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Towards a Sovereign Debt Work-out System;

Rory Macmillan

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Towards a Sovereign Debt Work-out System

*Rory Macmillan**

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I. Introduction: The Finance Minister's Nightmare

The Finance Minister of Moratoria, a medium sized Latin American (or perhaps East European) country, woke one morning in a cold sweat. His dream had gone something like this:

Inflation had left the currency (for want of a better name, the peso) overvalued, and when a series of political crises rocked the country, the foreign exchange dealers began to sell the peso which continued to plummet for the next week to half its earlier value. In recent years, Moratoria had got into the habit of increasing and rolling over its short term debt.[1] With the drop in the peso, the external debt (denominated in US Dollars, Deutsche Marks and Yen) immediately doubled in value. The government had spent its foreign reserves trying to prop up the peso and suddenly faced debt payments in the next six months of several billion dollars.

Nothing unusual in this dream — it had all happened before. So the Finance Minister hopped on a plane to New York. His first stop was the hedge fund managers who were largely responsible for the turbulence in the currency markets. "Everything's going to be all right," he assured them, citing vague unsupported statistics. Nevertheless, the next day the peso fell another 10%. Seeking emergency borrowing, his next stop was the offices of Citibank where he met the head of Syndicated Loans. "The Chairman has refused authority to lend, I'm afraid," said the banker. "It's just not the '80s any more." When the Finance Minister met with similar responses from other banks in New York that day, he took the next shuttle to Washington, D.C.

His first stop in D.C. was the U.S. Treasury Department. "Moriwhat?" asked the Secretary to the Treasury. "That's not near enough to the border to raise the immigration issue, Congress will never agree, and we spent our stabilization fund on Mexico. Sorry, try the IMF."[2]

[1] Perhaps Moratoria's Treasury Department had retired much of its Brady debt by issuing short and medium term Eurobonds. This way the collateral tied up in Brady Bonds could be used for the lofty social program promised by the government in its election campaign.

[2] The solution to a similar crisis in Mexico at the beginning of 1995 involved a $50 billion loan package, $20 billion of which came from the United States Exchange Stabilization Fund. The stabilization fund was primarily intended to defend the US dollar in currency crises.

The Finance Minister walked down Pennsylvania Avenue to the offices of the International Monetary Fund. "We can't cover it all," said the IMF Director. "Sure, the G10 doubled the General Agreement to Borrow, so we have access to more money now, but you are asking for more a multi-billion dollar liquidity facility, and if we had to do this for everybody, we'd run out of money. Also, we'd be bailing out investors again, and our member governments don't want to get into that expensive habit. What we can do is give you some temporary liquidity, but first you have to reach some accommodation with your creditors."

The Finance Minister took the next shuttle back to New York to meet his creditors. When his car dropped him on Wall Street, he looked up at the towering offices surrounding him and, with a sinking heart, realized that he had no idea where to begin.

In a future sovereign debt crisis, debt restructurings are inevitable simply because there is no alternative. Private lending becomes simply unavailable. The commercial banks were asked to lend to Mexico in early 1995 as part of the U.S. Government rescue plan, but the money never materialized.[3] The banks' experience of involuntary lending during the 1980s debt crisis was so unpleasant that they are unlikely to increase exposure to a troubled debtor in a crisis today. Other sources of finance are no more likely to yield support. Mexico was unable to return to the capital markets until six months after the crisis blew up.[4] For political and practical reasons, the U.S. government is unlikely to lend again as it did to Mexico. Despite recent increases in the IMF's power to lend to countries in emergencies, multilateral funds remain insufficient to cope with large scale crises. In any case, just as it did in the 1980s, the IMF would probably condition any finance upon some debt restructuring agreement between the debtor and its creditors. Coupled with the absence of new money, this means that countries will have to try to reach some agreement with their creditors.

However, the current legal and institutional framework is embarrassingly unprepared to handle a sovereign debt restructuring. An enormous amount of emerging market sovereign debt is now in bonds,

[3] Richard Waters & Leslie Crawford, *Banks Pull Out of $3bn Role in Mexican Rescue,* FIN. TIMES, Mar. 23, 1995, at 20; Timothy L. O'Brien, *Prospects Dim for Bank Loan to Mexico,* WALL ST. J., Feb. 13, 1995, at A3.

[4] *Prediction: No Mexican, Argentine Issues for 6 Months,* LDC DEBT REORT, Jan. 30, 1995, at 11. The first issue of Mexican sovereign debt did not come until July 1995. Leslie Crawford, *Mexican Bonds Welcomed,* FIN. TIMES, July 11, 1995, at 3. *See also,* Daniel Dombey, *Mexico to Restructure Debt Through $500m Bond Issue,* FIN. TIMES, July 26, 1995, at 4.

spread across a vast international market of different types of investors who are often holding the debt for very short periods of time. A debt work-out today involving bonds would be prohibitively difficult to organize for reasons that I will explain in Chapter II.

The world financial system now needs a mechanism for government debtors and their creditors to coordinate a debt work-out in such crises. In practical terms, a work-out system must accomplish two things. First, it must enable creditors and debtors to negotiate debt reschedulings whereby the timing of payments is postponed, or debt reduction whereby the burden of debt is reduced. Second, it must make new lending to the debtor country possible so as to provide liquidity, restoring it to immediate debt servicing capability.

I begin in Chapter II by explaining three mechanical problems that would be encountered by a country and its creditors if they attempted a debt restructuring in the current legal and institutional framework. These must be addressed to set up a system in which debt renegotiations are possible. They are first, with most sovereign debt now taking the form of bonds, there are no obvious parties to play a *leadership* role when a crisis arises. Second, there is no *coordination* mechanism for the large number and variety of ever-changing creditors to act together. Third, even if there were such *leadership* and *coordination*, creditors have no individual incentive to act together because they lack *solidarity* of interests. In each case, I compare these problems to the experience in the 1980s crisis and show how dramatically more difficult a sovereign debt work-out is today.

In the third chapter, I develop policy guidelines for constructing a sovereign debt work-out system, partly in response to Jeffrey Sach's proposal of an international bankruptcy court. In Chapter IV, I consider how bondholder councils operated in New York and London in the 19th and early 20th centuries and suggest that similar institutions could contribute to solve the mechanical problems explained in Chapter II.

I set out a blueprint for a sovereign debt work-out system in Chapter V. The problem of *leadership* could be solved by requiring sovereign debt issued in the United States to be governed by the Trust Indenture Act of 1939 with an Indenture Trustee taking some responsibility for bondholders in a default situation. Debt issued elsewhere, such as in the United Kingdom, could be made subject to similar legislation. I address the problem of *coordination* by exploring how bondholder councils might be structured. I develop two possible structures and suggest that governments need to set up institutions which will

enable bondholders to appoint their own representatives. In the third part of the fifth chapter, I consider possible solutions to the problem of bondholder *solidarity*. I begin with James Hurlock's suggestion that sovereign immunity be granted to governments in a crisis so that bondholders have no choice but to negotiate with the debtor. I then consider Barry Eichengreen and Richard Portes' proposal that the provisions of future debt instruments be changed so that a majority of bondholders under an issue of bonds have the legal power to restructure the entire issue. Finding problems with these suggestions, I set forth a new proposal which could effectively combine bondholders' interests. Solving these three problems will make restructurings possible without encountering the policy difficulties of other current proposals.

I offer some remarks in Chapter VI on bringing in new money for the troubled debtor and suggest that the recommendations in the preceding chapter will facilitate new lending from commercial banks by making it easier for existing creditors to give the new money priority over the outstanding debt.

II. Sovereign Debt Restructuring Today: Three Problems

When a crisis occurs. . .

Debt crises come in different ways. In Mexico's crisis at the beginning of 1995, the local currency was suddenly massively devalued against the U.S. dollar.[5] The government's reserves were severely depleted and large amounts of Mexican debt effectively denominated in U.S. dollars suddenly became much more expensive to service.[6] The 1980s Latin American debt crisis was another example of how macroeconomic factors can increase the cost of servicing government debt. Rising interest rates made the external debt more expensive while falling commodity prices reduced foreign currency reserves from export earnings.[7] Latin American governments did not have the foreign

[5] By the end of March 1995, the new peso had fallen by almost 50% in foreign currency terms since the exchange rate was allowed to float in December 1994. World Economic Outlook, 39 IMF annual report, Oct. 1995. *See also* Robert L. Bartley, *Mexico: Suffering the Conventional Wisdom,* Wall St. J., Feb. 8, 1995, at A14; Craig Torres & Paul B. Carroll, *Mexico Reverses Currency Policy; Peso Falls 12.7%,* Wall St. J., Dec. 21, 1994, at A3.

[6] Craig Torres, *Mexico's Central Bank Struggles as Reserves Reach Severe Lows,* Wall St. J., Feb. 3, 1995, at A8.

[7] Debt Crises are often produced by factors beyond the countries' control. For example, developing countries which did not depend upon oil revenues suffered in the global recession from collapsed trade and high interest rates. World Economic Outlook 56-57 (International Monetary Fund, Occasional Paper No. 21, 1983). *See also* Vito Tanzi, *Fiscal Policy Responses to Exogenous Shocks in Developing Countries,* 76 Am. Econ. Rev. 88, 89-90 (1986).

reserves to pay for the increasingly expensive debt burden.[8] Like falling dominoes, countries announced that they could not pay their debts.

. . .there is a downward spiral. . .

When a country's foreign reserves run low or the cost of its debt increases, debt payments become more difficult. When the problem looks overwhelming, lenders consider the debtor too risky and become reluctant to lend. This produces a downward spiral: the debtor cannot afford to pay its debt, so potential sources of borrowing lose confidence and dry up. This in turn further damages the debtor's liquidity.

. . .which the G10 initiative anticipates with an IMF lender of last resort. . .

Principally as a reaction to the sudden and overwhelming nature of the Mexican crisis, world leaders agreed to double the emergency funds of the International Monetary Fund.[9] The "General Agreement to Borrow," whereby the IMF may draw upon the funds of G10 governments and Saudi Arabia, has been increased to US$52 billion. This greatly increases official lending power for the sort of liquidity crises experienced by Mexico. It enhances the IMF's capacity as a lender of last resort.

The theory of the lender of last resort was first set out by Bagehot. He explained that if there were an institution ready to guarantee liquidity when the lending community doubted the debtor's liquidity, then commercial lenders would have confidence that new loans would be repaid. They would therefore be willing to lend to the debtor, albeit at penalty rates reflecting the greater risk.

. . .but this may undermine market discipline. . .

However, an increased IMF lending facility without a mechanism for renegotiating the debt may cause market distortions. Bond prices fluctuate for a number of reasons. One reason is the likelihood of payment on the debt. If a debtor looks like defaulting, the value of the debt will decrease as the market internalizes the risk. However, if

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[8] According to Morgan Guaranty Bank, in 1982, the ratio of debt service payments to exports was 179% in Argentina, 129% in Mexico, 122% in Brazil, 116% in Chile, and 95% in Venezuela (the five largest debtors). *International Lending: Implications of a Slowdown,* WORLD FIN. MARKETS, Oct. 1982, at 1 tbl. 5 [hereinafter *International Lending*]. By 1982, the ratio of debt to exports of goods and services had reached 144%. Their ratio of debt to GDP had reached 36%. E. Brau et al., Recent Multilateral Debt Restructurings with Official and Bank Creditors 4 tbl. 1 (International Monetary Fund, Occasional Paper No. 25, 1983).

[9] Robert Chote, George Graham and John Gapper, *IMF set to get more crisis cash,* FIN. TIMES, Oct. 9, 1995.

the market is aware that official funds are available to supply credit to the ailing debtor, the value will not drop so markedly and investors will not bear the loss of value. It may "undermine market discipline as investors rely on the international community rather than monitoring country risks."[10]

. . .at the cost of the public sector and without solving the problem.

This is at the cost of the public sector. The capital of the IMF is supplied by governments. By organizing the $50 billion Mexican loan package, the United States, the IMF and other governments bore the immediate cost of Mexico's collapse. Supporting Mexico as a model emerging market country was arguably a valid United States public policy because of its proximity to the United States. Moreover, the potential impact on other developing economies demanded a drastic solution. However, volunteering public funds in such situations is not a sustainable habit, particularly if maintaining market confidence requires the same scale of lending as Mexico. History has shown that debt crises tend to be regional shocks (Mexico's contained crisis in January had serious effects on its neighbors with Argentina borrowing substantially from the IMF). If Mexico needed the assurance of $50 billion, IMF funds would soon be exhausted if more than one country ran out of external finance. As I explained in the introductory chapter, private finance will probably be unavailable in a crisis. This leaves the only option of restructuring the debt.

A country and its creditor bondholders seeking to restructure the debt today will encounter three fundamentally mechanical problems. First, there is no obvious location of *leadership* responsibility for the creditors. Second, there is no *coordination* mechanism to enable creditors to negotiate collectively with the debtor. Third, individual creditors have no incentive to come to a collective solution because it will almost certainly involve a loss on their investments. They thus lack *solidarity*. If governments directly addressed these three problems of *leadership, coordination* and *solidarity,* they could set up a successful work-out mechanism for sovereign debt.

A. *Leadership* With No Indenture Trustee

Bank Advisory Committees in the 1980s provided leadership. . .

