SOVEREIGN DEBT RESTRUCTURING

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von

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I. INTRODUCTION: THE DEBT RESTRUCTURING PROBLEM

Nations take out loans and issue bonds in international financial markets in order to build highways, power stations or hospitals. The insolvency of companies is governed by corporate bankruptcy law. On the other hand if a country becomes insolvent, there are few, if any applicable rules in either national or international law governing the relationship between the sovereign and its creditors. Whereas insolvent companies are sometimes liquidated, that is they cease to exist as a legal entity and thus as a operating company, such an approach is unthinkable in the case of an entire country. Bankruptcy law is an essential feature of a functioning market economy on the national scale. Likewise, international financial markets are unable to handle situations of extreme financial distress in an efficient manner without a sound legal framework which establishes procedures to safeguard the rights of both debtor and creditor.

We say that a sovereign debt crises occurs when a country's foreign exchange reserves are insufficient to meet its foreign exchange payment obligations over an extended period of time.[1] It is important to note that a liquidity crisis – in contrast to a debt crises – is a short-term problem. A restructuring regime could be designed to apply to both debt and liquidity crises or could be focused on debt crises.

During the past 20 years there were major transformations in international financial markets[2]: On the one hand, there was a formidable explosion of private, highly volatile capital flows to the emerging market economies. On the other hand, the role of bond securities increased dramatically. Today bonds are the main instrument for financing the external debt of the emerging market economies. They have largely replaced loans (from governments and commercial banks) that had prevailed until the middle of the 1980s. Bonds tend to be spread among a large number of different investors with disparate interests.

Sovereign debt restructuring, albeit important, is part of a larger and (even more complex) issue: the reform of the international financial architecture. Ever since the Latin American crises of the 1980s, the deficiencies of the international financial architecture has been on the international agenda.[3] Subsequently, we witnessed the Mexican crises of 1995, the Asian crisis of 1997, the Russian crisis of 1998, the Brazilian and Ecuadorian crises of 1999 and, most recently, those of Turkey and Argentina in 2001-2002.This paper will only briefly touch upon this reform agenda in order to illuminate the question of whether we need institutional/statutory change to achieve orderly sovereign debt restructurings.

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[1] Krugman, 696. To some authors (for example Roubini, 321) "the very concept of insolvency is problematic in the sovereign context because a restructuring may result either from the sovereign's *inability* to pay or from its *unwillingness* to pay [italics added]. In addition, she contends that "the sustainability of a country's debt is always probabilistic." This "rush to default" in case of unwillingness to pay is a market failure on the side of the debtor.

[2] For an introduction to these transformations see Walter.

[3] See Fischer; Eichengreen/Portes.

The Rey Report[4] in 1996, prepared by a working group of the G10 set up shortly after the Mexican crisis, warned against frequent recourse to large-scale financing by the international community for the resolution of crises and advocated an equitable burden-sharing between debtor countries and private-sector creditors. This approach later became known as private sector involvement. This report included two important recommendations:

First, it envisaged the possibility of a temporary suspension of payments (standstill). Secondly, It advocated the inclusion of "collective action clauses" (CACs) in bond issues. These clauses enable a "super majority" of creditors, assembled in a bondholders' committee, to change the terms of a bond for all bondholders. It also recommended that the IMF should apply its policy of "lending into arrears" to a country in crisis in order to meet its needs for new money. Industrialized and also some developing countries, however, have responded only timidly to the urgency of reform and so far no major changes to the framework of sovereign debt workouts have been adopted.

The key question in the political and academic debate is about the nature and scope of a sovereign bankruptcy procedure for countries in financial difficulties. *Roubini* identifies three basic approaches: First, the market-based status quo regime using exchange offers. Secondly, collective action clauses (CACs) in bond contracts (the contractual/market-based approach). Thirdly, an international bankruptcy/liquidation procedure. We survey some of the most influential reform proposals advocated by economists and lawyers in part IV.

II. SOVEREIGN INSOLVENCY: DIVERGING INTERESTS

A. The Basic Collective Action Problem among Creditors and Moral Hazard[5]

Bankruptcy is a collective procedure aimed at resolving all claims against the debtor. In the beginning, the only goal was to provide a procedure to close down and liquidate a debtor's assets in an orderly fashion. From the 1860s onwards, a procedure with a different emphasis emerged in the United States: reorganization law designed to preserve the going-concern value of a company.[6] It is reorganization law that is of interest for sovereign debt restructuring, as sovereign states cannot possibly be liquidated.[7]

[4] Report of the Group of Ten, http://www.bis.org/publ/gten03.htm.
[5] Newman, Entry on "Corporate Bankruptcy"; www.uscourts.gov/bankbasic.pdf.
[6] A number of countries imported variants of this procedure. Cf. Unternehmensreorganisationsgesetz (URG) in Austria (BgBl I 1997/114). Absatz 2 definiert „Reorganisation" wie folgt: „[E]ine nach betriebswirtschaftlichen Grundsätzen durchgeführte Maßnahme zur Verbesserung der Vermögens-, Finanz- und Ertragslage eines im Bestand gefährdeten Unternehmens, die dessen nachhaltige Weiterführung ermöglicht."
[7] Schwarcz, 959; Sachs II.

Central to any bankruptcy is a so-called collective action problem (CAP). A CAP can be defined as a situation in which everyone (in a given group) has a choice between two alternatives and where, if everyone involved acts rationally (in the economic sense), the outcome will be worse for everyone involved, in their own estimation, than it would be if they were all to choose the other alternative (i.e. if they were all to act irrationally).[8] Bankruptcy law principles attempt to solve fundamental collective action problems such as this ability of the holdout creditor to undermine a negotiated settlement. Even though it may be in the interest of creditors as a whole to cooperate, it might be in the interest of an individual creditor to hold out and demand full repayment of its claim. In case of a sovereign borrower in financial distress, many of the same pressures and problems occur. Yet they are frequently of even greater complexity.[9] Another problem inherent to current IMF policy is possible moral hazard: Market participants may anticipate bailouts and incorporate them into to their risk evaluations.

Fundamental to any bankruptcy procedure, whether it involves liquidation or restructuring, is that it reduces creditors' incentives to compete with each other for the debtor's assets. When individual creditors see that the debtor's assets are insufficient to repay all debts, they might race to be repaid before the debtor's funds run out. Such a "grab race" is destructive, because it results in particular assets of the debtor being liquidated, even though the debtor's assets may be more valuable taken together. Bankruptcy procedure attempts to reduce creditors' incentive to race for payment by satisfying claims proportionately.

An individual activity (ie the request for payment) therefore has a harmful effect on the "common good". Collective action involves agreement to abstain from these detrimental activities.[10] In case of bankruptcy procedures, the law mediates this agreement. We can look at this as a negative externality: Even though everybody (ie every creditor) can be made better off by an appropriate agreement controlling other creditor's actions, each individual creditor has an incentive to free ride in the absence of strict enforcement. While each creditor benefits from the bankruptcy procedure, there exists at the same time an incentive to not contribute personally. The "public-good nature" of regulation enables individual creditors to free ride.

The genial feature of reorganization law is that it provides incentives, notwithstanding their diverging interests, to debtor and creditor alike to reach a voluntary agreement on the terms of a restructuring: Agreement is rewarded, failure to agree is penalized.[11]

[8] Cf. Olson, 5-16; Shepsle/Bonchek, Chapters 8-10.
[9] Sachs I; Sachs II.
[10] Hoffmann, 23.
[11] Schwarcz, 959.

B. The Imperfect Analogy between Corporate and Sovereign Debt

In the absence of externally imposed incentives (legal, political, and economic) the interests of creditors and the debtor will probably diverge so strongly that an orderly restructuring is almost infeasible. In principle, a bankruptcy mechanism similar to corporate reorganization seems appropriate for sovereign debt restructuring. Nevertheless, the analogy between corporate and sovereign debt restructurings does not fully operate because of certain special characteristics of sovereign States. In addition, the structure of the international legal system as well as economic and political interests are major roadblocks.

