THE PROBLEM OF SOVEREIGN DEBT RESTRUCTURING: NEED FOR A FEASIBLE SOLUTION

Dissertation submitted in Partial fulfillment of the Degree in LL.M (Business laws)

NATIONAL LAW SCHOOL OF INDIA UNIVERSITY BANGALORE

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CERTIFICATE

This is to certify that this Dissertation on "**The problem of Sovereign Debt Restructuring: Need for a feasible Solution**", submitted by Jyoti Shishodia (LL.M ID. No.275) for the Degree of Master of Laws (Business Laws) for the session 2007-09 of National law School of India University , Bangalore , is the product of bonafide research carried out under my guidance and supervision. This Dissertation or any part thereof has not been submitted elsewhere for any other degree.

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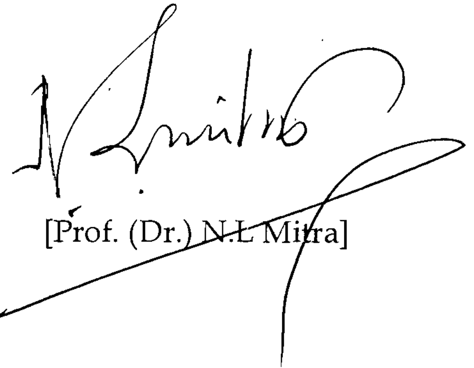

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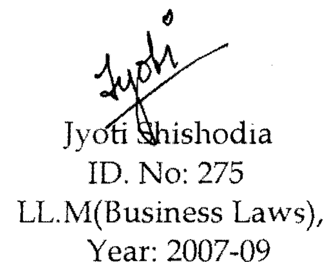
Declaration

I, Jyoti Shishodia, do hereby declare that the work titled "**The problem of Sovereign Debt Restructuring: Need for a feasible Solution**", is the product of research carried out by me under the esteemed guidance and supervision of **Dr. N.L Mira**, Ex-Vice Chancellor, National law School of India University, Bangalore.

I further declare that this work is original, except for such assistance, taken from such sources, as have been referred to or mentioned at the respective places, and for which necessary acknowledgements have been made.

I also declare that this work has not been submitter either in part or in whole for any degree or diploma at any other university.



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"When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor and least hurtful to the creditor."

Adam Smith, Wealth of Nations[1]

INTRODUCTION

As evidenced by Adam Smith's statement, the failure of a sovereign debt is neither a new development nor a new experience. As long as there have been banks with money to lend and governments that need to raise overseas credit-whether to finance wars or to promote development there has been sovereign lending. And as long as there has been sovereign lending there has been default, debt renegotiation and rescheduling. Classical historians trace these features of international banking back to the Greek city-states, which borrowed, heavily from one of the richest of the temples-Delos-and defaulted.[2] Medieval historians have told the story of the failure of European monarchs to honour debts to Italian banks; Edward III of England was notorious.[3] French kings from the sixteenth to the nineteenth century defaulted with some frequency, every thirty years on average.

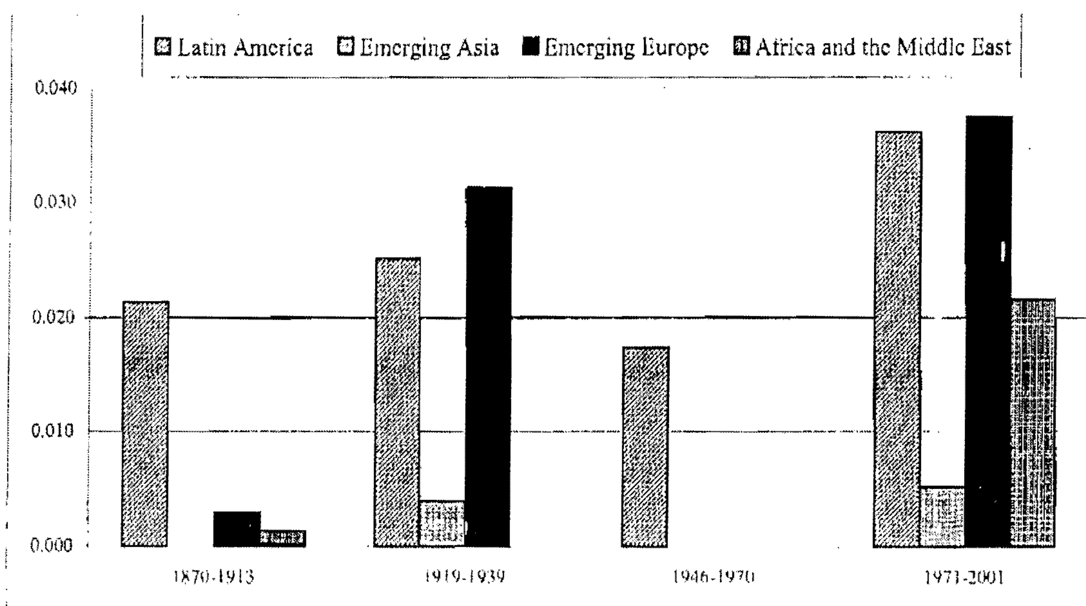
In the modern era, the past three decades have witnessed a higher incidence of sovereign defaults in the developing world (Figure 1.pg.2). During the last decade, we have seen

[1] Adam Smith, " Wealth of Nations" , Book V, Ch. III, at 416 (1776).
[2]Shridath.S.Ramphal,"Sovereign Default: A Backward Glance",Pg.2. See athttp://www.jstor.org/stable/3992741
[3] *Ibid.*,

several international financial crises, such as Mexico (1995), southeastern Asian countries (1997), the Russia (1998), Brazil (1999), Argentina etc. These experiences suggest that the difficulty of predicting the occurrence of financial crisis, despite the strong efforts made by international financial communities, such as monetary authorities, and private financial institutions.

Figure 1. Sovereign Defaults

(Number of events per country per year in region)



Sources: Lindert and Morton (1989); Reinhart (2001); and IMF staff estimates.

In addition to the difficulties of crisis prevention, the post-crisis efforts, resolution of crisis, has been proved difficult and even getting more difficult. **The main reason for this may be the transition of component of emerging countries' debts from bank**

loans to bonds. Until the late 1980s, the main finance source of emerging countries were bank loans, especially by the form of syndicated loans. When the debtor countries found the need to restructure their debt, it was relatively easy to negotiate with creditors, banks. Since, creditors were easily identifiable. And the debtor countries did not have to care about coordination of creditors' opinions, because it was done by so-called "commercial bank advisory committee"[4]. Therefore, negotiation for restructuring debts between debtor countries and creditors was not huge obstacle to restructure debts.

However, the restructuring of sovereign debts has been getting complicated with the transition of sovereign debts from bank loans to bonds, which was seen from early 1990. 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[5]

IMF debt which 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.

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[4] Kentaro Tamura , "The problem of sovereign debt restructuring: How can we deal with Holdout problem legally?", Harvard Law School Journal, International Finance Seminar, April 30,2002; pg.7. Available at http://www.law.harvard.edu/programs/pifs/pdfs/kentaro_tamura.pdf

[5] Hal S. Scott , "A Bankruptcy Procedure for Sovereign Debtors?"; pg 7. Available at http://ssrn.com/abstract_id=384220

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 the 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%, but at 14.1% in 1998 (defaults of Russia, Pakistan, and the Ukraine) and 13% in 2000 (default of Argentina).[6]But this only looks at losses from actual defaults on bonds, including distressed exchanges. 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 30 days after default, has been low–18% in Russia and 28% 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.

Due to the increase in the problem of Sovereign debt restructuring, it has really become a debatable .Difficulties in achieving an orderly sovereign debt workout in recent years derive from both administrative/behavioral as well as economic/legal aspects. 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

[6] *Ibid.,*

action clauses ("CACs") in bonds, a structured mediation or arbitration process for addressing sovereign debt crises, and various forms of sovereign bankruptcy.

RESEARCH METHODOLOGY

Hypothesis

The present framework of the sovereign Debt restructuring is inadequate to solve the problem of Sovereign debt Restructuring, hence there is a need of a feasible solution to this problem.

Chapterisation

Based on this hypothesis this research paper is organized on the basis of the following chapters. Chapter I of this study deals with a Short Summary of Debt Crises from 1970-2002. Chapter II discusses the reasons behind the problem of Sovereign Debt crises with special emphasis on the pointing out the differences between Sovereign Debt and Corporate debt. This chapter also deals specifically with the issues of Creditor Heterogeneity and the Divergence of Interests and problem of Holdout creditors. Chapter III deals with Sovereigns Debt Restructuring Procedures. Chapter IV deals with the principle reform proposals for Sovereign debt crises. Those are collective action clauses; Exchange offers/Exit consents and IMF SDRM proposal. Chapter V deals with the Conclusion and Suggestions.

Mode of Citation

Acknowledgement was given to the resources by footnotes. A select list of bibliography is also provided at the end of the dissertation. This paper follows a uniform mode of citation and footnoting. The style used a follows.

Books- Name of the Author, "Title of the Book", Name of the Book (Place Publisher, year of publication and page number.

Article –Name of the Author, "Title of the Article", Name of the Journal, edition, Volume and page Number

Web resources- Full URL

CHAPTER 1: A SHORT SUMMARY OF DEBT CRISES FROM 1970-2002

1.1 Overall Data

To begin with let see 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.[7]

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[8]	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[9]	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
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 % of line C	25%	50%		44%		41%

Source: World Bank Global Development Finance (2001)

[7]Supra *Note* 5 at Pg..6.

[8] Long term debt is debt with an original maturity of more than 1 year.

[9]Other private creditors are manufacturers, exporters, and other suppliers of goods, and bank credits covered by a guarantee of an export credit agency

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. Let us now turn to a short discussion of the major debt crises between 1982-2002.

1.2 Three Decades of Country Crises[10]

1.2.1 Period of 1980s: Repetitive Moratoria and Bank Debt Reschedulings[11]

In August of 1982, Mexico declared a moratorium on $80 billion of bank debt resulting from syndicated Eurocurrency loans, owed to 1400 banks. most to the world's largest banks whose exposure exceeded their capital. At the same time, the U.S. and the Bank 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 U.S., who had more than their total capital exposed in loans. The

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[10] H. Scott and P. Wellons, International Finance: Transactions, Policy and Regulation Ch. 22 (9th ed. 2002)
[11] Supra *note.5*

moratorium and rescheduling approach avoided loan write-offs due to the then existent accounting rules.

1.2.1.1 Role of London Club

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:

- A huge exposure for large U.S. banks;
- Actual moratoria were declared;
- There was no debt reduction;
- New official money was tied to private sector rescheduling and new money; and
- IMF conditionality for lending was tied to austere fiscal and monetary policy reforms which were highly unpopular in the countries concerned.

1.2.2 Early 1990s: Securitization and Reduction of Debt through the Brady Plan [12]

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**

[12] Supra *note.*5 at pg 9

Plan, launched by the incoming Bush administration in 1989, reduced and securitized the debt, particularly in Latin America.

1.2.2.1 Brady Plan: Under the Plan, banks could exchange their loans for 30 year bullet bonds (bonds on which the principal was due in one payment at the end of 30 years), so-called **Brady Bonds**. Principal and 12-18 months of interest were secured by 30 year U.S. zero coupon treasury bonds (bonds on which the principal and interest were due in one payment at the end of 30 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, 6¼%, or the principal would be discounted, e.g., by 35 %, and bear a market rate of interest, LIBOR plus 13/16%.

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 21 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% of their total debt.

1.2.3 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)[13]

1.2.3.1 Mexican Foreign Exchange Crisis of 1994[14]

In December 1994, the Mexican peso floated down by 50% against the dollar in four weeks. While such a sharp devaluation hurt Mexico in various ways, e.g., higher import costs and wealth loss for savers and investors, it also had a significant impact on the Mexican debt situation. 75% 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%. 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 U.S. 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

[13] Supra *note.*5 at pg.10
[14] *Ibid.*,

quintessential liquidity crisis in which there was an irrational and speculative run on the peso that was averted by international lenders of last resort.

1.2.3.2 Asian Crisis of 1997: The South Korea Example [15]

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. 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

[15] Supra note. 5 at pg 11

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 who 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 at 2.25 - 2.75% over LIBOR. Many thought these terms quite favorable to the foreign bank lenders. Unlike the case in Latin America in the 1980s, there was no fear that a Korean default would bankrupt foreign bank lenders. U.S. banks had lent $10 billion, barely 6% of the capital of the top 10 U.S. banks, while Japanese banks had lent $24 billion, about 9% 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 international lender of last resort.

1.2.3.3 The Russian Crisis of 1998: The Default Solution [16]

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

[16] Supra note 5 at pg.12

ruble's value collapsed. The Russian government announced a 90 day moratorium on servicing nonresidents' hard 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 was held externally, were rescheduled 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 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, e.g., repaying in full eurobonds while rescheduling or writing off other bank and portfolio debt.

1.2.3.4 Ecuador 1999: Bond Restructuring with Exit Amendments [17]

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

[17] Supra note 5 at pg 13

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% greater than on the 2030 Bonds but received higher interest. Almost 97% of the bondholders accepted the offer and Ecuador reduced the aggregate net present value of its bond obligations by almost 40%.

Ecuador was concerned that bondholders might refuse to tender old bonds and then 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 amendments.[18] 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% 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.

[18] L. Buchheit and G. Gulati, Exit Consents in Sovereign Bond Exchanges, 48 UCLA L. Rev. 59 (2000).

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.

1.2.3.5 Turkey 2001: Foreign and Domestic Debt [19]

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%. 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.

[19] Supra note 5 at pg. 14

Turkey's reserves fell 20% 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 which was then at 100% would go even higher and the exchange rate would further deteriorate.

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 for the first time 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.

1.2.3.6 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 which Standard and Poor's rated as "distressed" meaning that it was equivalent to a default. $95 billion in government bonds 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 $1000 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 which appeared 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 World Bank debt, first defaulting in October on $250 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 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 U.S.), 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.[20] 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.

1.2.3.7 Brazil 2002: More IMF Lending[21]

Brazil found itself in difficulties in 2002. It had 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

[20] K. Rogoff, Economic Focus, Managing the World's Economy, Economist, August 3, 2002, recounts the argument

[21] Supra note 5 at pg.19

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%. 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%. 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 were a mixed bag. We have 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 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.**

CHAPTER 2: REASONS FOR THE PROBLEM OF SOVEREIGN DEBT CRISIS

2.1 Understanding the problem of Sovereign Debt crises:

Sovereign debt is divided into four types: **loans owed to the international financial institutions (IFIs; mainly the IMF and the World Bank), official loans owed to governmental creditors, private loans owed to banks, and private loans owed to bondholders.**[22] By law, all four types have equal priority in a default, but loans from the IFIs are treated as having higher priority and are generally not rescheduled. **The Paris Club is the forum for renegotiating official debt, and the London Club is the forum for renegotiating commercial bank debt.**

The last group of sovereign creditors, **private bondholders,** has become extremely important. Following the Latin American defaults of the 1980s, commercial banks' sovereign loans were rescheduled and converted into bonds-called **Brady bonds**-which were sold to private investors. Brady bonds caused secondary markets for sovereign bonds to develop, and as of the mid-1990s, the number of such bonds had grown to the point where they constituted two-thirds of emerging-market debt.[23]

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[22] Michelle J. White , " Sovereigns in Distress: Do They Need Bankruptcy?", Brookings Papers on Economic Activity, Vol. 2002, No. 1 (2002), pg.29. Available at : http://www.jstor.org/stable/1209182,
[23] *Ibid.,*

Sovereign debt crises may occur in different ways[24].

A country facing the depreciation of domestic currency may face crises on account of unhedged foreign currency debt .(As happened in Korea, Thailand and Indonesia).Such a problem may happen due to private sector foreign currency debt or it may also happen due to sovereign guarantee system in the public sector foreign currency debt.

In case of private sector foreign currency, debt the solution lies on the national legal provisions of the country on cross-border bankruptcy law. In case of sovereign guarantee a satisfactory remedy has to be devised so that sovereign debt can remain within sustainability and crises can be managed efficiently.

2.2 Sovereign Debt Vs. Corporate Debt

In order to have better understanding of the SDR, it is important to examine the main differences between the sovereign debt and corporate debt.