During the prolonged Latin American debt crisis of the 1980s, the structure of the debt made it relatively easy for leaders to emerge which guided the creditor banks in the debt negotiations. The vast

[10] Lawrence Summers, *Summers on Mexico, Ten Lessons to Learn,* ECONOMIST, Dec. 23, 1995, at 62.

majority of the debt was in the form of syndicated bank loans. In a syndicated loan, a group (syndicate) of banks makes loans to a debtor under an agreement that binds all of the member banks to the basic payment terms as a lending group. The terms of a syndicated loan typically provide for ratable sharing of payments among the syndicate and cannot be altered by individual syndicate members. Decision-making authority and coordinating responsibility on several issues is usually ceded to the lead banks. The commercial banks therefore effectively had representatives which renegotiated the debt with the governments.[11]

Countries invited the banks to negotiate by forming an advisory committee.[12] Bank Advisory Committees (BACs) emerged, consisting of the lead banks which had organized the syndicated loans. These committees preferred not to be understood formally as representatives but as "communications links" on account of their lack of formal legitimacy.[13] The BACs represented the creditors and gave advice to the country on how best to progress with the restructuring considering what might be acceptable to the wider banking community.[14] They were informal creatures without the official authority of the creditor body. Their success was limited by their ability to steer the situation towards a consensus between the debtors and the syndicate banks which still had to accept the terms suggested. They obtained cooperation among the hundreds of creditor banks by making recommendations for a restructuring which they then imposed using their political leverage. Despite their lack of formal legitimacy, they operated much as a creditor committee might, effectively negotiating

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11 *See* Lee Buchheit & Ralph Reisner, *Inter-Creditor Issues in Debt Restructuring*, in LATIN AMERICAN SOVEREIGN DEBT MANAGEMENT: LEGAL AND REGULATORY ASPECTS 28 (Ralph Reisner et al. eds., 1991) [hereinafter, Buchheit & Reisner, *Inter-Creditor Issues*].

12 *See A Nightmare of Debt: A Survey of International Banking*, ECONOMIST, Mar. 20, 1982 at 27; Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks*, 23 COLUM. J. TRANSNAT'L L. 59, 65 (1984). In the earlier restructurings, these committees were large and unwieldy but by 1984 they had become smaller and more efficient. William C.F. Kurz, *Problem Loans and Sovereign Restructurings: An Introduction to International Workout Practices*, in INTERNATIONAL FINANCIAL LAW, (Robert Rendell ed., Euromoney Publications (1983)). The responsibilities of the advisory committees included assembling information on the sovereign borrower's financial state of affairs, negotiating the broad terms of a restructuring and new money deal, negotiating the legal document which implements the deal and persuading the international banking community to accept the deal. Lee Buchheit, *Advisory Committees: What's in a Name?*, INT'L FIN. L. REV., Jan. 9, 1991 at 9.

13 Mudge, *supra* note 12, at 65. "The formation and role of a bank advisory group is informal and without legal recognition, either as a matter of contract or as a matter of law." Mudge, *supra* note 12, at 64.

14 Mudge, *supra* note 12, at 65.

restructuring agreements and new money loans, mobilizing the commercial banks to participate in these agreements and passing information to the other creditors. Thus there were parties which were identifiably responsible to guide the process of debt negotiations.

. . .as does the Indenture Trustee in America for corporate bonds. . .

The vast majority of sovereign debt now takes the form of bonds rather than bank loans. In a crisis today, there is no provision for coordinated representation and leadership. Corporate bonds in the United States illustrate by comparison the lack of leadership for government bondholders. When a U.S. corporation defaults on its bond debt, corporate bondholders enjoy legal protection under the Trustee Indenture Act of 1939. Government bondholders do not have this protection[15] because the statute expressly excludes domestic and foreign government bonds.[16]

Corporate bonds are usually issued through an Indenture Trustee. In the event of a default, the Trustee has specific obligations to bondholders.[17] This makes collective action by bondholders possible where otherwise it would be difficult and expensive.[18] It acts as a communications center and so coordinates bondholders, enabling them to make collective decisions. It must follow any instructions from a majority of the bondholders and so plays a representative role. If bondholders do not give directions, the Trustee may unilaterally accelerate the balance due, recover a judgment against the obligor, or sue to enforce the covenants of the indenture.[19] The Trustee has "primary responsibility for enforcing the remedial provisions of the contract."[20] It

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15 *See* Charles P. Goodall, *Eurobonds Issued with the Benefits of Trust Deeds,* INT'L FIN. L. REV., Feb. 1983, at 19.

16 The Trust Indenture Act exempts securities issued by foreign governments, their subdivisions, municipalities, and instrumentalities. Trust Indenture Act of 1939 § 304(a)(6), 15 U.S.C. § 77ddd(a)(6) (1988).

17 The trustee becomes a fiduciary, and the standard of care changes (from a good faith standard) to require "the same degree of care and skill . . . as a prudent man would exercise or use under the circumstances in the conduct of his own affairs" to prevent injury to bondholders' interests. The trustee is required to give notice of the default to the security holders and keep the bondholders informed of the borrower's behavior regarding the bonds. 15 U.S.C.A. § 77ooo(c) (West Supp. 1994). The trustees will not be liable, however, for errors made in good faith. 15 U.S.C.A. § 77ooo(d)(2) (West Supp. 1994).

18 LOUIS LOSS & JOEL SELIGMAN, 4 SECURITIES REGULATION 1596 (1990).

19 Henry F. Johnson, *The 'Forgotten' Securities Statute: Problems in the Trust Indenture Act,* 13 TOLEDO L. R. 92, 100 (1981). The trustees are also empowered by the Act to excuse defaults on interest payments for up to three years with the consent of 75% of the bondholders. 15 U.S.C.A. § 77ppp(a)(2) (West Supp. 1994).

20 Albert S. Pergam, *Eurobonds: Trustees, Fiscal Agents and the Treatment of Default in Adaptation and Renegotiation of Contracts,* in INTERNATIONAL TRADE AND FINANCE 285 (Nobert Horn ed. 1984), at 337.

will commence bankruptcy proceedings, attend reorganization proceedings, vigilantly monitor the actions of a bankruptcy trustee, file petitions with the bankruptcy court, sit on creditor committees, perhaps petition the Court for the creation of additional committees, perhaps negotiate with the debtor and recommend reorganization plans to the bondholders.[21] The Trustee has a leadership role in a corporate bond default.

. . .but the Fiscal Agent for sovereign bonds has no leadership role. . .

There is no party responsible for taking these actions for holders of sovereign bonds. Because the 1939 Act does not cover sovereign bonds, most issued in the United States use a Fiscal Agent instead of an Indenture Trustee. The Fiscal Agent, which is also used in the United Kingdom in bond offerings, has a much weaker role than the U.S. Indenture Trustee. Among other things, fiscal agency agreements define the obligations of the Fiscal Agent which receives payments from the debtor and distributes the interest and principal to bondholders.[22] These agreements usually require the Fiscal Agent to give notice to the bondholders in several circumstances: if the debtor fails to deposit sufficient funds to pay the interest due; if a bondholder claims that an "event of default" or "default" has occurred; or if the bonds have been accelerated. Fiscal agency agreements expressly stipulate, however, that the agent acts solely as an agent for the issuer and does not have any fiduciary relationship to the bondholders, except with respect to the payments held in trust for them.

. . .even with Brady Bonds, which causes problems in default situations.

Brady Bonds constitute a large amount of Latin American and Eastern European external debt currently outstanding. Although the Brady Bond Fiscal Agent has more responsibility than most, it still plays a markedly weaker role than the Indenture Trustee plays in corporate bond defaults. Despite its duty to appoint a chairperson at bondholder meetings, the Fiscal Agent has neither the power nor the duty to represent bondholders or take action on their behalf. The Fiscal Agent assumes no leadership role to advise or represent the bondholders. Not having an Indenture Trusteeship system for sovereign bonds is a problem in a default situation. Without an identifiable

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[21] *See generally*, Wolcott B. Dunham, Jr. and Peter L. Borowitz, *The Role of the Indenture Trustee in Reorganization Cases under the Bankruptcy Code*, 102 BANKING L.J. 436 (1985).

[22] The Argentine Fiscal Agency Agreement, for example, provides that "[A]ll funds delivered to the Fiscal Agent by or on behalf of Argentina . . . shall be received by the Fiscal Agent . . . in trust for the benefit of the Bondholders." USD Discount and Par Bond Fiscal Agency Agreement Among The Republic of Argentina, Citibank, N.A., and Citibank (Luxembourg) S.A. 15 (1993) [hereinafter *Argentine Fiscal Agency Agreement*].

leader which can coordinate them and has a legal mandate to represent them, government bondholders are more likely to remain a mass of unorganized creditors following a default.

B. *Coordination* With No Coordinating Mechanism

Syndicated lending during the 1980s made it possible to coordinate creditors. . .

Rescheduling debt requires organizing all of the creditors to agree together over negotiations with the debtor. The creditors were easily identifiable during the 1980s crisis — they were the banks which were members of loan syndicates. As the lead banks of the syndicates had organized the syndicate in the first place, they knew which banks were in the syndicate.[23] Banks which had purchased loans on the secondary market could be traced. This made communication and decision-making possible.

. . .but today bondholders are harder to organize.

Today's creditors hold individual bonds whose only relation to each other is that the bonds in a series have the same legal terms as the others in that series and are paid through the same mechanism. In addition, as bonds are easily tradeable debt instruments, the identities of bondholders are constantly changing. Identifying and communicating with bondholders would probably require sending communications to them through clearance and settlement institutions such as the Depository Trust Company in the United States or CEDEL and Euroclear in Europe. Some bonds are bearer instruments which makes identification and communication almost impossible. Bondholders are also hard to organize because of their number. Whereas the 1980s saw hundreds of syndicate banks, we now have thousands of bondholders. The volume of creditors and their sectoral diversity makes decisions difficult to obtain because their variety of interests may not coincide. No organization and no procedure exists to make such coordination anything other than a chaotic scramble. Bondholder meetings could be organized albeit with difficulty, but, as I will explain below, the results obtainable from bondholder meetings are very limited.

Bank Advisory Committees had some political legitimacy in the 1980s. . .

Although the lead banks of the loan syndicates did not have any legal mandate to renegotiate the loans, the BACs effectively did so by

[23] As the crisis went on, a secondary market developed and syndicated credits were increasingly traded between banks and sold to other institutions.

recommending outcomes to the debtors which the banking community would accept. These outcomes were imposed upon the banks in the loan syndicates under pressure from the larger banks. Because the bank syndicates accepted (in varying degrees) that the debt crisis would be managed through the BACs, the BACs had enough political legitimacy to overcome their lack of legal mandate to act as representatives.

. . .but bondholders cannot reschedule all of the debt at a bondholder meeting. . .

Bonds which do not provide for bondholders' meetings leave bondholders with no obvious way to organize collective action and appoint representatives. Unlike many Eurobond agreements, the Brady Bond agreements do provide for bondholder meetings at the initiative of the bondholders or the sovereign debtor.[24] But other than information exchanges, these meetings cannot accomplish much. While the bond agreements provide that decisions taken at such meetings are binding on all bondholders, the basic contractual rights of bondholders cannot (just as would be the case with collective action under bonds which do not provide for meetings) be changed without the consent of each holder. For example, Brady Bonds provide that bondholders acting collectively need the consent of each bondholder who would be affected by a change of the principal maturity date or the interest payment date, a reduction of the principal or interest amounts, or a change of the currency of any payment on a bond. These are the fundamental ingredients of a debt restructuring. The ability of bondholders to deal with payment problems through a meeting is therefore very limited, falling short of the power to negotiate a restructuring of the entire issue.

. . .or even give a representative a negotiating mandate. . .

Although bondholders cannot make decisions at meetings that affect the basic terms of all of the bonds, they could vote to authorize a representative to negotiate such on their behalf. However, those bondholders who did not appoint the representative would not be bound by any agreement reached by the representative. If some bondholders refuse to allow changes to the terms of their bonds, it is unlikely that even the most virtuous bondholder would volunteer to restructure its bonds. No creditor wants to take a loss where others

24 If requested by ten percent of the bondholders, the Fiscal Agent must convene a bondholder meeting. It must give notice of such meetings and of defaults to all the bondholders. The Fiscal Agent appoints the chairperson of a bondholder meeting, unless the issuer called the meeting, in which case the issuer appoints the chairperson.

refuse to make the same sacrifice. If an equivalent of a Bank Advisory Committee were to be organized for bondholders, it might be accorded some political legitimacy as a representative committee, but it is unlikely that it could impose sufficient pressure upon unwilling bondholders to accept settlements arrived at with debtor governments. The BACs were sensitive not to be seen as the banks' negotiating representatives: it would be even harder for an equivalent body of bondholders to have much influence over the mass of bondholders. I will explore this problem of creditor solidarity in the next part of this chapter.

. . .so we have a vacuum.

Coordinated representation requires a method for communicating with bondholders to enable them to make collective decisions and a mechanism for appointing effective representatives. There is currently a vacuum: no legal structure, institution or procedure exists to perform these functions.

C. *Solidarity* Without Incentives

Without official funds, rescheduling should serve creditors' collective interests. . .

