

RETHINKING THE SOVEREIGN DEBT RESTRUCTURING APPROACH

*Alinna Arora and Rodrigo Olivares Caminal**

“Rather go to bed without dinner than to rise in debt.”
Benjamin Franklin (1706 - 1790)

I. INTRODUCTION

Recent events in Turkey and Argentina demonstrate that financial crises with the potentially profound consequences for economic and political stability are not a thing of the past. Such events also demonstrate the continued urgency of finding practical and concrete means to handle the crises that do occur.¹ Debt has been the largest source of capital flow to developing countries in the past fifty years.² Lending increased drastically during the 1970s until it was hit by the global debt crisis of the 1980s. As a result, most of the emerging market debt held by private investors is now in the form of bonds, not in commercial bank loans.³ “Since 1980 emerging market bond issues have grown four times as quickly as syndicated bank loans.”⁴ As a result of the rapid increase of bond issuance, “together with the

* Ms. Alina Arora is an associate in the corporate department with Luthra & Luthra Law Offices in New Delhi and has a LL.M. (Warwick) in International Economic Law; her personal e-mail is alinnaarora@rediffmail.com. Mr. Rodrigo Olivares Caminal has a LL.M. (Warwick) in International Economic Law and is a Ph.D. candidate from Queen Mary-University of London in the International Financial Law Unit; he is also admitted to practice in Argentina with an expertise in banking and corporate law; his personal e-mail is olivares-caminal@1stcounsel.com. The authors wish to express their appreciation to Dr. Jorge Guira for his comments, counsel, and suggestions on this study. Any error or omission is exclusively attributable to the authors.

1. A. FRAGA & D. GLEIZER, CENTRAL BANK OF BRAZIL, CONstrain DISCRETION AND COLLECTIVE ACTION PROBLEMS: REFLECTIONS ON THE RESOLUTION OF THE INTERNATIONAL FINANCIAL CRISES, WORKING PAPER SERIES NO. 34 (NOV. 2001), available at <http://www.bcb.gov.br/ingles/public/wps/wps/34.pdf> (last visited Sept. 14, 2003).
2. Randall Dodd, *Sovereign Debt Restructuring*, 9 FINANCIER 1-4 (2002), available at <http://www.the-financier.com> (last visited July 25, 2003).
3. LEE C. BUCHHEIT, UNITAR TRAINING PROGRAMS ON FOREIGN ECONOMIC RELATIONS, Doc. No. 1, SOVEREIGN DEBTORS AND THEIR BONDHOLDERS 4 (2000), available at <http://www.unitar.org/dfm/Resource-center/Experts/Buchheit/BooksChap.htm> (last visited Sept. 14, 2003).
4. 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), available at <http://www.imf.org/external/np/speeches/2001/112601.htm> (last visited July 24, 2003).

increased frequency of virulent financial crises, bond restructuring has gained in importance, particularly for sovereign borrowers.”⁵

The amounts of debt and its progressive increase have led to repayment problems and, in some cases, default. Thus, as countries amass unsustainable debt burdens (i.e. when the ratio of debt to gross domestic product rises to such an extent that no application of policies and circumstances can limit it) they have an increasing need to restructure sovereign debts.⁶ Broadly speaking, sovereign debt restructuring can be understood as the technique used by sovereign states to prevent or resolve financial and economic crises and to achieve debt sustainability levels. It basically has two aspects: procedural and substantial. While the procedural aspect focuses on the way in which the restructuring should be performed (for example, its architecture), the substantial aspect is the actual restructuring of debt, which is normally characterized by rescheduling amortization schedules as well as writing off the debt principal.

Currently, uncertainty surrounds the sovereign debt restructuring process.⁷ The only available mechanism requires the international community to bail out the private creditors.⁸ Substantially, the conventional remedy of providing debt service relief through a combination of rescheduling principal and compulsory new money infusion has been virtually exhausted for many debtor countries.⁹

Currently, the Argentine crisis presents the biggest sovereign debt default in history — \$88 billion in 2002. The problem of restructuring Argentina’s defaulted debt has increased in magnitude because the credit base has been increased from the limited number of banks involved in a syndicated loan to thousands of creditors holding the Argentine bonds.¹⁰ Argentina’s external debt profile today is completely different from that of two decades ago.¹¹

With many banks and bondholders now involved, private creditors

5. *Trade and Development Report, 2001*, U.N. Conference on Trade and Development, at 143, (2001), available at http://www.unctad.org/en/docs/tdr2001_en.pdf (last visited July 24, 2003) [hereinafter *Trade and Development Report*].

6. INTERNATIONAL MONETARY FUND, PROPOSALS FOR A SOVEREIGN DEBT RESTRUCTURING MECHANISM (SDRM): A FACT SHEET (Jan. 2003), available at <http://www.imf.org/external/np/exr/facts/sdrm.htm> (last visited July 25, 2003) [hereinafter IMF PROPOSALS FOR A SOVEREIGN DEBT].

7. John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Remarks at the Conference “Sovereign Debt Workouts: Hopes and Hazards?” Before the Institute for International Economics (Apr. 2, 2002), available at <http://www.ustreas.gov/press/releases/po2056.htm> (last visited July 27, 2003).

8. Krueger, *supra* note 4.

9. Lee C. Buchheit, *Alternative Techniques in Sovereign Debt Restructuring*, 1988 U. ILL. L. REV. 371, 374 (1988).

10. *Trade and Development Report*, *supra* note 5, at 143.

11. Michael Heise, An Improved International Finance Architecture Contributions from the Official and Private Sector, Speech at the Conference for New Sovereign Debt Restructuring Mechanisms: Challenges and Opportunities (Feb. 21-22, 2003), available at <http://www.dse.de/ef/sdrm/heise.htm> (last visited July 25, 2003).

have become increasingly numerous, anonymous, and difficult to coordinate. The variety of debt instruments and derivatives in use has also added to the complexity with which we must cope. As the International Monetary Fund (IMF) stated:

Bondholders are more diverse than banks, and so too are the goals with which they approach a restructuring. Some are interested in a rapid and orderly restructuring that will preserve the value of their claims. Others, which buy debt on the secondary market in hope of profiting through litigation, prefer a disorderly process allowing them to buy distressed debt more cheaply. Individual bondholders also have more legal leverage than banks and are less vulnerable to arm-twisting by regulators.¹²

This article proposes a rethinking of the existing sovereign debt restructuring procedures and mechanisms, and analyzes others that are being considered. It also proposes to explore the possibility of alternatives to the conventional methods of substantial restructuring. The goal of improved debt restructuring should be better and timely handling of unsustainable sovereign debts, while also protecting asset value and creditors' rights.¹³

II. CURRENT DEBATE ON SOVEREIGN DEBT RESTRUCTURING: PROCEDURES AND METHODS

While there is widespread agreement for a revamped sovereign debt restructuring process, there is also disagreement over what the actual process should be.¹⁴ As Lee Buchheit and G. Mitu Gulati have observed “a sovereign bond issuer of the early twenty-first century is much in the same spot as a distressed corporate or railroad bond issuer of the early twentieth century.”¹⁵ The financial community is again confronted with the same issue: court-supervised workouts in a bankruptcy proceeding or a purely voluntary bond workout.¹⁶ The question is: when sovereign debt restructuring, re-profiling, and reduction becomes necessary and unavoidable, what will be the appropriate regime that will provide orderly restructuring while safeguarding the balance of rights both of creditors and the debtor?¹⁷

12. Krueger, *supra* note 4.

13. *Id.*

14. Dodd, *supra* note 2.

15. Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, Working Paper No. 34 (Mar. 2002), available at http://www.bankofengland.co.uk/conferences/conf0207/buchheit_gulati.pdf (last visited July 27, 2003).

16. *Id.*

17. NOURIEL ROUBINI, PRIVATE SECTOR INVOLVEMENT IN CRISIS RESOLUTION AND MECHANISMS FOR DEALING WITH SOVEREIGN DEBT PROBLEMS 2 (July 2002), available at <http://www.bankofengland.co.uk/conferences/conf0207/roubini.pdf> (last visited July

Marcus Miller is of the opinion that Buchheit and Gulati, taking historical experience with corporate debt into consideration, are suggesting two ways to move forward: the New York court-ordered approach and the London-style solution of self-organizing creditors.¹⁸ In other words, the current debate is between the establishment of the international bankruptcy regime and the use of voluntary and contractual arrangements such as Exchange Offers, Collective Action Clauses (CACs), and other devices.

The former approach, called the Sovereign Debt Restructuring Mechanism (SDRM) that is “clearly inspired by the analogy of Chapter 11”,¹⁹ has been proposed by the IMF. The IMF believes that the scope of some of the voluntary mechanisms used in the past has been greatly diminished, particularly due to the shift from syndicated bank loans to bonds in sovereign borrowing. This shift has led to a wider dispersion of creditors and debtors, a larger variety of debt contracts, and has been associated with the growing spread and integration of the capital markets and innovations in sourcing foreign capital.²⁰

Among the proponents of the latter approach are Buchheit and Gulati;²¹ the G-10²² members; U.S. Treasury Undersecretary John B. Taylor;²³ Nouriel Roubini;²⁴ INSOL International (an association of international insolvency practitioners);²⁵ Emerging Markets Creditors Association (EMCA); Emerging Markets Trade Association (EMTA); Institute of International Finance; International Primary Market Association; International Securities Market;

27, 2003) (this paper was prepared for the Bank of England Conference on the Role of the Official Sector and Private Sector in Resolving International Financial Crises on July 23-24, 2002).

18. Marcus Miller, *Sovereign Debt Restructuring: New Articles, New Contracts—or No Change?*, INT’L ECON. POL. BRIEFS, No. PB02-3 (Apr. 2002).

19. *Id.*

20. *Trade and Development Report*, *supra* note 5, at 142.

21. Buchheit & Gulati, *supra* note 15.

22. The G-10 Rey Report was issued in May 1996 and recommends the adoption of CACs as a measure to facilitate debt restructuring. The G-10 or Group of Ten refers to the group of countries that have agreed to participate in the General Arrangements to Borrow (GAB). The GAB was established in 1962, when the governors of eight IMF members – Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom and the United States- and the central banks of two others, Germany and Sweden agreed to make resources available to the IMF for drawings by participants, and under certain circumstances, for drawings by non-participants. The GAB was strengthened in 1964 by the association of Switzerland, then a non member of the IMF, but the name of the G-10 remained the same. The following international organizations are official observers of the activities of the G-10: Bank of International Settlements, European Commission, IMF and OECD (see <http://www.imf.org/external/np/exr/facts/groups.htm#G10>, last visited Feb. 17, 2004).

23. Taylor, *supra* note 7.

24. ROUBINI, *supra* note 17.

25. INSOL INTERNATIONAL, STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO MULTI-CREDITOR WORKOUTS, *available at* <http://www.insol.org/statement.html> (last visited July 27, 2003).

