief, countries are sometimes forced into open default.[219] Delayed restructurings in turn lead to the loss of value,

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207. Das et al., *supra* note 11, at 12.
208. *Id.*
209. *Id.*
210. *Id.*
211. *Id.* at 13.
212. *Id.*; *see also supra* Part I.D.
213. *See, e.g.*, REIFFEL, *supra* note 15, at 50.
214. *Id.* at 56–94 (providing a detailed discussion of the Paris Club).
215. *See, e.g.*, REIFFEL, *supra* note 15, at 95–131 (providing a detailed discussion of the London Club).
216. Das et al., *supra* note 11, at 14.
217. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 270 (noting that there is "little doubt that debt crises are . . . a lose-lose situation: there is a 'deadweight loss' in the sense that value is destroyed without an offsetting benefit"); Gelpern, *supra* note 32, at 1114 (addressing the illegitimacy argument in explaining that "the debt restructuring process is captured by technocrats obsessed with efficiency, who are in turn captured by rich country politicians and bankers, so as to ensure that the burden of adjustment falls on the poor, while the rich are protected" and that interim financing "distribute[s] losses to those least able to bear them"); *see also* Benjamin & Wright, *supra* note 206, at 6, 8 (finding that sovereign defaults last for almost eight years on average, creditor losses average more than 40 percent, longer defaults are associated with larger haircuts, and default resolution is *not* associated with decreased sovereign indebtedness).
218. *See, e.g.*, Christopher Oechsli, *Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L. L. 305 (1981); Ugo Panizza, *Do We Need a Mechanism for Solving Sovereign Debt Crises? A Rule-Based Discussion* 3 (Graduate Inst. of Int'l Dev. Studies, Working Paper No. 03/2013, 2013).
219. Sachs, International Lender of Last Resort, *supra* note 54, at 2.

which hurts both creditors and debtors alike.[220] Also troubling is that a sovereign debtor's success in securing debt relief depends greatly on international politics, rather than primarily on financial merit.[221]

The consequences of the inequities and inefficiencies that accompany the current ad hoc processes are significant since sovereign debt restructurings often involve a large-scale redistribution of wealth within and across societies and generations.[222] When governments borrow to repay nonsovereign debt in connection with an IMF-coordinated restructuring or bailout, the citizens of the sovereign repay those debts through higher taxes, and suffer from reduced spending on healthcare, education, and infrastructure.[223] Furthermore, due to lack of savings and little access to social safety services, the poor are particularly vulnerable to the downside of financial crises brought on by their countries' excessive borrowing.[224]

B. Contractual Devices

This section discusses various contractual devices aimed at mitigating the deadweight costs associated with sovereign debt defaults and workouts. Part II.B.1 begins by discussing the problem of incomplete contracting. Part II.B.2 addresses collective action clauses. Part II.B.3 then discusses exit consents, and Part II.B.4 outlines trust structures and majority enforcement provisions.

1. The Problem of Incomplete Contracting

In response to sovereign debt defaults, issuers and creditors have strengthened the terms in sovereign debt contracts that support creditors' ability to enforce their claims judicially and that better empower sovereigns to restructure their debts.[225] These seemingly contradictory approaches

220. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 10; INT'L MONETARY FUND, *supra* note 104, at 20. For a fuller discussion of delayed restructuring, see also *supra* Part I.B.2.

221. Sachs, International Lender of Last Resort, *supra* note 54, at 2. Sachs argues that the evolution of the IMF has not kept up with the pace of changes in global financial markets. Compared with domestic financial markets, the legal and institutional structure at the international level is relatively "underdeveloped and poorly conceptualized," which adds unnecessarily to the instability of international capital markets. *Id.* Sachs points to the IMF's violation of its internal rules by granting Mexico a standby loan equal to seven times its quota, which in turn impacts future expectations. *Id.* Sachs also notes that there are almost no international standards for data disclosure, capital controls, prudential standards for nonbank institutions, and the role of monitoring institutions (such as the IMF and rating agencies), in spite of the importance of international capital flows, especially to emerging countries. *Id.*

222. *See, e.g.*, Buchheit & Gulati, *supra* note 12, at 69–70 (discussing the intergenerational tensions created by sovereign borrowing).

223. *See, e.g.*, Ross P. Buckley, *The Rich Borrow and the Poor Repay: The Fatal Flaw in International Finance*, WORLD POL'Y J., Winter 2002/03, at 59, 61–62. The World Bank estimated that as a result of the 1997 Asian financial crises, 30 million more people in Indonesia earned less than $1 a day than before the crisis. *Id.* at 62; *Crisis in Asia Spawns Millions Of 'Newly Poor*,*'* WALL ST. J., June 4, 1999, at B5A.

224. Buckley, *supra* note 223, at 62.

225. Choi et al., *supra* note 43, at 133.

reflect efforts to solve the incomplete contracting problem,[226] which requires the balancing of several goals: "encouraging sovereigns to repay in the good state; enabling value-increasing restructurings in bad states; preventing debtors from seeking to exploit divisions among creditors in order to opportunistically reduce their debt burden; and preventing debtors from taking risks in order to externalize the cost of default on creditors."[227]

According to one view, the central reason for costly debt crises is the impossibility of writing contracts that provide the appropriate incentives for the debtor and that efficiently share exogenous risk.[228] The difficulty of writing such contracts is largely a result of either an information gap or the absence of institutions to enforce such contracts.[229] That may be because "some contingencies are either not observable or not verifiable [by a] court, making it difficult if not impossible to contract directly on such contingencies."[230]

Many academics and policymakers have focused on improving contracts ex ante.[231] They have debated optimal terms and endeavored to persuade the market to adopt them.[232] But aside from the difficulties in providing for a comprehensive contractual solution, introducing new terms creates uncertainty costs since it is unclear how parties and courts will interpret them.[233]

2. Collective Action Clauses

Collective action clauses (CACs) have garnered much attention and have been widely adopted in sovereign bond contracts since 2003 under both U.S. and European law.[234] CACs are contract terms aimed at ameliorating problems presented by holdout creditors and collective action difficulties by enabling creditor majorities to bind a potential holdout minority in a debt restructuring vote.[235] Rather than having to get unanimous consent for a change in terms, CACs enable changes to the terms of a bond issuance to be

226. Sturzenegger and Zettelmeyer define the incomplete contracting problem as the "inability to write contracts that condition on all relevant actions of the debtor." *See supra* note 6, at 271.

227. Choi et al., *supra* note 43, at 133.

228. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 271–72.

229. *Id.* at 272; Choi et al., *supra* note 43, at 132.

230. Choi et al., *supra* note 43, at 132.

231. *See, e.g.*, Lee C. Buchheit & Mitu Gulati, *Drafting a Model Collective Action Clause for Eurozone Sovereign Bonds*, 6 CAP. MARKETS L.J. 317 (2011); Anna Gelpern & Mitu Gulati, *The Wonder-Clause*, 41 J. COMP. ECON. 367, 370–84 (2013).

232. *See, e.g.*, Buchheit & Gulati, *supra* note 231, at 320–25; Gelpern & Gulati, *supra* note 231, at 368.