If financial support is lacking, it is theoretically in the collective interest of creditors to renegotiate outstanding debt. Only by rescheduling the debt or finding new loans can the debtor regain the liquidity required to service its debt. Finding new loans will depend upon the extremity of the crisis. If it is not extreme, banks may lend at penalty rates without any debt reduction.[25] But in extreme situations, banks will probably not lend unless given some priority over existing debt or the existing debt is restructured. If the debt is not restructured and lending confidence has collapsed, existing funds will be insufficient to cover all of the obligations. The debtor would probably then take unilateral action. Brazil declared a moratorium on its external debt in 1987. Peru imposed an interest ceiling equal to a percentage of its GDP through much of the 1980s. Such unilateral action damages the relationship between the lenders and the borrower. It only makes it more difficult for a debtor to tap new sources of finance that would renew its liquidity and enable it to service its debts. Finance dries up if a debtor takes unpredictable unilateral action. This in turn only makes the position of existing creditors worse. The value

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[25] *See* Paul Krugman, *Private Capital Flows to Problem Debtors*, in DEVELOPING COUNTRY DEBT AND ECONOMIC PERFORMANCE (Jeffrey Sachs ed., 1989).

of their debt will drop, payments may be missed and they may encounter problems with their own balance sheets.

But if creditors can negotiate the debt on terms which the debtor government is able to meet, they would benefit collectively from the debtor's enhanced liquidity. Thus, in the absence of a lender of last resort, it is in their collective interest to agree to restructure. This is particularly so in the context of sovereign debt because there is very little hope of receiving payments by a distribution of liquidated assets. Governments keep few assets abroad for creditors to attach and are relatively safe at home. Therefore easing the liquidity of the country must be a priority for creditors.

. . .but the individual creditor can free ride by refusing to join in.

However, even if a mechanism existed to organize bondholders to act together, collective decisions are not necessarily in their individual interests. No creditor wants to take a loss. If some creditors reschedule their debt, those creditors which retain the face value of their debt "free ride" because the rescheduling increases liquidity and enables the free riders to be paid at face value. Knowing that negotiations would result in debt reduction or rescheduling, some bondholders will inevitably refuse to submit to the results of any negotiations. This may result in a breakdown of the collective interest so that in the end no creditor wants to submit its debt for rescheduling.

Free riders came under pressure in the 1980s. . .

This problem plagued the debt negotiations during the 1980s. However, in the first few years the lead banks were able to overcome it. The exposure of the large U.S. banks to Latin American debt in the early 1980s was such that if the debt had been declared non-repayable, those banks would have suffered enormous losses.[26] Major banks would have collapsed, threatening the world financial system.

Smaller banks were less exposed, however. Government bank regulators and the larger banks pressured the smaller banks to join in to restructure the existing loans and extend new loans to financially

26 While European banks had concentrated lending to Asian, Middle Eastern and African Countries, U.S. banks had focused on lending to Latin American countries. *See Morgan Guaranty Trust Company of New York*, WORLD FINANCIAL MARKETS, Feb. 1983, at 3. The amount of loans by Manufacturers Hanover to the five largest borrowers (Mexico, Brazil, Venezuela, Argentina and Chile) as a percentage of shareholders' equity was 254.7%. This percentage was 198.3% for Chase Manhattan; 179.6% for Chemical Bank; 178.6% for Citicorp; 166.8% for Bankers' Trust; 145.1% for Bank America; and 134.5% for Morgan Guaranty. ANATOLE KALETSKY, THE COSTS OF DEFAULT tbl. 6.3 (1985).

distressed sovereign debtors.[27] Smaller banks involuntarily increased their exposure to developing country debt. Joseph Kraft, who was involved in the reschedulings, related, "One by one, we identified the hard cases . . . We pinpointed their argument or excuse for not going along. Then we brought the appropriate pressure to bear — sometimes from state or Federal regulators; sometimes from figures in the local community; sometimes from other bankers."[28] These methods temporarily solved the free rider problem during the initial years of the debt crisis.[29]

Moreover, the syndicated loans which were to provide new money involved all of the creditors in a single agreement, thus providing strong creditor solidarity and less scope for individual action by any single creditor separate from a decision by the syndicate.

. . .but bondholders will not be so easy to influence. . .

Three factors would make debt rescheduling more difficult in a bond crisis today. First, it is unlikely that the systemic threat experienced by the banking industry could be repeated in a form that would produce sufficient pressures on creditors. Bonds are much more widely dispersed than syndicated loans were during the 1980s. Even if political pressures were exerted on bondholders by governments or creditors, a significant number of bonds will probably be spread among investors who are not as susceptible to pressure as were the banks. The banks were a highly homogeneous community of institutions which interacted with and depended upon each other. The number and sectoral variety of bondholders will make relations between bondholders more fluid. Their interests do not necessarily coincide.

. . .particularly if they expect official help. . .

Second, bondholders may hope that official sources will provide the necessary liquidity to enable their bonds to be paid in full without a rescheduling. The Mexican crisis has only served to consolidate this hope. The increase in the IMF's emergency lending facility (the General Agreement to Borrow) adds to this expectation. Bondholders have no individual incentive to volunteer their bonds for renegotiation.

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27 Charles Lipson, *Bankers' Dilemmas: Private Cooperation on Rescheduling Sovereign Debt*, 38 WORLD POL. 200 (1985). See also, Derek Asiedu-Akrofi, *Sustaining Lender Commitment to Sovereign Debtors*, 30 COLUM. J. TRANSNAT'L L. 1, 24 (1992).

28 JOSEPH KRAFT, THE MEXICAN RESCUE, 26, 53 (1984).

29 The free rider problem worsened as the 1980s negotiations proceeded. *See* Lee Buchheit, *Unseating Free Riders*, INT'L FIN. L. REV., Sept. 1989, at 14.

. . .and can bring lawsuits to disrupt negotiations. . .

A third factor making collective action and rescheduling difficult is the maverick bondholder which seeks redress in a court. As I have explained elsewhere,[30] bondholders can expect to obtain a judgment in a United States or United Kingdom court. Moreover, they will. For example, one of Brazil's creditors which held a large amount of bank loans brought a lawsuit in 1994 to enforce Brazil's obligations under the loans.[31] Peru has also recently been sued for its debt. In fact, some law firms are now advertising their expertise in suing foreign government debtors.

There were very few lawsuits by banks during the 1980s for a number of reasons. Legally, the banks could have brought suits over their loans: New York law or English law usually controlled the loan agreements, and neither of these countries apply foreign sovereign immunity to sovereign bonds.[32] In addition, all the loan agreements contained clauses waiving any right to plead sovereign immunity. But banks faced severe political consequences for suing and thereby breaking down the creditor solidarity which could help resolve the crisis. Smaller banks especially could not bring an action without damaging their positions within the banking community.

The nature of syndicated lending further hindered banks from suing on the debt. It made it very difficult for individual banks to take unilateral action. Syndicated loans contained contractual provisions

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30 Rory Macmillan, *The Next Sovereign Debt Crisis,* 31 STANFORD J. INT'L L. 305 (1995).

31 In 1994, after Brazil had prepared its $52 billion bank debt restructuring and Brady Bonds issue, Brazil's largest single creditor, the Dart Family, refused to join the restructuring. The Dart Family brought suit in federal court in New York, seeking payment of interest arrears. The Dart Family was technically Brazil's second largest creditor under the loan agreement in question. In September 1994, Banco Do Brasil held roughly 52% of the outstanding loans under the Multi-Year Deposit Facility Agreement (MYDFA) loans which was $1.58 billion, more than the $1.38 billion held by the Dart Family. Under loan agreements, the Agent banks (Citibank, NA) could declare an acceleration at the request of banks holding more than 50% of the aggregate unpaid principal of the MYDFA debt. The Darts argued that although Banco Do Brasil held over 50% of the outstanding debt, it should have been disregarded for the purposes of determining which party holds more than 50% because Banco Do Brasil was acting as "the alter-ego of, under the control of, and under common control with, defendant Central Bank, the borrower and Brasil, the guarantor." The Darts argument was therefore that they held over 50% of the vote and should be entitled to an accelerated payment of "the entire unpaid principal amount of the MYDFA, all past due interest, and all other amounts payable under the MYDFA." That such a large creditor would be prepared to go to such lengths to assert its legal rights and unsettle the restructuring process only serves to emphasize the danger of unrestrained smaller creditors.

32 Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 617-19 (1992); *see also* George R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later,* 88 AM. J. INT'L L. 257 (1994); George R. Delaume, *Sovereign Immunity and Public Debt,* 23 INT'L LAW 811 (1989).

which reduced the return any individual bank could expect from a lawsuit. The most important provision was the sharing clause. This mandated that any recovery in an action by a single creditor had to be shared with all of the other creditors of the loan agreement, thereby significantly reducing the recovery of the single creditor bringing the action. The political costs of an action therefore sufficiently outweighed the benefits to preclude individual creditors from taking action.[33] As the debt crisis progressed, creditors used such provisions more widely to cover all other creditors. The strength of this functional stay on proceedings was considerable: neither Brazil (which suspended interest payments in 1987), nor Peru (which limited its interest payments through much of the 1980s) were subject to legal actions by their creditor banks until much later.

. . .so the creditor body lacks the solidarity necessary to agree to restructure.

It would be very hard to impose political pressure upon a group as diverse and large as bondholders. In addition, bondholders are not bound together in the same way as lenders are under syndicated loans. In particular, bonds do not contain sharing clauses. Without fierce political disincentives against bringing a lawsuit, yet expecting to assert their legal rights in court, at least some bondholders will surely sue. The possibility of even a few bondholders pursuing their full rights will undermine bondholder solidarity: no creditor wants to take a loss while others enjoy full payments made possible by the rescheduling. Even without the prospect of attaching assets — difficult against a foreign government — some creditors may use lawsuits as a disruptive negotiating tool to bring pressure on the debtor and their fellow creditors. For these reasons, even if a work-out procedure or organization existed, bondholders do not have enough solidarity to agree to restructure the debt.

III. A Policy Framework

Bankruptcy systems traditionally protect creditors from each other. . .

The underlying rationale of corporate bankruptcy systems helps develop an approach to sovereign debt work-outs. Bankruptcy systems regulate competition over limited and rapidly depleting resources. Creditors' rights to be paid are suspended and they are obliged to submit to a group solution accepted by a majority of the creditors. The policy reasons for disturbing creditors' plain contrac-

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33 Lee C. Buchheit, *The Sharing Clause as a Litigation Shield*, Int'l Fin. L. Rev., Oct. 1990 at 15; Buchheit & Reisner, *Inter-Creditor Issues, supra* note 11, at 48.

tual rights were historically to protect creditors from each other. Without assurance of a group solution, individuals will pre-empt other creditors by seeking their share of the assets, leading to a stampede for resources, leaving some creditors with nothing. Bankruptcy systems control the vultures, but for the vultures' own protection. The method is to force the creditors to face the problem as a single group rather than as scattered individuals. This solves the "creditors' dilemma," the bankruptcy version of the prisoners' dilemma.[34]

This "collectivization goal"[35] of bankruptcy regimes produces certain features. As the bankruptcy crisis is one of resource availability, the rapid depletion of resources is stopped by an automatic stay on legal proceedings pending an orderly administration of the various claims.[36] The problem is competition between creditors, so equality regulates opportunity and initiative by imposing "equal treatment" among creditors.[37] Because it involves decision-making by creditors among themselves and negotiation with the debtor, the process provides for the coordination and representation of creditors. Simple Rawlsian justice[38] ensures equity between creditors and, in its more

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[34] *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982) [hereinafter Jackson, *The Creditors' Bargain*]; Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, 60 AM. BANKR. L.J. 399 (1986) [hereinafter Jackson, *Of Liquidation*]; Thomas H. Jackson and Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989); David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CINN. L. REV. 453 (1992); on the historical evolution of bankruptcy policies, *see* Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1,14 (1919); Risenfeld, *The Evolution of Modern Bankruptcy Law*, 31 MINN. L. REV. 401, 406 (1947); Charles Jordan Tabb, *The Historical Evolution of the Discharge*, 65 AM. BANKR. L.J. 325.

[35] Jackson, *Of Liquidation*, *supra* note 34, at 399.

[36] 11 U.S.C. § 362. In relation to sovereign debt: "Given the absence of any equivalent to domestic bankruptcy procedures, the litigation process cannot offer a solution to the crisis. On the other hand, litigation by individual fringe creditors — perhaps aimed at forcing the hand of other creditors in interbank negotiations — has considerable potential to impede an orderly solution through voluntary rescheduling." Howse, *The Courts, International Debt Crisis, and the Dilemma of Rescheduling: Rethinking the* Allied Bank *Decision*, 46 U. TORONTO FAC. L. REV. 578, 594 (1988).

[37] "The theme of the Bankruptcy Act is 'equality of distribution'. . ." Nathanson v. NLRB, 344 U.S. 25, 29 (1952).

[38] Jackson presents "bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such agreement from an ex ante position." Jackson, *Of Liquidation*, *supra* note 34, at 455. Korobkin criticizes Jackson for limiting those behind the veil of ignorance to creditors, making creditor wealth maximization the primary goal: Korobkin includes the debtors, their employees and communities in the decision, justifying Chapter 11 reorganization. *See* Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 544 (1993).

morally generous[39] and economically optimistic[40] form, shows mercy to debtors by providing a "fresh start" and "reorganization," promising forgiveness and time to get things together.

