

# Redesigning the International Lender of Last Resort

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## ABSTRACT

This paper is concerned with the issue of how to balance bailouts (or “lending into arrears”) with debt reductions (or “private sector involvement”) in the resolution of sovereign debt crises. It provides a review of recent proposals for improving the sovereign debt restructuring process. In addition to defending a sovereign bankruptcy proposal we have put forward in recent work, this article proposes a major reorientation of the IMF’s role in sovereign debt crises.

## I. INTRODUCTION

Since the Mexican Debt Crisis of 1994–95, which gave rise to an International Monetary Fund (“IMF”) bailout of unprecedented size, there has been a raging debate on how the IMF should handle sovereign debt crises. Despite the successful resolution of the crisis and Mexico’s quick repayment of all its emergency debt, the sheer size of the intervention has raised worries that bailouts could cause significant sovereign debt market distortions. These concerns, in turn, have led to a reconsideration of the prevailing wisdom that the IMF can and should act as the *de facto* international lender of last resort (“ILOLR”) by arranging bailouts in response to major sovereign debt crises. As is now widely recognized, the problem with a purely bailout-based policy is that it requires ever larger funds to be credible and successful. It also invites undesirable policies by debtor countries. The prospect of a bailout encourages sovereign debtors to borrow more than they should, and it tempts them to resort to highly risky fixed exchange rate policies as a quick fix towards

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macroeconomic discipline.<sup>1</sup> Of course, the worst debtor misconduct can be controlled to some extent by imposing conditions on the debtor country before granting a rescue program, but more often than not, the IMF finds itself in a weak bargaining position at the onset of a debt crisis. How credible is the IMF threat to withhold a financial aid package when a potentially contagious debt crisis is about to erupt? And once the bailout has been granted, why should the debtor country abide by the conditions it agreed to?

Because of the potentially enormous financial commitment a pure ILOLR policy requires, and because of the moral hazard it may induce in sovereign debt markets, it is now widely understood that bailouts need to be supplemented by at least a partial “bailin” of the private sector. According to this view, the IMF’s involvement in a debt crisis should be conditioned on debt reduction or rescheduling by private sector lenders. Private creditors should be required, that is, to share at least some of the costs of resolving a crisis. Despite this emerging consensus on the importance of private sector involvement, however, there is still considerable disagreement on the appropriate balancing between bailout and bailin, and on the best process for crisis resolution and debt restructuring.

The most ambitious overhaul of IMF policy contemplated so far involves the introduction of some form of bankruptcy institution for sovereigns and envisions a single forum where the extent of debt reduction and the size of new emergency lending would be decided simultaneously. There was considerable discussion and research of this strategy—which the IMF calls a Sovereign Debt Restructuring Mechanism (“SDRM”)—from late 2001, when the IMF first announced its support for a sovereign bankruptcy framework, up to the G-10 meetings in April 2003, when the IMF’s proposal was shelved. Despite all the writing and debates, many open questions were still unresolved at the time of the G-10 meetings, including the role of the IMF in an SDRM regime. No doubt these questions would have received further attention if the SDRM proposal had gone forward. But in the aftermath of the SDRM debate, no clear new role has been marked out for the IMF and no clear rules have emerged to direct the IMF’s balancing of bailins and bailouts in future debt crises.

As a result, the IMF now finds itself at a crossroads. Should it be content with the status quo and accept that it will be less and less equipped to deal with major emerging market debt crises? Or, on the contrary, should its size be

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<sup>1</sup> The IMF bears its own share of responsibility in recommending such policies. For critical assessments of IMF policy recommendations on macroeconomic stabilization and intervention during the Asia crisis of 1997–98, see Paul Blustein, *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (PublicAffairs 2001) and Joseph E. Stiglitz, *Globalization and Its Discontents*, 89–132 (Norton 2002). For a more sympathetic view, see Nouriel Roubini and Brad Setser, *Bailouts or Bail-ins?: Responding to Financial Crises in Emerging Economies* (Inst Intl Econ 2004).

considerably expanded, possibly by granting a more powerful role to Japan, China and other East Asian countries that are sitting on massive idle foreign exchange reserves? Or, even more radically, should the IMF disclaim any role in crisis lending and confine itself to an advisory and forecasting function, as Chari and Kehoe, Rogoff, and others have urged?<sup>2</sup>

In this paper, we argue that by establishing an adequate bankruptcy procedure for sovereigns, the international community could both fully address the problem of sovereign debt restructuring and redefine an ambitious crisis resolution role for the IMF. Far from stepping away from a crisis lending role, we argue that the IMF could, without increasing the size of its funding, enhance its ILOLR role within the framework of a sovereign bankruptcy procedure. How do we square this circle?

Corporate bankruptcy provides a useful analogy for describing the new role we envision for the IMF. When a nonfinancial corporation ends up in financial distress, it does not, as a rule, seek a bailout from the government. Instead it files for bankruptcy, thus receiving temporary relief from its creditors. This relief from creditors—or “stay”—is the characteristic of corporate bankruptcy that has been emphasized most in the sovereign context. But, in addition to a stay on debt collection, and more significant for our purposes, the distressed firm can also ask the court to approve new priority lending—usually in connection with so-called “first day orders” that authorize the company to continue paying its employees and thus preserve its going concern value.<sup>3</sup> When the bankruptcy court grants new priority lending, it is not extending its own funds, as the IMF

<sup>2</sup> In his powerful analysis of the history of World Bank and IMF lending over the past sixty years, Rogoff argues:

[M]y long-held view is that the Fund would serve better if it made no loans. In a nutshell, the Fund's current resources of \$150 billion seem like enough to cause moral-hazard problems (that is, to induce excessive borrowing) without being enough to deal with a really deep global financial crisis. The Fund is just too politicised to be a consistently effective lender of last resort, and if its financial structure is not changed, there are always going to be Argentinas . . . No, the right future for the Fund, as for the IBRD, is to phase itself out of the lending business. The Fund can still make itself very useful in co-ordinating the global financial system, in offering technical advice, and perhaps even in issuing debt ratings to countries that request it. If the global community can work its way towards an improved bankruptcy procedure for sovereign borrowers, this path will be far easier. I would recommend it regardless.

Kenneth Rogoff, *The Sisters at 60*, *Economist* 63, 65 (July 24, 2004). See also V.V. Chari and Patrick J. Kehoe, *Asking the Right Questions about the IMF*, Federal Reserve Bank of Minneapolis Annual Report Issue (1998) (arguing that there is no need for the IMF to serve as ILOLR given that the central banks of the G-7 can already intervene directly in the event of a crisis).

<sup>3</sup> First day orders are described in Marvin Krasny and Kevin J. Carey, *Editors Reply to an Anonymous Letter: Why is Delaware the Venue of Choice for Philadelphia-Based Companies?*, *Legal Intelligencer* 9 (March 22, 1996); Marcus Cole, “*Delaware is Not a State*”: *Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 *Vand L Rev* 1845, 1856 n 58, 1864–65 (2002).

does when it puts together a financing package for a distressed sovereign. All the court does is make way for new lending by the private sector—often the same lenders that have already lent to the distressed firm in the past—by granting the new loans higher priority status.