233. Choi et al., *supra* note 43, at 138.

234. *See, e.g.*, Gelpern & Gulati, *supra* note 231, at 368; Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1641–43 (2006). English law bonds have contained some form of CAC for more than a century and most Luxembourg and Japanese law bonds also contain CACs. *See, e.g.*, Das et al., *supra* note 11, at 44.

235. *See, e.g.*, Choi et al., *supra* note 43, at 142–43; Gelpern & Gulati, *supra* note 231, at 368.

applied to all bondholders of such issuance, provided a prespecified majority agree to the changes.[236]

Anna Gelpern and Mitu Gulati conducted a series of interviews with market participants and policy actors regarding CACs and found that CACs have been adopted largely as a symbolic measure intended to preempt the adoption of an international sovereign bankruptcy mechanism and that their technical efficacy was unimportant.[237] Indeed, several restructurings of bonds containing CACs have taken place without actually using the CACs available.[238] For example, the Greek bonds governed by U.K. law restructured in 2012 contained a CAC, but holdout investors successfully purchased blocking minorities in individual bond series that could not be offset by pro-restructuring majorities.[239]

Putting aside the argument that CACs are merely symbolic, another key criticism of CACs is that they do not bind creditors of different bond issues or other types of debt, such as syndicated bank loans.[240] Argentina, for example, had 152 bond issues outstanding at the time of its restructuring in 2005. Such a debt profile presents the obvious risk that some bond syndicates might approve a restructuring, while others reject it.[241] Thus, while CACs may prove effective where a sovereign has only a few bond issuances, the bond-by-bond restructuring strategy is much less effective when a sovereign is dealing with multiple bond issuances in multiple jurisdictions subject to multiple legal regimes with differing maturities and payout terms. Furthermore, CACs cannot bind creditors that have already received a judgment prior to the decision to restructure by a qualified majority of creditors. Additionally, as was the case with Greece, if the outstanding amount of a bond issue is small, a prospective holdout creditor can, with a relatively modest investment, own a sufficient percentage of the issue making it impossible for the CAC ever to be used to cram down a change to payment terms on that creditor.[242] Finally, CACs do nothing to mitigate the tendency for sovereigns to overborrow and to delay initiating a restructuring,[243] they do not necessarily decrease the amount of time a

236. Buchheit & Gulati, *supra* note 175, at 1324–30.

237. Gelpern & Gulati, *supra* note 231, at 368; *see also* Michael Bradley, James D. Cox & Mitu Gulati, *The Market Reaction to Legal Shocks and Their Antidotes: Lessons from the Sovereign Debt Market*, 39 J. L. STUD. 289, 320–21 (2010) ("[T]he market appears to attach little positive value to the use of CACs.").

238. Anna Gelpern & Mitu Gulati, *Foreword: Of Lawyers, Leaders, and Returning Riddles in Sovereign Debt*, 73 LAW & CONTEMP. PROBS., at i, viii (2010). In fact, according to Gelpern and Gulati, CACs have only been used once, in 2007, to restructure New York-law bonds issued by Belize, which "was not a high-stakes battleground for burden-sharing between taxpayers and private creditors, unlike the half-dozen CAC-less restructurings that came before." *Id.* at ix.

239. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 26.

240. *See, e.g.*, Choi et al., *supra* note 43, at 142.

241. *See, e.g.*, Buchheit & Gulati, *supra* note 231, at 318.

242. *Id.*; *see also supra* note 239 and accompanying text.

243. *See supra* Part I.B.1–2.

restructuring might take,[244] nor make the restructuring process more transparent and fair.

Some CAC proponents have advocated for, and some sovereign bonds have adopted, an "aggregation feature" that allows changes at the individual bond level to be decided with a lower majority of creditors if enough investors across all bond issues vote for a restructuring.[245] While such an aggregation feature may prove more effective than traditional CACs, a debt restructuring still must be voted on bond by bond, and the aggregation feature does nothing to help restructure a sovereign's nonbond debt, and it does not deal with broader information-sharing problems. Furthermore, aggregation clauses have not yet been utilized in any sovereign debt workouts.[246]

3. Exit Consents

Another contractual tool—exit consents—involves allowing the majority creditors to use the amendment clauses in their existing bonds to change certain nonpayment terms contained in those bonds (such as financial covenants or waivers of sovereign immunity) in order to encourage prospective holdouts to participate in a bond exchange.[247] A holdout bondholder would retain the original bond with the original payment terms, but because that bond would have been amended to remove key protective covenants, the value of the bond would be reduced and enforcement would be limited.[248] This technique is referred to as an "exit" consent because the sovereign issuer solicits the consent of its creditors to amend the old bonds as those lenders exchange their bonds for the sovereign's new debt instruments.[249] To effectively discourage holdouts, exit amendments must impair the secondary market value of the old bonds following the exchange, reduce the likelihood of eventual repayment, or make it harder for a holdout creditor to pursue legal remedies against the issuer.[250]

Exit consents have survived legal challenges in the corporate bond context.[251] The leading case is *Katz v. Oak Industries Inc.*,[252] where a

244. *See* Das et al., *supra* note 11, at 37, 45 (noting that some of the bonds exchanged by Dominica in 2004 and Argentina in 2005 contained CACs, but the Dominica restructuring took fifteen months to negotiate and the Argentine 2005 restructuring took more than two years to complete; furthermore, the CACs did not prevent a serious holdout problem following the restructurings).

245. *See* Buchheit & Gulati, *supra* note 231, at 319–22. The new European Stability Mechanism (ESM), *see infra* Part II.D.2, requires the inclusion of CACs in all new Eurozone bonds of more than a year's maturity issued after January 1, 2013. Treaty Establishing the European Stability Mechanism art. 12, para. 3, Feb. 2, 2012, http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf.

246. *See* Das et al., *supra* note 11, at 48.

247. *See, e.g.*, Lee C. Buchheit & C. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 65–68 (2000); Das et al., *supra* note 11, at 46–47.

248. *See, e.g.*, Buchheit & Gulati, *supra* note 247, at 65–68; Das et al., *supra* note 11, at 46.

249. Buchheit & Gulati, *supra* note 247, at 65–66.

250. *Id.* at 69.