Securities Industry Association; Bond Market Association; and E. Bartholomew, E. Stern, and A. Liuzzi.²⁶ Some observers, however, such as Barry Eichengreen, believe that the restructuring debate has three contenders: (1) those such as Anne Krueger, who push for radical reform; (2) those like himself, who advocate limited reform; and (3) those who believe that markets are perfectly capable of resolving debt crises so that no reform is necessary.²⁷ The authors of this article are of the opinion that Eichengreen's second and third categories (limited and no reform) will fall within the contractual and voluntary arrangements. Thus, the ultimate issue is whether it is better to continue with the market-based status quo regime, where exchange offers have customarily been used for bond debt restructuring, or should we move to the wholesale use of collective action clauses.²⁸ Alternatively, should we consider creating an international bankruptcy mechanism such as that proposed by the IMF.²⁹

A. SOVEREIGN DEBT RESTRUCTURING MECHANISM (SDRM)

Recently, the debate on reform of the international financial architecture has been centered around how to ensure orderly sovereign debt restructuring.³⁰ In this sense, the IMF believes incentives are lacking to help countries with unsustainable debts resolve them promptly and in an orderly fashion.³¹

The IMF has proposed a "twin-track" mechanism known as "Sovereign Debt Restructuring Mechanism" (SDRM), which is based on two complementary approaches to creating a more orderly and predictable process for sovereign debt restructuring. First is the contractual approach in which debt restructuring would be facilitated by enhanced use of certain contractual provisions in sovereign debt contracts.³² Second is the establishment of a universal statutory framework, which would create a legal framework for collective decisions by debtors and a super-majority of its creditors.³³ "The central objective is to put countries and their creditors in a better position to restructure unsustainable sovereign debts in an orderly

26. ED BARTHOLOMEW ET AL., JP MORGAN, TWO STEP SOVEREIGN DEBT RESTRUCTURING (Apr. 24, 2002), available at <http://www.emta.org/keyper/barthol.pdf> (last visited July 27, 2003).

27. Miller, *supra* note 18.

28. ROUBINI, *supra* note 17, at 2.

29. *Id.*

30. *Id.* at 20.

31. Krueger, *supra* note 4, at 1.

32. INTERNATIONAL MONETARY FUND, IMF BOARD DISCUSSES POSSIBLE FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (Jan. 7, 2003), available at <http://www.imf.org/external/np/sec/pn/2003/pn0306.htm> (last visited July 27, 2003) [hereinafter IMF BOARD DISCUSSES FEATURES OF SDRM].

33. *Id.*

and timely manner.”³⁴ Although a country can access the SDRM after default, ideally the SDRM would encourage a country with unsustainable debt and its creditors to restructure before default is the only option.³⁵

According to IMF representatives, a formal SDRM would need to be built on the following four key issues:³⁶

- (1) Preventing creditors from obtaining relief through national courts. For example, grant a legal stay or a standstill to avoid holdouts, rogue creditors, free riders, and vultures from disrupting negotiations that could lead to a restructuring agreement.
- (2) Providing a guarantee that the debtor country would act responsibly during the course of any standstill.
- (3) Encouraging private lenders to provide fresh money during the restructuring procedure to facilitate ongoing economic activity. New lenders will have priority over the previous lenders.
- (4) Restructuring agreements reached by the parties should be binding to all of them, and not only to the majority that has agreed.

SDRM is designed only to help sovereign states whose debts are unsustainable. The process allows states to reorganize their finances and activities to restore debt payments. SDRM allows creditors to decide collectively on a restructuring, though ultimately a debtor cannot use the SDRM without the consent of a super majority of its creditors.³⁷

The SDRM has changed since it was first proposed. The following chart³⁸ summarizes the evolution of characteristics of proposals during 2001 and 2002.

KEY FEATURES OF SDRM				
MECHANISM	LEGAL STAY	FINANCING REORGANIZATION	RESTRUCTURING DEBT	RESTRAINING HOLDOUTS
SDRM 2001	Automatic stay	Limited IMF lending + Preferred creditor status for new money	Negotiations supervised by IMF + IMF program	Super majority voting

34. IMF PROPOSALS FOR A SOVEREIGN DEBT, *supra* note 6, at question A.2.

35. *See id.* at 8.

36. Krueger, *supra* note 4.

37. *See* IMF PROPOSALS FOR A SOVEREIGN DEBT, *supra* 6, at questions D.3 & D.4.

38. Miller, *supra* note 18.

SDRM 2002	Short stay which may be renewed upon the decision of a super majority vote of creditors	Very limited IMF lending + preferred creditor status for new money	Negotiations supervised by neutral agency + IMF program	Super majority voting
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Under the SDRM, a super majority of the creditors, regardless of the bond issue or loan obligation they held, would be able to vote to accept new terms of payment under a restructuring agreement and minority creditors would be bound by the decision of the majority.³⁹ Consequently, a dispute resolution forum would be created for different purposes such as verifying claims, guaranteeing the integrity of the voting process that led to the restructuring, and adjudicating disputes among creditors. Thus, to grant a legal stay binding to all the parties, the mechanism must have the force of law universally.⁴⁰ Otherwise, creditors would be able to sue the debtor sovereign state in their own jurisdiction, in the jurisdiction that rules the bond issuance or in the jurisdiction of the sovereign state. Obtaining a convention or a treaty binding all countries would likely take a very long time. The IMF supposes that “even with unanimous political support this approach could not be in place for at least two or three years.”⁴¹ Some critics believe the process could take decades “and could end up being ineffective if too many nations refuse to join.”⁴²

The imposition of standstills and the use of majority voting for debt restructuring proposals, which could be binding on a dissenting minority, require an amendment to the IMF’s Articles of Agreement. An amendment requires the approval of 85 percent of member country votes. Because the United States has more than 15 percent of the votes, this means the U.S. Congress must approve the change. There is no indication, however, that there would be sufficient political support for the SDRM in Congress.⁴³ Even if a binding

39. BARRY EICHENGREEN & ASHOKA MODY, IS AGGREGATION A PROBLEM FOR SOVEREIGN DEBT RESTRUCTURING? (Jan. 2003), available at <http://emlab.berkeley.edu/users/eichengr/research/aeapapers&proceedings5jan15-03.pdf> (last visited Sept. 14, 2003).

40. Krueger, *supra* note 4.

41. *Id.*

42. Owen C. Pell, *Nations Need Bankruptcy Process*, OUTSIDE THE BOX, Feb. 8, 2002, available at http://www.whitecase.com/article_nations_need_bankruptcy_process_pell.pdf (last visited Sept. 14, 2003).

43. PATRICK BOLTON, INTERNATIONAL MONETARY FUND, TOWARD A STATUTORY APPROACH TO SOVEREIGN DEBT RESTRUCTURING: LESSONS FORM CORPORATE BANKRUPTCY PRACTICE AROUND THE WORLD, at 27-28, available at <http://www.imf.org> (last visited Sept. 14, 2003).

treaty were adopted, the IMF would have serious decisions to make: would the treaty be binding to the already-issued bonds (i.e. retroactive effects)?

Notwithstanding the aforesaid practical difficulties in implementing the SDRM, the IMF believes that due to a greater predictability in the restructuring progress afforded by the adoption of the SDRM, an improvement in the functioning of international capital markets should be expected.⁴⁴ However, according to Micheal Heise, while a SDRM would make the process of restructuring easier and faster, this may create an environment where governments do not try their hardest to avoid defaults in the first place.⁴⁵ Because sovereign debt always has the potential to lead to “opportunistic defaults” (unwillingness to pay as opposed to inability to pay), a restructuring that is too “easy” or “orderly” (with little or no cost to the debtor) may not be socially efficient.⁴⁶

Anne Krueger stated:

[T]he Fund’s involvement would be essential to the success of such a system [referring to the SDRM]. We are the most effective channel through which the international community can reach a judgment on the sustainability of a country’s debt and of its economic policies, and whether it is doing what is necessary to get its balance of payments back into shape and to avoid future debt problems.⁴⁷

What would happen if a sovereign state obtained an agreement with its creditors through a SDRM and thereafter defaulted again? It should be noted that although the SDRM is based on U.S. Chapter 11 Bankruptcy Laws, there is no ultimate sanction of liquidation and creditors cannot insist on a change in management. A twice-defaulting country would show that the SDRM is not a panacea, and it would question the IMF’s ability to provide supervision.

Further, establishing a quasi-judicial entity under the IMF would likely be a time-consuming and difficult process.⁴⁸ In addition, many countries fear that the introduction of statutory and even contractual mechanisms for debt restructuring would impair their access to international capital markets and discourage capital flows.⁴⁹

Thus, it is apparent that the SDRM has some shortcomings and many enemies. Its enemies include the private financial sector,

44. See IMF BOARD DISCUSSES FEATURES OF SDRM, *supra* note 32.

45. Heise, *supra* note 11.

46. ROUBINI, *supra* note 17, at 29.

47. Krueger, *supra* note 4.

48. Mark Jewett, Legal Approaches and Procedures, Speech at the Conference for New Sovereign Debt Restructuring Mechanisms: Challenges and Opportunities (Feb. 21-22, 2003), available at <http://www.dse.de/ef/sdrm/jewett.htm> (last visited July 23, 2003).

49. Yilmaz Akyüz, Some Reflections on SDRM, Speech at the Conference for New Sovereign Debt Restructuring Mechanisms: Challenges and Opportunities (Feb. 21-22, 2003), available at <http://www.dse.de/ef/sdrm/akyuz.htm> (last visited July 23, 2003).

especially representatives of different actors in the international bond market, and developing countries that feel no ownership of the proposal and express even less enthusiasm for it. In addition, it is unclear where developed countries stand or if they stand together.⁵⁰ The question then is whether we need an institutional change in the international financial system that would lead to a new way to provide for orderly sovereign debt restructuring.⁵¹

Despite its shortcomings, the SDRM does provide some benefits. It is innovative in bringing debtors and bondholders together whether or not bonds contain CACs in securing greater transparency and in providing a mechanism for dispute resolution.⁵² The SDRM goes further than the CAC restructuring approach by not requiring separate decisions from the holders of individual series of bonds or other creditors and allowing a single vote to restructure multiple debt instruments. The vote is an aggregate of the votes of the creditors holding participating debt instruments. Thus, it permits the debtor and its creditors to act as if all of the debt was governed by a single collective action clause.⁵³ This aggregation mechanism has been used in Uruguay's 2003 debt re-profiling, later in this article we will analyze this issue in depth.

Although the adoption of the SDRM could be considered a forward movement in debt restructuring, the effects of the SDRM can be achieved by the broader usage of CACs in a decentralized market-oriented approach as proposed by John B. Taylor by "using the tools we already have," or perhaps using them more creatively and more confidently to promote orderly workouts as proposed by Buchheit and Gulati.⁵⁴ It is important to note that the sovereign debt restructuring regime proposed by the IMF would not be substantially different from a contractual approach because it would be "creditor-centered" rather than being "IMF-centered."⁵⁵ Therefore, we suggest that the first part of the "twin-track" approach should be used. The IMF should promote the usage of CACs by granting financial incentives to encourage countries to adopt such clauses.

50. Barry Herman, The International Community Should Continue Work on a Mechanism for Restructuring Sovereign Debt, Speech at the Conference for New Sovereign Debt Restructuring Mechanisms: Challenges and Opportunities (Feb. 21-22, 2003), available at <http://www.dse.de/ef/sdrm/herman.htm> (last visited July 23, 2003).