We suggest that, just as a bankruptcy court does for corporations, the IMF could play the role of granting first-day orders to distressed sovereigns in the context of a sovereign bankruptcy procedure. Importantly, the IMF would not need any new funding to exercise this authority. Thus, a major additional benefit of sovereign bankruptcy is that it could open the way for a new enhanced role for the IMF. This new role would indeed strengthen the IMF's hand, as it would enable the IMF to facilitate much larger emergency lending packages consisting not just of IMF funding but private lending as well. In addition, it would not give rise to the same concerns about moral hazard as does the current form of intervention that relies on publicly funded IMF bailouts. In particular, since the fund would no longer just be extending its own funds, it would be subject to greater market discipline. The private lenders that the IMF would invite to provide the new capital could be expected to do so only if there were a plausible financial rationale for extending the loans. Moreover, the IMF could not extend priority status too liberally without imperiling its very existence.

To achieve this restructuring of the IMF's role, the underlying sovereign bankruptcy framework would need to provide coherent and enforceable priority rules.<sup>4</sup> In earlier work that did not envision this new role for the IMF, we argued that solidifying creditors' seniority rights may be the single most important benefit of establishing a sovereign bankruptcy regime.<sup>5</sup> In this Article, we take the analysis a step further, to incorporate a reconceptualized role for the IMF—a role that would avoid the increasingly real risk that the IMF might otherwise become obsolete.

The remainder of our article proceeds as follows. In Part II, we discuss the recent policy proposals for improving the sovereign debt restructuring process. We also consider the extent to which the benefits of a statutory procedure could be achieved through contractual alternatives, and briefly explore the implications

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<sup>4</sup> At a minimum this new role for the IMF is possible only if higher priority status can be granted to emergency lending. So far, the IMF has been able to implicitly enforce higher priority on its own and other International Financial Institution ("IFI") loans. However, this de facto priority is partly an illusion as the IMF has generally agreed to roll over its loans when the sovereign was unable or unwilling to pay. This higher priority status has also recently been tested by Argentina following its default on sovereign bonds. Conceivably, the IMF could already play the new role we propose—granting higher priority to emergency loans from the private sector—under the current legal environment. However, de facto, implicit enforcement of priority is likely to be more difficult to scale up and may need to be shored up by legal enforcement through the courts.

<sup>5</sup> Patrick Bolton and David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 *Emory L.J.* 763, 766–67 (2004).

of the recent debt crisis in Argentina. Part III maps out the new role for the IMF and assesses how IMF actions in debt crises may need to be circumscribed.

## II. INTERVENTION IN DEBT CRISES AND POLICY DEBATES

A wide range of reforms have been proposed as a partial or complete solution to the concerns described in the introduction. Such propositions have included greater use of collective action clauses (“CACs”) in bonds, a structured mediation or arbitration process for addressing sovereign debt crises, and various forms of sovereign bankruptcy. This section first briefly discusses CACs and some problems with their use, and then focuses at greater length on the IMF’s sovereign bankruptcy proposal, and on our own proposed framework—a more expansive alternative to the IMF proposal.<sup>6</sup>

Sovereign bonds governed by UK law have long included CACs specifying voting rules that permit a predetermined majority of bondholders to adjust payment or interest terms in the event of a debt crisis. In contrast, bonds governed by New York law have traditionally given each bondholder veto power to decide whether or not to agree to a restructuring. In the 1990s, an increasing number of commentators concluded that the New York “unanimity” approach made restructuring too difficult. To facilitate coordination among the sovereign’s bondholders, and to counteract the threat of holdouts, they argued, sovereign debtors should include CACs in all of their bonds.<sup>7</sup>

At its April 2003 meetings, the G-10, led by the US Treasury Department, endorsed a policy that strictly limits private sector involvement to only a voluntary inclusion of CACs in sovereign bond issues. Partly to stave off more drastic intervention in sovereign debt contracts and partly to placate the US Treasury, issuers have since introduced CACs into their new sovereign bond issues. In mid-2003, Mexico very publicly issued New York-registered bonds that permitted changes to the payment terms of bond with the consent of 75 percent of the holders, and several other sovereigns, including Uruguay and Brazil, followed suit.<sup>8</sup>

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6 Id.

7 For an early, influential emphasis on CACs, see Barry Eichengreen and Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* 49 (Centre for Econ Poly Rsrch 1995). More recently, Mitu Gulati has written extensively about the use and promise of CACs. See, for example, Lee C. Buchheit and G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 *Emory L J* 1317 (2002). For a nuanced view of the choice between CACs and the unanimity approach, see William W. Bratton and G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 *Vand L Rev* 1 (2004).

8 Since the end of 2003, nearly every new issuance of sovereign bonds has featured a CAC. Interestingly, the latest Uruguayan bond issues also include an aggregation clause that permits a combined vote of all the classes of bonds that include the clause. The clause is designed to

Despite these encouraging developments, however, there are still several reasons to suspect that CAC enthusiasts have oversold the virtues of the new clauses. First, CACs are more effective for restructuring one or a small number of classes of bonds, than for sovereign debtors with a more complicated capital structure.<sup>9</sup> Second, although CACs help counteract collective action and holdout problems, they do nothing to remedy any seniority and debt dilution problems as we explain below. CACs also do not address concerns such as the need for a standstill while the sovereign debtor is renegotiating its obligations.<sup>10</sup> Because of these shortcomings, we believe that a more interventionist policy, such as the statutory approach advocated by the IMF, is called for.

### A. THE IMF'S SOVEREIGN DEBT RESTRUCTURING MECHANISM

The IMF's sovereign bankruptcy initiative was first announced in a November 2001 speech by Anne Krueger. The IMF staff subsequently produced a series of detailed draft proposals outlining an SDRM in 2002 and early 2003. Because the IMF's proposal has been the lightning rod for recent debate over sovereign bankruptcy, we will explore it in some detail before considering our own proposed alternative.<sup>11</sup>

The guiding concern of the IMF's proposal is to resolve collective action problems among dispersed creditors in debt restructuring negotiations, while preserving creditor contractual rights to the greatest extent possible. Viewed from this perspective, the key element in the IMF's proposed mechanism is a majority vote among creditors on a restructuring plan that would bind a dissenting minority. With the aim of preserving creditor rights, the IMF's plan

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obviate the need for separate votes for each class of bonds by creating the possibility of a single, interclass vote on the terms of a restructuring. These developments are recounted and analyzed in Stephen J. Choi and G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 Emory L J 929 (2004) and Stephen Choi and G. Mitu Gulati, *The Evolution of Boilerplate Contracts: Evidence from the Sovereign Debt Market* (2004) (unpublished manuscript) (on file with the authors).

<sup>9</sup> This point is discussed in more detail in David A. Skeel, Jr., Can Majority Voting Provisions Do it All?, 52 Emory L J 417 (2003).

<sup>10</sup> Bolton and Skeel, 53 Emory L J at 773–76 (discussing this and additional shortcomings) (cited in note 5).

<sup>11</sup> Much of the description and analysis in this section is drawn from Bolton and Skeel, 53 Emory L J at 776–80 (cited in note 5). The IMF's first detailed proposal was IMF, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations* (Nov 27, 2002), available online at <<http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf>> (visited Mar 15, 2005). This proposal was subsequently adjusted. IMF, *Proposed Features of a Sovereign Debt Restructuring Mechanism* (Feb 12, 2003), available online at <<http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>> (visited Mar 20, 2005).

stops short of envisaging a stay on litigation and individual debt collection efforts or a standstill on debt payments. The relative difficulty of collecting sovereign assets, as opposed to corporate assets, is the main justification given for not introducing an automatic stay into an SDRM.