. . .but a sovereign work-out system must also protect the debtor.

Debates over whether reorganization or liquidation is more efficient for failing corporate debtors[41] are inappropriate in the context of government debtors: there can be no talk of an economically efficient liquidation and distribution of a people's government. Companies may go down, but governments must not.[42] This point necessarily informs the policy issues surrounding governments in financial distress. While bankruptcy systems have traditionally originated in the creditors' dilemma without great concern for the debtor,[43] we must assume that protection of the sovereign debtor is a greater policy objective than protection of its creditors. The modes by which the creditors' dilemma is resolved are as important for the protection of sovereign debtors as for their creditors.[44] The purpose of uniting creditors cannot only be to regulate competition among themselves. It must also enable the debtor to continue to function as a government.

But the debtor's status as a government means it is also in the interests of creditors as a whole to collectivize their efforts; governments do not hold many assets abroad available for attachment by creditors, and there is not likely to be a liquidation judgment against a

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39 Blending psychological and economic theories to examine the fresh start policy, see Thomas H. Jackson, *The Fresh Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985) [hereinafter Jackson, *Fresh Start]*.

40 The Congressional assumption in passing Chapter 11 was that "The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . It is more economically efficient to reorganize than liquidate, because it preserves jobs and assets." H.R.REP.NO. 595, 95th Cong., 1st Sess. 220 (1977) *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

41 *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); Lucian A. Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Michael Bradley and Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043; Jagdeep S. Bhandari and Lawrence A. Weiss, *The Untenable Case for Chapter 11: A Review of the Evidence*, 67 AM. BANKR. L.J. 131 (1993).

42 Which is not to say, as has frequently been unhappily illustrated, that governments *cannot.*

43 *See* Tabb, *supra* note 34.

44 Domestic bankruptcy experience can raise policy issues in sovereign debt. Chapter 11 has been criticized for not giving adequate control to creditors to bring genuine reorganization to reluctant debtors. *See* Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANK. L.J. 247. This naturally clarifies thinking policy of the desirable power balance between sovereign debtors and their creditors — one of the major criticisms of the international sovereign debt crisis of the 1980s was that the creditors exercised too much power over the debtors, to the point that economic reorganization had only the purpose of precipitating interest payments.

sovereign debtor at home. In the absence of official lending, the only realistic solution for creditors is to negotiate.

The necessity of debt restructuring as part of a sovereign debt work-out mechanism brings us back to the creditors' dilemma. The more inevitable it is that creditors must take a loss, the more carefully we must anticipate competitive behavior among them. A fundamental goal of designing a system will be to prevent individual creditors from disrupting proceedings or free riding on other creditors' settlements.

Although there is a lack of ideas for enabling sovereign work-outs. . .

World leaders chose to anticipate government liquidity crises by leaping to an expensive public solution — increasing money available to the IMF. This may seem surprising given the political climate in most of the world's richer nations — impatience with government expenditure and a preference for the natural flow of the market over public control. Actually, it reflected a bankruptcy of ideas: only now are proposals emerging for a workable solution which does not involve huge government spending.[45] What we need today is a system for the market to bear the costs of bad investments instead of the governments of the world shouldering that loss.

Until now, shifting the cost of a sovereign debt crisis to the market has mostly been suggested by politicians who can make political capital by characterizing investors as free riders. The strongest objectors to United States policy in the Mexican crisis claimed that investors were being bailed out from their losses.[46] Little attempt has been made to provide a mechanism by which market investors would take their share of the cost of a bad investment.

. . .Jeffrey Sachs has suggested a way for the markets to absorb the losses. . .

One suggestion has come from the Harvard economist Jeffrey Sachs. He has suggested that governments set up a sort of international bankruptcy regime for debtor governments.[47] Such a system would give the IMF legal powers analogous to a bankruptcy judge in Chapter 11 proceedings. The IMF would have the legal authority to

[45] Rory Macmillan, *New Lease of Life for Bondholder Councils*, FIN. TIMES, Aug. 15, 1995, at 11 [hereinafter, Macmillan, *Bondholder Councils*]; Barry Eichengreen and Richard Portes with Francesca Cornelli, Leonardo Felli, Julian Franks, Christopher Greenwood and Hugh Mercer, *Crisis, What Crisis?*, *Orderly Workouts for Sovereign Debtors* Council for Economic Policy Research, Sept. 1995 [hereinafter, Eichengreen and Portes, *Crisis, What Crisis?*].

[46] Pat Buchanan, *Mexico: Who Was Right?*, N.Y. TIMES, Aug. 25, 1995, at A27.

[47] Jeffrey Sachs, Do We Need an International Lender of Last Resort? (unpublished manuscript, 1995. On file with author).

declare a moratorium upon debt payments, stop legal proceedings and organize debt work-outs.[48] This would reapportion losses to the market, providing a less expensive solution for governments. All three problems of *leadership, coordination* and *solidarity* would be solved and imposed by the IMF.[49]

. . .but his international bankruptcy system turns to the international institutions. . .

Sach's solution looks to the international institutions as the answer. The profile of organizations such as the IMF and the World Bank makes them apparently the obvious place to begin. Their increasing role as development institutions, the IMF's part in the 1980s debt crisis and the 50th year anniversary of the Bretton Woods system have made them the focus of the debate about sovereign debt problems. The IMF's desire to play a world leadership role[50] was illustrated by its commitment to the Mexican crisis in 1995 when it applied several times Mexico's allotted share in an unrepeatable rescue.[51] Likewise, because the most developed analogy for debt work-outs is the U.S. Chapter 11 judicial proceeding, it also seems natural to think of a system with the IMF in the role of something analogous to the bankruptcy judge. However, for reasons I will ex-

48 There are earlier examples of this idea. *See* Benjamin J. Cohen, A *Global Chapter 11,* 75 FOREIGN POL'Y 109 (1989); Christopher G. Oechsli Note, *Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act,* 21 VA. J. INT'L L. 305 (1981); Stephen Bainbridge, *Comity and Sovereign Debt Litigation: A Bankruptcy Analogy,* 10 MD. J. INT'L L. & TRADE 1 (1986); Ruben Sklar, Note, Renegotiation of External Debt: The Allied Bank Cases and the Chapter 11 Analogy, 17 U. MIAMI INTER-AM. L. REV. 59 (1984).

49 It has been suggested that arbitration might be appropriate as a dispute forum for sovereign debt. In the middle of the 1980s debt crisis, it was thrown out as a possible solution that an international arbitration tribunal could be created which would have the power to enforce Chapter 11 principles. Note, *Renegotiation of External Debt: The Allied Bank Case and the Chapter 11 Analogy,* 17 U. MIAMI INTER-AM. L. REV. 59, 77-86 (1985). The problem with this suggestion was that it was over-ambitious. Using arbitral mechanisms would have involved creating a new international institution, choosing bankruptcy policies to guide the arbitrators, choosing arbitrators, and having all contracts contain arbitration clauses. The highly politicized nature of any such arbitration would have made agreement on all these aspects impossible to achieve.

50 Zanny Minton-Beddoes, who writes for The Economist, has suggested that the IMF overreached its capacity, not because of the U.S. influence on IMF policies, but because of its desire for relevance in the world economy. Zanny Minton-Beddoes, *Why the IMF Needs Reform,* FOREIGN AFF., May 1995, at 123. *See also,* Robert Chote, *Weaknesses in IMF Shown by Mexico,* FIN. TIMES, Apr. 25, 1995.

51 The IMF's contribution far exceeded the amount that would normally be available to Mexico under IMF rules. George Graham, *$50bn Mexico Aid Plan 'Averted a Global Crisis': 'Exceptional' Support Was Required, Says IMF Chief,* FIN. TIMES, Feb. 3, 1995, at 16. The IMF's contribution to support Mexican debt repayments has been estimated at almost a fifth of the IMF's liquid resources and seven times Mexico's quota. *Prospective on a Panic,* FIN. TIMES, Feb 11, 1995, at 8.

plain below, the IMF's role should be restricted to providing temporary liquidity and the conditionality of its adjustment programs.

. . .and would impinge upon national sovereignty.

Equipping the IMF with such legal powers would threaten the sovereignty of emerging market countries by giving the IMF the power to decide when a country could declare a moratorium on its debt. It would place a large amount of control in the hands of an institution which has often been the subject of criticism for its policies towards emerging market countries. It might also influence the terms of a debt rescheduling. A debt crisis is a highly political event. The 1980s showed the extensive impact it can have on a country's socioeconomic development, growth and stability. Until the world advances significantly beyond the location of political power in the nation state, a country's leaders should be able to negotiate with its creditors without depending entirely on intervention from the IMF.

This is made worse by the perceived partiality of the IMF. . .

Although it profoundly affects the international financial order and domestic economy, a debt crisis is simply a breakdown in contractual relations between two parties, a debtor and its creditors. The debtor is having difficulty meeting its obligations. The enormous body of creditors are usually predominantly located in rich countries. These countries have the voting power to control the IMF. Vesting such power in an institution which is controlled by the governments of the creditors would produce an unbalanced system.

. . .and might weaken international financial law. . .

Giving the IMF such legal powers would also revolutionize international financial law. Debt instruments governed by New York law or English law would be subject to the uncertainties of the international political order. These laws and legal systems are chosen for their sophistication and predictability. The IMF, an agent of its member governments, may be subject to unpredictable political influence. In the ever changing international order, it does not make sense to subject international financial relationships to the decision of an international institution. The real value of official intervention is in the provision of some emergency funding and some discipline in the country's economic policies.

. . .besides which, a work-out manager is unnecessary.

Apart from being politically unacceptable, a sovereign debt workout manager is unnecessary. At the other end of the spectrum from Jeffrey Sachs, James Hurlock, a lawyer at White & Case, has argued

that the problems of *leadership* and *coordination* are not significant.[52] Corporate debt work-outs are largely "self-executing in that creditors, in concert with the debtor, collectively determine the economic terms upon which the enterprise will be restructured."[53] Bankruptcy judges actually play a peripheral role in corporate debt restructurings because the real action is in the negotiations. A debt work-out system does not necessarily require any international government organization to play a central role because the difficulties consist of fundamentally mechanical problems which do not need government supervision. Debtors and creditors can reach restructuring agreements successfully without official intervention.

James Hurlock suggests giving governments legal immunity. . .

The real problem, he argues, is *solidarity* — the danger of the maverick bondholder disrupting the negotiations by taking its cause to a court. Hurlock suggests that this could be stopped by closing the courts to such investors. The sovereign immunity laws permit law suits in the U.S. and U.K. against foreign states. These should be amended so that a sovereign debtor would be immune from law suits in the midst of a negotiated work-out. Immunity would apply if the negotiations were being conducted in good faith by, or had been accepted by, a super-majority of creditors. This would protect the debtor and compel bondholders to join the collective process.

. . .but this also has drawbacks.

An ingenious answer, this has two problems. First, Hurlock underestimates the problems of *leadership* and *coordination.* As I explained in Chapter II, the next sovereign debt crisis will be far more complicated than the banking debt crisis.[54] Second, using sovereign immunity laws may herald a return to the 19th century when Latin American governments defaulted on their debts in the knowledge that the creditors had no legal remedies. This problem is usually called the "moral hazard." I will explore Hurlock's suggestion further in Chapter V.

The ideal system would avoid all of these problems. . .

An ideal system to handle sovereign debt crises would avoid the politico-economic problems outlined above. It would take advantage of the market by efficiently allocating the cost of risk and loss. It would not be an expensive official mechanism whereby public funds

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52 James Hurlock, *The Way Ahead for Sovereign Debt,* EUROMONEY, Aug. 1995, at 78 [hereinafter, Hurlock, *The Way Ahead*].

53 *Id.* at 79.

54 *See also,* Macmillan, *The Next Sovereign Debt Crisis, supra* note 30.

bear the cost of investors' losses. Rather, it would make investors bear the cost of debt adjustments themselves. It would not intrude unnecessarily upon the sovereignty of emerging market countries but would allow market negotiations directly between the parties. Lastly, it would avoid the moral hazard of countries defaulting irresponsibly on their debts.

. . .and Eichengreen and Portes have made suggestions in the right direction.

A recent paper by the Centre for Economic Policy Research takes such an approach to sovereign debt work-outs. Barry Eichengreen and Richard Portes suggest what appears to be a three pronged work-out system.[55] First, addressing the problem of *coordination*, they endorse the idea of creating one or more bondholder councils which, with the help of a mediation or conciliation service, would negotiate debt restructurings on behalf of bondholders. Second, they suggest that the lack of *solidarity* could be solved by an *ex ante* solution: if the legal provisions of future bonds allowed a majority of bondholders to negotiate changes to the essential terms of the bonds (maturity date, coupon payment date, principal and interest amounts, etc.) then bondholder councils could negotiate effectively with the sovereign debtor. To make this fair for dissenting minority creditors, they suggest that such creditors should have access to an arbitration tribunal if they do not like the solution negotiated by the majority bondholders. The third prong of their approach endorses the increase in the IMF's ability to provide emergency financing and encourages it to play a legitimizing role for a country which wishes to renegotiate its debts. Coupled with stronger conditionality, countries which are afraid to default because of the effect on their reputations would be enabled to do so with the approval of the IMF. The "Agenda for Reform" presented by Eichengreen and Portes contains some useful ideas, though none of them are fully worked out as yet. I will explore some of these issues in Chapter V.