This difficulty of sovereign debt restructurings is exacerbated by the CAP of reaching agreement among creditors and by the fact that a multitude of public and private actors are involved[12]. International financial institutions and the international community hope to avoid major crises and the accompanying repercussions to the global financial system. In some instances in the past, it was politically and/or economically imperative to provide short-term liquidity (ie to act de facto as international lender of last resort)[13].

Roubini identifies three crucial externalities resulting from CAPs among creditors[14]:

- "Rush to the exits": With a sovereign debt crisis imminent, many creditors try to liquidate their claims at the same time, causing chaos with real and avoidable costs.

- "Rush to the courthouse"/"grab race"[15]: Creditors use litigation to recover their claims. If creditors manage to attach debtor's assets this problem becomes serious. Because of sovereign immunity, this ability of creditors to attach is usually very limited in the sovereign context. But as we will see in Part C.b below, sovereign immunity in practice offers only limited protection.

- "Free rider/"rogue creditor"/"holdout": Whenever debt restructurings require unanimity among creditors, minority creditors may be able to prevent a restructuring which is beneficial to the majority of the creditors and/or the debtor. "Cramdown" or majority enforcement provisions are a possible solution.

[12] As *Roubini*, 323 notes, CAPs among creditors have always existed but have become more severe in recent years. In the 1980s sovereign debt was usually in form of syndicated bank loans. In the 1990s bond issues have mostly replaced bank loans. As a result of the emergence of secondary market for sovereign bonds, bondholders are nowadays highly heterogeneous, more numerous and divergent in their interests. This fact tends to increase the holdout problem (cf. Schwarcz, 960).

[13] Sachs II.

[14] Roubini, 322: "[The] CAPs that seem so intractable in theory may be less serious in reality" because there are a variety of mitigating factors.

[15] For an analysis of the expected consequences of a creditor suit in U.S. courts see Barnett, 88: A suit would "trigger cross defaults clauses in virtually all the debtor's other loan agreements, possibly precipitating an avalanche of litigation and hampering coordinated attempts at recovery or renegotiation of debt."

C. The Existing Legal Framework

The current framework for sovereign debt restructurings is characterized by the absence of specific rules in international law. Debt crises are frequently resolved politically, on an ad-hoc and individual basis. In sovereign debt litigation countries tried to resort to a number of different defenses based on general international law. We will briefly summarize four legal arguments before we examine their practical application in the context of sovereign debt case law in part III.

(a) Article VIII, Section 2b of the IMF Articles of Agreement[16]

One strategy a government might pursue is to ration scarce foreign exchange reserves by limiting payments to external creditors. Contracting parties, including the government itself, which are hindered from repaying their debts might then argue that they are no longer able to fulfill their obligations under the debt contract.

A successful defense based on Article VIII, section 2b has four prerequisites[17]: First, the contract in dispute must be an "exchange contract." Secondly, the contract has to "involve the currency" of an IMF member State. Thirdly, this contract must be contrary to that countries' exchange control regulations. And finally the exchange control regulations must be "maintained or imposed consistently with this Agreement".

Courts have tended to interpret the term "exchange contract" narrowly and therefore this defense was frequently rejected.[18] In addition, the debtor bears the burden of proof to demonstrate that the restrictions were imposed "consistently with this agreement". In the *Libra* case the court expressed doubts that Costa Rica's exchange controls were consistent with the IMF agreement. It noted that Article VIII, section 2b requires prior IMF approval for every restriction of payments and transfers for "current international transactions". Moreover, the court was doubtful as to whether contracts could be invalidated retroactively by exchange control regulations, even when they were imposed in harmony wit the IMF agreement.

[16] „Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions. Exchange rate contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

[17] Powers, 2274.

[18] Cf. *Libra Bank Ltd. v. Banco National de Costa Rica* (570 F. Supp. 870 (S.D.N.Y. 1983). For further references to both US and international jurisdictions see Powers, 2274.

(b) Sovereign Immunity

Another possible defense is sovereign immunity, which imposes a jurisdictional bar for (certain) suits against sovereigns. In the United States sovereign immunity was codified in the Foreign Sovereign Immunities Act of 1976. This act establishes sovereign immunity as a matter of principle, but nonetheless it contains several important exceptions. In case of sovereign debt litigation, the most important exception is undoubtedly the possibility to give up immunity by explicit or even implicit waiver.[19] In addition, there is an exception for "commercial activities". In *Republic of Argentina v. Weltover, Inc.*[20] the U.S. Supreme Court affirmed that sovereign borrowing constituted "commercial activity" within the meaning of the FSIA.

(c) Act of State Doctrine

At first sight the Act of State Doctrine might seem to be a more promising line of defense. This doctrine prevents courts from judging the validity of actions of a foreign sovereign performed within its own borders.[21] In our context it is important to note that in contrast to sovereign immunity it cannot be waived under any circumstances. There is, however, one major obstacle to the doctrine's effectiveness in our case: It only applies to acts performed within the territory of the foreign nation. The situs of the debt then "effectively determines whether the act of state doctrine will bar an action to collect the debt."[22] In the *Allied* case the court held that New York had the greater share in the debt situs for Act of State purposes.[23] Therefore the Act of State doctrine did not apply in this case. The holding of this case applies more generally: Whenever debt contracts provide for payment in U.S. dollars and jurisdiction in U.S. courts, then the Act of State doctrine will essentially be foreclosed.[24]

(d) International Comity

In *Hilton v. Guyot*[25], the U.S. Supreme Court defined comity as "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another country." In contrast to the Act of State doctrine, it is not a rule of law. Rather it is a rule of convenience intended to foster amiable relations among nations. In our context there are two important elements to international comity[26]: (i) Unlike the Act

[19] Sovereign bond and loan contracts often contain these waivers (Powers, 2278).
[20] 504 U.S. 607 (1992).
[21] Cf. Chief Justice Fuller in *Underhill v. Hernandez* (168 U.S. 250, 252 (1897)): "Every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgement on the acts of another done within its own territory."
[22] Powers, 2734.
[23] Powers, 2737.
[24] Ibid.
[25] 159 U.S. 113, 164 (1895).
[26] Powers, 2738.

of State Doctrine, comity has no territorial limitation; and (ii) comity will only be extended to sovereign acts that are consistent with the law and policy of the country granting comity.[27]

We will now examine four interesting US cases to illustrate the tremendous legal and political difficulties involved in sovereign debt restructurings.

III. RECENT SOVEREIGN DEBT CASE LAW

A. Allied Bank International v. Banco Credito Agricola de Cartago (1985)[28]

In 1981, Costa Rica suspended debt payments to its bank syndicate. A restructuring agreement was signed with all but one of the thirty-nine members of the syndicate: Fidelity Union Trust of New Jersey which sued through its agent, *Allied Bank*. Initially, the U.S. Court of Appeals for the 2nd Circuit upheld the district court's ruling in favor of Costa Rica. The court held that "Costa Rica's prohibition of payments of its external debt is analogous to the reorganization of a business pursuant to Chapter 11 of our Bankruptcy Code …. [it was] not a repudiation of the debt but rather was merely a deferral of payments while [Costa Rica] attempted in good faith to renegotiate its obligations." Shortly afterwards, *Allied Bank* requested a rehearing of the case. In the new proceedings, the U.S. government submitted an amicus curiae brief stating that contrary to the court's erstwhile assumptions, it did not agree with "Costa Rica's attempted unilateral restructuring". Rather they supported the renegotiation procedure under the auspices of the IMF "grounded in the understanding that while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable."

Even though the court was subsequently settled, the court implicitly suggested that an analogy to Chapter 11 of the US Bankruptcy Code is invalid in the case of a sovereign debt crisis: The court held that "the Costa Rican government's unilateral attempt to repudiate private, commercial obligations is inconsistent with the orderly resolution of the international debt problems."

