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Author(s): Hal S. Scott
Source: *The International Lawyer*, Vol. 37, No. 1, SYMPOSIUM: INTERNATIONAL COMPANY AND SECURITIES LAW (SPRING 2003), pp. 103-135
Published by: American Bar Association
Stable URL: http://www.jstor.org/stable/40707723
Accessed: 01-05-2018 15:54 UTC

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A Bankruptcy Procedure for Sovereign Debtors?

Hal S. Scott*

This article explores whether a more formal bankruptcy procedure, the Sovereign Debt Restructuring Mechanism (SDRM) as proposed by the IMF, or in some modified form, is needed to deal with sovereign debt problems. The key consequences of the invocation of such a procedure would be a standstill on creditors' collections of principal and interest, a stay on creditors' attachments or foreclosures on assets, and new money priority for any funds lent to a sovereign during the duration of the procedure. Negotiations would ensue between the sovereign and the creditors over the terms of restructuring, with super-majority voting on acceptance of any restructuring plan. Once accepted, creditors could not holdout by asking courts to enforce the original terms of their debt instruments.

A sovereign bankruptcy framework might enable countries to more easily restructure and reduce their debt, and to do so in a more orderly fashion. This would have significant benefits to the international financial system: countries would have more affordable levels of debt, the need for international rescue packages (primarily through the IMF) would greatly decrease, creditor moral hazard would be reduced, and the variability in credit rates due to legal uncertainty would be reduced as well. Creditors are, of course, concerned that this will reduce their payoffs, and there is a broader concern that use of the procedure might increase the cost of future sovereign borrowing. They have instead advocated more widespread use of collective action clauses (CACs) in sovereign bonds. Currently, the G-7 countries, including the United States, have supported a two-track approach—more widespread use of CACs in the shorter term and exploration of the use of SDRM in the longer term.

Part I of this article summarizes important trends in sovereign debt problems from the 1970s to the present. Part II discusses major concerns about the existing process of dealing with sovereign debt problems. Part III examines the two major solutions advanced to deal with these concerns, CACs and SDRM, and Part IV offers my own proposal.

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I. Background: A Short Summary of Debt Crises from 1970–2002

A. Overall Data

We can begin with some aggregate data on the size and composition of sovereign debt. Table A below sets forth statistics on the external debt outstanding to sovereign developing countries between 1970–1999. The data show that between 1970–1999 there was a thirty-fold increase in sovereign debt of longer than one year maturity, from $56 billion in 1970 to $1.6 trillion in 1999.

Table A
External Debt Outstanding of All Developing Countries:
($ billions, end of year)

Creditors	1970	1980	1985	1990	1995	1999
A. Public and publicly guaranteed long term debt[1]	47.2	365.0	741.5	1,114.5	1,432.7	1,542.4
of which: Commercial banks	3.6	123.9	277.8	257.4	173.6	218.8
Bonds	1.8	13.0	31.6	107.4	257.4	365.0
Other private creditors[2]	8.2	52.4	102.8	145.1	138.2	81.2
Bilateral official creditors	26.3	126.9	221.6	397.0	573.3	532.5
Multilateral creditors (not IMF)	7.3	48.8	107.7	207.6	290.2	344.9
B. Use of IMF credit	0.8	12.2	na	34.7	na	78.9
C. Subtotal (A+B)	56.0	377.2		1,149.2		1,621.3
D. Short-term debt (all types of creditors and borrowers)	9.4	138.9	163.7	245.1	428.1	406.8
E. Private non-guaranteed long-term debt	15.4	70.5	na	65.5	na	535.5
F. Total (A+B+D+E)	72.8	586.7		1,459.9		2,563.6
Note: Commercial banks, bonds, and other private creditors as percent of line C	*25 per-cent*	*50 per-cent*		*44 per-cent*		*41 per-cent*

Source: World Bank *Global Development Finance* (2001) supplemented by data from the World Bank.
1. Long term debt is debt with an original maturity of more than 1 year.
2. Other private creditors are manufacturers, exporters, and other suppliers of goods, and bank credits covered by a guarantee of an export credit agency

Private long-term guaranteed credit extended to developing sovereigns in 1970 was $13.6 billion, about 24 percent of all sovereign debt, thus the public sector (through its own loans or guarantees) was then predominant with a 76 percent market share. By 1980, debt to developing countries was shared equally between public and private creditors, but the pri-

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vate share of credit now seems to be decreasing, dropping by 1999 to 41 percent, $665 billion of the total $1.6 trillion.[1]

Of the private share, a major sea change occurred in the shift from bank to bond debt. In 1970, bank debt was twice that of bond debt, $3.6 billion compared to $1.8 billion. As late as 1990 bank debt still dominated, over twice as high as bonds, $257 billion compared to $107 billion. In 1999, the tables had turned. Bond debt had become more than 1.5 times as high as bank debt, $365 billion compared to $219 billion.

IMF debt that was largely related to financial crises in the developing countries (other multilateral/bilateral credit is a mix between project lending and crisis support) was the growth winner over the period of 1970–1999, growing from $800 million in 1970 to $78.9 billion in 1999, a 100 times increase, and this refers to actual use of IMF credit, lines extended were considerably greater.

Finally, there was a shift in debt maturity, to short-term from long-term debt, although the numbers are difficult to come by.

It is difficult to get reliable estimates on how much debt holders have lost in value over this period due to sovereign defaults. Moody's data shows that dollar-weighted loss (ratio of total defaulted debt volume per year divided by total dollar volume of debt at the beginning of the year) for speculative-grade bond issuers was highly volatile in the last several years; sometimes under 2 percent, but at 14.1 percent in 1998 (defaults of Russia, Pakistan, and the Ukraine) and 13 percent in 2000 (default of Argentina).[2] But this only looks at losses from actual defaults on bonds, including distressed exchanges on bonds. It does not look at defaults on loans and other forms of debt. Recovery rates on defaulted bonds, defined by Moody's as the first available bid price thirty days after default, has been low, 18 percent in Russia and 28 percent in Argentina. Actual recoveries, however, may be higher.

So to summarize, there has been a substantial growth of sovereign debt, the private creditor share of this debt is decreasing, debt extended by private creditors has shifted from bank debt to bonds, the IMF crisis lending has grown enormously, and an increasing proportion of sovereign debt appears to be short-term. We now turn to a short discussion of the major debt crises between 1982–2002.

B. Three Decades of Country Crises[3]

1. *1980s: Repetitive Moratoria and Bank Debt Reschedulings*

In August of 1982, Mexico declared a moratorium on $80 billion of bank debt resulting from syndicated eurocurrency loans, owed to 1,400 banks, most to the world's largest banks whose exposure exceeded their capital. At the same time, the United States and the Bank

1. The IMF observes, however, that the public share of debt has *decreased* in Latin America from 66 percent in 1980–1985 to 28 percent in the later 1990s. We are not told, however, whether or not it was on the rise in the 1990s. Anne Krueger, Sovereign Debt Restructuring: Messy or Messier, Address to the Annual Meeting of the American Economic Association 3 (Jan. 4, 2003).

2. Moody's Investors Service, Special Comment, Sovereign Bond Defaults, Rating Transitions and Recoveries (1985–2002) (2003) [10-year issuer weighted average cumulative default rate is 9.34 percent, 45.39 percent for speculative-grade issuers, roughly the same as for corporate bond defaults. Dollar-weighted for speculative-grade is highly volatile, 1998 14.1 percent (Russia, Pakistan, Ukraine), 2001 13 percent (Argentina). Default is missed payment or distressed exchange].

3. *See* Hal Scott & Phillip A. Wellons, International Finance: Transactions, Policy and Regulation ch. 22 (9th ed. 2002).

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for International Settlements (BIS) extended $4 billion in bridge loans to Mexico pending a resolution of the crisis, an early example of lending into arrears. In November 1982, the IMF extended a $3.7 billion three-year Stand-By loan to Mexico and banks rescheduled $19.5 billion in short term loans with a commitment to extend $5 billion in new loans. This pattern, moratorium, rescheduling of bank loans, new bank loans, and IMF support, was repeated in Mexico and in other Latin American countries, notably Brazil and Argentina, from 1983–1989. One of the principal reasons advanced for avoiding a true default and write-off was the financial precariousness of large bank lenders, particularly those from the United States, who had more than their total capital exposed in loans. The moratorium and rescheduling approach avoided loan write-offs due to the then existent accounting rules.

The rescheduling of bank debts and the pledges of new money were the result of lengthy negotiations under the auspices of the so-called London Club, which has no secretariat or formal procedures, but which follows a common practice. The creditor banks appoint a Bank Advisory Committee for each debtor government, usually of the banks with the largest stakes, led by the bank with the biggest stake.

The key features of the debt problems in the 1980s were: (1) a huge exposure for large U.S. banks; (2) actual moratoria were declared; (3) no debt reduction; (4) new official money was tied to private sector rescheduling and new money; and (5) IMF conditionality for lending was tied to austere fiscal and monetary policy reforms that were highly unpopular in the countries concerned.

2. *Early 1990s: Securitization and Reduction of Debt through the Brady Plan*

The 1980s rescheduling process stretched out debt but did not reduce it, as banks continued to supply new money in return for avoiding default on the old debt. The Brady Plan, launched by the incoming Bush administration in 1989, reduced and securitized the debt, particularly in Latin America.

Under the plan, banks could exchange their loans for thirty year bullet bonds (bonds on which the principal was due in one payment at the end of thirty years), so-called Brady Bonds. Principal and twelve to eighteen months of interest were secured by thirty year U.S. zero coupon treasury bonds (bonds on which the principal and interest were due in one payment at the end of thirty years). Creditors were given a choice of how to exchange their old debt. Brady Bonds could be at par with the old debt but at an interest rate substantially below market, 6–1/4 percent, or the principal would be discounted, for example, by 35 percent, and bear a market rate of interest, LIBOR plus 13/16 percent.

This arrangement was underpinned by subsidized official loans to the debtor countries. For example, on the Mexican Brady Bonds, the IMF, World Bank and Japan lent Mexico $84 million, at an interest rate of a small spread over the IMF borrowing rate, so that Mexico could purchase the U.S. zero coupon bonds that were to be used as collateral.

It is estimated that twenty-one countries restructured $170.2 billion in debt by using Brady Bonds from 1988–1995, reducing debt and debt service costs by $76 billion (present value), or an average of about 45 percent of their total debt.

3. *1990s to Present: Ad Hoc Responses to Crisis—Examples of Mexico 1994, Korea 1997, Russia 1998, Ecuador 1999, Turkey 2001, Argentina 2001, and Brazil 2002*

a. Mexican Foreign Exchange Crisis of 1994

In December 1994, the Mexican peso floated down by 50 percent against the dollar in four weeks. While such a sharp devaluation hurt Mexico in various ways, for example, higher

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import costs and wealth loss for savers and investors, it also had a significant impact on the Mexican debt situation. Seventy-five percent of Mexican government debt was in short-term peso notes indexed to the dollar (Tesobonos), much of them due between January and March of 1995. This meant that government redemption costs on the debt would increase by 50 percent. Many of the holders of the Tesobonos were foreigners who would take the peso proceeds from the redemptions and exchange them for dollars, putting further downward pressure on the peso, and exhausting Mexican reserves. It appeared that Mexico was headed for a major debt crisis.

In January 1995, official lenders supplied massive assistance to bolster Mexican reserves. The United States provided a $9 billion Federal Reserve credit line plus a swap of $12.5 billion for future dollar oil revenue, financed by the U.S. Exchange Stabilization Fund. The IMF provided a $17.8 billion Stand-By line of credit (seven times the Mexican quota for such Stand-Bys under IMF rules) and the BIS stood ready to supply an additional line of $10 billion (it was never used). The result was basically successful, as the peso stabilized and a debt crisis was averted. Mexico has since timely repaid and serviced the funds borrowed to stave off the crisis. Mexico is viewed by some as the quintessential liquidity crisis in which there was an irrational and speculative run on the peso that was averted by international lenders of last resort.

b. Asian Crisis of 1997: The South Korea Example

The Asian crisis began in July 1997 when capital outflows from Thailand spread to Malaysia, the Philippines, Indonesia and South Korea. While each crisis was somewhat different, and each country was dealt with differently, we focus here on Korea, the biggest debtor, with $103.4 billion.