1) First, at least in an abstract sense, a country can always service its debt, which makes it difficult to determine if a country is ever "insolvent." A company repays its debts because it must. If a company fails to repay its debts, the business can be dismantled by the unpaid creditors.' However, no parallel mechanism exists to force repayment by sovereign nations since no creditor has the ability to dismantle or liquidate a country. As a result, collection

[24] Dr.N.L Mitra, "Dialectics on International Legal Regime in Sovereign debt Crises", Publsihed in Scholasticus, Journal of National Law University, Jodhpur ,Vol. I No.2, 2004 pg. .32

remedies against countries remain **extraordinarily complex and difficult to execute.**

2) The second difference between corporate and sovereign debt, therefore, is that a country can use little (if anything) to secure debt in the traditional sense. **As a consequence, most sovereign debt remains "unsecured,"** which further frustrates collection remedies. In the corporate financing context, one of the major justifications for secured debt "is the desire to increase the likelihood of payment in the event of bankruptcy."Although there has been an ongoing debate over the value of secured debt generally,[25] secured debt plays a major role in corporate bankruptcies. The absence of secured debt in the sovereign debt context limits the suitability of using domestic bankruptcy law as a model for sovereign debt restructuring.

3) Third, **"the ability of a court to force a sovereign entity to comply with its wishes is extremely limited.**" As just explained, the traditional state law methods of debt collection are not applicable to sovereign debt. Further, no intergovernmental agency currently exists to adjudicate disputes between creditors and sovereign states. The absence of this structure is a major obstacle to any reorganization plan seeking implementation of domestic bankruptcy rules in the sovereign debt context.

[25] Robert E. Scott, "The Truth About Secured Financing" , 82 Cornell L. Rev. 1436, 1437 (1997)

2.3 Major problem with Sovereign Debt[26]:

a) Sovereign debt does not have collateralization on creating security interest nor is there any clear perception of priority principle in the claim settlement.

b) Who shall declare that a sovereign has become bankrupt or is facing a near bankrupt situation due to liquidity crunch and requires the restructuring?

c) Who shall administer the restructuring of the assets?

d) What should be the economic power of a nation-state in bankruptcy situation in so far as the running of the government of the country and in its macro-management?

e) What is going to happen if asset-restructuring scheme fails and there is insolvency situation?

f) How would the claims be settled and in what priority?

g) Who would determine the priority situation?

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[26] As pointed out Dr.N.L Mitra, "Dialectics on International Legal Regime in Sovereign debt Crises", Publsihed in Scholasticus, Journal of National Law University, Jodhpur ,Vol. I No.2, 2004; pg .29

h) What would be the extent of power of the committee of creditors both on settlement of past debt and for drawing future debts?

i) How would the disputes be resolved between the creditors inter-se and between any creditors and debtor- nation?

j) How and in what methods would one settle national claims and international claims, sovereign claims and individual claims (specifically in government guarantee in private contracts)?

k) How to resolve actions in multilateral forums?

l) What would be path for obtaining discharge from such an economic mess especially in view of the sovereignty attributed to the political status to the debtor member-state?

m) Who shall determine which debt to restructure and which not?

2.4 Recent complexities in the issue of Sovereign Debt

2.4.1 Difficulty in restructuring bonds

In addition the above problems, there is a major complexity associated with the recent sovereign debt crises. As pointed out in the first chapter, during the last two decades there has been a paradigm shift in the methodology of acquiring debt i.e. from Bilateral or

syndicated loans to debt instruments. This dominating phenomenon has been accentuated due to newly liberated developing countries in the post war period taking aggressive role in governance and in the development of the economy of the country.[27]As the governments of developing countries are indulging into all types of commercial activities, therefore sovereign debt is now not confined to the sovereign functions. Results of this change in the behaviour of developing countries was that there were innumerable numbers of creditors who do not have continuous relation with the sovereign-debtor and are only interested in the timely repayment of the claim with full interest agreed upon. These claimants do not have any permanent interest in the sovereign debtor's domestic affair. ***That brings uncertainty over the proposal of debt restructuring itself resulting in hesitation, buying of time and delay that causes further depletion of the asset value.***[28]

In addition to the above reason, there are several other factors which makes international bonds much harder to restructure than loans. ***Such as international bonds, typically involvse many more investors than do loans, even syndicated loans. Moreover, they may be in bearer form so investors may be untraceable.*** It may be really 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. **The recent debt crisis and default of Argentina has highlighted just how difficult comprehensive debt restructuring negotiations can be, when they involve hundreds of thousand different bondholders with a wide variety of objectives.**

[27] Supra *note.26* at pg.30
[28] Supra *note.26 at* pg.31

Another major problem associated with these debt instruments is that in these bonds there exist ***three parties which determines the "debt markdown" required to produce solvency: the debtor, creditors, and the global tax- payer through international financial institutions (IFI's)***[29]. The complex relationships among the borrowers, creditors, and the global taxpayer have made restructuring obligations a costly and time-consuming exercise, especially with the possibility of "**holdouts.**" **Both the sovereign borrower and its creditors have an incentive to avoid a restructuring in the hope of financial assistance from the global taxpayer**. Sovereign governments may not undertake the politically painful steps involved in beginning a restructuring when there is always the hope that official assistance will be forthcoming. Creditors may not accept a reduction in the value of their claims, also in the hope that official assistance will be forthcoming. Costs of postponed and disorderly restructurings are real and substantial. Delays in restructuring can drain a country's resources and increase the ultimate costs of restoring financial sustainability. Creditors bear a burden as well, because the losses associated with the restructuring are reflected in values of bonds.

During most of the 1990s, the differential treatment of sovereign claims has followed a pattern that is consistent with an implicit seniority of international bonds over international bank loans. **The restructuring of Russian sovereign debt** (August 1998-August 2000) is typical of this pattern. Domestic debt and Soviet era London and Paris Club debts have been restructured (with international bank creditors accepting a debt exchange involving a 40 percent reduction in the present value of their claims), while

29 Randall S. Kroszner "Sovereign Debt Restructuring",Pg.1. See at http://www.jstor.org/stable/3132203

Eurobonds have been left untouched. Market participants have viewed this latest Russian debt restructuring episode as further corroboration of sovereigns' tendency to treat creditors differently according to their power of nuisance

2.4.2 Creditor Heterogeneity and the Divergence of Interests

The diversity in sovereign bond restructurings, in many ways, reflects the diversity among investors in sovereign bonds. Sovereign bonds are held by large commercial banks, smaller commercial banks, local banks, investment banks, insurance companies, pension funds, mutual funds, retail funds, hedge funds, nonfinancial companies, and retail investors. Moreover, the extent to which these various investors hold bonds issued by any particular country differs markedly across countries and issues of bonds. **(For example, in the case of Pakistan, approximately one-third of the bonds subject to the restructuring were held by domestic residents and the remaining bonds were held by financial institutions and retail investors in the Middle East. For Ecuador, the bonds were widely held by institutional investors in New York and London. For the Ukraine, three of the bonds were held by a small number of investment banks and hedge funds, and the fourth bond was widely held by retail investors in Europe. For Uruguay, the dollar-denominated bonds were widely held by institutional investors in the United States, but more than one-half of all the bonds were held by domestic investors, principally retail investors.For Argentina, of the approximately $100 billion principal amount of debt subject to the (current) restructuring, approximately $50 billion is held by Argentine financial institutions, approximately $20 billion is held by retail investors in Europe, approximately $3 billion is held by**

retail investors in Japan, and the remaining $27 billion is held by institutional investors in the United States). [30]

These diverse investors, like the commercial banks that held sovereign debt in the 1970s, differ in their exposure, in the regulatory environments they confront, in the extent of their relationships with sovereign debtors, and in their involvement in the international capital markets. **The level of heterogeneity among these investors, however, is greater than the differences among commercial banks**. As a general matter, commercial banks follow a common business plan. They make loans to borrowers and hold cash deposits. They expect to make profits from the spreads between the interest rates charged on the loans and the interest rates paid on the deposits, as well as from fees for their services.[31] ***Investors in sovereign bonds, on the other hand, are engaged in a wide variety of businesses, and they purchase sovereign bonds for many different reasons***. For example, most mutual funds strive to create a diversified portfolio of assets and so they invest only a small portion of their funds in sovereign bonds.[32]Hedge funds typically purchase relatively large positions in sovereign bonds. Retail investors, in contrast, often hold sovereign bonds as part of a long-term investment strategy, such as to provide income during their retirement years. Moreover, the institutions and individuals holding

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[30]Jill E. Fisch & Caroline M. Gentile , "Vultures or Vanguards?: The role of Litigation in Sovereign Debt Restructuring", Emory Law Journal,2004.
Seeat:http://international.westlaw.com/result/result.aspx?rs=WLIN9.03&ss=CNT&rp=%2fWelcome%2fWorldJournals%2fdefault.wl&origin=Search&sv=Split&spa=IndiaU2003&cfid=1&fn=_top&rlt=CLID_QRYRLT975145382l4&n=126&mt=WorldJournals&eq=Welcome%2fWorldJournals&method=TNC&query=%22SOVEREIGN+DEBT+RESTRUCTURING%22&scxt=WL&effdate=1%2f1%2f0001+12%3a00%3a00+AM&db=HVLR%2cCLMLR%2cAMJIL%2cCLMJAL%2cGWILR%2cHVILJ%2cLAWREVPRO%2cYLJ%2cJILS%2cSTJIL&rlti=1&vr=2.0&fmqv=c&service=Search&cnt=DOC&rltdb=CLID_DB17842528214&utid=3

[31] *Ibid.*,

[32] Stephen Bainbridge, "Comity and Sovereign Debt Litigation: A Bankruptcy Analogy", 10 Md. J. Int'l L. & Trade 1, 5-7 (1986)

retail investors in Japan, and the remaining $27 billion is held by institutional investors in the United States). [30]

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Seeat:http://international.westlaw.com/result/result.aspx?rs=WLIN9.03&ss=CNT&rp=%2fWelcome%2fWorldJournals%2fdefault.wl&origin=Search&sv=Split&spa=IndiaU2003&cfid=1&fn=_top&rlt=CLID_QRYRLT975145382l4&n=12&mt=WorldJournals&eq=Welcome%2fWorldJournals&method=TNC&query=%22SOVEREIGN-DEBT-RESTRUCTURING%22&scxt=WL&effdate=1%2f1%2f0001+12%3a00%3a00-AM&db=HVLR%2cCLMLR%2cAMJIL%2cCLMJAL%2cGWILR%2cHVILJ%2cLAWREVPRO%2cYLJ%2cJILS%2cSTJIL&rlti=1&vr=2.0&fmqv=c&service=Search&cnt=DOC&rltdb=CLID_DB17842528214&utid=3
[31] *Ibid.*,
[32] Stephen Bainbridge, "Comity and Sovereign Debt Litigation: A Bankruptcy Analogy", 10 Md. J. Int'l L. & Trade 1, 5-7 (1986)

the bonds of any particular sovereign debtor continually change as the bonds are traded in the market.

As the group of investors holding sovereign debt has become more diverse, vulture funds have achieved particular notoriety. Vulture funds typically trade in distressed debt--purchasing bonds at prices that represent substantial discounts from their face values.[33] In making these purchases, vulture funds typically seek short-term gains, either through the restructuring process or by holding out and seeking additional payments from the debtors through negotiated transactions or as a result of litigation.

Investors in sovereign bonds also differ significantly in their levels of exposure to the risk of default on the bonds. The value of the bonds held in each portfolio as compared to the total value of the assets in the portfolio varies across the various types of investors as well as within the various classes of investors. Some investors may experience bankruptcy upon a default on the bonds, others may only experience a small loss.

Due to the growth of the secondary market, investors purchase sovereign bonds in the market at different prices. Unlike the restructurings of the 1930s in which investors had purchased bonds from banks at equivalent prices, and unlike the restructurings of the 1980s in which most of the commercial banks made loans to the sovereign debtors through the syndication process, investors today may purchase bonds at substantial discounts from their face values. These differences in prices create substantial disparities among bondholders. For example, retail investors who purchase bonds at the time of their

[33] Deepak Gopinath, "The Debt-Crisis Crisis", Institutional Investor, Aug. 2002, pg. 36, 38

issuance, at prices near the face values of the bonds, are likely to be reluctant to accept the terms of a restructuring that substantially reduce the principal amounts of the bonds.[34] Other investors, notably vulture funds, who purchase the bonds once the sovereign debtor begins to experience severe distress, pay a much lower price for the bonds and so may be willing to accept restructuring terms that impose significant reductions to the principal amounts of the bonds. In between these two extremes, institutional investors may be willing to accept limited reductions to the principal amounts of the bonds in a restructuring, depending upon the magnitude of the losses or gains they have sustained.

Investors in sovereign bonds also face significantly different regulatory environments. Banks and other institutional investors record the values of their portfolios of sovereign bonds at market prices, often daily and certainly monthly or quarterly. Retail investors, however, typically do not perform this exercise. By "marking to market," banks and other institutional investors record their gains and losses almost as they occur. Retail investors typically record gains and losses only upon sales of bonds. Because the values of their portfolios already reflect the losses due to financial distress, banks and other institutional investors may elect to exit a restructuring by selling their bonds in the market, rather than holding the bonds and working to complete the restructuring process. These sales further depress the price and create losses for other investors, including retail investors. Moreover, as secondary trading leads to shifts in the ownership of the distressed debt, it hinders efforts to reach consensus among the bondholders.

[34] Supra *note* 30 at pg.13

Like the large commercial banks that guided the restructurings of the 1980s, only large investors, particularly commercial banks and investment banks, have relationships with sovereign debtors that they are eager to use as a basis for generating additional business.[35]These investors are also the most likely repeat players in the international capital markets with the resulting expectations that they will work with one another in a variety of settings. As a result, these investors may support restructuring plans that are unacceptable to smaller investors, notably retail investors. In particular, large institutional investors may be willing to suffer a greater loss in a restructuring to solidify relationships with a sovereign debtor and to establish a reputation for success in restructuring sovereign bonds, both of which are likely to lead to future business opportunities and future revenues. Retail investors, like the smaller commercial banks that participated in the restructurings of the 1980s, invest in sovereign bonds only for the returns, not for the prospect of building future business relationships. As a result, they are unwilling to trade repayment of the bonds for future business opportunities.

Importantly, investors in sovereign bonds, like investors in the 1920s, lack an effective means of reaching consensus regarding the terms of restructurings. Although these investors generally agree on a policy of uniform treatment of all bondholders, they typically cannot reach agreement on restructuring terms. Moreover, unlike the restructurings of the 1980s, today's creditors lack a mechanism to impose their preferences on other investors.

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[35] Anne O. Krueger, The Evolution of Emerging Market Capital Flows: Why We Need to Look Again at Sovereign Debt Restructuring, Address at the Economics Society Dinner (Jan. 21, 2002) (describing most investors in sovereign bonds as lacking long-term relationships with sovereign debtors), at http:// www.imf.org/external/np/speeches/2002/012102.htm

The absence of widespread support for the terms of a proposed restructuring contributes to the decision of some bondholders to hold out and to refuse to support the restructuring. These holdout bondholders may instead pursue their claims against the sovereign debtor in court.

2.4.3 Problem of 'Holdout Creditors'

One of the greatest difficulties in restructuring claims against sovereign debtors is balancing the interests of the majority of the creditors with those of minority creditors generally referred as **'Holdout Creditors'.** These recalcitrant creditors generally seeks payments from the sovereign debtor, or seeks to get their claims purchased by other creditors that are anxious to complete the restructuring. In any event, holdout creditors are typically subject to significant pressure to accede to the terms that are acceptable to a majority of the creditors in the restructuring.

Holdout creditors are also often subject to extensive criticism.They have been charged with delaying the restructuring process, thereby imposing unnecessary burdens on the citizens of the sovereign debtors. They have also been denounced for seeking payments for themselves at the expense of other creditors and at the risk of jeopardizing the restructuring.

Over the course of the past several years, holdout creditors--particularly vulture funds--have increasingly used litigation as a means of pursuing their interests. [36]Specifically, these creditors have filed lawsuits to enforce their contractual claims against sovereign debtors. [37]Efforts by individual creditors, particularly vulture funds, to enforce their claims against sovereign debtors in court have been characterized as disruptive to the restructuring process and unfair to the creditors that participate in the restructurings.[38] Vulture funds, in particular, have been criticized for purchasing sovereign debt at distressed prices and then holding out of restructuring plans, including plans that are acceptable to the vast majority of the other creditors, in an effort to secure for themselves higher payments from sovereign debtors. Holdout creditors may seek to be paid the total amounts owed on the debts. [39] Alternatively, they may seek a relatively small premium over the proposed restructuring terms in an effort to coerce the debtors to avoid the nuisance costs associated with holdout litigation.

The resulting disruption in the restructuring process, critics argue, lengthens the time needed to complete restructurings and thereby increases the associated costs, burdening the citizens of the debtors and reducing the funds available to be paid to creditors.[40] Preferential payments to vulture funds further reduce the size of the payments that can be

[36] The term "vulture funds" generally refers to investment funds, particularly hedge funds and mutual funds, that purchase the debt of countries, or companies, that are in financial distress. These funds thus become creditors of the countries, or companies, through purchases of debt in the secondary market, rather than as primary lenders.