This case raises an interesting question: What would or could a procedure akin to Chapter 11 protect countries from in the first place?[29] What does make a default so costly from the debtor's perspective? The debtor country will have the means – at least in most cases – to unilaterally protect itself from its creditors because judgments cannot be enforced. Parts of the Economics literature on the subject asserts that failure to repay sovereign debts brings about a significant loss of reputation in international financial markets, thereby foreclosing this source of financing for an extended period of time[30]. In this view, the international legal system has no or very little bite on debtors. *Bulow* and *Rogoff* subsequently demonstrated the shortcomings

[27] See *Pravin Banker* III.C below for a fine example of the role of international comity in sovereign debt litigation.
[28] *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d cir. 1985); Rogoff, 7.
[29] Rogoff, 8.
[30] Rogoff, 8; Cohen /Sachs.

of a pure reputation model, ie that countries are concerned about more than just their reputation in financial centers. This lends support to the theory that the institutional framework for governing sovereign debt crises matters.[31]

B. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil (1995)[32]

This case involves the refusal of a wealthy US family to participate in Brazil's restructuring. The case is important as more than $60 billion were involved and because of the principles established by the U.S. District Court for the Southern District of New York.[33] This is illustrated by the fact that the US government, the Brazilian Central Bank as well as the Bank Advisory Committee (BAC) intervened in the case.

In 1982 Brazil defaulted on its debt. After a series of reschedulings, Brazil and its creditors signed a Multi-Year Deposit Facility Agreement (MYDFA) to restructure the majority of Brazil's debt to commercial banks. The terms of the MYDFA provided for the acceleration of the entire principal in case of Brazil's default. Brazil was shortly afterwards again unable to service its debt. The subsequent restructuring pursuant to the Brady plan[34] offered two options to convert the MYDFA debt into Brady bonds: 1. Par bonds (value of their MYDFA principal, but a lower, fixed interest rate) collateralized by U.S. Treasury bonds; 2. uncollateralized bonds at full principal value paying 4% interest initially, then rising up to 8%. After this accord had been finalized, Brazil sought to change the terms of the MYDFA to include a minimum of thirty-five percent of another form of collateralised bonds: discounted bonds from the face value of the MYDFA with a floating interest rate, covering a minimum of 35% of the principal. More than seven hundred creditors agreed to this new proposal and deep reductions to their claims, except for the Dart family.[35] This industrial family had purchased huge amounts of Brazilian debt in the secondary market. At the time of the conversion, they held bonds with a face value of $1.4 billion and were Brazil's fourth largest creditor.[36] The Darts obstructed the restructuring because they were set to reap a profit of $360 million from converting their MDYFA debt into uncollateralized bonds according to the original plan. The new agreement amounted to a potential profit of "only" $270 million.[37] They also had the option of selling their bonds on the secondary market for a profit. The Darts subsequently designated CIBC Bank and Trust Company (Cayman) Ltd. as holder-of-record for their MYDFA debt.

Brazil took defensive measures in order to prevent the Darts from gaining control of the majority of the debt: The Brazilian Central Bank kept $1.6 billion in MDYFA debt so that the Darts would not hold more than

[31] Rogoff, 8.
[32] *CIBC Bank and Trust Co. v. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D.N.Y. 1995).
[33] Goldman, 185.
[34] See Cline: The Brady plans suggests to restructure loans into discounted bonds with a floating interest rate or on par bonds with a fixed interest rate. The basic idea of the Brady plan was to increase the likelihood of paying the residual claims, in return for some forgiveness on the existing debt. The principal would be collateralised with US. zero-coupon bonds.
[35] Kenneth Gilpin, Darts Clash With Brazil Over Loans, N.Y. Times, October 23 1993.
[36] Ibid.
[37] Ibid.

forty-nine percent of the MDYFA after the Brady bond conversion. As a result, it was not possible to declare a default without BdB's vote. In anticipation of a lawsuit and attempts to attach Brazilian assets, Brazilian commercial banks operating in the US were instructed to deposit long positions over $10 million in BdB's subsidiary on the Cayman Islands.

After having failed to obtain better terms than other creditors, the Dart family filed suit against BdB in the Southern District of New York. They alleged that BdB had retained $1.6 billion in debt in bad faith in order to prevent the Darts from controlling the majority of the debt. They sought repayment of the full principal ($ 1.4 billion) and $60 million in accrued interest as well as a declaration that they had the right to accelerate the MYDFA debt without the consent of the Brazilian Central Bank. The defendant did not raise any defenses such as sovereign immunity or act of state. Rather BdB based its argument exclusively on the terms of the MYDFA.

First, they argued that CIBC lacked standing to sue because the assignment of the debt to CIBC was invalid under the provisions of the MYDFA. Second, BdB alleged that the assignment violated NY's champerty law[38]. The court dismissed both arguments by saying that such an assignment was endorsed by the MYDFA.

CIBC further alleged that BdB had breached the terms of the MYDFA because it had failed to pay parts of the interest accrued. The court found that there was a breach of contract in this respect and estimated the damages to the Darts at approximately $60 million. The court also concurred with CIBC in that BdB shall be liable for CIBC's costs and expenses according to the terms of the MYDFA.

As to the sought declaration, BdB argued that CIBC could not accelerate the MYDFA debt without the consent of the majority creditor, itself. While the Darts conceded that they were not controlling the majority of the debt, they went on to argue that BdB's share should be disregarded because it was retained in a bad faith attempt to block CIBC's move to accelerate the MYDFA. CIBC argued that the MYDFA contained an implied covenant of good faith and fair dealing[39] and reasoned by analogy to four areas of law in support of their argument: The NY common law on compositions which states that in the approval of the composition the votes of the creditors who are controlled by the debtor are discounted; section 1120 of the U.S. Bankruptcy Code, under which entities controlled by, or under common control with, the debtor shall not vote on whether a reorganization plan will be accepted[40]; Trust Indenture Act of 1939 under which bondholders controlled by the issuer are excluded from voting on default by the issuer; Section 612(b) of the

[38] The New York Judiciary Act, Section 489 prohibits the transfer of interest for the intent of bringing an action thereon.
[39] Goldman, 188.
[40] See 11 U.S.C. § 101(31) (1994).

New York Business Corporation Law, which prevents a subsidiary corporation from voting shares held in its parent.[41]

The court acknowledged the Darts' creativity, but found their argument "wholly unpersuasive."[42] The court said that the Trust Indenture Act explicitly does not apply to sovereign debt. Furthermore, the New York Business Corporation Law is "as distant in terms of reasoning as New York is from Brazil in terms of geography."[43] As to the law on compositions and section 1120 the Court noted that these sources merely prevent entities controlled by the debtor from voting whether to accept a reorganization in the first instance. The current case, however, deals with the interpretation of an already confirmed restructuring plan. Therefore an analogy to these two sources of the law is invalid. In addition, the court held that under the CIBC's interpretation, an implied covenant would override the express terms of a contract, changing express provisions contained in the MDYFA and significantly altering the rights of the parties. The court also noted that if the MYDFA wanted to exclude BdB's share from voting that would have done so. From the actual formulation of the MYDFA it is apparent that BdB is allowed to retain its share and "vote its share of that debt in order to hinder an attempt at acceleration by another creditor."[44]

As a result, the court dismissed the Dart's claim for a declaration of their right to unilaterally accelerate the debt. The reasoning of the court rests on the assumption that the question of whether the Darts had the right to unilaterally declare an acceleration was a question of pure interpretation of an „existing composition", ie the MYDFA. It could plausibly be argued that not the MYDFA, but the subsequent accord is the original source of Brazil's obligation and that Brazil's last-minute attempt to introduce a minimum requirement of uncollateralized bonds is an attempt to "alter the relative bargaining strengths of the debtor and [its] creditors in [the] reorganization negotiations."[45] Accordingly, if a court were more inclined to draw an analogy to the US Bankruptcy Code[46] it might view Brazil's "calculated retention of MYDFA debt as a bad faith attempt to retaliate against the Darts for refusing to accept the plan as offered" and to try to "cram down" an inequitable reorganization plan with the fourth-largest creditor in dissent.[47]

In 1996, the case was settled for a $25 million cash payment and $52.3 million in bonds (accrued interest). The court's dismissal of the claim to accelerate the principal could have a huge impact on future sovereign debt litigation. The court seems to suggest that contracts may be drafted to constrain secondary creditors. If acceleration may thus be restricted, the sovereign could try to restrict the possibility of suing by holding on

[41] Power, 2749.
[42] *CIBC Bank and Trust Co. v. Banco Central do Brasil.*
[43] Ibid.
[44] Ibid.
[45] Powers, 2750.
[46] A debtor in Chapter 11 must propose a reorganization plan in good faith (11 U.S.C. § 1129(a)(3) 1994) and this plan must subsequently be accepted by every impaired creditor class (§ 1129(a)(8) (1994). Alternatively, 11 U.S.C. § 1129(b)(1) contains a "cram down" provision. The plan can still be confirmed if it does not discriminate unfairly and if it is fair with respect to each class of impaired creditors which has not accepted the reorganization plan.
[47] Powers, 2750.

an appropriate proportion of the debt.[48] Most large financial institutions might well go along with this. If one creditor moves to accelerate, this creates a "snowball effect". The other creditors must also sue to preserve their interests. International commercial banks will be loath in most cases to destroy continuing relationships with the debtor nation. Their primary interest is that the debtor resumes servicing the debt. One could argue that this case is rather unique because in general the recalcitrant creditor(s) will hold less debt and that therefore the majority is controlled by large financial institutions with more "constructive" interests.