The main limitation on plaintiffs' gains envisioned by the IMF mirrors a legal rule in international insolvency law known as the "Hotchpot rule." This rule requires that any payment or asset collected by a plaintiff through litigation must be offset against the plaintiff's claim under the restructuring agreement. That is, any new claim the plaintiff would be entitled to under the restructuring agreement would be reduced by an amount equal to what the creditor obtained through legal action. Should the plaintiff obtain more than what the restructuring agreement specifies, the "Hotchpot rule" could be supplemented with a *claw-back* provision—but the IMF's proposed plan excludes such a provision on the grounds that it would be impractical.

The "Hotchpot rule" clearly reduces incentives for private litigation, but it does not eliminate them. Also, it does not directly address the concern that private litigation may be undertaken mainly as a negotiation or delaying tactic—for example by undermining the sovereign's ability to trade. The IMF's proposed plan recognizes this issue and proposes that a judge could have authority to stay specific legal actions on request of the debtor and subject to approval of creditors.

The voting provision and the "Hotchpot rule" are the centerpieces of the IMF's proposed plan. The plan also contains many more technical provisions dealing with notification of creditors, registration, and verification of claims. As in corporate bankruptcy these can be lengthy and difficult processes. An important additional complication is that the ultimate ownership of a sovereign bond is hard to trace. The court must be able to pierce through the veil of beneficial ownership to be able to ascertain whether the votes on a particular bond are controlled by the sovereign. Should that be the case, these votes ought to be ineligible for obvious conflict of interest reasons.<sup>12</sup> A related difficulty is that for widely dispersed debt structures many claims may not be registered in time. Given the large number of claims that will not qualify, a requirement that a supermajority of "registered" claims approve the plan may function more like a simple majority requirement in practice—thus resulting in weaker protection of

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<sup>12</sup> The problem of sovereign control of key claims, and through these claims, of a vote by creditors, figured prominently in a sovereign debt dispute involving Brazil in the 1990s. Through Banco do Brasil, which had participated in a syndicated loan agreement, Brazil managed to thwart an effort by other debtholders to accelerate the amounts due under the loan. *CIBC Bank and Trust Company v Banco Central do Brasil*, 886 F Supp 1105, 1118 (SDNY 1995) (refusing to intervene to impose implied obligations of good faith and fair dealing). For discussion and criticism, see Bratton and Gulati, 57 Vand L Rev at 75–77 (cited in note 7).

creditors. These difficulties underscore the need for a court-supervised restructuring procedure as well as the important benefits that might be available if an international clearinghouse were established.

Because the principal concern of the IMF's proposed plan is resolving of collective action problems among sovereign bondholders, the mechanism is underinclusive and incomplete as to the two other major facets of a restructuring procedure: the provision of interim financing and enforcement of absolute priority. The plan's only means of enforcing absolute priority is through the exclusion of several classes of debt from the SDRM. Thus, the plan proposes to exclude privileged claims, obligations to international organizations such as the IMF ("multilaterals"), and debt owed to other nations (the "Paris Club"). The IMF proposal also gives the sovereign debtor discretion to exclude other debt claims—such as trade credit, claims on the central bank, etc.—from the SDRM. An obvious difficulty with this approach is that it gives the debtor considerable power to undermine a given priority structure and to cut side deals with particular creditor classes in exchange for an exclusion of the claims from the formal SDRM proceedings.

The plan recognizes some of these difficulties and offers, as an alternative, to include Paris Club debt in the SDRM under a separate class. The plan also allows for other forms of classification and gives the debtor discretion to classify subject to the general requirement that classification does not result in unjustified discrimination among creditor groups.<sup>13</sup> While classification brings about greater flexibility it is important to understand that it does not in any way guarantee enforcement of absolute priority. To the contrary, as currently structured the IMF's plan may well facilitate deviations from absolute priority by giving a veto power, unconstrained by a cramdown or best interest rule, to a junior creditor class.

Just as the IMF's plan does not systematically address the issue of enforcing absolute priority it also only gives lip service to the issue of debtor-in-possession ("DIP") financing. With the objective once again of preserving creditor contractual rights as much as possible, the IMF's proposed plan only allows for "priority financing" if it is approved by "75 percent of outstanding principal of registered claims."<sup>14</sup> The main purpose of DIP financing is to address an immediate cash crisis and allow the debtor to function while restructuring negotiations are ongoing. Clearly, a creditor vote would be extremely difficult to organize in a timely fashion, making it virtually impossible to organize any such financing.

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<sup>13</sup> IMF, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations* at ¶ 25 (cited in note 11).

<sup>14</sup> *Id.* at ¶ 23.

The last key component of the IMF's plan is its proposal to set up an independent Sovereign Debt Dispute Resolution Forum ("SDDRF") to oversee the sovereign bankruptcy process.<sup>15</sup> The selection of SDDRF judges would be delegated to a selection panel designated by the IMF's Managing Director and charged with the task of creating a shortlist of candidate judges that might be impaneled when a debt crisis arises. The final shortlist would be subject to approval of the IMF's governing board. The president of the SDDRF would be charged with selection of the final group of four judges to be impaneled in the event of a crisis. While the plan goes to considerable lengths to guarantee the independence of the SDDRF it is still worth noting that this procedure is not a foolproof method to guarantee the full independence of the court.

Overall, the IMF plan is an extremely important development in our thinking about how best to address sovereign debt crises. As this brief overview makes clear, however, it also has serious limitations. Most importantly, the IMF plan focuses extensively on the ex post issue of solving creditors' collective action problems, but it pays much less attention to the equally important issue of the ex ante effects of an SDRM—in particular, the need to honor creditors' priorities in order to facilitate sovereign credit markets. In addition, the IMF's interim financing proposal is cumbersome and does not fully address the growing concerns about the nature of the IMF's funding and oversight role. Finally, the creation of an SDDRF within the IMF itself raises independence and conflict of interest concerns.

## B. ENFORCING SENIORITY

Although the IMF plan focuses on collective action problems, an equally important problem is debt dilution and the lack of enforcement of seniority in sovereign debt. In the absence of enforceable priorities, when a debtor country approaches financial distress any new debt it issues is partly at the expense of existing creditors who face a greater risk of default and will have to accept a greater "haircut" (or debt reduction) in the event of default, since the total resources the debtor can muster towards repayment of its stock of debt will have to be divided pro rata among all its creditors, old and new. In earlier work, we have highlighted how the lack of enforcement of an absolute priority rule encourages overborrowing by the sovereign as it approaches financial distress and also raises its overall cost of borrowing.<sup>16</sup>

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<sup>15</sup> Id at ¶ 227–73.

<sup>16</sup> Bolton and Skeel, 53 Emory L J at 771-72 (cited in note 5). For a more extensive analysis, see Patrick Bolton and Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of Seniority*, available online at <[http://gsbwww.uchicago.edu/research/workshops/finance/Bolton\\_Jeanne\\_October04.pdf](http://gsbwww.uchicago.edu/research/workshops/finance/Bolton_Jeanne_October04.pdf)> (visited Feb 9, 2005) (providing a formal analysis of optimal debt

Under the old IMF bailout-based policy the enforcement of an absolute priority rule was not a burning issue, since typically private creditors could expect repayment in full. But the shift in IMF policy towards private sector involvement following the Russian debt crisis of 1998 has brought to light the issue of priority in repayment and introduced new uncertainty in sovereign debt markets by upsetting market expectations concerning seniority. Two subsequent events roiled the waters still further: (1) the debt restructuring of Pakistan in 1999–2000; and (2) the decision by the Court of Appeals of Brussels in 2000 to grant Elliott Associates, a vulture fund that had invested in Peruvian debt, a restraining order against Euroclear—preventing it from accepting transfers from the Peruvian government towards paying other creditors before Elliott’s debt claims on Peru had been honored.<sup>17</sup>

The first event, Pakistan’s debt restructuring agreement of 2000, required for the first time that Eurobond holders be included in the restructuring agreement, thus shattering the market’s perception that these debts had higher priority status.<sup>18</sup> The second event, *Elliott Associates v Peru*, alerted the market to the potentially far-reaching possibilities that the traditional interpretation of the standard *pari passu* clause in sovereign bond issues might no longer be valid,<sup>19</sup> and that private litigants could threaten to disrupt the transfer of funds from sovereigns to creditors by obtaining restraining orders in court.