[37] John C. Coffee, Jr. & William A. Klein, " Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations", 58 U. Chi. L. Rev. 1207,, (1991)

[38] Buchheit & G. Mitu Gulati, "Exit Consents in Sovereign Bond Exchanges", 48 UCLA L. Rev. 59, 60-65 (2000)

[39] Arturo C. Porzecanski, "Dealing with Sovereign Debt: Trends and Implications, in Sovereign Debt at the Crossroads" .Available at http:// www.law.georgetown.edu/international/documents/Porzecanski_000.pdf .

[40] John Nolan, "Emerging Market Debt and Vulture Hedge Funds: Free-Ridership, Legal & Market Remedies" ,2001.Available at http://www.financialpolicy.org/DSCNolan.htm

made to creditors under restructuring plans, augmenting the sense of unfairness among the creditors that accept the terms of the restructurings.

Finally, critics argue that the potential for vulture funds to disrupt restructurings and to receive special payments not only discourages sovereign debtors from entering into the restructuring process but it also creates a collective action problem that dissuades other creditors from participating in the process. [41]

The use of litigation has heightened concerns regarding holdout creditors. Anne Krueger, the First Deputy Managing Director of the IMF, observed that:

> ***" the more recent success of an aggressive legal strategy employed against Peru by a vulture company . . . underlines the power the holdout creditors retain. The threat of disruption [of the restructuring process] remains likely to deter countries from seeking a necessary restructuring for longer than is desirable for either the country itself or the international community."*** [42]

Concerns about holdout litigation have acquired new urgency in the wake of Argentina's current financial crisis. This crisis, which includes the largest sovereign default in history,

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[41] Jill E. Fisch & Caroline M. Gentile , "Vultures or Vanguards?: The role of Litigation in Sovereign Debt Restructuring", Emory Law Journal,2004.
Seeat:http://international.westlaw.com/result/result.aspx?rs=WLIN9.03&ss=CNT&rp=%2fWelcome%2fWorldJournals%2fdefault.wl&origin=Search&sv=Split&spa=IndiaU2003&cfid=1&fn=_top&rlt=CLID_QRYRLT975145382l4&n=126&mt=WorldJournals&eq=Welcome%2fWorldJournals&method=TNC&query=%22SOVEREIGN+DEBT+RESTRUCTURING%22&scxt=WL&effdate=1%2f1%2f0001+12%3a00%3a00+AM&db=HVLR%2cCLMLR%2cAMJIL%2cCLMJAL%2cGWILR%2cHVILJ%2cLAWREVPRO%2cYLJ%2cJILS%2cSTJIL&rlti=1&vr=2.0&fmqv=c&service=Search&cnt=DOC&rltdb=CLID_DB17842528214&utid=3

[42] Anne Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring" , Address at the National Economists' Club Annual Members' Dinner, American Enterprise Institute (Nov. 26, 2001) ,See at http:// www.imf.org/external/np/speeches/2001/112601.htm .

came to a head in December of 2001 when Argentina defaulted on billions of dollars of outstanding bonds. Months later, in September of 2003, Argentina proposed to restructure approximately $94 billion in public debt through a debt swap resulting in a seventy-five percent reduction in the face value of the debt and forgiveness of past due interest. The proposal has been widely denounced by creditors, particularly vulture funds, [43] and it has spurred an unprecedented amount of litigation.

There are three main approaches to addressing the holdout problem, which has dealt by the author in the later part of this paper. The first is a market-based approach in which the sovereign restructures the debt through an exchange offer coupled with amendments to the terms of the original debt effected through exit consents. The second is a contractual mechanism, the use of CACs to facilitate the negotiation of a restructuring between the sovereign debtor and its creditors by enabling a majority of creditors to amend the terms of the debt over the objections of the holdouts. The third is an international bankruptcy procedure, the SDRM.

2.4.4 Problem of financing during restructuring

One final problem discussed by the IMF involves financing during the restructuring period. A country, like any corporation, needs money to operate during the restructuring period, as well as finances to implement the restructuring plan. If this type of financing is not given priority status, little incentive exists for creditors to loan money to sovereigns who are in default. Such a disincentive could impair the restructuring process.

[43] Dennis Small, 'Vulture Funds' Descend on Dying Third World Economies, Executive Intelligence Rev., Oct. 10, 2003, available at http:// www.larouchepub.com/other/2003/3039vultur_fnds.html.

CHAPTER 3: SOVEREIGNS DEBT RESTRUCTURING PROCEDURES: A HISTORY OF IDEAS

3.1 Proposal of Group of 77 developing countries, Arusha, 1979

The first policy initiative along these lines appears to be the proposal to create an **"International Debt Commission"** put forward by the Group of 77 developing countries during a meeting in Arusha in February of 1979, in preparation for the fifth United Nations Conference on Trade and Development in Manila in June of the same year. The Debt Commission would consist of "eminent public figures with recognized knowledge and experience of debt problems and economic development. Any interested developing country which believes it has, or may have a debt problem could address itself to the Commission. The commission will: ***(i) Examine the debt and development problems of the requesting country; (ii) In the light of such examination ... make recommendations on measures required to deal with the debt problem in the broader context of development including measures of debt reorganization and additional bilateral and multilateral finance; (iii) Convene a meeting of all parties concerned with a view to implementing the recommendations under (ii) above"*** [44].Although the "International Debt Commission" never materialized because of resistance from the creditor countries-and in any event would not have had powers other than making

[44] Kenneth Rogoff and Jeromin Zettelmeyer , "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001", Palgrave Macmillan Journals on behalf of the International Monetary Fund, IMF Staff Papers, Vol. 49, No. 3 (2002), pg.4. Available at http://www.jstor.org/stable/3872506

recommendations-the Arusha Programme foreshadowed several aspects of subsequent proposals for an international bankruptcy mechanism. These include the "debt reorganization" objective, the desire to coordinate all parties, a role for a neutral arbiter or mediator, and the emphasis on new financing. This said, it appears that the primary objective of the G-77 was to make debt negotiations with official creditors more debtor friendly compared to the Paris Club framework,[45] rather than addressing an inefficiency under the status[46]The earliest modem reference we could find on the desirability of a bankruptcy procedure for countries In particular, neither the Arusha Programme itself nor a subsequent back- ground report by the UNCTAD secretariat (UNCTAD, 1981) refer to problems caused by private creditors, or poor coordination among creditor groups.

3.2 Christopher Oechsli Proposal (1981)

The credit for the first proposal that invokes the Chapter 11 analogy and is explicitly motivated by problems of this kind goes to Christopher Oechsli (1981): "Many of the procedures set forth in Chapter 11 of the Bankruptcy Reform Act of 1978 for rehabilitating financially troubled businesses can be applied profitably to renegotiation of LDC debt" [47]. Of these procedures, Oechsli emphasizes three: a creditor committee, an independent "examiner, a monitoring party which does not d.splace the debtor from control of its business," and a formal initiation procedure. Oechsli believes the monitor could be the IMF, but stresses the need for "inclusion of the debtor in the formulation process" of a restructuring plan. The initiation procedure should allow either creditors or debtors to take the initial step, although *"creditors and the IMF need not accept the*

[45] *Ibid.,*
[46] Supra *note.* 44
[47] Supta *note.* 44

debtor LDC's formal petition." According to Oechsli, sovereign debt restructuring under the status quo suffers from several problems. Negotiations take too long, and their outcome is too uncertain, harming the debtor and delaying the rehabilitation process. Moreover, they may be insufficiently focused on *"an LDC's basic development as the means to strengthen the country's credit and debt service capacity"*. In Oechsli's view, this is due to the "lack of an established procedure" and poor creditor coordination. By the latter, he seems to mean primarily a lack of coordination between classes of creditors negotiating separately in particular, the private and official sectors-rather than across individual private creditors. In response, he proposes ***"an established procedural framework for debt renegotiation" that includes "all major official and commercial creditors in a comprehensive response. The procedure should avoid the long delays ...which result from separate renegotiations by different types of creditors.*** " In particular, "the commercial creditors would not have to delay their reaction to the LDC debt problem until after the completion of the official creditor club negotiations". Although he contemplates the creation of a **"court-like entity"** as a possibility, stating that "the IMF would seem the obvious choice for that role," Oechsli concludes that this is unnecessary. "Alternatively, creditors could specify binding arbitration procedures in their loan contracts" (including an arbitration entity along the lines of the International Centre for the Settlement of Investment Disputes). "Neither, however, is necessary for Chapter 11 procedures to be applied successfully in the renegotiation context. Establishment of a renegotiation plan could continue to be by the agreement and consensus of the parties, and not by imposition from some international institution".

A Chapter 11-like procedure is important to him not as a solution of the free rider problem, but mainly because it provides a predictable timetable and clear communications channels. This said, Oechsli's view of debt restructuring as a three-way negotiation (debtor, private creditor, and official creditor), and his insistence that the uncertainty about the timing and nature of the official response can complicate negotiations between debtor countries and private creditors was farsighted, and arguably borne out during the debt crisis.[48]

Oechsli's proposal does not seem to have become widely known outside a narrow legal literature. Ironically, the 1980s debt crisis itself initially seemed to stifle rather than inspire similar ideas, perhaps because the debate about strategies for resolving the debt crisis-including market-based debt reduction schemes, plans for a new "International Debt Facility" or "International Debt Discount Corporation"-that would centralize private debt in public hands, and finally the Brady plan, crowded out loftier proposals on international bankruptcy reorganization.[49]

3.3 Jeffrey Sachs's influential 1984 Princeton Study, "Theoretical Issues in International Borrowing"

Sachs's paper, which extended earlier work with Daniel Cohen (D. Cohen and Sachs, 1982), presents a simple, formal statement of some of the collective action problems associated with inter- national debt-both self-fulfilling debt crises, and free rider problems in the context of debt rescheduling or restructuring. Citing evidence from Cline

[48] Supra *note*. 44 at pg.7
[49] Supra *note*. 44 at pg.6

(1981) on Peru, and data on a 1983 rescheduling of loans to Brazil, Sachs argues that "even in bank syndicates significant free rider problems remain" (p. 33).

3.4 Proposals on Debt overhang problem and "market-based" debt reduction schemes(Mid 1980's)

A second major development in the mid-1980s was the recognition that high levels of debt could lead to inefficiently low levels of growth because the need to repay creditors acted like a tax on investment (the "debt overhang" problem). Taken to the extreme, this implied that debt forgiveness might benefit not only debtors but also creditors if the write-down of nominal claims was more than offset by an increased likelihood that the country might repay its remaining debt.[50]The debt overhang argument was used to justify "market-based" debt reduction schemes, in which the country itself took the initiative in reducing the debt stock by buying back debt at discounted prices, swapping bank loans for local currency that had to be invested in domestic equity (debt-equity swaps), or exchanging loans against discounted "exit bonds" with lower principal or interest.[51]Market-based schemes enjoyed considerable popularity in the late 1980s and were tried in several countries (buybacks in Bolivia and Brazil, debt-equity swaps in Argentina, Brazil, Chile, and Mexico, and exit bonds in Mexico and Argentina).[52]

However, they soon came under criticism from several angles. Some authors argued that any efficiency gains from market-based solutions would mostly benefit creditors, not

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[50] Kenneth Rogoff and Jeromin Zettelmeyer , "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001", Palgrave Macmillan Journals on behalf of the International Monetary Fund, IMF Staff Papers, Vol. 49, No. 3 (2002), pg.8. Available at http://www.jstor.org/stable/3872506

[51] *Ibid.,*

[52] Supra *note* 50

debtors (Bulow and Rogoff, 1988b; Dooley, 1988, 1989; and Bulow and Rogoff, 1991). In addition, it became clear that market-based schemes suffered from a very similar free rider problem as unilateral debt forgiveness or negotiations with uncoordinated creditors: participation in the scheme had the effect of increasing the repayment probability to the holdouts that chose not to participate (Sachs, 1988). Helpman (1989) showed that uncoordinated voluntary debt reduction will typically be suboptimally low. Indeed, the pure market-based approach mostly failed to achieve large-scale debt reduction and was eventually replaced by the Brady plan, which combined some elements of the market-based approach with coordinated negotiations and public sector funding.[53]

3.5 IMF Lending into Arrears Policy: Initiatives Within the Existing Statutory Framework(Late 1980's)

Two policy initiatives during the 1980s sought to facilitate the orderly resolution of debt crisis without formal changes in statutes. **The first was IMF lending into arrears**, which first occurred in the context of a stand-by arrangement with Bolivia in June 1986, and was formally adopted as part of the IMF's debt strategy in May 1989.[54] The IMF's prior policy had been to lend only if the projected balance of payments needs of a country were fully financed. "Accumulation of arrears did not count as financing." This implied that "if bank creditors refused to reschedule the country's debts, the Fund would normally suspend access to its own money".[55]Under the new policy, arrears to commercial banks were generally tolerated. From the perspective of solving the collective action and

[53] The basic idea of the Brady plan was to increase the certainty of servicing the residual claims, including by collateralizing the principal with U.S. zero-coupon bonds, in return for some forgiveness on the existing debt.
[54] Supra *note.* 50
[55] Supra *note.* 50

incentive problem associated with sovereign debt restructuring, this had two consequences. First, in principle, debtors could now receive IMF support after a payments suspension, while negotiations with creditors were in progress. This made the prospects of declaring a unilateral moratorium less daunting and weakened the bargaining position of private creditors, who were "no longer allowed to determine whether an [IMF] arrangement would be approved".[56]Second, it gave the IMF an instrument with which to exert leverage over a defaulting debtor. Cooperative debtor behavior during its negotiation with commercial bank creditors could be rewarded through lending into arrears.[57] In 1998, the policy was extended to include arrears to bondholders

3.6 Debevoise proposal (1984)

A second notable initiative during this period was the Debevoise (1984) proposal to use Article VIII, Section 2 of the IMF Articles to extend legal protections to debtor countries declaring a unilateral payments moratorium. Article VIII, Section 2 reads as follows: a) ***"Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions. 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. (...)"*** Debevoise argues that past attempts to use Article VIII(2)(b) to stay creditor enforcement against debtor countries were unsuccessful either because courts did not regard the term

[56] Supra *note.*50

[57] A. Haldane and M. Kruger "The Resolution of International Financial Crises: Private Finance and Public Funds." ,*The IMF and International Financial Architecture*, Oxford University Press;pg 8

"exchange contracts" as sufficiently broad to cover loan agreements, or because "the defendant had not met its burden of demonstrating that the currency regulations relied upon were 'maintained or imposed consistently with the Fund Agreement'." *Debevoise's proposal is to "establish a deferral mechanism" that exploits the IMF's power, under Article VIII, Section 2(a), to approve exchange restrictions. "A nation facing an unmanageable external debt profile would be eligible in principle. Application would be made to the Fund."* Following an "expedited appraisal of the applicant's need for the deferral mechanism ... the Fund would signify acceptance of an application by a formal decision of the Executive Board. This decision would include a statement that the applicant's exchange restrictions, particularly those on the making of payments and transfers for certain current international transactions, were maintained or imposed consistently with the Fund Agreement" (pp. 63-64). To deal with the problem that courts might still not recognize controls approved by the IMF, Debevoise suggests three alternative avenues: domestic legislation "providing that in any case in which an Article VIII(2)(b) issue is raised, a Fund decision involving the controls at issue will be determinative," making the IMF's deferral authority part of the debt contract, and finally, an authoritative, broad IMF interpretation of Article VIII(2)(b).

The Debevoise proposal does not seem to have had practical consequences, even though in January 1988 the IMF Legal Department did in fact propose, in an internal report, "that consideration be given by the Executive Board to the adoption of an authoritative interpretation of Article VIII, Section 2(b)." The proposed interpretation included a broad definition of the term "exchange contract" to include any "contract providing either for a

payment or transfer of foreign exchange, or for an international payment or transfer (that is, a payment between a resident and a nonresident; or a transfer of funds from one country to another)."[58] However, the purpose of this broad interpretation was not to protect sovereigns during payments suspensions, but rather to "promote more uniformity in the interpretation of Article VIII, Section 2(b)."[59] In any event, the Executive Board decided not pursue the issue.

