

## COMMENTS

### GONE BROKE: SOVEREIGN DEBT, PERSONAL BANKRUPTCY, AND A COMPREHENSIVE CONTRACTUAL SOLUTION

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*To the extent that bankruptcy theory attempts to justify bankruptcy law from any point in time after a party becomes a creditor of a firm, it begins the inquiry in the wrong place.*<sup>1</sup>

Both sovereign debt and defaults have appeared frequently in the news over the past few years.<sup>2</sup> However, the issue of sovereign debt restructuring is far from new. Restructurings have occurred as far back as the sixteenth century. Between 1557 and 1647, six debt crises in Spain were resolved using two of the same techniques discussed in modern restructurings: rescheduling principal payments and reduc-

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<sup>1</sup> Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 56 (1992).

<sup>2</sup> See, e.g., Richard Morin & Claudia Deane, *The Ideas Industry: AIDS Takes Toll on African Militaries*, WASH. POST, Mar. 4, 2003, at A21 (noting that a prominent American academic had been invited to France to hammer out differences over a “sovereign debt restructuring mechanism” proposed by the International Monetary Fund (IMF)); Kenneth Rogoff, *The Sisters at 60*, ECONOMIST, July 24, 2004, at 63, 65 (“If the global community can work its way towards an improved bankruptcy procedure for sovereign borrowers, this path will be far easier.”); Jeffrey D. Sachs, *Memorandum: How to Run the International Monetary Fund*, FOREIGN POLY, July/Aug. 2004, at 60, 63 (noting that “[t]he debt of emerging-market economies” will be an important issue for future leaders of the IMF); Ernesto Zedillo, *Resilience Is Not Forever*, FORBES, Nov. 15, 2004, at 45, 45 (discussing economic shocks and sovereign defaults).

ing interest rates.<sup>3</sup> Proposals of mechanisms to help sovereigns deal with defaults have been made as early as 1976.<sup>4</sup> Throughout the long discussion on how to help countries restructure their debt, most commentators have analyzed corporations undergoing bankruptcy and have compared them to countries in default to provide the basis of a model for sovereigns.<sup>5</sup>

This Comment argues that the corporate analogy is incomplete.<sup>6</sup> The analogy between personal and sovereign bankruptcy may provide additional insight: a sovereign and its needs in default have, in many ways, more in common with a person who has fallen into bankruptcy than a corporation that has done so. Part I elaborates on the person-sovereign analogy to find that three common challenges face the insolvent person and sovereign in the absence of bankruptcy laws: creditor holdout, moral hazard, and lack of coordination. Part II examines existing proposals for sovereign debt restructuring—the International Monetary Fund’s (IMF) Sovereign Debt Restructuring Mechanism (SDRM) and the inclusion of collective action clauses in bonds—to see if these challenges are addressed, and ultimately concludes that the existing proposals fall short. Part III proposes a contractual solution called a Designer Sovereign Debt Restructuring Mechanism (DSDRM), which would allow each debtor country to contract for its own insolvency and debt restructuring procedures. This

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<sup>3</sup> See ROSS P. BUCKLEY, *EMERGING MARKETS DEBT: AN ANALYSIS OF THE SECONDARY MARKET* 6 (1999) (discussing the Spanish debt crises of 1557, 1575, 1596, 1607, 1627, and 1647).

<sup>4</sup> See Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, 49 IMF STAFF PAPERS 470, 472 n.4 (2002) (recognizing Göran Ohlin, *Debts, Development and Default*, in *A WORLD DIVIDED: THE LESS DEVELOPED COUNTRIES IN THE INTERNATIONAL ECONOMY* 207, 221 (G.K. Helleiner ed., 1976), for identifying the need for “something like the institution of ‘honourable bankruptcy’” to resolve sovereign debt crises).

<sup>5</sup> See, e.g., Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguard?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1048 (2004) (arguing that sovereigns resemble corporations in many ways); Daniel K. Tarullo, *Neither Order Nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 EMORY L.J. 657, 669-70 (2004) (explaining that many authors have analyzed the similarities between corporations and sovereigns); Jonathan Sedlak, Comment, *Sovereign Debt Restructuring: Statutory Reform or Contractual Solution?*, 152 U. PA. L. REV. 1483, 1487-89 (2004) (examining the differences between a sovereign and a corporate debtor). *But see* Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159, 1179-85 (2004) (arguing that individual bankruptcy has implications for sovereign debt restructuring).

<sup>6</sup> Accord Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1115, 1122 (2004) (“Many commentators have written that the firm-state analogy is deeply flawed.”).

Comment concludes by considering which options might be included in a DSDRM and how the DSDRM could be implemented.

### I. WHAT IS THE PROBLEM WITH SOVEREIGN DEBT?

More often than not, commentators trying to find solutions to the problems associated with sovereign debt restructuring analogize a sovereign undergoing default to corporate bankruptcy.<sup>7</sup> The appeal of such an analogy is not entirely unexpected; both corporations and sovereigns are sophisticated, complex entities in terms of their ability to raise debt.<sup>8</sup> However, in many ways, the concept of personal bankruptcy bears a greater resemblance to a sovereign in the throes of default than corporate bankruptcy does. A comparison of sovereign insolvency to the bankruptcy of a hypothetical person may shine some light on the issue.

#### A. *Personal Bankruptcy and Sovereign Default: Some Similarities Between Fred and a Developing Country*

Imagine a hypothetical person, Fred Argent, living in a hypothetical state, Valeria, that enforces debt contracts. Fred is a widower and

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<sup>7</sup> See *supra* note 5 and accompanying text (giving examples of articles focusing on the analogy between corporate bankruptcy and sovereign debt restructuring).

<sup>8</sup> Large corporations have long been considered sophisticated actors. See *United States v. Lachman*, 387 F.3d 42, 56-57 (1st Cir. 2004) (noting that statutes are often addressed toward sophisticated parties like corporations); *Am. Airlines, Inc. v. Remis Indus., Inc.*, 494 F.2d 196, 199 (2d Cir. 1974) (citing evidence that corporations are “amply sophisticated” and able to utilize credit in an “informed” manner”); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799, 816-17 (1992) (arguing that corporations tend to continually interact with lawyers and thus are sophisticated users that can evaluate lawyers’ performance). Sovereigns have also become increasingly sophisticated due to access to the experienced counsel and debt instruments traditionally used by corporations. See Becky L. Jacobs, *Pesification and Economic Crisis in Argentina: The Moral Hazard Posed by a Politicized Supreme Court*, 34 U. MIAMI INTER-AM. L. REV. 391, 400 n.63 (2003) (noting that sovereigns are now able to access debt markets with sophisticated instruments); see also *infra* note 200 and accompanying text (noting that most sovereigns are represented by large New York City law firms experienced in capital markets transactions); cf. Katharine Florey, Comment, *Insufficiently Jurisdictional: The Case Against Treating State Sovereign Immunity as an Article III Doctrine*, 92 CAL. L. REV. 1375, 1433 (2004) (“[A] state waiving state sovereign immunity is likely to receive comprehensive and sophisticated legal advice . . .”). Indeed, sometimes corporations and sovereigns are lumped together as “sophisticated parties.” See Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1465 (1993) (reviewing PETER L. BERNSTEIN, *THE IMPROBABLE ORIGINS OF MODERN WALL STREET* (1992)) (noting that both corporations and sovereigns are sufficiently sophisticated to access certain types of debt markets).

has five children. Fred rents a modest house and the children all share beds and have but one toy to share among them. The cost of supporting Fred's family's basic needs—heat, water, food, education, and clothing—is \$20,000 per year. Fred works at a local restaurant as a waiter and is paid a salary of \$23,500, just slightly more than his total expenses. Although he can pay his bills, Fred wants to provide a better life for his children (and for himself). He notices that there are many jobs in his community paying \$30,000 for people with one-year college degrees, so Fred decides to study at a community college. Fred takes out a loan from the bank for \$4500 to pay for tuition, charges \$400 on his credit card to pay for books, and the school arranges for ten of his classmates to lend him \$10 each (\$100 total) for a bus pass. Thus, the total cost of his education is \$5000. Assume that there is a 75% probability that he will repay all creditors in full, and there is a 25% probability that after one year, he will only have \$3500 for his creditors. To account for the risk, his creditors charge him an interest rate of 10%.<sup>9</sup> All of the loans are due for repayment one year after he graduates. Thus, at repayment, Fred will owe \$5500. However, since Fred expects to be earning \$30,000 a year, his living costs (\$20,000) plus repayment of the loan (\$5500) will leave him with \$4500 to buy toys, books, and beds for his kids.

This situation can be analogized to the situation of a typical developing country. Developing countries often need to finance significant amounts of investment to foster the level of economic and social development they desire, just as Fred needs to finance his investment in education to earn a higher salary and provide a better life for his kids. According to the World Bank, significant investments in infrastructure, education, health, legal development, and other areas are

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<sup>9</sup> If there is a 75% chance that Fred will repay the full amount of the loan and a 25% chance that he will repay \$3500, then the bank must charge Fred \$5500 to recoup the full value of \$5000. The bank calculates the amount it must charge Fred by determining three figures: the amount of the loan ( $l$ ); the amount the bank expects to receive from Fred if he repays his loan in full ( $p$ ), multiplied by the probability of full repayment ( $q$ ); and the amount the bank expects to receive from Fred if he defaults ( $x$ ), multiplied by the probability of default ( $y$ ). Thus,  $l$  must equal  $(p \times q) + (x \times y)$ . Given that the amount of the loan is \$5000, the probability of repayment is 75%, the probability of default is 25%, and the amount of default repayment is \$3500, the calculation appears:

$$\begin{aligned} \$5000 &= (p \times .75) + (\$3500 \times .25) \\ \$5000 &= .75p + \$875 \\ \$4125 &= .75p \\ p &= \$5500 \end{aligned}$$

needed in order to close the “poverty gap.”<sup>10</sup> However, with a few exceptions, developing countries are unable to finance these investments using domestic funds, just as Fred is unable to pay for college out of his own pocket. Savings rates are often low in such countries, and export revenue is usually insufficient to meet financing needs.<sup>11</sup> Often, tax receipts do not cover budgetary outlays.<sup>12</sup> While “official development assistance” from the World Bank and other bilateral and multilateral entities cover some of these needs, “this source of resources has been shrinking for many years.”<sup>13</sup> As a result, developing countries often look to the private sector to finance budget support and new programs.<sup>14</sup>

Creditors are likely to lend to Fred because he is a good investment; that is, he is likely to pay the loan back. Fred generally has a

<sup>10</sup> See generally WORLD BANK, WORLD DEVELOPMENT REPORT 2004: MAKING SERVICES WORK FOR POOR PEOPLE (2003), available at <http://www-wds.worldbank.org> (Report No. 26895) (positing that a substantial increase in external resources in developing countries will be needed to increase the pace of human and economic development).

<sup>11</sup> See, e.g., César Calderón et al., *Determinants of Current Account Deficits in Developing Countries* 28 tbl.2 (World Bank, Policy Research Working Paper No. 2398, 2000), available at <http://econ.worldbank.org/files/wps2398.pdf> (noting that the mean private savings rate in heavily indebted poor countries was just 13% of gross national disposable income).

<sup>12</sup> See, e.g., Derek Huang Chiat Chen, *Intertemporal Excess Burden, Bequest Motives, and the Budget Deficit* 48 fig.2.1 (World Bank, Policy Research Working Paper No. 3086, 2003), available at <http://econ.worldbank.org/files/wps3086.pdf> (examining the history of budgets in developed and developing countries and finding that tax income rarely covered expenditures from 1953 to 1999). In addition, international funds also appeal to many countries given that external borrowing creates lower levels of inflation than domestic borrowing, because the money supplied is usually not in the home country’s currency. See Philippe Beaugrand et al., *The Choice Between External and Domestic Debt in Financing Budget Deficits: The Case of Central and West African Countries* 9 (Int’l Monetary Fund, Working Paper No. WP/02/79, 2002), available at <http://www.imf.org/external/pubs/ft/wp/2002/wp0279.pdf> (noting that external financing often appears attractive because of the reduced risks of inflationary pressures). Furthermore, external borrowing means that domestic funds can be channeled toward private investment rather than government priorities. See *id.* (“If the exchange rate and interest rates are subject to government control, resorting to domestic financing has a more direct crowding-out effect on private investment by reducing the amount of credit available to the private sector . . .”).

<sup>13</sup> Inaamul Haque & Ruxandra Burdescu, *Monterrey Consensus on Financing for Development: Response Sought from International Economic Law*, 27 B.C. INT’L & COMP. L. REV. 219, 246 (2004).

<sup>14</sup> See *id.* at 245 (“Developing countries see securing and sustaining private cash flows as imperative if they expect ‘to emerge from the poverty trap and to catch up with the richer countries . . .’” (quoting Intergovernmental Group of Twenty-Four on Int’l Monetary Affairs & Dev., Report on the G-24 Workshop on Financing for Development 6 (Sept. 6-7, 2001), available at <http://www.g24.org/ICFDRep.pdf>)).

sense of obligation to repay his debts, and he is unlikely to stray from this conviction. As such, default on a loan is likely to be a traumatic emotional experience for Fred and will probably do serious injury to his reputation.<sup>15</sup> Furthermore, defaulting on his loan is likely to impair Fred's credit rating and his ability to borrow in the future.<sup>16</sup> Accordingly, he is unlikely to default on the loan unless necessary. Likewise, sovereigns "try hard" to repay their debt obligations.<sup>17</sup> A government is also likely to consider reputational risk and the attendant consequences when deciding whether to comply with its financial obligations.<sup>18</sup> Outright repudiations of debt are rare, if for no other reason than sovereigns need continual access to credit markets, access that a default is likely to eliminate.<sup>19</sup> Furthermore, defaulting on debt may cause other problems for a sovereign and its economy, particularly with respect to international trade.<sup>20</sup> Regardless of whether one believes in the reputation theory of sovereign debt<sup>21</sup> or the enforcement theory of sovereign debt,<sup>22</sup> the sanctions imposed on

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<sup>15</sup> Cf. Lisa J. McIntyre, *A Sociological Perspective on Bankruptcy*, 65 IND. L.J. 123, 129 (1989) (suggesting that there are two predictors of bankruptcy: "moral conviction" (commitment to keep promises) and "social pressure" (fear of being stigmatized)).

<sup>16</sup> William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 401 (1994) ("A discharge harms the debtor's credit rating and can make future borrowing difficult or more expensive.").

<sup>17</sup> See William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 12 (2004) ("[S]overeigns rarely repudiate their debt contracts in whole.").

<sup>18</sup> See Harold L. Cole & Patrick J. Kehoe, *Models of Sovereign Debt: Partial Versus General Reputations*, 39 INT'L ECON. REV. 55, 56 (1998) ("[I]f a government is viewed as untrustworthy in one relationship, th[e] government will be viewed as untrustworthy in other relationships."); Avner Greif, *Impersonal Exchange Without Impartial Law: The Community Responsibility System*, 5 CHI. J. INT'L L. 109, 138 (2004) (finding that collective responsibility and reputation play a role in encouraging sovereigns to pay debts).

<sup>19</sup> See, e.g., Bratton & Gulati, *supra* note 17, at 13 (noting that the need to obtain future credit tends to deter countries from defaulting); Rory Macmillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 335 (1995) ("[T]he perception remains strong that renegeing on debt obligations endangers a country's creditworthiness and credibility.").

<sup>20</sup> See Marcel Fafchamps, *Sovereign Debt, Structural Adjustment, and Conditionality*, 50 J. DEV. ECON. 313, 316 (1996) (noting that sovereigns who default on debt may have to structure their trade through "smoke and mirrors" deals).

<sup>21</sup> See Bratton & Gulati, *supra* note 17, at 14 (defining the reputation theory of sovereign default as one where the primary cost of default is "exclusion from future borrowing").

<sup>22</sup> See *id.* at 15-16 (defining the enforcement theory of sovereign default as one where additional, nonreputation sanctions are needed to deter debtor countries from defaulting).

a defaulting nation are usually sufficiently severe to deter defaults that are entirely opportunistic.<sup>23</sup>

Now imagine that Fred's 25% risk comes to fruition and something goes wrong with his plan. Perhaps Fred gets sick, and is unable to work for a few months. Maybe Fred misunderstood the job advertisements and needed to study something different for the job he seeks. It could be that the jobs Fred seeks do not pay the rate Fred expected or that they materialize and disappear after a few months. Conceivably, Fred could spend his book money on beer and fail to graduate, becoming ineligible for a higher paying job. Perhaps the other students in Fred's class use their loans improperly and creditors think that Fred poses a similar risk, in which case creditors raise interest rates to cover the losses. In any of these situations, one can imagine that Fred will no longer be able to make his loan payments in full.

Fred's potential personal crisis parallels the financial crises endured by developing countries. Just as Fred may have chosen to study the wrong subject to obtain a new job, a financial crisis might occur in the sovereign context because a country has implemented the wrong economic policies to increase growth.<sup>24</sup> For example, overvalued exchange rates, unsustainable budgets, anti-export trade regimes, and other domestic policies may have led to the defaults of Latin American governments on bank loans during the 1980s.<sup>25</sup> Modern devaluations in exchange rates have also led to problems with servicing sovereign debt.<sup>26</sup> Much like Fred's job might not pay the wage he

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<sup>23</sup> For a discussion of opportunistic default, see *infra* text accompanying notes 33-40.

<sup>24</sup> See, e.g., Guillermo Perry & Luis Servén, *The Anatomy of a Multiple Crisis: Why Was Argentina Special and What Can We Learn From It?* 28-41 (World Bank, Policy Research Working Paper No. 3081, 2003), available at <http://econ.worldbank.org/files/wps3081.pdf> (discussing Argentine policies that led to the country's financial crisis and resulting default); cf. Frederic S. Mishkin, *Financial Policies and the Prevention of Financial Crises in Emerging Market Countries* 13 (Nat'l Bureau of Econ. Research, Working Paper No. 8087, 2001), available at <http://papers.nber.org/papers/w8087.pdf> (listing twelve categories of policies that countries can undertake to avoid defaulting on their loan obligations).

<sup>25</sup> See BUCKLEY, *supra* note 3, at 19-20 (identifying internal factors which led to sovereign defaults in the 1980s).

<sup>26</sup> See, e.g., Harald Sander & Stefanie Kleimeier, *Contagion and Causality: An Empirical Investigation of Four Asian Crisis Episodes*, 13 J. INT'L FIN. MARKETS INSTITUTIONS & MONEY 171, 171-72 (2003) (reviewing the causes of East Asian financial crises leading to default); Augusto de la Torre et al., *Living and Dying with Hard Pegs: The Rise and Fall of Argentina's Currency Board*, ECONOMIA, Spring 2003, at 43, 64-72 (discussing the crisis in Argentina in which fears of devaluation led to a hard currency shortage, in turn resulting in default); see also Richard Euliss, Comment, *The Feasibility of the IMF's Sovereign*

previously believed it would pay, ill-conceived projects in which developing countries invest the proceeds of external financing often fail to produce the increased revenue expected of them.<sup>27</sup> Just as Fred might misdirect part of his loan proceeds towards non-educational expenses, developing countries may face problems with corrupt leaders and the misdirection of loan proceeds.<sup>28</sup> The literature on domestic policies that may lead to the creation of economic crisis is far too broad to explore in this Comment, but it suffices to say that an economic crisis may be a country's own doing.