51. ROUBINI, *supra* note 17, at 20.

52. Akyüz, *supra* note 49.

53. IMF PROPOSALS FOR A SOVEREIGN DEBT, *supra* note 6.

54. Buchheit & Gulati, *supra* note 15, at 4.

55. ROUBINI, *supra* note 17.

B. VOLUNTARY AND CONTRACTUAL ARRANGEMENTS

1. *Status Quo*

In light of the proposed SDRM, how far can collective decision making provisions in sovereign bonds be used to facilitate debt workouts? In other words, how and to what extent, can the clauses be used to replicate the features of the international bankruptcy code as proposed by Anne Krueger?⁵⁶

Recent restructurings by Ecuador and the Ukraine clearly establish that restructuring is possible within the given parameter and limitations by the tactical and often complementary use of collective decision-making provisions and exchange offers. The terms of the bonds in each of these cases had determined the restructuring technique that was to be adopted, that is exchange offers and amendments (exit amendment or exit consents). The restructurings involved sovereign bonds that were governed both by the English law⁵⁷ (issued under trust deeds and fiscal agency agreements), and which included CACs as well as bonds governed by New York Law, including Brady Bonds, that did not contain such clauses for the payment terms. The vast majority of bonds issued by emerging market sovereigns are governed either by New York State Law or English Law. Unlike the sovereign bonds issued under English Law, payment terms for bonds issued under the New York Law can be restructured only by unanimous consent of the bondholders. Therefore, the technique of exchange offers is used to amend bonds issued under New York law.⁵⁸

[E]ach of the restructuring involved an exchange offer in which bondholders were invited to exchange their instruments for new longer maturity instruments. In each case, it was possible to secure agreement on comprehensive restructurings that both provided immediate cash-flow relief and contributed toward putting the members debt onto a basis consistent with a return to medium-term viability. In each case, participation rates were high, and there was no creditor litigation.⁵⁹

In addition, “Ukrainian bonds were restructured using an innovative hybrid mechanism that combined an exchange offer for all of the instruments with the use of collective action provisions in

56. See Buchheit & Gulati, *supra* note 15, at 21.

57. The governing law in the Ukraine restructuring was Luxembourg law, which for the purpose of CACS and amendment terms is the same as English law.

58. See BUCHHEIT, *supra* note 3.

59. INTERNATIONAL MONETARY FUND, INVOLVING THE PRIVATE SECTOR IN THE RESOLUTION OF FINANCIAL CRISIS—RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS 4, 9, available at <http://www.imf.org/external/pubs/ft/series/03/IPS.pdf> (last visited July 23, 2003) (prepared by the Policy Development and Review and Legal Departments) [hereinafter IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS].

three of the instruments.”⁶⁰ Of the four outstanding bonds, one series of the bonds was governed by German law and did not contain CACs and was therefore restructured by a one-step exchange to the new bond. Bondholders of the other three bonds, which contained CACs and were governed by Luxembourg law, were invited to tender their old bonds and, at the same time, to grant an irrevocable proxy vote to the exchange agent. The vote would be cast at a subsequent bondholders’ meeting and would favor modifications to the old bonds that would bring them in line with the payment terms of the new bonds being offered in exchange. As opposed to the Pakistan bond restructuring, the Ukraine made an innovative use of the CACs. Pakistan’s bonds were governed by English law, but due to the uncertainty of the outcome of the bondholders’ meetings, the use of CACs was not triggered.

To overcome this uncertainty, Ukraine predicated the calling of the bondholders’ meeting for the proposed amendments to the payment terms, subject to the receipt of sufficient irrevocable proxies in favor of the proposed amendments. On the receipt of sufficient proxies to amend the payment terms of the original bonds, a meeting was called, the proxies were voted, and the amendments were adopted, thereby making them binding on all the bondholders of the three series. Subsequent to the meetings, the bondholders participated in the exchange by tendering the modified bonds for new bonds containing the amended payment terms. “Using a tender process permitted numerous additional modifications of nonpayment terms to be adopted without bondholders formally having to accept each as an amendment to the old bond and ensured that the four original issues were merged into two relatively large issues which differed only by currency of denomination and the associated coupon.”⁶¹

This ground-breaking technique of using CACs with the predicated requirement of a majority of irrevocable proxies, the breach of which entailed substantial civil liabilities, not only provided certainty that bondholders who had tendered proxies would not back-track and reject the proposed amendments at the meetings, but also solved the holdout problem feared by Pakistan. Even if dissenting bondholders refused to participate in the exchange, they were still bound to the payment terms adopted by the qualified majority. Thus, “holdouts faced the prospect of being left with an amended illiquid old bond that paid out no earlier than the very liquid new bond offered in the exchange.”⁶²

The Ecuadorian debt restructuring led to the creation of another innovative technique, called the “Exit Consents” (also known as “Exit Amendments”). This innovation was the result of the

60. *Id.* at 6.

61. *Id.* at 33.

62. See Buchheit & Gulati, *supra* note 15, at 24.

limitations involved in restructuring Brady bonds and Eurobonds governed by New York law, which require the unanimous consent of the bondholders for the amendment of the payment terms. Unlike the Ukraine, where the CACs permitted the majority to amend all the terms (payment and non-payment terms) of the bonds and make them binding on the minority, Ecuador did not have such an option and therefore would have had to resort primarily to the exchange offer technique. Although the Ecuadorian bonds did not contain CACs to amend payment terms, it did contain amendment clauses that permitted a simple majority to amend all other terms, such as waiver of sovereign immunity, submission to jurisdiction, and financial covenants. Ecuador was the first sovereign to use the amendment clauses through exit consents to deal with the potential holdout problem in restructuring of international sovereign bonds that do not contain collective action clauses applicable to payment terms.⁶³

As Buchheit and Gulati have explained, through an exit amendment the specified majority or super majority of bondholders exercise its power to amend the old bond—just before those creditors leave the old bond—as an incentive for all other holders to come along with them.⁶⁴ To address this “potential holdout problem, Ecuador used exit consents (or exit amendments) to modify certain nonpayment terms in order to make the old bonds less attractive, thereby adding incentives for bondholders to participate in the exchange.”⁶⁵ Bondholders who tendered instruments under the exchange offer automatically voted in favor of a list of amendments to the non-payment terms in the instruments that they were about to leave. The amendments they consented to were the deletion of some of the non-payment terms such as: the requirement that all payment defaults must be cured as a condition to any rescission of acceleration; “the provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing;” the covenant that prohibits Ecuador from seeking a further restructuring of Brady bonds; the cross-default clause; the negative pledge covenant; and “the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange.”⁶⁶ Following the example of the Ukraine, each tender for exchange was made irrevocable and the completion of the exchange was made subject to bondholders holding the requisite majority consenting to the amendments.⁶⁷

Besides the use of exit consents to weaken the legal rights of bondholders who decided not to participate in the exchange, the

63. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 29.

64. See Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59, 67 (2000).

65. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 29.

66. *Id.* at 8, 35.

67. *Id.* at 35.

Ecuadorian government made some additional commitments to enhance the exchange offer. For example, the Ecuadorian government included the following clauses in the bonds:

- (1) **Mandatory Prepayment Arrangement:** This required the retirement of an aggregate outstanding amount of each type of bond by a specified percentage each year starting after eleven and six years for the 2030 and 2012 bonds, respectively, through purchases in the secondary market, debt-equity swaps or by any other means. Because Ecuador could be buying the Bonds in the secondary market, it would provide the liquidity that investors want.⁶⁸ “This feature is intended to give bondholders some assurance that the aggregate amount of the new bonds would be reduced to a manageable size prior to their maturity dates while giving Ecuador flexibility to manage its debt profile.”⁶⁹ If Ecuador failed to meet the reduction target, a mandatory partial redemption of the relevant bond would be triggered in an amount equal to the shortfall.⁷⁰
- (2) **Mandatory “Reinstatement” of Principal Clause:** Whereby Ecuador would be obliged to issue additional bonds in the same amount of the debt reduction obtained through the exchange offer in the event that an interest default occurs during the first ten years of the new issuance, and if this default continues for a period of twelve months. This clause was also introduced to discourage casual defaults on the new bonds by giving the government an incentive to making payments.⁷¹

Thus, the novel use of exit consents, combined with the described incentive clauses in the Ecuador debt restructuring, proved effective in ensuring by the expiration of the exchange offer that 97 percent of the bondholders agreed to participate.⁷² Exit consents were criticized at the time, as well as later, by some Ecuador creditors as being more coercive than encouraging.⁷³

Prior to the Ecuadorian restructuring, an article co-authored by Lee Buchheit opined that in comparison with other proposals for addressing the hold-out creditor problem (international bankruptcy codes, IMF administered stays on creditor remedies, and generally applicable legal defenses for sovereign debtors), exit consents—

68. HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE, TRANSACTIONS, POLICY, AND REGULATIONS 1304 (8th ed. 2001).

69. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 33.

70. *Id.* at 33-34.

71. *Id.*

72. *Id.* at 35.

73. Michael M. Chamberlin, At the Frontier of Exit Consents, Remarks at the Bear Stearns & EMCA Sovereign Creditors Rights Conference (Nov. 8, 2001), available at <http://www.emta.org/ndevelop/exitcons.pdf> (last visited July 23, 2003).

assuming they can be made to work—would do far less violence to the existing fabric of international financial and legal relationships.⁷⁴ The case of Ecuador proves that exit consents can be made to work. Michael Chamberlain, however, believes that sovereigns that attempt to push the exit consent frontier too far will someday be challenged in court by hold-out creditors.⁷⁵

The aforementioned restructuring cases are a clear illustration of the opinion of Buchheit and Gulati that the existing collective decision-making provisions in sovereign bonds, even within their given parameters and limitations, can, if used more confidently and creatively, mimic to varying degrees most of the features of domestic corporate bankruptcy such as (1) automatic stay, (2) cramdown, and (3) debtor in possession (DIP) financing, with the exception of the coordination feature.⁷⁶ Although the aforementioned authors have illustrated through a hypothetical case that it is possible to replicate the DIP financing feature of the domestic bankruptcy regime with the use of collective action clauses, it is significant to note that this feature has never been utilized in any sovereign debt restructuring. We should point out that, in 1992, Macy's (a U.S. department super store) obtained new working capital in a \$600 million loan through DIP financing only three weeks after filing its petition under the U.S. Bankruptcy Code, while Russia had to wait more than a year to obtain financing to restructure its debt.⁷⁷

Before we analyze the technique elaborated by Buchheit and Gulati for obtaining DIP financing in sovereign debt restructuring, let us first examine the concept as it exists under Chapter 11, section 364 of the U.S. Bankruptcy Code (Code).⁷⁸ Basically, it is a procedure by which a debtor company that has entered into reorganization can obtain financing for its reorganization and restructuring from the credit and capital markets, subject to the approval of the court.⁷⁹ This allows a company to continue its business operations while the plan of reorganization is being worked out.⁸⁰

A DIP company may enter into four different types of credit or debt under section 364 of the Code, depending on how it will secure them. Under section 364(a), a DIP is entitled to obtain unsecured credit and debt in the ordinary course of business. Section 364(b) entitles a DIP to obtain unsecured debt other than in the ordinary

74. See BUCHHEIT, *supra* note 3, at 25.

75. "Useful as exit consents may be, just how far is 'too far'?" Chamberlain, *supra* note 73, at 4.

76. Buchheit & Gulati, *supra* note 15.

77. See Jeffrey D. Sachs, *IMF, Reform Thyself*, WALL ST. J., July 21, 1994, at A14.

78. 11 U.S.C.S. § 364 (2003).

79. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 986 (2000).

80. See Buchheit & Gulati, *supra* note 15, at 25.

course of business. Section 364(c) entitles a DIP to obtain credit and incur debt with some special priorities (for example, all administrative expenses; debts secured by a lien on unencumbered property of the estate; or debts secured by a junior lien on unencumbered property) in the event that the trustee is unable to obtain unsecured credit under sections 364(a) and (b). Lastly, section 364(d) grants authority to the court to authorize the debtor to obtain credit and incur debt with a super priority.