3.7 Statutory Proposals

3.7.1 Proposals by Barnett, Galvis, and Gouraige (1984)

Barnett, Galvis, and Gouraige (1984) set out with an extensive legal analysis of the expected consequences of a creditor suit in U.S. courts following a unilateral debt payments moratorium. They conclude that *"the legal limitations upon the Bank's suit against the foreign sovereign would pale in comparison to the practical consequences of a unilateral suit."* [60]In particular, a suit would *"trigger cross default clauses in virtually all the debtor's other loan agreements, possibly precipitating an avalanche of litigation and hampering coordinated attempts at recovery or renegotiation of the debt"*. [61]In other words, a suit would trigger "a race to the courthouse". The authors then examine the feasibility of "a national level response" to this problem, in which a stay of payments and litigation would be imposed by presidential executive action, via the International Emergency Powers Act used by President Carter to freeze Iranian assets in the U.S. Apart from constitutional concerns, they find that this would raise jurisdictional problems and

[58] "Archives of the International Monetary Fund: A Factsheet." at IMF Legal Department (1988), p. 88.Available at http://www.imf.org/external/np/exr/facts/archive
[59] *Ibid.*,
[60] Barett, Barry C., Sergio J. Galvis, and Ghislain Gouraige, Jr., 1984, "On Third World Debt," Harvard International Law Journal. Vol. 25 (Winter)
[61] *Ibid.*,

not be suited to the international character of the problem. "Therefore, we must look to institutional reforms at the international level," including "the creation of an adjunct to the IMF to handle debt problems on a unified, international basis."[62] ***Barnett, Galvis, and Gouraige envisage a "supranational, multilateral body" that would be "independent from the IMF both in administration and decision- making."*** Its powers would include the authority to (1) convene mandatory discussions between a debtor state and its commercial bank creditors; (2) order the commencement of and preside over debt renegotiation proceedings; (3) preempt unilateral creditor suits; (4) determine fair terms of debt renegotiation and establish a ceiling on those terms; (5) preclude the parties from undertaking other renegotiation efforts; (6) permit creditor banks' suits to proceed as a sanction against a debtor which refused to accept the renegotiated terms; and (7) require the debtor to adopt internal adjustment measures as a condition to renegotiation.[63] The exclusive right to initiate adjunct proceedings would rest with the debtor state provided that specific criteria relating to debt sustainability were satisfied. Good-faith behavior by the debtor would be enforced by the implicit threat that the ban on litigation could be revoked. While Barett, Galvis, and Gouraige do not go into details on the legal basis of the proposed new institution, it is implicit that unlike Oechsli's (1981) proposal, their plan would require a formal multilateral agreement. They concede that "the political obstacles to approval of the plan are formidable ... A more modest plan, however, may prove acceptable." This would involve a legally nonbinding "central mechanism to handle debt problems," as well as "the adoption of a multilateral agreement establishing guidelines for debt renegotiation."

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[62] Supra *note*.60
[63] Supra *note*.60 at pg.135

3.7.2 Benjamin Cohen (1989)

Much along the lines of Barnett, Galvis, and Gouraige's proposal, which he was apparently unaware of, Benjamin Cohen (1989) calls for the creation, "by multilateral convention," of a new "**International Debt Restructuring Agency**" (IDRA). "Ideally, it would be organized as a wholly new and independent entity in order to underscore its neutrality ... In practice, it might be more feasible to get IDRA started as a joint subsidiary of the two multilateral agencies most involved with the problem now, the IMF and the World Bank." As in Barnett, Galvis, and Gouraige's proposal, the IDRA's primary role would be that of a facilitator, mediators and monitor, but Cohen's proposal allows for a more heavy-handed role if necessary: "IDRA could conceivably be authorized to compel agreement in the event of deadlock in order to suppress any remaining temptation among lenders to free ride. For example, dissenting creditors might be obliged to accept terms agreed by a qualified majority if IDRA declared the proposed settlement to be 'fair and equitable'." [64]Barnett, Galvis, and Gouraige and Cohen differ slightly in their characterization of the underlying collective action problem. While the former worry about competing creditor litigation, Cohen is concerned with incentives to free ride on a settlement reached by a majority, as well as the underprovision of new financing. His proposed solution is to require less than unanimous creditor support for the acceptance of a restructuring proposal, and if necessary, giving the IDRA powers to impose a settlement. As far as debtor incentives are concerned, Cohen suggests that debt relief granted under the process could be, in part, made conditional on good debtor

[64] Cohen, Benjamin J., "Developing Country Debt: A Middle Way," Princeton Essays in International Finance ,Princeton University Press, 1989a; pg.33

behavior: "Creditors would be permitted to withdraw all concessions on such matters as interest rates if IDRA determined that a debtor was not complying with its policy commitments." He is less clear on how the IDRA would encourage debtors to negotiate in good faith and stick to the specified timetable. Unlike Barnett, Galvis, and Gouraige, Cohen does not discuss the possibility of having the agency authorize, and if necessary revoke, a stay of litigation while negotiations are ongoing.

3.7.3 Brett Miller Proposal (1991) and Williamson(1992) Proposal

Miller dismisses the creation of an IDRA as unfeasible, and instead explores the **possibility of amending the U.S. Bankruptcy Code (in particular, Chapter 9) to allow sovereigns to benefit from U.S. bankruptcy protections.**[65] However, he cautions that this may not protect debtors from claims by non-U.S. creditors, and could lead to jurisdictional problems. In contrast, Williamson[66] (1992) embraces the IDRA idea and-echoing his 1985 contribution-suggests that it might operate largely on a private contractual basis: "An International Debt Restructuring Agency would base its legitimacy on clauses in future loan contracts specifying that the terms of the contract could be revised by the agency to take account of unforeseen contingencies, and that both creditors and debtors would be bound by its decision" .[67]

[65] Miller, Brett H., "Sovereign Bankruptcy: Examining the United States Bankruptcy System as a Forum for Sovereign Debtors," Law and Policy in International Business, 1991, Vol. 22, No. 1

[66] Williamson, John, "On the Question of Debt Relief," in Statement of the North South Round Table on Money and Finance ,Society for International Development), 1985, December 13-14

[67] Ibid., at pg.95

3.7.4 Raffer's (1990) proposal

Roughly coinciding with Cohen is Raffer's[68] (1990) proposal for an international insolvency procedure modeled after Chapter 9 of the U.S. bankruptcy code, which applies bankruptcy reorganization principles to municipalities. Like Barett, Galvis, and Gouraige and Cohen, Raffer envisages a structured negotiation procedure overseen by a new international body. Raffer refers to it as **a "neutral court of arbitration,"** implying that it would have considerable powers, much like a domestic bankruptcy court. In his plan, creditors and debtor countries would nominate an equal number of arbitrators, who in turn would nominate a chairperson. Raffer argues that in all other respects, *"an adaptation of Chapter 9 to the international setting would only require minor changes."* What distinguishes Raffer's proposal is the emphasis on Chapter 9 rather than Chapter 11 as the right domestic analogy for sovereign bankruptcy. **He seems to prefer Chapter 9 for two reasons.** First, it is not vulnerable to the objection that a Chapter 11 for countries would not work because of the impossibility of "liquidating" a state entity. Furthermore, as Raffer emphasizes, Chapter 9 limits court interference with the municipalities' political or governmental powers, and gives certain groups that might be affected by the reorganization plan (such as unions and debtor employees) the right to be heard. In Raffer's view, this provides an opportunity for balancing the interests of creditors with the welfare of domestic citizens as well as national sovereignty, which he thinks were disregarded in official attempts to resolve the debt crisis during the 1980s.

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[68] Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face," World Development, 1990, Vol. 18, No. 2

3.7.5 Daniel Kaeser's Proposal (1990)

A final contribution in this group is a little-known proposal by Daniel Kaeser (1990), a Swiss treasury official[69]. Building on suggestions by the "Languetin Group," an independent commission charged by the Swiss government with proposing solutions to the debt crisis, the centerpiece of Kaeser's proposal is the **creation of a sovereign debt workout mechanism under the auspices of the IMF or some other international agency.** However, Kaeser goes further in several respects. In essence, he wants to tackle three problems at once: *first, create a mechanism for efficient debt reduction; second, discourage future overindebtedness; and third, allow countries with sustainable debt levels to access private capital at relatively low cost.* Actual indebtedness would be continuously monitored through a centralized registry. In the event that debt-service commitments were to rise above the threshold, a country could petition the international bankruptcy agency. Relief would be tranched and conditioned on adjustment policies, in the context of an IMF program. Countries below the threshold would not be eligible for debt relief. In Kaeser's view, this mechanism would serve as a disincentive to excessive indebtedness while still allowing countries with low debt to access the capital market. To further encourage such access, he additionally suggests **an insurance fund** that would partly guarantee interest payments by countries staying below the debt service threshold. Furthermore, he proposes using the same criterion to differentiate the provisioning requirements of creditor banks. Since debt service would (by definition) fall below the threshold after a restructuring, this would also help address the underprovision of new financing emphasized by Sachs and many others. **Kaeser seems to be the first author to**

[69] Supra *note* .50 at pg.17

suggest a sovereign bankruptcy mechanism strictly geared to countries that are over indebted as defined by some "objective" criterion, as opposed to any country in payments difficulties. As we shall see, this idea fades in the 1990s, but eventually reappears (Krueger, 2001).

3.8 Suggestions for a bankruptcy court

3.8.1 Jeffrey Sachs (1995), "Do We Need an International Lender of Last Resort?" (April 20, 1995)[70]

The implementation of the Brady plan in 1991 and the subsequent resumption of capital flows to emerging markets brought a temporary lull to the literature on sovereign debt restructuring mechanisms. This was quickly reversed in the wake of the Mexican crisis and the ensuing U.S./IMF crisis loan, beginning with an influential lecture by Jeffrey Sachs (1995), "Do We Need an International Lender of Last Resort?" (April 20, 1995) The essence of Sachs's argument is that the international financial system does indeed suffer from inefficiencies that could be used to justify a lender of last resort, but that in practice the IMF is so ineffective in exercising this function partly by design, partly due to incompetence that these inefficiencies would be addressed much more successfully if it were to give up its lending role and instead assume that of a **bankruptcy court**. **"IMF practices should be reorganized such that the IMF plays a role far more like an international bankruptcy court and far less like the lender of last resort to member**

[70] Jeffrey Sachs, "Do We Need an International Lender of Last Resort?" 1995, Frank D. Graham Lecture at Princeton University, Vol. 8, April 20. Available at : http: www.ksg.harvard.edu/cid/ciddirector/publicat .

governments".[71] He was the first person to contain a detailed discussion of the desirable scope for a sovereign bankruptcy mechanism, arguing that it ought to cover domestic as well as all external debt (except for debt owed to IFIs).

Prof. Sachs also argued about the '**rouge creditors**' who threatens national economy by their immediate and casual attitude, without having concern for the interest in the national economic revival.

The study of Prof Sachs was actually based on several assumptions[72]. *Firstly, if there can be bankruptcy proceedings to be conducted against a corporate entity; there is a possibility to have a bankruptcy law against the state as an entity. Secondly, that the harassed sovereign debtor would likely to come before the bankruptcy court seeking facilities to restructure. Thirdly, the international Financial Institutions are free to determine their own course of action and would be quite willing to place a substantial fund at the disposal for sovereign debt restructuring as required by the sovereign state from time to time.*

All the above mention assumptions were made on the basis of some quick conclusions without taking into account the nature of the international law and plural agreements, especially Briton-wood system.[73]

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[71] *Ibid.*, at pg 14
[72] Supra *Note* 24 at pg 36
[73] Supra *Note* 24 at pg 37

Prof. Sachs did not take into full account of the possibility of the committee of creditors to be dominated by those 'rouge' creditors. He also does not state how holdout creditors would be disciplined under his plan, and whether this would require changes in member countries' domestic laws. Besides that, in his suggestions, it is also questionable to take a private law principle in the public law structure especially when complex constitutional matters are involved.

Further, with regard to IBC, Sachs does not go into details on how his vision of the IMF as a bankruptcy court would be implemented. A Bankruptcy court even accepted within the domain of international law, cannot be established and given effect to without the consent of involved states. Why state would come forward to destabilize its economic structure? If International funding institutions were so generous to facilitate the states to restructure their obligations then there would be no need of any bankruptcy court. Moreover, the issue of determination of priority of claims is also critical in IBC, without the participation of all the parties.

3.8.2 Bulow's proposal (1986)

Bulow's concept of International Bankruptcy court is completely opposite to what Prof. Sachs suggested. According to him, International Financial Institutions (IFIs) and Funding agencies have poured in too much of resources in order to pamper the inefficient and aggressive governments.

Government can neither do business no they ought to be allowed to do the same. According to him, any restructuring of debt system must have to be a precondition of disciplining the government within the government functions. Government is required to withdraw from commercial functions.[74] Based on financial discipline only restructuring is to be allowed. Therefore, he is totally against any further funds of IFIs to be misused for debt restructuring unless sovereign debtor agrees to withdraw from the commercial functioning and needs special consideration for withdrawal.

So Bulow's proposal comprises for an asset- restructuring proposal of a sovereign debtor with a complete and fair disclosure. [75] He argued that unless there is a regular system of debt restructuring the debtor- nation would never achieve the discipline in the system of governance. A quick restructuring mechanism would be able to direct the economy in the desired path that can save the interest of both, sovereign debtor and creditors and such a legal regime can be established by a multi-partite agreement under the care of IMF.

Actually, Bulow's proposal also has few defects. Through his proposal, he brings the fiscal and monetary management system of debtor country under heavy scrutiny. He refuses to believe that government of a state has commitment to his people. Moreover, it would be impossible for any financial institutions, like IMF, to monitor the complexity of political economy under the ministerial system of a state.

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[74] Supra *note.* 24 at pg.38
[75] Supra *note.*24 at pg.38

3.8.3 *John Chun's proposal*[76] *(1996)*

Even more than Sachs-whose perspective is broader, marrying the experience of the 1994-95 crisis with that of the 1980s-Chun is motivated by the Mexican crisis. The emphasis is squarely on **international bankruptcy as an alternative to last resort lending**, and the market failure that the author seems to have in mind is primarily a self-fulfilling debt crisis, not an externality arising during debt workouts (although the creditor free rider problem is mentioned to justify a cramdown provision). Chun's article was written after the June 1995 Halifax summit, at which both the possibility of an **International Bankruptcy Agency (IBA) and a large-scale "Emergency Financing Mechanism" (EMF)** were discussed, and takes the form of comparing these two proposals. He comes down strongly on the side of the IBA. His ideas on how this agency would function rely heavily on the Chapter 9 analogy, and include an automatic stay, preference for new financing, monitoring powers for the IBA, and a cramdown provision. Chun argues that the IBA should be established as a separate and independent affiliate of the IMF. The main novelty of Chun's article is the way in which the desirability of an independent IBA is argued. The primary comparison is not with a situation of uncoordinated default, but rather with crisis management involving large-scale IMF lending. Chun makes Sachs's point that a bankruptcy procedure would improve over the IMF's current international lender of last resort function because of the inherently hesitant nature of IMF lending, which requires a reform program, conditionality, and possibly tranching. In addition, however, **Chun argues that an IBA is better than an EMF on the grounds that it does not create moral hazard, a point not made by Sachs.**

[76] Chun, John H., "'Post-Modern' Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?" Fordham Law Review, Vol. 64 (1996), p. 2647.

Together with Macmillan (1995b) and the G-10 Working Group (see below), Chun is one of the first authors to explicitly invoke the moral hazard argument to argue for a sovereign debt restructuring mechanism.

3.9 Orderly Workouts Without a Bankruptcy Court

3.9.1 James Hurlock's proposal[77] (1995)

Hurlock is one of the first to emphasize that the classic problems of international debt restructuring-uncoordinated litigation, underprovision of new financing, and the holdout creditor problem-are made worse by the shift to bond financing since the early 1990s. He rejects an IMF-based bankruptcy court as a solution to these problems, however, on the grounds that "the Fund is ill-suited to the role of neutral arbiter of sovereign debt disputes" because of its "political nature and voting structure." ***Instead, he proposes working through the U.S. and U.K. legal systems to impose a stay and deal with rogue creditors.*** "The essential predicate would be for certain key nations, such as the U.S., to close their courts on a limited basis to creditors seeking to undermine a legitimate and fair restructuring process that had been endorsed by an overwhelming majority of similarly situated creditors." This could be achieved by an amendment of the U.S. Foreign Sovereign Immunities Act "that would render a foreign state immune from suit, or its property immune from attachment, if, in the context of a sovereign debt workout, the litigating creditor were attempting to bring suit notwithstanding a restructuring plan that was being negotiated in good faith by, or had been accepted by, a supermajority of similarly situated creditors."