Other times, exogenous circumstances may cause a crisis. Just as Fred might get sick, developing countries may endure natural disasters that dampen economic output.<sup>29</sup> Just as a financial crisis might prevent a future employer from hiring Fred, a sovereign's policies may meet some initial success, but external circumstances can lead to poor results.<sup>30</sup> Still other times, debtor countries suffer from contagion of crises from other countries. Just as Fred's classmates' malfeasance

*Debt Restructuring Mechanism: An Alternative Statutory Approach To Mollify American Reservations*, 19 AM. U. INT'L L. REV. 107, 116 (2003) (finding that the risk of dramatic growth in debt burden and default increases during hard currency shortages).

<sup>27</sup> See William Easterly, *Growth Implosions, Debt Explosions, and My Aunt Marilyn: Do Growth Slowdowns Cause Public Debt Crises?* 5 (World Bank, Policy Research Working Paper No. 2531, 2001), available at <http://econ.worldbank.org/files/wps2531.pdf> (“[P]olicy variables that make some countries slow down less or more than others do have fiscal consequences.”); Rodrigo Suescún, *Raising Revenue with Transaction Taxes in Latin America: Or Is It Better to Tax with the Devil You Know?* 24 (World Bank, Policy Research Working Paper No. 3279, 2004), available at <http://econ.worldbank.org/files/wps3279.pdf> (arguing that temporary, rather than permanent, imposition of a transaction tax is likely to raise more revenue).

<sup>28</sup> See BUCKLEY, *supra* note 3, at 20-21 (arguing that corruption was a principal reason why Latin American sovereigns had difficulty repaying petro-dollar loans); see, e.g., Raymond Fisman & Jakob Svensson, *Are Corruption and Taxation Really Harmful to Growth? Firm-Level Evidence* 3 (World Bank, Policy Research Working Paper No. 2485, 2000), available at <http://econ.worldbank.org/files/wps2485.pdf> (concluding that corruption is more harmful to growth in Uganda than is taxation); see also Stijn Claessens et al., *Resolving Systemic Financial Crises: Policies and Institutions* 13 (World Bank, Policy Research Working Paper No. 3377, 2004), available at <http://econ.worldbank.org/files/wps3377.pdf> (suggesting that corruption leads to systemic banking crises).

<sup>29</sup> See, e.g., Henry F. Jackson, *The African Crisis: Drought and Debt*, 63 FOREIGN AFF. 1081, 1083 (1985) (observing that drought in Africa caused many countries to draw heavily on their foreign currency reserves to purchase food abroad).

<sup>30</sup> For example, if a country were to invest in exploiting a natural resource commodity, and the price of that commodity unexpectedly fell, the investment would turn out to be unprofitable. See, e.g., Angus Deaton, *Commodity Prices and Growth in Africa*, J. ECON. PERSP., Summer 1999, at 23, 31 (arguing that some well-intentioned investments in natural resource and commodity exploitation have been unsuccessful because of commodity price fluctuations).



might lead to higher interest rates for Fred, investor panic resulting from economic crises in neighboring countries might lead to regional capital flight, regardless of an individual country's policies. Such "herd behavior" on the part of investors is thought to result from a combination of high trading volatility and information deficits.<sup>31</sup> The result is that yield spreads—the cost of servicing debt—"do not only capture country-specific information but also relate to spillovers from developments in one particular country."<sup>32</sup> In these cases, a debtor country may be unable to repay its debt through no fault of its own.

One of the key differences between corporate default and consumer default is in the concept of opportunistic default. Some might argue that Fred is opportunistically defaulting because technically he could pay back the entirety of his debt: he has an income of \$23,500 in the default state and only owes \$5000. However, Fred's minimum expenses are \$20,000, meaning that he can pay at most \$3500 ( $\$23,500 - \$20,000 = \$3500$ ) without sacrificing food or shelter. One could argue that Fred is opportunistically defaulting because he could simply stop feeding and clothing his children or elect to go homeless to make up the additional \$1500. Perhaps one could even suggest that Fred reduce his diet to a few cups of rice—just enough to survive on. The same logic is often applied to corporations, which are asked to close parts of their businesses or reduce operations in order to continue paying creditors.<sup>33</sup>

These options, while perhaps plausible for a corporation, are not plausible for a person. Fred must eat, must be clothed, and if he wants to live a reasonable life, must be sheltered. Even if Fred did own a house or a car, it might not be in his best interests to sell it. For instance, Fred might need a car to earn the amount of income neces-

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<sup>31</sup> See, e.g., Luca Barbone & Lorenzo Forni, *Are Markets Learning? Behavior in the Secondary Market for Brady Bonds* 34 (World Bank, Policy Research Working Paper No. 1734, 1997), available at <http://econ.worldbank.org/files/wps1734.pdf> (suggesting that the behavior of Brady Bond traders "responds to the level of uncertainty in the market").

<sup>32</sup> Norbert Fiess, *Capital Flows, Country Risk, and Contagion* 3 (World Bank, Policy Research Working Paper No. 2943, 2003), available at <http://econ.worldbank.org/files/wps2943.pdf>.

<sup>33</sup> See, e.g., Mark Belko, *Airline to End Europe Flights: US Airways' Decision Leaves Region Without a Nonstop to Continent*, PITTSBURGH POST-GAZETTE, Aug. 13, 2004, at A1 (reporting that US Airways had decided to cut its flight schedules from Pittsburgh, its once-largest hub, as part of a restructuring plan); Constance L. Hays, *Retail Consultant Says Kmart Will Seek To Close 312 Stores*, N.Y. TIMES, Jan. 11, 2003, at C2 (discussing Kmart's plans to close stores in order to reduce costs and pay creditors as part of a bankruptcy plan).

sary to sustain his family,<sup>34</sup> and a home is necessary for shelter.<sup>35</sup> In this sense, one could argue that Fred is opportunistically defaulting: he has the opportunity to pay back his debt, but the social costs of not feeding his children or providing himself with shelter are higher than the economic costs of default. Fred, unlike a corporation, is not merely an “investment vehicle” for himself and his children.<sup>36</sup>

Likewise, a sovereign is not merely an investment vehicle for its citizens. A sovereign makes decisions based not on returns to investors, but rather based on a complicated equation of politics, social conditions, and economics.<sup>37</sup> As a result, a sovereign may opportunistically default when it is “simply . . . unwilling to make the required payments.”<sup>38</sup> For example, a debtor country whose economy is heavily dependent on commodity exports may decide to forego debt service when the price of the commodity drops. This would allow the debtor country to divert funds intended for debt service to soften the domestic economic blow of the decline in export revenues.<sup>39</sup> While Fred would almost certainly default in his situation, the concept of a wholly strategic sovereign default has so far been limited to academic literature.<sup>40</sup> However, while debtor countries almost always have the ostensible choice of defaulting or raising taxes and cutting popular social programs, “[s]o long as the sovereign has a choice as to whether or not to default, strategy inheres in the fact pattern.”<sup>41</sup> Given the choice

<sup>34</sup> The Federal Bankruptcy Code recognizes that Fred’s car, valued up to a certain amount, will be necessary for a “fresh start,” and therefore allows him to keep it. See 11 U.S.C. § 522(d) (2000) (listing property, including an automobile for personal use, that is exempt from liquidation during bankruptcy proceedings).

<sup>35</sup> See Phyllis A. Klein, Note, “A Fresh Start with Someone Else’s Property”: *Lien Avoidance, the Homestead Exemption and Divorce Property Divisions Under Section 522(f)(1) of the Bankruptcy Code*, 59 *FORDHAM L. REV.* 423, 429-30 (1990) (discussing the homestead exemption’s expansion to provide a debtor with a fresh start after bankruptcy).

<sup>36</sup> See Rasmussen, *supra* note 5, at 1163 (describing corporations as investment vehicles in order to distinguish corporations and sovereigns).

<sup>37</sup> See Sedlak, *supra* note 5, at 1487-88 (explaining the factors entering a sovereign’s decision-making calculus with respect to the repayment of debt).

<sup>38</sup> Fisch & Gentile, *supra* note 5, at 1048.

<sup>39</sup> See *id.* at 1049 (giving an example in which a sovereign that is dependent upon export taxes for revenue might choose to default during a commodity price crisis so as “to ameliorate the effects of the shock in prices”).

<sup>40</sup> There is little evidence that any country has ever defaulted for entirely opportunistic reasons. While most sovereigns will not default in good economic conditions, most will take into account political and social conditions in deciding when to default. See Bratton & Gulati, *supra* note 17, at 17 (“[A]lthough strategic defaults are a theoretical possibility, sovereigns as a practical matter only default under identifiably bad economic conditions.”).

<sup>41</sup> *Id.*

between completely cutting social programs and default, sovereigns frequently find a partially opportunistic default the more palatable choice.<sup>42</sup>

To sum up, persons—e.g., Fred—and sovereigns default on loans for a very wide variety of reasons. Unlike corporations, however, Fred and sovereigns will most likely default before they have liquidated all of their assets to repay their debt. Thus, faced with the choice of starvation or default, Fred will probably stop repaying his creditors.

### B. *Options To Collect Debt: An Analysis of Fred and the Sovereign*

The creditors that have lent to Fred and to a developing country are now faced with a dilemma: how can they collect the money that they lent? This question is difficult, and the answer may concern not only Fred or the developing country, but also their peers. If creditors cannot easily collect any of the money they have lent to a debtor who defaults, they will charge an interest rate to reflect this, just as Fred was charged 10% interest based on the 25% risk that he would pay less than the full amount of the loan.<sup>43</sup> For example, if creditors only had a 50% chance of collecting on Fred's assets, his interest rate would rise to slightly over 20%.<sup>44</sup> A country will be charged a similar risk premium for the possibility that the creditors will not be able to collect. A number of commentators have remarked that a high risk premium is one of the principal motivations to optimize the collection of sovereign debt.<sup>45</sup> This is particularly true for sovereign lending where more efficient debt collection systems are likely to “ultimately reduce the future cost of sovereign borrowing, because creditors would receive a higher recovery under such a system and this should cause them to

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<sup>42</sup> See Sedlak, *supra* note 5, at 1488 (“[A] country will always reach a point beyond which the costs of servicing its debts exceed the costs of defaulting.”). The cost of servicing a country's debt is ostensibly a social cost.

<sup>43</sup> See Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 608 (2000) (“When creditors can reach assets, their insolvency state payoffs increase, thereby inducing a fall in the interest rate.”).

<sup>44</sup> Using the figures from before, if Fred has a 25% chance of being able to pay \$3500 in the default state, but his creditors have only a 50% chance of obtaining that amount because of potential obstacles to collection, the value of the default-state repayment would decrease to  $(0.25 \times 0.5 \times \$3500 = \$437.5)$ . Accordingly, the amount of money collected in the non-default state would have to rise to \$6083 to make up the difference  $((0.75 \times \$6083) + \$437.5 = \$5000)$ . Thus, interest rates would have to rise to 20.83%.

<sup>45</sup> See Tarullo, *supra* note 5, at 661 (arguing that, “[a]s is regularly noted,” if sovereign debt workouts are too easy, the costs of capital for other debtor nations might rise).

decrease the cost of sovereign lending.”<sup>46</sup> As Alan Schwartz argues, “the ultimate object of bankruptcy law is to help maximize social wealth. This object implies the instrumental goal of minimizing the cost of debt capital.”<sup>47</sup> Thus, it is necessary to examine the two accepted means of collecting debt: liquidation and restructuring.

### 1. Liquidation of Assets

Ostensibly, Fred’s creditors could ask Fred to sell—or, in the terminology of bankruptcy, “liquidate”—some of his possessions in order to pay back his debt.<sup>48</sup> If Fred’s creditors were particularly smart, they would have secured their loans with collateral, which would entitle them to take possession of the collateral and sell it after Fred’s default.<sup>49</sup> However, in the hypothetical presented, the problem is obvious: Fred has very few possessions. He owns no car and he rents his home rather than owning it. The meager food that Fred is able to purchase is unlikely to qualify as collateral, and would be difficult to “liquidate.” A sovereign debtor typically presents the same problems. Sovereigns can rarely offer collateral in exchange for their loans.<sup>50</sup> Just as Fred’s creditors cannot simply “liquidate” him as a corporate creditor could a corporate debtor,<sup>51</sup> a sovereign cannot be liquidated or sold off. Unlike a corporate entity, which may have buildings, bank

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<sup>46</sup> A. Mechele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 EMORY L.J. 997, 1011-12 (2004); see also Alon Seveg, *When Countries Go Bust: Proposals for Debtor and Creditor Resolution*, 3 ASPER REV. INT’L BUS. & TRADE L. 25, 26 (2003) (arguing that “lenders are forced to increase interest rates to cover potential losses” caused by defaults).

<sup>47</sup> Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1814 (1998).

<sup>48</sup> This option is analogous to Chapter 7 bankruptcy. See 11 U.S.C. §§ 701-707, 721-728 (2000) (setting forth the procedures for Chapter 7 liquidation of personal assets); see also Michelle J. White, *Why It Pays To File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685, 687-89 (1998) (explaining Chapter 7 bankruptcy procedure and exemptions).

<sup>49</sup> See U.C.C. § 9-610 (2000) (explaining the disposition of collateral in cases of default).

<sup>50</sup> See Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763, 774 (2004) (“It is harder for sovereigns than for corporate debtors to offer collateral . . . , and enforcement is quite tricky when the debt does purport to provide security.”). Sovereigns rarely have significant assets outside of their own country. See Bratton & Gulati, *supra* note 17, at 11 (“And defaulting sovereigns try their best not to leave valuables lying around.”). Enforcement of security interests in domestic assets, whether physical or financial, is likely to be tricky. See *infra* note 52 and accompanying text.

<sup>51</sup> See, e.g., Adler et al., *supra* note 43, at 586 (“The insolvent consumer cannot be liquidated . . .”).

accounts, and other assets within the reach of domestic courts, existing courts would have no effective jurisdiction or enforcement power over a sovereign's domestic assets.<sup>52</sup>

The inability to collateralize debt has not always been central to the understanding of sovereign lending. Prior to the early twentieth century, sovereign debt was often "secured" by assets like tax receipts or land. During the debt defaults of the 1910s, however, creditors found that they could not enforce their security interests without the aid of military or diplomatic initiatives by their governments.<sup>53</sup> As a result, many of these debtors found their security interests to be of little value in collecting on their debt.<sup>54</sup> In more recent times, creditors have occasionally been able to secure loans with export revenues or foreign bank accounts.<sup>55</sup> These situations, however, are few and far between. The current understanding is that, "[u]nlike a defaulting corporate borrower, a sovereign cannot be liquidated."<sup>56</sup> Likewise, neither Fred nor a sovereign will have any "equity" to speak of.<sup>57</sup> Accordingly, the only situation in which a creditor is likely to receive full repayment from either Fred or a sovereign is to allow their debts to be restructured.

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<sup>52</sup> See Gelpert, *supra* note 6, at 1122 ("[E]ven today's diminished view of sovereignty precludes outside control over debtors' principal assets—national economies and government finances."). It is worth noting that, in theory, a sovereign's own courts could order it to sell domestic assets to satisfy foreign debts. However, a defaulting sovereign's political situation often makes it unlikely that creditors can depend on local courts. See Bratton & Gulati, *supra* note 17, at 11 ("[T]he sovereign lender has no recourse to a reliable enforcement authority.").

<sup>53</sup> See Kris James Mitchener & Marc D. Weidenmier, *Supersanctions and Sovereign Debt Repayment 2* (Nat'l Bureau of Econ. Research, Working Paper No. 11472, 2005), available at <http://www.nber.org/papers/w11472.pdf> (finding that supersanctions, such as military intervention, were used as an effective means of sovereign debt collection during the 1910s).

<sup>54</sup> See Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 898 (2004) (describing the evolution of "secured lending to sovereign borrowers").

<sup>55</sup> See Gabrielle Lipworth & Jens Nystedt, *Crisis Resolution and Private Sector Adaptation*, 47 IMF STAFF PAPERS 188, 192 (2001) ("Some debt instruments are collateralized with foreign assets and designed in such a way that should default occur, the recovery value is very high . . .").

<sup>56</sup> Bratton & Gulati, *supra* note 17, at 11; see also Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 971-72 (2000) (arguing that criticism of Chapter 11 regarding inefficient choices of reorganization over liquidation is irrelevant to sovereign debt restructuring because a sovereign cannot be liquidated).

<sup>57</sup> See Bratton & Gulati, *supra* note 17, at 12 (arguing that the citizens of a debtor country are the closest thing to equity a debtor country has).

## 2. Restructuring

Fred and his family cannot be liquidated and have few existing assets to seize, and he is still unable to pay the full amount of his debt: Fred can only pay \$3500 of the \$5000 he borrowed. If his creditors want to collect the full amount of the debt, they will have to wait another year;<sup>58</sup> in other words, they will have to restructure his payment of principal and interest. The same is true in the sovereign context. Since a sovereign's creditors cannot liquidate or seize assets to satisfy the debt, they must wait until the sovereign has sufficient assets to satisfy its obligations. As one commentator argues:

[W]hen a country cannot (or will not) pay all its creditors in full and on time, it serves the collective interest of all creditors to agree on a restructuring where all might lose some value relative to the original promise, provided the debtor's prospects of economic recovery go up and with it the repayment prospects of the restructured debt.<sup>59</sup>

Although restructuring debt appears to be the only plausible means for Fred and the sovereign's creditors to collect in full, this solution is not without its own problems. The next Subpart will discuss how creditor holdouts, moral hazard, and lack of coordination might impede an efficient restructuring.

### C. *Potential Pitfalls of Restructuring: Creditor Holdouts, Moral Hazard, and Lack of Coordination*

#### 1. Creditor Holdouts

In the hypothetical, Fred has twelve creditors: a bank, a credit card company, and ten individuals. Each type of creditor has lent a different amount, and all want to be repaid. Fred, in the default state, is able to pay \$3500 in Year 1, which is 70% of the \$5000 debt he initially incurred. Assume there is no cooperation or communication among creditors, that each wants to be paid back as soon as possible, and that there is no regulatory scheme that assigns priority to creditors. Each creditor will then rush to court to sue for enforcement of its loan. If the bank reaches the courthouse first, it will recover all of the \$3500 to satisfy its \$4500 loan, and no other party will be paid un-

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<sup>58</sup> Without depriving himself of the bare necessities of feeding, clothing, and sheltering himself and his family, Fred can pay a maximum of \$3500 per year. Thus, in the default state, in Year 1, Fred can pay \$3500, and in Year 2, he will be able to repay the remaining \$1500 of principal, plus accrued interest.

<sup>59</sup> Gelpert, *supra* note 6, at 1138.

til Year 2. Alternatively, if the credit card company reaches the courthouse first, it will take \$550 (\$500 principal plus 10% interest) and will be paid in full, leaving \$2950 to be allocated among the other creditors. If an individual creditor reaches the courthouse first, she will be paid \$11 (\$10 principal plus 10% interest) and be paid in full, leaving \$3489 for remaining creditors. The problem here is that some creditors will receive more than other creditors simply because they arrived at the courthouse first.