To encourage or attract lenders, the Code grants certain priority to these loans by granting them the status of an administrative expense of the bankruptcy,⁸¹ which enjoys a priority over other credits. Moreover, as Schwarcz has pointed out, if the priority scheme laid out is inadequate to attract sufficient financing, the judge may authorize the granting of collateral and, if necessary, the judge may even authorize the obtaining of credit secured by a senior lien on property already pledged as collateral if the original secured party is adequately protected.⁸²

As we all know, “access to funding is critical for the economic rehabilitation: a financially troubled State will need ‘fresh working capital during restructuring, so that critical governmental functions don’t collapse.’”⁸³ This financing can be obtained from two main sources: (1) official financing (bail-outs) or (2) private sector (bail-ins). Each alternative has drawbacks.⁸⁴ Indeed, the issue of bail-ins versus bail-outs is the most controversial question in the debate on the reform of the international financial architecture.⁸⁵

As previously mentioned, a large scale private lending during a crisis has never taken place and it is primarily the IMF that has always provided the bail-outs to defaulting sovereign nations. This is why the IMF has become known as the International Lender of Last Resort (IOLR) or the IMH (Institute for Moral Hazard).⁸⁶ Nouriel Roubini has explained that the existence of inter-creditor coordination failures is one of the major justifications for an IOLR.⁸⁷ He further explains that such existence is going to continue as long as the coordination problem cannot be resolved at low cost. Conversely, Buchheit and Gulati claim that even in the absence of a solution for the coordination problem, DIP financing from private lenders is possible and is a technique that can be used to

81. 11 U.S.C.S. §364(a) (2003).

82. Schwarcz, *supra* note 79.

83. *Id.* at 986 (quoting Jeffrey Sachs, Do We Need an International Lender of Last Resort?, Frank D. Graham Lecture at Princeton University 8 (Apr. 20, 1995) (unpublished manuscript, on file with author), available at <http://www.hiid.harvard.edu/about/people/sachs/jsachs.html>).

84. Buchheit & Gulati, *supra* note 15, at 26.

85. ROUBINI, *supra* note 17.

86. Robert J. Barro, *The IMF Doesn't Put Out Fires, It Starts Them*, BUS. WEEK, Dec. 7, 1998, at 18.

87. ROUBINI, *supra* note 17

overcome a liquidity crisis as an alternate to permanent restructuring of private sector claims.⁸⁸ However, “[t]he important point here is that there are very few or no pure liquidity cases.”⁸⁹ We believe that having access to capital from the private sector in a way equivalent to DIP financing can be an alternative to bail-outs to sovereign states, as it is a technique that can be used to tide over a liquidity crises without permanent debt restructuring as proposed by Buchheit and Gulati and also enables the sovereign debtor (the DIP) to raise the required financing to perform a permanent debt restructuring when there are debt sustainability problems in an economic or financial crisis.

Although obtaining DIP financing for a country with liquidity crisis (as Buchheit and Gulati suggest) as well as an economic or financial crisis can be very difficult and expensive, it can be arranged by granting the DIP financiers a legally enforceable priority over the existing lenders; similar to the one provided under section 364(d) of the Code through a voluntary inter-creditor agreement encompassed within the terms of the bonds by the use of CACs and without the intervention of any court. This would be accomplished by amending the *pari-passu* clause of the existing bonds with the aid of the CACs.

As stated before, bonds are issued primarily under New York and English Law. Under the law of New York, the clauses of the bonds can be classified into three main categories for the purposes of amendment:⁹⁰

- (1) Category I are those clauses that explicitly are made subject to unanimous amendments. Examples of such clauses include the payment amount, interest rate, due date, currency of payment, and amendment requirements. These first category clauses are clearly off-limits to majority exit consents because they are explicitly subject to the 100 percent amendment requirement.
- (2) Category II are clauses that, if changed, might have the same practical effect as a change in payment terms. Examples of such clauses include the governing law, events of default, and right of acceleration.
- (3) Category III are all the other clauses, including waiver of sovereign immunity, submission to jurisdiction, financial covenants (such as negative pledge), and maintenance of listing.

The issue is whether an amendment to the *pari-passu* clause to evidence the subordination would fall within the list of unanimous

88. See Buchheit & Gulati, *supra* note 16, at 25-28

89. ROUBINI, *supra* note 17, at 10.

90. This classification was utilized by Michael Chamberlin for analysing exit consents. Chamberlin, *supra* note 73. However, this classification can also be used for analyzing amendments to bond clauses.

consent amendments of Category I or the gray area of Category II. As Buchheit and Gulati have stated:

Does [the *pari-passu* clause] change a payment date in the old bonds? No. Does [the *pari-passu* clause] reduce the amount of principal or interest due under the old bonds? No. Does [the *pari-passu* clause] change the currency in which the old bonds are payable? No. Does [the *pari-passu* clause] alter the voting percentages of the old bonds? No.⁹¹

Based on this analysis, it seems probable that the amendment of the *pari-passu* clause does not have the effect of amendment to payment terms and therefore can be amended by bondholders of 66^{2/3} of the outstanding amount of the specific series of bonds. In contrast, under English law all terms of bonds, including the *pari-passu* clause, can be amended by a simple majority of the outstanding nominal amount of the series subject to the quorum requirements.

It is important to stress that subordination would not release or discharge the sovereign's obligation to make payments on its existing bonds; it would merely evidence an inter-creditor arrangement giving the DIP finance seniority over the old bonds.⁹² In the event of another default, this so-called targeted subordination would make it less likely that the sovereign would be able to make payments on the amounts due on its existing bonds due to the new obligation of the loan. This is simply the result of legal priority.

In the case of a liquidity crisis, the current creditors would therefore be faced with the dilemma of accepting or rejecting the targeted subordination. Their choice is the possibility of a restructuring tomorrow versus the certitude of a restructuring today.⁹³ In making a decision, the bondholders would have to weigh the benefit of receiving continued debt service payments while the DIP financing is being disbursed against the incremental severity of restructuring terms in the event a restructuring proves unavoidable. They would also have to take into account that had this financing come from the official sector, those institutions would have claimed for themselves de-facto senior creditor status. In either case the bondholders would be faced by a larger component of senior debt if restructuring became necessary.⁹⁴ This proposal only "privatizes the source of funding."⁹⁵

We believe that in addition to a liquidity crisis, DIP financing can also be used in a financial and economic crisis. DIP financing as an alternative has gained particular preponderance in response to the

91. Buchheit & Gulati, *supra* note 15, at 27.

92. *Id.* at 26.

93. *Id.* at 27.

94. *Id.*

95. Schwarcz, *supra* note 79, at 136.

IMF's refusal to bail-out countries in economic distress. The options for the current bondholders would be subordination due to a bail-in (which would imply a smaller hair-cut); a remote possibility of a bail-out (which would imply a larger hair-cut); or selling the bonds on the secondary market at great losses (if there are any buyers left). In summary, in the absence of an IMF bail-out, the existing bondholders have no option other than resigning themselves to a subordinated status.

Steven Schwarcz points out that permitting debtors to grant priority in order to attract new money credits tends to create value for the unsecured creditors, even though those creditors' claims are subordinated to the new money.⁹⁶ The availability of new money credit increases a debtor's liquidity, thereby reducing the risk of failure and increasing the expected value of unsecured claims. Likewise permitting a debtor state to grant priority in order to increase liquidity will reduce the risk of economic failure to some extent.⁹⁷

DIP financing can be in the form of syndicated loans or may be raised again from the capital markets. Schwarcz has proposed that this funding may be raised from the capital markets by the IMF acting as an Intermediary Funding Source rather than involving itself directly.⁹⁸ Accordingly, the IMF would borrow funds from the capital markets on a non-recourse basis and re-lend those funds to the debtor-state. The debtor state's priority loan would be given as collateral for the capital borrowed by IMF from the market. Schwarcz considers that the lenders thus would be in the same position as if they had made the loan directly to the state. Further, because the borrowing would be on a non-recourse basis, the IMF would avoid liability for the debtor-state's potential default and thereby reduce moral hazard given that the capital market lenders could look only to their collateral (the debtor-state's assigned loan) for repayment. Moreover, the intermediary funding approach would enable the IMF to continue its current practice of imposing conditionality on funding.

With regard to the Schwarcz proposal, we would like to point out that it has been based on the basic premise that the IMF can act as an Intermediary Funding Source and issue collateralized securities. In our opinion, it is highly improbable that the articles of the IMF, unless they are amended, would be interpreted to permit the IMF to act as an Intermediary Funding Source and to issue securities.⁹⁹ Further, any amendment to the articles of the IMF would require the

96. *Id.*

97. *Id.*

98. *Id.*

99. INTERNATIONAL MONETARY FUND, ARTICLE V: OPERATIONS AND TRANSACTIONS OF THE FUND § 2, available at <http://213.133.111.71/allgemein/divers/inf.node7.php> (last visited July 20, 2003).

approval of at least 85 percent of member-country votes.¹⁰⁰ We believe, however, that instead of the IMF, the World Bank or the International Finance Corporation (IFC) may act as the Intermediary Funding Source, as it has already been done in the past. Asset-backed securitization may be used for a variety of reasons, including a desire for liquidity, reducing financing costs or mismatches between assets and liabilities, and managing balance sheets better.¹⁰¹

In the light of the remote possibility of an IMF bail-out or funding for restructuring, a sovereign would be required to arrange financing for restructuring through a mechanism similar to DIP financing. What would be the financial price of the DIP financing for the sovereign country? Although it may seem at first sight to be very expensive and difficult due to the distressed situation, financing is not impossible and in fact may prove to be financially more viable. We propose that this DIP financing should be raised by the World Bank or the IFC, which would act as the so-called “Intermediary Financing Fund” to borrow funds from the capital markets by securitization of the asset pool of receivables from the sovereign debtor and simultaneously re-lend those funds back to the sovereign debtor. The asset pool of receivables from the sovereign debtor on these loans would be the collateral for the capital raised by World Bank or the IFC from the market. The diagram below illustrates how such a plan could work.

STRUCTURE TO OBTAIN DIP FINANCING FROM THE CAPITAL MARKETS THROUGH SECURITIZATION¹⁰²

(Insert Chart #1)

To ensure that the investors do not have recourse to the World Bank or the IFC and to avoid any liability for the sovereign debtor’s potential default, the World Bank or the IFC would have to set up a Special Purpose Vehicle (SPV) and transfer all the assets (the receivables) to it. The investors would only have recourse to the assets of the SPV (the asset pool of receivables from the sovereign debtor), which will also be the collateral for the securities¹⁰³. Such a financing plan could be a workable solution in cases such as Ecuador or the Ukraine where the number of series or the total outstanding amount was limited. The case of Argentina, however, is completely different because there are seventy-eight series of bonds and the defaulted amount totals \$88 billion approximately. Bearing in mind

100. *Id.* art. XXVIII.

101. SCOTT & WELLONS, *supra* note 68, at 759.

102. *See id.* at 760, Exhibit 1.

103. For a detailed discussion of Asset Backed Securitization, *see* SCOTT & WELLONS, *supra* note 68, Ch. 13, International Asset Securitization.

that a solution is still needed to restructure Argentina's debt, we can use DIP financing not as the mechanism to restructure, but as a supplemental mean in the whole restructuring procedure. Nevertheless, the possibility of the World Bank or the IFC accepting to issue the securities backed by the right to collect the amount due by the sovereign rests on a political issue.