251. *Id.* at 70.

bondholder sought to enjoin an exchange offer that included exit amendments that would remove all financial covenants binding the issuer, on the grounds that it was "coercive" and violated the issuer's obligation to act in good faith with respect to its bondholders.[253] The Delaware Court of Chancery, however, rejected this argument, reasoning that a corporation does not owe its debtholders fiduciary duties and that the exchange offer was not so impermissibly coercive as to constitute a breach of an express contractual duty or the implied duty of good faith and fair dealing.[254]

But in a subsequent case, *Federated Strategic Income Fund v. Mechala Group Jamaica Ltd.*,[255] a court found that an exit consent went too far. In that case, the debtor corporation sought the consent of bondholders to move the corporation's assets to another entity (not an obligor of the bonds) and to eliminate certain guarantees for the bonds.[256] After the debt exchange, any remaining bondholders would only have recourse against a borrower without assets.[257] Judge Harold Baer of the Southern District of New York held that the objecting bondholders made a sufficient showing that the offer and proposed amendments constituted an impairment of the right to sue for payment in violation of the indentures and the Trust Indenture Act of 1939, since the offer did not require the unanimous consent of all affected noteholders.[258]

More recently, in *Assénagon Asset Management S.A. v. Irish Bank Resolution Corp.*,[259] a U.K. court found the use of an exit consent in an Irish bank's restructuring as unduly oppressive and ruled in favor of the minority bondholder challenging the exchange.[260] Holders of Anglo-Irish bank bonds, issued pursuant to a trust deed governed by English law, had been invited to exchange their holdings for new bonds at twenty cents on the euro.[261] At the same time, holders were asked to vote for a resolution amending the terms of the existing bonds so as to give the issuer the right to redeem nonparticipating bonds at €0.01 per €1,000, effectively destroying their value.[262] In rejecting the validity of the exit consent, the court concluded that the "only function [of the exit consent] is the intimidation of a potential minority, based upon the fear of any individual member of the class that, by rejecting the exchange and voting against the resolution, he (or it) will be left out in the cold."[263]

However, exit consents have been successfully deployed in the context of sovereign debt restructurings. In 2000, the Republic of Ecuador

252. 508 A.2d 873 (Del. Ch. 1986).
253. *Id.* at 877–78.
254. *Id.* at 880–82.
255. No. 99 CIV 10517 (HB), 1999 WL 993648 (S.D.N.Y. Nov. 2, 1999).
256. *Id.* at *3–4.
257. *See id.* at *4.
258. *Id*. at *7.
259. [2012] EWHC (Ch) 2090 (Eng.). Irish Bank Resolution Corp. was formerly known as Anglo-Irish Bank Corp. *Id.* [6].
260. *Id.* [84]–[87].
261. *Id.* [30].
262. *See id.*
263. *Id.* [84].

accomplished a successful exchange of its existing Brady bonds and Eurobonds with a participation rate of approximately 98 percent.[264] The transaction resulted in a reduction in the face value of Ecuador's debt stock of 40 percent and involved haircuts ranging from 19 to 47 percent.[265] The high rate of participation in the exchange was likely due to a number of exit amendments to the old bonds, including removal of the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange, the cross-default clause, and the negative pledge clause restricting the issuance of collateralized debt.[266]

Despite the successful use of exit consents in exchange offers by Ecuador and other countries,[267] this approach will likely not be viable in all circumstances.[268] In many instances, "[t]he magnitude of the changes to the payment terms of the original bonds, particularly the reduction in the total principal amount of the bonds, necessary to relieve the sovereign debtor's financial crisis may be so great as to prohibit an exchange from being economically feasible."[269] Additionally, a court may refuse to enforce an exit consent against holdouts, as was the case in *Federated Strategic Income Fund* and *Assénagon*.[270] Further, some commentators argue that in some cases, the "buoying-up effect" of the restructuring may overcome the negative effects of the exit consents.[271] When an exit consent is employed, a holding out bondholder retains the original bonds with the original payment terms but without the protective covenants, and by design the value of the original bond is subsequently reduced.[272] Upon completion of the restructuring, however, the sovereign debtor's total debt burden is reduced and the value of the bonds is thereby increased.[273] This increase in value, the so-called "buoying-up" effect, may be greater than the decrease in value caused by the exit consents, rendering the exit consents ineffective.[274]

264. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 157–60; Buchheit & Gulati, *supra* 247, at 83–84.

265. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 159–60; Buchheit & Gulati, *supra* note 247, at 84.

266. STURZENEGGER & ZETTELMEYER, *supra* note 6, at 160; Buchheit & Gulati, *supra* note 247, at 84.

267. Pakistan and Uruguay have also used exit consents to successfully restructure their bonds. *See, e.g.*, STURZENEGGER & ZETTELMEYER, *supra* note 6, at 141–43, 218; Fisch & Gentile, *supra* note 100, at 1092. More recently, bond restructurings of Dominica (2004), the Dominican Republic (2005), Argentina (2005), and Belize (2007) amended some nonpayment terms. *See* Das et al., *supra* note 11, at 47.

268. *See* Fisch & Gentile, *supra* note 100, at 1092.

269. *Id.*

270. *See supra* notes 255–63 and accompanying text.

271. *See, e.g.*, Fisch & Gentile, *supra* note 100, at 1092.

272. *Id.*

273. *Id.*

274. *Id.*

4. Trust Structure and Majority Enforcement Provisions

Most sovereign bonds issued in the United States are issued pursuant to a fiscal agency agreement that governs the relationship between the sovereign debtor and the fiscal agent, which is typically the investment bank serving as lead underwriter for the bond offering.[275] Under a fiscal agency agreement, bondholders usually have the power to act individually in the event of a default on the bonds, including acceleration of the principal amount and suing to enforce the agreement.[276] Jill Fisch and Caroline Gentile have suggested limiting disruptive holdout litigation by eliminating the right of individual bondholders to accelerate the principal amounts of their bonds in the event of a default.[277] Instead, each bondholder might be limited to the right to sue the sovereign debtor only for unpaid interest and principal. This change "would reduce the attractiveness of holdout litigation by sharply limiting the size of the judgment potentially available to a bondholder while simultaneously increasing the expense of pursuing the claim."[278] Such an arrangement would more closely resemble a trust indenture or trust deed, commonly used in the United Kingdom, under which the trustee, as agent for the bondholders, possesses the right to accelerate the principal amount of all the bonds and to sue the debtor for the total amount.[279] Additionally, Fisch and Gentile suggest that bondholders' unilateral power might be limited by contractually requiring the affirmative vote of a specified percentage of the outstanding bonds to commence any litigation against the debtor.[280] A sharing clause could further discourage litigation by requiring that any amounts recovered via litigation must be shared with all bondholders on a pro rata basis.[281] In a similar vein, a recent Note has advocated for the application of a "supertrustee" structure, which has been proposed in the corporate bond context,[282] for sovereign bonds.[283]

As with other contractual tools, holdout litigation may be successfully deterred by using some form of trust structure combined with a majority enforcement provision and a sharing clause.[284] But larger problems of

275. Buchheit & Gulati, *supra* note 175, at 1332; Fisch & Gentile, *supra* note 100, at 1102.

276. Fisch & Gentile, *supra* note 100, at 1102–03.

277. *Id.* at 1103.

278. *Id.*

279. Buchheit & Gulati, *supra* note 175, at 1331.

280. Fisch & Gentile, *supra* note 100, at 1104; *see also* Rory Macmillan, *Towards a Sovereign Debt Work-Out System*, 16 NW. J. INT'L L. & BUS. 57, 103–04 (1995) (discussing a similar proposal).

281. Das et al., *supra* note 11, at 43–44.

282. *See* Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 450–51 (1999).

283. Robert Auray, Note, *In Bonds We Trustee: A New Contractual Mechanism To Improve Sovereign Bond Restructurings*, 82 FORDHAM L. REV. 899, 931–35 (2013) (suggesting that in addition to negotiating any restructuring and enforcing bond covenants, the "supertrustee would be charged with actively monitoring the debtor country . . . . [which] would address the current widespread lack of creditor monitoring").