Curiously, the ruling leaves open whether the Darts could eventually recover the full $1.4 billion of outstanding principal at maturity of the MYDFA debt, a question that the court was not technically asked to address. The *Allied* case at first sight answers this in the affirmative. We have already suggested, however, that sovereign debt cases are peculiar in that a multitude of foreign policy and humanitarian consideration might influence the final decision. The United States issued a Statement of Interest urging the court to dismiss the Dart's request to accelerate the MYDFA debt. This is in sharp contrast to the U.S. position in *Allied,* where the U.S. government put an emphasis on a private contract rights and enforcement. This casts doubt on the continuing validity of the *Allied* case with respect to purchases of sovereign in the secondary market. Has U.S policy shifted so substantially over the course of a decade?

In its brief[49], the U.S. government argues that "there has been a dramatic increase in the number of secondary market purchasers of sovereign debt", and as a consequence the relationship between LDC and their creditors has dramatically altered. Back at the time of the *Allied* case, a number of factors contributed to an orderly resolution of sovereign debt crises, among them "pressure from like-minded fellow creditors that helped constrain impulsive or short-sighted behavior; a limited number of "rogue banks "unwilling to participate in sovereign debt restructurings, preferring instead to litigate to enforce their contractual rights." The growth of the secondary market is significant because secondary market purchasers "do not necessarily have the same long-term interests as the commercial bank creditors." In the absence, of "a neutral decision making body, such as a bankruptcy court, with authority to restructure sovereign debt" this is a reason to worry: One could therefore expect a larger number of lawsuits stemming from sovereign debt crises in the future.

In the *Allied* case, the U.S. government was concerned that a judgment in favor of Costa Rica would lead sovereign debtors to resort to litigation in order to extract more advantageous terms than they could obtain through negotiation with their creditors.[50] In *CIBC,* by contrast, the U.S. was very much concerned with the prospect of creditors "abusing" courts to extract unfair concessions from LDC. Interestingly, the administration also suggested that the availability of "cheap", discounted sovereign debt in the secondary

[48] Goldman, 188.
[49] Statement of Interest of the United States of America in Opposition to the First Amended Complaint, *CIBC Bank And Trust Co. (Cayman) Ltd. V. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D.N.Y. 1995) (No. 94 Civ. 4733) [Statement of Interest].
[50] Powers, 2752.

market "has lowered creditors' reasonable expectations of full repayment."[51] The Statement of Interest states that "[sovereign] debt obligations have two values": The original legal contract value and the generally recognized market value. While the U.S. government stops short of suggesting that the Darts, who purchased at a 55% discount, should only be able to recover the debt's second value and not the full outstanding face value of the bonds, the Statement of Interest notes that "certain creditors – like Dart - … may seek through litigation to benefit from *voluntary* debt reduction previously agreed to by the commercial banks … rather than negotiate a restructuring with the debtor in the orderly manner"[italics added] that is consistent with US foreign policy and evidenced in the Brady plans.[52] The U.S. thus asserts its opposition to litigation on the part of secondary market purchaser to obtain more favorable terms than the rest of Brazil's creditors who accepted considerable write-offs from their MDYFA debt by accepting discounted Brady bonds and thereby supported the U.S. foreign policy objective of an orderly restructuring of Brazil's debt and of stability in the international financial system.

C. Pravin Banker Associates v. Banco Popular del Peru[53] (1997)

Sovereign debt litigation involves a number of policy considerations. In this case, which revolves around the proper amount of discovery and the holdout creditor, the defendant *Banco Popular* tries to resort to the defence of international comity.

Banco Popular del Peru is a state-owned, commercial bank which had borrowed the money on behalf of the government of Peru which guaranteed the debt. The debt was payable in New York in US dollars. In 1983, the Peruvian government imposed restrictions on the payment of foreign exchange in order to prevent the depletion of its already insufficient reserves. As a result of these exchange control regulations, Banco Popular had stopped making payments towards the principal, only paying mature interest. Most of Peru's creditors, including Mellon Bank, filed suit in order to preserve their claims in light of the statute of limitations. In 1990, Alberto Fujimori won the presidential elections, instituted major economic reforms and Peru forthwith attempted to comply with IMF prescriptions. A Bank Advisory Committee headed by Citibank agreed to stay all lawsuits to restructure the debt under the Brady Plan.

In 1990, at a time when the debt was in technical default, *Pravin Banker* acquired a small portion ($9 million) of Peruvian foreign debt at a 73% discount off its face value. Notified of the assignment, Peru made interest payments to *Pravin Banker.* Two days later all but $ 1.4 million of the debt was sold to other investors for an undisclosed price. In February 1992 *Pravin Banker* served *Banco Popular* a notice of

[52] Statement of Interest.
[53] *Pravin Bankers Assocs Ltd. v. Banco Popular del Peru.*

default. In 1992, the Peruvian financial regulator instituted liquidation procedures against *Banco Popular*. *Pravin Banker* did not file a claim in *Banco Popular*'s liquidation proceedings and refused to participate in the Brady plan negotiations, but instead chose to file suit against in NY. Action was brought against both *Banco Popular* and the Republic of Peru, which acted as guarantor of the debt.

At the time of filing suit, Peru's debt in the secondary market stood at thirty-four cents on the dollar. In view of the purchasing price, *Pravin Banker* would therefore have been set to reap a profit of seven cents for each dollar of debt sold. In case of judgement in its favor *Pravin Banker* would gain a profit of seventy-three cents on each dollar of debt in its portfolio. Because of the ongoing Brady Plan restructuring negotiations with its commercial banks, *Pravin* could also be confident that the Peruvian government had every interest to settle the suit quickly and quietly. This is due to the fact that the stay on pending lawsuits was dependant upon no other collection action going forward against Peru. If *Pravin Banker* were to succeed, the commercial bank creditors would no longer be bound by this freezing agreement, and most likely they would (be forced to) reactivate their lawsuits.[54]

Peru raised two defenses: First, they argue that a judgment in favor auf *Pravin Banker* would "reawaken all the other lawsuits that the BAC had succeeded in staying."[55] Thus, this suit would completely disrupt Peru's ongoing restructuring negotiations.[56] In the words of the defendant "U.S. public policy … encourages negotiation under the auspices of the IMF".[57] To grant summary judgment would thus be inconsistent with U.S. foreign policy objectives. *Pravin Banker*'s suit thus agued that the suit should be dismissed in the interest of international comity. The court notes that comity's purpose is "to promote cooperation and reciprocity within foreign lands". Yet comity "remains a rule of practice and convenience rather than law."[58] "[C]ourts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States."[59] Moreover Peru argued that allowing *Pravin Banker* to recover the full face value of the outstanding debt would constitute unjust enrichment.[60]

Responding to the comity defense, *Pravin Banker* argued that its collection rights were established by the *Allied* case law. In addition, adopting Peru's argument on unjust enrichment would "create massive

[54] Power, 2755.
[55] *Pravin Bankers Assocs., Ltd. v. Banco Popular del Peru*.
[56] See Defendant's Memorandum in Support of Their Motion to Dismiss or Stay and in Opposition to Plaintiff's Motion for Summary Judgement, July 19, 1993, *Pravin Bankers Assocs., Ltd. v. Banco Popular del Peru*, 895 F. Supp. 660 (S.D.N.Y 1995) (93 Civ. 0094): "Pravin is misusing the Court's process to create disruption in an internationally sanctioned procedure for resolving Peru's sovereign debt problems. Pravin appears to be trying to use the threat of this case to extract concessions which Peru can not provide to other similarly situated creditors." [Defendant's Memorandum].
[57] Ibid.
[58] Ibid.
[59] Ibid. [*quoting Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516, 522 (2d Cir. 1985)].
[60] Ibid.

disruption of the financial markets, in which instruments payable at par are regularly purchased at a discount."[61] Noting that *Pravin Banker* had not offered any explanation for its refusal to participate in the Peruvian liquidation of *Banco Popular*, the court adjourned both motions for a period of six months.