[77] Hurlock, James, "The Way Ahead for Sovereign Debt." Euromoney (August1995), pp. 78-9

3.9.2 Proposal of Eichengreen and Portes (1995)

An extensive study[78] by Eichengreen and Portes (1995) takes a similar view of the underlying problems, but surveys a much broader set of potential solutions. After reviewing the rationale for bankruptcy procedures and the history of institutions for renegotiating sovereign debts, the authors consider the potential role for "an international bankruptcy court or tribunal," but ultimately reject the idea, primarily for feasibility reasons. Closing the courts to rogue creditors, as suggested by Hurlock, is also dismissed, on the grounds that a change in statute in a single country would not solve the problem, and enacting a treaty seems unlikely given "the trend in recent years away from sovereign immunity," as well as international human rights law guaranteeing court access. The authors then come down in favor of a set of pragmatic institutional reform proposals, including the *creation of an international **"Bondholder Council"** to complement the Paris and London Clubs, a redefined role for the IMF that could include sanctioning standstills as a signaling device **("a definitive reinterpretation of Article VIII(2)(b) would support the IMF in this role even if it did not have legal effect in national courts")**, a bigger emphasis on information dissemination, and large-scale financing in a narrow set of circumstances, including contagion and self- fulfilling runs.* The most influential idea among Eichengreen and Portes's proposals, however, was to **use majority clauses in debt contracts** as the main device for over- coming creditor collective action problems in the aftermath of a debt crisis. While such clauses had long been included in bonds issued under U.K. law, this was not true for most other jurisdictions, including

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[78] Eichengreen, Barry, and Richard Portes, "Crisis? What Crisis? Orderly Workouts for Sovereign Debtors" ,Centre for Economic Policy Research, London, 1995

New York. By pushing for the universal adoption of such clauses, Eichengreen and Portes became the fathers of what is now referred to as the "contractual approach" to orderly crisis resolution.

3.9.3 Rory Macmillan's proposal[79] *(1995)*

Macmillan is particularly concerned with coordination problems among bondholders, which he describes in some detail. He is the one of the first to reject large-scale crisis lending on the grounds that it creates moral hazard. His proposal comprises two main elements. *First, the creation of an inter- national bondholder council along the lines proposed by Eichengreen and Portes, or several national bondholder councils in the major financial centers, each representing the holders of bonds issued there. Second, addressing the free rider problem among bondholders, through one of two alternative solutions.* The first is a much milder variant of the Hurlock idea of a stay via sovereign immunity, which would apply only to emergency situations, and to bondholders individually but not collectively. *"Rather than granting complete immunity to the debtor, legislation might remove bondholders' rights to sue but vest those rights collectively in the bondholder council."* His second, preferred, approach is to **"engineer solidarity"** among bond- holders by changing some of the rules under which creditors could sue. Specifically, he proposes: **(1) "a sharing obligation imposed by simple legislation" that would force bondholders to share payments received from a court judgment with other bondholders; (2) legislation requiring that "all legal actions over the bonds be consolidated into a single legal action"; and (3) a legal minimum threshold**

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[79] Roly Macmillan, "Towards a Sovereign Debt Work-Out System," Northwestern Journal of International Law and Business, Vol. 16, No. 1. 1995;pp. 57-75.

of bond- holders to bring a suit. This threshold would need to be sufficiently high to solve the free rider problem. Macmillan reckons that 10 percent would be sufficient. Macmillan argues that this approach would also solve the problem of encouraging new financing: "if the incentives of existing creditors can be aligned so that prioritized new money is in their collective interest because there is no alternative, then they will agree to a restricted subordination of their own debt.

3.9.4 Report of the G-10 Deputies Working Group[80] (1996), written in response to the Halifax summit's

The G-10 Working Group is very concerned with ***"minimizing moral hazard for both creditors and debtors."*** It shares Eichengreen and Portes's concerns about the feasibility of an international bankruptcy procedure, but in addition is skeptical on the applicability of the bankruptcy analogy as such, on the grounds that the management of economic policies in a sovereign state cannot be taken over by a trustee, and that litigation "has not in the past been a serious problem for sovereign debtors. Such debtors have few assets to seize and some of these benefits from sovereign immunities"[81]. The paper recognizes the potential usefulness of temporary standstills, but does "not consider that it would be feasible to operate any formal mechanism for signaling the official community's approval of a suspension of payments bv the debtor." The proposed approach is to encourage standstills "in exceptional circumstances" via IMF lending into arrears. Most of the emphasis is on **"contractual or statutory provisions governing debt contracts"** that

[80] Group of Ten, 1996, "The Resolution of Sovereign Liquidity Crises: A Report to the Ministers and Governors Prepared Under the Auspices of the Deputies," May 1996. Available at http://www.bis.org/publ/other.htm#Gten

[81] *Ibid.*,at pg.10

would improve communication between debtor and creditors and discipline rogue creditors. "Such provisions are those that ***(a) provide for the collective representation of debt holders in the event of the crisis, (b) allow for qualified majority voting to alter the terms and conditions of debt contracts, and (c) require the sharing among creditors of assets received from the debtor.*** " Developments in this direction should be "market led" but "should receive official support as appropriate." **No specifics are offered on what form this official support could take.**

3.10 Proposals during 2000-2001

After 1996, there was a brief lull in the literature on sovereign debt workouts, as world attention focused on the Asian financial crisis, which revolved mainly around private debt. However, this soon gave way to a second wave of crises in which sovereign debt played a significant role (including in Russia, Ukraine, Brazil, Ecuador, Pakistan, Turkey, and Argentina). By 2000, proposals to improve the handling of sovereign debt crises were back on center stage. For the most part. they relate closely to the preceding discussion round during 1995-96, but a few go substantially beyond. In what follows, we survey the main contributions prior to Anne Krueger's November 2001 speech proposing a Sovereign Debt Restructuring Mechanism, focusing on contributions by Haldane and M. Kruger (2001), Eichengreen (2000), Lerrick and Meltzer (2001), and Schwarcz (2000). As we shall see, these four papers occupy the full spectrum from proposals that would require little or no statutory changes to ambitious statutory initiatives.

3.10.1 Barry Eichengreen's proposal[82] (2000)

Barry Eichengreen's (2000) main thesis is that attempts to limit "***the moral hazard caused by IMF bailouts" are not credible, and will not be effective, so long as the international community does not find alternative ways to resolve sovereign debt crises.*** He argues in favor of a **nonstatutory approach**, along the lines of his 1995 report with Richard Portes. He concentrates on two of the proposals advanced in that report: IMF-endorsed standstills and collective action clauses in bond contracts. Standstills would deal with liquidity problems and self-fulfilling runs, while collective action clauses would be the main instrument for addressing the "restructuring problem."

Eichengreen's view that standstills are good only as panic breakers but insufficient in the context of debt restructuring seems to rest on two arguments. *First, standstills do not address the collective action problems associated with debt restructuring negotiations-in particular, the holdout creditor problem-and do not by themselves protect the debtor from litigation. In the case of a panic, this is less of an issue, since the debtor pays in full after the panic is over. Second, unless backed up by Article VIII or changes in national laws, the leverage of the IMF over the debtor in a standstill is relatively weak.* The IMF has some effect on the debtor's reputation and the potential "carrot" of lending into arrears, but it cannot influence the debtor by, say, threatening to remove the standstill. This does not matter in a pure panic, which, by definition, can be resolved without corrective actions on the side of the debtor, but it may matter in a debt restructuring.

[82]Barry Eichengreen, "Can the Moral Hazard Caused by IMF Bailouts Be Reduced?" Geneva Reports on the World Economy Special Report 1, August, 2000

when policy adjustments and good faith bargaining by the debtor are required **Eichengreen argues that collective action clauses are the right instruments to solve these additional problems**. He proposes that "the official community should lead by example, as the British and Canadian governments have done, and that it should subsidize the issue of bonds featuring CACs [collective action clauses], perhaps by having the IMF express a readiness to provide emergency assistance on more attractive terms of countries prepared to adopt the measure" [83]

3.10.2 Lerrick and Meltzer's proposal[84] (2001)

Lerrick and Meltzer (2001) propose an **IMF-supported debt workout mechanism** .The main elements proposed are : first, an **IMF-endorsed moratorium on debt payments; second, debtor-creditor negotiation during the moratorium; third, IMF financial support[85].** However, the form that this support would take is radically different. Rather than lending funds conditionally for general balance of payments use, the IMF would lend unconditionally, for a limited time period. to place a floor below secondary market debt prices at 80-85 percent of the fraction of debt that is deemed sustainable. Thus, the sole purpose of this form of IMF financing would be to prevent debt prices falling below "reasonable" levels during the restructuring period. While the Lerrick-Meltzer approach does not require a new treaty or changes in national laws, this constitutes a large departure from the IMF's traditional role that could require an amendment of the Articles of Agreement. The role of this form of IMF support is not to create good debtor

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[83] *Ibid.*, at pg 39
[84] Adam Lerrick and Allan H. Meltzer. "Blueprint for an International Lender of Last Resort", Caregie-Mellon University, Pittsburgh. 2001
[85] Supra *note*.50

incentives while the country is restructuring (Lerrick and Meltzer do not believe this to be a significant issue), but to prevent creditor panic and contagion by maintaining the liquidity of the sovereign debt market during the restructuring period

There is no legal instrument in Lerrick and Meltzer's proposal that would protect the debtor from litigation and impose a majority-backed agreement on holdouts. Lerrick and Meltzer argue that this is not necessary, both because the international assets of a sovereign debtor are hard to attach, and because the existence of a debt price floor would reduce the profitability of holding out. "Vulture funds" could no longer buy debt at extremely low prices, and the margin between the price floor and the face value of the debt might not be worth the costs of a court battle.

3.10.3 Steven Schwarcz's proposal[86] (2000)

Steven Schwarcz presents perhaps the most comprehensive legal treatment so far on how the provisions of Chapter 11 (or Chapter 9, the distinction is dismissed as secondary) could be applied at the international level. According to Schwarcz, the status quo embodies three inefficiencies: ***"the collective action problem of reaching agreement among creditors," "moral hazard" created by IMF bailouts (both vis-a-vis countries and creditors), and the underprovision of new private financing, leading to an excessive reliance on public money via the IMF.*** To address these, he proposes "a **supranational legal framework for sovereign debt restructuring**," a draft of which is attached to his paper. He argues that "recent proposals to contractually solve the

[86] Steven L. Schwarcz,"Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach," Corell Law Review, Vol. 85, 2000, pp. 101-187

collective action problem in bonds by introducing supermajority voting clauses in new bond issues are unlikely to be successful" because "only consenting bondholders would be bound. As a result, a state cannot rely on a contractual approach to bind holders of the large stock of existing long-term bonds, much less future creditors that choose not to consent".[87] However, Schwarcz takes a much more minimalistic approach than previous statutory approaches. His intellectual strategy is to set out desirable principles for an international Chapter 11-basically, fostering economic rehabilitation of the debtor while "minimally affecting non-bankruptcy incentives"-and ask how these could be attained with as little "adjudicatory discretion" as possible. The result is remarkable for what it does not contain: *(1) no automatic "stay" of creditor claims following inititation, on the grounds that the sovereign can declare a payments moratorium, and creditors have no significant recourse against this since there are "relatively few assets located in other jurisdictions"; (2) no officially organized creditor committees, since his convention would provide sufficient incentives for creditors to organize themselves on an ad hoc basis; (3) no cramdown rule (over and above the basic supermajority rule) to impose a restructuring agreement on a dissenting creditor class, on the grounds that implementing cramdown requires valuing the debtor as a going concern, which is hard to do for sovereigns and (4) no international bankruptcy court or greatly extended role for the IMF, on the grounds that his proposed convention would be largely self-enforcing.*

What survives from Chapter 11 in Schwarcz's convention are three simple proposals regarding initiation, new private financing, and supermajority agreement to a restructuring plan: "(1) **only a State itself, and not its creditors, may commence the**

[87] *Ibid.*, at pg 166

restructuring case, and must do so in good faith; (2) financiers of the debtor-State's debt restructuring must have priority over claims of other creditors .. .; and (3) all creditors be bound to a plan or reorganization that is agreed to by super-majority voting by classes of claims, and, upon such agreement, debts not provided for in the plan be discharged. The Convention would also require each ratifying State to enact the Convention's rules into national law".[88] Schwarcz argues that while a full-fledged international bankruptcy court would bé superfluous under his convention, "a tribunal would be required to settle interpretive disputes in very limited circumstances".[89]For this limited role he proposes creating **an arbitration panel along the lines of the World Bank Group's International Centre for the Settlement of Investment Disputes.** He also sees a role for the IMF as "the location where States file their debt-restructuring cases," to help the arbitration panel decide whether a filing occurred in good faith and if excessive new financing undermined the rights of existing creditors, and as a source or intermediary for interim financing.

3.10.4 Kruger's (2001) SDRM proposal

Kruger in his paper attempted to develop a voluntary mechanism for debt restructuring by a sovereign state. His Sovereign debt restructuring mechanism (SDRM) is based on two challenges to any established system, *firstly, the present uncertainty in crises management in debt servicing does no good to debtors and the creditors, secondly, there are several financial constraints of the debtor on any collective mechanism*[90].

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[88] Supra *note* 86, at pg 158-159

[89] Supra *note* 86, at pg 179

[90] Krueger, Anne, 2001, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring," Available at http://www.imf.org/external/pubs/ft/exrp/sdrm/eng sdrm.pdf

The SDRM is based on two basic principles: (a) It is applicable on voluntary submission. A state party shall have to request for debt restructuring. (b) It is to be invoked only in very limited circumstances. Specially when the debt burden is clearly unsustainable. Kruger's model is almost similar to any corporate rehabilitation model having four steps as suggested by him. The mechanism starts with a stay on creditors for enforcement of their claims during the period of restructuring negotiations. This has to be have measures to protect the interest of the creditors during the stay period. Ten starts the mechanism that would facilitate negotiations for new financing during the period of restructuring. Finally, there must be a mechanism to bind the parties to an agreement reached for restructuring on basis of negotiations with the qualified majority.

Further Kruger's emphasis on the need of enough incentives for the debtor to come forward to volunteer the reconstruction, and there must be an IMF supported program for protecting the interest of creditors. Any additional finance needed during the process of restructuring would have to given by agreement of priority. During the restructuring proceedings the **Committee of creditors** has to play a significant role for ***(a) arriving n agreement on restructuring,(b)assisting the debtors to adopt policy that protects value of assets; (c) agreeing on the priority financing during the process and; (d) working with the IMF for quick restructuring of the assets so that the debtor has enough incentives to seek restructuring in time.***

In the whole scheme of SDRM, Kruger's did not address the most significant issue i.e. to have a binding Dispute resolution mechanism like WTO, non-fulfillment of whose obligation attracts sanction.

CHAPTER 4: PRINCIPAL REFORM PROPOSALS

Three 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.[91] Second, academics, most notably Jeffrey Sachs,[92] and the IMF, in the person of **Anne Kreuger,**[93] 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).**

[91] J. Taylor, "Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference on Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, April 2. 2002. See generally International Monetary Fund, Legal Department, The Design and Effectiveness of Collective Action Clauses, June 6, 2002 and International Monetary Fund. Policy Development and Review, International Capital Markets and Legal Departments, Collective Action Clauses in Sovereign Bond Contracts–Encouraging Greater Use, June 6, 2002.

[92] J. Sachs, "Do We Need An International Lender of Last Resort, Frank D. Graham Lecture at Princeton University 8, April 20, 1995.

[93] A. Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, Address at the National Economists' Club Annual Members' Dinner, AEI, November 26, 2001, was later modified in A. 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" (April 1, 2002), and A. Krueger, "A New Approach to Sovereign Debt Restructuring", International Monetary Fund, April 2002. called by some IMF Krueger Lite.

Both proposals have similar objectives[94]: ***(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.[95]The U.S. Treasury seems to prefer CACs. In April 2002, John Taylor was highly critical of the SDRM,[96]but Secretary O'Neill subsequently put forward the two track approach.[97] Some G-7 countries, particularly the U.K. and Canada seem less convinced of the efficacy of CACs and would prefer a faster track for SDRM.