284. *See* Das et al., *supra* note 11, at 43–44.

overborrowing and restructuring too little and too late would remain. And it is not clear that these kinds of contractual tools would make the restructuring process any more efficient, orderly, or transparent.

C. National Legislation

Multilateral efforts to remedy problems presented by holdout litigation have been stalled, and contractual devices are of limited efficacy at best and require significant lead time (since outstanding bonds cannot be amended to contain novel contractual provisions). This has led to demands for statutory reform at the national level. Part II.C.1 outlines statutory proposals in Belgium, the United Kingdom, and the United States aimed at limiting recovery via holdout litigation against the world's poorest countries. Part II.C.2 discusses a statutory proposal designed to respond to the Second Circuit's decision in *NML Capital*.[285]

1. Caps on Recovery Against Highly Indebted Poor Countries

Antivulture fund laws, aimed at preventing holdouts from initiating legal action for recovery of debts from poor countries, have been introduced or enacted in countries where key international financial markets are centered, including Belgium, the United Kingdom, and the United States. The thrust of these laws is limited and, in their current forms, do not provide a comprehensive solution for problems associated with sovereign debt restructurings. Even if these laws became more expansive in their coverage, all countries where major international financial centers are located would need to enact substantially similar legislation.

a. Belgium

In 2008, the Belgian senate unanimously approved a law designed to safeguard development cooperation funds from actions taken by vulture funds.[286] The Belgian law inserts clauses into future bilateral agreements that prevent vulture funds from seizing Belgian aid that is set aside for specific projects.[287] Because the Belgian law only covers bilateral loan agreements and does not touch other types of debt instruments, such as bond contracts, its present scope is particularly narrow.

b. The United Kingdom

The Debt Relief (Developing Countries) Act was enacted in the United Kingdom in 2010, and, in 2011, the U.K. Treasury ordered it permanent.[288] The law is designed to curb vulture creditor activity by limiting the

285. *See supra* Part I.C.4.

286. GAIL HURLEY, EUROPEAN NETWORK ON DEBT & DEV., TAMING THE VULTURES: ARE NEW MEASURES ENOUGH TO PROTECT DEBT RELIEF GAINS? 10 (2008).

287. Nancy Dubosse, *IFIs Foot Dragging on Key Debt Issues*, BRETTON WOODS PROJECT (Apr. 1, 2008), http://www.brettonwoodsproject.org/art-561011.

288. The Debt Relief (Developing Countries) Act, 2010, c. 22 (U.K.).

recovery available on the historically incurred debt of the 40 countries qualifying for the World Bank and IMF's Highly Indebted Poor Countries Initiative (HIPC).[289] The Act only applies to qualifying debt incurred before June 8, 2010.[290] Although the U.K. law covers more debt instruments than its Belgian counterpart, it is only applicable to HIPCs. That means that the law does not cover an upper-middle-income country such as Argentina,[291] still battling vulture funds that are trying to recover on debt incurred before June 8, 2010. Furthermore, the U.K. law does not limit recovery on debt incurred after June 8, 2010.

c. The United States

Congress has considered legislation to limit vulture fund recovery in the United States, but it failed to make it out of committee.[292] A proposed bill would have prevented any private creditor holding defaulted sovereign debt, issued by a qualified poor country, from using litigation in a U.S. court to achieve payment of more than the total amount paid for the credit plus 6 percent interest from the date the debt was acquired.[293] Similar to its U.K. law counterpart, if passed, this legislation would only offer protection to a select group of poor countries.

2. Legislative Countermeasure to *NML Capital*

A recent Committee on International Economic Policy and Reform (CIEPR) paper has proposed the adoption of legislation that immunizes payment and clearing systems in large financial centers from attachment or being otherwise blocked judicially.[294] To be effective, substantially similar legislation must be adopted in the key financial centers where sovereign bonds are issued and traded.[295] Such a limited reform may provide a solution to the problem of holdout creditors bolstered by the *NML Capital* decision,[296] but it would only restore the status quo that existed prior to *NML Capital*.[297] It would do nothing to address broader problems of overborrowing and restructuring too little and too late.[298] And it would do nothing to make the restructuring process faster, more transparent, or more legitimate.

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289. Press Release, Her Majesty's Treasury, Government Acts To Halt Profiteering on Third World Debt Within the UK (May 16, 2011), *available at* https://www.gov.uk/government/news/government-acts-to-halt-profiteering-on-third-world-debt-within-the-uk.

290. The Debt Relief (Developing Countries) Act §§ 9–10.

291. *Country and Lending Groups*, WORLD BANK, http://data.worldbank.org/about/country-classifications/country-and-lending-groups#Upper_middle_income (last visited Mar. 25, 2014).

292. Stop VULTURE Funds Act, H.R. 2932, 111th Cong. (2009).

293. *Id.* § 3(4); *see also HR 2932 Legislative Leave Behind Packet*, JUBILEE, http://www.jubileeusa.org/vulturefunds/leavebehindpacket.html (last visited Mar. 25, 2014).

294. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 31–32.

295. *Id.* at 31–32.

296. *See supra* Part I.C.4.

297. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 31–32.

298. *Id.* at 32.

D. Multilateral Arrangements

This section examines multilateral arrangements for coordinating sovereign debt crises. Part II.D.1 discusses proposals for a sovereign bankruptcy regime, including the proposals' theoretical underpinnings, and Part II.D.2 briefly addresses the European Stability Mechanism.

1. Sovereign Bankruptcy

Modern proposals for a formal bankruptcy framework for sovereign debtors have been debated since at least the early 1980s.[299] The most widely discussed bankruptcy proposal is the Sovereign Debt Restructuring Mechanism (SDRM) proposed by Anne Krueger of the IMF beginning in 2001.[300] Following the sovereign debt crises in the Eurozone and the *NML Capital* saga, the debate regarding sovereign bankruptcy has recently resumed in earnest.[301] This section proceeds by first discussing fundamental bankruptcy principles. Next, it discusses the IMF's SDRM and some of the debate that followed. The section concludes by outlining other proposals for sovereign bankruptcy.

a. Fundamental Bankruptcy Principles

Insolvency presents a classic "common pool" or "prisoner's dilemma" problem.[302] Judge Richard Posner has explained that the reason for having involuntary as well as voluntary bankruptcy is to solve a transaction-cost problem that is created when there is a major default and many creditors.[303] When there are many creditors with conflicting claims, normal market mechanisms supported by normal contract enforcement in the courts, are unlikely to be efficient.[304]

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299. *See* Das et al., *supra* note 11, at 88–92 (discussing various proposals for a sovereign bankruptcy regime); Oechsli, *supra* note 218; Rogoff & Zettelmeyer, *supra* note 25; *see also supra* notes 23–24 and accompanying text.

300. *See, e.g.*, Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), *available at* http://www.imf.org/external/np/speeches/2001/112601.htm; ANNE O. KRUEGER, INT'L MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING (2002); INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf [hereinafter INT'L MONETARY FUND, SDRM PROPOSED FEATURES].

301. *See, e.g.*, COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 32–42; Gelpern, *supra* note 32; Panizza, *supra* note 218.

302. JACKSON, *supra* note 31, at 8–18; *see also supra* Part I.D.

303. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW §§ 14.5–.6 (1986).