A sovereign faces the same problems in trying to obtain a restructuring. Individual creditors opting out of a restructuring may be able to enforce their claims in full, or at least sooner and for more than they would get by participating in the restructuring. “[C]reditors have an incentive to collect debts promptly . . . rather than coordinate collection efforts with other creditors.”<sup>60</sup> The creditor holdout problem, however, poses a more serious conundrum for a sovereign: while Fred has taken out just a few loans with a total of twelve creditors, a sovereign is likely to have many types of loans, such as syndicated bank loans, trade credit, and bond issues, with thousands of creditors.<sup>61</sup> Which creditors decide to collect and when they do may depend on the value and maturity of their respective claims.<sup>62</sup> Collection upon default decreases the amount of money available to other creditors after a restructuring<sup>63</sup> and increases uncertainty in the restructuring process.<sup>64</sup> For example, creditors might seize the planes of state-run

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<sup>60</sup> Schwartz, *supra* note 47, at 1840; *see also* Gelpert, *supra* note 6, at 1138-39 (“[A]n individual creditor that refuses to restructure stands to gain disproportionately from the others’ concessions.”).

<sup>61</sup> *See* Seveg, *supra* note 46, at 46 (“[T]he move from syndicated bank lending to bonds . . . has made coordination of creditors [in sovereign debt restructurings] much more difficult . . .”); *see also* Vladimir Werning, JP Morgan, Argentina: Roadmap for Restructuring: What to Look for at Each Stage of the Process 7 (Oct. 8, 2004), *available at* <http://www.cbonds.info/comments/materials/6990/arg1004.pdf> (noting that Argentina has at least 152 separate bond issues).

<sup>62</sup> *See* Lipworth & Nystedt, *supra* note 55, at 202-03 (noting that longer-term creditors may be unwilling to restructure if they believe the restructuring will benefit shorter-term creditors and that shorter-term creditors would not agree to a payment suspension unless the present value of a deal sweetener exceeds the value of short-term credit).

<sup>63</sup> *See* Bratton & Gulati, *supra* note 17, at 24-25 (noting that a bankruptcy system might create a surplus or at least prevent it from dissipating); *cf.* Schwartz, *supra* note 47, at 1808 (arguing that “piecemeal liquidation” of a firm could result from prompt collection in an unregulated system, thus reducing funds available to the creditor pool as a whole).

<sup>64</sup> *See* John B. Taylor, Under Sec’y for Int’l Affairs, U.S. Treasury Dep’t, Remarks to the IMF Conference in Honor of Guillermo Calvo (Apr. 16, 2004), <http://www.treas.gov/>

airlines that land in creditor states,<sup>65</sup> or capture funds that are transferred through banks located in creditor states.<sup>66</sup> The result is that “ruthful bondholders, however large their majority, are . . . at the mercy of their most ruthless colleagues.”<sup>67</sup> This is called the “holdout litigation” or “grab race” problem, and the holdout creditors are known as “vulture funds.”<sup>68</sup>

Sovereigns have offered a variety of defenses designed to stave off holdout litigation. Argentina, for example, argued that the Foreign Sovereign Immunities Act (FSIA)<sup>69</sup> created a defense against seizure of assets to satisfy creditor claims.<sup>70</sup> The Supreme Court, however, found that issuance of debt—in particular, a bond—constitutes commercial activity under the statute<sup>71</sup> and thus falls within the FSIA’s exception to sovereign immunity.<sup>72</sup>

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press/releases/js1473.htm (“[C]ollective action cases [a]re the more promising and feasible way to introduce more predictability into the system.”).

<sup>65</sup> See Bolton & Skeel, *supra* note 50, at 782 (“If [a] sovereign [that operated a state-run airline] defaulted, creditors could seek to attach the sovereign’s airplanes after they landed in a country that permitted such actions.”).

<sup>66</sup> Commentators have noted that under the *pari passu* clause in a bond contract, a vulture fund could attach sovereign funds traveling through the Euroclear system that were intended for other bondholders. See, e.g., Buchheit & Pam, *supra* note 54, at 877-79 & nn.16-19 (citing *Ex parte Elliott Assocs.*, No. 2000/QR/92, slip op. (Brussels Ct. App., 8th Chamber, Sept. 26, 2000) (Belg.), as an example of a creditor trying to intercept a Brady Bond payment).

<sup>67</sup> Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1320 (2002). In fact, this is one of the primary concerns of “the official sector [, which] wants to ensure that private creditors do not escape by imposing losses they should bear onto others.” Lipworth & Nystedt, *supra* note 55, at 190.

<sup>68</sup> See, e.g., Fisch & Gentile, *supra* note 5, at 1098 (“[H]oldout litigation may provide a means of avoiding the failures . . . by allowing creditors to enforce their claims against sovereign debtors.”); Bratton & Gulati, *supra* note 17, at 21-22 (noting that “[i]nstitutional bondholders known as ‘vulture funds’ specialize in” purchasing distressed debt at a substantial discount and then decline to participate in an exchange offer).

<sup>69</sup> 28 U.S.C. §§ 1602-1605 (2000).

<sup>70</sup> See *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 615-17 (1992) (noting Argentina’s argument that in issuing bonds it was acting as a sovereign, not as a commercial entity, and that it should therefore be immune from suit).

<sup>71</sup> See 28 U.S.C. § 1605(a)(2) (2000) (providing an exception to sovereign immunity for suits based upon a sovereign’s commercial activities that have a “direct effect” in the United States).

<sup>72</sup> See *Weltover*, 504 U.S. at 614 (“[W]hen a foreign government acts . . . in the manner of a private player within [a market], the foreign sovereign’s actions are ‘commercial’ within the meaning of the FSIA.”); see also *Conn. Bank of Commerce v. Republic of Congo*, 309 F.3d 240, 260-61 (5th Cir. 2002) (suggesting that oil and tax revenues may be commercial activity under the FSIA); Avi Lew, Note, *Republic Of Argentina v. Weltover, Inc.: Interpreting the Foreign Sovereign Immunity Act’s Commercial Ac-*



Peru, in one effort to stave off holdout litigation, asserted the defense of comity<sup>73</sup> against a debt collection effort by Pravin Banker Associates.<sup>74</sup> Pravin Banker Associates was a holdout creditor that refused to participate in an ongoing restructuring of Peruvian sovereign debt and had sued for enforcement.<sup>75</sup> Although the Second Circuit recognized the policy of U.S. courts to “ordinarily refuse to review acts of foreign governments and defer to proceedings taking place in foreign countries,” it held that comity would not prohibit the court from reviewing Peru’s decisions to restructure debts, including those involving Pravin.<sup>76</sup> The court therefore denied Peru’s request to refuse to enforce Pravin’s debt claims.<sup>77</sup> Judge Calabresi held that comity was not a requirement, but merely a “rule of practice, convenience, and expediency” that could be ignored if deferring to the foreign act would be contrary to U.S. policy.<sup>78</sup> The Second Circuit agreed with Pravin that extending an indefinite stay on enforcement of sovereign debt would be contrary to U.S. policy, and thus enforced Pravin’s claim notwithstanding the Peruvian restructuring.<sup>79</sup>

Peru tried another tactic in *Elliott Associates v. Banco de la Nacion*.<sup>80</sup> Elliott Associates, a vulture fund, sued for enforcement on Peruvian debt that it had purchased.<sup>81</sup> It allegedly acquired the debt specifically for the purpose of enforcing it in court, with the intent of extracting concessions from creditors in exchange for dropping its suit.<sup>82</sup>

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*tivity Exception to Jurisdictional Immunity*, 17 FORDHAM INT’L L.J. 726, 741-42 (1994) (interpreting *Weltover* to mean that bond reschedulings fall within the definition of “commercial activity” of the FSIA); *cf.* *Allied Bank Int’l v. Banco Credito Agricola de Cartago*, 757 F.2d 516, 522 (2d Cir. 1985) (holding that when a foreign state takes property located in the United States, its actions are not exempt from U.S. jurisdiction under the “act of state” doctrine).

<sup>73</sup> Comity is a judicial policy that gives deference to acts of foreign jurisdictions. *See* *Hilton v. Guyot*, 159 U.S. 113, 164 (1895) (stating that comity normally requires a court to enforce a foreign judgment).

<sup>74</sup> *See* *Pravin Banker Assocs. v. Banco Popular del Peru*, 109 F.3d 850, 854 (2d Cir. 1997) (noting Peru’s argument that international comity prevents U.S. courts from exercising jurisdiction over disputes between Peru and its creditors).

<sup>75</sup> *Id.* at 850-51.

<sup>76</sup> *Id.* at 854-56.

<sup>77</sup> *Id.* at 856.

<sup>78</sup> *Id.* at 854-55 (internal quotation marks omitted).

<sup>79</sup> *Id.* at 855-56.

<sup>80</sup> 194 F.3d 363 (2d Cir. 1999).

<sup>81</sup> *Id.* at 365-67.

<sup>82</sup> *See id.* at 368 (relying on the district court’s finding that “Elliott purchased the Peruvian debt with the intent and purpose to sue” (quoting *Elliott Assocs. v. Republic of Peru*, 12 F. Supp. 2d 328, 332 (S.D.N.Y. 1998))).

Banco de la Nacion and Peru argued that New York champerty statutes prohibited a party from purchasing debt for the purpose of bringing a suit or proceeding thereon.<sup>83</sup> The Second Circuit found that the champerty defense, like the comity defense, was without merit, and ultimately enforced Elliott Associates' claim.<sup>84</sup>

One of the rare cases in which courts did grant a sovereign's request to deny enforcement of its debt contracts is *CIBC Bank & Trust Co. (Cayman) v. Banco Central do Brasil*.<sup>85</sup> In *CIBC Bank*, a creditor who had elected not to participate in a "Brady conversion"<sup>86</sup> of bank loans to bonds tried to enforce an acceleration clause in the loan agreement, which would have required the debtor to immediately repay the principal and remaining interest.<sup>87</sup> However, Banco Central do Brasil retained \$1.6 billion of the original debt, which gave it a majority interest and allowed it to block any attempt to accelerate the loan.<sup>88</sup> Notwithstanding CIBC's claims of tortious interference with the contract, the court found that the terms of the loan agreement between CIBC and Banco Central do Brasil governed and that so long as Banco Central held a majority of the remaining debt, CIBC could not accelerate.<sup>89</sup>

In conclusion, courts have tended to side with vulture funds when sovereigns offer defenses to litigation intended to compel repayment. Holdout litigation will therefore continue to be a problem for sovereign debt restructurings unless a suitable solution is found.

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<sup>83</sup> See *id.* at 367-69 (noting Peru's reliance on N.Y. JUD. CT. ACTS LAW § 489 (McKinney 1983), to support its position that the court should not entertain Elliott Associates' suit).

<sup>84</sup> See *id.* at 381 ("[W]e hold that [the champerty statute] is not violated when, as here, the accused party's 'primary goal' is found to be satisfaction of a valid debt and its intent is only to sue absent full performance.").

<sup>85</sup> 886 F. Supp. 1105 (S.D.N.Y. 1995).

<sup>86</sup> The term "Brady conversion" is used to describe the exchange of loans for bonds with a capital injection by the U.S. Treasury Department during the 1980s. It is named after former Treasury Secretary Nicholas Brady, who initiated the program. For a more extensive explanation of the Brady conversion program, see BUCKLEY, *supra* note 3, at 102-10.

<sup>87</sup> 886 F. Supp. at 1107-08.

<sup>88</sup> *Id.* at 1107.

<sup>89</sup> See *id.* at 1119-20 (denying CIBC's tortious interference claims on the grounds that the contract language was unambiguous and permitted Banco Central's actions).

## 2. Concern About Moral Hazard

Fred's creditors may have another concern. If the creditors allow Fred to restructure his loans unconditionally, he may choose to continue delaying repayment indefinitely.<sup>90</sup> Many think of restructuring as an insurance against income loss: if a person is able to restructure her debts, she can reduce the impact of a temporary loss in income.<sup>91</sup> However, it is not always clear that the temporary loss in income will be the result of exogenous conditions or creditor negligence. Just as auto accident insurance can cause the insured to be less concerned with cautious driving,<sup>92</sup> the option of restructuring may cause Fred to be less concerned with ensuring that he earns a sufficient income to repay his loans. Consequently, Fred's creditors may not want to provide him the option of restructuring because they think that it will make him more likely to engage in activities that increase the risk that he could not repay his loan in full. If Fred is able to restructure his current debt obligations, his creditors might not want to lend to him in the future.<sup>93</sup> Although bankruptcy continues to carry severe moral repercussions,<sup>94</sup> some authors have argued that the existence of certain restructuring procedures has led to an increase in the number of bankruptcy filings and irresponsible financial behavior on the part of consumers.<sup>95</sup>

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<sup>90</sup> See Adler et al., *supra* note 43, at 595 (“[T]he more ‘bankruptcy insurance’ the borrower has, the less is the difference between the borrower’s solvency and insolvency state returns, and the less hard he will work to avoid insolvency.”).

<sup>91</sup> See *id.* at 587 (noting that bankruptcy exists to provide “partial wage insurance”).

<sup>92</sup> See Eric D. Beal, *Posner and Moral Hazard*, 7 CONN. INS. L.J. 81, 81-82 (2000) (“[I]f the insurer, not the insured, is on the hook for a loss, then the insured may invest less in care, e.g., driving less or more slowly, installing smoke detectors, or eating a low fat diet.”).

<sup>93</sup> See Adler et al., *supra* note 43, at 589-90 (citing evidence that low income consumers have a harder time getting credit in states with higher bankruptcy exemptions); *id.* at 598 n.23 (“[W]hen there can be moral hazard, a firm that has few assets to offer to creditors in the insolvency state may be unable to borrow.” (citing Alan Schwartz, *The Absolute Priority Rule and the Firm’s Investment Policy*, 72 WASH. U. L.Q. 1213 (1994))).

<sup>94</sup> See Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 397-99 (2001) (“[W]hen a lender extends credit to a borrower, the lender trusts the borrower to repay the amount borrowed and such trust relationships inevitably carry with them an element of moral obligation. . . . Moral intuitions against bankruptcy [are] universal among societies . . .”).

<sup>95</sup> See Lynn M. LoPucki, *Common Sense Consumer Bankruptcy*, 71 AM. BANKR. L.J. 461, 462 (1997) (arguing that the bankruptcy system treats alike debtors that are dishonest and profligate and debtors that are honest and frugal); White, *supra* note 48, at 690 (noting that for debtors living in states with higher property exemptions in bankruptcy, filing for bankruptcy would be a “win-win” situation); Zywicki, *supra* note 94, at

Many sovereign lenders fear that the same moral hazard that might cause Fred to be less diligent in finding a job or more extravagant in his spending will cause sovereigns to be less careful with their investments or more profligate in their spending.<sup>96</sup> Much of the criticism directed at the current proposals for sovereign debt restructuring are directed at the moral hazard issue; many creditors fear that making debt restructuring easier will also make it more frequent.<sup>97</sup> Thus, to combat moral hazard and the resulting frequency of defaults, many creditors feel that it is necessary to make restructuring difficult. Creditors argue that if debtors know *ex ante* that they will not be able to renegotiate their debt easily, they are less likely to take actions that would imperil their ability to repay their loans.<sup>98</sup> Of course, this risk already exists to a certain extent with the International Monetary Fund (IMF) “lending into arrears,” which occurs when the IMF lends to debtor countries after they have defaulted with the intent of helping a creditor deal with a short term crisis.<sup>99</sup> Even restrictions on this

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407 (finding that the increased availability of credit to consumers made it easier for them to “live beyond their means” because of the prospects of “easy bankruptcy”).

<sup>96</sup> See Seveg, *supra* note 46, at 44 (arguing that writing off a country’s debt might give governments an incentive to over-borrow). *But see* Beth A. Simmons, *Money and the Law: Why Comply with the Public International Law of Money?*, 25 YALE J. INT’L L. 323, 325 (2000) (arguing that sovereigns comply with their legal obligations so that they may “enjoy future economic benefits on favorable terms”).

<sup>97</sup> See Lipworth & Nystedt, *supra* note 55, at 190 (noting that the official sector is concerned with moral hazard); Arturo C. Porzecanski, *A Critique of Sovereign Bankruptcy Initiatives*, BUS. ECON., Jan. 2003, at 39, 42 (arguing that most savvy investors fear that making sovereign restructuring easier will lead to a greater need for restructuring); Giovanni Dell’Ariccia et al., *Moral Hazard and International Crisis Lending: A Test 5* (Int’l Monetary Fund, Working Paper No. WP/02/181, 2002), available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02181.pdf> (finding statistical evidence of moral hazard in international lending); Anne O. Krueger, First Deputy Managing Director, Int’l Monetary Fund, *Sovereign Debt Restructuring Mechanism—One Year Later*, Address to the European Commission (Dec. 10, 2002), <http://www.imf.org/external/np/speeches/2002/121002.htm> (noting that creditors fear that if the SDRM reduces the cost of restructurings, they will become more frequent). This problem can also be seen in corporations. Since stockholders face only limited liability for acts of a corporation, they may be tempted to divert funds to themselves and away from the hands of eager creditors. *See, e.g.*, Dale B. Tauske, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 3 (“Because stockholders ordinarily are not individually liable for debts of the corporation, they may have incentive in certain circumstances to conduct the affairs of the corporation in ways that adversely affect the interests of the debtholders.”).

<sup>98</sup> See Bolton & Skeel, *supra* note 50, at 770-71 (“Because sovereign debtors know they cannot easily renegotiate their debt *ex post*, they will have a powerful incentive to repay the obligations.”).

<sup>99</sup> See Stephen Anthony, *IMF Structural Adjustment Programs: An Econometric Evaluation*, 3 GEO. PUB. POL’Y REV. 133, 134 (1998) (describing the rationale for IMF assis-

moral hazard are flouted: the IMF's self-imposed limits on such lending have been regularly exceeded in recent years.<sup>100</sup> Furthermore, the conditions on debtor country policies which are often a part of the IMF loan are often ignored,<sup>101</sup> and as a result, many countries continue the ruinous policies that led to their initial need for restructuring.<sup>102</sup> Given that economic crises are often brought about by factors outside of the control of sovereigns, the argument that restructuring leads to significant moral hazard is not always applicable.<sup>103</sup> However, given the numerous causes of default, moral hazard will likely arise as a consideration in any restructuring.

### 3. Lack of Coordination

As a simple logistical matter, Fred's creditors may have a hard time arranging a time to meet. Bank officials may have to travel from distant cities. The credit card company may be loath to send a decision maker to such a small restructuring. Fred's classmates are all busy and may not get along or even know each other. Furthermore,

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tance to debtor countries). Thus far, the discussion of moral hazard has been limited to *debtor* moral hazard. However, IMF lending into arrears and other bailouts can also cause *creditor* moral hazard, which is the risk of unsustainable lending by creditors who are under the belief that their credit risks will be underwritten by those providing the bailout. See Seveg, *supra* note 46, at 44-45 ("The IMF and U.S. government practice of guaranteeing part of a sovereign debtor's interest and principal payments underwrites what would otherwise be unsustainable policies."). Creditor moral hazard can also pose grave problems for sovereign lending practices. See Barry Eichengreen, *Bailing In the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 FLETCHER F. WORLD AFF. 57, 57 (1999) ("The moral hazard thereby created . . . set[] the stage for still larger crises and bailouts.").