As of mid-1997, $67.3 billion of this debt was short-term debt of Korean banks to foreign banks. This debt typically rolled over at maturity. With only $6 billion in reserves and foreign bank claims on Korean banks of $28 billion to be settled before the end of February 1998, Korea was in trouble as foreign banks failed to rollover their credits, and outflows amounted to $1 billion a day. This was not a straightforward sovereign debt crisis; the debtors in difficulty were the Korean banks, not the government. But because the government was unwilling to have its banks fail, it stood behind the banks as many governments do. The inability of the government to do so, without obtaining more foreign reserves, is what made this a sovereign crisis.

In December 1997, the IMF released $8 billion of a $21 billion Stand-By loan to Korea, hoping that this would stop the outflow of funds. In addition, $14 billion of funds were pledged by the Asian Development Bank and World Bank, with a further commitment of $22 billion from the G-7 countries if the assistance provided by the multilaterals proved insufficient. These funds and pledges of future funds did not stop the outflows, and the $8 billion in IMF funds was effectively paid out to the foreign banks that refused to rollover their debt.

In January 1998, the IMF released further funds after the foreign banks agreed to rollover short-term debt to March 1998 and Korea had agreed to a lengthy list of conditions, extending beyond monetary and fiscal policy to structural changes, including legal reforms. In early 1998, after the macro situation had stabilized, private creditors agreed to restructure $24 billion worth of debt into 1–3 year loans backed by Korean government guarantees. Interest rates were between 2.25 and 2.75 percent over LIBOR. Many thought these terms were quite favorable to the foreign bank lenders. Unlike the case in Latin America in the

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1980s, there was no fear that a Korean default would bankrupt foreign bank lenders. U.S. banks had lent $10 billion, barely 6 percent of the capital of the top ten U.S. banks, while Japanese banks had lent $24 billion, about 9 percent of the capital of Japanese banks.

This case raised substantial concerns about creditor moral hazard since foreign banks used IMF funds to get their money out when they refused to rollover in the early phase. Moreover, building on Mexico, the IMF seemed to be taking on a new role as the international lender of last resort.

c. The Russian Crisis of 1998: The Default Solution

As of August 1998, Russia's total external long-term government debt was about $120 billion, mostly incurred by the Soviet Union. Faced with huge capital outflows, the government could no longer support the value of the ruble against the dollar, and the ruble's value collapsed. The Russian government defaulted on both domestic and foreign currency debt.

The Russians later determined how they would deal with the various components of their external debt. Short-term Ruble denominated treasury bills (GKOs) and medium-term bonds (OFZs), much of which were held externally, were rescheduled by up to five years. The foreign currency obligations of Russian banks, including loans and forward exchange contracts, were subject to negotiations in which each creditor negotiated separately with each bank, with the result that most of these loans were written off. Existing eurobonds (bonds issued on the international market) were not rescheduled and were serviced according to their terms. Three features of the Russian approach are noteworthy. First, no IMF money was involved after Russia announced its default. While there was an IMF Stand-By outstanding as of July 1999, none of these funds were disbursed because Russia would not meet IMF conditions, such as enacting a new bankruptcy law. Second, Russia actually defaulted on, and ultimately wrote off, a significant portion of its debt. Third, Russia treated different kinds of its debts differently, such as repaying eurobonds in full while rescheduling or writing off other bank and portfolio debt.

d. Ecuador 1999: Bond Restructuring with Exit Amendments

Hit by El Nino and falling prices for key export commodities, Ecuador defaulted on Brady Bond payments in August 1999. At the time, Ecuador had about $13 billion in sovereign debt outstanding, composed in part of four different kinds of Brady Bonds ($5.9 billion) and eurobonds ($.7 billion). Initially, Ecuador delayed servicing two of the Brady Bonds, but by October it had defaulted on all of its bonds, including eurobonds. This was the first default on eurobonds. The Ecuador case, like Russia, raised the problem of discrimination among debtors.

On July 27, 2000, the government of Ecuador offered to exchange new U.S. dollar Global Bonds due in either 2012 or 2030 for the outstanding Brady Bonds and the eurobonds. Bondholders who chose the 2012 Bonds had to accept a discount 35 percent greater than on the 2030 Bonds but received higher interest. Almost 97 percent of the bondholders accepted the offer and Ecuador reduced the aggregate net present value of its bond obligations by almost 40 percent.

Ecuador was concerned that bondholders might refuse to tender old bonds and then would sue to collect full payment. There were no collective action clauses in the old bonds binding all bondholders to a majority decision. To address this risk, Ecuador used exit

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amendments.[4] New York law (the applicable law in the old bonds) permitted bondholders to make any amendments by majority vote except those matters concerning payment, which required 100 percent approval. When holders tendered their old bonds, they agreed to certain amendments of the old bonds, so-called exit amendments. These amendments removed the cross-default, cross-acceleration, and negative pledge clauses in the old bonds. The amendments also removed covenants to make annual reports, include the old bonds in later conversions, keep the bonds listed, and prevent the government from buying old bonds while they were in default. The idea was to make the old bonds so unattractive that all of the creditors would tender them for the new bonds.

The IMF's role in Ecuador was limited. Initially, it was not willing to provide Ecuador with emergency funds that would allow the country to service the debt. Lenders saw this as a response by the IMF to its critics during the Asian financial crisis, and a signal that the IMF was changing its policy of bailing out foreign lenders. Indeed, it appeared that the IMF was trying to "bail in" creditors that had been exempted from restructurings of the past.

e. Turkey 2001: Foreign and Domestic Debt

While many of the above crises involved IMF assistance to enable countries to service foreign currency debt, the focus of IMF assistance in the Turkish crisis was government debt denominated in the domestic currency, the Lira. This crisis represented the debut of the Bush administration in dealing with sovereign debt issues, against the background of criticisms of both former U.S. Treasury Secretary O'Neill and Undersecretary Taylor as to how this problem had been dealt with by the Clinton administration.

The crisis began in November 2000 when Demir Bank, a medium-sized bank, failed and sold its substantial portion of Lira denominated government securities. The big increase in the market supply of government paper pushed interest rates on new government debt issues up to 100 percent. Foreign investors, who held a large share of government debt securities, having lost confidence in the government's ability to service its debt, sold their securities, converted their Lira receipts to foreign currency, and repatriated their funds. Turkey's reserves fell 20 percent in a few days and the market anticipated the rapid depletion of reserves unless something was done.

To help stem the outflow, the IMF supplemented the outstanding Stand-By credit of $3.7 billion it had granted in December 1999 by $7.3 billion in December 2000, adding many conditions as to how Turkey should restructure its economy. These funds were extended without any restructuring of existing debt. The outflows continued however, and in January 2001, Turkey was forced to abandon its crawling peg against the dollar (a quasi-fixed exchange rate).

The immediate problem facing Turkey was that $20 billion worth of government short-term debt in Lira was due within the next six months. If the foreign exchange outflow continued (creditors refused to rollover), it would reduce the supply of funds in domestic markets, in turn pushing interest rates up even higher. The government lacked funds in its budget to meet existing debt service, let alone an increase. If it printed more Lira to service the domestic debt, inflation that was then at 100 percent would go even higher and the exchange rate would further deteriorate.

4. Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. Rev. 59 (2000).

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In mid-May 2001, the IMF expanded its Stand-By credit to $19 billion. The Stand-By was tied to commitments by foreign banks to roll over their short-term loans. The foreign banks' supervisors, working with the IMF, adopted a system to monitor bank performance of this obligation. By November 28, 2001, Turkey had drawn on about $11.7 billion. The last draw in November was for about $3 billion, at which time the IMF commended Turkey on its progress toward fiscal and structural reforms. In addition, in May 2001, the World Bank added another $1.8 billion for specified projects to the $5 billion in loans that it was already providing.

The Turkey case shows that the Bush administration had not cut back on the role of the IMF. While the IMF did insist on foreign creditor rollovers in May 2001, unlike in December 2000, IMF assistance was expanded to help deal with domestic currency as well as foreign currency sovereign debt. However, the Turkey case also shows how interrelated these two types of debt are. In the view of the IMF, a foreign currency debt crisis could only be averted if the domestic currency debt problem was solved, and improving the foreign currency debt situation would help to avert a domestic currency debt crisis.

f. Argentina 2001: A Step into the Unknown

Argentina's existing debt is estimated to be about $155 billion. Argentina experienced debt servicing problems in 2001 which led to a swap in June of $29.5 billion of its existing debt for new debt. Argentina had a Stand-By credit from the IMF, which had been increased to $14 billion in January 2001, of which it immediately drew $3 billion. The Stand-By was further increased by about $8 billion to $21.57 billion in September 2001, at which time Argentina drew another $6.3 billion. The Stand-By provided for an additional drawing of $1.24 billion later in the year. Further drawings were conditional on meeting budget reduction targets. On November 2, the IMF stated that it would make no additional disbursements ahead of schedule.

On November 10, Argentina proposed another debt exchange that Standard and Poor's rated as "distressed" meaning that it was equivalent to a default. Government bonds in the amount of $95 billion was to be exchanged for lower yielding sovereign guaranteed loans. Foreign creditors expressed concerns that the exchange would be limited to local creditors and that it would result in the subordination of their credits in favor of the new loans. This proposal resulted in a debt swap of $55 billion with domestic financial institutions.

On December 3, Argentina imposed substantial limits on bank withdrawals as a result of the beginning of a run on the banks. Withdrawals were limited to $250 per week per account or $1,000 a month. On December 6, the IMF refused again to release the $1.24 billion installment because of non-compliance with targeted budget reductions. On December 12, the Finance Minister Carvallo and President de la Rúa resigned, and there followed a period of severe political instability and riots. The IMF refused to come to the rescue, reportedly largely at the urging of the U.S. Treasury. On December 24, Argentina announced a debt default that appeared to be aimed at foreign rather than domestic creditors, since it applied only to "external debt."

The situation continued to deteriorate in 2002. The peso continued to devalue against the dollar, banks were periodically closed and bank withdrawals limited. Argentina even defaulted on its World Bank debt, first defaulting in October on $250 million of private debt guaranteed by the World Bank, and then in November on a $805 million payment due on a World Bank loan. This made it ineligible for new lending from the Bank and $2 billion in planned disbursements were stopped. It defaulted on another $1.8 billion in World

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Bank debt in December 2002. More importantly, there were indications that Argentina might default on its IMF loans. The IMF rolled over a $900 million payment in July to avoid default, and did the same with a payment of $141 million in November 2002 and of $980 million in January 2003. The IMF also agreed in January 2003, over abstention of some Board members (not the United States), to reschedule an additional $6.78 billion due in 2003 in exchange for pledges on fiscal and monetary policy. The IMF rollovers gave some credence to those arguing that IMF lending is a quasi Ponzi scheme in which defaults are averted only by making new loans.[5] A default on the IMF loan would have been a significant rallying point for reform, since defenders of the existing regime would no longer be able to say that IMF lending was justified because the IMF never loses money.

Given the IMF rollover in Argentina, and IMF assistance in Turkey and Brazil as described below, it seems unlikely that the failure of the IMF or countries to loan new money to Argentina represented a fundamental policy decision to cut back on bailouts. Most agree that the inability of Argentina to agree to necessary fiscal reforms made clear that any plausible level of funding would not solve the new crisis.

g. Brazil 2002: More IMF Lending

Brazil found itself in difficulties in 2002. It had a large public debt, about $290 billion, and the prospect of left wing political leadership, in the form of the popular candidacy of Lula da Silva. This put significant pressure on the Real-dollar exchange rate. In June, Brazil indicated it would draw on a $10 billion IMF Stand-By credit and received approval from the IMF to free up another $5 billion in reserves by lowering its reserve floor from $20 billion to $15 billion. Around the same time, U.S. Treasury Secretary O'Neill stated that he was against throwing money at Brazil because of political uncertainty, and that money lent to Brazil and Argentina could end up in Swiss bank accounts. By the end of July the Real was down 30 percent. In August, the IMF approved a $30 billion loan, $6 billion to be disbursed immediately, with the balance coming in 2003 after the elections. O'Neill now said Brazil was different than Argentina because it had the right economic policies in place. No restructurings were done by private creditors, indeed some analysts urged creditors to use the reserve infusion to get out. Following the rescue package, the Real further depreciated by 4.1 percent. In December, Brazil drew another $3.1 billion on the IMF credit. Lula da Silva took power in January 2003 and his new Finance Minister has stated that the former commitments to control inflation would be honored. Whether or not the situation has stabilized is as yet unclear. Brazil might be another "liquidity" crisis like Mexico, perhaps the strongest type of case for continued IMF support.