Since the aim of this article is to deal with the different sovereign debt restructuring methods and techniques we will only state that DIP financing is a workable solution although there are many aspects that should be analyzed in depth.

With regard to the fourth feature of the domestic corporate bankruptcy regime, the coordination feature, Buchheit and Gulati have pointed out that the existing CACs have a serious limitation; because they operate within the four corners of the bonds containing the clauses, they cannot be used to deal with the coordination problem.¹⁰⁴ According to the two authors, some other method, which is yet undiscovered or unused, will have to encourage closer coordination among the various creditors, such as the Paris Club (Official Bilateral Creditors), trade creditors, and multilateral creditors.¹⁰⁵

The proposed SDRM discussed earlier in this article purports to be a method that can resolve this issue by allowing a single vote to restructure multiple debt instruments. We would like to point out, however, that this method is limited in its scope. It excludes the IMF and the domestic creditors from the ambit of participating creditors in debt restructuring, and the method is inclined to exclude the Paris Club, thereby implying parallel restructurings.¹⁰⁶ On the other hand, if we consider whether CACs that help to solve problems of intra-issue coordination might also create a simpler setting for inter-issue coordination, we would agree with Eichengreen and Mody that in the presence of CACs the holders of an issue might be more likely to speak with one voice in negotiations with other classes of creditors, thereby achieving approximately the same degree of coordination as under the SDRM.¹⁰⁷

Moreover, we believe that all participating creditors, whatever their roles and responsibilities, share a basic interest to prevent and resolve crises and promote greater financial stability. As such, they would be willing to expedite restructuring by participating in debtor creditor consultations. The Ukraine is an illustration of how the common inter-creditor interests and market mechanics facilitate coordination. The restructuring of the bond debt through an exchange offer was made in the context of an arrangement under the

104. See Buchheit & Gulati, *supra* note 15, at 21-22.

105. See *id.* at 22.

106. See IMF PROPOSALS FOR A SOVEREIGN DEBT, *supra* note 6, at question B.2.

107. EICHENGREEN & MODY, *supra* note 39.

Extended Fund Facility, and a request for a debt restructuring by Paris Club creditors (though at the time of the exchange offer, the Ukraine's right to draw under the arrangement had been temporarily interrupted).¹⁰⁸

With regard to the issue of intra-coordination (coordination within similarly situated creditors such as different series of bonds), Buchheit and Gulati believe that in cases where the majority of the bonds are issued and governed by U.S. law, engaging the equity powers of the U.S. federal courts under Rule 23 of the Federal Rules of Civil Procedure may be more feasible in the oversight of some sovereign bond workouts.¹⁰⁹ The bondholders could be homogenized into a single voting class, and any-court approved compromise of the action would bind all members of the class.¹¹⁰ Buchheit and Gulati, however, have also raised concerns about the utility of the equity powers of the U.S. courts in cases where there are non-U.S. sovereign bonds.¹¹¹ They also question how the court would deal with other categories of creditors, such as the Paris Club, multilateral lenders, or trade creditors that cannot be easily included in class actions.¹¹² On December 30, 2003 a motion for class action under U.S. Federal Rule of Civil Procedure 23 was granted¹¹³. Please note that two previous class action cases¹¹⁴ were settled by sovereigns to avoid its consequences. The Argentine government argues that “*once class action treatment is granted in one action, there will be a “run” on proposals for class actions, which at least would eventually be unmanageable.*”¹¹⁵ The final outcome is still uncertain.

We believe that in the case of Argentina, the equity powers of the U.S. federal courts may be used given that the majority of the Argentine bonds are governed by and subject to the jurisdiction of the New York state law. Further, Argentine Eurobonds (comprising the second largest majority of Argentine bonds) are governed by English law, but may be amended to be governed by New York state law by resolution passed by a majority. This would resolve the concerns raised by Buchheit and Gulati on possible inconsistent judgments. Another alternative could be found in the manner in which a probable conflict of judgments was avoided in the proceedings of *Maxwell Communication Corp.*¹¹⁶ as well as in other

108. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59.

109. *See* Buchheit & Gulati, *supra* note 15, at 30.

110. *See id.* at 16.

111. *See id.* at 33.

112. *See id.* at 32.

113. H. W. Urban GmbH, D. and H. Urban Found. v. Argentina (2003 U.S. Dist. Lexis 23363).

114. Hirshon v. Republic of Bolivia, 979 F. Supp. 908 (D.D.C. 1997); Carl Marks & Co. v. U.S.S.R., 665 F. Supp 323 (S.D.N.Y. 1987).

115. *See* H. W. Urban GmbH, D. and H. Urban Found., *supra* note 113.

116. Maxwell Communication Corp. v. Societe Generale, 93 F.3d 1036, 1047 (2d Cir. 1996).

more recent cases such as *In re Loewen Group International, Inc.*;¹¹⁷ *In re Olympia & York Maiden Lane Co.*;¹¹⁸ and *In re Federal Mogul Global Inc.*¹¹⁹, where there was certain coordination between different courts, including local and foreign courts.. Even in light of the cases, it is highly improbable that a sovereign state would voluntarily subject itself to another sovereign jurisdiction.

Moreover, this would still not resolve the inter-creditor issue raised by Buchheit with regard to how the court would deal with the other categories of creditors such as the Paris Club, the multilateral lenders, or the trade creditors that may not be included in a class action.

Perhaps the court would decide that it could not approve any settlement of a bondholder class action as ‘fair, adequate and reasonable’ until it had received confirmation that the other creditor groups had also agreed to moderate their own claims on the sovereign’s foreign exchange reserves going forward or, in the case of the multilateral creditors, agreed to augment those reserves through new lending.¹²⁰

2. *Decentralized, Market-Oriented Approach*

Another proposal within the category of the Voluntary and Contractual Approach has been authored by U.S. Under Secretary John B. Taylor and is supported by Eichengreen. It is the “decentralized, market-oriented approach, as opposed to the centralized, non-market approach of SDRM.”¹²¹ It proposes that the sovereign borrowers and their creditors put a package of new collective action clauses in the bonds that would describe as precisely as possible what happens when a country decides that it has to restructure its debt.¹²² This would “prevent a minority of creditors from blocking negotiations with the debtor”¹²³ and “create. . . a more orderly and predictable workout process.”¹²⁴ These clauses would represent a decentralized, market-oriented approach to reform because the borrower and lenders would have determined both the contracts and the workout process described by the contracts on their

117. *In re Loewen Group Int’l Inc.*, 274 B.R. 427 (Bankr. D. Del. 2002).

118. *In re: Olympia & York Maiden Lane Company LLC and Olympia & York Maiden Lane Finance Corporation, Debtor. Marine Midland Bank, as successorTrustee, etc., Plaintiff, - against - Zurich Insurance Company, et al., Defendants.* Chapter 11, Case No. 98 B 46167 and 46168 (JLG) Jointly Administered, Adversary Proceeding No. 98/9155A, United States Bankruptcy Court for the Southern District of New York, 1999 Bankr. LEXIS 91.

119. *In re: Federal-Mogul Global, Inc.*, 282 B.R. 301 (Bankr. D. Del. 2002).

120. Buchheit & Gulati, *supra* note 15, at 32-33.

121. Dodd, *supra* note 2, at 3.

122. Taylor, *supra* note 7.

123. Dodd, *supra* note 2, at 3.

124. Taylor, *supra* note 7.

own terms.¹²⁵

Currently, the inclusion of these clauses is optional and often depends on the market convention.¹²⁶ While bonds issued under trust deeds and fiscal agency agreements governed by English law contain collective action clauses, they are not included in bonds governed by New York law, including Brady bonds.¹²⁷ These clauses, however, have been excluded from bonds issued under New York law as a matter of practice and not due to any legal impediments. The CACs that can be found in international sovereign bonds that have been restructured consist only of (1) majority restructuring provisions, which enable a qualified majority to bind a minority to a restructuring plan (including payment terms) either before or after default; and (2) majority enforcement provisions, which enable a qualified majority to limit the ability of a minority to enforce their rights following a default.¹²⁸

John Taylor proposes the inclusion of a new package of clauses based on the following templates of collective action clauses:¹²⁹

- (1) **MAJORITY ACTION CLAUSES:** Designed to empower a super majority (often 75 percent) of bondholders to agree to a change in payment terms in a manner that is binding on all bondholders, thereby preventing holdouts.
- (2) **COLLECTIVE REPRESENTATION CLAUSES:** Designed to establish a representative forum (such as a trustee or committee) for coordinating negotiations between the issuer and the bondholders and to empower it to initiate litigation, at the behest of a specified majority of bondholders.
- (3) **“COOLING-OFF” PERIOD CLAUSES:** Designed to provide a cooling-off period between the date when the sovereign notifies its creditors that it wants to restructure and the date that the representative is chosen, setting a fixed time limit period. During this temporary suspension, a deferral of payments might be necessary and the possibility of such suspension or deferral should be incorporated in the clause along with appropriate penalties. During the cooling off period, bondholders would be prevented from initiating litigation.

Taylor does not support the inclusion of the Sharing Clause in bonds. The Official Sector, however, supports the inclusion of the standard Sharing Clause in syndicated loans (along with Representation clauses and Majority Action Clauses) because it ensures that all payments made by the debtor are shared among the

125. *Id.*

126. *Trade and Development Report*, *supra* note 5, at 144.

127. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 4.

128. *Id.*

129. Taylor, *supra* note 7, at 3.

creditors on a pro-rated basis. The Official Sector also believes that if the clause is included in bonds, it would help to prevent maverick litigation, rogue creditors and vultures even after the cooling off period proposed by Taylor.¹³⁰ Orderly restructuring would then result. Conversely, some speculate that the absence of the Sharing Clause in the Brady bonds has made litigation a more attractive option for the new creditor class.¹³¹

After the Mexican debt crisis in 1998, the Official Sector has been urging the emerging markets borrowers to include the aforesaid CACs in bond contracts in efforts to improve communication with bondholders and facilitate bond restructuring.¹³² The G-10 agreed to work with emerging market countries and creditors to incorporate standardized contingency clauses¹³³ into debt contracts, and to simultaneously coordinate with the IMF to provide incentives for the adoption of these clauses.¹³⁴ According to the UN Trade and Development Report 2001, however, it is estimated that only half of all outstanding international bond issues (including those issued by the industrial countries) do not include CACs, and that this proportion is even greater for emerging market bonds.¹³⁵

Buchheit and Gulati have stated a number of reasons for the resistance to the inclusion of Majority Action Clauses in sovereign bonds.¹³⁶ First, as long as sovereign borrowers have the expectation of receiving an Official Sector bail-out, they will see no advantage in adopting a debt instrument that could permit a consensual restructuring without the need of a bail-out.¹³⁷ Secondly, some sovereign borrowers may exclude them deliberately to demonstrate to the market that there is no possibility of restructuring.¹³⁸ Third, these provisions facilitating orderly restructuring of debt would only invite casual requests to restructure.¹³⁹ Fourth, including these provisions in their bonds would raise the costs of borrowing.¹⁴⁰ As has been pointed out by the aforementioned authors as well as John Taylor, however, the empirical evidence on the impact of CACs on the cost of international bond financing is inconclusive.

130. *Trade and Development Report*, *supra* note 5, at 143.