IV. The Historical Perspective

The structure of sovereign debt in emerging markets has been transformed in the last five years. As a result of the Brady Initiative and numerous new issues, bond finance, largely dormant for more than half a century, has become the dominant means of external borrowing. Because some of the problems to be faced in a sovereign debt

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[55] Eichengreen and Portes, *Crisis? What Crisis?*, *supra* note 45.

work-out today resemble those encountered in early Latin American sovereign bond defaults, a brief review of the history may illuminate our search for solutions.

The United Kingdom has seen sovereign bond defaults before. . .

19th century Latin America saw a sweep of sovereign debt crises.[56] An enormous volume of loans to Latin American states in the early 1820s from British investors[57] was followed by mass defaults throughout the middle of the 19th century.[58] Creditors had no enforceable legal rights at that time: the doctrine of sovereign immunity stopped British courts from giving judgments against foreign governments. Local Latin American courts would not entertain suits against their states.[59] Without a judicial remedy, bondholders developed procedures by which they negotiated payment of some of the defaulted debt.

The defaults began with the "first Latin American debt crisis" in 1826. Reschedulings occurred over and over again. Often the Latin American states were denied access to credit — which proved to be the creditors' most powerful weapon — until the 1870s. In May 1828[60] the comprehensiveness of the Latin American defaults brought about a general bondholders' meeting at the City of London Tavern where it was proposed "that a committee be formed to apply to the [British] government for assistance, and request that it urge the consuls recently appointed to Latin America at great public expense to press the claimants' cause with the defaulting nations more energetically."[61]

56 *See* Frank Dawson, The First Latin American Debt Crisis 197 (1990); *see also* SEC Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Pt. V, 120-142 (1937) [hereinafter, SEC Protective and Reorganization Committees Report].

57 *See generally* Herbert Feis, Europe: The World's Banker (1932) (discussing European foreign investment before World War I) [RCC]; Leland Hamilton Jenks, The Migration of British Capital to 1875 (1927).

58 *See generally* Dawson, *supra* note 56, chs VI-X.

59 The United States also pursued a similar doctrine of sovereign immunity. *See generally* Schooner Exchange v. McFadden, 11 U.S. 116, 135-46 (1812) (without a waiver, sovereign immunity is a defense). Professor Borchard concluded as late as 1951 that "as a general principle it is not possible to sue a foreign state on its public bonds." Edwin Borchard, State Insolvencies & Foreign Bondholders, Vol. 1, 166 (1952). The Tate Letter in 1952 changed the policy to a more restricted doctrine of sovereign immunity, denying immunity for a sovereign's commercial activities. Jack Tate, Letter from the Acting Legal Adviser to the Attorney General (May 25, 1952), *reprinted in* 26 Dep't St. Bull. 984 (1952).

60 Before 1828, "bondholder meetings had been confined to creditors of a particular country." Dawson, *supra* note 56, at 164.

61 Dawson, *supra* note 56, at 164.

During the 1830s, a Spanish-American Bondholders Committee was formed as an umbrella organization uniting various bondholder committees which pressured defaulting states in the press, lobbied parliament and persuaded the securities exchanges to deny the defaulting states access to credit by further bond issues.[62] A flood of defaults by a number of non-Latin American states produced the first single centralized institution: the Council of Foreign Bondholders in London in November 1868. The Council lobbied parliament for support and negotiated rescheduling agreements with the debtor states.[63]

The major benefit to bondholders was to give them a unified organization to represent them without a conflict of interests. Without a bondholder's organization, the only institutions to act on their behalf were the banks which had underwritten the bonds. These issuing houses had divided loyalties to bondholders and debtors.[64]

The Council was composed of bondholders, members of loan-contracting houses and of the stock exchange. During its first three years the Council was funded by subscriptions from bondholders, but in 1873 it was incorporated as a company existing not for profit or trade but a public object.[65]

Its effectiveness was in the strength of community it provided between the bankers, the stock exchange and the bondholders. Although the stock exchange had refused access to credit for defaulting governments in the past,[66] the concerted action was even more effective to refuse listings of new issues.[67] Thus in 1874 the Council of Foreign Bondholders persuaded the London and the European stock

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62 DAWSON, *supra* note 56, at 195.

63 It also became involved in "supervising customs collections, managing banks and railroads, and overseeing other economic sectors of debtor states." DAWSON, *supra* note 56, at 195.

64 The committee appointed to set up the Council commented that "contractors have found themselves in an embarrassing situation towards the [debtor] Government and Bondholders, being under certain obligations to both. On such occasions the Council will be ready to act as mediator between the [debtor] Foreign Government and the Bondholders, relieving thereby the contractor from his unpleasant and sometimes equivocal position." Quoted in BORCHARD, *supra* note 59, at 204.

65 Under s23 of the Companies Act 1867; *see* BORCHARD, *supra* note 59, at 205.

66 Spain, Russia, Bulgaria, Greece, Austria and Turkey are examples: *see* FEIS, EUROPE THE WORLD'S BANKER, *supra* note 57, at 115; and BORCHARD, *supra* note 59, at 174; "One of the rules of the Exchange, adopted in 1825, was to refuse quotation to new loans to governments who were in default on existing obligations and who had refused to negotiate in good faith with their creditors, and in extreme instances to strike from the list all loans of the offending government." Eichengreen and Portes, *After the Deluge: Default, Negotiation, Readjustment* in EICHENGREEN and LINDERT, THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE, 15 (1990).

67 The Stock Exchange relied on the Council for information on the status of readjustment negotiations the relationship between the two institutions.

exchanges to block new Mexican issues while Mexico defaulted on its debts during civil war.[68] Turkey's loan of 1877 was denied listing for five years at the request of the bondholders until previous unpaid bonds were settled.[69]

The increasing availability of French and German capital towards the end of the century weakened this form of pressure. The Paris stock exchange, which "took up the bulk of the new loans floated after 1881,"[70] and the Berlin[71] stock exchange were subject to government policies of capitalization, particularly in Germany where nationalist colonial ambitions pushed foreign investment.[72]

. . .and so has the United States.

Foreign governments began to issue large amounts of bonds in the United States at the beginning of the 20th century. Again, enormous defaults occurred, particularly during the 1930s. American creditors used the same methods as had the European bondholders.[73] Protective committees were organized by entrepreneurial bankers and bondholders. These committees offered to negotiate on behalf of bondholders. They required that bondholders deposit their bonds with them, giving them wide discretion in negotiations.[74] Their negotiating authority depended on the amount of bonds entrusted to them: if they held more, their representative position was stronger.[75] A number of competing protective committees arose.[76] The committees

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68 DAWSON, *supra* note 56, at 197.

69 BORCHARD, *supra* note 59, at 174. This method was not always successful: the outcry in 1871 of holders of defaulted Mexican bonds at the issue of a loan secured by an assignment of the Mexican Republic was ignored and the stock exchange did not refuse a quotation to the loan. WYNNE, STATE INSOLVENCIES AND FOREIGN BONDHOLDERS VOL. 2, at 34 (1995); a similar result obtained in 1874.

70 Albert Fishlow, *Lessons from the past: capital markets during the 19th century and the interwar period*, in MILES KAHLER, THE POLITICS OF INTERNATIONAL DEBT, 67.

71 For example, when London bankers were skeptical of the creditworthiness of the Mexican government which sought a loan in 1888, Berlin proved much more open: *see* WYNNE, *supra* note 69, at 47.

72 FEIS, *supra* note 57, at 115.

73 *See generally* BORCHARD, *supra* note 59 (discussing European bondholder remedies).

74 Conflicts of interest persisted: the unfettered discretion could be abused by members of the protective committees. Some were more interested in profit than in obtaining a favorable result for bondholders. SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 120-142.

75 These committees had to develop the confidence and authority of the bondholders and then establish their negotiating authority with the foreign government. SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 212. "Control over deposited bonds and possession of proxies are obviously evidence of authority." SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 220.

76 SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 271, 376.

negotiated with the foreign government to persuade it to resume payments. The bondholders who had deposited their bonds with the committees were bound by the settlements they reached.

After the 1929-1931 crash, the Foreign Bondholders Protective Council was organized to represent bondholder interests.[77] The Council did not actually hold bonds: its negotiating authority derived from its quasi-official status as a statutorily created institution. Bondholders were not bound by the results of negotiations. The Council recommended the settlements to them[78] and the bondholders then chose whether to accept or reject the settlement. However, the alternative was usually to receive *no* debt service payments, so bondholders usually submitted to the Council's recommendation, much like the banks submitting to the Bank Advisory Committees in the 1980s. However, because the Council was a quasi-official institution, it could not represent bondholders with complete independence. Because the bondholders' negotiating leverage was limited to political pressure imposed on the sovereign debtor by the bondholders' government, they were dependent upon U.S. government help and therefore influenced by its policies.[79]

Sometimes bondholders pursued their remedies through the issuing banks, which either funded a protective committee or acted directly for the bondholders. As underwriters of the bonds, they had a relationship with the debtor and the ability to contact bondholders.[80] But the issuing banks had the same conflict of interests experienced in the United Kingdom the previous century. They remained firmly loyal agents of the issuer.[81]

We could use the historical models to organize bondholders today. . .

The historical bondholder councils have been criticized because they were never very successful at securing payment on the bonds.

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[77] SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 62-83. BORCHARD, *supra* note 59, at 193. The SEC compared the different committees and preferred representation by the FBPC to the private ad hoc committees because it avoided the conflicts of interest of the ad hoc committees. SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 618, 738.

[78] SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 214, 366-67.

[79] SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 389. "[I]f the State Department was unsympathetic to negotiations at a particular time, the Council would not go ahead with them ." SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 391 (footnote omitted).

[80] SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 507.

[81] SEC PROTECTIVE AND REORGANIZATION COMMITTEES REPORT, *supra* note 56, at 512-531.

The lack of legal redress in the courts gave them very little power, and they were mostly dependent on their own governments to apply political pressure on the debtor. However, we can draw two conclusions from this history which help resolve the mechanical problems outlined in Chapter II. First, bondholders and their governments have organized representative institutions before to negotiate with sovereign debtors. The problem of *leadership* has been dealt with before and could be solved again by using similar institutions. Bondholder councils took the lead with bondholders and produced collective representation. They thus also solved the problem of *coordination* by communicating with bondholders and negotiating reschedulings which they accepted. 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. Moreover, such institutions need to bring a larger number and wider variety of bondholders together. In the second part of the next chapter, I will explore how they could be structured.

. . .and make them successful by developing bondholder solidarity.

Secondly, bondholders acted together through committees and councils because it was their best option — they had no alternative. Their best result was produced by acting together because together they enjoyed more weight in negotiations. Thus the "collectivization goal" inherent in a work-out scenario resulted from a *solidarity* of creditors' interests which was produced by necessity. In this way, the third problem explained in Chapter II never arose. Today, there is a lack of creditor solidarity because bondholders may benefit from acting alone or simply not acting together at all. However, it may be possible to induce creditors to act together if it is made their best option. In the third part of the next chapter, I will explore ways to make collective action the best option for creditors.

V. Blueprint for a Sovereign Debt Work-out System

In Chapter II, I explained the mechanical problems created by the size and complexity of the creditor body in today's legal and institutional framework. Collective representation is now so difficult to achieve that debt restructurings are virtually impossible. In the third chapter, I argued that current suggestions for handling debt crises encounter economic or political problems — they are expensive non-market solutions, they violate the national sovereignty of debtor nations or reintroduce the moral hazards of the 19th century. I gave an overview in Chapter IV of the bondholder councils of the 19th and

early 20th centuries and suggested that we could learn how to solve today's problems from historical experience. In this chapter, I suggest that reforming the Trustee Indenture Act of 1939 to provide an Indenture Trustee for sovereign bondholders would help to fill the *leadership* vacuum, at least in the United States. Similar legislation could be implemented in other countries to make this solution effective globally. I propose reviving and remodeling bondholder councils in order to provide *coordination* of bondholders in negotiations. I then consider ways to engineer *solidarity* to produce collective decisions. The mechanisms I propose would avoid the problems I discussed in Chapter III: they would not distort the market pricing of risk, would cost governments very little, do not resort to the vagaries of international public sector control and avoid the moral hazard.

A. *Leadership* — Indenture Trustees for Sovereign Debt

Fiscal Agents should be more like Indenture Trustees...

Simple legislation could provide for *leadership*. In the United States, reform of the Trust Indenture Act of 1939 so that some provisions applied to debt issues by foreign governments would contribute order to the chaos of a sovereign bond default. This should be done cautiously, however. The Securities and Exchange Commission is considering repealing the 1939 Act because many of its provisions are now obsolete as a result of changes in market practice. But if the Fiscal Agent had some of the responsibilities of the Indenture Trustee, it would act immediately on behalf of the bondholders. It would communicate with them, enter discussions with the debtor and even negotiate restructurings which it would then recommend to bondholders.