Overall the 1990s was a mixed bag. We had bailouts, some successful and some not, voluntary restructurings and defaults. Generally, the IMF role expanded into a lender of last resort for foreign currency debt, and in Turkey for domestic debt, and significantly expanded the amount of its lending. In 1994, massive lending worked in Mexico, and all creditors were repaid. However, this was not the case in the Asian crisis. Despite statements from the U.S. Treasury, there was no fundamental change in bailout policy as demonstrated by Turkey and Brazil. Instead, the concern with creditor moral hazard has increased. In addition, rancorous dissatisfaction has been expressed about IMF conditionality. Some

5. Kenneth Rogoff, *Economic Focus, Managing the World's Economy*, The Economist, Aug. 3, 2002, at 62, recounts the argument.

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governments defaulted and reduced their debt, Ecuador and Russia, and some defaulters began to discriminate among different creditors. Argentina is a step into the unknown.

II. Major Concerns from the Crises

In reviewing the experience with handling debt crises over the last 30 years, certain key concerns emerge: (1) the large expenditure of public funds and the increase of emerging market sovereign debt levels; (2) the creation of the IMF as the lender of last resort, for government guaranteed and domestic currency debt, as well as foreign currency debt; (3) the increase in creditor moral hazard; (4) the ineffectiveness of IMF conditionality; (5) sovereign debtors' discrimination among different kinds of debt; and (6) the problem of holdout creditors.

A. Large Expenditures of Public Funds and Increasing Emerging Market Debt

One clear feature of these crises is that they have required large expenditures of money by the IMF and other official lenders. IMF debt outstanding as of 1999 was $78.9 billion. On top of this other multilateral and official creditors have extended over $877 billion in funds. Over the last seven years, $280 billion of public money has been expended. While much of this is structural development lending, a substantial part is related to financial crises.

The debt burden of major debtors is significant. Argentina, Brazil and Mexico had $8.4 billion in long-term debt in 1970, as compared with $267 billion in 1999. Debt in these three countries rose from 23.4 percent of GNP in 1970 to 62.3 percent by 1999.[6] Both creditors and debtors would be better off with a significant reduction in debt levels.

Not all of this debt is current; 4 percent is in arrears.[7] Official country debt has continually been rescheduled through the Paris Club process. Argentina just recently defaulted on World Bank debt, and would have defaulted on the IMF but for permitted rollovers. And neither the IMF nor the United States has received anything close to a market rate on its loans.[8]

B. IMF as Lender of Last Resort

This period has seen the emergence of the IMF as an international lender of last resort (LLR). While the IMF cannot be a classical LLR, because it cannot print its own currency, it does command very sizeable resources due to support from G-7 countries. The IMF (as supplemented by other multilaterals and sovereigns) has extended loans when the market would not do so itself. In Korea and Turkey it extended loans exceeding 2000 percent of these countries' quotas.[9] While one can argue that all of these crises represented liquidity rather than insolvency situations, since governments could have commanded the resources

6. *BIS Quarterly Review – International banking and financial market developments*, Bank for Int'l Settlement (2001).

7. O. Jeanne & J. Zettelmeyer, *International Bailouts, Moral Hazard, and Conditionality*, CESife, (Working Paper No. 563, 2001).

8. Rogoff, *supra* note 5. The claim that all public funds have been repaid (Stanley Fisher, *Financial Crises and Reform of the International Financial System*, Nat'l Bureau of Econ. Research, Working Paper No. 9297, 2002) is not completely true and is incomplete given the subsidized rates.

9. Arturo C. Porzecanski, *Bankruptcy Lite*, The Int'l Economy 38, 40 (Summer 2002).

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to repay debts on time through tax and borrowing powers (albeit with a huge cost), they are unlike classic domestic liquidity crises, where a temporary extension of funds remedies irrational or speculative attacks on debtor banks. The only case where this was plausibly true was Mexico in 1994 and perhaps Brazil in 2000. In all the rest, fundamental problems in the economy and financial systems caused these crises. Vast amounts of aid did not restore the health of banks or values of currencies. And even in Mexico, it is clear that fundamental problems in the system existed before and after the 1994 crisis.

The type of debt that has been bailed out by IMF assistance has been extended in the 1990s beyond foreign currency debt to foreign lenders in two significant ways. First, it now includes sovereign guaranteed debt. This was the clear message of the Korean crisis, where the government needed reserves in order to provide them to private banks (recently privatized) to serve the banks = foreign short-term debt. These funds were not made available because of a formal government guarantee of bank debt. The government decided, like many other governments have, that it did not want its banks to fail due to the damage this would do to the financial system and economy. Moreover, there were no established procedures in Korea at the time for dealing with bank bankruptcies. Extension of IMF assistance to cover guarantees naturally makes the use of guarantees more likely and increases their value to beneficiaries.

A second extension has been the use of IMF assistance to cover domestic currency debt. This has been seen most dramatically in the Turkish crisis. While Turkey could have printed money to service its domestic currency debt, this would have been inflationary, and have created political instability if accompanied by contractionary fiscal policies. Also, inflationary policies would have reduced the value of government bonds, imposing significant losses on already shaky Turkish banks.

C. Increase in Creditor Moral Hazard

A third important feature of these crises, as they have progressed, is that they increase creditor moral hazard, thereby decreasing market discipline on sovereign borrowing. If private creditors will be bailed out, they are more likely to make bad loans. The moral hazard effect may be reflected in the general statistics concerning sovereign lending over the 1982–2000 period. Bank debt, on which there were significant defaults and reschedulings in the 1980s, followed by reductions as part of the Brady Bond process, dropped precipitously in the 1990s, and was replaced by bond debt on which there had been no defaults, and overall debt shifted from the private to the public sector.

If the market disciplined sovereign borrowing, the number and intensity of crises and the concomitant need of public funds would decrease. The moral hazard problem has become worse over time. In the 1980s, no public funds were extended during a crisis until banks had agreed to reschedule their debt and lend new funds. Although banks were insulated from default, and thus from the necessity to write-off loans under existing accounting rules, they did experience severe consequences. And, when the Brady Plan was adopted, the banks actually did have significant write-offs of their loans as part of the debt exchange.

In contrast, in the 1994 Mexican case, the United States and IMF extended over $38 billion of funds to Mexico, used to service external debt, without any negative consequences for existing creditors. While this has been justified on the grounds that the official support staved off a crisis, the result was that public funds were used to pay off private debt, thus increasing moral hazard. In Korea in 1997, the IMF gave the government $8 billion before obtaining any rollover commitments from foreign banks. This was justified on the grounds

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of the intensity of the crisis and the need to act swiftly, but again foreign creditors were bailed out without agreeing to rescheduling or write-offs. There is a real question whether bank creditors ever experienced negative consequences from their bad lending decisions given that the lengthening of loan maturities as part of a later rescheduling was accompanied by up to 275 basis point spreads over LIBOR and Korean government guarantees. And again in Turkey, the IMF in December 2000 extended $3.8 billion in Turkey without any rescheduling or rollover commitments from private creditors. The same proved true in Brazil in 2002.

Some have argued that creditor moral hazard is not a major problem. Some studies posit that if moral hazard were a problem spreads on government bonds generally should decrease after the IMF provides support on the theory that such support shows that default on outstanding bonds is more unlikely. Some studies have shown such decreases but others have not.[10] Bond spread analysis is flawed, however. First, it lumps together the debt of all countries. The real question is whether demonstrations of bailouts decrease creditors' risks in any significant countries. Second, new bailouts may not serve to increase the estimated probability of future bailouts but rather to confirm previous estimated probability levels. In such case, spreads should not be significantly affected. Finally, a variety of other more important factors could be affecting bond spreads, such as changes in rates of interest and inflation.

Others have argued that in many countries creditors have paid a price. Debt was rescheduled in Asia, restructured on terms that reduced net present value in Ecuador, Pakistan and the Ukraine, and defaulted on in Russia and Argentina. However, the issue is not whether creditors have paid a price for making bad loans, but whether the price has been commensurate to the risk. IMF and official support have sheltered creditors from paying the full price of the risks they have assumed.[11] The result has been that they have been

10. Steven B. Kamin, *Identifying the Role of Moral Hazard in International Financial Markets*, Bd. of Governors of the Fed. Res. Sys., Int'l Fin. Discussion, Working Paper No. 736 (2002) (no increase); *but see* Jeanne & Zettelmeyer, *supra* note 7, at 3 (increase in spreads in Russia and Pakistan where the IMF did not intervene). The evidence is summarized in Barry Eichengreen, Financial Crises 54 (2002).

11. Andrei Shleifer, *Will the Sovereign Debt Market Survive?* (Nat'l Bureau of Econ. Research, Working Paper 9493, 2003), contends that the real problem is that creditors' rights are being eroded under the present system and would be further eroded under SDRM. Shleifer adduces no evidence that creditors have lost a lot of money. Indeed, the evidence is that they have not, and that they have lost a lot less than they should have. Yes, they lost money in Russia and Argentina (though the extent of losses remains to be seen), but they were bailed out in Mexico, Asia, Brazil and Turkey. He then argues that SDRM is based on the too debtor friendly Chapter 11 model (without the countervailing creditor power to oust management and liquidate) and cites his prior work showing that strong debt markets require strong creditors' rights, and claims such erosion would therefore harm debt markets. Although he characterizes Chapter 11 as debtor friendly overall, would he seriously contend that U.S. corporate credit markets are not well developed? Patrick Bolton, *Towards a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice around the World* (Working Paper 2002), at 11, 18–20, contends that Chapter 11 may be important for the development of the corporate bond market, and that the U.K. bond market, which is more protective of creditors, is much less developed than the U.S. corporate bond market. And as an historical matter, Chapter 11 was intended to be more protective of creditors than the more rigid Chapter 10 that had preceded it, G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 Bus. Law. 1, n.34, p. 9 (1999).

Shleifer also claims that municipal debt markets in the United States are well developed because when municipalities get into trouble they pay off their creditors. One way they do so is by being rescued by the infusion of state funds, in other words, a bailout. Shleifer completely ignores the creditor moral hazard issue. It is one thing to respect contracts, it is another to bail out creditors from bad loans.

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more willing to make loans than they would otherwise have been, and that debtor countries have incurred more debt or engaged in less prudent fiscal and monetary policies than they otherwise would have had they known no official support would be forthcoming. In short, there has been a huge deficit in market discipline.

D. IMF Conditionality Does Not Work

One possible justification for official assistance, particularly from the IMF, is that it provides the leverage to achieve reforms, both macro and micro, in debtor countries. As the argument goes, the IMF would not be able to achieve reform without providing funds, and debtor governments would not be politically able to implement reforms without the justification of the need for funds. Put another way, if the IMF did not lend, the government would be unable to implement reforms. There are two major weaknesses in this argument. First, there is little evidence that IMF conditions, usually requiring contractionary fiscal and monetary policies, have worked.[12] After all, Latin America has experienced repeated debt crises in the last two decades despite numerous IMF conditionality programs. On this issue, I am in fundamental agreement with Joseph Stiglitz[13] in his debate with Ken Rogoff.[14] Furthermore, as Morris Goldstein[15] has argued, IMF conditionality has been extended substantially beyond traditional macro policy to a variety of micro issues, like bankruptcy law reform and corporate governance, with little proof of success in reducing debt crises.