304. Sachs, International Lender of Last Resort, *supra* note 54, at 7. Sachs further explains:

> Consider the case of a corporation with many creditors which should be reorganized rather than liquidated. Under normal contract law, each creditor is allowed to press its claim as soon as the enterprise fails to service the debts as they come due. The creditors have an interest not only in staking a claim against the enterprise, but in doing so *ahead* of the other creditors. This poses an enormous collective action problem for the creditors, in which all may lose.

Bankruptcy law exists to further "collectivization" goals—to give debtors a financial fresh start when warranted and to ensure that creditors do not worsen an already bad situation (insolvency) by engaging in a destructive race to the debtor's assets.[305] Bankruptcy regimes, as they have been formed in domestic legal systems, address the common pool problem by encompassing three central objectives: (i) avoidance of a "run" on assets and holdout litigation; (ii) assurance of the payment of claims according to priority; and (iii) provision for the cancellation of unpaid claims following bankruptcy.[306] The central goal of bankruptcy law is to maximize the efficiency of the conversion and restructuring process in order to inflict as little damage upon creditors as possible.[307] In many cases, no outstanding debt is actually canceled.[308]

Sovereign bankruptcy proposals are grounded in these fundamental bankruptcy law principles and are premised on the notion that the deadweight costs of sovereign debt crises are significantly related to coordination failures and free riding. Coordination failures may delay and make it more difficult to resolve inevitable restructurings. Timely and comprehensive restructurings may be obstructed by holdout litigation. Thus, proposals for sovereign bankruptcy procedures have focused on mechanisms that make a restructuring legally binding on holdouts and shield debtors from litigation while negotiations are ongoing.

b. Lessons from Municipal Bankruptcy in the United States

Application of bankruptcy law principles to sovereigns is not unprecedented. Chapter 9 of the U.S. Bankruptcy Code extends the mechanism for corporate reorganization to municipalities.[309] The three basic principles of Chapter 11 are included: (1) the automatic stay,[310] (2) debtor-in-possession financing,[311] and (3) the possibility of confirmation of the reorganization plan by cramdown.[312] But in Chapter 9, the Bankruptcy Code expressly recognizes that governments carry out political functions that financial distress should not impair.[313] In particular, under 11 U.S.C. § 904, courts may not interfere with: (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of

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Id.

305. JACKSON, *supra* note 31, at 8–18.

306. Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, 50 IMF STAFF PAPERS 43–45 (2003).

307. Charles Seavey, Note, *The Anomalous Lack of an International Bankruptcy Court*, 24 BERKELEY J. INT'L L. 499, 502 (2006).

308. *Id.*

309. 11 U.S.C. §§ 901–946 (2012).

310. *Id.* § 922.

311. *Id.* § 364; FED. R. BANKR. P. 4001(c).

312. 11 U.S.C. §§ 943–944.

313. Sachs, International Lender of Last Resort, *supra* note 54, at 8–9; *see also* Sachs, *Roadblock*, *supra* note 54, at 75 ("The goal [of Chapter 9] is to preserve the functioning and the autonomy of the municipality due to the vital public services that it renders.").

the debtor; or (3) the debtor's use or enjoyment of any income-producing property. According to Sachs, this provision indicates:

> The fact that the debtor is a government is not seen as a reason to forgo the relief of the bankruptcy law, but on the contrary, as a reason to strengthen the relief in order to maintain the political functions of the government, and to prevent the descent into the Hobbesian world, brought on by the financial weakness of the state.[314]

c. IMF's SDRM Proposal

The IMF's proposed SDRM was aimed at providing a framework that reinforced incentives for a sovereign with unsustainable debt and its creditors to reach a swift and collaborative restructuring agreement in a way that preserves the economic value of assets and facilitates a return to medium-term sustainability.[315] In recognition of the importance of sovereignty principles, the SDRM would have been activated by the debtor country.[316] A key element of the SDRM was the "cram down" feature that would provide for a majority vote among creditors on a restructuring plan that would have bound a dissenting minority.[317] But the IMF's proposal did not provide for an automatic stay on litigation or an automatic cessation of payments, since the IMF staff took the position that in some instances it would not be necessary for a sovereign debtor to interrupt payments and because imposing a mandatory cessation on payments and a stay on litigation would incentivize creditors "to rush for the exit" when activation of the SDRM appeared imminent.[318] Instead, a stay and cessation of payments would have been permitted if approved by 75 percent of outstanding creditors.[319]

Under the IMF's proposal, the Fund's Executive Board would have made determinations about debt sustainability, but a dedicated Dispute Resolution Forum would have resolved other disputes.[320] The IMF's proposal provided incentives to induce interim financing by providing that new financing could be excluded from the restructuring if the extension of such financing was approved by 75 percent of outstanding creditors.[321] The SDRM incorporated the Hotchpot rule—a principle in international solvency law that requires that any payment or asset collected by a creditor plaintiff through litigation must be offset against the plaintiff's claim in the restructuring agreement.[322] Notably, the IMF's proposal provided for coordinating official bilateral debt and private debt either outside the

314. Sachs, International Lender of Last Resort, *supra* note 54, at 9.
315. INT'L MONETARY FUND, SDRM PROPOSED FEATURES, *supra* note 300, at 2.
316. *Id.* at 24.
317. *Id.* at 26.
318. *Id.* at 5.
319. *Id.* at 25.
320. *Id.* at 28.
321. *Id.* at 26.
322. *Id.* at 10, 25.

SDRM or as a separate creditor class.[323] The proposal also contemplated imposing sanctions on debtor countries attempting to misuse the SDRM.[324] Finally, the IMF's proposal included many technical provisions dealing with notification of creditors and registration and verification of claims.[325]

Implementation of the SDRM would have required an amendment to the IMF Articles of Agreement, which requires approval by three-fifths of the member countries having 85 percent of the votes.[326] Because the United States has more than 15 percent of the votes, it has a functional veto.[327] Thus, as a practical matter, any initiative that necessitates an amendment to the IMF Articles of Agreement must garner the support of the United States in order to be implemented.

d. Reception of the IMF's SDRM Proposal

In 2003, more than 70 percent of IMF member states supported the SDRM proposal,[328] but some industrial countries and financial markets strongly opposed it.[329] For the United States, a key concern was that the SDRM's provisions would interfere with the contractual claims of U.S. investors.[330] Another concern was that the jurisdiction of the proposed dispute resolution body, although limited, would have superseded that of U.S. courts during the restructuring process.[331]

The private sector consistently warned that the SDRM, if adopted, would adversely affect the volume and price of capital to emerging market countries.[332] Many market participants, including the banks that underwrite sovereign bonds, argued that the SDRM would have made it too easy for sovereigns to default.[333] Emerging market sovereigns similarly objected, reasoning that if restructuring became easier, credit would become more expensive.[334] Patrick Bolton and David Skeel argued that the evidence suggested these concerns were overstated, since countries are reluctant to default on their debt and, due to reputational concerns, do so only as a last