<sup>100</sup> See Porzecanski, *supra* note 97, at 44 tbl.1 (noting that Thailand and Indonesia were granted access to about 500% of their quotas in 1997, South Korea was granted access to about 1940% of its quota in 1997, and Russia obtained a program worth about 450% of its quota in 1998).

<sup>101</sup> See David Fuhr & Zachary Klughaupt, Note, *The IMF and AGOA: A Comparative Analysis of Conditionality*, 14 DUKE J. COMP. & INT'L L. 125, 128 (2004) (noting that many bemoan the IMF's "unwillingness to insist that the conditions be strictly followed"); cf. Seveg, *supra* note 46, at 45 ("The IMF and U.S. government practice of guaranteeing part of a sovereign debtor's interest and principal payments underwrites what would otherwise be unsustainable policies . . .").

<sup>102</sup> And indeed, few expect this trend to stop. See Tarullo, *supra* note 5, at 665 ("[S]ome moral hazard will continue to affect the market, even if the relative seriousness of the moral hazard is reduced. This is just another way of saying that the IMF will continue to provide access to its resources for emerging markets undergoing financial distress.").

<sup>103</sup> See *supra* text accompanying notes 25-28 (arguing that debt crises stem from a number of conditions).

Fred's creditors may not even know that the others exist; they may simply know that they are not getting paid the money they are owed.

This same problem exists for sovereign creditors, but on a much larger scale. As discussed before, a sovereign is likely to have many more creditors than a typical consumer debtor.<sup>104</sup> A simple vote among creditors on how to restructure the debt—already tricky in the case of Fred—is likely to be even more difficult in the case of a sovereign.<sup>105</sup> Just as with Fred's creditors, the diversity of interests that exists among a sovereign's creditors may make it difficult even to get everyone to sit at the same table.

In addition, there is no leadership among the creditors; just as Fred's credit card company might resent the Bank taking the lead in negotiating the restructuring, sovereign creditors have no predetermined leader, and thus may be at a loss when a default occurs.<sup>106</sup> Complicating matters further, there may not even be a list of known creditors when a sovereign defaults: sovereign bonds are traded and sold on a regular basis, usually without the prior knowledge of the debtor.<sup>107</sup> It is worth noting that this situation has not always been true. During the 1980s, when most debt was held in the form of syndicated bank loans, "Bank Advisory Committees" were able to serve in a coordinating role.<sup>108</sup> However, with the recent multitude of debt issued in the form of bonds with more dispersed creditors, the challenge of coordinating creditors will be an important consideration in formulating a restructuring plan.

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<sup>104</sup> See *supra* note 61 and accompanying text; see also Seveg, *supra* note 46, at 46 (noting that a "proliferation of Brady bond issuances" has exacerbated the collective action problem in restructurings).

<sup>105</sup> Cf. Bratton & Gulati, *supra* note 17, at 25 (discussing the frictions inherent in a restructuring process).

<sup>106</sup> See Rory Macmillan, *Towards a Sovereign Debt Work-out System*, 16 NW. J. INT'L L. & BUS. 57, 65 (1995) (noting that creditors face problems of "coordinated representation and leadership" in negotiating with a sovereign).

<sup>107</sup> See *id.* at 85 ("Bondholder Councils would be more complex today because of the speed at which bonds are now traded. The changing identities, location and sectoral variety of bondholders complicates representation.")

<sup>108</sup> See Ronald J. Silverman & Mark W. Deveno, *Distressed Sovereign Debt: A Creditor's Perspective*, 11 AM. BANKR. INST. L. REV. 179, 181 (2003) (asserting that the confluence of interests of banks making syndicated loans allowed for the creation of "steering committees," and therefore that "coordination of . . . a rescheduling effort proved to be a manageable task").

## II. WHAT ARE THE EXISTING PROPOSALS FOR RESTRUCTURING SOVEREIGN DEBT?

Both Fred and a sovereign debtor need a way to restructure their debt that addresses the concerns identified in Part I. To recap, neither Fred nor a sovereign debtor likely has any assets for creditors to reach. Furthermore, neither Fred nor a sovereign debtor can be “liquidated.” Accordingly, their debt must be restructured in order for creditors to maximize their collection returns. However, such a restructuring will be hampered by three principal problems: creditor holdouts, reluctance to restructure because of moral hazard, and lack of creditor coordination.

Luckily for Fred, a practicable debt restructuring mechanism already exists: Chapter 13 personal bankruptcy.<sup>109</sup> Chapter 13 bankruptcy allows debtors with a regular income, like Fred, to pledge their disposable income over a period of three to five years to repaying their debts.<sup>110</sup> Creditor holdouts are solved by a stay on litigation; no creditor is allowed to make a grab for Fred’s \$3500.<sup>111</sup> The coordination problem is solved by the involvement of a bankruptcy judge,<sup>112</sup> as well as a trustee to handle the administration of Fred’s repayment plan.<sup>113</sup> Some authors argue that moral hazard exists for consumers; their argument centers around the ease of filing for bankruptcy and its relationship to credit offered to the poor.<sup>114</sup> However, the problem of creditors not offering a restructuring to a debtor is solved by the fact that filing for bankruptcy is voluntary in the United States, and creditors are bound by a bankruptcy judge’s order.<sup>115</sup>

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<sup>109</sup> 11 U.S.C. §§ 1301-1307, 1321-1330 (2000). For an overview of Chapter 13 restructuring, see White, *supra* note 48, at 691; Adler et al., *supra* note 43, at 587-88.

<sup>110</sup> 11 U.S.C. § 1322.

<sup>111</sup> *See id.* § 1301(a) (providing, with a few exceptions, that a creditor may not file a civil action to collect consumer debt from the debtor in bankruptcy).

<sup>112</sup> *Id.* §§ 105, 1324.

<sup>113</sup> *Id.* § 1302.

<sup>114</sup> *See, e.g.,* Adler et al., *supra* note 43, at 589 (arguing that more liberal bankruptcy protections to debtors lead to a decrease in the provision of credit to the poor); Reint Gropp et al., *Personal Bankruptcy and Credit Supply and Demand*, 112 Q.J. ECON. 217, 219-20 (1997) (finding that increasing the level of exemptions in bankruptcy might decrease credit offered to all consumers and may completely prevent credit from being offered to the poor). *See generally* White, *supra* note 48, at 686 (analyzing why bankruptcy filings have become more frequent in the United States).

<sup>115</sup> *See* 11 U.S.C. § 105 (setting forth the power of a bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate” to process a bankruptcy filing).

A sovereign, however, is not so lucky. Currently, all restructuring is done in an ad hoc manner; nothing resembling the Chapter 13 protections available to Fred and his creditors is available to a sovereign.<sup>116</sup> Some parties find nothing wrong with this. One commentator has argued that creditors are eager for debtors to “bind [themselves] to the mast” of their debt so that they are not tempted to restructure capriciously.<sup>117</sup> Others find some positive attributes in holdout litigation. In particular, Fisch and Gentile argue that holdout litigation protects minority creditors,<sup>118</sup> helps to aggregate debt in vulture funds,<sup>119</sup> provides a check on opportunistic default,<sup>120</sup> and provides liquidity in the market by attracting investors interested in distressed debt.<sup>121</sup> Still other commentators find that existing proposals, as this Comment will conclude, are simply inadequate.<sup>122</sup> Nevertheless, the official sector (government and international organizations),<sup>123</sup> the private sector,<sup>124</sup> and the legal academy<sup>125</sup> seem to be coa-

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<sup>116</sup> For a discussion of options that currently exist for a sovereign facing an investor panic crisis, see BARRY EICHENGREEN, CAN THE MORAL HAZARD CAUSED BY IMF BAILOUTS BE REDUCED? 6-12 (Geneva Rep. on World Econ., Spec. Rep. 1, 2000).

<sup>117</sup> Bolton & Skeel, *supra* note 50, at 771.

<sup>118</sup> See Fisch & Gentile, *supra* note 5, at 1098 (“[H]oldout litigation offers a mechanism by which minority creditors can challenge restructurings designed principally for the benefit of the majority of the creditors.”).

<sup>119</sup> See *id.* (“By aggregating claims, vulture funds may serve as a forum for coordinating the actions of creditors . . .”).

<sup>120</sup> See *id.* at 1099 (“If sovereign debtors expect that creditors, especially recalcitrant creditors, will enforce their claims through litigation, then they may be less likely to default when they are able to make the payments required on their debts.”).

<sup>121</sup> See *id.* at 1100 (“[Vulture] funds create liquidity for other investors by offering them a means of exiting the market for a fixed sum of money.”).

<sup>122</sup> See, e.g., Porzecanski, *supra* note 97, at 39, 44 (criticizing both the SDRM and what the author considers the less harmful option, collective action clauses).

<sup>123</sup> See, e.g., Haque & Burdescu, *supra* note 13, at 243-44 (discussing the goals of the official sector as represented at the Monterrey conference, including an improvement in the way that sovereign debt is restructured); Lipworth & Nystedt, *supra* note 55, at 190 (discussing official sector goals for improving sovereign debt restructuring); Tarullo, *supra* note 5, at 660-64 (examining five goals of the official sector with regards to sovereign debt restructuring).

<sup>124</sup> See, e.g., Whitney Debevoise, *The Debt Crisis Debate*, LATINFINANCE, Nov. 2002, at 52, 53 (discussing the private sector’s move to bolster the proposal for collective action clauses over the one for the SDRM).

<sup>125</sup> See, e.g., Bolton & Skeel, *supra* note 50 (advocating a sovereign debt restructuring framework); Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000) (arguing for the use of exit consents to address sovereign defaults); Gelpern, *supra* note 6 (proposing a new “seating chart” for sovereign debt restructurings); Macmillan, *supra* note 106 (recommending policy guidelines for constructing a sovereign debt restructuring mechanism).



lescings around the idea that changes need to be made in the way that a defaulting sovereign restructures its debt.

So far, commentators have proposed a number of changes. One commentator has proposed a sovereign bankruptcy convention based loosely on Chapter 11 bankruptcy in the United States.<sup>126</sup> This proposal has not attracted much support because of the inherent problems in applying a corporate debt restructuring framework to a sovereign,<sup>127</sup> as well as the substantial challenges, including the very slow response time, in getting an international convention negotiated and approved.<sup>128</sup>

Other commentators propose applying Chapter 9 municipal bankruptcy to the sovereign context.<sup>129</sup> At first glance, this proposal has some merit; like sovereigns, municipalities are polities and thus cannot be liquidated.<sup>130</sup> Yet, this proposal is fraught with problems. First, existing proposals that use a Chapter 9 framework may tilt too far towards protecting the debtor.<sup>131</sup> As discussed before, restructuring regimes that provide too much protection for debtors may lead to moral hazard, and, ultimately, to an increase in lending costs.<sup>132</sup> Furthermore, the application of Chapter 9 to municipalities in the United

<sup>126</sup> See Schwarcz, *supra* note 56, at 966-67 (arguing that a multilateral bankruptcy convention, monitored by the IMF, would be superior to contractual solutions).

<sup>127</sup> See Rasmussen, *supra* note 5, at 1162 (“[C]orporate reorganization law cannot capture all of the relevant dynamics surrounding sovereign debt restructuring.”).

<sup>128</sup> See Stephen B. Burbank, *Jurisdictional Equilibration, the Proposed Hague Convention and Progress in National Law*, 49 AM. J. COMP. L. 203, 203 (2001) (noting that negotiating international agreements is “no sport for the short-winded” (internal citation and quotation marks omitted)); Susan B. Hunt, *ASIL Sponsors Panel at UNA National Assembly in Washington*, AM. SOC’Y. INT’L L. NEWSL., Sept.-Oct. 1995, at 16, 16 (finding that the International Law Commission, responsible for drafting many conventions, works at a “glacial” speed); cf. Elizabeth Warner, *Behind the Wedding Veil: Child Marriage as a Form of Trafficking in Girls*, 12 AM. U. J. GENDER SOC. POL’Y & L. 233, 268 (2004) (noting the difficulties in amending international conventions).

<sup>129</sup> See, e.g., ANN PETTIFOR, NEW ECON. FOUND., CHAPTER 9/11? RESOLVING INTERNATIONAL DEBT CRISES—THE JUBILEE FRAMEWORK FOR INTERNATIONAL INSOLVENCY 3 (2002), [http://www.jubilee2000uk.org/analysis/reports/jubilee\\_framework.html](http://www.jubilee2000uk.org/analysis/reports/jubilee_framework.html) (proposing a debt restructuring framework based on Chapter 9); see also Seveg, *supra* note 46, at 68-75 (providing an extensive discussion of the Jubilee Framework proposal).

<sup>130</sup> See 11 U.S.C. § 904 (2000) (“[T]he court may not, by any stay, order, or decree, in the case or otherwise, interfere with . . . any of the property or revenues of the debtor [municipality] . . .”).

<sup>131</sup> See Seveg, *supra* note 46, at 75 (claiming that a proposal for sovereign debt restructuring based on Chapter 9 would lead to moral hazard because it facilitates restructurings by sovereigns without sufficient safeguards against abuse).

<sup>132</sup> See *supra* notes 96-103 and accompanying text (discussing problems of moral hazard in restructuring).

States has rarely been tested because courts have required that municipalities be completely insolvent—that is, without any money to pay their debts—before allowing a petition to be filed.<sup>133</sup> Yet it is rarely the case that a sovereign meets this requirement.<sup>134</sup>

Finally, notwithstanding the limitations on interference with a municipality's political prerogatives, a municipality remains subject to the sovereignty of the federal government, as well as the control of state governments.<sup>135</sup> As a result, some commentators argue that a bankruptcy judge might have the power to refuse approval of a reorganization plan unless a municipality raises taxes.<sup>136</sup> Given that supranational organizations have had difficulty effecting similar policy changes in debtor countries<sup>137</sup> (and that creditors have been unable to enforce their security interests in loans without military intervention),<sup>138</sup> it is unlikely that courts will be able to intervene successfully in the domestic affairs of a foreign state.

Of the remaining proposals, the two that have attracted the most attention are the Sovereign Debt Restructuring Mechanism, proposed

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<sup>133</sup> See Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613, 637-38 (2001) (“[T]he municipality must be either not repaying its debts or unable to pay debts as they become due.”).

<sup>134</sup> See *supra* notes 17-22 and accompanying text (discussing the factors that deter sovereigns from outright and opportunistic repudiation of debt).

<sup>135</sup> See Christopher Smith, Comment, *Provisions for Access to Chapter 9 Bankruptcy: Their Flaws and the Inadequacy of Past Reforms*, 14 BANKR. DEV. J. 497, 499 (1998) (showing that the power to legislate and adjudicate municipal bankruptcies is divided between the federal and state governments).

<sup>136</sup> See, e.g., Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 465-66 (1993) (suggesting that *Kelley v. Everglades Drainage District*, 319 U.S. 415 (1943), and *Fano v. Newport Heights Irrigation District*, 114 F.2d 563 (9th Cir. 1940), might give a bankruptcy judge the power to deny a reorganization plan that did not raise taxes if in the best interests of creditors).

<sup>137</sup> See Carlos Santiso, *Good Governance and Aid Effectiveness: The World Bank and Conditionality*, 7 GEO. PUB. POL'Y REV. 1, 8 (2001) (“The failure of [the World Bank's policy of] conditionality to attain its desired objectives and bring about sustained policy reforms is widely recognized.”).

<sup>138</sup> See Buchheit & Pam, *supra* note 54, at 898 (“[B]ondholders typically lacked the ability to enforce the security interest in the borrower's own territory absent some diplomatic or military assistance from their own governments.”). As a result, secured lending to sovereigns has declined in the past century. *Id.*

by the IMF's Anne Krueger,<sup>139</sup> and the use of collective action clauses in bonds, supported by the U.S. Treasury Department.<sup>140</sup>

#### A. Sovereign Debt Restructuring Mechanism

In 2001, Anne Krueger, first deputy managing director of the IMF, proposed a Sovereign Debt Restructuring Mechanism (SDRM) in response to a series of recent debt crises.<sup>141</sup> She identified four key features of the restructuring mechanism. First, the SDRM would include the possibility of a stay of litigation in national courts.<sup>142</sup> Second, the SDRM would require the debtor to negotiate with its creditors in good faith.<sup>143</sup> Third, the SDRM would provide for a form of debtor-in-possession financing by guaranteeing that new lenders to the sovereign would have priority in post-restructuring repayment schedules.<sup>144</sup> Last, the SDRM would be binding on all creditors.<sup>145</sup> Krueger argued that these features would make “an early agreement [to restructure debts] more likely and eliminate the threat of disruptive litigation later.”<sup>146</sup> Krueger further argued that placing responsibility for administration of the SDRM in the IMF would prevent forum shopping,

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<sup>139</sup> Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, Address to the National Economists' Club Annual Members' Dinner, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), <http://www.imf.org/external/np/speeches/2001/112601.htm>.

<sup>140</sup> See, e.g., Richard H. Clarida, Assistant Sec'y for Econ. Policy, U.S. Treasury Dep't, Remarks at the National Association for Business Economics Annual Meeting (Sept. 30, 2002), <http://www.treas.gov/press/releases/po3481b.htm> (reporting that agreement was achieved to move forward with the use of collective action clauses); John B. Taylor, Under Sec'y for Int'l Affairs, U.S. Treasury Dep't, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Institute for International Economics Conference Sovereign Debt Workouts: Hopes and Hazards (Apr. 2, 2002), <http://www.treas.gov/press/releases/po2056.htm> (explaining more extensively the U.S. proposal to encourage the use of collective action clauses).

<sup>141</sup> See Krueger, *supra* note 139 (setting forth Krueger's proposal for the SDRM); see also Silverman & Deveno, *supra* note 108, at 192 (highlighting ten key points of the SDRM proposal).

<sup>142</sup> Krueger, *supra* note 139.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Remarks at the Institute for International Economics Conference Sovereign Debt Workouts: Hopes and Hazards (Apr. 1, 2002), <http://www.imf.org/external/np/speeches/2002/040102.htm>.

ensure a uniform interpretation of the procedure, and avoid free-rider problems.<sup>147</sup>

The IMF's proposal—spelled out in *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations*—clarified several things: the rationale for the SDRM, which claims would be covered under the SDRM, what the consequences of activation would be for the debtor, and how creditor participation would be coordinated.<sup>148</sup> Several months later, the IMF elaborated on its proposal in *Proposed Features of a Sovereign Debt Restructuring Mechanism*.<sup>149</sup> The IMF wrote that debtors would be able to initiate a restructuring without any ex ante review,<sup>150</sup> and that the stay of litigation would not be automatic (and perhaps would not occur at all).<sup>151</sup>

The IMF's proposal attracted substantial commentary from legal scholars. Skeel and Bolton noted that, while an automatic stay would not be included in the SDRM, the “[Hotchpot] rule requires that any payment or asset collected by a plaintiff through litigation must be offset against the plaintiff's claim in the restructuring agreement.”<sup>152</sup> Furthermore, an SDRM judge might, with the approval of creditors, approve a limited stay on litigation.<sup>153</sup> Bratton and Gulati added that a stay of payments would be approved only if the creditor was acting in good faith in pursuing a restructuring.<sup>154</sup> Commentators have also addressed the SDRM's selection of bankruptcy judges,<sup>155</sup> debtor-in-

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<sup>147</sup> *Id.*

<sup>148</sup> LEGAL & POLICY DEV. & REVIEW DEP'TS, INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS (2002), <http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf> [hereinafter IMF, FURTHER CONSIDERATIONS].