It is not clear why issues of debt by foreign governments were excluded from the scope of the 1939 Act in the first place. The Securities and Exchange Commission report which gave rise to the Act did not address whether the proposed corporate bond Indenture Trustee would be similarly appropriate for foreign government bonds.[82] Likewise the reports of the Senate Committees passing the legislation said nothing more than that "substantially different considerations apply to [foreign government bond] issues."[83] Perhaps now is the time to reconsider whether this is really so. It seems that political considera-

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82 SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI, TRUSTEES UNDER INDENTURES (June 18, 1936) (hereafter SEC TRUSTEE REPORT).

83 SENATE COMMITTEE ON BANKING AND CURRENCY, TRUST INDENTURE ACT OF 1939: REPORT TO ACCOMPANY S. 2065, S. Rep. No. 248, 76th Cong., 1st Sess. 26 (1939) at 16; SENATE

tions in subjecting foreign governments to the extensive requirements of the securities laws played a part. Indeed, financially mature countries might still resent the imposition of such legislation on their debt issues (though most wealthy countries issue their debt on the domestic markets). But an emerging market sovereign debtor should welcome the existence of an Indenture Trustee because it would ease debt restructuring. Moreover, the absence of a bankruptcy regime for sovereign debt suggests that an Indenture Trustee is even more appropriate for sovereign debt than for corporate debt.

To the extent that it is appropriate, similar legislative reforms in other major capital centers would be a move toward a global solution. Most sovereign bonds are issued under New York or English law, so just changing the 1939 Act and the equivalent English legislative regime would provide significant *leadership* in a sovereign bond crisis.

. . .but we still need a mechanism for organizing bondholders.

This may not, however, be sufficient to organize and coordinate bondholders to the point where a debt restructuring is possible. First, leadership does not guarantee a following — obtaining the consent of every bondholder would still be necessary. Second, a debtor may have a number of issues of bonds on the market, each with a different Fiscal Agent. Even if these Fiscal Agents had the responsibilities of Indenture Trustees, they themselves would need *coordination.* Some might find that serving the interests of their bondholders required uncooperative behavior, perhaps bargaining to take a smaller cut of the restructuring losses.

Lastly, even if Fiscal Agents were coordinated to act together, significant involvement is necessary from bondholders. Without an effective bankruptcy regime, bondholders would rely heavily on the Fiscal Agent to negotiate for them. Bondholders usually become involved in negotiations themselves or through representatives—Indenture trustees are not necessarily expected to perform this role. Historically, even when the agent took an active part, it often suggested that the bondholders form a committee.[84] Fiscal agents are not

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COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, Trust Indenture Bill of 1939: REPORT TO ACCOMPANY S. 2065, S. Rep. No. 1016, 76th Cong., 1st Sess. (1939) at 42.

84 When the State of Maranhao, Brazil, defaulted on its bonds, Bankers Trust Company, the Trustee, more like today's Fiscal Agent than today's Indenture Trustee, wrote to bondholders saying, "We, as Trustee feel that the interest of the bondholders are being affected so vitally by present developments in Brazil, that the bondholders should be apprised of such developments as have come to our attention. We also believe that they should be advised of the necessity of organizing a committee to collaborate with the Trustee for the protection of their interests. It is also felt that in the course of his dealings with the Brazilian authorities, our representatives will

actually creditors, and although they may become obligated to act as if they were the creditors themselves, there is no substitute for creditors directly appointing their own representatives. Indeed, usually in corporate bankruptcies, the leadership role is taken up by bondholders who hold significant amounts of debt. The reason this will not happen now—and did not happen in the Mexican crisis—is that the expectations, assumptions and even hopes of the investment community are such that the bondholders do not anticipate being actively involved in a sovereign work-out. For these reasons, some *coordination* mechanism is needed to enable bondholders to produce collective representation, as well as to alter their expectations so that they recognize that investors have a role in a debt crisis.

B. *Coordination* — Bondholder Councils

An effective work-out system must be able to draw bondholders together to renegotiate foreign government debt. In the 19th and early 20th centuries, bondholder councils performed this role. If revived and redesigned for our age, they could provide a market solution to debt crises.[85]

(1) Scope of a Creditors Council?

Should one council cover all external debt?

A preliminary question in setting up a representation mechanism for bondholders is whether there should be one international creditor council which represents all of a country's creditors, including bondholders, bank creditors (including trade debt) and perhaps even multilateral institutions and governments. The "collectivization goal" would suggest incorporating all of a country's creditors in one negotiating organization, an international work-out council. However, the organizational cost of bringing together the holders of different types of debt might be too unwieldy. Indeed, the existence and successful history of the Paris Club for official creditors and the London Club for commercial bank creditors suggests that these gatherings should continue in the same roles. Cooperation between them could be extended to the bondholder councils.

be greatly aided if the opinion of the bondholders can be obtained on questions affecting their interests." SEC TRUSTEE REPORT, *supra* note 82, at 159.

85 *See* Macmillan, *Bondholder Councils, supra* note 45.

(2) International Council or National Councils?

Should there be one international bondholder council . . .

A second issue is whether bondholders should be organized by one international bondholder council or a number of national bondholder councils. In the former case, repayment and rescheduling of all of the bonds of a debtor government would be negotiated by the single "International Bondholders Council." Bondholders all over the world would be represented by that institution.

The international location of bondholders and the international transferability of bonds argue for an international organization which would sit naturally beside the London Club and the Paris Club, perhaps as a New York Club. All of a country's foreign creditors — bondholders, banks and governments — would be neatly represented by a trinity of organizations. However, whereas banks and governments are relatively easy to coordinate, bondholders might find a single international organization too far removed from them, unable to coordinate them fairly and competently. The fact that certain banks and governments are permanent players in sovereign debt lending provides natural leadership in the London and Paris Clubs. But because most investors in sovereign debt do not play a key role in the general business of issuing the debt, leadership would be difficult to achieve in an international organization. Moreover, the difficulties of international legal cooperation and a natural reluctance to create another international organization suggest that it would be better to set up a number of national councils in some key jurisdictions.

. . .or several national bondholder councils?

Rather than choosing a supranational or intergovernmental solution, national councils might be charged with representing the interests of bondholders. But which council would represent which bondholders? Bonds are issued in different countries, in different currencies, under different laws to bondholders who have different nationalities. One of two factors could determine the nationality of a bondholder council. First, the location of creditors: U.S. creditors might be represented by a U.S. institution and German creditors by a German institution. However, this would produce an uncoordinated multitude of councils in every country which has creditors, which is evidently undesirable. Second, the law and jurisdiction governing the documents: the bondholder council in the chosen jurisdiction is probably the most appropriate for any investor holding those bonds. Rather than decisions about the legal relations being resolved by a court, the council would negotiate them. The council would be effec-

tively operating in place of the courts of the jurisdiction specified in the bond agreements. Holders of a bond whose documentation specified that any disputes must be decided in an English court according to English law would have a choice of suing in England or going through the bondholder council. For this reason, it would be sensible for the legal jurisdiction of the bonds (rather than the locality of bondholders) to determine which bondholder council is appropriate for holders of those bonds. Holders of foreign government bonds issued under New York law and submitting to the New York courts would be represented by a resurrected Foreign Bondholders Protective Council in New York. Holders of bonds issued under English law would go to a resurrected Council of Foreign Bondholders in London. Because the vast majority of bond offerings still submit to English and New York courts and law, only a small number of councils would need to be set up.

(3) Structuring a Bondholder Council

A bondholder council should be a representative organization. . .

The historical councils were representative organizations. They negotiated with the debtor on behalf of the bondholders to obtain payments and reschedulings of their bonds. The same model could be used today to organize bondholders, provide representational unity and enable negotiations where they are currently impossible. Much as the Bank Advisory Committees of the 1980s provided a representational role in the debt restructurings, the councils would take the bondholders' place at the negotiating table.

Simply having an institution to communicate with bondholders, coordinate collective action and provide a resource for advice and help, would provide some organization presently lacking. But the goal of creating bondholder councils should be more ambitious than enabling communication and providing information. The aim should be to produce a negotiated restructuring in a debt crisis.

. . .but its structure depends on two questions. . .

Two issues enable us to analyze the structure that bondholder councils should take if they are to achieve this goal. First, who would appoint representatives to negotiate with the debtor: governments, bondholders or some combination? Second, what legal mandate would the representatives enjoy: would they have the power to negotiate agreements binding on the bondholders, or merely recommendations which bondholders could accept or reject?

These two questions are interrelated. The greater the level of government involvement in appointing representatives, the weaker the legitimacy of the councils in representing creditors' interests. On the other hand, if the councils directly represent bondholders, they might justifiably be given a greater legal mandate to bind the bondholders to a rescheduling agreement.

. . .which could produce two different models of organization.

A bondholder council might be set up on one of the two broad models outlined below. The first envisions a council much like the historical councils, a quasi-official agency without a direct representative mandate or binding power but with enough influence over bondholders to produce some sort of debt rescheduling. The second model outlines an institution which enables bondholders to appoint their own representatives who would then negotiate with the debtor, having the legal power to bind the bondholders.

One would be a quasi-official permanent representative. . .

A bondholder council might be a permanent quasi-official institution whose staff are appointed by or with the consent of the national government or members of the financial community. Decisions would be made quickly without the need to consult large numbers of bondholders and require them to elect representatives. This is particularly crucial in a crisis situation where the market will lose confidence in a slow and unclear process. It could employ financial and legal experts to act as a permanent body of negotiators, but the sporadic nature of debt crises suggests that it may be more appropriate to employ a minimal staff and engage experts (law firms, finance firms, economists, etc.) on an *ad hoc* basis at the onset of a crisis.

. . .having significant political power.

As long as the national government had influence over the choice of officers, a council would enjoy some derivative political weight from the government. This might be advantageous because of the relatively strong position sovereign debtors enjoy compared with individual bondholders. It might equalize the power distribution in the negotiations. Such a bondholder council (whether an international organization or a national council) could be an important political body, wielding much power in the international financial markets. Its pronouncements would be carefully monitored by the media and market analysts. It could influence the economic policies of countries before and during a debt crisis. A world player, it would resemble the historical councils which had a significant influence over events in countries such as Egypt, Turkey and Hungary at the end of the 19th century.

It would negotiate with the debtor. . .

The council would communicate with all of the investors holding bonds of the debtor. It would inform them of the debtor's financial difficulties and its intention to negotiate with the debtor. Its staff would negotiate with the foreign government. It would then announce the outcome of the negotiations to bondholders. If bondholders agreed to the negotiated terms, bonds would be changed pursuant to the debt rescheduling or other arrangement agreed to by the council and the debtor. The council might be given the power to take some initiatives on behalf of the bondholders, such as bringing legal actions or commencing negotiations. It might be granted the authority to take such action unilaterally without having to consult with the bondholders.

. . .but only with the power to recommend outcomes to bondholders, not to bind them.

However, the influence of the national government over the council's policies would weaken its representational legitimacy. The interests of the American government, for example, are not necessarily the same as those of Wall Street investors. It would be difficult to provide such an organization with anything more than the power to recommend outcomes to bondholders because it would lack the legitimacy of a directly elected representative. It would be acting in much the same way as did the Bank Advisory Committees during the 1980s and the historical councils, producing non-binding recommendations for the bondholders. Without the ability to bind bondholders, the council would lack an important power. As I explained in Chapter II, bondholders will not be susceptible to pressure to agree, let alone accept a mere recommendation from a council. Although some of the methods of producing bondholder solidarity may result in bondholders submitting to recommendations, perhaps solving the legitimacy problem so as to enable the council to bind bondholders would be better. This requires a closer connection between the bondholders and their representatives.

Alternatively, the council would help them appoint their own representatives. . .

A council could simply facilitate unified bondholder action. Under this model, the council would not be the representative organization itself, but would enable bondholders to appoint representatives. It would contact the holders of each series of bonds outstanding, organize bondholder meetings and guide them through procedures to appoint representatives. It would provide logistical and

information support to the representatives in negotiations. Once a negotiated settlement was reached, the council would convey the terms to bondholders. Because the council would enable bondholders to appoint representatives rather than serve as the representative itself, it would not have the same politically derived power as a permanent representative institution described above. But as elected representatives, the negotiators would have greater legitimacy and would perhaps be able to bind bondholders to its settlements, enabling reschedulings to occur more easily. In this way it would resemble the historical private bondholder committees which asked bondholders to deposit their bonds with the committee and grant it the power to reach legally binding agreements with the debtor on their behalf. It would also be more like a corporate debt work-out whose rules essentially allow the parties to appoint negotiators with minimal official intervention.

. . . having rules governing their election to a negotiating committee.

The council might have a set of rules ("Council Rules") which govern the appointment of representatives and require communications between them and bondholders. It would oversee and facilitate the appointment process. The Council Rules might provide that each series of bonds outstanding has the right to appoint one representative by a majority of the attendees at a bondholders meeting. The Rules would provide that the elected representatives form a "Bondholders Negotiating Committee." The Rules would perhaps limit the number of representatives on the Committee to about ten, and provide for consolidation of Committee members if this produced an unmanageably large number of representatives. The Rules would set out procedures for Committee decisions and its legal authority to change the terms of the bonds submitted to it. The Rules might provide that the representative of the largest aggregate principal amount of bonds or an elected institution would chair the Committee in its negotiations with the debtor. Alternatively, staff in the Bondholder Council might chair the Committee. This structure would give bondholders confidence to allow the council to restructure their bonds. The problem would be to encourage every bondholder to submit their bonds to its negotiating discretion. Confidence, together with the methods discussed below in part C, could make this possible.