E. Debtor Discrimination among Private Creditors

The problem of sovereign debtors discriminating among private creditors is a rather recent one, related mainly to the rise in bond debt. There were very few problems of this kind related to bank lending. Bank lending to sovereigns is invariably syndicated; many banks loan to the sovereign within the structure of one loan document. That document provides that default as against one lender is default as against all lenders (cross-default clause) and that a payment to one lender must be shared pro-rata with all lenders (pro-rata sharing clause). While these clauses effectively constrain discrimination among members of a syndicate, there is still the potential problem of discrimination among different syndicated loan agreements.

This is partially addressed by cross-default clauses that permit lenders in Syndicate A, subject to certain voting procedures for their group, to accelerate their loans and declare default if the sovereign defaults on any other loan agreement, such as Syndicate B. The fear would be that the sovereign was going to make some payments to Syndicate B (even following default on B), or perhaps even to Syndicate C, without paying Syndicate A. The threat of cross-default would, in theory, prevent such discrimination from occurring. But using the acceleration and cross-default power might make the A creditors worse off, as the result might be that the sovereign would be unable to pay A anything. A might be better

12. *See* Alex Dreher & Roland Vaubel, *Does the IMF Cause Moral Hazard and Political Business Cycles? Evidence from Panel Data* (Institut für Volkswirtschaftslehr, Working Paper No. 598–01, 2001) (IMF lending generates high spending and inflationary monetary policy).

13. Joseph E. Stiglitz, Globalization and its Discontents (2002).

14. Kenneth Rogoff, *An Open Letter to Joseph Stiglitz*, *at* www.imf.org/external/np/vc/2002/070202.htm (July 2, 2002).

15. Morris Goldstein, IMF Structural Programs (Working Paper, 2000).

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off being discriminated against and getting partial payments or making a deal to get at least more than B. In fact, such discrimination on bank loans is constrained not by legal clauses but by three institutional factors.

First, many large banks will be members in all of the syndicates, thus greatly decreasing their potential gains as beneficiaries of discrimination. The fact that they are repeat players decreases their incentives to extract the maximum advantage from one "game" of debt default. Second, sovereign defaults on bank loans have been handled through Bank Advisory Committees under the control of large banks that pressure small banks to go along with an equal treatment regime. Third, this pressure is "enforced" by central banks who threaten to impose sanctions, such as restricted discount window access or more supervisory scrutiny, if small banks do not go along.

The problem with bonds is that the institutional mechanisms to avoid discrimination are missing. The holders of these claims are more numerous than bank lenders, there are no major players to hold everyone together, and there is no enforcement counterpart for bondholders of central bank "suasion" over banks. So, there is a much greater potential for the sovereign discriminating among claimants under different bond issues, and more generally between bondholders and bank creditors.

F. Increased Difficulty in Restructuring Bond Debt—the Issue of Holdout Creditors and the Prospect of Foreign Asset Seizures

The increase in bond debt in the 1990s has substantially increased the problems of restructuring debt. It is harder for countries to deal with large numbers of dispersed bondholders, often with vastly different investment agendas, with no commitment to repeat lending, and not subject to pressure from their governments and central banks, than it is to deal with banks. While this permits more discrimination, as set forth above, it also, and perhaps even more importantly, makes it harder to engage in restructuring at all.

A key element of the problem is the holdout creditor, often a vulture fund investor who seeks to profit by not going along with restructuring. After restructurings have been agreed, these creditors seek full collection of their debts in foreign courts. Bond debt obligations are not normally protected in foreign courts by sovereign immunity as the issuance of such debt is regarded as a commercial activity, and commercial activities are outside the protection of sovereign immunity.[16]

Pursuit of court remedies by holdout creditors will only be effective if there are assets outside of the jurisdiction of the debtor country for creditors to obtain in satisfaction of court judgments. The extent of such assets has been subject to much debate, given that most sovereign assets are within their borders and effectively immune from seizure. However, there may be significant assets available for attachment abroad. The case of *Elliott Associates v. Banco de la Nacion and the Republic of Peru*, showed that a major asset available for seizure is foreign currency payments on the restructured debt itself.[17] In *Elliott*, vulture creditors who had acquired interests in outstanding loans to Peru, refused to tender the loans for Brady bonds, and then, by way of an action in a Brussels court, attached interest payments that were to be made on the bonds through Euroclear bank accounts in Brussels.

16. *See* Republic of Argentina v. Weltover, 504 U.S. 607 (1992).
17. Elliott Assoc. v. Banco de la Nacion and the Republic of Peru, 194 F.3d 363 (2d Cir. 1999).

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The general point is that foreign payments, whether on restructured bonds, other debt, or even for the importation of goods and services, may be fair game for attachment by creditors. There may also be other significant assets, like foreign bank and security custody accounts.[18] Countries hold foreign bank accounts to make and receive payments and as a store of value. They also have foreign securities in custody abroad, often in connection with central bank reserve holdings. Argentina reportedly transferred a substantial portion of its deposits out of New York in anticipation of its default.[19]

Finally, there is the issue as to whether assets of state-owned enterprises are subject to seizure. In principle, such assets might be thought to be generally immune from seizure in that they are owned by different entities than the sovereign. In corporate bankruptcies, assets of an affiliate are not generally available to creditors of a sister. Thus, if Holding Company (HC) fully owns shares of Companies A and B, and A fails, creditors of A cannot generally seize the assets of B. There is a limited exception to this rule under the doctrine of collapsible corporations, which provides that if B is generally run as part of A, the assets of B might be collapsible into A in the event of A's bankruptcy. In effect, A's bankruptcy would trigger the consolidated bankruptcy of both A and B, with the consolidated assets of both companies subject to both companies' creditors.

On the other hand, if HC were to go bankrupt, HC's creditors could seize the assets of HC, including its equity in A and B, and then liquidate the assets of A and B in satisfaction of their own debts, after satisfying the creditors of A and B. The latter situation is more analogous to the sovereign debt situation. Default by a sovereign would expose its equity holdings in state-owned entities to seizure, and thus could result in the liquidation or reorganization of such entities, a prospect that sovereigns would regard with great trepidation.[20]

In my view, the chances of holdout creditors collecting on their debts is a real one. This explains why sovereigns, like Peru in the *Elliott* case, have generally paid off the holdouts.[21] The problem going forward is that payoffs to holdouts make it less likely that creditors will agree to restructurings in the first place. Why should they accept a greater discount on restructured debt than do holdouts on the original debt?[22]

Some have argued that the holdout problem can be minimized through the exit consent process, where old bonds are poisoned by tendering creditors.[23] In the Ecuador restructuring, creditors tendering old bonds for new bonds agreed to amendments to the old bonds that were designed to make them unattractive, such as retraction of waivers of sovereign immunity or consents needed for listing. The problem is that under New York law, under which most outstanding bonds are issued, payment terms cannot be amended other than by all creditors,

18. Nigeria reportedly had $1 billion of claims to assets in Swiss bank accounts that had been stolen by a former leader. Felix Salmon, *Nigeria rewrites the rule book*, EUROMONEY 67 (Oct. 2002).

19. Eichengreen, *supra* note 10, at 69.

20. *See* First Nat'l Citibank v. Banco Para El Commercio Exterior De Cuba, 462 U.S. 611 (1983).

21. According to the IMF, threats to sue have obstructed debt negotiations in Ecuador and the Ukraine. If such threats were empty, they would have no effect. International Monetary Fund, Policy Development and Review and Legal Department, *Involving the Private Sector in the Resolution of Financial Crises—Restructuring International Sovereign Bonds* 2, 6 (Jan. 11 2001), *at* http://www.img.org/external/pubs/ft/series/03/.

22. The U.K.'s idea of going after vulture funds themselves seems unfocused and impractical. Rosemary Bennett, *Chancellor plans Crackdown on 'vulture funds'*, FIN. TIMES, May 5, 2002.

23. Buchheit & Gulati, *supra* note 4.

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and payment terms are all that holdout creditors care about.[24] Further, it is quite unclear whether courts would sustain such exit amendments if it regarded them as an abuse of minority bondholders.[25] Exit amendments cannot alter the real prospect of asset seizures by holdout creditors. The only way to make sure that holdouts are avoided is through legal compulsion. The need to avoid holdouts is a main reason for the creation of bankruptcy laws.[26]

III. Principal Reform Proposals

Two major reform proposals have been put forward to meet the concerns about the sovereign debt problem. First, private creditor groups and the U.S. Treasury, principally in the person of John Taylor, the Undersecretary for International Affairs, have called for a contractual mechanism, use of collective action clauses (CACs) in sovereign bonds, to facilitate restructuring.[27] Second, academics, most notably Jeffrey Sachs,[28] and the IMF, in the person of Anne Kreuger,[29] the first deputy managing director, have called for the creation of a statutory sovereign bankruptcy procedure. The focus here is on the IMF proposal, the Sovereign Debt Restructuring Mechanism (SDRM).

Both proposals have similar objectives: (1) facilitating restructuring by making deals between debtors and creditors easier to negotiate; (2) allowing a super-majority of creditors to block holdout creditors; (3) reducing debtor discrimination against particular types of creditors; and (4) reducing the need for multilateral and bilateral country support as a result of increased use of restructuring. The IMF has the additional objective of preventing creditors from seizing debtor country assets and facilitating priority for new lending once the SDRM has been invoked.

Current G-7 policy is to pursue both options, CACs now and SDRM in the longer term.[30] The U.S. Treasury seems to prefer CACs. In April 2002, John Taylor was highly critical of

24. Indeed, post-Ecuador a number of bonds have been issued with provisions preventing the amendment of non-financial terms. Eichengreen, *supra* note 10, at 89.

25. Moody's Investors Service, Special Comment, What Happens If A Sovereign Defaults? (2000) (study of holdout creditors).

26. Marcel Kahan, *Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights*, 77 N.Y.U. L. Rev. 1040, 1067 (2002).

27. John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference on Sovereign Debt Workouts: Hopes and Hazards, Institute for International Economics (Apr. 2, 2002), transcript *available at* http://www.ustreas.gov/press/releases/po2056.htm; *see generally* International Monetary Fund, Legal Department, The Design and Effectiveness of Collective Action Clauses (2002) [hereinafter IMF Legal Department]; and International Monetary Fund, Policy Development and Review, International Capital Markets and Legal Departments, Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use (2002), *available at* http://www.imf.org/external/np/psi/2002/eng/060602a.htm [hereinafter IMF Development and Review].

28. Speech, Jeffrey Sachs, Do We Need an International Lender of Last Resort? Frank D. Graham Lecture at Princeton University 8 (Apr. 20, 1995); *see also* Barry Eichengreen et al. eds., Crisis? What Crisis? Orderly Workouts for Sovereign Debtors (1995).

29. Her original proposal, Anne Krueger, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at the National Economists' Club Annual Members' Dinner (Nov. 26, 2001) (transcript *available at* http://www.imf.org/external/np/speeches/2001/112601.htm), was later modified in Anne Krueger, *New Approaches to Sovereign Debt Restructuring: An Update on our Thinking*, Address at Institute for International Economics Conference on Sovereign Debt Workouts: Hopes and Hazards (Apr. 1, 2002) (transcript *available at* http://www.imf.org/external/np/speeches/2002/040102.htm) [hereinafter Krueger, *New Approaches*], and Anne Krueger, *A New Approach to Sovereign Debt Restructuring*, International Monetary Fund, Apr. 2002, called by some IMF Krueger Lite.

30. Jack Boorman, Speech at ASEM Finance Minister's meeting in Copenhagen (July 5–6, 2002).

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the SDRM,[31] but Secretary O'Neill subsequently put forward the two-track approach.[32] Some G-7 countries, particularly the United Kingdom and Canada, seem less convinced of the efficacy of CACs and would prefer a faster track for SDRM. We shall now turn to an examination of each proposal.

A. CACs

The discussion of CACs will describe the different clauses under consideration, and whether their inclusion in sovereign bonds would meet concerns with the sovereign debt problem.

1. *Different CACs*

The major focus of the call for CACs has been on clauses that permit a super-majority of creditors to change the financial and other terms of sovereign bonds in a restructuring. Sovereign bonds issued under U.S. law, approximately 59 percent of the $354 billion outstanding,[33] require unanimity to change terms.[34] This is in contrast to sovereign bonds issued under U.K. law, which permits majority action clauses in so-called British style covenants, which typically permit a two-thirds majority of creditor to change any bond terms.