The new uncertainty as to which types of sovereign debt will be subject to restructuring, and as to the meaning of the ubiquitous *pari passu* clause, has propelled the issue of priority and debt seniority to the forefront of discussions about sovereign finance. Before examining how debt seniority can best be enforced, we begin by describing the *Elliott* decision and the legal debate surrounding it in more detail.

Elliott Associates, playing an aggressive holdout strategy, refused to go along with Peru’s proposed Brady Plan debt restructuring of 1995. Instead, it attempted to obtain repayment on its debt by initiating a series of lawsuits and eventually prevailed in the Court of Appeals of Brussels in September 2000.

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structure in the absence of any legal enforcement of seniority). The authors show that creditors attempt to achieve higher priority de facto by making their debt difficult to restructure. ● Overall, this results in an excessively high cost of financial distress. Id.

<sup>17</sup> *Elliott Assocs, LP v Banco de la Nacion*, 194 F3d 363, 366–67 (2d Cir 1999); Elliot Assocs, LP, General Docket No 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept 26, 2000).

<sup>18</sup> See Jeromin Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* (Sept 29, 2003) (unpublished working paper draft, IMF Research Department) (on file with authors) and Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 Emory L J 1115, 1128–30 (2004).

<sup>19</sup> The competing interpretations of the *pari passu* clause are described below. See note 23 and accompanying text.

Eager to avoid a default on its Brady bonds, the Peruvian Government decided to settle following the court's decision by paying Elliott in full.<sup>20</sup>

Underlying the Brussels court's decision was a seemingly straightforward interpretation of the *pari passu* clause. The clause states that "[t]he obligations of the Guarantor hereunder [the Peruvian Government] do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon."<sup>21</sup> The court interpreted this language as meaning that when the debtor is unable to repay all its debts in full, all claims of equal ranking under the *pari passu* clause should get a pro rata share of the total amount the debtor pays out. Most importantly, the court deemed that the debtor could not make payments to some creditors (the creditors who agreed to the restructuring) and default on others (the creditors who held out and retained their original bonds). It was on the basis of this interpretation that the court granted Elliott Associates a restraining order against Euroclear, the entity to which Peru had wired funds to pay consenting bondholders the scaled down amounts they had agreed to accept.<sup>22</sup>

The court's interpretation provoked a torrent of criticism.<sup>23</sup> Most commentators favor an alternative reading of the *pari passu* clause: that it is designed to prevent the borrower from issuing new debt that is senior to existing debt. Which interpretation the courts will adopt in the future is still uncertain, although in light of the outpouring of academic writing and briefs following the Brussels Opinion, the narrower interpretation favored by most legal scholars seems likely to prevail.

Lost in the hand-wringing over the Brussels Court of Appeals' novel interpretation of the boilerplate *pari passu* clause is the possibility that the court's remedy could open up a new strategy for enforcement of sovereign debt payments—with far-reaching consequences not conceived of before. Crucial to this possibility is the fact that the court granted a restraining order against EUROCLEAR, rather than limiting itself to a judgment against Peru.

To appreciate the implications, start with Gulati and Klee's ominous warning that:

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<sup>20</sup> G. Mitu Gulati and Kenneth N. Klee, *Sovereign Piracy*, 56 *Bus Law* 635, 635–36 (2001).

<sup>21</sup> *Id.* at 636. See also *Elliott Assocs, LP v Banco de la Nacion*, 2000 US Dist LEXIS 14169 (SDNY Sept 29, 2000) and *Elliott Assocs, LP v Republic of Peru*, 2000 US Dist LEXIS 368 (SDNY Jan 18, 2000).

<sup>22</sup> In effect, Elliott claimed that it was entitled both to claim its share of the payments being made to consenting bondholders, and (unlike the consenters) to continue to insist on payment of the full face amount of its bonds. See Gulati and Klee, 56 *Bus Law* at 636–37 (cited in note 20).

<sup>23</sup> For critiques of the Elliott ruling, see, for example, *id.* at 635; William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, 53 *Emory L J* 823 (2004); Lee C. Buchheit and Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 *Emory L J* 869 (2004).

What the Brussels Opinion does is to put a large hammer in the hands of holdout creditors, thereby enabling them to cause even more disruption in restructurings. Those inclined to be holdouts have a stronger position, and it encourages others to hold out. For the sovereigns and, we argue, for the majority of creditors, this is a nightmarish situation.<sup>24</sup>

The restraining order does indeed amount to a big stick for creditors, which plausibly should not be put in the hands of holdout creditors. Interesting new possibilities, however, can be imagined if one thinks of this stick as potentially applying to the enforcement of debt payments and seniority more generally. If creditors' inability to seize assets and a sovereign's limited capacity to issue collateralized debt interfere with a sovereign's ability to borrow, then an effective way of relaxing the sovereign's borrowing constraint may be to give creditors the means to credibly threaten to shut out a defaulting sovereign from international financial markets by preventing it from paying off new creditors.

The greater enforcement powers made possible by *Elliott*-type injunctions have inspired several commentators to outline the contours of a contractual approach to the enforcement of seniority in sovereign debt. One suggestion, put forward by both Zettelmeyer and Gelpern, is for senior creditors to enforce the priority ostensibly granted to them by a sovereign debtor vis-à-vis other junior creditors pursuant to a "third-party beneficiary" theory. Junior creditors would agree to subordinate their claims, and courts might enforce the subordination, based on the theory that the junior creditors could be construed as beneficiaries of the financing from the senior creditor.<sup>25</sup> Another suggestion, first offered by Wood, is to contractually require the sovereign to include senior creditors as parties in subsequent junior debt issues.<sup>26</sup> If sovereign debtors began to include these kinds of subordination arrangements in their debt contracts, one could conceive of *Elliott*-type injunctions that courts might grant to senior creditors against a sovereign that later attempted to violate the terms of the earlier agreement. If a sovereign debtor that had agreed to subordinate any subsequent debt failed to do so, a creditor could ask a court to enjoin the new issuance.

While such remedies might conceivably discipline sovereigns and open the way for contractual enforcement of an absolute priority rule for sovereign debt, one concern is that the cure could be worse than the disease. There exists a real potential for nightmarish disruptions to the payment system, and one can also imagine a multiplication of costly legal actions among creditors. In addition, this strategy would impose a continuous monitoring burden on the senior creditors. Because any subordination clause included in a creditor's contract with the

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<sup>24</sup> Gulati and Klee, 56 *Bus Law* at 638 (cited in note 20).

<sup>25</sup> Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* (cited in note 18); Gelpern, 53 *Emory L.J.* at 1152-53 (cited in note 18).