4.1 Collective Action Clause: Market-based approach

The day after the IMF announced its ambitious plan to enact an international bankruptcy court, the U.S. Department of the Treasury responded with its own ideas about the proper way to solve future sovereign debt crises. The Treasury Department plan. presented by Secretary of the Treasury Paul O'Neill, rejected the idea that an SDRM or any other

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[94] Hal S. Scott , " A Bankruptcy procedure for Sovereign Debtors?": pg.32 ,See at http://ssrn.com/abstract_id=384220
[95] Ibid.,
[96] Supra note 91
[97] Supra note.94

statutory solution was necessary to address future economic concerns.[98]The Treasury Department. convinced about the virtue of market solutions,[99] proposed the idea of encouraging creditors and debtors to rewrite the way bonds were written in an attempt to alter the terms under which countries borrowed money.[100]Just like the IMF's SDRM proposal, the Treasury Department's plan was not uniquely conceived.[101]Similar ideas have been examined in academic journals over the past several years.[102] In fact, some of the major criticisms of the Treasury Department's plan claim that it is identical to a 1996 G-10 proposal that proved unworkable and that it is simply an old plan regurgitated.[103]

The Treasury Department has chosen to emphasize a different set of concerns than the IMF. According to the Treasury Department, **the primary problem with sovereign debt restructuring is the lack of a process to restructure debt.**[104] With no process in place, investors are unable to adequately assess the cost of default. Without this information, not only are bonds priced inaccurately, but great uncertainty ensues when a country has debts that are unmanageable. With that latter concern in mind, the more modest goal of the Treasury Department is to "reduce the uncertainty that now surrounds

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98 Jonathan Sedlak , "Sovereign Debt Restructuring: Statutory Reform or Contractual Solution? ", University of Pennsylvania Law Review, Vol. 152, No. 4 (Apr., 2004), pp. 1483-1515.Available at http://www.jstor.org/stable/3313046

99 *Ibid.,*

100 Kenneth Rogoff & Jeromin Zettelmeyer, "Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001", 49 IMF STAFF PAPERS 470 (2002) at http://www.imf.org/external/pubs/ft/staffp/2002/03/pdf/rogoff.pdf ,

101 *Ibid.,*

102 Buchheit & G. Mitu Gulati, "Sovereign Bonds and the Collective Will", 51 EMORY LJ. 1317, 1358 n.87 and Barry Eichengreen & Ashoka Mody, "Would Collective Action Clauses raise borrowing costs?"Pg.no. 22-23 ,See at http://papers.nber.org/papers/w7458.pdf

103 Michelle J. White, "Sovereigns in Distress: Do They Need Bankruptcy?", 2002, Brookings Papers on Economic Activity ;Pg.no287, 308 & Marcus Miller, "Sovereign Debt Restructuring: New Articles, New Contracts-or no Change? "Pg.no 6

104 John B. Taylor. "Using Clauses to Reform the Process for Sovereign Debt Workouts: Progress and Next Steps", EMTA Annual Meeting (Dec. 5, 2002), See at http://www.treas.gov/press/releases/po3672.htm .

restructurings."[105]The Treasury Department does not specify the kind of restructuring procedure it would like to see implemented. Having faith in the market system, the Treasury Department leaves the terms of the process up to the individual creditors and debtor nations. Major statutory reforms are not required, nor is the creation of an international bankruptcy court. If debtors and creditors are given incentives to include contractual provisions relating to restructuring in their loans, uncertainty will be reduced, and the markets will function more efficiently (and, hopefully, with fewer defaults).

4.1.1 Different classes of CACs

4.1.1.1 Majority-Amendment Clauses

The first of these clauses is a collective action clause, which is designed to ***"allow a super-majority of bondholders to alter the key financial terms of a bond."***[106] While the Treasury Department does not define which financial terms would be subject to the collective action clause, a review of the academic literature suggests that "financial terms" refers to either a change in the due date for the payment of a bond's principal or interest or a reduction of the interest or principal on the bond.[107] Currently, these financial terms cannot be changed in over seventy percent of the bonds outstanding to sovereign nations. However, if creditors included the authority to alter such terms in their bonds,

[105] John B. Taylor, "Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference, Sovereign Debt Workouts: Hopes and Hazards?", Institute for International Economics (Apr. 2, 2002, See at http://www.treas.gov/press/releases/po2056.htm .
[106] *Ibid.,*
[107] Supra Note. 98

then the cost of coordinating negotiations during restructuring would be significantly reduced.

Sovereign bonds issued under U.S. law, approximately 69% of the $154 billion outstanding,[108] require unanimity to change terms. 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.[109]

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

[108] Supra *note*.105
[109] L. Buchheit and G. Gulati, " Sovereign Bonds and the Collective Will", Emory L.J. 1317 (2002); Pg.51

constitute a significant percentage and even a majority, might be pressured by their sovereigns to abuse the foreign creditors.[110]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.[111] 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.

While the G-7 and creditor groups both favor use of CACs, the G-7, including the U.S., would favor a lower majority percentage, 75%,[112]than private creditor groups which reportedly call for a 90% requirement.[35] 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.

[110] Supra *note.* 105
[111] Supra *note.* 105

[112] Supra *note.* 105

4.1.1.2 Acceleration Clause

The other important CAC currently used in sovereign bonds deals with acceleration.[36] ***Acceleration refers to the ability of bondholders to declare the bond payable immediately if it falls into arrears.*** This allows them to sue the borrower for the entire principal, rather than just the missed interest payments. Thus, absent the right to acceleration, bondholders have very little incentive, either individually or collectively, to initiate legal action against the sovereign.

Most sovereign bonds, whether issued under U.S. or U.K. law permit and require a vote of 25% of creditors to accelerate payments, i.e. full payment of interest and principal.[113]This is important because acceleration of claims increases the potential cost of default for debtors. Absent a vote of 25% of creditors, a creditor seeking to recover on a default could only ask for payment of past due interest payments. The 25% requirement would seem to impose some break on vulture creditors, but, in practice, some bond syndicates are quite small, e.g. less than $100 million, and when bonds trade down to 20¢ on the dollar, it does not take much money to obtain a 25% 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% position.[114]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%

[113] Hal S. Scott , "A Bankruptcy Procedure for Sovereign Debtors?": pg 35. Available at http://ssrn.com/abstract_id=384220

[114] *Ibid.,*

discount is unacceptable to at least 25% 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.[115]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.

4.1.1.3 Engagement clause

Another type of clause the Treasury Department to wants included in all newly issued debt instrume.its provided to emerging markets is an engagement clause. This clause is designed to "describe the process through which debtors and creditors come together in the event of a restructuring,"[116] giving debtors and creditors the opportunity to flesh out some of the specific details regarding the actual process of restructuring. The Treasury Department suggests that this clause could include the designation of a creditor representative- an individual or group of individuals chosen to negotiate on behalf of all the creditors-who would have the exclusive right to initiate litigation against the

[115] Supra *note.* 113
[116] Supra *note.* 105

sovereign. This provision, like that of the IMF proposal, appears to be designed to attack the minority holdout problem. In addition, the engagement clause could be used to specify both the information the debtor must provide to the creditor representative and the timeframe for providing that information. The implementation of this clause will likely establish specific guidelines for the parties to follow.

4.1.1.4 Initiation clause

As suggested by Taylor, this clause describes the procedure by which a sovereign country initiates the restructuring process.[117]Ideally, the sovereign would notify the creditor's representative (as de- fined by the engagement clause), and the two groups would begin negotiating a restructured deal. The quicker the process can occur, the more asset value will be protected. Significant coordination problems remain, however. The sovereign must be given time to notify and properly document the need for restructuring, while, at the same time, the creditor's representative must determine its respective bar- gaining position. An interesting aspect of the Treasury Department's proposal concerning the initiation clause is its suggestion that the parties may wish to include a "cooling-off" period during which no litigation may be initiated against the sovereign. This feature is similar to the stay pro- vision in the IMF's SDRM plan, but its existence is curious in this context. Its stated purpose is to prevent bondholders from initiating litigation. However, as mentioned above, with the adoption of an engagement clause, only the creditor's representative will have the authority to initiate litigation. Treasury Department documents do not clearly express the intent of this cooling-off period provision.

[117] Supra *note*. 105

4.1.2 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.

  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.[118] 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.[119]

[118] Supra *note* 113
[119] Supra *note* 113

- **Second,** there would be a substantial transition issue since 69% of bonds outstanding do not presently have such clauses and have an average maturity of five years. It is estimated it would take 10 years to replace these non-CAC bonds.[120]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. 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

As Anne Kreuger has repeatedly observed, the CAC solution will not work across different credit instruments.[121]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

[120] International Monetary Fund, Policy Development and Review, International Capital Markets and Legal Departments, "Collective Action Clauses in Sovereign Bond Contracts–Encouraging Greater Use", June 6. 2002.Available at www.imf.org/external/np/psi/2002/eng/060602a.pdf

[121] A. Krueger, "Shadow Financial Regulatory Committee Symposium, The IMF Proposal for Sovereign Debt Restructuring". October 7, 2002.

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% requirement, others 90%.[122]

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[123] 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.

[122] Supra *note.* 113

[123] A Schwartz, "A Contract Theory Approach to Business Bankruptcy", Yale L. J. 1807 (1998) ;Pg.107

- **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 was 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.***

4.1.3 Problem of Holdouts: Is CAC a solution to Holdouts?

If all bond issues had CACs, sovereign debtors would have the power to prevent a minority of creditors within each bond issue from acting as holdouts, as long as the required supermajority within each bond issue was willing to accept a restructuring plan. However, this approach would not prevent a trustee who represented a majority of holders of a particular bond issue from suing the debtor. Further. even with CACs, bondholders cannot be forced to accept a restructuring offer if the group of bondholders that prefers to hold out is larger than the number required to block agreement (usually one-fourth in U.K.-issued sovereign bonds). Similarly, even if all bond issues contained CACs, bondholders could not be forced to come to the bargaining table if the group of bondholders that prefers to delay negotiations is larger than the blocking minority. Thus CACs by themselves do not prevent holdouts and do not give the debtor the power to force all bondholders to participate in negotiations, if the dissenting minority is large enough. An additional problem with CACs is that individual bondholders can easily defeat them by purchasing at least a blocking minority of any particular bond issue. In the future, creditors may demand that debtors provide many smaller bond issues, or may

demand that the blocking majority be reduced in size, so that investors can count on controlling any bond issue they purchase.[124]

Another problem is that if more bond issues in the future contain CACs, creditors' gain from holding bond issues that do not contain CACs will rise. Being a holdout becomes more profitable the fewer the number of other potential holdouts, because the sovereign debtor is more likely to buy out holdouts when they are few. Thus creditors may defeat attempts to make CACs universal by offering better terms on sovereign bond issues that do not contain them or by buying only small issues in which they can purchase a majority. In effect, the market may defeat attempts to make CACs universal.

Finally, CACs do not eliminate the strategic use of litigation, the stated goal of their inclusion in debt instruments. Unless and until courts develop a jurisprudence clarifying the rights and responsibilities of creditor groups in restructurings, holdout creditors will continue to enforce their claims against sovereign debtors in courts. In addition to holdout litigation, CACs may spawn a new class of inter-creditor suits as dissenting bondholders challenge the restructuring terms imposed by the majority or supermajority of bondholders. Indeed, the uncertainty associated with judicial review of all these claims may offer a partial explanation for the failure of the market to attribute greater value to bonds subject to CACs.

[124] Michelle J. White. "Sovereigns in Distress: Do They Need Bankruptcy?", Brookings Papers on Economic Activity, Vol. 2002, No. 1 (2002), pg.29. Available at http://www.jstor.org/stable/1209182,

4.1.4 Additional Challenges

The following challenges may hamper faster progress in introducing CACs for sovereign bonds issued in major markets:

1. First, the process at arriving at fairly standard CACs in terms of definite/final formulations that are valid in all major legislations (France, Germany, Japan, Luxembourg, United Kingdom, United States) is not yet finished.
2. Second, even if there were such clauses, these were only introduced over time and the old large stock of sovereign debt would be without such clauses. The data in Table 2 may provide some indication of the time frame involved. Similarly, CACs only apply to one issue of homogeneous bonds. A country has usually several classes of bonds outstanding and the question whether or not the calling upon the CACs in one-bond issues affects the others is largely unresolved (i.e. the question of accelerating clauses).
3. Third, many emerging economies and some market participants still fear that there may be costs involved or that they may provide a greater incentive to default when introducing CACs. While this may contradict the facts and current empirical evidence, poor communication or fear alone may act as a deterrent. The challenge is to ensure that emerging market economies are actively involved in moving this process forward (to ensure ownership). CACs will have (to continue to be) adopted by some larger emerging market economies as several industrial economies have already led by example.

4. Fourth, CACs may prove a toothless tiger if something like a bankruptcy court may not be threatening in the end. The big stick may have to be somewhere, especially if both debtor and creditors conclude in negotiations that it might be better to hold out as the .official international community. may come to the rescue. Or, we may come up with other mechanisms, which will effectively cope with the current motivations for introducing CACs. The challenge to bind the progress on CACs or on the statutory

4.2 "Exit consents" and "Exchange offer"

Several proposals have been made to deal with holdout problem. These are creation of international bankruptcy court, implementation of Collective action clauses, utilizing standstill by IMF. Although these measures may have effective impact on holdout problems, they require time, money and sometimes change of legal system, to be implemented. On the contrary, utilizing the so-called "exit consents", a major restructuring technique of corporate bond does not require any change of current system.[125]

Therefore it is worth examining whether this restructuring technique can be used in sovereign debt restructuring and be effective.

[125] Lee C. Buchheit "Exit Consents in sovereign bond exchanges", UCLA Law Review 59 (2000), pg. 83. "Using exit amendments in sovereign bond exchanges to address the holdout creditor problem may thus be less damaging to the fabric of the international financial system than the other alternatives now being discussed."

"Exit consents" is the technique, which is often utilized in restructuring U.S. corporate bonds. There are two ways to restructure distressed corporate bonds. One way is to restructure corporations' financial status under the U.S. Chapter 11 of the bankruptcy Code, another way is to re-issue new bonds which reflects company's financial status and exchange with its existing bonds. Under the Chapter 11, a plan of reorganization can bind minority bondholders who oppose the plan.[126] Although proceedings of bankruptcy can bind all bondholders, corporate managers do not prefer this restructuring process. Since corporate managers were often fired during the reorganization proceedings, managers try to avoid bankruptcy proceedings. Instead, corporate managers tend to use "exit consents" when conducting "exchange offers"[127], while exploiting the ability to bind minority bondholders.

As pointed out above, exchange offers cause holdout problem. In order to avoid or reduce this holdout problem, it is necessary to think about the way to raise the acceptance rate of exchange offers. Theoretically, there are two ways to raise it, one way is to make new bonds more attractive, or put sweetener on transactions(For example, debtor may buy out existing bonds above the market price), another way is to reduce the attractiveness of the existing bonds. First one is sometimes difficult for debtors to take, because debtors have to spend additional money. In order to reduce the attractiveness of existing bonds, issuers and majority bondholders drastically change non-payment terms of the existing bonds that potential holdouts might find valuable. Buchheit pointed out that "when this was done in the context of an offer by the issuer to exchange those old bonds for new debt

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[126] See, 11 U.S.C. § 1129
[127] Supra *note* 125

instruments, the disfiguring amendments to the old bonds tended to encourage acceptance of the new bonds and thus reduce or eliminate the likelihood holdouts."[128]

4.2.1 *Exit consents in Sovereign Debt Exchanges (Ecuadorian debt crisis)*

How can this "exit consents" be utilized in sovereign debt restructuring? Ecuador was the first sovereign to employ "exit consents" in restructuring its bonded debts.

In September 1999, Ecuador became the first country that defaulted on a Brady bonds. At that time, Ecuador had two external bonded debt, one is collateralized Bradys (Pars and Discounts) which totaling about US$3.1 billion, and un-collaterized Bradys (Past-Due-Interest, PDIs) amounting to US$2.8 billion . Ecuador defaulted on its collaterized Discounts Brady and subsequently Pars, the un-collaterized PDIs and Interest Equalization Brady bonds.[129] In May 2000, Ecuador announced their intention to restructure all existing Bradys and other international bonds, insisting that there would be no side deals with particular groups of creditors.[130] On July 27, 2000, Ecuador announced a comprehensive exchange offer to swap the defaulted bonds into a single global U.S. dollar-denominated step-up 30- year bond carrying a 4 percent interest rate that increases 1 percent a year to maximum 10 percent in 2006 and thereafter[131]. The Bradys issued by Ecuador were among the most heavily traded bonds issued by emerging market countries,

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[128] Supra *note*.125

[129] Moody's, "Sovereign Restructurings: Putting Too much faith in Exit Consents", March 2001

[130] IMF Staff, "*Resolving and Preventing Financial Crises: The Role of the Private Sector*",March 26,2001

[131] IMF Staff paper, "Involving the Private Sector in Resolution of Financial Crises". January 2001

and widely held by investors with substantial holdings of emerging market debt[132] These characteristics of Ecuador Bradys might imply the difficulties of restructuring.