Upon resumption of the suit, *Pravin* asserted that "regardless of any defences *Banco Popular* may assert, [by virtue of Peru's guarantee in the United States] it may not assert these defences on its own behalf."[62] *Pravin Banker* thus argued that the ongoing liquidation of *Banco Popular* should not prevent it from suing Peru directly. Responding, Peru reiterated that it was negotiating in good faith with its BAC in order to accomplish an orderly restructuring and that *Pravin's* suit should be stayed until the closure of the negotiations with the commercial bank creditors. The court issued an additional stay of sixty days and asked both plaintiff and defendant to respond to a variety of questions on the progress of Peru's negotiations.[63]

The following twist of the case may have tilted the decision in favor of *Pravin Banker*. The parties offered markedly different accounts of the status of the Peruvian negotiations. *Pravin Banker* submitted various press reports to prove that – while negotiations with the BAC were continuing and without informing the commercial banks[64] – Peru had secretly bought back approximately $2 billion of its total outstanding debt of $3.8 billion at a forty-five percent discount in the secondary market using privatisation proceeds located in Swiss bank accounts.[65] In its memorandum, *Pravin Banker* pointed to the implications of the quiet buy-back: "[Peru] is circumventing the debt restructuring negotiations by using its dollar reserves to secretly cash out certain holders of its debt while keeping the balance of its creditors at bay"[66]. Agreeing with *Pravin Banker*, the court seems to have interpreted Peru's action as dilatory tactics and as evidence that Peru itself was willing to risk the success of its negotiations. Thus the court reached the conclusion that Peru violated the equitable principle of treating all its creditors equally and was therefore not entitled to international comity.

Reaffirming the holding of the *Allied* case[67], the court granted *Pravin Banker*'s motion for summary judgement. In a second step, the court sought to determine to what extent U.S policy on sovereign debt restructuring had shifted since the time of the *Allied* case. Peru argued that subsequent advocacy in favor of the US Brady Plan was evidence of a shift in US policy towards debt forgiveness for sovereign debtors in

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[61] Plaintiff's Memorandum in Opposition to Defendants' Motion to Dismiss or Stay and in Further Support of its Motion for Summary Judgement, August 6, 1993, *Pravin Banker Assocs., Ltd. V. Banco Popular del Peru*, 895 F. Supp. 660 (S.D.N.Y. 1995) (93 Civ. 0094): The "purchaser of [sovereign debt] acquires the right to enforce the obligations in accordance with their terms, not watered down rights as measured by its subjective expectations at the time of purchase." [Plaintiff's Memorandum].

[62] Plaintiff's Memorandum.

[63] Powers, 2757.

[64] "Peru saves $1 bn in Daring Debt Buy-Back of Foreign Debt", Financial Times, August 1 1995: the buy-back "has angered some banks because Peru has used money which, they believe, could have been used to repay debt and, instead, has bought back its obligations at discounted price."

[65] Ibid.

[66] Plaintiff's Memorandum.

[67] Namely that a sovereign debtor's unilateral suspension of external debt is not entitled to deference in the interest of international comity unless this suspension is consistent with U.S. public policy.

financial distress. Moreover, the Peruvian government drew the attention of the Court to US Statement of Interest in *CIBC*: The U.S. government had argued that the emergence of a secondary market for sovereign debt had dangerously tilted the balance of power in sovereign debt negotiations and had lowered the legitimate expectations on eventual repayment.[68]

While acknowledging that U.S. policy had shifted significantly since the *Allied* case, the court was not persuaded by these arguments: The Brady plan calls "for *voluntary* participation by creditor banks … [it] does not abrogate rights of creditor banks, nor does it *compel* creditors to forbear from enforcing those rights while debt restructuring negotiations are ongoing, or prohibit them from "opting out" of settlements resulting from such negotiations."[69] Thereby the Court affirmed – as it already had affirmed in the *Allied* case for commercial bank creditors – the creditor's right to reject a restructuring proposal supported by a majority of creditors.[70] The Court notes that the "CIBC Statement of Interest's observation that secondary market sovereign debt purchasers often have divergent interests from original lender creditors cuts in favor of *Pravin* … [its] interest may well diverge from those of the creditor banks …. the [BAC] does not provide *Pravin* with a forum in which to exert influence on the negotiation affecting the restructuring of [its] debt.[71]

There is an apparent contradiction between the affirmation in the *Allied* case that creditors have a unilateral right to hold the sovereign to the loan agreement and the holding in the *CIBC* case[72]. To the court in CIBC, the Darts had sued in order to effectively *change* the terms of their loan agreements whereas in the *Pravin* case just an enforcement of the terms of the agreement was sought.

Curiously enough, even though the court had twice stayed *Pravin Banker's* action on comity grounds, the same rationale was not applied to deny summary judgment.[73] One possible explanation for the court's apparent reversal is the secret Peruvian buy-back of $2 billion of outstanding debt.[74] The court may well have been concerned that Peru was using dilatory tactics, superficially negotiating with its creditors while quietly buying back its debt at steep discounts. Interpreting comity in a novel way (as cutting both ways and also binding the sovereign by reciprocity), the court might have taken into account in its balancing of competing interests that Peru was itself willing to jeopardize its debt restructuring negotiations, which Peru had argued were vital to U.S. policy. The court therefore seems to suggest that invoking comity in this context is only possible if the sovereign abstains from undermining the U.S. policy interests upon which comity shall be extended.

[68] Statement of Interest.
[69] *Pravin Bankers Assocs., Ltd. v. Banco Popular del Peru*.
[70] Powers, 2758.
[71] *Pravin Bankers Assocs., Ltd. v. Banco Popular del Peru.*
[72] Powers, 2759.
[73] Powers, 1759.
[74] See the reference to the press reports in the court's decision.

By looking at this situation from Peru's perspective, one could point out an apparent double standard in the court's decision. Peru could rightly argue that is was only trying to reap the same benefits of steep discounts in the secondary market as *Pravin Banker* itself had done. Pravin sought to benefit from the very same market conditions as Peru and initiated a suit to that end, putting the ongoing negotiations at risk. Moreover, the court initially failed to pay much attention to the Peruvian unjust enrichment argument. It is only upon the defendants' move to vacate the judgment by virtue of the fact that it was not for a fixed sum that the court entertained the issue in some more depths.

At re-argument, Peru contended that face value recovery upon default was not contemplated by either party. By the same token, recovery would constitute unjust enrichment and, most importantly, *Pravin Banker* is set to gain a huge windfall profit from the economic plight of the Peruvian people.[75] The court, however, was not swayed by this emotional appeal and pronounced a judgment for the full face value of the outstanding principal and overdue interest.[76] It affirmed that the substantial discount in the secondary market price at the time of purchase through *Pravin Banker* was irrelevant to the determination of the amount owed upon default. According to the court, it merely reflects the expected probability of eventual full repayment. If one follows through the court's reasoning to its logical conclusion, *Pravin Banker* would have had to expect to be repaid the full amount even in case of default. Certainly, *Pravin* believed it had purchased the *right* to receive full repayment; this is, however, not the same as expecting *actual* repayment.[77] It should be noted that *Pravin Banker* is set to reap a substantial even if Peru repaid only a small percent of the principal and paid interest in regular intervals.