<sup>149</sup> LEGAL & POLICY DEV. & REVIEW DEP'TS, INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003), <http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf> [hereinafter IMF, PROPOSED FEATURES].

<sup>150</sup> *See id.* at 4 (“[T]he debtor should be allowed to activate the mechanism unilaterally, without third-party confirmation that the activation is justified.”).

<sup>151</sup> *See id.* at 9-10 (weighing the pros and cons of an automatic stay of litigation and finding that it may tilt the SDRM too far in favor of the debtor).

<sup>152</sup> Bolton & Skeel, *supra* note 50, at 777.

<sup>153</sup> *See id.* (“The IMF's proposed plan . . . propos[es] that the judge could have the authority to stay specific legal actions on request of the debtor . . .”).

<sup>154</sup> *See* Bratton & Gulati, *supra* note 17, at 28 (noting that the IMF would only grant a “standstill” if “the debtor is acting in ‘good faith’ and is committed to adjusting its debts”).

<sup>155</sup> *See, e.g.,* Bolton & Skeel, *supra* note 50, at 811-12 (faulting the SDRM judicial selection process as too biased in favor of the IMF and suggesting use of existing bankruptcy courts as an alternative); Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debt-*

possession (DIP) financing,<sup>156</sup> and systems of priorities for repayment.<sup>157</sup>

At first glance, the SDRM has some attractive features. The plan recognizes that sovereign debt needs a restructuring plan, not a liquidation plan. It addresses the creditor holdout problem by providing for at least the possibility of a stay of litigation.<sup>158</sup> The creditor coordination problem is solved by providing for bankruptcy judges and an institutional debt restructuring forum.

However, the SDRM falls short because it does not adequately address the problem of debtor moral hazard. Just as lenders fear that making bankruptcy easy for Fred will lead him to make opportunistic decisions, creditors feel that the SDRM makes it too easy for sovereigns to default (and that as a result they will do so opportunistically). For example, the managing director of ABN AMRO, a bank heavily involved in sovereign lending, argued that the proposed SDRM “has started to alienate the already limited investor base for sovereign bonds that are rated below investment grade.”<sup>159</sup> Anne Krueger explicitly acknowledged this in a speech reviewing her proposal, noting that creditors wonder: “[T]o the extent that the SDRM reduces the cost of restructurings, will it not increase their frequency?”<sup>160</sup>

Debtor nations also opposed the SDRM because they were fearful that it would eventually raise their cost of credit by introducing restructuring procedures that rely on the relatively weak powers of in-

ors?, 37 INT'L LAW. 103, 134 (2003) (suggesting that the selection of judges be based on the selection process for arbitrators in NAFTA disputes).

<sup>156</sup> See, e.g., Alinna Arora & Rodrigo Olivares Caminal, *Rethinking the Sovereign Debt Restructuring Approach*, 9 LAW & BUS. REV. AM. 629, 641-46 (2003) (arguing that DIP financing could replace current IMF lending into arrears); Bratton & Gulati, *supra* note 17, at 33 (“If the [DIP] loan proceeds are badly managed and the new capital does not assist the recovery process, but instead, say, flows out of the country, then a priority credit facility worsens the position of preexisting creditors.”); Bolton & Skeel, *supra* note 50, at 779 (“[The IMF Plan] only gives lip service to the issue of DIP financing.”); Sedlak, *supra* note 5, at 1510 (arguing that the SDRM is superior to collective action clauses because of the DIP financing provisions).

<sup>157</sup> See, e.g., Gelpert, *supra* note 6, at 1138-55 (proposing a contractual alternative to the priority system set out in the SDRM); Scott, *supra* note 155, at 124-25 (distinguishing the priority systems in the SDRM and Chapter Eleven Bankruptcy).

<sup>158</sup> The hesitancy of the IMF to promote something like a full automatic stay, however, could be a potential pitfall of the plan as well. Cf. Bolton & Skeel, *supra* note 50, at 777 (noting that only a limited stay is foreseen in the SDRM).

<sup>159</sup> Porzecanski, *supra* note 97, at 39, 44. Note that Porzecanski acknowledges that the alienation stems from “the Treasury [Department’s] and IMF’s persistent advocacy on the issue,” and not necessarily from the SDRM itself. *Id.* at 44.

<sup>160</sup> Krueger, *supra* note 97.

ternational bodies.<sup>161</sup> Other debtor-countries expressed concerns about the infringement on sovereignty.<sup>162</sup> The IMF plan might distort credit markets and thus be costly to national economies.<sup>163</sup> Given that the IMF will control the restructuring process, creditors are unlikely to agree upon a resolution any more quickly than they are in the absence of the SDRM.<sup>164</sup> Additionally, the SDRM does not allow for restructuring procedures to be tailored specifically to a country's needs. These concerns echo those directed at mandatory corporate bankruptcy in the United States, namely, the idea that a broad, legislatively implemented bankruptcy system cannot take into account individual creditor and debtor interests.<sup>165</sup> Debtors might simply try to contract around default bankruptcy rules that they find unpalatable.<sup>166</sup> Lastly, approval of the SDRM would require an amendment to the IMF Articles of Agreement.<sup>167</sup> Given that such an amendment would require

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<sup>161</sup> See Antonio Palocci Filho, Minister of Finance, Brazil, Statement to the International Monetary Fund and Financial Committee Meeting (Apr. 12, 2003), <http://www.imf.org/external/spring/2003/imfc/state/eng/bra.htm> (representing the countries of Brazil, Colombia, the Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, and Trinidad and Tobago and arguing that the "creation of the SDRM could reduce the volume of capital flows to developing countries and increase their borrowing costs"); see also Celeste Boeri, Development, *How To Solve Argentina's Debt Crisis: Will The IMF's Plan Work?*, 4 CHI. J. INT'L L. 245, 252-53 (2003) (arguing that the SDRM would increase risk for investors, implying a rise in borrowing costs).

<sup>162</sup> See Boeri, *supra* note 161, at 250 (arguing that Argentina would resent the SDRM as an illegitimate intrusion on its sovereignty); Nicolás Eyzaguirre, Minister of Finance, Chile, Statement to the International Monetary Fund and Financial Committee Meeting (Sept. 28, 2002), <http://www.imf.org/external/am/2002/imfc/state/eng/chl.htm> (representing the countries of Argentina, Chile, Paraguay, and Uruguay and advocating that "the framework . . . envisage sufficient flexibility for the sovereign debtor to determine the categories of debt to be excluded from the mechanism").

<sup>163</sup> See Bratton & Gulati, *supra* note 17, at 10 ("A bankruptcy procedure suited to the IMF's institutional preferences could also be distortionary and costly if it made lenders to a distressed sovereign worse off than they would have been in its absence . . .").

<sup>164</sup> See *id.* at 31-32 (arguing that if the IMF continues to lend into arrears, creditors may decline to participate in the SDRM process).

<sup>165</sup> See Rasmussen, *supra* note 1, at 60 ("It is hard to imagine that either the courts or Congress can better protect the values at issue than those immediately affected.").

<sup>166</sup> See *id.* at 62 ("If, however, the gain from the switch [from a default rule] to the more efficient [contractual] rule exceeds the bargaining cost, the parties will bargain to the more efficient result.").

<sup>167</sup> Articles of Agreement of the International Monetary Fund, *adopted* July 22, 1944, 60 Stat. 1401, 2 U.N.T.S. 39, *amended by* Amendment of Articles of Agreement of the International Monetary Fund, *approved* May 31, 1968, 20 U.S.T. 2775, *amended by* Second Amendment of Articles of Agreement of the International Monetary Fund, *approved* Apr. 30, 1976, 29 U.S.T. 2203, *amended by* Third Amendment of Articles of

the approval of 85% of the total voting power,<sup>168</sup> and that the United States, which has declared its opposition to the SDRM,<sup>169</sup> controls 17% of the vote,<sup>170</sup> the initiative is simply unlikely to pass.

### B. *Collective Action Clauses*

The solution that has thus far caught the attention of markets has been the “collective action clause” (CAC).<sup>171</sup> To understand why the CAC represents a change in the way sovereign lending occurs, one must look back almost seventy years, to 1939. The year after Congress provided for corporate debt reorganization,<sup>172</sup> it passed the Trust Indenture Act, which required that bonds be issued via a trust indenture and specified that “the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security . . . shall not be impaired or affected without the consent of such holder.”<sup>173</sup> As a result, no bond term concerning repayment could be amended without the unanimous consent of all bondholders, thus giving rise to the term “unanimous action clause” (UAC). Of

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Agreement of the International Monetary Fund, *approved* June 28, 1990, T.I.A.S. No. 11,898 [hereinafter IMF Articles]; see François Gianviti, *The IMF and the Liberalization of Capital Markets*, 19 HOUS. J. INT'L L. 773, 782-83 (1997) (arguing that, even if the IMF Articles were to be reinterpreted, the SDRM would still require subsequent amendments).

<sup>168</sup> IMF Articles, *supra* note 167, art. XXVIII(a).

<sup>169</sup> See John W. Snow, U.S. Treasury Sec'y, Statement to the International Monetary Fund and Financial Committee (Apr. 12, 2003), <http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm> (“[I]t is neither necessary nor feasible to continue working on SDRM.”); see also HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, & REGULATION 671 (11th ed. 2004) (describing the United States's position).

<sup>170</sup> See Int'l Monetary Fund, IMF Members' Quotas and Voting Power, and IMF Board of Governors, <http://www.imf.org/external/np/sec/memdir/members.htm> (last updated Nov. 21, 2005) (detailing member states' voting power and listing the United States as controlling 17.08% of the total votes).

<sup>171</sup> For a more extended discussion of collective action clauses, see SCOTT, *supra* note 169, at 664-70.

<sup>172</sup> Chandler Act, Pub. L. No. 75-696, 52 Stat. 840 (1938) (codified as amended in scattered sections of 11 U.S.C.).

<sup>173</sup> Pub. L. No. 76-253, 53 Stat. 1149 (1939) (codified as amended at 15 U.S.C. § 77aaa-bbbb (2000)). Specifically, § 77eee(b)(1)(A) requires the Securities and Exchange Commission to refuse to register any bond issue that has not been issued under a qualified indenture, and § 77ppp(b), as quoted above, prohibits the impairment of payment obligations to a creditor without the consent of that creditor. See generally PHILIP R. WOOD, INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION 167 (1995) (discussing trustee requirements in the United States); Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 EMORY L.J. 691, 701-02 (2004) (examining the history behind and subsequent to the prohibition on majority action clauses).

course, the Act explicitly exempted securities issued by foreign governments, which were free to amend payment terms by majority consent—the so-called “majority action clause” (MAC)—as English bonds did.<sup>174</sup> Nevertheless, for a variety of reasons, including drafting inertia and network externalities, sovereign bonds issued in New York tended to include UACs instead of MACs.<sup>175</sup>

The problem that UACs pose for restructurings is that they permit a minority of bondholders to resist restructuring. Instead, the minority bondholders may hold out for full payment and sue to collect their debt if they are not paid. These lawsuits can then trigger cross-default clauses in the debtor’s other debt instruments, which can lead to an even greater financial crisis.<sup>176</sup> Furthermore, bonds rarely contain “sharing clauses” requiring that bondholders who collect through litigation share the proceeds with the other bondholders in the issuance.<sup>177</sup> On occasion, a debtor country could escape these restraints with an exit amendment to certain nonpayment terms (such as the waiver of sovereign immunity or consent to jurisdiction), thus reducing the value of the existing bonds.<sup>178</sup> These “exit consents” can be tricky, however, because they appear to many to be coercive and could be used to achieve nonrestructuring goals.<sup>179</sup> Thus, the U.S. Treasury

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<sup>174</sup> See 15 U.S.C. § 77ddd(a)(6) (2000) (exempting bonds issued by a foreign government from regulation under the Trust Indenture Act); Ahdieh, *supra* note 173, at 698 (noting that English bonds typically contain majority action clauses); see also Barry Eichengreen & Ashoka Mody, *Bail-Ins, Bailouts, and Borrowing Costs*, 47 IMF STAFF PAPERS 155, 158 (2001) (describing English-style majority action clauses).

<sup>175</sup> See Ahdieh, *supra* note 173, at 702 (finding that a “path dependence of form contracts” might have contributed to the reluctance to drop UAC requirements from sovereign bond contracts).

<sup>176</sup> See EICHENGREEN, *supra* note 116, at 14 (“A lawsuit can trigger cross-default clauses in the country’s other debt instruments, in turn activating acceleration clauses requiring those debts to be repaid immediately.”).

<sup>177</sup> See *id.* (“Bonds lack sharing clauses requiring individual creditors to share any amounts recovered with other bondholders . . .”); see also Torbjörn Becker et al., *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?*, 61 J. INT’L ECON. 127, 130 (2003) (noting that such sharing provisions are one of three key identifying features of collective action clauses).

<sup>178</sup> See Buchheit & Gulati, *supra* note 125, at 78-79 (noting this strategy’s emergence in the late 1980s). Such exchanges have been held legal as applied to corporate bonds with unanimous action clauses. See, e.g., *Katz v. Oak Indus.*, 508 A.2d 873, 880 (Del. Ch. 1986) (holding that an exit consent exchange offer did not violate the implied covenant of good faith); see also Buchheit & Gulati, *supra* note 125, at 70-75 (analyzing the *Katz* case). Indeed, some countries have even been able to take advantage of exit consents. See Porzecanski, *supra* note 97, at 41-42 (noting that Ecuador, Russia, the Ukraine, and Pakistan have used exit consents to restructure bonds).

<sup>179</sup> See Buchheit & Gulati, *supra* note 125, at 68 (“Exit amendments of this kind involve an obvious element of coercion.”).



Department proposed that future bonds be issued with CACs that would allow a supermajority of bondholders to amend payment terms in order to restructure debt.<sup>180</sup> The idea is that “restructuring of problem debts could then be left to the consenting adults involved,” without the involvement of governments or international organizations.<sup>181</sup> The supermajority of bondholders would ostensibly delay some payments and perhaps reduce the principal owed. This would give the debtor country the “fresh start” envisioned in consumer bankruptcy<sup>182</sup> by providing fresh resources to generate growth and eventually allow the debtor country to repay its debts.

With the explicit support of the United States government,<sup>183</sup> a sizeable number of countries have begun to include CACs in their New York-issued bond agreements.<sup>184</sup> The growing number of countries now including CACs in bond agreements means that creditors have, at least reluctantly, acceded to the reality of collective action clauses. Thus, the contractual solution appears to be winning out over the SDRM. CACs, like the SDRM, provide creditors the option of restructuring, but not liquidation. They address the problem of creditor holdouts by allowing a majority of bondholders to impose new terms on a minority holdout. The CAC improves upon the SDRM by at least partially addressing the moral hazard problem: only bondholders can invoke the CAC, so ostensibly sovereigns will not receive restructurings if they are acting opportunistically. Thus far, evidence

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<sup>180</sup> John B. Taylor, Under Sec’y for Int’l Affairs, U.S. Treasury Dep’t, Using Clauses to Reform the Process for Sovereign Debt Workouts: Progress and Next Steps, Remarks to the Emerging Market Traders Association Annual Meeting (Dec. 5, 2002), <http://www.treas.gov/press/releases/po3672.htm>. One might argue that collective action clauses reflect the “creditors’ bargain” theory of sovereign debt, in that “creditors first extend credit to the firm and thus obtain their nonbankruptcy-law collection rights” by purchasing bonds, “and then they craft a bankruptcy regime among themselves based on these rights,” if necessary, through the use of collective action clauses in times of crisis. Rasmussen, *supra* note 1, at 59.

<sup>181</sup> Eichengreen & Mody, *supra* note 174, at 158.

<sup>182</sup> See *supra* notes 34-35 and accompanying text (discussing the Bankruptcy Code’s allowance for a personal debtor to retain certain assets so as to have a “fresh start”).

<sup>183</sup> See Press Release, U.S. Treasury Dep’t, Statement of Under Secretary John B. Taylor Regarding the Decisions by Countries to Issue Bonds with Collective Action Clauses (CACs) (Feb. 3, 2004), <http://www.treas.gov/press/releases/js1144.htm> (“The Treasury [Department] encourages all countries that issue external bonds under New York law to include collective action clauses in their offerings.”).

<sup>184</sup> The list of countries that have issued New York bonds with collective action clauses includes Mexico, Brazil, Korea, South Africa, Turkey, the Philippines, Panama, Colombia, Costa Rica, Indonesia, and Israel. Taylor, *supra* note 64; see also *id.* (describing the “dramatic progress that has been made in implementing [CACs]”).

shows that markets are not charging higher risk premiums for bonds with CACs.<sup>185</sup>

CACs, however, pose serious coordination obstacles for truly comprehensive restructurings. First, a CAC allows changes only to the bond containing it. For a small country with one or two bond issuances, this may not be a problem. But when one looks at a country like Argentina, which has 152 separate bond issues<sup>186</sup> and a multitude of other forms of debt, the coordination problems become quite a bit trickier.<sup>187</sup> The diversity of investors exacerbates coordination problems: a large bank with a syndicated loan may have a different perspective on default than does a retail investor.<sup>188</sup> Even the Treasury Department acknowledges this problem, noting that “most proposals do not allow for collective action across different classes of debt.”<sup>189</sup> Furthermore, the fact that there is no “standard” CAC in all debt instruments means that there may be varying potential for holdouts.<sup>190</sup> One commentator has noted that CACs pose the risk of undermining absolute priority schemes.<sup>191</sup> Others find that CACs create the possi-

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<sup>185</sup> See Becker et al., *supra* note 177, at 157 (finding that collective action clauses have a minimal, if any, impact on sovereign bond yield spreads). *But see* Eichengreen & Mody, *supra* note 174, at 157 (“These clauses appear to raise the costs of market access for borrowers with low credit ratings . . .”). Nevertheless, “the penetration of CACs [in the market] is both wide and increasingly deep.” Sergio J. Galvis & Angel L. Saad, *Sovereign Exchange Offers in 2010*, 6 CHI. J. INT’L L. 219, 224 (2005).

<sup>186</sup> See *supra* note 61 and accompanying text (illustrating the complexity of sovereigns’ loans and specifically describing Argentina’s bond issues).

<sup>187</sup> See Gelpern, *supra* note 6, at 1116 (describing a long history of “intercreditor battles in sovereign debt crises”); *supra* Part I.C.3 (discussing coordination problems in bonds).

<sup>188</sup> See Fisch & Gentile, *supra* note 5, at 1071 (discussing the different justifications for purchasing and holding bonds among different types of investors).

<sup>189</sup> Taylor, *supra* note 180.

<sup>190</sup> See Bratton & Gulati, *supra* note 17, at 47 (“Although the 75 percent threshold [of creditors’ votes required for a restructuring] appears to be winning, it is still too early to predict where the market will settle, or whether it will settle on CACs at all.”); Debevoise, *supra* note 124, at 53 (noting that the Emerging Markets Creditors Association proposed a 95% threshold and that the executive board of the IMF considered this too high). Earlier CACs with lower thresholds risk being undermined by subsequent CACs with higher thresholds. For example, creditors who have enough votes to restructure Bond A containing a CAC with a 75% threshold may be hesitant to do so if they know that Bond B containing a 95% threshold will not be restructured because of holdouts. The holdout creditors of Bond B will receive a side payment to facilitate restructuring, allowing them to receive a higher pro rata share of the debtor’s assets than the holdout creditors of Bond A.