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323. *Id.* at 4.
324. *Id.* at 27.
325. *Id.* at 23–29.
326. *Id.* at 17; *see also* Articles of Agreement of the International Monetary Fund art. XXVIII, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39 (as amended effective Mar. 3, 2011), *available at* http://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf.
327. *See IMF Members' Quotas and Voting Power, and IMF Board of Governors*, INT'L MONETARY FUND, http://www.imf.org/external/np/sec/memdir/members.aspx (last updated Mar. 11, 2014).
328. Ed Bartholomew et al., *Two-Step Sovereign Debt Restructuring: A Market-Based Approach in a World Without International Bankruptcy Law*, 35 GEO. J. INT'L L. 859, 859 (2004).
329. *See, e.g.*, Sean Hagan, *Designing a Legal Framework To Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 391 (2005) (discussing opposition in the United States).
330. *Id.*
331. *Id.*
332. *See id.*
333. *See, e.g.*, Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763, 764–65 (2004).
334. Scott, *supra* 87, at 125.

resort.[335] Furthermore, empirical evidence indicates there is a significant overborrowing problem on the part of many sovereigns, which suggests that tighter borrowing constraints, in the form of more expensive capital, would actually improve welfare.[336]

Another central criticism of the design of the SDRM was the IMF's role.[337] Under the SDRM, the IMF would have continued to lend to crisis-afflicted countries, it would have determined debt sustainability for purposes of approving a restructuring plan, and it would have housed the tribunal for adjudicating disputes.[338] But as a major "priority" lender, the IMF may have had a conflict of interest in assuring its own debt was repaid.[339] Fairness under the IMF's SDRM was a major concern since official bilateral lending would either have been negotiated outside of the SDRM or as a separate creditor class.[340] Furthermore, the major creditor country members dominate the IMF and its decisionmaking, and as such, the Fund is not an impartial institution.[341] Amid controversy and criticism and without the support of the United States, the IMF's SDRM was never implemented.

e. Sovereign Bankruptcy Back on the Table?: Sovereign Debt Adjustment Program

Recently, a group of sovereign debt experts have advocated for the formation of what they call a Sovereign Debt Adjustment Program (SDAP) based within the IMF.[342] The SDAP is premised on the idea that governments should be discouraged from delaying necessary restructurings by relying on borrowing from official lenders, and that this can be accomplished by making the restructuring process less risky and more predictable.[343] Its proponents argue that the only "practical" way of achieving that is through a modification to the way in which the IMF assists countries with unsustainable levels of debt.[344] The CIEPR proposal advocates for the establishment of what they call a Sovereign Debt

335. Bolton & Skeel, *supra* note 333, at 766; *see also supra* Part I.A.2.

336. *See supra* Part I.B.1.

337. *See, e.g.*, Scott, *supra* note 87, at 133; Panizza, *supra* note 218, at 16–17.

338. *See* INT'L MONETARY FUND, SDRM PROPOSED FEATURES, *supra* note 300, at 26, 28.

339. *See, e.g.*, Scott, *supra* note 87, at 126; Panizza, *supra* note 218, at 16–17 ("Being a creditor itself, the Fund is unlikely to be *perceived* as an impartial arbiter in a debt restructuring exercise.").

340. Scott, *supra* 87, at 126.

341. *See, e.g.*, Kapur, *supra* note 53, at 125–28 (discussing the lack of financial and political risks experienced by the IMF in connection with its lending programs); Scott, *supra* 87, at 126; *see also* ROUBINI & SETSER, *supra* note 35, at 375 ("The IMF sometimes may get too close to some of its members and it has an institutional bias as a credit cooperative against pushing one of its members to do something that it does not want to do. The G-7 countries, both individually and collectively, like to be seen as trying to help rather than hurt major emerging economies and geostrategic friends and allies: The biases of the IMF's largest shareholders may also be reflected in IMF lending decisions.").

342. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 32–35.

343. *Id.*

344. *Id.*

Adjustment Facility (SDAF) that would be dedicated to assisting high-debt countries.[345]

Meeting the SDAF criteria would trigger a two-step procedure.[346] In the first step, a debtor country could request a traditional adjustment program, and if certain country-specific criteria were met, the IMF would be prohibited from lending further unless the country's debt also underwent a restructuring.[347] The second step would be the debt restructuring.[348] The key difference between this proposed process and the status quo is that, under its current rules, the Fund has broad leeway to adjust conditionality and continue lending even after programs go off track.[349] Under an SDAF, this leeway would be restricted to support programs only if they include a restructuring of the distressed sovereign's existing debt.[350]

The SDAF would commence with a request from a debtor country.[351] Upon accepting the request, the IMF would prepare a draft Debt Sustainability Analysis (DSA).[352] The DSA would be based on principles of equitable burden sharing across all creditor classes, except for multilateral lending institutions, trade and supplier creditors, and similar commonly recognized exceptions.[353] The DSA would be disclosed publicly, discussed with the debtor country, and comments would be invited from civil society groups.[354] The debtor country would then use the DSA in negotiating with its creditor groups, and the IMF would review the ultimate restructuring proposal.[355] The final restructuring proposal would then require the approval of holders of 75 percent of impacted debt instruments.[356]

The CIEPR proposal contemplates dealing with holdouts by "immunizing" the assets of the debtor country against attachment in all IMF member countries by a holder of a debt instrument that was invited to participate in a Fund-approved SDAF but declined to do so.[357] This reform would be accomplished by amending the IMF's Articles of Agreement.[358] This change would not directly impact creditor rights, but enforcement of a judgment against a sovereign debtor would become impracticable. Thus, under this proposal a creditor like NML Capital could still hale Argentina into a U.S. court and obtain a judgment, but it would not be able to enforce

345. *Id.* Qualifying countries would be those facing a situation in which debt sustainability cannot be achieved without substantial debt relief, and the criteria for SDAF would be established ex ante. *Id.*
346. *Id.* at 33.
347. *Id.*
348. *Id.*
349. *Id.*
350. *Id.*
351. *Id.*
352. *Id.*
353. *Id.*
354. *Id.*
355. *Id.*
356. *Id.*
357. *Id.* at 34.
358. *Id.*

such a judgment by, for example, obtaining an injunction blocking the movement of an Argentine military vessel.[359]

The SDAF proposal is appealing in that it would be a less dramatic change to the status quo than the SDRM. Implementation would be relatively simple, particularly since it would not require the creation of a new international organization. But, to quote the CIEPR authors themselves, "by requiring less, they also achieve less."[360] In particular, basing the SDAF at the IMF would have the same institutional bias problems as the SDRM.[361]

2. European Stability Mechanism

The European Stability Mechanism (ESM) was born out of broad dissatisfaction with the ad hoc and inefficient management of the recent Greek debt restructuring and the subsequent spillover effects experienced throughout Europe.[362] The ESM establishes a fund to provide conditional financial assistance to member countries experiencing severe financing problems.[363] Gelpern has described the ESM as a "proto-bankruptcy regime,"[364] but it has also been called a "permanent bail-out fund."[365] The ESM does nothing to address overborrowing problems—if anything it will exasperate them since its very existence may increase moral hazard[366]—nor does it address holdout problems in a comprehensive way.[367] Thus, it is not clear that the ESM provides an adequate solution for the Eurozone, much less a model to be replicated elsewhere.