Bonds issued under U.S. law do appear to permit a majority of creditors to change non-payment terms, like the waiver of sovereign immunity or listing permissions, through exit amendments adopted pursuant to debt exchanges. But, they prohibit majority action on payment terms. Restrictions on changing bond terms spring from a concern that a majority of creditors can abuse a minority. This fear was reflected in the enactment in 1939 of the Trust Indenture Act (TIA) restricting the use of majority action clauses in corporate issues.[35]

Although the TIA applies only to corporate and not sovereign bonds, contracting practice for sovereign bonds has followed the statutory requirements for corporate bonds. While one might attribute this to path dependence, there are two competing explanations. First, creditors may generally prefer such restrictions. Indeed, foreign investors have expressed concerns that domestic investors holding sovereign bonds, which in some cases might constitute a significant percentage and even a majority, might be pressured by their sovereigns to abuse the foreign creditors.[36] This can be made harder by restricting majority action. Second, there is a possibility that U.S. courts would use common law doctrines, like abuse of fiduciary duty, to nullify majority actions that were seen as abusive to a minority.[37] It is not clear that U.S. courts will even sustain exit amendments changing the non-financial terms of bonds. If these considerations are important, then CACs could only be used with confidence if federal or New York statutory law (U.S. bonds are invariably issued under New York law) legitimated CACs. Current CAC proposals do not contemplate such enactment. While this problem could be circumvented by issuing bonds under U.K. law, U.S. creditors may generally feel more comfortable in having their disputes governed by New York law and New York courts.

31. Taylor, *supra* note 27.
32. Paul O'Neill, Remarks to the Bond Market Association, New York City, Apr. 25, 2002.
33. IMF Development and Review, *supra* note 27, at 4–6.
34. IMF Legal Department, *supra* note 27, at 4.
35. Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 Emory L.J. 1317 (2002).
36. IMF Legal Department, *supra* note 27; Imf Development and Review, *supra* note 27, at 11–12.
37. IMF Legal Department, *supra* note 27, at 11–12.

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While the G-7 and creditor groups both favor use of CACs, the G-7, including the United States, would favor a lower majority percentage, 75 percent,[38] than private creditor groups, which reportedly call for a 90 percent requirement.[39] This difference reflects different objectives and concerns. Private creditors are concerned that too low a percentage would give sovereigns more leverage, through their control of domestic creditors as discussed above. Further, too low a percentage would make it generally easier for the sovereign to make a deal—requiring a higher percentage can give creditors more leverage to get better terms. Here is an example of a creditor negotiation line: 75 percent of us are willing to agree to a 35 percent discount but you are never going to get the other 25 percent to agree to this—they would rather wait for an IMF bailout or take you to court. We can only get a deal with less of a discount, say 25 percent.

The other important CAC currently used in sovereign bonds deals with acceleration.[40] Most sovereign bonds whether issued under U.S. or U.K. law permit and require a vote of 25 percent of creditors to accelerate payments, that is, full payment of interest and principal.[41] This is important because acceleration of claims increases the potential cost of default for debtors. Absent a vote of 25 percent of creditors, a creditor seeking to recover on a default could only ask for payment of past due interest payments. The 25 percent requirement would seem to impose some break on vulture creditors, but, in practice, some bond syndicates are quite small, for example, less than $100 million, and when bonds trade down to 20 cents on the dollar, it does not take much money to obtain a 25 percent position. Also, vultures prefer to exercise their rights after the more passive creditors have been taken out in an exchange offer, leaving it relatively easy for the remaining bond holders to get a 25 percent position.[42] One might think that such an obstacle could be strengthened by creating an even higher percentage requirement. But this would probably not be in the interest of many creditors who would fear too high a percentage would decrease their leverage in negotiations. Another example of a creditor negotiation line: Your offer of a 35 percent discount is unacceptable to at least 25 percent of the creditors. Unless you improve the offer, they will accelerate and sue.

The important point about collective action clauses is that there is a tension for creditors in considering appropriate percentages. Debtors would always want a relatively low majority action percentage and a high acceleration percentage, both to limit holdouts and preserve their negotiation leverage.[43] Creditors would share the debtors' percentage preferences with respect to holdouts but would want a relatively high majority action percentage and low acceleration percentage to maximize their leverage. To the extent the G-7 is advocating CACs to make debt restructuring easier, it may have a more debtor oriented view of the appropriate percentages. Indeed, the very fact that the G-7 seeks to change current practice suggests a leaning toward the debtor side.

There are two other kinds of CACs, not presently in sovereign bonds, that have been

38. Taylor, *supra* note 27.

39. The creditors' proposal significantly does not actually specify a percentage. THE INSTITUTE OF INTERNATIONAL FINANCE INC. ET AL., *Sovereign Debt Restructuring* (Discussion Draft, Dec. 6, 2002), *available at* http://www.emta.org/ndevelop/sdrm.pdf.

40. *See* IMF LEGAL DEPARTMENT, *supra* note 27.

41. Kahan, *supra* note 26, at 1050.

42. E-mail from Lee C. Buchheit to author (Jan. 6, 2003) (on file with author).

43. Absent an effective right to holdout and sue, creditors would demand a higher coupon so the bond would be more, not less, risky. MOODY'S INVESTORS SERVICE, *Proposal Frameworks for Sovereign Debt Restructuring* 10 (Sept. 2002).

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suggested by John Taylor.[44] The first is a clause that would subject the initiation of litigation to a majority vote or delegate it to a representative. This clause would pose a more substantial obstacle to holdout creditors than the 25 percent acceleration requirement. It could also be used to impose a standstill at the outset of negotiations. The second is a sharing clause, which would require creditors recovering assets in satisfaction of claims to share the proceeds pro-rata with other creditors. Such clauses are common in syndicated loans, but not bonds. Again, it is far from clear that creditors would want such clauses since they have an interest in maximizing leverage through threats of litigation. An initiation clause would make the commencement of litigation more difficult and a sharing clause would make litigation less profitable.

2. *Are Majority Action Clauses the Solution?*

We turn to the question as to whether majority action clauses (the main clauses at issue) offer a plausible solution to the sovereign debt problem. This is highly doubtful.

First, creditors and debtors may not want them. As already discussed, creditors may only want them with very high percentage requirements, making them less useful in facilitating debt restructuring. Further, although debtor countries might prefer the clauses in the abstract, they recognize that the increased leverage they would obtain would come at a price of a higher cost of credit. While empirical studies, looking at the comparative costs of bonds issued under U.S. and British style covenants are inconclusive,[45] there seems to be a general consensus that there would be substantial first mover costs.[46] Countries adopting CACs for the first time might rightfully be concerned that they were signaling an increased probability of default with a consequence of higher debt costs. Mexico did not issue new eurobonds in September 2002 with majority action clauses, even after an IMF meeting where it was reported that countries would work together to put such clauses in newly issued bonds. The IMF could try to overcome market costs by making its resources conditional on use of clauses but there is no consensus in the Fund to do so where a country otherwise complies with Fund conditions for lending.[47] There is also concern that it is the wrong time to change bond clauses when a country is already in difficulty, the very time countries come to the Fund for assistance.[48] Mexico did adopt a 75 percent CAC in a $1 billion bond offering in February 2003 at an estimated additional cost of twenty basis points and indicated its intention to use such clauses in the future. Some saw this as a favor to the U.S. Treasury, which applauded Mexico's action.[49]

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44. Taylor, *supra* note 27. *See also* IMF Legal Department, *supra* note 27.

45. Eichengreen, *supra* note 10, at 88, n.76 (summarizes the evidence). Eichengreen's own study indicates costs would increase for less creditworthy borrowers. *Compare* Barry Eichengreen & Ashoka Moody, Would Collective Action Clauses Raise Borrowing Costs? Nat'l Bureau of Econ. Research (Working Paper No. 7458), Jan. 2000, *with* Torbjörn Becker et al., Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly? (Working Paper 2001) (finding that CACs do not increase yields). A major difference in methodology between the two studies is whether to consider the choice of clauses by sovereigns to be endogenous, e.g., whether borrowers that anticipate having to restructure choose English law majority clauses and those that do not choose the U.S. unanimous consert clause. Eichengreen and Moody believe the choice is endogenous (not governed by sovereign anticipation) while Becker et al. do not.

46. Press Release, International Monetary Fund, IMF Board Discusses Collective Action Clauses in Sovereign Bond Contracts (July 26, 2002), *available at* http://www.imf.org/external/np/sec/pn/2002/pn0277.htm.

47. *Id.*; IMF Development and Review, *supra* note 27.

48. *Id.*

49. John Authors, *Mexico sends Signals with Bond Clauses*, Fin. Times, Feb. 27, 2003, at 31.

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Second, there would be a substantial transition issue since 69 percent of bonds outstanding do not presently have such clauses and have an average maturity of five years. It is estimated it would take ten years to replace these non-CAC bonds.[50] This process could be accelerated with bond swaps, but this could impose significant "sweetner" costs to create an incentive to exchange and would risk opposition from holdout creditors due to the inability to use exit amendments to alter payment terms.

Third, there is the issue, already discussed, as to whether courts applying U.S. law, particularly U.S. courts, would uphold majority action where there was a case that a minority, with different interests, was being abused. This could only be guarded against by new statutory enactments that would be difficult to obtain. But there are two more major problems.[51]

As Anne Kreuger has repeatedly observed, the CAC solution will not work across different credit instruments.[52] Even if the same CAC were inserted in all sovereign bonds, other major debt that would be simultaneously subject to restructuring negotiations, like syndicated bank debt or trade credit, would not have such clauses. In addition, a major issue in the Asian crisis, as well as elsewhere, was the government guarantee of private interbank debt to foreign banks. Such guaranteed debt would also have to be restructured and would not have collection action clauses. Indeed, it is a heroic assumption to think that all bonds would have the same CACs, some might have a 75 percent requirement, others 90 percent.[53]

This is a very fundamental point. The very existence of corporate bankruptcy laws responds to the collective action problem of providing for such a process through private contract. It simply cannot be done because different creditors, not in privity, interact with debtors over time and provide different terms in their contractual documentation for the resolution of disputes. A common set of procedures can only be provided by statutory or common (judge-made) law; contract will not work. Although legal scholars, like Alan Schwartz,[54] have argued that the state should permit parties to contract for the corporate bankruptcy system they prefer, such contracting takes place against a default system of law. The same goes for private ordering through workouts—it is shaped by the shadow of law. Such a shadow is entirely missing in the Taylor CAC proposal and will thus not work.

Finally, CACs will do very little to facilitate restructurings as long as IMF or official lending is available. Creditors and debtors will wait for a bailout rather than restructuring. Both benefit by subsidized credit, at least in the short term. Indeed, this is presently the case in Argentina. Neither Argentina, nor its creditors, are likely to seriously consider restructuring as long as public money is in the wings.

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50. IMF Development and Review, *supra* note 27.

51. There is also a technical issue as to how a majority action clause would function in the context of the Paris Club (the framework for renegotiating official bilateral credits) rule requiring private debt to be restructured on terms comparable to official debt.

52. Krueger, *supra* note 29. Shadow Financial Regulatory Committee Symposium, *The IMF Proposal for Sovereign Debt Restructuring*, Partial Transcript (unedited) (Oct. 7, 2002). *See also* Jack Boorman, Sovereign Debt Restructuring: Where Stands the Debate? Address at Conference cosponsored by the CATO Institute and The Economist in New York (Oct. 17, 2002), *available at* http://www.imf.org/external/np/speeches/2002/101702.htm.

53. It is even more unrealistic to contemplate that the same CACs could be put into all debt contracts, as suggested by Kenen. *See* Peter Kenen, *The International Financial Architecture: Old Issues and New Initiatives*, 5 Int'l Fin. 23 (2002).

54. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L.J. 1807 (1998).