The court went to great length in order to distinguish the *Pravin* decision from *CIBC* on purely legal grounds.[78] The court emphasizes that Brady plan negotiations are meant to be *voluntary*. Denying summary judgment *to Pravin Banker* would imply that enforcement of the underlying debt – inconsistent with U.S. policy – were conditional on a debt negotiation procedure with no clear deadline.[79] There is a legitimate

[75] See Defendant's Memorandum: "Pravin was not an original lender to Banco Popular; it has never conferred any benefits upon Banco Popular or Peru. Pravin is not in the same position as the many lenders who lent funds to Peru and have waited many years for repayment. Pravin is merely a speculator in the secondary market debt who is attempting to use the tactics of disruption to obtain a windfall which it could not obtain through the marketplace… the Peruvian people have suffered through a three-year austerity program that has required many sacrifices, lost jobs, high prices, and a dwindling value of their currency… Due to the success of Peru's economic program, Peruvian non-performing debt is not quoted by Citibank at 34 cents. This benefit is exactly the benefit Pravin expected to receive when it purchased the Banco Popular debt … it was general knowledge in the international financial community that Peru did not have the capacity to repay its foreign debt… Pravin, which is a sophisticated investor, was well aware that it could not recover the princip[al] of the Banco Popular in the near future. In response, Pravin Banker argued that the face amount of the debt instruments could not be recovered, "no investor would ever purchase distressed debt instruments at a discount – in essence paying $..50 for the privilege of *possibly* getting $.50 back in the future." [Italics added]. [Memordandum of Pravin Banker Assocs, Ltd. In Support of Judgement and in Reponse to Defendant's Reply Memorandum in Opposition to Notice to Settle Judgement."

[76] *Pravin Banker*: "The term principal amount [does not have] a different meaning once a default occurs than it would [have] if the debt were paid on schedule … The incentive for acquiring [this] type of debt, at whatever cost, is the possibility of eventual full payment of principal as due under the contract."

[77] Powers, 2761.

[78] Powers, 2762.

[79] Goldman, 192.

question to be asked: Just why does the court arrive at two opposing results in apparently very similar situations? The probable key element is a different outcome of a tricky balancing act between competing interests: On the one hand, it is U.S. official policy to advocate the Brady Plan and support foreign debt crises resolution under IMF auspices.[80] On the other hand, the U.S. government has a major interest in ensuring the enforceability of rights established in accordance with contract law.[81]

The fact that the balance tilts differently in the two cases may be conveniently explained by a single, albeit important factual difference: *Pravin* held exactly $1.4 *million* in Peruvian debt, whereas the Darts held $1.4 *billion* in Brazilian debt. The Dart's claim – by virtue of its enormous size - had the very real potential to ruin Brazil's Brady Plan restructuring and to wreak economic havoc in the largest country in Latin America. *Pravin's* smaller claim – despite the fact of being an unwelcome factor in Peru's negotiations – was less likely to cause seriously affect the negotiations.[82] Because Peru had violated the equitable principle of treating all its creditors equally in the judgment of the court, there was an additional argument in favor of maintaining *Pravin Banker's* rights.

By now it should be apparent that sovereign debt cases are not just about plain contract interpretation. Rather, U.S. courts engage in a pragmatic balancing of creditor's rights against the economic condition of the country concerned as well as the sustainability of its debt. Sovereign debt cares are not decided purely on legal grounds; rather they have a political and humanitarian dimension as well, often closely intertwined with the legal case. The question can therefore only be addressed with an understanding of the context in which the creditor's rights were established. One might be tempted to regard these creditor rights as *sui generis.*

D. Elliot Associates v. Banco de la Nacion[83] (1998)

An investment fund purchased Peruvian debt and subsequently attempted enforcement as Peru was experiencing a foreign exchange crisis. In many ways the case is similar in the court's reasoning to *Pravin Banker*. *Elliot Associates* is a speculative ("vulture") fund[84] which had already operated very successfully in the secondary sovereign debt market in the past.[85] In the present case, the fund had purchased $20.7 million

[80] See Statement of Interest.
[81] Goldman, 191.
[82] Goldman, 2762 ; See also Gold or Guano? The Economist, November 4 1995 considering that the terms of the contract are highly favourable to Peru: :[A]fter 12 years of paying almost nothing to its creditors, Peru … has secured a 40% discount on $10 billion of debt and interest; last year neighboring Ecuador got only 23%"; Peru Reaches Debt Accord, N.Y. Times, October 30 1995 noting that "two months after the court granted Pravin's motion for summary judgement, Peru and its commercial bank creditors signed an agreement-in-principle to proceed with the country's Brady deal."
[83] *Elliott Associates.*
[84] A fund that invests primarily in debtors that have defaulted on their payments to creditors or more broadly in "distressed" debtors.
[85] It had purchased $ 28.75 million of Panamanian debt for $17.5 million. The firm managed to recover about $ 57 million.

of Peruvian debt, discounted to $11.4 million.[86] Shortly afterwards, Elliott sent a notice of default to *BdlN* in which it formally requested repayment. Pursuant to the Foreign Sovereign Immunities Act[87] the complaint was removed to the District Court for the Southern District of New York. The fund moved to attach Peru's U.S. Treasury Bonds to satisfy its claims and motioned for summary judgment.

The District Court dismissed the action referring to Section 489 as a violation of the NY champerty law[88], noting that "Elliot purchased the Peruvian debt with the intent and purpose to sue."[89] The judgement is reversed on appeal by the Second Circuit, holding that "Section 489 [of the champerty law] is not violated when, as here, the accused party's "primary goal" is found to be satisfaction of a valid debt and its intent is only to sue absent full performance."[90]

The case is an excellent illustration of Peru's exercise of the champerty defense: Peru successfully argued that Elliot Associates had violated New York's champerty law[91]. That is to say that Elliot purchased the debt with intent to bring suit thereon. Interestingly, the timing of the purchase coincided with the Second Circuit's decision in the *Pravin Banker* case. Elliott purchased its debt only after the *Pravin* decision was rendered. The court held that the vulture fund failed to negotiate in good faith, failed to seriously explore alternatives to litigation, did not participate in the Brady plan negotiation and waited until shortly before the final Brady reorganization deal was to be signed before filing suit. The timing was probably chosen in order to be able to attach the U.S. Treasury Bonds, deposited with the Federal Reserve Bank of New York, which Peru was about to purchase pursuant to the Brady Plan reorganization. In addition, the District Court noted that Section 489 was "a penal law directed at the public interest, and therefore cannot be waived."[92] The Court also said its proper role was "not to make policy assessments".[93]

Finding that "acquisition of a debt with intent to bring suit against a debtor is not a violation where the primary purpose is the collection of the debt"[94], the Second Circuit reversed the decision. The Circuit Court based its decision on *Moses v. Divitt*[95], though decided more than hundred year ago, "still remains good law". The holding of this case states that a violation of Section 489 depends on whether "the primary purpose of the purchase was to bring suit, or whether the intention to sue was only secondary and contingent, and the suit was resorted to only for the protection of rights of the purchaser, in case the primary purpose was

[86] The discount was caused by two factors: 1. a possible Peruvian default. 2. it was "Working capital debt" (direct loans between single lenders and borrowers), which typically trades at a discount of several percentage points from syndicated bank debt because of higher associated risks and its illiquidity (Goldman, 192).
[87] 28 U.S.C. 1441 (d) 1994.
[88] According to Black's law dictionary "an agreement between a stranger to a lawsuit and a litigant by which the stranger pursues the litigant's claim as consideration for receiving part of any judgement proceeds."
[89] *Elliott Associates.*
[90] Ibid.
[91] *Elliot Associates*: "Commentators have traced the doctrine of champerty … back to Greek and Roman law, through the English law of the Middle Age, and into the statutory or common law of many of the states."
[92] *Elliot Associates.*
[93] Ibid.
[94] Ibid.
[95] 88 N.Y. 62 (1882).

frustrated."[96] Thus, the main purpose of the purchase must not be a lawsuit, the suit may only be one option among others. The court finds that the debt was enforceable because the decision to litigate was secondary[97], "incidental and contingent" to the decision to purchase the debt. "Incidental" in the sense that the primary purpose was to receive satisfaction of the claim, "contingent" because the suit was initiated only after the debtor's refusal to pay.[98] In addition, the court seems to take into account *Elliot's* "legitimate business purpose" and the fact that Elliott had suffered "a real loss". [99] This last point in particular is highly questionable.