<sup>191</sup> See Bolton & Skeel, *supra* note 50, at 774-75 (arguing that if restructuring is done through collective action clauses, there is no guarantee that absolute priority will be observed).

bility of opportunistic collusion.<sup>192</sup> All of this uncertainty poses problems for valuing risk, and may result in higher borrowing costs than if there were greater certainty as to the restructuring process.<sup>193</sup>

While the problem of moral hazard and lack of U.S. support appear to have dealt the SDRM a fatal blow,<sup>194</sup> the problem of coordination with CACs can be remedied. The key will be to create a more extensive contractual solution that can be custom tailored to a debtor country's coordination needs, but that lacks the moral hazard of the SDRM.

### III. A PROPOSAL:

#### A "DESIGNER" SOVEREIGN DEBT RESTRUCTURING MECHANISM

This Comment proposes that each debtor country create a "Designer" Sovereign Debt Restructuring Mechanism (DSDRM) tailored to each country's individual needs. It is worth noting at the outset that this idea is not entirely new; various commentators have remarked on the ramifications of allowing countries to create bankruptcy contracts.<sup>195</sup> This Comment intends to elaborate on these proposals, and to argue that a contractual solution will best meet the needs of debtor countries.

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<sup>192</sup> See Bratton & Gulati, *supra* note 17, at 60 (hypothesizing a scenario in which a debtor makes a side payment to a majority of creditors to amend bonds under the collective action clauses in a way that would prejudice the minority not voting for the amendment).

<sup>193</sup> See Rasmussen, *supra* note 1, at 57-58 ("So long as a creditor can anticipate its treatment in bankruptcy, it can ensure that it receives a market-based rate of return on its loan.").

<sup>194</sup> See Walden Bello, *Globalist Project Crisis and the New Economics of Empire*, BUSINESSWORLD, June 20, 2003, at 1 ("[T]he US Treasury recently torpedoed the IMF management's proposal for a Sovereign Debt Restructuring Mechanism (SDRM) to enable developing countries to restructure their debt while giving them a measure of protection from creditors."); *supra* notes 159-69 and accompanying text (explaining the fatal defects of the SDRM proposal).

<sup>195</sup> See, e.g., Bolton & Skeel, *supra* note 50, at 818-21 (discussing whether a debtor country should be allowed to design its own SDRM); Gelpern, *supra* note 6, at 1150-52 (proposing that countries explicitly set forth priority structures by contract); see also John A. Carlson et al., *Debt Reduction and New Loans: A Contracting Perspective* 8-15 (Int'l Monetary Fund, Working Paper No. WP/97/95, 1997), available at <http://www.imf.org/external/pubs/ft/wp/wp9795.pdf> (using econometrics to analyze contracts that provide for rescheduling).

### A. *The Theoretical Framework*

The initial challenge with a contractual bankruptcy framework is that, at least within the United States, there are few examples to draw on. Use of the Bankruptcy Code in the United States is mandatory;<sup>196</sup> thus, one sees few ex ante restructuring contracts. This, however, does not mean that contractual bankruptcy frameworks would be impossible. In fact, it seems that bankruptcy is the “odd man out” when one considers contracts. While the law of contracts contains a number of default rules, there are relatively few mandatory contract rules. With bankruptcy law, the opposite is the case.<sup>197</sup> No commentator has suggested that contracting around mandatory rules in the field of personal bankruptcy be allowed, probably owing to the inequality of bargaining power;<sup>198</sup> however, there have been suggestions to allow contracting around corporate bankruptcy laws.<sup>199</sup> In this way, a sovereign is more like a corporation than an individual; both a sovereign and a corporation tend to be sophisticated contracting parties. Sovereigns,

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<sup>196</sup> 11 U.S.C. § 362 (2000) (providing for an automatic stay of litigation upon commencement of a bankruptcy litigation and thus foreclosing enforcement of contractual alternatives); see also *In re Weitzen*, 3 F. Supp. 698, 698 (S.D.N.Y. 1933) (“The agreement to waive the benefit of bankruptcy is unenforceable.”).

However, some commentators argue that certain provisions of the Bankruptcy Code have been waived contractually. See Susan Block-Lieb, *The Politics of Privatizing Business Bankruptcy Law*, 74 AM. BANKR. L.J. 77, 80 n.17 (2000) (citing several articles that recognize that there is increasing use of waivers in bankruptcy cases). But see NAT’L BANKR. REVIEW COMM’N, BANKRUPTCY: THE NEXT TWENTY YEARS 459-87 (1997) (listing the considerations weighing for and against enforcement of bankruptcy contracts and concluding that neither bankruptcy law nor policy would permit the waiver of rights contained in Chapter 11 bankruptcy). Nevertheless, courts are divided on the enforcement of these waivers, and few scholars expect Congress to explicitly authorize greater private contracting for bankruptcy. See Block-Lieb, *supra*, at 84 (“No commentator has predicted the enactment of legislation authorizing the contract bankruptcy proposals . . .”).

<sup>197</sup> See, e.g., Rasmussen, *supra* note 1, at 53 (arguing that mandatory bankruptcy rules are “anomalous” when considered within the greater context of contract law).

<sup>198</sup> See Rasmussen, *supra* note 5, at 1164 (“The case for allowing freedom of choice for individuals is more problematic, with most agreeing that individuals should not be able to waive their right to file for bankruptcy.”); see also *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 & n.7 (D.C. Cir. 1965) (suggesting that inequality of bargaining power might make a contract unenforceable on the grounds that it would be unconscionable).

<sup>199</sup> See, e.g., Rasmussen, *supra* note 1, at 66 (proposing that corporations be able to elect from a “menu of bankruptcy options”); Schwartz, *supra* note 47, at 1809 (advocating a contract theory of bankruptcy with respect to firms). Rasmussen argues that sovereigns present an “intermediate case,” and should perhaps be allowed unlimited freedom of choice. Rasmussen, *supra* note 5, at 1164.

like corporations, are generally represented by large law firms, most of whom have had experience with sovereign lending contracts.<sup>200</sup>

Much of the theoretical groundwork for contractual bankruptcy frameworks has been set forth in two articles by Alan Schwartz.<sup>201</sup> In these articles, Schwartz argues that while some structural rules are needed for efficient bankruptcy adjudication, the number of mandatory rules is greater than that for which the structural explanation would account.<sup>202</sup> These excess mandatory rules, in turn, lead American firms to choose either bankruptcy systems that fail to fully serve the firm's bankruptcy needs or capital structures that serve the firm's bankruptcy needs but fall short during times when the firm is solvent.<sup>203</sup> Given that the ultimate goal of bankruptcy is to reduce capital costs by providing for a greater potential return in insolvency, Schwartz argues that firms should be able to choose bankruptcy systems *ex ante* that maximize return for creditors and allow the firm to maintain an optimal capital structure.<sup>204</sup> In other words, one can more efficiently decide how to deal with a firm before it becomes insolvent, rather than afterwards.

Schwartz, however, has his detractors. Lynn LoPucki has written extensive critiques of his proposals.<sup>205</sup> Yet these critiques largely rest on how Schwartz deals with the choice between liquidating or reorganizing a firm—a choice, as explained in Part I.B.1, that is irrelevant to sovereigns.<sup>206</sup> LoPucki concedes that, notwithstanding his ex-

<sup>200</sup> See Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 950-51 tbl.2 (2004) (listing law firms that handle sovereign debt issuance and finding that experienced law firms are often both issuer and investment bank counsel).

<sup>201</sup> Schwartz, *A Contract Theory Approach to Business Bankruptcy*, *supra* note 47; Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343 (1999).

<sup>202</sup> See Schwartz, *supra* note 47, at 1841 (arguing, for example, that 11 U.S.C. § 1129(a)(7)(A)(ii) (1994) unnecessarily favors insolvent estates by giving dissenting creditors the market value of their claims rather than the "going-concern value").

<sup>203</sup> See *id.* at 1811 (describing this "difficult problem").

<sup>204</sup> See *id.* at 1814 ("To summarize, in the economic view, the ultimate object of bankruptcy law is to help maximize social wealth. This object implies the instrumental goal of minimizing the cost of debt capital.").

<sup>205</sup> Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) [hereinafter LoPucki, *Reply I*]; Lynn M. LoPucki, *Bankruptcy Contracting Revisited: A Reply to Alan Schwartz's New Model*, 109 YALE L.J. 365 (1999) [hereinafter LoPucki, *Reply II*].

<sup>206</sup> In Schwartz's model, a firm is "bribed" with a percentage of the insolvency-state payoff to creditors in order for it to contractually choose the bankruptcy procedure—restructuring or liquidation—that would maximize recovery. The "bribe" is modified in subsequent contracts to reflect the current amount necessary to induce a firm to

pressed concerns, “Schwartz’s failure to prove bankruptcy contracting feasible does not prove it infeasible. Given the strong preference of law and economics scholars for a contract solution to the bankruptcy problem, it is inevitable that others will attempt to do what he could not.”<sup>207</sup> Susan Block-Lieb criticizes the theory of contractual bankruptcy on the ground that it will create “immense decision-making costs.”<sup>208</sup> However, Block-Lieb’s analysis largely rests on the ground that there is another option: statutory bankruptcy.<sup>209</sup> As discussed before, the option of statutory bankruptcy for sovereigns does not appear to be politically plausible, and is, moreover, undesirable from the point of view of creditors and debtors.<sup>210</sup>

Thus, the appropriate analysis compares contractual bankruptcy to nothing. As Block-Lieb points out in another article, creditors and debtors could easily choose to move towards greater contracting in bankruptcy.<sup>211</sup> One can see that in the sovereign lending context, creditors and debtors have already made this choice through increasing their use of collective action clauses, which themselves are a

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choose the proper contract. *Schwartz, supra* note 201, at 346-48. LoPucki argues that Schwartz’s paradigm fails to account for the possibility that debtors may erroneously or strategically underestimate the bribe needed to induce the proper choice. *See* LoPucki, *Reply I, supra* note 205, at 325, 328-29 (criticizing Schwartz’s proposal to have creditors bribe an insolvent firm to choose the most efficient form of bankruptcy and arguing that Schwartz fails to address the fact that most junior creditors would prefer ill-advised reorganizations to liquidations in which they might recover nothing); LoPucki, *Reply II, supra* note 205, at 376 (“The *deus ex machina* in this happy drama is Schwartz’s assumptions that (1) the debtor firm knows what bankruptcy contract is optimal and (2) the debtor firm must offer that contract.”). This choice, however, would be irrelevant in the sovereign context, as creditors would be left only with the option of restructuring. *See supra* Part I.B.1 (explaining that a sovereign cannot be liquidated).

<sup>207</sup> LoPucki, *Reply II, supra* note 205, at 379; *see also* LoPucki, *Reply I, supra* note 205, at 340 (“Schwartz’s failure to deliver a model of bankruptcy contracting that works does not mean that such a model is impossible.”).

<sup>208</sup> *See* Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 536-55 (noting that external and internal decision-making costs rise when considering various contractual bankruptcy models).

<sup>209</sup> *See id.* at 558-60 (concluding that contractual bankruptcy models may raise costs when compared to existing bankruptcy laws). Block-Lieb herself acknowledges that “[m]arket resolution may permit parties to adopt bankruptcy rules to fit their specific needs, without incurring or imposing unmanageable decision-making costs.” *Id.* at 560.

<sup>210</sup> *See supra* text accompanying notes 126-37 (discussing political barriers and technical problems with statutory bankruptcy frameworks for sovereigns).

<sup>211</sup> *See* Block-Lieb, *supra* note 196, at 95 (arguing that the potential for contractual bankruptcy is linked less to politics than the parties’ willingness to contract around existing bankruptcy provisions).

somewhat more limited form of contractual insolvency resolution.<sup>212</sup> Sovereign creditors and debtors should take the next step.

### B. *Why Should Countries Create a DSDRM?*

The DSDRM has two principal advantages. First, it provides the advantages of existing proposals while eliminating their key disadvantages. In Part II.A, this Comment analyzed the SDRM proposed by the IMF and found that it had the advantage of providing a comprehensive solution to the restructuring dilemma: it resolved the creditor coordination problem by providing a single forum in which creditors could negotiate the restructuring.<sup>213</sup> The SDRM proposal, however, has been criticized on a number of fronts—academic, political, and business—for the additional moral hazard that would be introduced into the markets if debtors were allowed to restructure their debts without any restrictions.<sup>214</sup> The DSDRM provides the option of adopting a complete or adapted version of the CAC approach, either allowing only creditors to invoke the DSDRM, or allowing debtors to invoke the protections in limited circumstances.<sup>215</sup> Furthermore, the DSDRM approach reduces debtor moral hazard by giving creditors a key role in helping to draft the contours of the restructuring mechanism. Creditors could ostensibly participate in the drafting of a menu of options for the DSDRM from which countries would select, and creditors could also lobby countries on which specific options to select. Creditor participation, and thus Wall Street support, should help reduce U.S. opposition to the proposal.<sup>216</sup> Furthermore, the fact that the IMF will no longer play a key role in resolving debt disputes should make

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<sup>212</sup> See *supra* notes 183-84 and accompanying text (discussing the increase in the usage of collective action clauses in sovereign lending).

<sup>213</sup> See IMF, PROPOSED FEATURES, *supra* note 149, at 13-16 (discussing various proposals for the organization of creditors and advocating the Sovereign Debt Dispute Resolution Forum, which would provide a forum for the resolution of nearly all creditor claims against a debtor country).

<sup>214</sup> See *supra* notes 159-61 and accompanying text (citing criticisms of the SDRM on ground of moral hazard).

<sup>215</sup> See *infra* Part III.C.1-2 (discussing who may invoke the DSDRM and when they may do so).

<sup>216</sup> Cf. Bello, *supra* note 194, at 1 (“[T]he SDRM was vetoed by US Treasury in the interest of US banks.”).

the DSDRM more palatable than the SDRM to developing countries.<sup>217</sup>

In Part II.B, this Comment analyzed the CAC proposal of the U.S. Treasury Department and found that it had the advantage of at least partially addressing moral hazard concerns; by allowing only creditors to initiate a restructuring after a super-majority vote, debtors would not be as tempted to engage in behavior giving rise to the need for a restructuring.<sup>218</sup> In contrast, the failure to provide for creditor coordination was a key pitfall of the CAC proposal, a point acknowledged even by its key supporters.<sup>219</sup> The DSDRM, like the SDRM, provides a comprehensive solution to the coordination problem; it reduces the cost of creditor coordination by having the debtor country spell out, *ex ante*, how creditors will be organized into classes and how they will negotiate and vote on a restructuring plan.<sup>220</sup>

In addition, the DSDRM adopts the CAC approach to jurisdictional questions, allowing each individual country and its future creditors to determine by contract which courts would have jurisdiction over disputes concerning the restructuring.<sup>221</sup> As noted previously, a key concern of countries regarding the SDRM was that it would infringe upon their sovereignty.<sup>222</sup> Thus, while it is unlikely that a country would specify that its own courts would be the dispute resolution

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<sup>217</sup> See John H. Chun, Note, "Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?, 64 FORDHAM L. REV. 2647, 2698 (1996) ("[A] significant amount of distrust of the IMF exists in the developing world.").

<sup>218</sup> See *supra* notes 184-85 (noting that many creditors purchase bonds with CACs at yields only slightly higher, if higher at all, than bonds with UACs).

<sup>219</sup> See *supra* note 189 (citing the Treasury Department's concession that CACs are not well suited for coordination).

<sup>220</sup> See *infra* Part III.C.4 (outlining a variety of options available for organizing creditor classes and restructurings).

<sup>221</sup> See *infra* note 287 and accompanying text (noting that countries could elect to choose a variety of forums to resolve disputes).

<sup>222</sup> See *supra* note 162 and accompanying text.



forum in a DSDRM,<sup>223</sup> allowing a country the option to select from among court systems may allay concerns regarding sovereignty.<sup>224</sup>

The second advantage of the DSDRM approach is that it gives the market a large role in determining which options work best for debtors and creditors and which might be discarded. Neither of the other existing options would provide this advantage.

On the one hand, the SDRM, which would be created through an amendment to the IMF Articles,<sup>225</sup> would allow only one approach to debt restructuring: that specified in the SDRM. Other variations of creditor organization, plan approval, debtor-in-possession financing, and creditor stays would necessarily be forsaken in favor of the SDRM approach. While creditors could surely provide ex ante input about which variation would work best, once the SDRM was approved by the IMF, the markets could only vote “yea” or “nay.”<sup>226</sup>

The CAC, on the other hand, provides too much flexibility. Since the CAC only allows creditors to amend the payment terms of a bond contract,<sup>227</sup> the parameters of a proposed restructuring are not set out before the restructuring occurs, and thus cannot be evaluated by the markets.

The DSDRM approach, however, differs from the CAC and the SDRM approaches in that it allows both parties—debtors and creditors—to play a role in crafting a “designer” restructuring mechanism. Additionally, the DSDRM provides an ex ante restructuring plan of

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<sup>223</sup> One key reason may be that creditors will not be amenable to adjudication of disputes in a sovereign’s own courts, which might be subject to influence or corruption. See Edgardo Buscaglia & Maria Dakolias, *An Analysis of the Causes of Corruption in the Judiciary*, 30 LAW & POL’Y INT’L BUS. 95, 95-97 (arguing that corruption in any form can pose a problem for private sector development, and noting that judicial corruption specifically poses a problem because the judiciary “is supposed to provide an essential check on [corruption] in the other public institutions”); Santiso, *supra* note 137, at 16-17 (discussing the need to reduce corruption in legal and judicial systems to foster private sector development).

<sup>224</sup> Admittedly, one possible concern with submitting disputes over a CAC to a domestic court is that sovereigns would have no incentive to abide by the decision of that court. However, a sovereign which balked at following the decisions of a domestic court would ostensibly lose the protections of its DSDRM.

<sup>225</sup> IMF Articles, *supra* note 167; see Gianviti, *supra* note 167 (considering the possible requirement of amending the IMF Articles).

<sup>226</sup> Arguably, creditors and debtors unhappy with the IMF approach could contract around it. The DSDRM proposed in this Comment is an example of such a contract. However, efficiency gains from this approach would be doubtful unless there was widespread consensus on the IMF approach. Given the discussion in Part II.B, *supra*, this seems unlikely.

<sup>227</sup> See *supra* note 180 and accompanying text (discussing the CAC proposal).

which all future investors can be made aware. Thus, future investors would presumably be willing to accept lower rates for debt instruments issued by a country with a DSDRM that they think increase their return in insolvency and higher rates for countries with DSDRMs that are less likely to provide high returns. This pattern has been demonstrated with consumer bankruptcy laws,<sup>228</sup> laws on corporate dividend distribution,<sup>229</sup> and non-payment terms in corporate<sup>230</sup> and sovereign bonds.<sup>231</sup> Thus, the market would likely evaluate the DSDRM by accounting for it in the price of future sovereign bonds. If these clauses are invoked in the future, debtor countries and creditors alike would then be able to determine on the basis of this experience which clauses will provide greater creditor protection and adjust the price (and the terms of future DSDRMs) accordingly. In this sense, the DSDRM could be market rated.