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B. SDRM

The consideration of SDRM begins by outlining the IMF proposal and then examines whether it will work. There is a significant question whether even a modified corporate reorganization model is appropriate for the design of SDRM. Also, there are a significant number of implementation issues that remain unsolved. The three most fundamental ones involve the role of the IMF in the SDRM, the treatment of domestic versus foreign debt, and, as in the case of CACs, the unlikely use of the procedure without restrictions on public credit.

1. *The IMF's SDRM Proposal*[55]

The IMF proposal envisions that at the debtor's request a majority of creditors could impose a standstill on payments and a stay on creditor litigation for a fixed duration of time that was potentially renewable. In the short-term, perhaps for ninety days, the IMF itself could impose the standstill and stay, upon a finding that such an SDRM was justified, while creditors themselves met to decide this issue for themselves.

The proposal also contemplates that a super-majority of creditors supplying new financing during the SDRM could subordinate existing claims, modeled on debtor-in-possession (DIP) financing in corporate bankruptcy.[56]

Certain creditors would not be subject to the SDRM. Multilaterals like the IMF and the World Bank would not be included. Whether Paris Club creditors would be included is unclear. Also unclear is whether domestic debt, however defined, would be included.

A restructuring plan, like under CACs, could be approved by a super-majority of creditors; the exact percentage has not yet been determined. The IMF staff contemplates a 75 percent requirement (by value), the percentage required under U.K. CACs rather than the 66.6 percent requirement required under U.S. Chapter 11, and does not specify whether there would be an additional requirement by number of creditors; Chapter 11 requires a majority.[57] This staff proposal seems responsive to creditor groups seeking an even higher percentage. The approval of the plan, however, would have to be informed by the IMF's view as to whether the remaining debt level was sustainable.[58] Future IMF funding would be conditional on such a finding.

An independent tribunal, perhaps a judicial organ, would adjudicate issues like lack of equitable treatment or valuation of claims.

Neither IMF lending, nor lending by other multilaterals or countries is restricted under SDRM. Indeed, Kreuger has stated: "Under an SDRM, the nature of the financing decisions that the IMF would need to make before, during and after a debt restructuring would not change."[59]

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55. The focus here is on the latest IMF proposal. *See* Krueger, *New Approaches*, *supra* note 29.

56. *But see* INTERNATIONAL MONETARY FUND, LEGAL AND POLICY DEVELOPMENT AND REVIEW DEPARTMENTS, *The Design of the Sovereign Debt Restructuring Mechanism— Further Considerations* (Nov. 27, 2002) [hereinafter *Sovereign Debt Restructuring*], *available at* http://www.imf.org/external/np/pdr/sdrm/2002/112702.htm (suggesting subordination may not be the right approach).

57. *Id.* at 45.

58. Debt levels are regarded as unsustainable when debt relative to GNP will grow indefinitely—this is determined in practice by debt/GNP ratios or debt to export ratios in some cases. *See* Krueger, *supra* note 1, at 2; INTERNATIONAL MONETARY FUND, Proposals for a Sovereign Debt Restructuring Mechanism (SDRM), A Factsheet (Jan. 2003), at 5.

59. Krueger, *supra* note 29, at 22.

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The SDRM would be adopted by an amendment to the IMF Articles of Agreement which requires 3/5ths of the votes of members having 85 percent of the votes. This means that the U.S., which has over 15 percent of the votes, would have to agree.

2. *The Chapter 11 Model*

The Chapter 11 model has provided the intellectual origins of the SDRM. This can be traced back at least to Sachs's proposal in 1995,[60] but there is a significant issue as to whether even a modified Chapter 11 model is appropriate for sovereign debt.

The whole SDRM process is fundamentally different than Chapter 11.[61] Chapter 11 converts debt to equity. Typically prior equity is ousted and the value of the firm as a going concern value is distributed in the form of new equity claims to creditors in accord with their priority—the absolute priority rule—and their debt claims are reduced. Creditors must receive at least as much in a Chapter 11 reorganization as they would in a Chapter 7 liquidation. A single creditor can torpedo a plan by showing that he is worse off in Chapter 11 than in Chapter 7.[62]

In sovereign restructurings, there is no conversion of debt to equity, for obvious reasons. The exercise is different. Debt is restructured only by changing its amount or terms. Further, there is no Chapter 7 liquidation value for judging whether creditors are fairly compensated.[63] These fundamental differences make Chapter 11 an inappropriate model. Whereas the United States has a Chapter 9 for municipal bankruptcies, where similar problems exist, Chapter 9 has been rarely used and most commentators think it does not really work.[64]

It is interesting to compare the two procedures in terms of their protections for creditors. Absent the liquidation alternative, creditors in SDRM have much less leverage than they do under Chapter 11. They cannot threaten to liquidate an uncooperative debtor. Further, under SDRM they would have little confidence that the debtor would manage itself in the future to fulfill its new restructured obligations. Under Chapter 11, creditors control the selection and continued operations of new management. Finally, in Chapter 11, there is no discrimination against or in favor of certain creditors. All creditors are subject to a common set of procedures and a court makes sure there is equitable treatment for all. Under the proposed SDRM, multilateral creditors are entirely excluded, and Paris Club creditors may be excluded. And as discussed further below, the treatment of at least some domestic creditors may have to be different than foreign creditors. These exclusions make the solution less comprehensive and create serious issues of fairness.

In some respects, however, creditors are given more rights under SDRM than they would have under Chapter 11. The sovereign debtor must obtain approval from the creditors, and perhaps initially from the IMF, to invoke the SDRM. Under Chapter 11, the debtor merely

60. Kenneth Rogoff & Jerome Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas*, 49 IMF Staff Papers 470 (2002), *available at* http://www.imf.org/external/pubs/ft/staffp/2002/03/pdf/rogoff.pdf.

61. For general requirements of Chapter 11, see Eichengreen, *supra* note 10.

62. 11 U.S.C. § 1129(b) (LEXIS, through 2002 legislation). I thank Elizabeth Warren for bringing this to my attention. *See* ELIZABETH WARREN & JAY WESTBROOK, THE LAW OF DEBTOR AND CREDITORS 794 (4th ed. 2001)).

63. *See* Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613, 634 (2001); Bolton, *supra* note 11; Shleifer, *supra* note 11, also makes this point.

64. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Sovereign Bankruptcy*, 60 U. CHI. L. REV. 425 (1993).

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files. The choice of the debtor to invoke the protections of bankruptcy is not subject to creditor approval, nor does it even depend on a showing of insolvency. It is true that under the Chapter 9 procedure for municipal insolvencies,[65] and under some non-U.S. bankruptcy regimes, filing is subject to a showing of insolvency,[66] but it is never subject to creditor approval as under the proposed SDRM.

In addition, the SDRM proposal does not contemplate a cramdown procedure. SDRM simply provides that a super-majority of creditors can approve a restructuring plan. Under a Chapter 11 cramdown,[67] junior classes of creditors or equity holders can be forced by the court to accept a plan, if senior classes are fully compensated and one impaired class approves the plan, again assuming no creditor gets less than in liquidation.[68] Perhaps, SDRM is silent on a cramdown because it contemplates that there will be only one class of unsecured creditors and that there is thus no need for a cramdown. If so, then it is significant that SDRM leaves the acceptability of the plan entirely to a vote of creditors. Under Chapter 9, where it is likely that all creditors are unsecured, a court can disallow a plan, even if voted for by the creditors, if it is not in the "best interests of the creditors."[69]

In fact, there could be senior sovereign creditors, given that Brady bondholders are secured by U.S. zero coupon bonds and that some forms of trade debt involve security. Furthermore, multilateral debt is currently treated as senior to all other debt even though it is not secured. If it were to be included in SDRM with its current priority, it would constitute another class of senior debt. SDRM does not contemplate that senior classes could bind more junior classes to a plan through a cramdown. While this may be better for the junior creditors, it may be worse for the more senior creditors.

3. *The Prospects of SDRM*

The adoption of SDRM would seem problematic because of political opposition and a number of problems in its design. Emerging market sovereigns and their private creditors generally oppose SDRM because it will raise the price of credit due to the increased ease of restructuring and the corresponding decrease in bailouts.[70] This would increase the debt service cost for sovereigns and lead to lower levels of borrowing. While this may be good for sovereigns in the longer term, they would prefer not to take the medicine and continue to enjoy subsidized borrowing rates due to bailout expectations. Creditors are similarly situated.[71] They do not like a reform that will lead to less demand for their funds and higher risks for funds they do provide. While they presumably will be compensated for this risk through higher rates, there is some level of risk that they may find unacceptable at any price. And they may take an unanticipated hit on outstanding debt.

The main beneficiaries of the SDRM proposal are the taxpayers of the debtor and creditor countries. But it is unclear that their interests will prevail. As discussed, debtor governments may only focus on their short-term debt servicing costs rather than the burden on their taxpayers. Creditor governments may be unwilling to limit bailouts due to political

65. *Id.*
66. Bolton, *supra* note 11.
67. 11 U.S.C. § 1129(b)(2) (2003).
68. Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 Bus. Law. 441, 448–449 (1984) (stating that each creditor has to do just as well in reorganization as in liquidation).
69. McConnell & Picker, *supra* note 64, at 464–65; 11 U.S.C. § 943(b)(7).
70. Krueger, *supra* note 29.
71. The Institute of International Finance, Inc., *supra* note 39.

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objectives, for example the case of Turkey, or for fear of financial contagion, the case of the Asian crisis, whatever the cost to their taxpayers.

SDRM also has substantial design problems. SDRM significantly increases the power of the IMF. Under the proposal, the IMF continues its lending, plus is heavily involved in the SDRM mechanism. It approves the initial invocation of the procedure, makes a judgment of debt sustainability as part of the approval of the plan, and may be the tribunal for adjudicating disputes. Giving the IMF a major role in SDRM is problematic. As a major "priority" lender, it has an obvious interest in seeing that its own debt is repaid which may color its decisions on many issues. For example, it may prefer to reduce the level of private debt service to insure its own debt can be repaid.

Also, IMF is an organization that often does the bidding of the governments of the major creditors. This may dispose it to pursue solutions that have a political payoff but may be financially unattractive to debtors and/or creditors. In short, the IMF is not impartial. Allowing the IMF to operate the SDRM mechanism would be like putting a class of secured creditors, rather than a court, in charge of a corporate reorganization.

Another concern arises from doubt over whether SDRM can be fair or effective. The issue of fairness arises from the exclusion of significant creditors. The issue of effectiveness relates to the lack of a cramdown power and questions about whether the procedure will ever be used given the possibility of IMF or official creditor bailouts. This is the same problem that plagues the effective use of CACs. Even if one were to assume that no bailout would be forthcoming, there is the issue of what benefit the SDRM would provide to a sovereign that it could not achieve acting on its own outside of SDRM, as did Russia in the 1998 crisis. The SDRM's major benefit is the stay on asset seizures and the binding of holdout creditors once a plan has been approved. A sovereign might believe that the threat of asset seizures and holdout creditor suits was low,[72] and prefer to fashion its own set of procedures to scale down its debt.

Finally, there is the problem that the very existence of SDRM could cause faster withdrawals of credit once there was a whiff of bankruptcy in the air.[73] This is a real concern and could only be met by the fashioning of voidable preference rules that would permit recovering funds withdrawn from some period prior to the commencement of SDRM.

C. Domestic versus Foreign Debt

An issue for both CACs and SDRM is the extent to which these tools would be used to restructure domestic as well as foreign debt. Both proposals would seem to exclude domestic debt, defined as debt issued under local law and subject to enforcement in local courts. This would exclude substantial local currency debt held by foreigners, for example Russian ruble debt. Government bonds of many countries, developed and emerging alike, are held by foreigners. It would also exclude some foreign currency debt held by foreigners since developed countries issue foreign currency debt under their local laws. The exclusion of such debt may reflect the unwillingness of developed countries to subject themselves to procedures they are developing for emerging markets. While there has been discussion of developed countries including CACs in their debt instruments, as a demonstration effect for

72. The fact that the threat of litigation has not stopped prior restructurings is not dispositive, Porzecanski, *supra* note 9, given the new possibilities of asset seizures opened up by the *Elliott* case.

73. Tarullo, *supra* note 63, at 630.

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emerging markets, no one has squared this suggestion with the apparent exemption of "domestic" debt.