The important result of this case is that champerty law will in general not shield sovereign debtors from collection. The court establishes that the enforceability of sovereign debt limits the U.S. policy interest in the success in an IMF-led restructuring.[100] In contrast to the District Court, the Circuit Court explicitly acknowledges the influence of economic policy considerations on its decision: By refusing enforceability of the debt, NY's attractiveness as a world financial center would be dramatically reduced, encouraging "potential parties … to conduct their business elsewhere"[101], at the detriment of LDCs seeking to borrow capital. In the eyes of the court, Section 489 is akin to the "cram-down" procedure of the US Bankruptcy Code, "making debt instruments unenforceable once the BAC has reached an agreement in principle, and undermining the voluntary nature of the Brady plan."[102] The Court also seems to be concerned about the viability of the secondary market, saying that it "could be disrupted and perhaps destroyed"[103], if creditors were unable to sue. Emphasizing the principle of *voluntary* Brady plan negotiations, the Court says holdout investors should not be condemned merely because it decided to "stand apart from the lenders who had agreed to the Brady restructuring, and to use judicial process to compel full payment."[104] The court's balancing potentially has an adverse impact upon future sovereign restructurings.

In the last section, we will sketch out the main currents of official and academic reform proposals to improve the sovereign debt restructuring process.

[96] *Elliot Associates.*
[97] Ibid.
[98] The court's reasoning is partly tautological: "Although the district court found Elliott knew Peru would not … pay …, this does not make Elliott's intent to file any less contingent." Indeed, taking this reasoning to its logical conclusion, (almost) any lawsuit would be "contingent". This extremely narrow interpretation voids the champerty statute of its applicability in all practical cases.
[99] *Elliott Associates.*
[100] Ibid.
[101] Ibid.
[102] Goldman, 195.
[103] Ibid.
[104] Ibid.

IV. SURVEY OF PROPOSALS

Roubini frames the overarching policy question of debt restructurings as follows: "When sovereign debt restructuring or debt reduction becomes unavoidable, what is the appropriate regime that provides for an orderly restructuring while safeguarding the balance of rights of both the creditors and the debtors?"[105]

A. Market-based and statutory proposals

Statutory proposals envisage changes in either national or international law to create rules or institutions which would allow to impose majority-backed agreements on holdout creditors, to give seniority to new financing and to shield sovereign from litigation during standstills or while negotiations were ongoing.[106] The market-based or contractuary approach, on the other hand, focuses on the wording of contracts between debtors and creditors. The incorporation of certain clauses in bond contracts imposes a majority-backed restructuring agreement on rogue creditors. Some proposals go further and require the sharing of proceeds from litigation.

B. Oechsli/Cohen: Analogy to Chapter 11 U.S. Bankruptcy Code [1981/1989][107]

In 1981, legal scholar *Oechsli* set out one of the first reform proposals: "Many of the procedures set forth in Chapter 11 of the US Bankruptcy Reform Act of 1978 for rehabilitating financially troubled businesses can be applied profitably to renegotiation of LDC debt."[108] *Oechsli* singles out two major problems with the status quo: the lack of an established procedure (ie negotiations take too long and their outcome is uncertain) and poor creditor coordination among the private and official sector. He stresses three essential elements of a new framework: (i) a creditor committee, (ii) a monitoring party which leaves the sovereign government fully in charge and (iii) a formal initiation procedure. The independent third-party could be the IMF.

Oechsli emphasizes that the debtor needs to be closely involved in the process and that the procedure could be triggered by petition of creditor or debtor. The IMF, however, would not be bound to accept such a request. Even though Oechsli looks into the creation of a "court-like entity" to fulfill that role, he believes such an institution is ultimately not necessary. Rather "creditors could specify binding arbitration procedures in their loan contracts (including an arbitration entity along the lines of ICSID"). Notwithstanding, he says that in most circumstances private agreement among the parties should be sufficient for a successful renegotiation.

[105] Roubini, 321.
[106] Rogoff, 29.
[107] Cooper, 90–103.
[108] Oechsli, 305-341.

During the 1980s debt crises a number of strategies to deal with this particular crisis were put forward, among them market-based reduction schemes, a proposal for an International Debt Facility, an International Debt Discount Corporation and the Brady Plan. It seems that these proposals targeted at specific crises crowded out more ambitious attempts at reform[109]. One had to wait till the early 1990s for a second wave of proposals, which at the same time went significantly beyond *Oechsli's* original contribution. In addition, some authors asked how a sovereign bankruptcy procedure could fit into the existing institutional framework.

Cohen (1989)[110] extends *Oechsli's* and *Barnett's* proposals. At the core of his suggestion is the creation of an "International Debt Restructuring Agency" by multilateral convention. Ideally, the IDRA would be a "new and independent entity", but in practice it might be more feasible to set it up as a "joint subsidiary of … the IMF and the World Bank". The IDRA's primary role would be that of a "facilitator, mediator, and monitor". Cohen also envisages a more forceful role: The "IRDA could conceivably be authorized to compel agreement in the event of deadlock in order to suppress any remaining temptation among lenders to free ride." This could include an obligation on dissenting creditors "to accept terms agreed by a qualified majority if IDRA declared the proposed settlement to be 'fair and equitable'". Two primary concerns underlie Cohen's proposal: (i) The incentives to free ride on a settlement reached by a majority and (ii) the under provision of new financing. The solution is to drop unanimity super majority support, replacing it by a super majority of creditors. The IDRA would also be given the powers to implement a settlement. Debt relief should be made conditional on good debtor behavior, ie the IDRA would determine whether or not a debtor complies with its policy commitments.

C. Raffer: Analogy to Chapter 9 U.S. Bankruptcy Code [1990]

Raffer (1990) proposed an international insolvency procedure modeled not after Chapter 11, but after Chapter 9 of the U.S. bankruptcy code, which is tailored to municipalities.[111] He put forward a structured negotiation procedure overseen by a new international body. This "neutral court of arbitration" would yield considerable powers, akin to a domestic bankruptcy court and would closely involve civil society. The arbitration panel would be appointed in equal proportions by the creditors and the debtor. Subsequently, the arbitrators would select their president.

[109] Rogoff, 7.
[110] Cohen.
[111] Professor of Economics at the University of Vienna. See Raffer I; Raffer II, Raffer III.

What distinguishes *Raffer's* proposal is the emphasis on Chapter 9 as the correct analogy.[112] Firstly, it elegantly does away with the objection that Chapter 11 could not possibly apply to sovereign bankruptcies because states could not be liquidated. Secondly, it allows for a proper protection of the citizen's welfare and national sovereignty. There would only be limited court interference with the political structure and a society's policies. Furthermore, affected groups should have the right to be heard. Such a mechanism would balance the interests of creditors with those of the debtor and its population, according to *Raffer* to a much greater extent than it is currently the case. This proposal has enjoyed a fairly broad resonance in the subsequent policy debate.[113] *Miller* discussed the possibility of amending the U.S. Bankruptcy Code so that sovereign states could benefit from Chapter 9 protections.[114] An extensive IMF paper of 1995 also privileges the analogy to Chapter 9.[115] Arguably the most important endorsement was the one by the Jubilee Campaign in 2002.[116]

D. Sachs [1995]

In the wake of the Mexican crises, the influential development economist Jeffrey Sachs from Harvard added his weight to calls for a sovereign debt restructuring mechanism.[117] He argues that while the international financial system does indeed suffer from various inefficiencies which might justify a lender of last resort, the IMF is incapable of exercising this function properly.[118] Consequently, giving up its lending role and instead assuming the role of a bankruptcy court is likely to be a more successful strategy: "IMF practices should be reorganized such that the IMF plays a role far more like an international bankruptcy court and far less like the lender of last resort to member governments."[119] Sachs does not give much detail on how the IMF should transform into a bankruptcy court.