III. A FULL-FLEDGED SOVEREIGN BANKRUPTCY REGIME OFFERS THE BEST POTENTIAL IMPROVEMENT TO THE STATUS QUO

For most of the nineteenth century, as Jeffrey Sachs explains, classic bank runs occurred regularly despite the fact that Henry Thornton recognized the fundamental solution to these runs as early as 1802,[368]

359. *See supra* notes 192–94 and accompanying text.
360. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 32.
361. *See supra* Part II.D.1.d.
362. Treaty Establishing the European Stability Mechanism, *supra* note 245, art. 3.
363. *Id.*
364. Gelpern, *supra* note 32, at 1112.
365. *See European Stability Mechanism: CAC Flap*, ECONOMIST (Feb. 3, 2012, 7:24 PM), http://www.economist.com/blogs/freeexchange/2012/02/european-stability-mechanism (expressing skepticism that the ESM is up to the task of providing a lasting response to the financial crisis and describing the ESM as "a permanent bail-out fund for the euro zone").
366. *See supra* notes 47–54, 87–88 and accompanying text.
367. *See supra* Part I.D.2. The ESM does mandate the inclusion of CACs in all new Eurozone bonds of more than a year's maturity issued after January 1, 2013. *See supra* note 245.
368. HENRY THORNTON, AN ENQUIRY INTO THE NATURE AND EFFECTS OF THE PAPER CREDIT OF GREAT BRITAIN (F.A. v. Hayek ed., A. M. Kelley 1965) (1802), *noted in* Thomas M. Humphrey, *Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It*, 30 CATO J. 333, 334–43 (2010); Sachs, International Lender of Last Resort, *supra* note 54, at 4.

which were further developed and promoted by Walter Bagehot in 1873.[369] Only gradually, two primary institutions evolved in domestic economies: (1) the role of the central bank as lender of last resort; and (2) state-run deposit insurance.[370] Both institutions required considerable time and debate before being established and widely accepted.[371] For example, in the United States, the Federal Reserve System was not established until 1913, and the Federal Deposit Insurance Corporation was not launched until 1933.[372] The utility of both institutions was extensively debated right up to their adoption and application.[373] Today, many observers consider the adoption of federal deposit insurance to be the key tool in ending the periodic bank panics in the United States,[374] and no mainstream economist would question the utility of a central bank.[375] Sachs further explains that the historical record clearly indicates that a variety of private market responses to bank panics had been chronically insufficient for more than a century in taming the sporadic outbreak of deep and costly crises.[376] This has also been the case with sovereign debt crises.[377] Decades of experience with ad hoc deals and private contractual tools in the modern era of sovereign debt crises have established a similar record of persistent failure.[378] And as was the case with bank panics, the establishment of an effective and comprehensive legal institution is necessary to correct these costly market failures.

The current ad hoc regime for coordinating and resolving sovereign debt crises is unpredictable, messy, inefficient, and it lacks legitimacy.[379] Contractual devices fail to provide a comprehensive solution.[380] And in the absence of a comprehensive solution, collective action problems go

369. *See generally* BAGEHOT, *supra* note 14, *noted in* Humphrey, *supra* note 368, at 344–53; Sachs, International Lender of Last Resort, *supra* note 54, at 4.

370. Sachs, International Lender of Last Resort, *supra* note 54, at 4.

371. *Id.*

372. *Id*.

373. *Id*.

374. *Id*.

375. *See, e.g.*, Brian F. Madigan, Dir., Div. of Monetary Affairs, Bd. of Governors of the Fed. Reserve Sys., Bagehot's Dictum in Practice: Formulating and Implementing Policies To Combat the Financial Crisis (Aug. 21, 2009), *available at* http://www.kc.frb.org/publicat/sympos/2009/papers/Madigan-2009.pdf.

376. *Id.* According to Sachs, "Private market innovations included: (1) temporary suspensions of convertibility of bank deposits into legal tender, as a *force majeure*; and (2) private deposit insurance schemes and bank clearinghouses, which lacked the financial strength and credibility to withstand full-fledged bank panics." *Id.*

377. *See supra* Parts I.B, I.D, II.A–B.

378. *See supra* Parts I.B, I.D, II.A–B.

379. *See supra* Part II.A.

380. *See supra* Part II.B. Furthermore, the recent CIEPR report thoughtfully notes that:

> [C]ontracts as interpreted by judges have proven inadequate to mediate the tension between the lack of enforcement and the impossibility of discharge in sovereign debt. To the extent that contracts improve over time and leave less room for interpretation, this problem may recede. [But] experience suggests that this is at best an uncertain process that will take several decades—adaptation is a long and winding road littered with institutional problems, and is not at all certain to address interpretive shocks or result in more perfect contracts.

COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 20.

unmitigated,[381] the overborrowing problem persists,[382] and the well-documented problems of restructuring too little and too late remain.[383]

A. Goals of Reform

Reform should try to achieve four central goals[384]: (1) correct overborrowing and mispricing of risk by providing a predictable, orderly, and transparent regime that limits official sector participation (i.e., bailouts) and corrects the incomplete contracting problem;[385] (2) provide legitimacy for sovereign debt restructurings where debt is unsustainable, thereby removing incentives for sovereigns to delay restructuring;[386] (3) provide an efficient debt restructuring framework that reduces the deadweight costs associated with debt workouts and does not leave sovereigns with too much debt;[387] and (4) overcome coordination failures and eliminate holdout risks.[388]

B. An International Bankruptcy Court Is the Best Solution

These goals can best be accomplished by establishing a rules-based sovereign bankruptcy regime through a multilateral treaty organization. International institutions should provide public goods that are not provided by the market. They should provide an international legal framework for overcoming problems of market failure, analogous to domestic institutions that provide that role within national economies. In the realm of financial insolvency of sovereign borrowers, the existing international institutional framework is inadequate. The creation of a new treaty-based institution could therefore help to improve the efficiency of international capital markets and promote global economic stability by better addressing these sources of market failure. Both debtor and creditor countries would benefit from the formation of a sovereign bankruptcy court or tribunal.

The international bankruptcy regime should include the traditional features of bankruptcy law.[389] These include a standstill on payments and creditor enforcement once the mechanism has been initiated, the payment of claims according to priority, the possibility of obtaining interim financing, and the ability to enforce the restructuring plan by the approval of a majority of creditors. Furthermore, in order to achieve a standstill and enforce an effective restructuring plan, the jurisdiction of the tribunal should apply to both domestic and foreign creditors.

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381. *See supra* Part I.D.
382. *See supra* Part I.B.1.
383. *See supra* Part I.B.2–3; *see also* Sachs, International Lender of Last Resort, *supra* note 54, at 8 ("Decentralized market-based behavior will not be efficient when governments fall into financial distress.").
384. These goals for reform have been identified elsewhere, such as in COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 29.
385. *See supra* Part II.B.1.
386. *See supra* Part I.B.2.
387. *See supra* Part I.B.3; *supra* note 217.
388. *See supra* Part I.D.
389. *See supra* notes 306, 308, 310–12 and accompanying text.