131. See Philip J. Power, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 *FORDHAM L. REV.* 2701 (1996).

132. *Trade and Development Report*, *supra* note 5, at 143.

133. This includes Majority Action Clauses, Engagement Clauses, and clauses ruling the process by which a rescheduling or a restructuring would be initiated.

134. See Richard H. Clarida, Remarks at the Conference on The Role of the Official and Private Sectors in Resolving International Financial Crises (July 23-24, 2002), available at <http://www.bankofengland.co.uk/conferences/conf0207/clarida.pdf>.

135. *Trade and Development Report*, *supra* note 5, at 144.

136. Buchheit & Gulati, *supra* note 15.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

Taylor has also suggested that the inclusion of the CACs could be encouraged by making them a requirement for every country that has or is seeking IMF funding.¹⁴¹ Alternatively, it could serve as the basis for lower borrowing costs on loans from the IMF.¹⁴² In the words of Eichengreen and Mody, a combination of moral suasion, regulatory, and financial incentives would be used to encourage lenders and borrowers to adopt these provisions¹⁴³. Further, such incentives would be especially useful to encourage borrowers to swap existing debt with the new clauses.

The year 2003 has been the year that defined the discussion of whether the inclusion of CACs in sovereign bonds is convenient and/or if it would impact on the bond's price. Mexico, Qatar, Egypt, Lebanon, Brazil, South Africa, Korea and Belize are some examples of the countries that decided to include CACs in their bond issuances to simplify future possible restructurings. A clear example that the inclusion of these clauses would not affect the price of the bond is that Brazil's issuance was oversubscribed in a 700%. Moreover, Uruguay closed a comprehensive re-profiling of its foreign currency bonds. All the new Uruguayan bonds include CACs and an aggregation mechanism. This notwithstanding, it should be noted that there are many bonds that are still being traded in the market that do not include CACs or that their payment terms could not be amended because they are subject to New York law.

3. Code Approach

Another outcome of the voluntary market-oriented approach is the "Code Approach." The Code Approach is characterized by a compilation of non-mandatory principles or guidelines suggested by the private sector to apply to sovereign bond restructuring. This approach also promotes the use of CACs by either amending the existing CAC clauses or proposing the inclusion of model CACs in bonds.

The Code Approach has many proponents, which can be broadly placed (in tandem with the bond groups) into two groups: New York Code Approach and U.K. Code Approach. Sovereign bond reorganization is also influenced by principles set out by the Council on Foreign Relations. In its report, "Roundtable on Country Risk in the Post-Asia Crisis Era: Identifying Risks, Strategies, and Policy Implications. Key Recommendations from Working Group Discussions 10/99 - 9/00,"¹⁴⁴ certain principles for sovereign debt

141. Taylor, *supra* note 7.

142. Taylor, *supra* note 7.

143. EICHENGREEN & MODY, *supra* note 39.

144. Barbara Samuels, *Key Recommendations from the Roundtable on Country Risk in the Post-Asia Crisis Era*, COUNCIL ON FOREIGN RELATIONS, available at http://www.cfr.org/pub3810/key_recommendations_from_the_roundtable_on_country_risk_in_the_postasia_crisis_era.php (last visited Feb. 20, 2004).

restructurings are discussed. This report was issued to promote a more predictable restructuring process between private creditors and sovereign states, and was the first significant proposal by the private sector regarding sovereign bonds reorganization. A basic underlying premise of the principles is that the effective techniques in the non-sovereign setting (which operate in the shadow of the applicable insolvency legal framework) could also work in a sovereign setting to which insolvency laws are not applicable.¹⁴⁵ The major characteristics of these principles are: (1) organization of creditors through an ad-hoc steering committee to encourage dialogue; (2) cooperation of the sovereign; (3) retention of professional advisers; (4) coordination with the Paris Club; (5) sharing of information among the parties; (6) voluntary stay of legal action; and (7) changes in bond documentation (including CACs and representation clauses).¹⁴⁶

Two main characteristics are particularly relevant. First, the voluntary stay of legal action is important given that the IMF has determined that there would be no written agreement that would legally preclude creditors from taking action.¹⁴⁷ Therefore, a critical question is whether such an approach would be effective with a large number of creditors, some of whom may be less interested in a collective negotiating process and more inclined to initiate litigation against the debtor to secure a restructuring on preferential terms.¹⁴⁸ Second, the coordination with the Paris Club is important because the principles provide that “all relevant private and Paris Club debt should be included in any restructuring in a manner that fairly represents each creditor group’s position with respect to the sovereign.”¹⁴⁹ Although the principles indicate that the Paris Club should be included together with other private creditors, no definitive position has been adopted in this regard. Further, the principles make no mention on how to coordinate private creditors.

Under the U.K. Code Approach, INSOL International (a worldwide federation of national associations for accountants and lawyers who specialize in turnaround and insolvency) drafted the “INSOL Lenders Group Global Principles for Multi-Creditor Workouts.”¹⁵⁰ The major characteristics of INSOL’s principles are: (1) creditors’ cooperation (through a standstill period and a litigation stay); (2) sovereign’s cooperation (refraining from taking any action which might adversely affect the prospective return to relevant creditors); (3) creditor’s coordination (one or more representative

145. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 18.

146. *See id.*

147. See Krueger at note 4; IMF PROPOSALS FOR A SOVEREIGN DEBT, *supra* note 6; IMF BOARD DISCUSSES FEATURES OF SDRM, *supra* note 32.

148. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59, at 22.

149. *Id.* at 19.

150. *See* INSOL INTERNATIONAL, *supra* 25.

coordination committees and professional advisers' appointment); (4) sharing of information to be treated as confidential; (5) proposals and inter-creditor agreements to reflect applicable law; and (6) priority status to additional funding.¹⁵¹

The New York Approach is comprised of the Code of Conduct for Emerging Markets (CCEM) and a model set of CACs under New York law and English law.¹⁵² The CCEM represents a more comprehensive approach to strengthening the framework of emerging markets' finance, including, but not limited to, debt restructuring when debt levels have become unsustainable.¹⁵³ The CCEM outlines the respective roles that key parties would be expected to play in emerging markets' finance, particularly during times of crisis.¹⁵⁴ The CCEM's background statement clearly states its purpose:

[T]his approach rests on the premise that all participants, whatever their roles and responsibilities, share a basic interest in promoting greater financial stability and growth in emerging markets. It reaffirms a commitment by all parties to strengthened crisis prevention, promotes debtor-creditor consultations before problems become unmanageable, and envisions the incorporation of marketable clauses in sovereign bond contracts that could help to make the restructuring process more flexible. Furthermore, this approach explicitly recognizes that market participants accept full responsibility for their investment and lending decisions in emerging markets and that they do not expect "bail outs" from the official sector. This approach also takes into consideration the issue of aggregation of voting rights and addresses this through proven market practices on a case-by-case basis.¹⁵⁵

Even if the success of the CCEM's efforts is questionable because there is no common superior authority, the approach is instructive. Banks have made clear that they are willing to take responsibility for the restoration of financially weak private sector enterprises.¹⁵⁶ While there is much common ground in these three private initiatives, there are significant differences and much work to be

151. *Id.*

152. The New York Approach was created by a group of creditor associations, formed by the Emerging Markets Creditors Association; Emerging Markets Trade Association; Institute of International Finance; International Primary Market Association; International Securities Market; Association Securities Industry Association; and, the Bond Market Association.

153. See Draft of Letter from Michael Chamberlin et al. (various creditors association) regarding their discussion draft Marketable Bonds Package, Annex B, A Code of Conduct for Emerging Markets (Jan. 31, 2003), available at http://www.emta.org/ndevelop/Final_merged.pdf (last visited July 14, 2003).

154. *Id.*

155. *Id.* at Annex B.

156. Christoph G. Paulus, *Some Thoughts on an Insolvency Procedure for Countries*, 50 AM. J. COMP. L. 531 (2002).

done. This notwithstanding, the most important issue of the Code Approach is that if these principles or codes of conduct are adopted, the sanction will not be a statutory one - it will be a moral applied by the market players. The disciplinary effect would be the same or even tougher than any legal measure that is not enforced due to a matter of international comity. Although bonds will be easier to restructure due to the inclusion of the CACs and the guidelines of the CCEM, emerging market investors will have to take steps to prevent its excessive use or misuse.

4. *Voluntary-Contractual: "Two-Step" Sovereign Debt Restructuring*

The 100 percent requirement in New York law bonds is intentional,¹⁵⁷ and has tended to result in exchange offers rather than amendments for most recent sovereign bond restructurings.¹⁵⁸ As a result, sovereign states have had to create new instruments to attract creditors and have used exit consents to avoid holdouts (such as those recently seen in the Ecuadorian Crisis). In its intent to create new instruments, the Market-Oriented Approach developed into a new proposal known as "two-step" sovereign debt restructuring.¹⁵⁹ The rationale behind this proposal is to provide a market-based framework in a world without an international bankruptcy law for sovereign debt restructuring.

The major aims of the two-step approach are: (1) to restructure the debt under terms that are sustainable over time; and (2) to minimize the length of time between default and restructuring. The steps can be summarized as follows¹⁶⁰:

STEP 1: Align creditors' interests and commit them to an expeditious debt re-negotiation; and,

STEP 2: Implement the terms of the agreed re-negotiation.

In the first step, an intermediate restructuring instrument such as an Interim Debt Claim (IDC) should be created. An IDC will align investors' interests and provide a legal mechanism for collective action, sharing, and representation. The actual restructuring will come in the second step when the IDCs are exchanged for new bonds.¹⁶¹ The success of the first step will depend on the participation rate. Therefore, a cash incentive should be offered.¹⁶² This amount would then be deducted from the face value of the IDC. Exit consents would be used to remove non-financial covenants from the defaulted bonds to induce creditors to accept the terms of the

157. This 100 percent requirement is perplexing to many academics and official sector policymakers.

158. Chamberlin, *supra* note 73.

159. BARTHOLOMEW ET AL., *supra* note 26.

160. *Id.* at 1.

161. *Id.* at 3.

162. Cash incentives may include accrued interest up to the time of default or an additional amount up to 5 percent of the par value of the claim.

IDCs exchange offer. In addition, the IDCs would include CACs in order to enable a friendly restructuring. Both mechanisms would work together with the IDCs to promote a bond exchange.

As proposed, the IDCs would not pay interests in cash; instead, they would accrue and capitalize interest until the definitive exchange offer (under Step 2) is implemented.

To avoid trapping IDC holders in a perpetual security without the normal recourse available to bondholders, IDCs should have a very short nominal maturity (perhaps six months). While a negotiated settlement might well take longer, this nominal maturity would serve to give IDC holders (collectively) legal parity with other bondholders in terms of recourse to international courts.¹⁶³

It is unclear if in the bond-IDC exchange the bondholders are waiving their right to sue the defaulted sovereign state. It is also unclear whether the bondholders recover their rights in accordance to the terms of the bond or the IDC.

The second stage will take place after the terms of a definitive exchange offer are agreed upon during the interim period of the IDCs. The parties to the offer would be the defaulted sovereign state and the creditor committee.¹⁶⁴ Holdouts that did not participate in the first stage would be able to accept the terms of the exchange offer, but would neither receive the cash incentive nor more beneficial terms than the ones offered to the IDC holders.