<sup>26</sup> Philip R. Wood, *The Law of Subordinated Debt* (Street & Maxwell 1990).

borrower could not bind a subsequent third-party borrower who might be ignorant about the priority arrangement, the senior creditor would be forced to police the debtor to make sure that the sovereign included a subordination provision in each subsequent debt issuance.<sup>27</sup>

We do not mean to discourage these contractual innovations, which may be the only realistic way forward in the absence of a renewed effort on the part of major debtor and creditor nations to introduce a sovereign bankruptcy procedure. But it is important to recognize that the contractual approach brings important risks which could be largely avoided under an expanded statutory debt restructuring mechanism, as we now explain.

### C. OUR PROPOSAL

The SDRM either ignores or does not satisfactorily address three critical issues: (1) the absence of a coherent priority scheme; (2) the need for an interim financing strategy that refines and alters the role of the IMF; and (3) the need for an independent decisionmaker to oversee the sovereign bankruptcy framework. In earlier work, we have explained how an expanded sovereign bankruptcy framework might handle each of these issues.<sup>28</sup>

With respect to priority, the sovereign bankruptcy framework should include a straight first-in-time priority scheme, together with voting procedures that call for absolute priority treatment—that is, the assurance that higher priority creditors will be paid in full, and that any haircut will be aimed first at lower priority creditors. Under our proposal, priority would be based on the time that the credit was extended, with the debt of any given year taking priority over debt issued in a subsequent year. Based on this priority, the sovereign debtor would divide its creditors into classes at the outset of a two tier voting process for restructuring the sovereign's debt. For the purposes of the first vote, the debtor would make a proposal as to how much of its overall debt would be discharged—that is, how large the overall haircut to creditors would be—and submit the proposal to a vote of all creditors.<sup>29</sup> If a majority of all creditors

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<sup>27</sup> If the priority arrangement were somehow deemed to be binding on a subsequent creditor, the higher "due diligence" burden would fall on new lenders, who would need to determine what the stock of outstanding senior debts was before making a loan. Short of setting up a central register of senior debt that could be easily accessed by new lenders this would often be an impossible task.

<sup>28</sup> Bolton and Skeel, 53 *Emory LJ* at 763 (cited in note 5).

<sup>29</sup> At first glance, it may appear that the first step vote would invariably lead to a 49 percent haircut under a simple majority voting rule, since a bare majority of creditors would form a coalition to cut off the remaining creditors, thus increasing the likelihood of repayment for the winning creditors. But the minimum winning coalition intuition only applies if there are numerous, same-sized classes of creditors. If there were only one large creditor class, for instance, the class would presumably agree to whatever haircut optimizes its repayment, based on the sovereign debtor's

approved the haircut, the debtor would submit a restructuring plan outlining the proposed treatment of each class of creditors for a second, class-by-class vote.<sup>30</sup> If the requisite majority of each class voted yes, the plan would be implemented according to its terms. In the event that one or more classes rejected the plan, on the other hand, the court would reduce the creditors' claims in the amount of the agreed upon haircut, starting with the lowest priority creditors and working up the priority hierarchy.

This two-step approach has several crucial virtues. Perhaps most importantly, it would clarify creditors' priorities outside of bankruptcy and sharply reduce the risk of debt dilution. Since creditors would know that any subsequent bankruptcy would be governed by the first-in-time priority scheme, the priorities would apply within and without sovereign bankruptcy.<sup>31</sup> For sovereigns that actually invoked the procedure, the two-step voting structure would provide a mechanism for pushing the parties towards a resolution even if bargaining broke down, much as the threats of liquidation or cramdown do in ordinary corporate bankruptcies under US Chapter 11.<sup>32</sup>

The principal exception to absolute priority in our sovereign bankruptcy framework comes with its second key feature, interim financing. As with corporate debtors under Chapter 11, our framework would provide first priority for interim financing in order to counteract the debt overhang problem that otherwise might discourage lenders from financing the restructuring process. Because of the risk that priority treatment would encourage overborrowing, however, we distinguish between two categories of loans. Loans to finance the

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financial condition. In the real world, the capital structure of a sovereign debtor will fall somewhere between the two extremes of numerous, same-sized classes and a single giant class. The first stage vote will also be affected by other factors, such as the sovereign debtor's interest in seeking only as much of a haircut as is necessary, in order to preserve credibility and its access to sovereign debt markets after the bankruptcy.

<sup>30</sup> Our proposal does not specify the required voting percentage, as the voting rule could be tailored by each sovereign when the bankruptcy framework was adopted. But we speculate that many would require a two-thirds supermajority, as under US Chapter 11. Bolton and Skeel, 53 *Emory L J* at 797 (cited in note 5).

<sup>31</sup> Sovereigns could, of course, still try to game the system and dilute earlier debt by issuing debt with very short maturities as their finances deteriorated. They would have difficulty finding buyers for such debt, however, because investors would know that their interests would be wiped out if the sovereign debtor filed for bankruptcy before repaying the new debt.

<sup>32</sup> Under Bankruptcy Code section 1112(b), creditors can propose that a case be converted to Chapter 7 in order to liquidate the debtor; and section 1129(b) provides a mechanism for "cramming" down a reorganization plan despite the objection of one or more classes of creditors. 11 USC §§ 1112(b), 1129(b) (2000). Although sovereign debtors cannot be liquidated and the absence of a liquidation option makes cramdown difficult to implement, the two-tiered voting regime is designed to achieve a similar effect.

sovereign's trade debt would be presumptively permissible,<sup>33</sup> whereas some form of approval, such as from a majority of the sovereign's creditors would be required for larger loans. This strategy would effectively cabin the size of interim loans. In addition to minimizing the risk of overborrowing, the limited interim financing would also reduce the impact on the IMF's budget if the IMF continued to serve as interim financier.<sup>34</sup>

The final issue is who should oversee the sovereign bankruptcy framework. Unlike earlier proposals, which would vest authority in a panel of experts set up by a new or existing international organization, our proposal would permit sovereign debtors to file their case in the bankruptcy or insolvency court of any jurisdiction where the sovereign has issued bonds (currently, this is likely to mean New York, London, Frankfurt, or Tokyo). Not only would judges be better decisionmakers than the experts selected by a bureaucratic process, but giving sovereigns a choice would promote jurisdictional competition and, as a result, further enhance the decision-making process. The competition would be loosely analogous to the benefits of venue choice for corporate debtors in the US.

#### D. APPRAISING ARGENTINA'S DEBT RESTRUCTURING CHALLENGES

It took only three months after a final futile attempt by the IMF to rescue Argentina in September 2001 followed by a desperate move by the Argentine government to restructure its domestic debt, for Argentina to face the inevitable and declare a default on its foreign debt. At the same time, Argentina also ended its nearly decade long currency board experiment, resulting in a rapid and substantial depreciation of the peso, which precipitated a systemic bank run. The nation's new government hastily responded with a general freeze on bank deposits that lasted for over half a year, with devastating effects on the economy. The dislocation of the Argentine economy provoked by the default and its aftershocks was so great that GDP contracted by 11 percent in 2002—with a predictable sharp increase in poverty and unemployment. Understandably, in the midst of an economic crisis of such magnitude and the associated political turmoil, external debt restructuring was not a priority for the Argentine government in 2002. Creditors were also reluctant to initiate negotiations at a

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<sup>33</sup> For a description of the contours of trade debt financing, see, for example, IMF, *Trade Finance in Financial Crises: Assessment of Key Issues* (Dec 9, 2003), available online at <<http://www.imf.org/external/np/pdr/cr/2003/eng/120903.pdf>> (visited Feb 7, 2005).