(4) Funding a Bondholder Council

Issuing fees could provide funding.

How should councils be funded? Debt crises can be sudden disasters punctuating long periods of stability or prolonged years of repetitive negotiation. Organizing funding for an institution with unpredictable expenditure patterns will be difficult. Market regulation, although expensive, does not have to be paid from central government funds. The Securities and Exchange Commission, for example, receives funds from filing fees, essentially a direct levy upon issuers and investors. Similarly, the funding necessary to institute a bondholders council could be lifted from the issuance of the bonds. A percentage fee would be paid from the price of sovereign debt securities when issued, calculated in the same way that the SEC calculates its fees, but applying only to the issuance of bonds by foreign sovereign issuers. The premium paid by the issuers, underwriters and investors would reflect the costs of the future risk of managing default, thus internalizing at an early stage the financial costs of organizing negotiations. This would remove one of the disincentives of negotiating with a debtor — the organizational costs. It would be a form of insurance for future crises. Alternatively, the bondholder council could charge fees for organizing the Bondholder Negotiating Committee or take a percentage of the restructured debt payments, and maintain itself on its operating costs from previous renegotiations. The unsteadiness of the debt crisis industry would make this method of funding unpredictable and the council may not be financially stable enough to be useful in practice. Perhaps a combination of an issuing fee and a rescheduling fee would balance the anticipatory provision for crises with the projected expenditure at the time.

C. *Solidarity* — Getting Bondholders to Agree

To make a council work, negotiations must be the best option for bondholders.

To remedy the lack of *solidarity* outlined in Chapter II, the legal structure of bondholder councils must make negotiations through the council the most effective remedy for all of the bondholders. Historically, councils pressed defaulting governments to make payments, negotiating rescheduling agreements which they recommended to bondholders. Bondholders had no option but to submit to the councils because they had no other way to obtain payments. They could not sue the government debtors because foreign governments enjoyed sovereign immunity in the U.S. and U.K. courts. Bondholders there-

fore benefitted from collective action: the more bondholders who joined together to pressure the debtor government, the more effective such pressure would be. There was a clear *solidarity* of interests.

Bondholder councils could organize bondholders today, but to be effective they must be made the best option for every bondholder. If bondholders can pursue their rights more effectively by any other means, such as in court, some of them may refuse to group together to negotiate debt restructurings. If some investors refuse to cooperate, this will undermine the effort of others.

(1) Variations on an Automatic Stay

Debtors might be granted sovereign immunity in a crisis. . .

James Hurlock has suggested that the law of sovereign immunity in the U.S. and the U.K. might be altered to give debtors immunity from lawsuits in a crisis.[86] Bondholders would not be able to sue the sovereign government because of the equivalent of the automatic stay under the Bankruptcy Code. This would give bondholders the incentive to negotiate a debt restructuring because, assuming no official bailout was on the horizon, they would have no alternative means to obtain their payments.

. . .but this produces a moral hazard. . .

The problem with this solution is that it tempts debtors to default on their payments unjustifiably, knowing that they are immune from legal pressures from their creditors. This problem is commonly called the moral hazard and plagued the world of sovereign debt throughout the 19th century. The moral hazard is avoided in domestic bankruptcies by the oversight of the court which can reject applications for bankruptcy and allows some creditor control of the bankrupt entity if it is not acting in good faith. Hurlock suggests that the immunity from suit should be dependent upon the good faith of the negotiators. However, if courts in the United States, the United Kingdom and elsewhere become empowered to review the good faith of emerging market countries, this may violate their sovereignty. The good faith of a sovereign debtor and its creditors is more an economic and political question than a legal one. The moral hazard might be contained for sovereign debtors by conditioning immunity from suit upon an IMF adjustment plan. Debtors would take economic measures designed to restore debt servicing capability as recommended by the IMF because they would not wish to subject themselves to the threat of disruptive

[86] *See* Hurlock, *The Way Ahead, supra* note 52. *See also* Macmillan, *The Next Sovereign Debt Crisis, supra* note 30.

law suits. However, this also introduces problems of sovereignty because the IMF would have enormous leverage over the country's economic policies.

. . .and robs creditors of their legal rights.

Granting sovereign immunity would reverse the trend towards making foreign governments legally accountable in their commercial relationships with the private sector. Nearly all sovereign debt instruments contain clauses whereby the debtor waives any immunity it might have as a result of its sovereign status. Overriding such clauses would trample on carefully developed creditor rights. It would also change the nature of sovereign debt. Governments only default on their debt in some form of crisis. If creditors cannot sue on the occasion when a government defaults, the debt is arguably not meaningfully a legal obligation. Indeed, it could take sovereign debt back to the 19th century when the courts refused to enforce the terms of sovereign bonds on the ground that they were merely "engagements of honour."[87]

This could be solved by centralizing legal rights in a bondholder council. . .

One way to solve these two problems (removal of creditors' rights and violations of national sovereignty) would be to allow the creditors themselves to apply pressure on the debtor directly rather than by expecting the IMF to do so. Rather than granting complete immunity to the debtor, legislation might remove bondholders' rights to sue but vest those rights collectively but exclusively in the bondholder council. Bondholders could still sue, but only collectively through one organization. It would effectively make the council the exclusive means for bondholders to obtain payments on their bonds. This would give bondholders no choice but to submit their bonds to the council which would then represent them in negotiations with the debtors. It would create *solidarity* between bondholders who, having collective action as their only solution, would pursue goals that were in their collective interest.

Their collective interest would be served by a restructuring which enables the country to resume its payments, stabilize its economy and

[87] The English Court of Appeal summed up the situation in 1877:

> [T]hese so-called bonds amount to nothing more than engagements of honour, binding, so far as engagements of honour can bind, the government which issues them, but are not contracts enforceable before the ordinary tribunals of any foreign government, or even by the ordinary tribunals of the country which issued them, without the consent of the government of that country.

Twycross v. Dreyfus, 5 Ch. D. 605, 616 (1877) (Jessel, M.R.).

build up foreign reserves. Bondholders' collective interests would not be served by dragging the country through excruciating sacrifice which would worsen its future debt servicing capability. They would certainly not benefit from bringing disruptive legal actions. The bondholder council would therefore be unlikely to sue for payment. A determination of good faith would be made by the creditors themselves, with enlightened self interest. Only if the debtor was able but unwilling to pay its debt would bondholders resort to a lawsuit in order to bring pressure.

. . .but not permanently — only in a debt crisis.

Debt crises are the exception in economic history. Most debtors manage to continue servicing their debts even when in financial difficulty. Giving a bondholder council permanent exclusive power to sue on the bonds for all sovereign debt (including debt of industrialized democracies?) would transform the nature of sovereign debt, making it more restrictive than syndicated bank loans. Even banks in a syndicate can sue on their portion of the whole loan. Bondholders would not be a group of individuals but a permanently powerful creditor body. For this reason, if bondholder councils were to be given such exclusive power, it should only be in emergency situations. The trigger would most naturally be a declaration (by the country or the IMF) that the country was defaulting on its debt in good faith and that bondholders should pursue a negotiated solution.

(2) Creditor Decisionmaking by Majority

A majority of bondholders might be authorized to reschedule debt issues. . .

A second proposal comes from Barry Eichengreen and Richard Portes who suggest that the disruptive bondholder could be overcome if bondholders owning a majority in principal amount of the bonds had the power to change the terms of the bonds.[88] Currently, bonds allow a majority to change their terms except for core terms governing the amounts of interest and principal to be paid and the interest payment and maturity dates.[89] This rules out comprehensive debt restructuring because it is extremely difficult to get unanimous agreement on such questions. However, if new issues of sovereign debt were changed to allow a majority of bondholders under each issue to reschedule that entire issue of bonds, they argue that a debt work-out would be much easier to achieve.

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[88] Eichengreen and Portes, *Crisis, What Crisis?*, *supra* note 45.

[89] *See* Macmillan, *The Next Sovereign Debt Crisis*, *supra* note 30, at 343.

. . .which makes sense for corporate debt. . .

Another comparison with corporate debt may illuminate some of the implications of this proposal. The question of whether corporate bondholders having a majority in principal amount of the bonds should be able to change the core terms of the entire issue and reschedule every holder's bond has been debated since the Trustee Indenture Act of 1939. Before then, some indentures provided for bondholders' meetings at which bondholders having a majority of between 51% and 75% in principal amount of the bonds could "assent to and authorize any waiver, modification or compromise of the right of the bondholders" and any such action would "be binding upon the holder of all of the bonds."[90] These did not, however, allow changes to the core terms of payment amounts and dates. Some American and British indentures, on the other hand, did allow bondholders at a meeting to modify the obligations of the issuer to pay principal and interest.[91] The Securities and Exchange Commission report which led to the 1939 Act argued that such terms did not give sufficient protection to minority dissenting bondholders.[92] This was worsened by the lack of responsibility taken on by the Indenture Trustee at that time.[93] In order to protect such minorities, the 1939 Act provided that every bondholder must consent to any changes to the core terms of its bonds.[94] (Of course this only applied — and still only applies — to corporate debt and not sovereign debt.) This meant that any attempt to reschedule the corporate bonds would probably fail, drive the debtor into bankruptcy and result in a negotiated rescheduling supervised by the court, thereby guaranteeing fairness to minority bondholders. This has been criticized precisely because it makes voluntary debt work-outs more difficult outside a bankruptcy proceeding.[95]

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90 *See* SEC TRUSTEE REPORT, *supra* note 82, at 135.

91 *See* SEC TRUSTEE REPORT, *supra* note 82, at 143.

92 SEC TRUSTEE REPORT, *supra* note 82, at 61. ". . . the dissenter may be remitted to the mercy of a protective committee and the majority. The fate of minorities cannot fairly be left in the hands of majorities and protective committees without control or restraint." SEC TRUSTEE REPORT, *supra* note 82, at 63.

93 "This inactivity of the trustee generally leaves minorities unrepresented . . . Indeed, if the minority bondholders do not constitute a sufficient percentage of the bonds to compel the trustee to act, they may be absolutely at the mercy of the protective committees." SEC TRUSTEE REPORT, *supra* note 82, at 62.

94 "The indenture to be qualified shall provide that, notwithstanding any other provision thereof, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security . . . shall not be impaired or affected without the consent of such holder." Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp (1982).

95 Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

There are two principal arguments in favor of changing the 1939 Act to allow majority voting in corporate bonds. First, the concerns of the SEC in 1939 are no longer valid today. The SEC was concerned that creditors who were insiders (having some connection to the corporation) might abuse their position if they could form a majority. Today securities are traded so widely that insiders are unlikely to be a danger.[96] Second, now that two-thirds of the creditors in a bankruptcy can override a minority in a Chapter 11 reorganization proceeding, and do so without much intervention by the bankruptcy judge, there is no protection left for minority creditors in the courtroom, which makes protection outside the bankruptcy court pointless.[97] If minority protection is appropriate, the bankruptcy court is the appropriate place, not the trust indenture.[98]

. . .but may undercut creditors' rights too severely in sovereign debt. . .

The first of these arguments — that there is no need to protect minority creditors from majority creditors — applies to some extent to sovereign debt. There is no prospect of insiders cheating the minority. However, there are potentially significant dangers. The experience of the 1980s reminds us of potential disparities of interests between creditors and of abuses of power by larger creditors. The large banks pressured smaller banks to reschedule loans and provide new money to debtors.[99]

The second argument — that the two-thirds majority in corporate bankruptcies makes the prohibition on voting in pre-bankruptcy situations redundant — is translated weakly to sovereign debt crises. In a corporate restructuring there is some general judicial oversight and where there is none, there is significant control by creditors of the debtor. The weak position of a minority creditor is compensated by the generally strong position of the creditors as a body. In the sovereign debt context there is no judicial oversight and no creditor control beyond IMF adjustment plans. Anything more than this would im-

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96 *Id.*

97 *Id.* at 255. "Since the principal impetus behind the Trust Indenture Act's prohibition was to require judicial scrutiny in bankruptcy of a recapitalization plan, the prohibition's raison d'etre is now gone."

98 *Id.* at 266.

99 Charles Lipson, *Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, 38 World Pol. 200, 203 (1985) (also in Cooperation Under Anarchy (Kenneth Oye ed., 1985)). The danger in which large U.S. banks found themselves in 1982 raised complicated questions because the larger banks were often the agent banks in loan syndicates and had more influence over the events than the smaller banks. Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks*, 23 Colum. J. Transnat'l L. 59, 61-63 (1984).

pinge on the sovereignty of the debtor state. The weaker position of a sovereign debtor's creditors as a whole would put minority creditors of a sovereign debtor in a much weaker position than minority creditors of a corporate debtor. Without such independent judicial oversight and creditor influence — which are not possible in the sovereign context — majority rule leaves minority bondholders in a very vulnerable position.

Majority control may be too drastic for the same reason that an automatic stay using sovereign immunity is too drastic. It undercuts creditors' legal rights. The individual bondholder becomes subject to the majority without so choosing. Some protection for minority bondholders is necessary.

. . .and an arbitration tribunal would not help address minority creditor grievances.