4.2.1.1 Restructuring strategy taken by Ecuador

Given this situation, Ecuador took innovative restructuring strategy. Among these was the use of "exit consents", weakening the legal rights of bondholders, who decided not to participate in the exchange. Under the exchange offer, bondholders who accepted the exchange offer automatically voted in favor of a list of amendments, making the existing bond less attractive.[133] The following provisions were eliminated in order to make existing bonds less attractive.[134]

(a) The requirement that all payment defaults must be cured as a condition to any recision of acceleration,

(b) The provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing,

(c) The covenant that prohibits Ecuador from seeking a further restructuring of Brady bonds,

(d) The cross-default clause,

(e) The negative pledge covenant,

(f) The covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange

In addition to that, the completion of the exchange offer is predicated on bondholders holding the requisite majority agreeing the amendment. As a result, even if the

[132] *Ibid.,*
[133] Supra *note.*131
[134] Supra *note.*131

bondholders who refused to accept the "exchange offer" became a majority of the original bond, they cannot reverse the amendments without the consent of sovereigns. By taking this strategy, using exit consents, Ecuador almost successfully conducted exchange offer, though there still remained few bondholders. It can be said that exit consents played the leading role to conduct exchange offers successfully, by discouraging bondholders to remain in existing bond, prevent potential vulture fund from causing holdout problem.

4.2.2 Exit consents/Exchange offers are not the perfect solution

Exit consents have been criticized by its coercive nature. Since it discourages bondholders to hold existing bonds by reducing the attractiveness of bonds, otherwise they may find attractive.

The use of exchange offers is a pragmatic response to the difficulty of getting bondholders to a meeting to vote to amend their bonds. But exchange offers have their disadvantages. The magnitude of the changes to the payment terms of the original bonds, particularly the reduction in the total principal amount of the bonds. necessary to relieve the sovereign debtor's financial crisis may be so great as to prohibit an exchange from being economically feasible. Alternatively, a court may find the exit amendments to be too substantial and refuse to enforce them against holdouts.

Finally, in some cases, the buoying-up effect of the restructuring may be sufficiently great to overcome the negative effects of the exit consents. By holding out, a bondholder retains the original bonds, with the original payment terms but without the protective

covenants, so that the value of the bonds is reduced. Upon completion of the restructuring, however, the sovereign debtor's total debt burden is reduced, thereby increasing the value of the bonds. This increase in value caused by the restructuring, often called the "buoying-up" effect, may be greater than the decrease in value caused by the exit consents.

4.3 IMF Proposed SDRM

IMF formulated a comprehensive paper[135] on dealing with the sovereign debt crisis initially with the voluntary submission by a sovereign debtor to opt for the crises management system and once it is option is exercised, the state is bound to observe a compulsive monitoring system during the restructuring phase. **IMF paper is actually a revised version of Kruger's SDRM model added with a WTO model of dispute resolution mechanism.**[136]

Under the restructuring scheme of IMF, a sovereign debtor would be absolutely free to take decision for submitting to debt restructuring mechanism. The sovereign debtor would decide which debt to come under the restructuring and which debt to kept out of the system. It would also exercise the option at its own time. There are two factors that are to be remembered here :(a) a sovereign debtor would be expected to respect the advise of the IMF for the purpose of submission to such a restructuring mechanism

[135] INTERNATIONAL MONETARY FUND, "The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations", November 27, 2002, Available at :http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf

[136] Dr.N.L Mitra, "Dialectics on International Legal Regime in Sovereign debt Crises", Published in Scholasticus, Journal of National Law University, Jodhpur, Vol. I No.2, 2004; pg. 43

because IMF is the expert and impartial body engaged in the pursuit of constantly reviewing the economic position of each country; (b) There should be a sufficient incentive in opting for such a restructuring delay. The present experience is that a sovereign debtor hesitates to come for such an option until economy of the country is badly damaged and asset is irreparably depleted.[137] The incentive based arrangement with the IMF would ensure that advise of IMF is always seriously taken and it also highlightens the importance of full disclosure of information.[138]

In order to facilitate a timely action, as a part of full and complete disclosure, the sovereign debtor is required to submit three comprehensive lists with discriminatory treatment that the debtor proposes to apply. These three list are: ***(1) First list comprises the debts that are proposed to be restructured within SDRM; (2) Second List including the list of debts that are proposed to be restructured outside SDRM; (3) Third list comprising the categories of debts that are not to restructured and that the state would settle the debts according to the terms of the debts.***

4.3.1 Important features of Proposed SDRM

The proposed SDRM contains the following basic structure that is in conformity with the basic principles of Modern International Law, Such as (1) Respect to sovereignty[139]; (2)

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[137] Ibid.,

[138] Supra *note*.127

[139] International Monetary Fund, "The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations" , November 27, 2002,
Available at :http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf
Sixth principle, pg. 7 states as follows: The mechanism should not interfere with the sovereignty of debtors. The mechanism could not be activated without the sovereign's request. Accordingly, the sovereign would only seek to activate the mechanism when it had formed a judgment that the features of the SDRM would enhance its capacity to restructure its debt rapidly and in a manner that limits economic dislocation.

voluntary Submission to the jurisdiction;[140]; (3) recognition of the power of the sovereign to exercise discretion to declare one debt unsustainable and another, not[141];(4) Formation of independent judicious body of experts as Sovereign Debt Dispute Resolution Forum(SDDRF).[142]

Another notable feature of this SDRM is **the formation of Creditors committee and theirs role in Restructuring mechanism.** The committee would play a key role in the negotiation process in circumstances where the case in question is particularly complex. Not only would it provide the debtor with a single counterpart but also it would play an important role in resolving inter-creditor issues, including issues involving official bilateral creditors. It may also facilitate the restructuring process in other respects. For example, a committee could play a useful role in the verification of claims process: a subcommittee could be established for the specific purpose of determining whether registered claims should be challenged in circumstances where evidence suggests, for example, that the creditor is not independent of the sovereign debtor. As noted in an earlier section, creditor committee approval could also be a vehicle to obtain creditor approval for an order that would enjoin specific enforcement actions. ***Accordingly, it is recommended that a representative creditors' committee be given a role under the SDRM to address both debtor-creditor and inter-creditor issues.***

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[140] Ibid., at Pg 9 .regarding Activation states as follows: Consistent with the principle of sovereignty, the mechanism could only be activated at the initiative of the member. When activating the mechanism, the member would represent that it had formed the judgment that its debt was unsustainable.

[141] Supra *note.*139 at pg 6

[142] Supra *note.*139 at Pg. 11, Para 28 states as ,"The Sovereign Debt Dispute Resolution Forum (SDDRF) would be established in a manner that ensures independence, competence, diversity and impartiality".

4.3.2 Critical Review of the Proposed IMF SDRM

There are certain agonizing issues that need to be examined for the critical review of the proposed mechanism.

4.3.2.1 Present vs. future debt

All future debts naturally increase the burden of the debtor outside the SDRM unless SDRM is only switch action, i.e. 'a momentary' one time action requiring very short time and space for the entire process to be completed from proposal to execution .But that is neither possible nor contemplated. So all future debts not linked up with the debt servicing ability under SDRM can be objected by the committee because the same increases the burden on those included in the restructuring. The only ground on which the Sovereign debtor may seek exemption under the present draft is 'economic and financial dislocation'.

4.3.2.2 Extent of economic and financial dislocation

It would be really complex issue to determine the extent of economic and financial dislocation to come outside the clutch of the Committee of creditors. This is the sovereign prerogative and in a democratic system an essential part of the political economy. Any externality is considered in the international law interference in the internal matters of sovereign. But from the creditors' interest view point, this is vital issue of interest of them. One may certainly argue that in the absence of credit worthiness one may asked to bow any conditionality. But this may lead to an argument for attaching common law vitiating factor of undue-influence in international agreement.

4.3.2.3 Creditors' objection on sovereign expenditure

Rationalizing and rightsizing the expenditure of the sovereign- debtor is directly connected with its capacity to generate resources for debt servicing. Shall the committee or the fund have power to insist in any issue relating to bankruptcy process of the sovereign- debtor opting for debt restructuring under SDRM? The transparency and disclosure norms are applicable on the debtors, that too, very rightly. The debtor must also be clear about the extent of right of the creditors. Para.32 [143]of the IMF draft includes some phrases and parts of speech, which have very severe implications. The right of the creditors must be clear vis-à-vis obligations of the debtors opting for SDRM. The Draft completely betrays on the issue. It is quite natural for the creditors to demand that any budgetary provision for subsidy is in conflict with the interest of the creditors. But there has to balancing of interest because international law does not anticipate any 'imposition' nor it allows any subjection of people's interest due to any international agreements between the nations.

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[143] Supra *note* 139 at Para 32, Pg. 13 states that "Notwithstanding the likely need for a broad restructuring, a debtor may decide exclude certain types of claims from a restructuring, particularly where such exclusion is needed to limit the extent of economic and financial dislocation. By way of example, a debtor may decide to exclude trade credit and certain types of domestic money market instruments (such as Treasury bills) so as to preserve its continued ability to mobilize these types of financing. Clearly, creditors holding instruments that are to be covered by a restructuring will take a keen interest in the design of the proposed financing package, and will want to ensure that exclusions from a restructuring serve to help preserve a debtor's capacity to generate resources for debt service, rather than increasing the burden on those included in the restructuring."

4.3.2.4 General exclusion

All International agreements of finance, trade, commerce and investments contain general exclusionary provision for national security, food security, public health, public interest and public morality. **But excepting economic and financial dislocation nothing is included in the draft.** This seems to be very peculiar. The self- determination on which debt could be excluded from the scheme of restructuring is interpretatively narrow. The test is that (a) Debtor's ability to generate resources for debt servicing is retained and (b) burden of those creditors included in SDRM ought not to be increased.[144] These two conditions are mutually exclusive. Resource generation for security interest; food security; poverty alleviation; public health; and sustainable development are not excluded form the rumblings of the dispute resolution system. In all trade related economic legislations of global understanding between nations contain these minimum exceptions.

The incentives generated under various paras of the IMF paper[145] sounds to insignificant concession for a debtor to come forward for restructuring. The mental framework of the creditors is quite apparent even before this multipartite treaty is in the process of conception. The private sector creditors strongly argue to include even bilateral claims to be included in the SDRM.[146] If SDRM would compel the debtor to allow committee of

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[144] Supra *note* 139

[145] Supra *note* 139, Principle 7

[146] Supra *note* 139, at Para 74, pg.23. states : During the most recent discussions, the preliminary view of the Executive Board was that official bilateral claims should be excluded from the SDRM, at least initially, but that close coordination would be needed between Paris Club and SDRM restructurings. Nevertheless, the private sector has expressed the strong view that inclusion of official bilateral creditors within the SDRM—albeit as a separate class—would be critical if the SDRM is to establish a framework that provided for greater inter-creditor equity. The private sector has also expressed a concern that Paris Club restructurings may not address the sustainability of a sovereign's debt since it typically deals only with a window of claims falling due. rather than with the stock of debt, and. for that reason, often relies on repeated reschedulings

creditors [147] to seat on judgment on the macro-economic management system through budgetary process there would be few takers of SDRM on voluntary basis.

4.3.2.5 Limited choice to the sovereign- debtor

In order to do critical review of the entire argument, we now look into the all the conditionality of SDRM in a sequence. (1) Only the central government of the debtor country would be able to activate the SDRM[148];(2) The debtor has really very limited choice of keeping any claim excluded from the unsustainable credit line, only trade credit, or few domestic debt instruments, may be excluded;(3) In the aggregate financing package such concession would be approved if only the same do not impair the debt-servicing capacity to the debtor.;(4) The committee of Creditors may claim to have the right to review all such budgetary proposals [149];(5) The debtor shall have a responsibility of being completely transparent.[150] That means that the debtor have to place before the committee accounts of all claims whether to be covered under SDRM or not.;(6) Any violation of the transparency rule shall attract the breach of member's obligation under the Articles of agreement of the fund.[151]

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147 Supra *note* 139 at Para.21, pg 10 states: As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues.

148 Supra *note* 139 at Para 13, pg 4

149 Supra *note* 139 at Para 32, pg 13

150 Supra *note* 139 at Para 37, pg 14 states : Only the central government of a member would be able to activate the SDRM. Once activated, all eligible claims (to be defined below) on the central government could be brought into the SDRM restructuring process. For this purpose, the central government would include, all administrative divisions and agencies that form part of the central government's budgetary process

151 Supra *note* 139 at Para 26, pg.11 states :It is recommended that the provision of false information by the sovereign during the restructuring process constitute a breach of the member's obligations under the Articles of Agreement. With respect to sanctions for non-cooperation or inappropriate use of the mechanism, it is recommended that the Fund would rely on its existing financial policies, including its lending into arrears policy

Analysing the above point leads to only one conclusion that the current draft of IMF is unable to answer the plight of Debtor –nation, which has been a matter of concern in debt crises. The committee of creditors, as for eg. may be continuing objections on the subsidy-structure in the government expenditure holding that any subsidy is against the interest of creditors, putting the political economy of debtor country under doubts.

4.3.2.6 Government accounting system

Many newly independent and most of the developing nations such as India and china are still could not convert their accounting system into modern accounting practice and still continuing with 'cash-basis' accounting system. The creditors may insist on the asset-based accounting to lay their hands on assets, which may cause de-motivation among sovereign debtors to change to modern accounting system. A thorough and detailed accounting system needed by creditors would lead to understanding of the use and misuse of debts. SDRM would itself require detail and scientific accounting and audit practice. No report can be transparent unless accounting procedures is itself not unquestionable. As such SDRM would call for a transparent and detail accounting and audit practice. In many developing countries accounting and audit system is so defective that there would be a requirement of a building capacity in the governance for switch over to introduction of such a system of government accounting and audit practice.

The committee of creditors would naturally insist on maintaining accounting system according to the international standard norms, which may lead to serious doubts in the

mind of debtors about the intention of creditors. As asset-accounting would lead t exercise of the creditors' right on government assets, including immovable properties, which a sovereign debtor would not like to be divested with.

4.3.2.7 SDDRF-Dispute resolution body

The IMF has also proposed the establishment of an exclusive dispute resolution forum to verify claims, oversee voting and adjudicate disputes once the SDRM is activated. The Sovereign Debt Dispute Resolution Forum (SDDRF), to be established through an amendment of its Articles of Agreement, is the Fund's version of the independent arbitration panel in the Free and Transparent Arbitration Process (FTAP) framework. The draft also enlisted the powers of the Forum, [152] which inter-alias, include functions of three dimensions, viz., **Administrative, Dispute resolution , and Injunctive relief.**

The draft has several provisions that would generate litigations. The dispute resolution body would find it difficult in such open-ended assignment of functional responsibility. As for example, under SDRM there would be a range of claims identified that could be potentially restructured, but it would be for the debtors to propose the subset of eligible claims that would be covered in restructuring and this is likely to require consultation between debtor and creditor so as to ensure that the proposed framework could attract, broadly speaking creditors' support. One may wonder in these four sets of agenda where would be the striking equilibrium of interest of the contesting parties.

[152] Supra *note.* 139 at Para 28,pg11

Further with regard to SDDRF the Fund envisages it, 'although it would be an organ of the Fund, the SDDRF would be established in such a manner that it would operate—and would be perceived to operate— independently'.[153] However, this 'independent' SDDRF will have no authority to challenge decisions made by the Executive Board of the Fund, including with regard to the adequacy of members' policies or the sustainability of the members' debts for purposes of financial assistance from the Fund. Just as importantly, it will have no authority to over-ride the decisions of a qualified majority of creditors on such issues as the terms of a restructuring plan or the length of a stay. Its role will be essentially reactive. For example, although the Forum can resolve disputes regarding the application of creditor classification rules, it will not be responsible for classifying creditors in the first place. The dispute resolution forum would, in effect, only certify that the vote of the creditors has taken place in accordance with the procedural requirements. The certifications themselves would be exclusively based on the decisions of a qualified majority of creditors. Thus, effectively, the IMF, both as a major creditor and as the agent of creditors, is the final authority in the 'independent' Dispute Resolution Forum of the SDRM. Given the fact that the SDRM will be the first ever attempt to bring together a diverse range of sovereign creditors, this suggestion by the Fund of leaving virtually no independent power with the Dispute Resolution Forum in eventual disputes is an unambiguous attempt to put in place a very weak institution within the overpowering reach of the IMF Board.

[153] Supra *note*. 139 at pg 28

4.3.3 Certain crucial aspects of IMF SDRM

4.3.3.1 <u>Identity of the debtor</u>

Although it is generally agreed that the mechanism will be limited to the restructuring of sovereign claims, the definition of what will constitute "sovereign" claims for purposes of the mechanism raises a number of questions.

4.3.3.1.1 Central Government

Only the central government of a member would be able to activate the SDRM. Once activated, all eligible claims (to be defined below) on the central government could be brought into the SDRM restructuring process. For this purpose, the central government would include all administrative divisions and agencies that form part of the central government's budgetary process.