### C. *What Would a DSDRM Look Like?*

Since one of the primary justifications for attempting to provide a DSDRM is that such a contract would allow sovereigns and their creditors to tailor restructuring to country-specific situations, it is impossible to explain exactly what a DSDRM would look like. As Schwartz points out, “[i]n the world of bankruptcy, one size cannot fit all.”<sup>232</sup> Some countries with relatively simple debt profiles may have short and simple contracts, while others may need to outline more complex procedures. This subpart will attempt to outline some key options that should be included in a DSDRM.

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<sup>228</sup> See *supra* note 114 (citing evidence that states with more liberal bankruptcy protections for debtors adversely impact provision of credit to the poor).

<sup>229</sup> See Craig A. Peterson & Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L. REV. 175, 221-25 (1997) (citing the results of empirical research illustrating that investors make decisions based in part on corporate law regarding the distribution of dividends).

<sup>230</sup> See Buchheit & Gulati, *supra* note 125, at 68 (noting that a number of corporations avoided Chapter 11 by changing the non-payment terms of the bond contract, thus making them less valuable and consequently inducing holdout creditors to restructure).

<sup>231</sup> See Fisch & Gentile, *supra* note 5, at 1092 (stating that Pakistan, Ecuador, and Uruguay have used exit consents, in which a non-payment term is amended to make a bond less valuable so as to induce an exchange).

<sup>232</sup> Schwartz, *supra* note 47, at 1850.

### 1. Who Could Invoke the DSDRM?

Bonds currently using a collective action clause allow only the creditors to invoke a restructuring.<sup>233</sup> The IMF's proposed SDRM would allow a debtor to invoke a restructuring as well.<sup>234</sup> The question of who is allowed to invoke a restructuring bears heavily on moral hazard. As discussed previously, one of the major moral hazard concerns of the SDRM was that creditors feared overly frequent debtor restructurings.<sup>235</sup> Their concern may be well founded: while there are certainly substantial sanctions for sovereigns defaulting on their loans,<sup>236</sup> a simple look at personal bankruptcy in the United States shows that voluntary restructurings are far more common than involuntary restructurings.<sup>237</sup> Political and social concerns may similarly encourage sovereigns to declare a default before their creditors force a restructuring.<sup>238</sup> Moreover, allowing creditors, and not debtors, to initiate restructuring "would help to offset the perception that sovereign bankruptcy is too lenient on sovereign debtors."<sup>239</sup>

However, there are good arguments in favor of allowing some sort of voluntary restructuring. Sovereigns are probably in a better position to foresee internal and external conditions that could lead to a default, just as Fred can probably foretell a personal financial crisis before his banks can.<sup>240</sup> Furthermore, delaying a restructuring until

<sup>233</sup> See *supra* notes 180-85 and accompanying text (discussing the operation of collective action clauses and noting that a majority of creditors, not the debtor, may alter a bond's terms and conditions).

<sup>234</sup> See *supra* notes 141-46 and accompanying text (summarizing a proposal which would allow a debtor to invoke the protections of the SDRM).

<sup>235</sup> See *supra* note 160 and accompanying text (noting creditors' concern that debtor countries would use the SDRM opportunistically).

<sup>236</sup> See *supra* note 16 and accompanying text (considering the possible negative impact of default upon credit ratings and future ability to borrow).

<sup>237</sup> See John C. McCoid, II, *The Origins of Voluntary Bankruptcy*, 5 BANKR. DEV. J. 361, 361 (1988) ("Debtors resort to voluntary bankruptcy far more often than creditors institute involuntary proceedings against them."). The reason that more consumers are so inclined to resort to voluntary bankruptcy may be the moral hazard created by pro-debtor bankruptcy laws in the United States. See F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. LEGAL STUD. 187, 192 (1998) ("In a lax legal regime, opportunistic debtors will petition even though they can repay their creditors; in a more rigorous regime, debtors will forgo the bankruptcy option unless their backs are to the wall.").

<sup>238</sup> See *supra* notes 37-42 and accompanying text (noting that sovereigns consider social and political concerns in their decision to default).

<sup>239</sup> Bolton & Skeel, *supra* note 50, at 787.

<sup>240</sup> See Michael Chui et al., *Sovereign Liquidity Crises: Analytics and Implications for Public Policy*, 26 J. BANKING & FIN. 519, 527 (2002) ("Information about the fundamen-

creditors are aware of these conditions—or until a default occurs—is likely to impose additional costs on all parties.<sup>241</sup> Additionally, pre-default restructuring might raise creditor, and hence investor, expectations; if creditors believe that a country is likely to default in the near future, they may want to restructure the debt so as to avoid a default and the resulting decrease in the value of their bonds or loans.<sup>242</sup> Lastly, debtors who seek additional financing because they do not have the option to initiate a restructuring may default later, which will then decrease returns for prior creditors.<sup>243</sup>

Thus, a debtor and creditor might have three options: (1) permitting only a creditor to invoke a restructuring clause; (2) permitting both debtors and creditors to invoke a restructuring clause; and (3) permitting creditors to invoke a restructuring clause and allowing debtors to invoke the clause only under certain conditions or penalties.

## 2. When Could a Debtor Invoke a Restructuring Clause?

A variety of carrots and sticks could be used to prevent a debtor from opportunistically invoking a restructuring clause in a designer sovereign debt restructuring mechanism. Some initial drafts of the SDRM required the IMF to certify that a country's debts were unus-

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tals of an economy is frequently not transparent and creditors are often unsure about the information and analysis of other market participants.”); Dickerson, *supra* note 46, at 1005-06 (arguing that sovereigns facing a solvency or liquidity crisis often wait too long to restructure, implying that sovereigns sometimes have ex ante knowledge of crisis conditions that could give rise to default).

<sup>241</sup> See INT'L MONETARY FUND, ANNUAL REPORT 2002, at 35 box 3.4 (2002), *available at* <http://www.imf.org/external/pubs/ft/ar/2002/eng/pdf/file2.pdf> (“[S]overeigns wait too long before seeking a restructuring, leaving both their citizens and creditors worse off.”); Dickerson, *supra* note 46, at 1006 (noting that delaying a restructuring leads to increased costs).

<sup>242</sup> See Bratton & Gulati, *supra* note 17, at 18-19 (discussing pre-default restructuring).

<sup>243</sup> If a debtor is aware that its debt is unsustainable but is still able to access the credit markets, it may do so if it cannot voluntarily initiate restructuring. Assuming that a debtor country has  $x$  resources to repay  $y$  loan obligations, and it can initiate a restructuring, then creditors will receive a proportion of their debt equal to  $x/y$ . However, if the debtor country cannot initiate a restructuring but instead obtains additional financing  $z$  which is not used to repay creditors, the proportion of recovery will shrink to  $(x)/(y+z)$ . Although some of this risk can be reduced by the use of priority rules, allowing a debtor to initiate restructurings would also help. See Bolton & Skeel, *supra* note 50, at 788-92 (discussing the problem of dilution of recovery by later creditors and the use of absolute priority to address this problem).

tainable before allowing a restructuring to occur.<sup>244</sup> At least one author has proposed a “good faith” requirement.<sup>245</sup> This requirement, however, would not necessarily create certainty; “good faith” is certainly open to interpretation.<sup>246</sup> In addition, using a creditors committee to make an ex post determination of good faith creates transaction costs. As one author argues:

A system that leads to a quick, predictable, and orderly restructuring of the sovereign’s private and public debt would ultimately reduce the future cost of sovereign borrowing, because creditors would receive a higher recovery under such a system and this should cause them to decrease the cost of sovereign lending.<sup>247</sup>

One way to resolve this problem would be to precisely define “credit event” or “unsustainable debt” in the DSDRM. There is a vast literature on the economic factors that can be used to determine the likelihood of default, including the debt-to-GDP ratio, the primary-balance-to-GDP ratio, and the level of public expenditures.<sup>248</sup> One author has linked the specific likelihood of default on commercial bank debt to “high private arrears relative to total debt, high short-term debt and a low proportion of private debt service due being paid.”<sup>249</sup> Ostensibly, these factors could be customized to analyze the debt sustainability of a specific country and determine when creditors would gain from restructuring that country’s debt. Thus, an SDRM could limit the ability of debtor countries to default in situations when their debt becomes verifiably “unsustainable” as defined in the contract. Such definitions could be crafted so as to rely on independently veri-

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<sup>244</sup> See Dickerson, *supra* note 46, at 1035 (“An earlier version of the SDRM prevented a sovereign from activating a restructuring unless the IMF certified that its debts were unsustainable.”). However, the IMF might not serve this function well. See Bolton & Skeel, *supra* note 50, at 792-93 (“[T]he IMF is in a weak position to effectively fulfill th[e] role [of imposing financial discipline], as has been argued in many places and is widely recognized.”).

<sup>245</sup> See Dickerson, *supra* note 46, at 1036 (arguing for a good faith standard to be adjudicated by a creditors committee).

<sup>246</sup> See *Consove v. Cohen (In Re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983) (“[T]he good faith requirement [in the bankruptcy provision at issue] is not susceptible of precise definition . . . .”); Robert S. Adler & Richard A. Mann, *Good Faith: A New Look at an Old Doctrine*, 28 AKRON L. REV. 31, 43-44 (1994) (discussing various interpretations of “good faith”).

<sup>247</sup> Dickerson, *supra* note 46, at 1011-12.

<sup>248</sup> See Fiess, *supra* note 32, at 17 (surveying numerous studies that have cited these indicators as correlating with country credit ratings).

<sup>249</sup> David McKenzie, *An Econometric Analysis of IBRD Creditworthiness* 26 (World Bank, Policy Research Working Paper No. 2822, 2002), available at <http://econ.worldbank.org/files/wps2822.pdf>.

fiable data, such as that provided by debtor countries to the IMF.<sup>250</sup> By restricting a debtor country to declaring default only when it is or will shortly become unable to repay its obligations, a DSDRM could eliminate the difficulty in deciding when a country is simply unwilling to pay.<sup>251</sup> The determination of these factors will be tricky, and some ex ante negotiation will be needed to ensure the proper balance between the rights of creditors and those of debtor nations.<sup>252</sup>

### 3. Would There Be a Stay of Litigation?

The threat of creditor holdout litigation may implicate the need for an automatic stay. As previously discussed, the creditor holdout problem reduces the total amount of assets available to nonholdout creditors.<sup>253</sup> When holdout creditors use litigation as a bargaining tool to increase their returns, it not only reduces the overall base of assets, but it can also prove particularly disruptive to restructuring.<sup>254</sup> For these reasons, many authors suggest that an automatic stay on litigation, similar to that available to Fred in Chapter 13 bankruptcy, would be necessary to “strengthen[] the overall leverage of creditors.”<sup>255</sup> It may also offer some “breathing space to the sovereign

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<sup>250</sup> See INT’L MONETARY FUND, ANNUAL REPORT 2004, at 24-26 (2004), available at <http://www.imf.org/external/pubs/ft/ar/2004/eng/pdf/file2.pdf> (reviewing IMF debt sustainability surveillance mechanisms); Gianviti, *supra* note 167, at 779 (discussing the IMF data dissemination system). This use of the IMF as a data provider would probably not engender the hostility that the SDRM faced, because the proposed SDRM was going to be used primarily as a “bankruptcy court.” See *supra* text accompanying notes 141-51 (discussing the proposed components of the SDRM); *supra* notes 161-62 (identifying debtor country concerns about intrusions on sovereignty).

<sup>251</sup> See Lipworth & Nystedt, *supra* note 55, at 192 (suggesting that “strategic default” might occur when a debtor is unwilling to pay, rather than when it is actually insolvent).

<sup>252</sup> See *id.* at 200 (“[T]he balance between creditor and debtor ‘rights’ is a subtle one, and great care needs to be taken to not shift the balance too far in either direction.”).

<sup>253</sup> See *supra* part I.C.1 (discussing why the creditor holdout problem impedes a restructuring).

<sup>254</sup> See *supra* notes 67-84 (reviewing creditor holdout litigation and its resulting effects); see also Lipworth & Nystedt, *supra* note 55, at 202-03 (discussing the “sweeteners” that a debtor country would need to offer to persuade creditors to accept a voluntary payments suspension). But see Bratton & Gulati, *supra* note 17, at 34-35 (arguing that countries can structure their transactions to avoid assets being captured in holdout litigation).

<sup>255</sup> Stijn Claessens & Leora F. Klapper, *Bankruptcy Around the World: Explanations of Its Relative Use* 20, (World Bank, Policy Research Working Paper No. 2865, 2002), available at <http://econ.worldbank.org/files/wps2865.pdf>. But see Lipworth & Nystedt, *su-*

debtor.”<sup>256</sup> Some argue that a situation-specific stay on litigation is so important that it ought to be a mandatory feature of any bankruptcy system.<sup>257</sup> Others, however, argue that the relative difficulty in collecting sovereign assets through litigation makes a stay less necessary and perhaps more burdensome to a restructuring scheme.<sup>258</sup> One commentator notes that even the IMF, in drafting the SDRM, was unsure whether an automatic stay on litigation would be beneficial to creditor and debtor alike.<sup>259</sup> Still others argue for an intermediate road, which would allow an automatic stay contingent on the approval of a majority of bondholders.<sup>260</sup> In summary, there are three options regarding creditor litigation: (1) no stay, (2) an absolute automatic stay, or (3) a limited stay. The decision to elect one of these options for a DSDRM might depend on the extent of assets outside the debtor country, the debtor’s perception of the threat of creditor litigation, and the creditors’ perception of a successful renegotiation.

Similar to the concept of a litigation stay, a country could also spell out a planned imposition of temporary capital controls in the DSDRM. Rapid capital flight is a serious problem during a financial crisis and often accompanies sovereign debt defaults.<sup>261</sup> And there is some evidence that risk of a default may accelerate capital flight.<sup>262</sup> Thus, a country could establish temporary capital controls to prevent the rapid flight of capital out of the country. Capital controls either directly or indirectly regulate or prohibit cross-border capital transactions.<sup>263</sup> One should note that the IMF currently has the power to al-

*pra* note 55, at 205 (noting that creditors may respond by preferring to lend on a short-term basis and thus reduce their risk).

<sup>256</sup> Lipworth & Nystedt, *supra* note 55, at 203.

<sup>257</sup> See Schwartz, *supra* note 47, at 1840-41 (arguing that a stay is necessary to prevent foreclosure when doing so would maximize the value of the bankrupt estate).

<sup>258</sup> See, e.g., Schwarcz, *supra* note 56, at 985 (“The costs of a stay, however, would outweigh the[] benefits [of minimizing the collective action problem].”).

<sup>259</sup> See Bolton & Skeel, *supra* note 50, at 782 n.50 (relying on IMF, FURTHER CONSIDERATIONS, *supra* note 148, to support their argument that the IMF equivocated on the potential benefits of an automatic stay).

<sup>260</sup> See *id.* at 782-83 (arguing for a creditor referendum on a stay); see also David A. Skeel, Jr., *Can Majority Voting Provisions Do It All?*, 52 EMORY L.J. 417, 423 (2003) (discussing the option of a limited stay).

<sup>261</sup> See Fiess, *supra* note 32, at 13 (analyzing capital flight after financial crises in Latin America and Asia).

<sup>262</sup> See Gianviti, *supra* note 167, at 778 (discussing the capital flight in Mexico after the risk of default became apparent).

<sup>263</sup> See Duncan E. Williams, Note, *Policy Perspectives on the Use of Capital Controls in Emerging Market Nations: Lessons From the Asian Financial Crisis and a Look at the International Legal Regime*, 70 FORDHAM L. REV. 561, 571 (2001) (setting forth the options for

low, or, under certain circumstances, to require the imposition of capital controls.<sup>264</sup> By showing that it will impose capital controls, whether on its own or due to IMF mandate, a debtor country can increase creditor confidence that assets potentially funding a restructuring will remain in-country, and therefore help stem further financial crisis.<sup>265</sup>

#### 4. How Would Creditor Priority and Voting Be Handled?

Procedures for creating a plan to restructure a country's debt will be central to a DSDRM. Current practice with collective action clauses simply allows creditors to meet, create a plan, and submit the plan to a vote of creditors, a majority or supermajority of which must approve it.<sup>266</sup> The DSDRM solves three major problems created by CACs. First, a creditor meeting and majority vote become increasingly complicated as a country's debt profile increases in complexity.<sup>267</sup> Second, the plan might undermine absolute priority by according junior creditors power equal to senior creditors to propose and approve a plan. For example, holders of a recent bond issue could collude with banks to create a restructuring plan that would repay these claims before payment of senior debt or secured claims, such as trade debt.<sup>268</sup> Third, some vulture funds are using *pari passu* clauses<sup>269</sup> for the pur-

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capital controls). For example, under Taiwan's capital control provision, "foreign investors must gain approval from Taiwan's security markets regulatory agency prior to making investments in the Taiwanese stock exchange." *Id.* at 573.

<sup>264</sup> *See id.* at 776 ("[T]he [IMF] may request a member to impose exchange controls on capital movements in order to avoid an excessive use of the [IMF]'s resources.").

<sup>265</sup> *Cf. Gianviti, supra* note 167, at 774-75 (discussing the problems that occurred after Mexico failed to prevent rapid capital flight during the 1994 crisis).

<sup>266</sup> *See supra* note 180 and accompanying text.

<sup>267</sup> *See Skeel, supra* note 260, at 422-23 ("If the sovereign has issued, say, a dozen or two separate bonds, holding individual votes on each of the bonds is a much more complicated endeavor.").

<sup>268</sup> This occurred in Ecuador in 1999, when collateralized Brady Bonds, ostensibly senior to non-collateralized bonds, were restructured first, leaving junior creditors with increased assets to pay their claims. *See Bolton & Skeel, supra* note 50, at 775 (noting that this "turned the bonds' ostensible priority scheme on its head").

<sup>269</sup> A *pari passu* clause "prevents the borrower from incurring obligations to other creditors that rank legally senior to the debt instrument containing the clause." Buchheit & Pam, *supra* note 54, at 872. *See also* Gelpern, *supra* note 6, at 1133-34 (reviewing the various interpretations given to *pari passu* clauses by courts).



pose of delaying restructuring deals where some creditors would get paid in advance of others, thus undermining creditor priority.<sup>270</sup>

Consequently, it might be helpful to identify classes of debt. Classification of claims exists in personal bankruptcy in the United States; Fred's restructuring plan might separate his bank, his credit card company, and his personal creditors into separate classes for the purpose of repayment under a plan.<sup>271</sup> Likewise, a DSDRM could identify possible classes of debt that a country could incur and rank them according to seniority. Some authors have argued that ranking creditors in declining order based on how recently they have lent to the debtor country would be an effective way to stem overborrowing.<sup>272</sup> The rationale is that creditors will be less likely to lend to an overextended sovereign if they know that their debt will be ranked lower in a potential restructuring.<sup>273</sup> Other commentators, however, have argued that this type of priority ranking would discourage even sensible financing of countries with large debt burdens and would encourage countries to borrow even more heavily during prosperous economic times.<sup>274</sup>

Another means of prioritizing claims would be to give higher priority to creditors who made sustainable loans to a sovereign and lower priority to those who lent after debt became unsustainable,<sup>275</sup> as would

<sup>270</sup> See Buchheit & Pam, *supra* note 54, at 880-83 (finding that vulture funds have derailed restructurings where their debt was repaid in a manner than ranked them junior to other debt). Given the instability in the jurisprudence, a DSDRM would provide an extra veneer of certainty *ex ante* by establishing priority and eliminating *pari passu* clauses.