Eichengreen and Portes address this problem by suggesting that an arbitration tribunal be created to deal with such complaints by bondholders.[100] But in addition to the effort involved in setting up another institution, it is difficult to see what it could contribute in this context. Their concern appears to be to remove such disputes from the courts because court cases disrupt negotiations. But an arbitration tribunal will not solve this problem. Arbitration tribunals simply remove decision making from courts and place it in the hands of party-selected arbitrators. The arbitrators then make a decision according to the law of the contract under dispute. If the bonds give a majority the power to change the terms of the bonds, arbitrators would have to allow that the majority bondholders could do so. An arbitration tribunal for aggrieved bondholders would give them no redress or comfort: it would only tie them up in prolonged and expensive proceedings. Moreover, there is no reason why an arbitration proceeding by a minority of bondholders would disrupt negotiations any less than would a court case. Arbitral awards are usually immediately enforceable as if they were judicial judgments. Thus it makes no difference whether such disputes are handled in a court or by an arbitral tribunal. In either case they will disrupt negotiations.

Majority rule could only cover future debt. . .

Changing the covenants in the documents has two other problems. First, it only governs new issues. What about debt that is already on the market? Much sovereign debt — Brady Bonds for ex-

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100 *See* Eichengreen and Portes, *Crisis, What Crisis?*, *supra* note 45, at 41.

ample — will not mature until as late as 2025. We need a solution that will cover all sovereign debt, whether issued or not.

. . .and is too discretionary, though legislation could make it comprehensive.

Second, it relies upon the sovereign debtor to draft the debt instruments with such clauses. Debtors may try to do so because it is in their interest to make reschedulings easier. But risk factors in buying the securities have to be disclosed to investors. Securities which explicitly tell bondholders that other bondholders may revise their rights without their consent might not be marketable or may simply cost the debtor too much in its selling price. To work, majority rule would have to be a comprehensive public policy solution: otherwise some debtors might insert such clauses and others might not. In a regional crisis, we might end up with one country's debt being nicely renegotiated while another's lurches from one chaotic problem to the next. Just as the Trust Indenture Act of 1939 requires corporate bonds to contain certain clauses, the Act might be changed to require that sovereign debt contain clauses allowing a majority of bondholders to change the time and amount of payments.

However, a better solution than majority rule would be one wherein every bondholder has an interest in reaching a collective solution without minority dissent. In the next section, I show how this could be achieved without completely overriding minority creditors' rights.

(3) Engineering *Solidarity*

Sharing obligations would raise the threshold for the disruptive bondholder. . .

The absence of a centralized judicial bankruptcy system requires that the "collectivization goal" be introduced and imposed from elsewhere. Creditor solidarity must arise from economic and legal relationships rather than crude judicial enforcement. It has been and still is entirely possible to manipulate these to produce the required result. Some features of the debt crisis of the 1980s may provide an effective solution. One of the most important causes of solidarity then was the obligation upon banks to share any payments made directly to them with the other banks in the syndicate.[101] This meant that any bank

101 "While the loan agreement contemplates that payments by the borrower will be made to the agent for the benefit of the members of the syndicate, there are times when individual members may directly receive payment on their note. The borrower may make a voluntary payment to the bank, but more likely the bank will exercise its right of setoff to satisfy all or a portion of

bringing a lawsuit had to disburse any amounts it received equally among the other banks.[102] This was one of the main reasons that so many reschedulings could be negotiated throughout the 1980s.

If bondholders were required to share any payments received from a court judgment, they would have no great incentive to pursue their claims unless they were doing so collectively. A sharing obligation could be imposed by simple legislation. It would not remove the legal rights of the bondholders but it would collectivize their interests. It does not completely remove the threat of an individual bondholder bringing a lawsuit: a bondholder could still sue in order to bring pressure upon other bondholders to take the suing bondholder's views into account. But it does reduce the interest in suing and so raises the cost-benefit threshold for the maverick bondholder.

. . .and consolidating all legal proceedings would increase creditor solidarity.

In order to develop creditor solidarity towards unanimity, two additional methods could be used. A complementary idea for collectivizing bondholders' interests would be to require that all legal actions over the bonds be consolidated into a single action. In the event of a dispute, the effect of this would be that bondholders will make decisions together with regard to their collective interest rather than each bondholder making an individual decision in its own interest. Such provisions have been used before in bond documents when the provisions refer disputes to arbitration. An agreement may provide that a bondholder, by bringing a proceeding against the debtor or a collateral agent, consents to the consolidation of its arbitration with any

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the borrower's obligations to that bank. One of the assumptions in entering into a syndicated agreement is that each of the banks will share ratably all payments made by the borrower based on the amount of the loans outstanding to the borrower by all members of the syndicate. To ensure that all banks share payments by the borrower on a ratable basis, a procedure must be established for payments received outside the normal payment mechanisms of the loan agreement. This provision [the sharing clause] requires that if a bank receives such a payment, it will purchase a participation in the outstanding loans to the borrower by all the other member banks in the syndicate in an amount that will give each syndicate member its appropriate ratable share of the payment received from the borrower." SANDRA SCHNITZER STERN, STRUCTURING COMMERCIAL LOAN AGREEMENTS 10-20 (2d ed. 1990).

[102] Buchheit, *supra* note 33, at 15. *See also,* Buchheit & Reisner, *Inter-Creditor Issues, supra* note 11, at 46. Moreover, mandatory prepayment clauses applied not only within a single syndicate, but between syndicates, so that any payments made before obligations were due had to be ratably shared among all creditors. Additionally, cross-default clauses—whereby a default in any one loan agreement signaled a default in other syndicated loan agreements—may have multiplied the number of creditors with a right to accelerate their loans to the point that it was impracticable for any single syndicate to take action, creating an effective automatic stay. *See* Buchheit & Reisner, *Inter-Creditor Issues, supra* note 11, at 48.

other such arbitrations. This means that all arbitrations under that agreement will be consolidated so that the bondholders become a single party in the dispute. Legislation could require bondholders suing a foreign government to bring one single lawsuit together in the same way.

With a minimum requirement of bondholders to bring a lawsuit. . .

A third method could be used to tighten bondholder solidarity. Rather than allowing a majority to restructure all of the bonds as Eichengreen and Portes suggest, legislation could require that a minimum amount of the bondholders is required to bring a lawsuit. Just as a minimum percentage (usually 25%) of bondholders is required to accelerate the debt in the event of default, a minimum amount would be required if they wanted to go to court. This would still mean that bondholders could sue, but would require that if they wish to do so, they must work together. Similar provisions have existed in indentures in the distant past.[103]

A percentage as low as 10% might be sufficient to make a lawsuit counter-productive to the plaintiffs. If such a large amount of bondholders wanting to sue the debtor had to consolidate their cases as one, it would obviously be contrary to their interests to drive the debtor's financial position into the ground. A judgment for millions of dollars would be unrealistic to pay and would make it harder for the debtor to raise money elsewhere. The value of bonds depends partly upon the debtor's future ability to make payments. In the absence of new money, payments would only be possible by debt rescheduling or debt reduction. For these reasons, bondholders would be more likely to seek a compromise whereby the debtor's liquidity were eased, allowing renegotiated bond payments to resume.

. . .this would result in a collective approach to the crisis. . .

None of these things alone would guarantee creditor solidarity, but taken together they would align the interests of bondholders so that they operate together and come to a collective position in negotiations with the debtor. The individual bondholder would be pushed to think of the collective interest rather than its individual short term gain. If a bondholder council were in operation, it would soon have the agreement of all bondholders to negotiate a restructuring.

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103 An indenture before the court in Allan v. Moline Plow Co., 14 F.2d 912 (8th Cir. 1926), provided that no noteholder could sue unless the trustee refused to do so after demand by holders of 25 percent of the outstanding notes. SEC TRUSTEE REPORT, *supra* note 82, at 62.

. . .which avoids the moral hazard without trampling on creditors' rights.

This solution has two principal advantages over other suggestions. First, it does not remove the contractual rights under the bonds from the bondholders. They can still bring lawsuits but must do so as a group. Second, it does not introduce violations of sovereignty because it does not require an independent judgment from any institution to set a process of negotiations going. Upon intimation of a request for debt negotiations from the debtor, the bondholders would use the organizational mechanisms of the council to act together and negotiate with the debtor. It also avoids the moral hazard problem. If they still had the legal right to sue the debtor, they could use this together to discourage the debtor from unjustifiably defaulting on its debt. On the other hand, if the debtor was plainly unable to pay its debts, the creditors would be able to negotiate collectively without any danger of disruption from individual creditors.

VI. New Money: A Postscript

If a debtor has liquidity problems and cannot meet its debt obligations, the debtor usually needs to borrow in order to maintain debt payments and ongoing financial operations. This is so even where debt is rescheduled. As I explained in Chapter II, in a debt crisis, lenders lose confidence and refuse to make money available.

Involuntary lending supplied new money in the 1980s. . .

The same political pressures that restrained banks from initiating lawsuits and pushed them into debt reschedulings during the 1980s also forced unwilling banks to lend more to the debtor governments. The lead banks called upon all of the creditor banks to lend new money in proportion to their existing exposure. Today, however, bondholders would refuse to increase their exposure based upon their holdings of outstanding debt. Many bondholders are institutional pension funds or other investors which are not even in the business of lending. Moreover, the expectations of the market have changed. For instance, after the experience of the 1980s, Brady Bonds explicitly prohibit the debtors from calling upon bondholders to lend new money.

. . .but today new money would need some legal priority. . .

There are three obvious sources of new lending. The first is to tap official sources, as Mexico did in early 1995. As I explained in Chapter II, making government money the main resource for liquidity is an unsustainable and expensive way to spend public funds.

Although a significant contribution can be made by institutions such as the IMF, the resources of the private sector must be harnessed.

The second source is from new debt issues. However, it was six months before Mexico was able to raise money on the capital markets.[104] It was only able to do so because it already had the official backing of the US government and the IMF. Six months is too long a period for a government to wait to secure lending in a crisis.

The third possible source is from commercial banks. Lenders will only expose themselves to a risky debtor if there is some indication of repayment. Where there is a "lender of last resort," the commercial lender can have confidence of repayment even if the debtor encounters difficulties. Governments have increased the IMF's funds to enhance this function. There is an alternative situation whereby private lenders can be induced to lend to a struggling debtor. Jeffrey Sachs has argued that a mechanism is needed to give potential creditors confidence that their new debt would be repaid ahead of the outstanding debt.[105] If the rescuing new money takes priority over the old debt, commercial banks may be induced to lend.

. . .which leadership, coordination and solidarity could produce.

The problem in today's financial system is in getting creditors to agree to subordinate their outstanding debt to new money. Doing so means increasing the risk that the new debt will be repaid without leaving sufficient resources to pay off the old debt. However, without new money, even with a rescheduling the immediate payments on bonds may be jeopardized. Giving the new money priority would provide the liquidity to make payments flow again on their outstanding debt. The problems with securing such liquidity are the same as those which make it difficult to renegotiate the outstanding debt. There is no legal provision to impose such a priority on new debt. However, as I have shown in this article, there are alternatives to a court imposed legal structure in work-outs. If the incentives of existing creditors can be aligned so that prioritized new money is in their collective interest because there is no alternative, then they will agree to a restricted subordination of their own debt. The need then is to have *leadership*, *coordination* and *solidarity* of interests. If a procedure or institution for coordinated representation existed, and if there were a clear solidarity of interests, it would be within the creditors' collective interest to subordinate their outstanding debt to the new money. Thus, if the underlying problems of a debt restructuring were solved, the require-

[104] *See* note 4.
[105] *See* Sachs, *supra* note 47.

ment of new money should fall into place. If this should fail, legislation in countries whose laws apply to the terms of the debt could provide that following a debt restructuring agreement any new lending to the country will have legal priority. A time restriction — perhaps six months — might apply. This would encourage the parties to reach a restructuring agreement because lenders would be waiting in the wings to lend.

VII. Conclusion

The problems in restructuring sovereign debt result from inadequacies in the international legal order. Despite numerous popular arguments that the nation state is becoming obsolete because capital and trade flows make borders irrelevant, the legal structure is far from supranational. Numerous commissions and quasi-courts exist, but with the notable exception of the Court of Justice in the European Union, these are either subject to political influence so that the rule of law is weak (like the International Court of Justice) or they are specialized technical tribunals (like the World Trade Organization). Trade in bananas and washing machines can be regulated by decision makers whose discretion and susceptibility to political influence is constrained to some extent by the rule of law. But, the enormity of a sovereign debt crisis makes it very difficult to ensure that discretion and political influence are isolated and decisions are made according to neutral criteria.

For this reason I have sought to construct a system in which the parties involved in a crisis can act with enlightened self interest to pursue collective goals. The most obvious way to do this is usually to have laws of a common sovereign authority regulating behaviour, but this is not possible in today's international order. I have shown that the legal, institutional and economic relations between the parties can be structured so that an alignment of interests achieves the same goals of a domestic bankruptcy system. Having an Indenture Trustee for sovereign debt is an obvious — and somewhat belated — suggestion. Developing bondholder councils requires significantly more careful thought but has been done before and is therefore demonstrably possible. Creditor solidarity may be achieved by an intricate set of legal provisions, some of which were shown to work during the 1980s. In today's framework, a debt restructuring is next to impossible. Current suggestions are either impractical or expensive. The initiatives I have recommended in this article would transform the situation without great effort by or cost to any government.