4.3.3.1.2 Public Entities

Should the government have the option of using the mechanism to restructure the debt of these entities? One argument[154] to answer this question is that a government Company and a public corporation are assigned separate personality- character like other corporations. These institutions have their own assets and liabilities not clubbed with that of sovereign. These *corps juries* institutions are subjected to domestic law and domestic courts. Therefore, these institutions though radiating in the name of the sovereign owner, need not be clubbed in SDRM. They must be allowed to operate separately on their own strength and weaknesses provided there is no other continued financial link, budgetary or otherwise, and inflow-outflow of resources with and in relation to the sovereign.

[154]Supra *note.* 136 at pg .55

4.3.3.2 Nature of the Claim

4.3.3.2.1 Proposed definition of eligible claims

Subject to the exceptions discussed below, it is recommended that an eligible claim would be defined as a right to receive a payment under a contract (whether in money or in goods) relating to commercial activities of the "sovereign". An activity would be considered "commercial" if it could be conducted by a private party, *i.e.*, it would not be limited to activities where the sovereign is engaging in the activity for a commercial purpose, *i.e.*, as a merchant. The definition of eligible claims necessarily excludes non-contractual claims and claims arising from non-commercial activities.

4.3.3.2.2 Privileged claims

When extending credit, certain creditors will—pursuant to contractual terms or statutory provisions—have the right to collect upon pre-specified assets of the sovereign in the event of default. These contractual terms may provide for the creation of a security interest over specific collateral and, in some cases, the only recourse that a creditor has against the sovereign in the event of default is to foreclose upon this collateral; *i.e.*, in the event that the value of the collateral is less than the value of the claim at the time of default, the creditor has no right to proceed against the sovereign for any deficiency (limited recourse financing).[155] The nature of such "privileged" claims varies considerably but all of them give creditors an advantage over general unsecured creditors in the event of default. It should be noted that the exclusion of most public entities from the coverage of the mechanism would reduce the significance of security under the

[155] Supra *note*.139 at Para 60, pg 20

SDRM, since most collateralized borrowing is conducted by public entities rather than the sovereign itself.

4.3.3.2.3 Domestic debt

According to IMF, draft eligible claims would exclude claims that are governed by domestic law and subject to the exclusive jurisdiction of the domestic courts. However, where a claim governed by domestic law and subject to the exclusive jurisdiction of the domestic courts is recognized and enforced by a court outside the territory of the sovereign, such a claim would be treated as an eligible claim for purposes of the SDRM.[156]

The treatment of IMF for domestic debt seems to be discriminatory. In a country like India, there is no discrimination between the domestic and foreign debt of a company under its corporate law, when a company goes into liquidation, unless there is any security interest specially creating a right in favour of any claimant. Domestic debt is treated under domestic law and in the domestic courts, is no reason for doing discrimination between the two. Similar restructuring scheme may be applicable though through two forums.

[156] Supra *note.*139 at Para 60 pg 21

4.3.3.3 Identity of the Creditor Holding the Claim

4.3.3.3.1 Bilateral and Trade creditors

IMF draft outlines four kinds of foreign sovereign debts (a) institutional (b) multipartite or consortium such as Paris club's lending ;(c) Bilateral and ;(d) trade credit. All such lending have bilateral overtone. What special rationale argument can there be to treat bilateral lending in different footings unless the party lending stipulates a special condition by way of contract. Same is the case with trade credits. There is no reason to treat these credits differently except these are different on the time scale.

4.3.3.3.2 Institutional credit and Multipartite credit

Credit offered by International organizations has a different connotation and understanding and hence may not fall under common SDRM. Same is the case with consortium lending. Naturally, these are exempted from the list under SDRM. If IMF lending is kept out of SDRM, then why any misstatement on the part of the sovereign debtor be treated as the violation of the Agreement of the Fund.[157]

4.3.3.4 Activation

According to the IMF draft, the mechanism could only be activated at the initiative of the member. When activating the mechanism, the member would represent that it had formed the judgment that its debt was unsustainable. Activation of SDRM brings the incentive of

[157] Supra *note*.139 at Para 72 Claims against the sovereign that would otherwise fall within the definition of "eligible claims" (as discussed in the previous sections) could not be restructured under the SDRM if the creditor were an international organization.

restructuring the debt of the sovereign in the form of repudiation or reduction of the claim, rescheduling the payment, redesigning of the conditionality and financing the restructuring. The claimants have the incentive of protection of the marketable assets form deteriorating assets value, reassurance in the creditworthiness of the sovereign, and participation in the economic decision making the sovereign –debtor so as to ensure the protection of the interest of the claimants.

4.3.3.5 Consequences of Activation: Provision for information, registration and verification

Upon activation, a procedure would unfold that would require the debtor to provide all information regarding its indebtedness (including debt that will not be restructured under the SDRM) to its creditors. Moreover, an expeditious registration and verification process would take place that would enable creditors to be in a position to vote on an aggregated basis. This would need to accommodate secondary market trading. The Sovereign Debt Dispute Resolution Forum (the SDDRF) would resolve disputes arising during the verification process.

The information given by the debtor would lead to preparation of three list , (1) the claims proposed to restructured under SDRM by the debtor,; (2) claims proposed to restructured outside SDRM by the debtor and ;(3) Claims intended not to be restructured.

Another list is also required to be prepared with the claims having collateral security interest indicating the value of security interest. This list may be a part of the claim-list 2

under the head, claims to be paid off and/or restructured within the collection value of the security-interest. The registered claim requires verification by the SDDRF. Any claim not contested by the Debtor is to be taken verified. The verification must be complete with all conditionalities attached to the claim. Facilities must be accorded to the SDDRF for impartial verification to have access to all records and documents by all parties concerned.

4.3.3.6 Stay on enforcement

There is inherent limitation to the rights of claimants against a sovereign. It is justified in arguing that sovereign ought to bind themselves with a positive moral framework, which the multi partite world bodies are able to administer through an agreed code of conduct. The agreement of SDRM would be something in line with rule-based course as followed by WTO. As such, the agreemental principles must be enclosed in the form of rules on the practices to be followed. Some such related issues are: ***(a) Should there be generalized stay on credit enforcement; (b) What should be extent of the undue influence and in what circumstances; (c) Should the structured majority vote be the only way of restraint on the creditors to stay of enforcement of contract; (d) Should there be any parallel to fraudulent transfer of the domestic law on insolvency, such as unreasonable preference and (e) What would be the extent of common law principles like sovereign immunity and sovereign non-attributable to separate entities?*** All the above questions need to be answered before reaching to a conclusion on the framework of SDRM.

4.3.3.7 Valuation of claims

For the purpose of inter-creditors relation, valuation of claims in a common denominator would be necessary. SDDRF has to have a clear operational understanding as to when the claims would require to be converted into the denominator currency of the debtor[158].The cut-off date for the purpose could be the date of activation. However for the general terms the SDDRF may have a list of certified valuer of assets for the purpose of finalizing restructure of claims.

4.3.3.8 Creditors' participation

IMF draft recommends[159] that a representative creditors' committee be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. The creditors committee has to play a crucial role in SDRM if it has to succeed as a codified rule based system. The committee first job is to start negotiating with the sovereign to consider the structural proposal, outline of which was to be submitted by the debtor. The negotiation is complex, and keeping the balance of conflicting interest in the inter-creditors relation is typical.

The committee may come in conflict with the regular budgetary functioning of the sovereign. The draft talks about the best practices[160] and experience on the functioning of

[158] Supra *note.*136 at pg.58
[159]Supra *note.*139 at Para 164,pg 44
[160] Supra *note.*139 at Para 164,pg 44

the committee but does not enumerate the same. Their are certain other issues[161] regarding the powers of the committee which need to be answered by the IMF before finalizing the process of SDRM. They are (a) can the committee participate on the taxation system and structure?; (b) can a committee participate in commenting and voting on the allocation of funds including provision of subsidies?; (c) can the committee vote on the public debt, internal and external?; (d) can the committee comment on the instrument and marketing management on public debt instrument? ; (e) Can a committee insist on fiscal discipline? All these answer has to be given taking into consideration of constitutional governance

4.3.4 Issues that Remain

1. **Removal of Right of debtor to obtain Stay**: By removing one of the central components of the SDRM, namely, the right of the debtor to obtain a generalized stay on payments and a mandatory ban on creditor litigation during a debt restructuring process, the IMF's proposed international sovereign bankruptcy framework has become ineffectual. It is therefore unlikely to be of any use in its proclaimed fundamental objective—to ensure a timely and orderly debt work-out that would enable a debtor country in a payment crisis to restructure and become sustainable. A generalized stay on payments is necessary if the framework is to have some predictability and to avoid the unnecessary delays and costs/losses involved in a disorderly work-out. Creditors have to be made to accept that by

[161] Supra *note.* 136 at pg.60

allowing a stay on debt repayments for a particular time duration they are in effect gaining, as, instead of declaring a default, countries will be able to recover from an imminent payment crisis to deal with economic growth problems and get on to a path of recovery. But, rather than taking on the private sector financial community, for which the IMF had revealed the will for the first time, the Fund has bowed to market interests once again.

2. **SDRM more favourable to creditors than debtors**: It is clear that the proposed framework is now heavily tilted in favour of the creditors and against the interests of the debtor countries, even more than before. Unlike a domestic bankruptcy court, creditors, and not an independent arbitration panel, will make all the big decisions under the SDRM. SDRM will allow a majority among the creditors to coerce a minority, but overall control of the procedure will remain with the powerful creditors. (A defaulting country will also need the agreement of creditors to gain access to new private finance.) While the IMF says that it will virtually play no part itself, by virtue of being a creditor—in fact one of the largest lenders to sovereigns—and given the proposed formulation and mandates of the SDDRF, the Fund's role will be immense in an SDRM in the present format. The debtors will remain at the receiving end in future debt restructurings.

3. **Inter-creditor fairness and an assurance that debtors can be returned to a sustainable situation:** This also remain crucial issues that the IMF has failed to address in a systematic manner. For ensuring the latter, a restructuring plan should

be considered feasible only if the debtor can emerge from the reorganization with reasonable prospects of financial stability and economic viability. This essentially means that debt servicing will have to be brought in line with the foreign-exchange earning capacity of the country. At one level, this might involve reduction in debt levels in specific cases; at another level, this is also about enhancing the country's capability to obtain increased foreign exchange in the medium to long term. The latter would entail addressing the fundamental structural imbalances in international trade, which persist despite the so-called free trade era heralded by the WTO agreements. While the creditors pressure debtor countries to pay their debts and to open up their markets to exports, they keep their own markets closed to the exports of debtor nations. Markets in which developing countries would have enjoyed a natural comparative advantage, such as agricultural products, are among the most protected.

4. **Role of Sovereign debtor to its civil society:** How the debtor countries will be expected to reform their economies and what degree of flexibility the debtor countries will have under the SDRM for protecting the basic welfare needs of its population are also questions that remain to be answered. As the civil society has been demanding, it has to be explicitly accepted and incorporated into an international insolvency procedure that no country can be forced to fulfill its obligations to its creditors while placing its population in an inhumane situation and subjecting it to serious basic failure, as happened in Argentina. This necessarily requires that IMF-type economic reform policies, which have failed

time and again, not be made a part of the SDRM, explicitly or implicitly. The debtor country should have the flexibility to decide its own policies. That is, if the Fund and the creditor community are genuinely interested in finding a permanent solution to the sovereign debt problem, they should first give up the conditions imposing economic policy prescriptions, and let the concerned debtor country decide how to make economic recovery possible to then work out the repayment schedule.

5. **No provision for SDR fund:** The draft does not contain any provision for the establishment of SDR fund. Constituting a SDR fund for the purpose of claim restructuring would have facilitated the economic reconstruction of the sovereign debtor with a short time.[162] The fund can be constituted by the contribution of both the creditors and debtors nations and with some subsistence grant from the IMF.
6. **Legal framework of SDRM:** SDRM under the proposed draft has been designed to be fitted within the framework of the agreement of the fund. This will put fund under the additional burden but facilitating inter-member relations. Another issue here is that if fund's claim is not in the SDRM, then why the sanction for non or wrong disclosure should attract violation of the terms of the agreement of the fund. However, if the debt restructuring is put into the part of the agreement of fund, it would require legal reform. If there is no mental block of the members with the bankruptcy legal regime and claim restructure is based on the mutual co-operation, respect to sovereignty, and non-interference in macro economic

[162] Supra note 136 at pg 61

management of the sovereign, SDRM can be subsumed with the international legal paradigm of the fund.[163]

There are issues on the above suggestions that such a move may lead to violation of balance of interest of the sovereign debtor and the creditor. Therefore, the IMF has now to determine the extent of its involvement in the process of SDRM.The present form of SDDRF as proposed is likely to operate as an economic tribunal like the Sovereign Bankruptcy Court as designed by Prof. Sachs and others, rather than facilitating participatory mechanism of dispute resolution with a procedure of detail inquiry. In that situation, the fund may be always engaged in the litigation process of adducing evidence. If fund has any interest in SDRM, the fund would facilitate the Debtor – creditor settlement for debt restructuring. It may even facilitate additional financing for the purpose. Hence, it would be prudent to keep SDRM at a safest distance s autonomous body with a dispute resolution mechanism, SDDRF. This requires a certain codified structure and a detailed procedure for the mechanism to adhere to the best practices.

Another strategy for the Legal framework of SDRM could be developed by multipartite agreement as a separate body with its own conditionality to which 'International Organisations' in the creditor's role may also approach for restructuring. [164] In such a case, the Agreement of the Fund may also not require readjustment eg. Paris club.The fund can only recommend a code for the SDRM

[163] Supra *note* 136 at pg 60
[164] Supra *note* 136 at pg. 61

agreement acceptable to nation-members of the agreement. Once the agreement is arrived the SDRM with all its other bodies including independent and certified valuers and the dispute resolutions bodies should be independent[165]. Fund may only assist the functioning of the mechanism. Such type of mechanism could be a better solution to this problem.

7. **Adjustment with National Laws:** It is quite logical to argue that member- states ratifying the change in the agreement to and ratifying a separate multilateral agreement on SDRM have to adjust the national legal regime in the line with Agreement or the treaty as the case may be.

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[165] Supra *note* 136 at pg.61

CHAPTER 5: SUGGESTIONS AND CONCLUSION

In the present paper, We have characterized the development of ideas on international bankruptcy over the last 25 years, starting from the suggestion of Proposal of Group of 77 developing countries, Arusha, 1979 till the recent one of IMF proposed SDRM.After analysing all the proposals, it can be concluded that till present there is a lack of a comprehensive legal procedure for sovereign debt restructuring which would act in the interest of sovereign debtor as well as the creditors.

The recent proposal of IMF SDRM seems to be a good initiative for the sovereign debt restructuring as it has various distinct features, but still there are plenty of critical issues[166], which needs to be resolved by the fund, before reaching to a concrete solution to this problem. To list the most important issue is the role of IMF in the proposed SDRM as also pointed out by Kruger's in her suggested SDRM. In the said proposal, IMF has to take key decisions on activation of stay on creditors' action, extension of the stay and the approval of restructuring agreement. [167]

Too much interference of IMF in the process of SDRM would arise plethora of issues on its functioning. Both creditors and debtors may distrust its judgments. This is because not only 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 its power might be used to favor a particular debtor when

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[166] Discussed in Chapter 4

[167] Kruger, "A New Approach To Sovereign Debt Restructuring" , IMF papers, 2002
Available at : http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf

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. So in order to solve this issue, **there is a need of minimizing the role of the IMF in the administration of the SDRM.**

Other few points which need to be taken into consideration before forming any concrete solution to the problem of SDR are as follows: ***(a) To ensure that each actor has the appropriate incentives is of paramount importance to the reform of the process for sovereign debt re structuring. (b)Countries should not be encouraged to take on excessive debt. (c)Creditors and debtors should have the incentive to negotiate in a timely manner when a debt burden becomes unsustainable and (d) Need of forming Sovereign Debt Restructuring fund***

To conclude it may be said, no solution deals with all dimensions of all problems.IMF should take lessons from the past experiences of Sovereign debt restructuring and then come up with a final proposal. In a present era, where there is lots of mistrust on the functioning of WTO working mechanism, it is hard to say that having a dispute resolution mechanism for SDR on the line of WTO would be a best solution now. In a short may be the countries agree on the conditionality of on Bond contract and in a long run we may have an independent dispute resolution body like WTO. In between, the IMF must form a SDR fund for helping the economies under stress. Moreover, a graduated

and calibrated dialogue would assuage the feeling of the developing and Least developing countries.

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