Exclusion of a substantial portion of debt will create substantial discrimination problems and make any restructuring plan less comprehensive and effective. It would permit holders of "domestic" debt to resort to attachment of country assets while subjecting "foreign" debt to a stay on creditor actions, through either a vote of bondholders or the operation of the SDRM.

What is the reason for excluding domestic debt? With respect to SDRM, the IMF is concerned that inclusion of domestic debt would necessitate the imposition of extensive foreign exchange controls and threaten the domestic payment system.[74] The payment system problem would be caused by the possibility that non-payment by the sovereign of debt held by banks could bankrupt such banks, causing them to freeze deposit withdrawals and render the payment system inoperable. The experience of Argentina in late 2001 is cited as an example.

This argument is not convincing. Foreign exchange controls would not be necessary just because "domestic" debt was covered through a restructuring mechanism. The imposition of exchange controls is principally designed to stem capital outflow and the accompanying downward pressure on exchange rates and erosion of reserves. Even if domestic debt were serviced, holders of domestic assets would fear devaluation and try to convert local currency into foreign currency assets thus necessitating broad exchange controls, applying to a wide range of assets, not just bank deposits. Further, the fact that banks were receiving service on their government bonds would not likely stop massive deposit withdrawals motivated by fear of devaluation and the ultimate need to freeze bank deposits. If it were believed that bank runs were less likely if domestic government debt held by banks were serviced, such payments could be exempted from the operation of any payment standstill. This would be a better solution than exempting such debt entirely from restructuring.

D. Restraints on IMF and Official Lending

An absolutely critical ingredient of any scheme to deal with sovereign debt is to limit public funding of emerging markets. As long as such funding is available, or even thought to be available, emerging markets will not make use of restructuring mechanisms, whether in the form of CACs or a SDRM.[75] The Kreuger proposal anticipates no change in IMF lending policies as a result of the creation of SDRM. It envisions new IMF lending after the restructuring to help build reserves and pay for essential services and imports. Such new lending should not be needed if restructuring does its job. The major objective of a restructuring mechanism should be to let countries deal with their problems by restructuring debt, not by getting more public funds. The problem is even more pronounced for the CAC proposal, which envisions private solutions to the restructuring problem. To work, the adoption of CACs would have to be combined with restrictions on public funding.

How could credible limits be placed on public funding? The joint proposal of the Bank of Canada and Bank of England offers one approach.[76] Using the U.S. FDICIA legislation

74. Krueger, *supra* note 29. Shadow Financial Regulatory Committee Symposium, *supra* note 52.

75. As Bolton points out, the bond-exchange proposed by Russia in 1998 may have failed because bondholders were banking on an IMF bailout. Bolton, *supra* note 11, at 31.

76. Andy Haldane & Mark Kruger, *The Resolution of International Financial Crises: Private Finance and Public Funds* (Bank of Canada Working Paper 2001–20) (Nov. 2001).

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as a model, the proposal would require extraordinary procedures to be adopted before the IMF lent funds. The idea is that the necessity to engage in such procedures would deter lending. Exceptional lending would only be provided upon a recommendation in a report of the IMF staff followed by a super-majority vote of the Executive Board.

IV. My Proposals

I offer the following proposals to address the sovereign debt problem.

1. Impose credible restraints on public funding.

I would start where the problem really is, by restraining public lending.[77] Without such restraints we cannot solve the moral hazard problem. Without such constraints sovereign debtors will have little incentive to use either CACs or SDRM. The problem is in designing credible restraints, particularly given the political incentives to use public funding. The Bank of Canada/ Bank of England approach does not preclude such lending; it just makes it somewhat harder. Which of the cases in the 1990s where public funding was available would have turned out differently with a requirement of a super-majority vote of the Executive Board? One cannot be confident that this would have made any difference at all. Even weaker are the presumptive limits proposed by the Council on Foreign Relations.[78] Their limits only apply to the IMF and could be exceeded by the IMF in its discretion in any case of contagion.

In confronting this issue one needs to be realistic: Mexico is on the doorstep of the United States; the Asian crisis posed an unknown risk of worldwide contagion; and Turkey is a key ally in the Muslim world. It may be entirely rational politically for the G-7 countries to subsidize these economies to avoid contagion or to cement alliances.

I believe the best we can achieve on this issue is to make the leaders of the G-7 countries more internally accountable for funding solutions to debt problems. This could be achieved by putting strict limits on IMF lending, truly binding quotas, with the understanding that individual or groups of countries could provide rescue money where their decisions were subject to internal political procedures. Strict quotas could be combined with a system in which IMF debt was *junior* to other debt, increasing the IMF's exposure and thus reluctance to make such loans. We need to increase, not decrease, the risk to the IMF of extending public funds. This would address the IMF's own moral hazard problem.

As indicated earlier, the IMF staff has proposed that new money supplied during the pendency of the SDRM would not have automatic priority. New lenders would be required to obtain subordination agreements from prior debt.[79] While this is justified by the reluctance to alter private contract, the effect will be to give the IMF a monopoly on new lending since under the current rules it has automatic priority whenever it lends. This can be addressed by absolute constraints on IMF lending or depriving the IMF of priority. If this is

77. I agree with Roubini on where to start, although as discussed below, I disagree that this is all we need to do. Nouriel Roubini, *Do We Need a New Bankruptcy Regime*, 1 Brookings Papers on Economic Activity 321 (2002).

78. Council on Foreign Relations, Independent Task Force Report, *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (2001) (stating that the IMF should adhere to normal lending limits for country crisis, 100 percent of country's quota or IMF subscription annually and 300 percent of quota cumulatively, but can exceed in contagion cases).

79. *Sovereign Debt Restructuring*, *supra* note 56, at 47.

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not done, or not done completely, this prohibition of automatic new money priority is counterproductive to the goal of decreasing the role of the IMF.

These changes would make rescue decisions more democratically accountable. The IMF could continue to provide the economic analysis that would serve as a backdrop to these decisions, serving to supplement the analyses of individual countries. It is true that speed of action could be affected under a system of more transparent decision-making, but this was not a problem in Mexico where U.S. funds played such a prominent role. Moreover, key national leaders are consulted now before significant IMF actions. Speed would only be a problem where internal forces mounted opposition to action, for example, the rescue of Asia becomes the subject of extensive congressional hearings, but this kind of delay is inherent and perhaps desirable in democracy.

2. Abandon the CAC project.

The insertion of collective action clauses in sovereign bonds is an exercise in futility that will not solve the collective action problem. Emerging market governments are unwilling to voluntarily accept such clauses given their concern that they may increase their debt costs and signal their increased likelihood to default. Whatever may be the mixed results of the studies, common sense tells us that if a country insists on a meaningful collective action clause, it is more concerned about how to deal with the prospect of default. This is the so-called first mover problem. This signaling problem could only be avoided by mandating such clauses. This would be difficult because we are unsure exactly what to mandate. To be effective in helping restructuring, the threshold requirement should be rather low, say two-thirds, but to avoid manipulation of creditors controlled by the government and to preserve creditor leverage arising from the possibility of independent legal action, the threshold would need to be higher, and the exact mix might be different in different countries. Mandated collective action clauses would beg the question of other mandates, such as limits on rates of interest. No one is advocating mandated collective action clauses at the present time. Incentive schemes like public subsidies for adopting such clauses seem impractical. Conditioning IMF aid on adoption of the clauses fails to recognize the point discussed above, that the availability of IMF aid, or other public funding, will undercut the utilization of clauses, even if they were to be adopted.

The other major problem with CACs is that they don't work. As previously discussed, even if universally adopted in similar terms in all bonds—a heroic assumption—they would do nothing to deal with loans, trade debt and other debt at issue in any potential sovereign restructuring. It is this collective action problem which largely accounts for the enactment of national bankruptcy laws to deal with corporate restructuring.

A final reason for dropping the CAC proposal is that it is diverting time and effort from other reforms that can make a real difference.

3. Create a more private creditor friendly SDRM.

One can argue that the effort to create a workable SDRM is doomed to failure because we can never impose credible restraints on public funding. If we cannot impose such constraints, such critics would be right. But there is a serious chicken and egg problem here. Public funding will be a virtual necessity without a restructuring alternative, which is largely the case today. So an SDRM is a necessary complement to a system of credible restraints.[80]

80. Boorman, *supra* note 52; Bolton, *supra* note 11.

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To say we need an SDRM is not to say that we need the SDRM proposed by the IMF. The general weakness in the IMF proposal is that it would significantly decrease the leverage creditors currently have in insuring that their debts be repaid. As Ben Friedman points out more generally, making default too easy for sovereigns is undesirable because such debt is generally unsecured.[81] Creditors will suffer under my proposal as a result of fewer bailouts, and that suffering is justified by the benefit of having more market determined levels of emerging market debt. But this decrease in creditor welfare comes from the justified constraints on public funding. Further, and perhaps unjustified, decreases in creditor welfare come from the design of the SDRM itself. I would propose the following changes in that design.

a. Develop a benchmark on debt valuation.

In a Chapter 11 proceeding, creditors cannot be made to accept an outcome that gives them less value in a reorganization than they would get in a liquidation. This protects creditors against being forced to accept a reorganization that is worth less to them than liquidation. Creditors should generally accept this approach because it maximizes their welfare. They should favor reorganization when it is worth more to them than liquidation.

In order to make this calculation, two values must be known: the value of the rights creditors receive in the reorganization and the value they would receive in liquidation. Liquidation value is determined by the best value that the debtor's assets would fetch when sold, given that the sale might involve part or all of the ongoing business, or of particular assets themselves. The reorganization value involves estimates of the ongoing prospects of the business and the claims creditors would have, through newly created rights, for example equity or debt, to the future value of the business.

With sovereign debt, two aspects of this valuation process are missing. First, it makes no sense to determine a liquidation value because there will never be a liquidation to pay off sovereign debts. Secondly, it will be more difficult to create value for creditors in a sovereign restructuring. Sovereign creditors, unlike corporate creditors, will never be able to take pure equity, with claims to future earnings, to compensate for losses in the value of their debt claims. There have been sovereign bonds with special claims to tax revenues but this is different than an equity claim in which one receives the capitalized value of a future income stream. Sovereigns are not businesses and are not for sale.

The IMF's SDRM proposal does not address these differences. It creates no floor on value for creditors as a substitute for liquidation value. Instead, it allows a super-majority of creditors to approve a plan, subject to the IMF's view of the sustainability of the debt burden, without giving creditors the absolute protection of liquidation value. This could be subject to considerable abuse—for example, sovereign debtors could conspire with domestic debtors under their control—with the result that foreign creditors would suffer losses on existing debt and charge substantial premiums for future funds. Some valuation benchmark, equivalent to liquidation value, is needed. We also need to devise instruments that give creditors something akin to the upside of an equity stake. Perhaps this could be done in some cases by giving creditors stakes in state-owned enterprises; in effect, sovereign restructuring could be a spur of privatization.

81. Benjamin M. Friedman, *How Easy Should Debt Restructuring Be? in* MANAGING FINANCIAL AND CORPORATE DISTRESS (Charles Adams, Robert Lorton and Michael Pomerleano eds. 2000).

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In the Lerrick and Meltzer plan,[82] under which the IMF stands ready to buy distressed bond debt at some discount from its (minimum restructured value,) it is of course necessary to determine such value. The authors believe this value should be based on realistic projections about the debtor's debt service capability. It appears this value would be set through negotiations of the debtor and creditor, based on macroeconomic models, and would be subject to IMF approval since it would have to support a discounted version of this price. In my view, a methodology should be accepted, as part of the SDRM, to determine the "minimum restructured value," and creditors would have to receive at least that value under a plan.

b. Eliminate debt discrimination.

The IMF proposal discriminates among various forms of debt. Multilateral debt is left outside the process, and it is unclear what happens to official bilateral debt. Further, it is contemplated that domestic debt and secured debt might also be excluded.[83] In my view all unsecured debt should be included and treated equally. Multilateral debt should have no preference. Indeed, as indicated above, IMF credit should be junior to discourage its use.