<sup>34</sup> Our earlier article contemplated that the IMF would continue to play this role. See Bolton and Skeel, 53 *Emory L.J.* 763 (cited in note 5). In Part III of this Article, we propose a new strategy for interim financing that entails a restructuring of the IMF's role.

time when the economy and Argentina's perceived ability to repay its external debt were at their lowest.

While Argentina was undergoing the worst economic crisis in its history, commentators in the SDRM debate sometimes pointed to Argentina as a test case, which would vindicate advocates of a contractual approach to sovereign debt restructuring and show that it was possible to orchestrate a voluntary debt restructuring successfully in a short period of time. Unlike the few prior cases of successful debt restructuring such as Pakistan, the Ukraine, and Ecuador, the size and complexity of Argentina's external debt restructuring problem—involving multiple bond issues held by hundreds of thousands of creditors all over the world and adding up to nearly ninety billion dollars total face value of debt—would truly put the contractual approach to the test. Could a voluntary restructuring of such magnitude and involving so many creditors be completed successfully in a reasonable amount of time? And could Argentina avoid falling prey to holdout creditors and to the uncoordinated legal actions of multiple creditor groups?

Advocates of a contractual approach argued that the risk of private litigation and the potentially disruptive consequences of court rulings in the wake of *Elliott Associates v Peru* were highly exaggerated. They predicted that no US or English court would grant *Elliott*-type injunctions to Argentine creditors. They also maintained that once negotiations started and an offer was on the table, the contracting parties would be able to reach a swift agreement without undue delays. The only source of delay, they maintained, was due to the Argentine government dragging their feet and refusing to initiate negotiations. Furthermore, a statutory mechanism for debt restructuring, as envisioned by the IMF, would fare just as poorly in inducing the Argentine government to the negotiating table.

Their predictions have only partially been borne out by events. The risk of private litigation did indeed turn out to be less important than many commentators had feared. There have been fewer lawsuits than expected and the US District Court for the Southern District of New York in particular—where several actions against Argentina have been brought—has shown considerable restraint and willingness to first give negotiations a chance. The court has also ruled in favor of Argentina in limiting creditors' ability to seize Argentine assets in the US, such as Argentine military assets and Argentine payments to its embassy.<sup>35</sup> The same court had earlier certified a class action suit by a group of creditors and granted these creditors the right to attach Argentina's commercial assets worldwide. Partly in response to this ruling, Argentina had to take several

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<sup>35</sup> Angela Pruitt, *US Judge Limits Scope of Discovery on Argentine Assets*, Dow Jones Newswires (May 13, 2004).

precautionary steps to protect its assets—such as transferring funds to its embassies through channels outside the banking system, and temporarily renationalizing the postal service to preempt the attachment of postal service assets abroad. While clearly disruptive, these steps have not, however, imposed substantial costs on Argentina as had been feared.

Predictions of advocates of a *laissez faire* approach have proved inaccurate, on the other hand, as to the likely ease and speed of the voluntary restructuring approach. Argentina's experience in the three and a half years following the declaration of default on its external debt has, if anything, underscored the difficulties and inefficiencies of a contractual approach, and provides support for the more interventionist policy envisioned by the IMF under the SDRM. Indeed, nearly four years have passed and an incomplete restructuring agreement has only just now been secured. These nearly four years of delay are not entirely attributable to the Argentine government's reluctance to negotiate. A first offer in September of 2003 to write off 75 percent of the nominal value of the debt had been flatly rejected by creditors as too low, especially in light of the promising signs of recovery of the economy in the early months of 2003. After the collapse of this first round of negotiations, creditors did not sit still. Many small holders of Argentine bonds, mainly based in Europe, organized themselves under the Global Committee of Argentina Bondholders ("GCAB")—a bondholder committee seeking to represent dispersed bondholders in direct negotiations with the Argentine government.

Although a recent debt-swap offer has been accepted by a roughly 75 percent majority of creditors, there have never been formal direct negotiations between the GCAB or any other representative bondholder committee in the past two years.<sup>36</sup> Indeed, with the strong backing of Argentine public opinion and a strengthening economy, the Kirchner government adopted a hard negotiating line and refused to make significant concessions on its first offer. Although Argentina's ability to repay its debts has significantly improved over the past two years, its willingness to pay has if anything decreased. Most of Argentina's costs of default had been incurred in 2002 and were sunk by the time negotiations started. Neither the Argentine economy nor the government was in urgent need of borrowing from international capital markets. With the GCAB insisting that Argentina's ability to repay should be the only criterion for determining the size of a reasonable haircut, there was little room for a mutual understanding between the two parties.

Despite the tough stance taken by the Argentine government and its decision to move forward with a new unilateral, take-it-or-leave-it, debt swap offer, it still took considerable time to put forward a new proposal. There were

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<sup>36</sup> Adam Thomson, *Argentina Seeks to Ease Creditor Concerns on Debt Clause*, *Fin Times* 6 (Jan 15, 2005).

initial hesitations as to the form of the offer and the extent to which early adopters should be favored over later adopters to build in an incentive to accept the exchange.<sup>37</sup> The Argentine government had further difficulty in enlisting an investment bank to organize the debt exchange. And finally, following a worldwide road-show to advertise the exchange, Argentina still had to receive the approval of a number of National Financial Regulators in countries like Italy, where a large number of small Argentine bondholders resided.

The successful completion of the recent swap is not due to Argentina coming around to bondholders' demands. Rather, after sticking to its tough bargaining stance for nearly four years, Argentina has managed to wear down a large fraction of creditors. Also, Argentina has benefited from a sharp decline in emerging market debt yields—an unexpected development that has produced a substantial increase in the real value of the debt exchange.

At the time of writing it is not possible to say what will happen to the holdouts of the recent debt exchange. Will their bargaining position be strengthened or weakened? Will they prevail in court against attempts by the Argentine government to stay in default on those bonds? Thus, even after Argentina's resounding victory in the latest debt exchange, it is still not clear how successfully the voluntary debt restructuring process will play out with the significant fraction of holdouts. Few observers would describe this experience as vindication of a *laissez faire* approach. It is even harder to describe Argentina's debt restructuring experience as particularly favorable to creditors. Bondholders could hardly have obtained worse terms had the restructuring taken place under a more formal bankruptcy procedure such as that proposed by the SDRM. In all likelihood they would have secured a deal much sooner and under better terms.

In hindsight, the Argentine experience points to one major advantage of a statutory approach: it can be structured to keep the negotiating process moving forward by specifying hard deadlines for offers to be submitted, as in Chapter 11, and by structuring incentives for the parties to come to a quick resolution of the restructuring process. The Argentine experience also highlights that creditors can be put in a weaker bargaining position under *laissez faire* through a coercive exchange offer than they would be under a statutory procedure where final approval depends on some form of supermajority voting.

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<sup>37</sup> According to Dow Jones, the Argentine government eventually decided to abandon initial plans to include "exit consent" clauses in Argentina's debt-swap offer as a way of avoiding potential future litigation and securing approval of the plan with some countries' financial regulators. *Argentina Lavagna: Confirms No Debt Swap "Exit Consents"*, Dow Jones Newswires (Nov 5, 2004).

### III. TRANSFORMING THE IMF'S ROLE AS A LENDER OF LAST RESORT

The IMF's place in the international financial architecture is now more uncertain than it has been since the collapse of the Bretton Woods framework in the 1970s. The size of the Fund relative to international financial flows and to the stock of foreign reserves held by central banks around the world has been shrinking to the point where it can no longer play a credible leadership role as lender of last resort for any but the smaller emerging market borrowers. As a result, the Fund has increasingly been drawn to focus on emerging market countries and to redefine its mission as one of macroassistance to developing nations and to poverty reduction—a role traditionally performed by the World Bank. It is not clear whether the Fund has the expertise to fill this new role effectively, and there is a risk that it may end up being marginalized by the World Bank and other development aid agencies. But more importantly, the new mission that has been pressed onto the IMF due to lack of funding is not the mission that the Fund has been set up to pursue.