As prior experience has demonstrated, debtor and creditor countries may continue to be wary of the establishment of an international bankruptcy court.[390] To address some of the concerns of reluctant debtor countries, the bankruptcy treaty must provide reassurance that the participating states' sovereignty will be preserved. Any treaty establishing an international bankruptcy tribunal should include protections akin to those of Chapter 9 of the U.S. Bankruptcy Code, which expressly prohibit the court from interfering with the government's political and economic powers.[391]

The key advantage of a full-fledged bankruptcy regime would be comprehensiveness. Closely related to this would be the compulsory nature of the process, meaning that creditors would be unable to decline participation, and holdouts would no longer present a problem. Furthermore, process centralization in the form of a single forum, with a single set of rules, and claims paid out of a single set of assets, would be advantageous, particularly for predictability and efficiency purposes.[392] Finally, the greater likelihood of achieving an equitable outcome that is viable for the medium-term would increase the legitimacy of the institution.

Because of institutional bias problems,[393] a sovereign bankruptcy regime should be established outside the IMF. Some experts argue that the IMF is the only institution with sufficient expertise and capacity to carry out the complex task of navigating sovereign debt crises. But who would endorse the idea of creditor banks acting as the arbiter of collection actions in domestic bankruptcy law?[394] Could a tribunal structured this way be expected to reach an equitable and legitimate outcome? Certainly not.

Perhaps the chief criticism to a treaty proposal is that achieving it would be difficult, if not impossible. Implementation of a sovereign bankruptcy treaty would require domestic legislation in most member countries. However, simply because something would be difficult to achieve is a poor reason for not trying to do so.

Another criticism of the formation of a sovereign bankruptcy regime is that it may result in higher capital costs. However, this concern is overstated. As discussed above in Parts I.B.1 and II.D.1.d, empirical evidence suggests that many countries overborrow above a socially optimal amount.[395] Therefore, tighter borrowing constraints in the form of higher

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390. *See supra* Part II.D.1.d.

391. *See supra* notes 313–14 and accompanying text. The text of 11 U.S.C. § 904 (2012) provides:

> Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—
>
> (1) any of the political or governmental powers of the debtor;
> (2) any of the property or revenues of the debtor; or
> (3) the debtor's use or enjoyment of any income-producing property.

See also BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 41 (1995).

392. *See supra* notes 195–97 and accompanying text.

393. *See supra* Part II.D.1.d.

394. *See supra* notes 337–41 and accompanying text.

395. *See supra* notes 92–95, 332–36 and accompanying text.

capital costs would actually be a desirable result since it would correct this market distortion.

C. Potential Starting Points for Treaty Negotiations

The World Trade Organization's (WTO) dispute resolution body regularly decides complex trade disputes through compulsory adjudications that are largely deemed apolitical.[396] Thus, the WTO could provide a model for an international bankruptcy tribunal and, potentially, a starting point for treaty negotiations. A significant difference between an international bankruptcy tribunal and the WTO dispute settlement mechanism is that the WTO adjudicates disputes between states, while a bankruptcy tribunal would adjudicate disputes among states and private creditors. However, the Iran-United States Claims Tribunal provides a precedent and model for an international tribunal with jurisdiction to resolve disputes between states or between states and private creditors.[397]

Treaty negotiations could also be initiated by the United Nations. For example, in May 2003, following the fall of Saddam Hussein's regime in Iraq, the U.N. Security Council adopted Resolution 1483.[398] Among other things, that resolution encouraged the new government in Iraq to restructure the debt stock it inherited from its predecessor regime, and it temporarily immunized all petroleum assets of Iraq against "any form of attachment, garnishment, or execution" and similarly protected the proceeds of Iraqi oil sales.[399] Resolution 1483 was enacted pursuant to Chapter VII of the Charter of the United Nations, and thus bound all members of the organization. Although the scope of Resolution 1483 is significantly narrower than the formation of a comprehensive international bankruptcy mechanism, it provides a precedent for the United Nations using its authority to facilitate the orderly resolution of an international sovereign debt dilemma.[400] The United Nations could certainly provide a forum and

396. *See, e.g.*, Daniel C. Esty, *Good Governance at the Supranational Scale: Globalizing Administrative Law*, 115 YALE L.J. 1490, 1546–47 (2006); Joel P. Trachtman, *The Domain of WTO Dispute Resolution*, 40 HARV. INT'L L.J. 333, 365 (1999); *see also* Panizza, *supra* note 218, at 15 (making a similar argument).

397. *See* Declaration of the Government of the Democratic and Popular Republic of Algeria (General Declaration), 1 Iran-U.S. Cl. Trib. Rep. 3 (1981); Undertakings of the Government of the United States of America and the Government of the Islamic Republic of Iran with Respect to the Declaration of the Government of the Democratic and Popular Republic of Algeria, 1 Iran-U.S. Cl. Trib. Rep. 13 (1981); Declaration of the Government of the Democratic and Popular Republic of Algeria Concerning the Settlement of Claims by the Government of the United States of America and the Government of the Islamic Republic of Iran (Claim Settlement Declaration), 1 Iran-U.S. Cl. Trib. Rep. 9 (1981); *see also* EICHENGREEN & PORTES, *supra* note 391, at 39; IRAN-U.S. CLAIMS TRIBUNAL, http://www.iusct.net (last visited Mar. 25, 2014).

398. S.C. Res. 1483, U.N. Doc. S/RES/1483 (May 22, 2003), *available at* http://www.un.org/ga/search/view_doc.asp?symbol=S/RES/1483%282003%29.

399. *Id.* ¶¶ 15, 22.

400. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 4, at 41, also discusses the precedential value of Resolution 1483, but in doing so, advocates for a more limited reform approach than that of this Note.

jumping-off point for the formation of a formal international bankruptcy regime.[401]

Alternatively, a country that has already demonstrated an interest in taking the lead on addressing issues related to sovereign debt crises, such as Belgium, could lead treaty negotiations.[402] However, it is not clear that Belgium, or any other country, is interested in taking on this leadership role at this time.

CONCLUSION

This Note described sovereign debt markets, crises, and related legal issues. It discussed various proposals for dealing with these problems in sovereign debt markets, and concluded that a multilateral treaty-based sovereign bankruptcy regime would provide the best solution for coordinating sovereign debt crises. Formal sovereign bankruptcy is the only way to fully solve the incomplete contracting problem inherent in sovereign debt and to effectively mitigate collective action problems. Furthermore, a well-designed comprehensive bankruptcy regime would correct many of the distortions and failures in sovereign debt markets, such as overborrowing, mispricing of risk, and restructuring too little and too late. While obstacles to implementation of a sovereign bankruptcy regime, including lack of political will, would certainly be formidable, that is not a legitimate reason for abandoning an otherwise desirable goal.

401. The International Court of Justice, for example, was established in June 1945 by the Charter of the United Nations and is the principal judicial body of the U.N. INT'L CT. JUST., http://www.icj-cij.org/court/index.php?p1=1 (last visited Mar. 25, 2014). As of July 31, 2013, 193 sovereign states were parties to the Statute of the Court and twelve disputes between state parties were pending. Rep. of the Int'l Court of Just., 68th Sess., Aug. 1, 2012–July 31, 2013, U.N. Doc. A/68/4, Supp. No. 4, 10 (Aug. 1, 2013).

402. *See supra* Part II.C.1.a.