Including all debt addresses the debtor's total situation. Favoring some debt over others imposes one-time unjustified losses on disfavored debt and makes such debt more costly in the future, a result that may be economically counterproductive. For example, the exclusion of domestic debt may make international debt more expensive, even though under a nondiscrimination regime it would be cheaper than domestic debt. From a Miller and Modigliani perspective, one might argue that the increased cost to international debt might be compensated for by the cheaper cost of domestic debt, but these two forms of debt are not complete substitutes.

As discussed, the IMF has proposed excluding domestic debt. One concern of the IMF is vote rigging, the possibility that sovereign control over domestic debtors would allow the sovereign undue control over the approval of the plan.[84] This issue can be handled by requiring that domestic debt be in a separate class; it does not require exclusion. Indeed, the IMF staff contemplates that if official bilateral debt were included, it would constitute a separate mandatory class, to preserve its power.[85] Of course, without cramdown, inclusion of domestic debt would give that class the power to block any plan by withholding its approval, and the threat to do so could give the class and the sovereign added leverage. The IMF obviously thinks this is desirable in the case of bilateral but not domestic debt. As discussed below, the potential blocking power of a separate class of domestic debt is not a problem for my proposal, since I favor cramdown. Indeed, we can see that the availability of cramdown permits broader latitude on debt inclusion.

The only legitimate concern with the inclusion of domestic debt is the possible effect on banks of including government debt, a primary bank asset, in any payment standstill. As previously argued, if it were believed that bank runs were less likely if domestic government debt held by banks were serviced, such payments could be exempted from the operation of any payment standstill. This would be a considerably narrower exclusion than now

82. Adam Lerrick & Allan H. Meltzer, Blueprint for an International Lender of Last Resort (Oct. 22, 2001) (unpublished manuscript) (*available at* http://www.carnegie-rochester.rochester.edu/crApril02.htm).

83. The secured debt exclusion is recommended by the Legal and Policy and Review Departments. *Sovereign Debt Restructuring*, *supra* note 56.

84. *Id.* at 45.

85. *Id.* at 51–53.

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proposed. We have standstill exemptions in corporate bankruptcies as well, like payments to employees.

The IMF is also contemplating the exclusion of secured debt or the secured portion of any debt in order to protect contractual rights.[86] Under Chapter 11, secured debt is fully included but the value of the secured claim is fully protected. As the IMF points out, some other legal systems do not include secured debt within a reorganization. The inclusion of secured debt is principally designed to allow the protection of key assets of the debtor, which if taken by the secured party would doom the reorganization of the business. This problem is absent in the sovereign debt situation because the sovereign is not in business and collateral seems to consist primarily of financial instruments, for example, the U.S. zero coupon treasuries securing the Brady bonds. The IMF is concerned that this will lead to more secured debt and that this might be undesirable from a macroeconomic point of view, without specifying why. Indeed, if all debt were secured, the system might be better off. Defaults would have minimal impact (on the unsecured portion of the secured debt) and moral hazard would be reduced. This exclusion is justified.

Government guaranteed debt would have to be included in the SDRM to the extent the sovereign had to honor its guarantee as a result of the default of the primary debtor. This is a debt of the sovereign like any other debt. Trickier is the case where the guarantee may not be clear, as is often the case with government guarantees of bank debt. Whereas such guarantees have been explicit in some countries, for example, historically in Japan, in other countries they have been implicit, e.g. historically in the United States for large banks. To avoid discrimination, servicing of implicit as well as explicit guarantees should be subject to the SDRM.[87]

Finally, there is the discrimination issue raised by recoveries of creditors in anticipation of the use of the SDRM. The IMF has suggested that if a plan is approved under the SDRM, the bankruptcy administrator would use the hotchpot rule from British bankruptcy law under which anything recovered outside of bankruptcy in a legal action would be subtracted from residual claims in the SDRM. The IMF recognizes this doesn't work if recovery outside SDRM exceeds the residual claim, but is unwilling to adopt a broader voidable preference rule, such as under U.S. bankruptcy law, which would allow recovery of all debt collected for a certain period in advance of filing a bankruptcy petition. The IMF thinks this might be too intrusive.[88] Both approaches are "intrusive," and the voidable preference approach results in fewer incentives to trigger debt runs and less discrimination.

c. Use a Cramdown.

A cramdown is a technique that permits a court to impose a plan of reorganization even when a class of affected creditors votes against it. The IMF proposal does not propose such a mechanism. Under Chapter 11, a cramdown can be imposed only if senior classes of creditors are fully compensated and one impaired class approves of the plan. This, of course, requires a judgment of whether senior creditors—and there may be some in sovereign debt situations-even if secured creditors are excluded, for example, multilaterals, are fully com-

86. *Id.* at 9.

87. The IMF contemplates that guaranteed claims would only be restructured where the underlying claim is in default. *Id.* at 20. This may be undesirable where there are guarantees of bank debt, as this would require the banks to go bankrupt first.

88. *Id.* at 37.

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pensated. If there was no senior debt, one could use the chapter 9 best interest of creditors standard, assuming that multiple classes of unsecured creditors were paid pro-rata.[89] This assumes that one has a valuation benchmark to replace the Chapter 11 standard of liquidation value.[90] Both of these standards are likely to depend crucially on the debtor's reasonable capacity to pay.

The cramdown does require the administrator of the SDRM to have the discretion to impose a cramdown. This is a substantial power. But given some fundamental "floor" valuation protection, as discussed above, and a fair and impartial decision maker as discussed below, this power could be exercised in a manner acceptable to both the debtor and creditors.[91]

d. Minimize the role of the IMF in the administration of the SDRM.

The IMF should not administer the SDRM. Both creditors and debtors may distrust its judgments. This is not only because it may have a direct conflict of interest, as an existing or potential creditor, but also because it is basically an instrument of developed creditor countries like the United States. Creditors may legitimately fear that its power might be used to favor a particular debtor when this served the political needs of the creditor countries, and the debtors may fear the opposite, that its powers would be used to favor creditors. Further, the IMF has had definite views about what debtor countries need to do to rehabilitate themselves, and might use its power to make sure such measures were adopted, even when both debtor and creditors opposed them. These legitimate fears require an impartial and independent decision-maker.

This does not mean one needs to create a court to administer the process; indeed I would oppose this because the process needs to be responsive to political concerns that courts cannot easily deal with.[92] I would, therefore, prefer some kind of administrative body that would be responsive to the interests involved. A new international commission should be created with representatives of all parties affected that would be given the power to choose an administrator from a list of certified experts agreed to in advance, a procedure akin to that used for WTO dispute resolutions.[93]

Bolton's suggestion,[94] that creditors be given the choice of forum between any new forum created and creditor country courts, is intriguing. It might make the SDRM framework more creditor-friendly if it could be administered by creditor country courts. But debtor

89. Brunstad & Sigal, *supra* note 11, at 19.

90. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1008, n.311 (2000) (seemingly confusing the liquidation value benchmark problem with the issue of cramdown). Shleifer, *supra* note 11, also adopts the "best interests of creditors" standard.

91. It might be difficult to satisfy the requirement for the approval of one impaired class since typically one would have only two classes, one secured that had to be fully compensated, and one other, unsecured. This requirement would not seem to be indispensable, however, where it could not be satisfied.

92. Shleifer, *supra* note 11, argues that creditors would best be protected by independent courts. This is certainly not my impression based on U.S. experience. He alternatively suggests that creditor countries take over the finances of defaulting debtor countries, an unrealistic throwback to gunboat diplomacy.

93. Glenn Hubbard's proposal for a sovereign debt dissolution forum similarly recognizes the need for a governing body responsive to the variety of interests involved. R. Glenn Hubbard, *Enhancing Sovereign Debt Restructuring*, Remarks of R. Glenn Hubbard, Chairman, Council of Econ. Adv. at AEI Conference on the IMF's Sovereign Debt Proposal (Oct. 7, 2002), *available at* http://www.whitehouse.gov/cea/EnhancingSovereignDebtRestructuringAEIOct72002.pd.

94. Bolton, *supra* note 11.

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countries would be less likely to use such a procedure for fear it would not be administered fairly.

The IMF staff contemplates a Sovereign Debt Dissolution Resolution Forum (SDDRF) under which a pool of judges would be established in advance from which a panel would be chosen in a particular case. The pool would be chosen by a selection panel. The selection panel would be named by the Managing Director of the IMF. The selection panel would recommend to the IMF Board candidates for the pool, as well as a President. The Board could vote the slate up or down but could not make changes. The President would select the panel to use in a particular case.[95] This approach gives too much selection power to the IMF. A new Commission should be created that is responsive to all of the interests involved, debtor and creditor countries, and creditors themselves. This Commission should then choose the pool of judges and the President. Perhaps the procedure should then be more like the one for NAFTA where the parties to the dispute each choose members of the dispute resolution panel with the tie-breaker being a neutral party selected by the President of the Commission.[96]

A critical question remains as to the IMF's role in approving a restructuring plan. Currently, it proposes that it would have an important role in this process. The restructuring plan would be informed by the IMF's view of the sustainability of the restructuring, and future IMF debt would be conditional on it making such a finding. I have no objection to the IMF making its own future lending, within the new circumscribed limits to its capacity, subject to its sustainability judgment. Like any other lender, the IMF should be able to determine under what conditions it will lend. It is likely that the importance of IMF future lending will lead to it having a powerful role in the determination of the plan, but the views of major private lenders will also have to be considered. There are certainly contentious issues as to how the IMF should make this sustainability judgment because that judgment will be linked to its views of appropriate fiscal and monetary policy, as well as other elements of conditionality. This is an important debate but one that should be resolved in parallel and not part of the design of the SDRM.

V. Implementation of the Proposal

Let me conclude with a few thoughts as to how such a regime would be implemented and enforced.

A. Implementation

Article VIII, Section 2 of the IMF Articles of Agreement entitled "Avoidance of restrictions on current payments," provides in subsection (b):

> (b) Exchange 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. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.

95. *Sovereign Debt Restructuring*, *supra* note 56, at 58–63.

96. *See* North American Free Trade Agreement, Annex 1901.2; 67 Fed. Reg. 68,717 (Nov. 12, 2002).

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If one regarded the SDRM as an "exchange control regulation" it could be implemented by the IMF under existing Section 2(b) without the need for amendment. Exchange control regulations, however, usually refer to restrictions on conversions of local currency to foreign currency. Furthermore, this would be such a major change in IMF procedures, that as a practical matter it would at least need the type of consensus required by an amendment to the IMF Articles.

IMF Articles of Agreement can be amended, pursuant to Article XXVIII, upon the agreement of 3/5ths of the members, constituting 85 percent of total voting power. This would require a very broad consensus. Given the fact that there are 183 members of the IMF, the vote of 110 in favor would be required. IMF voting power is distributed on the basis of a variety of economic factors, including members' GDP, current account transactions (amount of trade), and official reserves. Given the 3/5ths (60 percent) requirement, almost all of the more wealthy countries would have to go along. The seven countries with the largest number of votes by percentage, as of June 13, 2001, were: United States (17.16), Japan (6.16), Germany (6.02), France (4.97), United Kingdom (4.97), Italy (3.27), and Saudi Arabia (3.24). In total, these countries control 45 percent of the vote.

Nonetheless, under the Articles of Agreement, this change could be implemented without the consent of many of the major sovereign debtors that have been most prone to debt crises. The votes of 10 major debtors, Argentina (.99), Brazil (1.41), Ecuador (.15), Indonesia (.97), Korea (.77), Mexico (1.20), Nigeria (.82), Philippines (.42), Russia (2.76), Thailand (.51) only amount to 10 percent, and without Russia to 7.24 percent. It is quite conceivable that these countries may oppose the plan. This is because they fear higher debt costs if less IMF subsidy and more private creditor pain results from the proposal.

One could argue that it would be inadvisable to adopt this proposal without the consent of the major debtors, for the simple reason that use of the SDRM is voluntary. If the debtor countries do not like the procedure and thus do not use it, the underlying objectives will not be obtained. On the other hand, one could argue that once the procedure exists, particularly if the IMF is constrained from lending, the countries will have to adopt the procedure. This argues for adopting the procedure without necessarily having the consent of the major debtor countries.

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