One obvious way of restoring the IMF's original role, advocated by some G-7 countries, is to substantially increase the size of the Fund. But even if this enlargement were feasible, the history of past interventions would still raise major concerns about the potential distortions large bailout packages can introduce into sovereign debt markets. Another way forward, advocated by several leading economists, is to move in the opposite direction—further scaling back the size of the fund, phasing out IMF programs entirely, and confining the IMF to a purely advisory role.<sup>38</sup>

We believe that neither of these two options is desirable. If the IMF were no longer a major source of emergency lending for distressed sovereigns, as advocates of a scaled back IMF propose, why should sovereign governments pay any attention to its advice? Even free advice would not be welcome, and the IMF would be doomed to irrelevance. More importantly, once the IMF exited the lending business, it could no longer play its role as catalyst to help resolve liquidity crises and debt panics.<sup>39</sup> The alternative solution, a much larger but unreformed and highly political institution, would give rise to moral hazard in lending and other distortions. Perpetuating the status quo is equally undesirable, since it would be equivalent to condemning the institution to a slow death.

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<sup>38</sup> See Rogoff, *The Sisters at 60*, Economist at 65 (cited in note 2); Chari and Kehoe, *Asking the Right Questions about the IMF*, Federal Reserve Bank of Minneapolis Annual Report Issue (cited in note 2).

<sup>39</sup> See Giancarlo Corsetti, Bernardo Guimaraes, and Nouriel Roubini, *International Lending of Last Resort and Moral Hazard: A Model of IMF's Catalytic Finance*, NBER Working Paper No 10125 (Dec 2003), available online at <<http://papers.nber.org/papers/w10125.pdf>> (visited Mar 20, 2005).

Rather than any of these alternatives, we believe that the IMF's role should be reconfigured in a very different way, as part of a sovereign bankruptcy framework that establishes an enforceable priority system for sovereign debt. The role we envision would strengthen the IMF's ability to act as an ILOLR in emerging market liquidity and confidence crises. It would also strengthen the IMF's hand in resolving sovereign debt insolvency crises. Yet it would not require any new public funding.

The proposal is quite simple. Instead of acting like a central bank that provides liquidity to a bank facing a bank run, the IMF would function like a bankruptcy court charged with granting first-day orders and other DIP financing. In practice, not much change would be required in the way the IMF operates. A distressed sovereign would still begin by approaching the Fund with a request for an assistance package. The size of the loan and its conditionality would still be negotiated between the Fund and the sovereign behind closed doors. The loan agreement would still have to be approved by the IMF's Board. But under the new role we envision, the IMF would put together a funding package that would include priority lending from the private sector along with its own funds and any other public funding it can assemble. Over time, the IMF would need to rely on a greater and greater contribution from the private sector.

To secure this sovereign debt version of DIP financing, the negotiations inevitably would involve the private sector as well as the IMF, since few private lenders are anxious to lend on a sight-unseen basis. In practice, the private sector involvement would be an important benefit of the new model we envision. Currently, when a package is put together the private sector does not participate in the negotiations and essentially must take the deal the IMF has worked out with the sovereign as a *fait accompli*. This process not only makes it more difficult to involve the private sector, but also encourages free riding by private lenders on the IMF's emergency lending. Under our proposed new system, private lenders would be directly involved in the negotiations; private sector involvement would thus automatically be tied to the rescue deal. The coordination between private lenders and the IMF's role as ILOLR is an important benefit of our framework.

Another important benefit of the new model is that it would gradually shift from taxpayer to private sector money and would be subject to more and more market discipline. If the private sector viewed a proposed rescue package as just more money down the drain, it would in all likelihood refuse to extend new lending even if the new loans had higher priority status.<sup>40</sup> Similarly, if the

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<sup>40</sup> This intuition is buttressed by the experience in Chapter 11 cases. The existing empirical evidence suggests that DIP financiers are more likely to lend to debtors that have a significant chance of successfully reorganizing, than to more precarious firms. See, for example, Maria Carapeto, *Does*

sovereign were a repeat offender it would, over time, have less and less access to emergency lending and would risk being shut out of the international credit markets.<sup>41</sup> The reason is simply that following each crisis the sovereign would have accumulated a larger stock of still outstanding priority debt and would be less and less able to secure new DIP financing, particularly if, as we propose below, prior DIP loans have priority over any subsequent DIP financing.<sup>42</sup>

While the new role we envision calls for a radical departure from existing policy, it would not fundamentally change the process by which the larger crises are currently handled. Consider, for example, how the IMF managed South Korea's debt crisis in 1997. After a substantial rescue package was put together on December 3, 1997, it quickly became clear that the funds promised to the South Korean government would be insufficient.<sup>43</sup> The package had not adequately reassured markets, and banks continued to pull out of Korean sovereign debt, refusing to roll over their short-term loans, something they had never objected to doing in the past. Faced with an impending crisis, the Treasury and Federal Reserve resolved as a last resort to convene a meeting with the major lenders under the auspices of the New York Fed on December 22, 1997, and managed to wring an informal agreement from those present to continue rolling over their loans.<sup>44</sup> The only way the Treasury and Fed could entice the banks to attend the meeting, and then to cooperate by agreeing to roll over their loans, was *moral suasion* bolstered by the fear of a major financial crisis if banks refused to follow the IMF's lead. As several commentators have observed, moral suasion is a rather weak inducement to rely on in dealing with a crisis of these proportions. It would be foolish to depend on such a policy to maintain

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*Debtor-in-Possession Financing Add Value?* (unpublished manuscript, 2003), available online at <<http://www.cass.city.ac.uk/faculty/mcarapeto/papers/DIPFinancing.pdf>> (visited Mar 20, 2005) (finding that debtors receiving interim financing more likely to reorganize); Sandeep Dahiya et al, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J Fin Econ 259 (2003) (same).

<sup>41</sup> Our approach would not preclude debt reduction initiatives for Highly Indebted Poor Countries ("HIPCs"). These initiatives would merely take a different form. Instead of forgiving previously granted official multilateral debt, the international community would buy private debt in the secondary market and then retire it.

<sup>42</sup> See text accompanying note 49.

<sup>43</sup> A total of fifty-five billion dollars, of which twenty-one billion dollars was contributed by the IMF, was promised the South Korean government. This represented the highest amount the IMF had ever lent to a single country and exceeded the normal quota by a multiple of six. See Blustein, *The Chastening* at 148 (cited in note 1).

<sup>44</sup> Six US banks—Citibank, J.P. Morgan, Chase, Bank of America, Bankers Trust, and Bank of New York—attended the first New York meeting, which kick-started a series of negotiations with international banks that eventually led to a rescheduling agreement of twenty-two billion dollars in short-term loans in exchange for a sovereign bond, with the Korean government on January 28, 1998. *Id.* at 177–205.

international financial stability. It is not difficult to imagine a different outcome to the Korean crisis, with some major banks deciding not to attend the meeting at the New York Fed for example, and others unwilling to go along with the IMF or unable to agree on how the cost of rolling over their debts should be shared.