In addition, he suggests that Article VIII Section 2(b) of the IMF Articles might be used to officially sanction payment moratoria. This provision should be interpreted broadly or, if necessary, be amended. Thus the IMF would endorse standstills. Moreover, priority should be given to new lending. Sachs pioneers "private sector involvement" in the resolution of debt crises, arguing that the private sector could do the lending much more effectively than the IMF and that it therefore should replace official lending. Sachs' popularized the idea of international bankruptcy[120] and his lecture had considerable influence on policy discussions.[121]

[112] According to Schwarcz, 54 the distinction is secondary because Chapter 9 adds little to Chapter 11 and mainly contains reference provisions.
[113] Memorandum of Prof. Raffer, http://www.publications.parliament.uk/pa/cm200203/cmselect/cmintdev/256/256ap16.htm.
[114] Miller. He immediately cautions, however, that this approach will probably neither protect the sovereign from claims from non-US creditors nor from suits in other fora.
[115] IMF Note on an International Debt Adjustment Facility, May 26, 1995.
[116] Pettifor, http://www.jubileeplus.org/analysis/reports/jubilee_framework.pdf.
[117] Sachs, II.
[118] Rogoff, 17.
[119] Rogoff, 14.
[120] Rogoff, 18.
[121] See Wall Street Journal, June 13, 1995, A4, which indirectly credits Sachs for putting the idea on the agenda of the G-7 Halifax Summit; "New York Times, June 22, 1995, p.2 "In Mexico-Style Crises, the I.M.F. Could Be a Bankruptcy Court".

E. IMF/Krueger: Sovereign Debt Restructuring Mechanism (SDRM) [2001, 2002][122]

In November 2001 the deputy managing director of the International Monetary Fund, Anne *Krueger*, announced a fairly radical plan to avoid chaotic defaults. When *Krueger* originally unveiled her proposal it sent shock waves through the financial world.[123] According to the original IMF proposal, countries in a sovereign debt crisis would call a halt to debt payments while they negotiated with lenders. These negotiations would be overseen by an independent arbitral tribunal, which would adjudicate eventual disputes. The IMF would endorse payment moratoria according to an established set of criteria. Most importantly, the mechanism would override the rights of bondholders to insist upon unanimous approval for a debt restructuring. A supermajority (60-75%) would make the terms of a restructuring binding on the remaining creditors.

The SDRM is intended only for rare cases when "there is no feasible set of sustainable macroeconomic policies that would enable the debtor to resolve the immediate crises." *The Economist* called it "clever compromise", which to its credit would address all creditors and would cover all outstanding bonds.[124] Still, *Krueger's* proposal, modified and softened in 2002[125], was greeted with fierce resistance and so far has failed to assemble sufficient political backing.[126] In Europe there was fairly strong support for such a mechanism, while the Bush Administration, powerful international financial interests[127] and many emerging market economies[128] (for fear of losing access to international capital markets) were highly skeptical.

F. US Administration/Taylor [2002][129]

Taylor's proposal is a market-based, "voluntary" approach, encouraging borrowing countries to issue their bonds with collective action clauses (CACs). These CACs in bond covenants would spell out the rights and

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[122] Krueger I, www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf; Krueger II, www.imf.org/external/np/speeches/2001/122001.htm.

[123] „Bankruptcy System for Nations Fails to Draw Support", Washington Post, April 2 2003, p. A14: "Wall Street reacted with outrage at the idea, warning that capital flows to emerging markets would dry up if creditor rights were infringed."

[124] „Sovereign bankruptcies", The Economist, April 6 2002.

[125] Krueger III, www.imf.org/external/np/speeches/2002/040102.htm).

[126] „Restructuring Plan Sparks Trouble – Emerging Market Creditors Are at Loggerheads With the IMF Over the Latter's Proposal To Overhaul Debt Restructuring", The Banker, October 1, 2002.

[127] For example the Institute for International Finance, which represents the interests of bank creditors, and the Emerging Markets Traders Association (EMTA). They fear that the SDRM would increase debtor moral hazard. See EMTA Position Regarding the Quest for More Orderly Sovereign Work-Outs, October 17 2002. Available online at www.emta.org/keyper/. See also "Institute of International Finance Comments on Sovereign Bankruptcy Proposals," (available at http://www.iif.com/press.index.quagga); Galvis. 145–155.

[128] "US scorns IMF plan for bankrupt governments", Financial Times, April 5 2002, 7.

[129] Taylor, www.ustreas.gov/press/releases/po2056.htm.

obligations of creditors and debtors in the event of default. Among other things, these CACs would describe exactly how a default would be initiated, how the restructuring would proceed and how disputes between

different creditors would be adjudicated. At the same time, they would allow a supermajority of bondholders to accept a debt restructuring. The minority would then be bound by the decision of the majority. Taylor also proposed to include incentives for the rapid insertion of CACs, such as cheaper and easier access to IMF borrowing. He also suggest to make CACs part of IMF conditionality.

One drawback is that CACs in principle only bind investors of a particular bond issue.[130] They would not solve the difficulty of coordinating across debt instruments or across jurisdictions.[131] Reaching an agreement in a situation where a defaulting country has many outstanding bonds would therefore remain extremely difficult. In addition, it would probably take up to ten years to introduce CACs into all emerging market bonds, because emerging market bonds typically have maturities of ten years.[132] Inserting them retroactively would present major difficulties and would almost certainly require statutory changes. Quite ironically, CACs seem to introduce a new collective action problem. According to *The Economist* such clauses are an "unattractive prospect" when issuing debt. They are "as romantic as a prenuptial agreement": Borrowing countries are afraid that these clauses will raise the costs of raising capital, while financial centers fear their business might move elsewhere.

[130] According to the *The Economist* , "Mr Taylor offered no credible way to persuade countries to adopt these clauses for all their debt." See „Sovereign bankruptcies", The Economist, April 6 2002.
[131] Ibid.
[132] „Bankruptcy System for Nations Fails to Draw Support", Washington Post, April 2 2003, A14

V. CONCLUSION AND OUTLOOK

Organizing the disparate interests of diverse bondholders in different jurisdictions has time and again proved to be a nightmare. There is a clear need for radical improvement and the rapid adoption of a sound legal framework for the debt restructuring process. One of the biggest challenges is to encourage coherent collective action among creditors. Moreover, more emphasis needs to be placed on the basic needs of the population. A (future) insolvency procedure for countries thus faces the monumental challenge of focusing the disparate interests of the different classes of creditors and the debtor on economic recovery (and eventual repayment) and sustainable debt reduction while simultaneously safeguarding the human rights of the people.

Sovereign debt crises are a frequent phenomenon and probably here to stay. As the recent Argentinean experience vividly illustrates, sovereign debt crises painfully affect the livelihood of millions of people. Already a number of creditors have brought suit against Argentina.[133] Argentina's debt restructuring negotiations promise to be both difficult and protracted.[134]

In 1976 *Adam Smith* wrote in his Wealth of Nations: "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy procedure is always the best measure which is both least dishonourable to the debtor, and least hurtful to the creditor."[135] Two hundred and twenty-five years later, it is high time that Adam Smith's insight be finally implemented at the international level.

[133] Among others see LG Frankfurt/M., Urteil v. 14.3.2003 – 2-21 O 509/22; Lightwater Corp. Ltd. v. República Argentina (2003 WL 1878420 (S.D.N.Y)); CMS Gas Transmission Company v. The Republic of Argentina, Case No. ARB/01/08 ICSID.
[134] „An amber light", The Economist, January 31 2004: "[Argentina] has offered to restructure its bonds, but on terms which creditors say write off more than 90% of their value". And the government of Argentina argues that "its first priority must be to revive the economy and address poverty."
[135] Smith, 883.