The adoption of the two-step restructuring leads to a number of questions that must be addressed. They are summarized as follows:

- (1) Bondholders' rights would be diminished by the bond-IDC swap.
- (2) The two-step approach still remains untested. Will the Argentinean example represent the acid test for the new approach?¹⁶⁵
- (3) If in the end, the two-step approach can be summarized as a double exchange offer, would it be easier to accomplish the goal in only one step by using the amendment clauses of the bonds without diminishing creditor's rights?
- (4) Will it be appropriate to use a technique that is based on the following inconclusive assumptions:
 - that the bondholders participation rate in the first stage will be very high;
 - that the sovereign state will have some funds from the cessation of its debt service payments to pay accrued interests and the 5 percent face value

163. BARTHOLOMEW ET AL., *supra* note 26.

164. In accordance with this proposal, a ratification of these terms by a super majority is required.

165. Miller, *supra* note 18.

- payment in advance;
 - that there will be a secondary market of IDCs from a defaulted country; and
 - that the sovereign state will agree to a reform program with the IMF, including an assessment of a sustainable debt profile to define the scope of the restructuring menu for the second stage.
- (5) There is a lack of definition on how the waiver of the right, if any, to sue would be implemented.
- (6) Also unsettled is whether payments on the new bonds can be protected from attachment so that the sovereign might be able to delay resuming payments on the un-restructured debt for monitored period of time.¹⁶⁶
- (7) A final issue is what happens after the bond-IDC swap is performed and no agreement is reached with the committee or if not enough IDC holders accept the terms of a unilateral exchange offer.

III. SUBSTANTIAL SOVEREIGN DEBT RESTRUCTURING: THE CONVENTIONAL METHOD

The debt management techniques developed in the wake of Mexico's announcement of a moratorium on repayment of foreign currency debt in August 1982 have been applied, with certain variations, by more than a dozen countries. These techniques have now taken on a heavy mantle as the "conventional" restructuring techniques.¹⁶⁷

During the past two decades, many Latin American nations were dubbed "emerging nations" and given loans to enable them to strengthen their economies.¹⁶⁸ Since the time of Mexico's request for help, most of Latin America has followed suit. Argentina, Brazil, Chile, Costa Rica, Cuba, the Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Nicaragua, Panama, Uruguay, and Venezuela have all sought restructurings. Bolivia has gone one step further and suspended payments of principal and interest since mid-1984.¹⁶⁹ Peru took a different path and allocated a fixed amount of foreign exchange for debt service.¹⁷⁰

Unfortunately, "the history of sovereign lending is the history of sovereign default."¹⁷¹ Even countries that had applied the techniques

166. BARTHOLOMEW ET AL., *supra* note 26, at 8.

167. Buchheit, *supra* note 9.

168. Jessica W. Miller, *Solving the Latin American Sovereign Debt Crisis*, 22 U. PA. J. INT'L ECON. L. 677, 708 (2001).

169. Anthony Mauger, *Sovereign Debt Restructuring: The Practical Background*, 1 J. INT'L BANKING L. 100 (1986).

170. *Id.*

171. LUISA PALACIOS, SOVEREIGN DEBT DEFAULTS AND RESTRUCTURING IN EMERGING

developed in the Mexican crisis have defaulted again. A clear example of this paradigm is Argentina, who has indebted itself several times and has entered into several restructuring procedures until the recent 2001-2002 crisis that finished with the workable fiction of the conventional debt restructuring. Argentina's example proves that their techniques were not working, and that the conventional techniques are virtually exhausted. Other clear examples include Mexico, Brazil, Chile, and the Philippines.

The conventional techniques are based on providing debt service relief through a combination of (1) rescheduling principal; (2) working an interest relief, and (3) new money infusion. After a country's announcement of default, moratorium or standstill on the repayment of the debt, the maturity of principal is normally rescheduled on a medium to long-term period. The conventional technique assumes that while debtor nations can almost indefinitely defer repaying principal on commercial bank debt, interests must be kept current.¹⁷² As such, many banks' policies were influenced by the regulatory and accounting regimes under which they operate because the banks are required to ensure that interest payments could be made in order to avoid having to write off the debt. Due to regulatory and accounting rules, if interest payments are not made within ninety days of due dates, the debt should be declared non-performing. The banks, therefore, had no choice but to adopt a policy that would ensure uninterrupted interest payments.¹⁷³ The issue then is whether it is necessary to follow the conventional technique in cases like Argentina, where the majority of the debt holders are unsophisticated investors? Besides the "sacrosanct" characteristic of the interests to commercial banks that will not give too much maneuvering space, requiring interests payments to remain current may drain an alarming amount of the country's foreign currency earnings and leave little to finance the economic recovery necessary to restore sustainable debt service capability.¹⁷⁴

The quota of new money infusion is normally established by the execution of loan agreements with multilateral organizations such as the IMF, World Bank or Inter American Developing Bank (or through a syndicated loan with a group of banks). These agreements cover the gap of payment shortfalls and external financing until the economy strengthens. Between the evils of making an involuntary loan to a less-than-creditworthy borrower or allowing existing loan assets to slip into the "non-performing" category, most banks tend to

MARKETS: A PRELIMINARY REVIEW, JBIC INSTITUTE (JULY 2002) (quoting Vincent Truglia, Moody's (Oct. 23, 2000)), available at www.jbic.go.jp/japanese/research/report/working/pdf/wp06-e.pdf. (last visited July 14, 2003).

172. Buchheit, *supra* note 9.

173. Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305 (1995).

174. Buchheit, *supra* note 9.

prefer the former.¹⁷⁵ Currently, some of the more pragmatic institutions publicly recognize that international banks will have to carry refinanced debt for several years as well as contribute new loans to sovereign borrowers until more stable payments positions are achieved.¹⁷⁶ Without new money, it is difficult to see how banks could have continued receiving interest in certain financially constrained countries in recent years, but such agreements are beyond the scope of this article.

A. ALTERNATIVE TECHNIQUES: THE “INNOVATIVE APPROACH” TO DEALING WITH INTEREST SERVICE SUSTAINABILITY

The conventional restructuring technique of rescheduling interest and principal maturities might bring “immediate” relief. After several more rounds of rescheduling, however, it became apparent that the rescheduling policy was not a long-term solution to debt crises. By borrowing new money to pay down accrued interest, the debtor countries had merely increased their debt burden without improving their economic health.¹⁷⁷ For example, if a government following a conventional program finds itself without sufficient foreign exchange to finance its economic recovery program, the government may have only four options:¹⁷⁸

- (1) default on interest payments owed to foreign creditors;
- (2) borrow an amount equivalent to a portion of current interests payments through a new money arrangement;
- (3) borrow an amount equal to current interest payments using a mechanism other than a new money arrangement; or
- (4) discharge the current interest obligations by giving lenders some alternative consideration *in lieu* of immediate payments in foreign currency.

For example, Argentina has undergone these four alternatives on numerous occasions.¹⁷⁹ Prior to the most recent default of interest payments’ announcement on December 23, 2001, Argentina had executed a stand-by credit arrangement with the IMF dated March 10, 2000, for the agreed amount of 16.9 billion. Between January 1, 2000, and September 18, 2000, Argentina also issued (or received commitments for) 18.9 billion of debt to discharge current interest obligations. Approximately 8.4 billion of the total 18.9 billion was debt issued under exchange offers. The rest was issued as dollar-denominated global bonds, euro-denominated bonds, and yen-denominated bonds. This illustrates that interest payments in foreign

175. *Id.*

176. Mauger, *supra* note 169.

177. Power, *supra* note 131.

178. Buchheit, *supra* note 9.

179. Prior to default on interest payments owed to foreign creditors, Argentina used the options in (2), (3), and (4).

currency are the major problem when using conventional techniques.

That the conventional technique has become ineffective is evidenced by Argentina's case that has been described, "to be in a kind of a financial coma."¹⁸⁰ Argentina has been depleting its foreign currency reserves to avoid default and a collapse of the restructuring program, but in the process its reserves have fallen below the level necessary to finance economic recovery. Thus, Argentina's case establishes Buchheit's contention that while debtor countries do not actually die using this technique, very few have returned to health.¹⁸¹ Rather than simply avoiding default or collapse of its restructuring program, the objective of restructuring Argentinean debt should be to prevent interest payments from putting the country in a "financial coma." For example, innovative ideas, such as indexing with the price of commodities (a technique that has been used successfully in the restructuring of syndicated loans) might be successfully applied to Argentina.

B. PROPOSED ALTERNATIVE TECHNIQUES FOR DEALING WITH THE INTERESTS: INDEXED INTERESTS

A country without adequate foreign currency earnings may be unable to service interest payments due on its debt.¹⁸² Interest indexing would only enable the country to avoid default and to achieve debt sustainability levels. Two options to create an interest index are illustrated below:

- (1) A country that depends heavily on one or two primary commodity exports for its foreign currency earnings may seek to link the payable interest amount to the prevailing world market price of that commodity.¹⁸³
- (2) A country may create an index to calculate the interest based on its trade deficit.¹⁸⁴ The interest rate should move inversely in relation to the movements in the trade deficit. The annual percentage variations in trade deficits would then be taken into account, based on official data on the import and export activity of the country. If the trade deficit decreases (implying an increase in the net exports), the interest rates would increase or decrease proportionately. For example, if the trade deficit decreases, interest rates would increase by a

180. Buchheit, *supra* note 9.

181. Of note, the Argentine crisis is different than all other crises regarding bond issuance because there are more than 700,000 bondholders, many of them retail investors (unsophisticated bondholders). Market confidence, therefore, is a primary issue.

182. Buchheit, *supra* note 9.

183. This was the case of Mexico in 1986, whose financing program contained two financing mechanisms that were directly or indirectly linked to the price of oil.

184. We would like to thank our learned friend Ioannis Kokkoris for his time spent with us discussing different alternatives to obtain a sustainable interest and for his contributions in this regard.

maximum of 25 percent of the percentage decrease in the trade deficit.

To negate the effect of exchange rate fluctuations and any contagion effects of trade with the neighboring countries on the calculation of the interest rate, a common denominator such as the U.S. Dollar or the Euro should be used. Although this would have the positive effect of safeguarding against possible factors of instability, which ensures the bondholder's proceeds and sustainability of debt, it also has the negative effect in that not all the proceeds from a change in trade deficit will be represented in the accompanying change in interest. In addition, because the imports and exports to the United States or the European Union are arguably to be more stable in comparison to other trading countries, sudden and unprecedented variations in the volume of the trade deficit are unlikely. Hence, we have a trade off between increased but unstable interest payments indexed by taking into account the total amount of imports and exports (the total trade deficit), or a reasonable and secure future continuous flow of interest payments.

The crucial aim of restructuring is not to withdraw the valuable resources necessary for the sustainable development of a financially-distressed country, but to assist it in achieving debt sustainability for future economic development while simultaneously protecting the interest of the bondholders. To ensure the success of these proposals, the interest rate should be fixed at an optimal rate to ensure sustainability, taking into account factors such as short and long term interest rates, the relationship between inflation rate, nominal rate, and real interest rate. Although these procedures may not seem favorable to the bondholders initially, and there might be significant resistance in applying it, the rationale behind this mechanism of computing interest payment is the betterment of the economic and financial health of a distressed sovereign state. This proposal might open a negotiation window that may be completed with a minimum and maximum cap. Keeping in mind the current economic scenario, however, the use of a minimum interest cap could again lead to an unsustainable situation. Even so, it may be a risk worth taking in the long run in comparison to the probability of immediate liquidity and an increase in exports. In the particular case of Argentina, the viability of the proposed indexing alternatives should be analyzed with the following factors in mind:

- the restructuring procedure would include additional money injection;
- the current value of the Argentine Peso makes Argentine products more competitive in the international market; and,
- the reduction of trade barriers among the MERCOSUR countries has led to an increase in exports of Argentine products (with Brazil being the major importer of

Argentine products).