<sup>271</sup> See 11 U.S.C. § 1322(b)(1) (2000) (the restructuring plan "may designate a class or classes of unsecured claims"). A claim can be put in a class only if it is "substantially similar" to the other claims in the class. 11 U.S.C. § 1122(a).

<sup>272</sup> See Bolton & Skeel, *supra* note 50, at 800-01 (analyzing a first-in-time priority system).

<sup>273</sup> See *id.* at 788-92 (discussing the debt dilution that may result if a first-in-time absolute priority system is not established).

<sup>274</sup> See, e.g., Gelpern, *supra* note 6, at 1145-46 (criticizing a first-in-time priority ranking system).

<sup>275</sup> Of course, it is likely that the IMF and other official creditors would comprise a separate creditor class with high priority. In part, this is because the Paris Club (the restructuring group for official bilateral creditors) mandates a comparability treatment assumption, which requires that other restructurings be on terms no more favorable as those offered by the Paris Club. Seveg, *supra* note 46, at 40-41. As such, Paris Club debtors are unlikely to agree to a restructuring which would accord them lower priority in payment, and thus terms less favorable than those offered to other creditors. *Id.*; see also Magnus Saxegaard, Comment, *Creditor Participation in the HIPC Debt Relief Initiatives: The Case of Guyana*, 32 GA. J. INT'L & COMP. L. 725, 729 (2004) (explaining that Guyana was forestalled from settling with a disgruntled creditor because of the comparability treatment assumption).

be defined by means discussed above at Part III.C.2. This would provide an ex ante signal to potential creditors as to how they are likely to get repaid in the event of a default.<sup>276</sup> This task is not without its difficulties, however. Governments borrow through different forms and at different times, and identifying priority for the foreseeable future may not be an easy task.<sup>277</sup> Nevertheless, pre-default classifications have been used with states and municipalities in the United States.<sup>278</sup> Thus, debtor countries would be able to elect from one of many options for determining creditor priority and organizing creditor classes.

Creation of a plan could be effected by ad hoc meetings which involve all creditors or a creditors committee, with representatives elected from each class.<sup>279</sup> Alternatively, the DSDRM could use a trustee to work with creditors in creating a restructuring plan. The “super-trustee” would consult with the various creditor classes to create a plan that the trustee believes would win approval and would be in the best interests of creditors.<sup>280</sup> The plan, as Bolton and Skeel propose, could include some form of debt reduction and restructuring of payments.<sup>281</sup>

The plan would then be submitted by the super-trustee to a vote of creditors. The process for approval has been debated in the academic literature. One commentator has proposed that a supermajority requirement would be sufficient to address both creditor holdouts and moral hazard issues.<sup>282</sup> Others have proposed supermajority votes within classes, but unanimity among the classes.<sup>283</sup>

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<sup>276</sup> See Gelpern, *supra* note 6, at 1117 (“A priority structure that is beyond borrower discretion, clear ex ante, and enforceable ex post, gives creditors a good sense of where they stand relative to one another.”).

<sup>277</sup> See *id.* 1117-18 (noting the difficulty in establishing an ex ante priority system).

<sup>278</sup> See *id.* at 1123-24 (noting that California’s constitution and bond documentation set out the priority treatment for creditors in the event of default).

<sup>279</sup> See Ahdieh, *supra* note 173, at 756 (finding that there is a need to develop “a norm on the use of bondholder committees”); Bolton & Skeel, *supra* note 50, at 772-73 (endorsing a mechanism to coordinate reorganizations that is similar to supercommittees in equity receiverships). *But see* Schwarcz, *supra* note 56, at 1002 (insisting that creditors committees would be undesirable in the sovereign context because of increased administrative costs).

<sup>280</sup> See Bratton & Gulati, *supra* note 17, at 46 (proposing the use of “super-trustees” to solve collective action problems in sovereign debt restructurings).

<sup>281</sup> See Bolton & Skeel, *supra* note 50, at 796-97 (proposing a plan that would balance creditor and debtor interests and strictly prioritize classes of claims).

<sup>282</sup> See Schwarcz, *supra* note 56, at 1005-06 (advocating a supermajority requirement).

<sup>283</sup> See Bolton & Skeel, *supra* note 50, at 794 (arguing that “veto power of each class over the proposed restructuring plan” is necessary to maintain priority).

There are a couple of options if the requisite number of creditors fail to approve the plan. One would be to simply have the parties renegotiate. The other would involve a “cramdown procedure,”<sup>284</sup> which essentially forces an agreement on the parties. A cramdown procedure would require an adjudicatory authority to determine that the plan was in the best interests of creditors, as in Chapter 9 municipal bankruptcy in the United States,<sup>285</sup> or as in Fred’s Chapter 13 bankruptcy plan.<sup>286</sup> This adjudicatory authority—a judge or arbitral panel,<sup>287</sup> for example—would be specified in the DSDRM. As with priority structures, a variety of options could be offered to debtors for the design of the adjudicator of the cramdown procedure.

### 5. Debtor-In-Possession Financing

Debtor-in-possession (DIP) financing is relevant in the sovereign context both because of the need to provide financing when a sovereign has declared a default and the method to determine the priority with which the financing will be treated subsequently. One might analogize DIP financing in the sovereign context to social insurance programs such as unemployment insurance, which may be utilized by families undergoing personal bankruptcy to bridge the financing gap while they reorganize.<sup>288</sup> Just as Fred could avail himself of the bene-

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<sup>284</sup> See *id.* at 795 (suggesting that a cramdown provision is essential to creating a successful sovereign debt restructuring plan). But see Schwarcz, *supra* note 56, at 1008 (“[T]he threat of invoking cramdown would lack credibility, and creditors would have little incentive to reach a consensual plan solely to avoid that threat.”).

<sup>285</sup> See Bratton & Gulati, *supra* note 17, at 38-39 (analyzing the “best interests of creditors” standard of Chapter 9).

<sup>286</sup> See 11 U.S.C. § 1325(a)(1), (3) (2000) (allowing a court to approve a personal bankruptcy plan that is offered in good faith and complies with other statutory requirements).

<sup>287</sup> These arbitral panels could ostensibly include existing international panels such as the International Centre for Settlement of Investment Disputes (ICSID). See generally Ibrahim F.A. Shihata, *The Settlement of Disputes Regarding Foreign Investment: The Role of the World Bank, with Particular Reference to ICSID and MIGA*, 1 AM. U. J. INT’L L. & POL’Y 97 (1986) (commenting on the use of ICSID to resolve disputes).

<sup>288</sup> See Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 158 (2005) (noting that bankruptcy and unemployment insurance both provide a “wage insurance function” that allows a debtor to “retain new income” received after unemployment). DIP financing is also a key part of corporate bankruptcy. See Bolton & Skeel, *supra* note 50, at 802 (“For corporate debtors, access to interim financing is a crucial determinant of the outcome of the restructuring process.”). See generally Bruce A. Hensch, Comment, *Postpetition Financing: Is There Life After Debt?*, 8 BANKR. DEV. J. 575 (1991) (discussing the need for and the means of providing post-petition financing for debtors).

fits of unemployment insurance while trying to weather a personal bankruptcy crisis, countries may need temporary financing to weather a financial crisis.

Thus, a DSDRM could provide an ex ante arrangement for DIP financing, either by a specified bank or by arranging for pre-default creditor consent. The inclusion of DIP financing might also have the positive benefit of reducing the need for IMF lending into arrears.<sup>289</sup> In addition, the financing could be accorded high priority so that it does not go to financing existing debt on which the country has defaulted.<sup>290</sup> If so desired, creditors could vote on whether or not to authorize this financing.<sup>291</sup>

#### D. *How Could a DSDRM Be Created?*

Going forward, a DSDRM could simply be inserted into future sovereign debt contracts. Although the DSDRM is likely to be complicated, existing debt contract documentation already covers a wide range of terms and conditions,<sup>292</sup> so the additional burden is not likely to be great. Furthermore, many contracts already include sophisticated contract language dealing with political and financial risks.<sup>293</sup>

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<sup>289</sup> See Bolton & Skeel, *supra* note 50, at 806 (suggesting that providing DIP financing might avoid wasteful bailouts by the IMF); Bratton & Gulati, *supra* note 17, at 33 (arguing that reducing the IMF's role in the sovereign debt restructuring process would be beneficial because IMF participation can shift power away from creditors). Reducing the role of the IMF and other government entities in restructuring would also result in fewer debtor countries and creditors sharing the perception that "investment decisions hang on the understanding that [a] foreign government is viewed with favor by the White House, Downing Street, and beyond . . . [and that it] will be rescued on strategic grounds, despite the cause of [its] woes, the merits of [its] reaction plan, or the availability of legal recourse." Porzecanski, *supra* note 97, at 43-44.

<sup>290</sup> See Bolton & Skeel, *supra* note 50, at 802-03 (arguing that high priority should be accorded to post-default financing). The high priority accorded to such DIP financing would have to be an exception to restrictions placed by a sovereign on its ability to voluntarily invoke its DSDRM as described in Part III.C.2.

<sup>291</sup> See *id.* at 805 (supporting a proposal that would allow creditors to vote on post-default financing partly on the grounds that "some of the larger institutional creditors will be better informed about the debtor's financial position and political constraints").

<sup>292</sup> See *id.* at 819 ("[T]he pricing of sovereign debt is already complex and nation-specific; it is unlikely that a tailored SDRM would add significantly to this complexity."); see also WOOD, *supra* note 173, at 15-89, 135-43 (listing the various and often complex terms and conditions in term loans and in bonds).

<sup>293</sup> See, e.g., Haque & Burdescu, *supra* note 13, at 253-54 (discussing political risk insurance contracts).

Some law firms have begun to envision such clauses,<sup>294</sup> and there are indications that inklings of DSDRMs are beginning to appear in bond documentation.<sup>295</sup> The future use of DSDRMs in loan documentation, however, may be slow in coming, and until there is widespread experience with more reduced forms of contractual debt restructuring, DSDRMs are unlikely to be popular.<sup>296</sup> This is particularly true for bonds, which are heavily dependent on standardization for the purpose of trading, and, more significantly, for sovereign debt, which requires a liquid market.<sup>297</sup> In addition, greater diversity among debt contracts may increase risk premiums charged to borrowers.<sup>298</sup> Finally, there is some evidence that there will be hesitation to accept such contracts until they have been interpreted by courts.<sup>299</sup>

Given that allowing countries and their creditors to draft contracts that are overly diverse might result in higher risk premiums, a substantial degree of standardization would be necessary. One potential solution would be to allow the IMF, the Emerging Markets Traders Association, or another organization to draft a model law with a menu of possible options.<sup>300</sup> Allowing creditors to play a significant role in the

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<sup>294</sup> See, e.g., Debevoise, *supra* note 124, at 52 (“Engagement clauses basically describe a debt restructuring process. They would specify how the creditors would be represented, what data the sovereign must provide to the creditors’ representative and by when.”). Debevoise is a partner at Arnold & Porter. *Id.* at 54.

<sup>295</sup> See Ahdieh, *supra* note 173, at 709 (noting the appearance of a “super-CAC,” which is an aggregated voting provision, in a bond); Buchheit & Pam, *supra* note 54, at 916 (discussing a Philippine bond offering that provides that the government “will not create any preference or priority in respect of any External Public Indebtedness pursuant to [the Philippines Civil Code] unless amounts payable under the Bonds are granted preference or priority equally and ratably therewith” (quoting Prospectus, U.S.\$500,000,000 Republic of the Philippines 8.875% Bonds Due 2008, at 71 (Apr. 2, 1998))).

<sup>296</sup> See Choi & Gulati, *supra* note 200, at 937-38 (arguing that financial innovation arrives slowly and in stages before widespread use).

<sup>297</sup> See Ahdieh, *supra* note 173, at 715 (“Given the greater likelihood of sovereign default, the tradability of a sovereign bond is necessarily more important.”).

<sup>298</sup> See, e.g., *id.* at 714 (noting that standardization helps to reduce risk premiums); see also Dickerson, *supra* note 46, at 1027 (suggesting that requiring consistency in some aspects of restructuring “should remove some of the uncertainties associated with . . . restructurings”).

<sup>299</sup> Cf. Ahdieh, *supra* note 173, at 717 (finding that judicial interpretation of contracts might have aided the spread of CACs in New York bonds by reducing uncertainty about contract terms).

<sup>300</sup> Such standardization would ostensibly reduce some of the advantage of having a restructuring plan individually tailored to each country’s needs. Thus, the envisioned standardization would be more akin to a menu or a “fill-in-the-blanks” contract than a complete standardization of terms and conditions. See Rasmussen, *supra* note 1, at 66 (“The solution to both the transaction-cost problem and the strategic-action

drafting of such a “model” would ostensibly reduce resistance to it in the creditor community.

However, there is already a lot of existing sovereign debt<sup>301</sup> that will not benefit from the inclusion of DSDRMs in future contracts. A sovereign might address this by amending its existing debt contracts to include a DSDRM, a plan that would necessarily entail extensive negotiations with all creditors, use of exchange offers or exit consents, and increased cost.<sup>302</sup> Thus, one might argue that some sort of unilateral action is necessary. Some authors who support contractual bankruptcy for corporations call for debt restructuring procedures to be included in corporate charters.<sup>303</sup> This theory has been extended to the world of sovereign debt, where one author has proposed setting forth debt priorities in a debt restructuring protocol.<sup>304</sup> Sovereigns who opt for this choice, however, would have to be careful to protect such a protocol from the whims of future political leaders. As Rasmussen points out, if a sovereign debt protocol were to be amended after it was issued, “[t]he benefit that a firm receives from committing to a bankruptcy option . . . would evaporate because the commitment would not be credible.”<sup>305</sup> This is not to say that such a protocol should never be amended, but rather that it should be amended only rarely and with careful creditor consultation.

#### CONCLUSION

Although the DSDRM might appear to be a radical proposal at first glance, it actually represents an incrementalist approach. CACs already represent a foray, if only a slight one, into the world of con-

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problem is to have a menu of bankruptcy options available.”). Over time, market-testing would likely reveal the best “menu” of options.

<sup>301</sup> See WORLD BANK, WORLD DEVELOPMENT REPORT 2005: A BETTER INVESTMENT CLIMATE FOR EVERYONE 263 tbl.4 (2004), available at <http://www-wds.worldbank.org> (Report No. 28829) (listing the total debt for low and middle income countries at over \$2.3 trillion).

<sup>302</sup> See Dickerson, *supra* note 46, at 1016 (finding that such a process would be “time-consuming and could be extremely costly”).

<sup>303</sup> See Rasmussen, *supra* note 1, at 55 (arguing that including bankruptcy information in a company’s corporate charter would “eliminate the potential for future expropriation of wealth from creditors to shareholders”). *But see* Schwartz, *supra* note 47, at 1811 (speculating that such provisions will not preserve enough flexibility).

<sup>304</sup> See Dickerson, *supra* note 46, at 1027 (“[P]ermitt[ing] sovereigns to customize their debt restructuring procedures (just as parties involved in transnational insolvency proceedings do by using protocols), will more effectively resolve sovereign debt crises . . .”).

<sup>305</sup> Rasmussen, *supra* note 1, at 117.

tracting for bankruptcy. The DSDRM would simply expand on CACs by adding additional procedures to a majority vote on restructuring. Such an incremental approach is likely to appeal to investors.<sup>306</sup> Furthermore, the DSDRM provides greater certainty for both the debtor country and creditors as to what will happen during a restructuring. As one commentator argues:

In the corner of every room in which the terms of sovereign debt contracts are negotiated and considered sits the 800-pound gorilla of potential debt restructuring. The sovereign bond contract—by which nation-states receive an influx of investment for national growth and development, in exchange for a stream of principal and interest payments—is one designed with a strong premonition of breach. Yet the international financial order lacks any effective cage for its gorilla.<sup>307</sup>

The current reality of sovereign lending is that creditors and debtors both implicitly take into account what could happen during a default, but neither actually provides for it in their contracts. This remaining uncertainty probably leads to increases in interest rates.<sup>308</sup> Recent restructurings show that uncertainty regarding restructuring has altered credit ratings and raised the cost of issuing debt globally for both healthy and unhealthy economies.<sup>309</sup> Furthermore, various strategies to affect ad hoc restructurings, such as exit consents, have undermined previous assumptions of priority, something that is likely to alienate investors further.<sup>310</sup> Lastly, sovereign debt structures are becoming larger and more complicated, meaning that the applicability of current solutions is likely to erode further.<sup>311</sup> A DSDRM, by pro-

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<sup>306</sup> See Tarullo, *supra* note 5, at 671-72 (arguing that an incrementalist approach to restructurings would be best because of effects on reputation and credibility).

<sup>307</sup> Ahdieh, *supra* note 173, at 693-94.

<sup>308</sup> Cf. Rasmussen, *supra* note 1, at 57 (noting that investors consider a bankruptcy regime before lending, thus impacting interest rates).

<sup>309</sup> See Gelpern, *supra* note 6, at 1129 (discussing Pakistan's restructuring and the resulting effects on the market).

<sup>310</sup> See Bolton & Skeel, *supra* note 50, at 766-67 (highlighting the problems Ecuador faced during a restructuring because its priorities had changed); see also Gelpern, *supra* note 6, at 1152-53 (noting that unlike Argentina, which leaves investors in the dark regarding priority, California specifies its priorities before a creditor lends).

<sup>311</sup> See Boeri, *supra* note 161, at 245 (discussing Argentina's \$141 billion default in 2001, the largest in history); Gelpern, *supra* note 6, at 1137 (noting that both domestic debt and international debt have become more widely held and that lines between the two have blurred, thus complicating bankruptcy matters). Restructurings, until relatively recently, were simply not this difficult. See, e.g., *A.I. Credit Corp. v. Gov't of Jamaica*, 666 F. Supp. 629 (S.D.N.Y. 1987) (quickly resolving a dispute over Jamaica's 1987 restructuring through summary judgment).

viding a contractual framework, provides some flexibility for thinking about future crises.

In conclusion, the problems shared by personal debtors and sovereigns—creditor holdout, moral hazard, and lack of coordination—are not insurmountable. Various restructuring schemes, such as the IMF proposal for the SDRM or including CACs in New York-issued bonds, have been proposed to address these problems. Both, however, fall short. The SDRM fails to address debtor moral hazard, while CACs cannot fully address lack of coordination. A third, more comprehensive solution would be to combine many of the positive attributes of the SDRM and the market-based contractual solution of CACs. The result would be a designer sovereign debt restructuring mechanism, which would provide comprehensive procedures for restructuring a sovereign's debt. Such a DSDRM could be effected at first by a unilaterally issued "protocol" and subsequently by inclusion in debt instrument documentation. The DSDRM would provide more security for creditors, who would know *ex ante* their rights in default, and would lower costs for sovereigns, who would no longer flounder in the wake of a financial crisis. Ultimately, a DSDRM's most important impact will be on the populations of debtor countries, who may finally begin to enjoy the economic stability and prosperity that they so desperately need.