Now imagine the same situation, but with the IMF wielding new powers to grant priority status to banks' new emergency lending. In contrast to the situation at the time, under this new regime banks would have had an incentive to attend the meeting, since this might have given them an opportunity to obtain higher priority status for their new loans. The higher priority would have put them in a stronger position than the banks that did not attend the meeting if the rescue plan failed and Korea defaulted on its existing debts. In addition, for those banks attending the meeting, the IMF would have been able to secure their cooperation much more easily by granting seniority status to their new loans.<sup>45</sup>

While the potentially huge benefits of this new role for the IMF are obvious, there also are several potential concerns. A first issue is whether a highly politicized institution like today's IMF would abuse its new powers and grant priority lending too liberally. This was a constant worry in the early days of Chapter 11, with courts permitting debtors to drag out cases for years, and generally deviating too easily from enforcement of absolute priority.<sup>46</sup> The history of IMF bailouts suggests that similar problems could undermine the framework we have described unless the ability to grant priority status to emergency lending was constrained. One such constraint might be to require creditor approval of DIP loans, if the loans are beyond a certain size or involve a high proportion of new lenders.<sup>47</sup>

There is a delicate balancing here, however, as any approval required by creditors before the DIP financing is granted could undermine the IMF's ability to respond quickly and quietly to a crisis. Announcing to all creditors that a sovereign is seeking their approval for new DIP financing is tantamount to

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<sup>45</sup> Although the size of the bank loans would often be quite large, there is no reason to suspect that this would jeopardize the financing process we propose. In ordinary corporate bankruptcy cases, bankruptcy courts have overseen major loans—such as the \$1.5 billion DIP loan to United Airlines—without a hitch.

<sup>46</sup> See for example Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 Wisc L Rev 729 (documenting the increased length of Chapter 11 cases).

<sup>47</sup> The possibility of a creditor vote on financing in the corporate context is considered and critiqued in George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 Vand L Rev 901, 915–16 (1993). Our previous article proposed that financing in amounts sufficient to cover a sovereign's trade debt should presumptively be approved, without a creditor vote. Bolton and Skeel, 53 Emory L J at 808 (cited in note 5).

broadcasting the sovereign's financial distress to the world and may well do more harm than good. Therefore, unless the sovereign was already in default and had suspended debt payments, and short of reforming the governance of the IMF, a more practical protection would be to either put ex ante limits on the size of DIP financing (such as a maximum percentage of outstanding debt) or to allow for the possibility that courts could reverse the priority status of the most egregious forms of DIP financing ex post if the sovereign subsequently invoked the bankruptcy procedures once again. This latter possibility would instill some market discipline on the DIP lenders and limit the worst forms of abuse of DIP financing—although at the cost of introducing additional uncertainty into the lending markets.<sup>48</sup>

A second concern is whether a priority rule for sovereign debt could be enforced at all. How would the IMF be able to enforce priority? How should a recalcitrant sovereign be dealt with? So far the IMF has on the whole been able to enforce the higher priority of its own funds.<sup>49</sup> The IMF's success can be traced to a major carrot and stick it can apply to enforce its priority status. Compliant sovereigns continue to have access to IMF programs at favorable rates, whereas a recalcitrant sovereign risks losing its membership and facing some form of exclusion from sovereign debt markets. There is no reason a priori to expect that the IMF's enforcement powers would disappear if the loan were made by the private sector with the IMF's blessing. But, should the stock of senior debt become so large that the sovereign might be tempted to default and to ignore the priority status in a restructuring, one could still envision enforcement of priority through the courts via *Elliott*-style remedies.

Third, what happens when a sovereign repeatedly runs into financial distress and accumulates senior loans from past DIP financing? Wouldn't new DIP financing risk diluting old DIP loans, if the sovereign debtor defaulted a second or even third time on all its debt? And if this dilution were anticipated wouldn't it prevent the IMF from obtaining emergency lending from the private sector? An obvious way of addressing these problems would be to make sure that past DIP loans had priority over current and future DIP loans. In effect, the first priority DIP loans would themselves be subject to a first-in-time priority regime.

Fourth, how would Paris Club and other bilateral government debt be treated? Ideally, Paris Club creditors would be subject to the same restructuring process as other creditors. It is unlikely, however, that sovereign lenders would

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<sup>48</sup> Under US bankruptcy law, a court's initial decision on DIP financing generally cannot be reversed so long as the credit was extended in good faith—a protection that is justified as necessary to ensure certainty. See 11 USC § 364(e).

<sup>49</sup> See Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* (cited in note 18).

agree to put themselves under the authority of the IMF or a sovereign bankruptcy regime. The most plausible approach for handling Paris Club debt would be to treat it as a priority obligation. Although this poses the risk that Paris Club loans will dilute the interests of private creditors, one benefit is the possibility that an alternative source of emergency lending to sovereigns would be available that could serve the role of a safety valve in cases where the IMF failed to intervene, perhaps for political reasons.

The final issue is implementation: What changes would need to be made to restructure the IMF's role as we have described? Advocates of sovereign bankruptcy have proposed a variety of implementation strategies. One commentator suggests that sovereigns could unilaterally adopt a sovereign bankruptcy regime.<sup>50</sup> Under this approach, a model law could be drafted by UNCITRAL or another international organization, and the legislatures of sovereign debtor states could pass legislation based on the draft law. In effect, the bankruptcy framework would set the parameters of the debtor's obligations to its creditors. A second strategy would rely on treaties among the creditor and debtor nations or a convention ratified by the legislatures of the various affected countries. Still another strategy centers on an amendment of the IMF's articles, which would require majority approval by the IMF and approval of three-fifths of the Fund's members.<sup>51</sup> Members would then be expected to take appropriate steps to implement the change under their domestic law. This third approach is the strategy the IMF planned to use to implement its SDRM.<sup>52</sup>

We believe that the new role we envision for the IMF would not by itself require *any* of these changes. Since our proposal would simply reconfigure the IMF's existing role—retaining IMF oversight while privatizing the lending function—it should not require the IMF to go back to its members to ask for different or additional authority. This suggests that the IMF could adopt the reconfigured role on an ad hoc basis, by negotiating a financing package that relies on private lending the next time it intervenes in a sovereign debt crisis. In our view, the ease with which the proposal could be adopted is one of its signal attractions.

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<sup>50</sup> Christoph G. Paulus, *A Legal Order for Insolvencies of States* 6–7 (unpublished manuscript), available online at <<http://www.inwent.org/ef-texte/sdrm/paulus.htm>> (visited Mar 20, 2005).

<sup>51</sup> More precisely, amendment of the IMF Articles requires three steps: (1) the Executive Board votes on a proposed amendment, and it is approved by a majority of those who vote; (2) the amendment is approved by a majority of the Board of Governors who vote; and (3) it is approved by three-fifths of the members of the Fund, with at least 85 percent of the total voting authority. See for example IMF, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations* at ¶ 275–82 (cited in note 11) (describing the amendment process).

<sup>52</sup> *Id.*

Adjusting the IMF's role by itself, however, is an incomplete solution to the shortcomings in the existing international financial architecture; most importantly, it would not address the need for a coherent, enforceable priority scheme—a need that we have stressed throughout the Article. But even in the absence of a more complete reform such as sovereign bankruptcy, the reconfigured IMF role offers two hugely important benefits: it would address the IMF's funding limitations and would bring the private sector into the heart of the debt restructuring process. More generally, the reconfigured role would preserve the IMF's relevance for the sovereign debt markets of the new century. These benefits suggest that it would make sense to adopt the new approach now, without waiting for more sweeping reforms such as implementation of a sovereign bankruptcy regime.