Data from the Argentine Economic Ministry lends support to our proposals. It indicates that during the first four-month period of 2002, the total amount of exports was USD 7.8 billion while the total amount of exports for the same period of 2003 was USD 8.8 billion; implying that there was an 11.25 percent increase in exports.¹⁸⁵ At the time of negotiations for ascertaining the minimum cap of indexing, however, the government and the debt holders should take into account objective criteria, such as the weighted average over a period of time, to minimize the possibility of unsustainable debt service and defaults.

IV. CURRENT TRENDS

A. MEXICO AND BRAZIL'S 2003 ISSUANCE OF BONDS

A new trend is emerging in 2003 with the bond issuances of Mexico and Brazil. Mexico has sold a total amount of 5.5 billion in bonds and became the first sovereign to sell a bond with CACs when it issued a 1 billion bond in February 2003. In comparison, Brazil issued a three-year, eight-month, 1 billion bond, yielding 10.9 percent with a 10 percent coupon. This bond was nearly seven times oversubscribed. The importance of this bond, as well as Mexico's bond issued in February 2003, is that they bear CACs. Even so, the bonds differ significantly; the Mexican bond requires a 75 percent super majority while the Brazilian requires 85 percent in each series.¹⁸⁶ Brazil declined to follow the super majority percentage because the market was expecting a standardized 75 percent threshold to change the payment terms on any bond. After all, this is what Mexico (considered a trail-blazer) had done, what Uruguay had put into its own exchange offer, and what the G-7 countries had said they would do in their own issuance.¹⁸⁷

The EMTA reacted against Mexico's issuance, arguing that an 85 percent super majority would better reflect the intention of the bondholders. Brazil, however, is adhering to a stricter standard by increasing the required super majority by 10 percent as well as

185. Information obtained from the Argentine National Institute of Statistics and Censuses (INDEC) which is the technical government agency responsible for the coordination and supervision of all public statistical activities taking place in the Argentine territory. INDEC regularly elaborates and compiles social and economic indicators and produces other basic statistical information. For more details see <http://www.indec.gov.ar>.

186. Anne O. Krueger & Matthew Fisher, *Building a Decade of Experience: Crisis Prevention and Resolution*, Prepared for the Centre for the Study of Globalization and Regionalization Conference: *International Financial Crises: What Follows the Washington Consensus?* (Jul. 11-13, 2003), University of Warwick, available at http://www.warwick.ac.uk/fac/soc/CSGR/Conf_6/Papers/Fisher.pdf (last visited Feb. 21, 2004).

187. F. Salmon, *Brazil Goes Off on a CACs Tangent*, 34:410 EUROMONEY 156 (June 2003).

requiring the higher percentage in each of the outstanding series. The use of CACs is a trend that should be followed in order to restructure sovereign debt in an orderly manner. Conversely, if more countries follow Brazil's lead and go with an 85 percent CACs, they could actually be making it harder, rather than easier, to restructure their debt, thereby defeating the whole purpose of introducing CACs in the first place.

B. URUGUAY'S DEBT RE-PROFILING

Uruguay's restructuring plan, completed on May 29, 2003, has been aptly described by Alan Beattie as one that is almost straight out of the U.S. Treasury Wall Street Rulebook of "voluntary market-based" solutions.¹⁸⁸ Alejandro Atchugarry, Minister of Economy and Finance of Uruguay, has stated that the terms of this debt re-profiling reflect extensive consultations with the market.¹⁸⁹ This restructuring is of paramount significance because it is the first time that a sovereign has replaced all its bonds with new ones that bear CACs.¹⁹⁰

Uruguay had 18 series of bonds issued in the international markets, denominated in U.S. dollars, Euros, Yen, Sterling and Chilean Pesos, of which approximately a 50 percent was held by residents of Uruguay. In short, the Uruguayan debt stock was fragmented and dispersed; characteristics that are shared by the debt stocks of many other emerging market sovereign borrowers¹⁹¹.

The restructuring, comprised of an international exchange offer and a domestic exchange offer along with the amendment of a Samurai bond (Yen-denominated bond issued by non-Japanese entities), resulted in the successful restructuring of more than 90 percent of the country's 5.2 billion outstanding foreign currency bonds.¹⁹² The international exchange offer invited the holders of eighteen bonds, including Uruguay's Brady bonds denominated in four currencies and governed by U.S. and U.K. law, to exchange their bonds.¹⁹³ The exchange was generally at par and at the same coupon rate¹⁹⁴ for new bonds of Uruguay with either an extended maturity bond (Maturity Extension Alternative) that deferred the

188. See Alan Beattie, *Uruguay Provides Test Case for Merits of Voluntary Debt Exchange*, FIN. TIMES, Apr. 23, 2003, available at <http://www.globalpolicy.org> (last visited July 16, 2003).

189. *Uruguay Announces Debt Exchange Offer*, BRADYNET FORUM, Apr. 10, 2003, available at <http://www.brady.net.com/bbs/uruguay/100012-0.html> (last visited July 16, 2003).

190. See John Barham, *Cooking Up a New Solution*, LATIN FIN., June 1, 2003, at 10.

191. Lee C. Buccheit & Jeremiah S. Pam, *Uruguay's Innovations*, draft on file with the authors, a Spanish version of this article has been published on La Ley, Nov. 26, 2003.

192. See *Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring*, CLEARLY GOTTLIEB NEWSWORTHY (May 29, 2003), available at www.cgsh.com (last visited July 16, 2003).

193. *Id.*

194. *Uruguay Announces Debt Exchange Offer*, *supra* note 189.

maturity date by five years or one of three benchmark bonds (Benchmark Bond Alternative) that offered greater liquidity.¹⁹⁵ The new securities were offered as part of the international offer described in a Prospectus and a Prospectus Supplement, each dated April 10, 2003,¹⁹⁶ that had been filed with the U.S. Securities and Exchange Commission.¹⁹⁷

The offer also solicited optional “exit consents” or the “Check the Box Exit Consents” that received strong support from participating bondholders and authorized the amendment of seventeen of the eighteen old bonds to carve out money streams for payment on the new bonds from the waiver of immunity under the old bonds.¹⁹⁸ The offer had proposed that the use of exit consents be made separately under each series of eligible bonds in connection with a closing of the transaction. The amendments were to become effective for any series only if they were approved by the holders of a majority of the principal amount of the bonds outstanding under that series and if a closing occurs under the offer.¹⁹⁹

In separate but cross-conditioned transactions, Uruguay conducted a domestic exchange offer on terms similar to the international offer and asked holders of Uruguay’s Samurai bond, which contained a collective action clause allowing changes to payment terms with the consent of 66^{2/3} percent of holders voting at a meeting, to amend its payment terms to extend the maturity date.²⁰⁰ Uruguay’s new bonds were issued under a trust indenture rather than the more typical fiscal agency agreement. Following the U.S. trust indentures, enforcement rights were centralized in the trustee except in the case of payments that are not made on their regularly-scheduled dates, for which each bondholder can sue individually.²⁰¹

The new bonds contain collective action provisions that permit a modification to the payment terms of any single series of new bond with the consent of the holders of 75 percent of the aggregate principal amount of that series.

Uruguay’s version of CAC’s also included an “aggregation” mechanism by which a proposed amendment to a payment terms of two or more series of bonds will become effective for a particular series if approved by (i) holders of 85% of the aggregate principal amount of all affected series and (ii) 66^{2/3}rd % of that specific series²⁰². This transaction marks the first time that such a provision

195. *Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring*, *supra* note 192.

196. A copy of the prospectus is available at the website of Banco Central de Uruguay, at <http://www.bcu.gub.uy/autoriza/sgoioi/reperfilamiento/reperfilamiento1.htm>.

197. *Uruguay Announces Debt Exchange Offer*, *supra* note 189.

198. *Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring*, *supra* note 192.

199. *Uruguay Announces Debt Exchange Offer*, *supra* note 189.

200. *Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring*, *supra* note 192.

201. See Buchheit & Pam, *supra* note 191.

202. *Id.*

for aggregated voting, designed to facilitate future restructuring, has been used by a sovereign issuer, and the first time that payment terms of a sovereign's Samurai bond have been amended under Japanese law using a collective action clause.²⁰³

Although the Uruguayan case could be a blueprint for Argentina, Gulati points out that Uruguay is a small country and its bonds represent a sliver of most bond indices, so its debt restructuring process would not necessarily set a precedent.²⁰⁴ A significant Argentine issue would be necessary to really establish a new standard for CAC bonds.²⁰⁵ Even so, Uruguay is the largest sovereign debt issue under New York law with CACs.

C. ARGENTINA: IS THERE AN OPTION FOR THE CREDITORS AND THE SOVEREIGN?

Although default has been a common characteristic in developing countries, and no one is exempt.²⁰⁶ Argentina has a long history of financial mismanagement and has repeatedly been in default.²⁰⁷ For example, it defaulted in 1982, restructured its Brady bonds in 1992, and defaulted again in 2000. Many wonder if it will restructure or default again in 2012?

The Argentine crisis presents the problem of having to resolve the biggest sovereign debt default in history. Argentina has issued 152 series of bonds, in 7 different currencies and subject to 8 different laws (not being able to amend the payment terms in all of them). In accordance to the Argentine Government, the total outstanding capital is USD 87,050. Almost 45 percent of it is held by retail investors while the remaining 55 percent is held by institutional investors.

Thus, the issue that we are confronted with is determining which would be the best approach to follow to resolve the crisis: the SDRM (New York Approach) or one of the Voluntary Contractual Approaches (London Approach) such as the Status Quo Approach of using CACs and exchange offers, the Decentralized Market Centered Approach, the Code Approach, or the Two-Step Restructuring Approach? Moreover, how should any approach resolve the crisis with an orderly and timely restructuring?

Given that Argentina has already defaulted, the Uruguayan debt re-profiling is not a workable solution. The SDRM, however, may

203. *Uruguay in Groundbreaking \$5.2 Billion Debt Restructuring*, *supra* note 192.

204. Barham, *supra* 190, at 13 (quoting G. Mitu Gulati).

205. *Id.*

206. Even the United Kingdom and France defaulted during the Great Depression of the 1930s.

207. Jorge Guira, *Latin America at Undue Cost and Risk? The Brave New World of Sovereign Debt. Restructuring and its Private Sector Counterpart*, in YEARBOOK OF INTERNATIONAL AND FINANCIAL AND ECONOMIC LAW (1999).

not be the solution either. The SDRM proposed by the IMF has not yet been drafted and its implementation is questionable. In addition, it would “require a new international bankruptcy bureaucracy, a change in national laws to override traditional creditor remedies and a surrender by sovereign debtors of authority over the issues that will immediately affect the sovereign’s handling of its economic and financial affairs.”²⁰⁸ Going through a bankruptcy proceeding is not a possible solution for a sovereign state in the absence of a SDRM.

In comparison, the Code Approach has not been as widely accepted as would have been anticipated. Although, it might be a prospective solution if its proponents are able to develop it as a more coherent and cohesive code to replace the numerous approaches that are currently being considered, in its current situation, however, it does not offer a solution to the current crisis. The Two-Step Restructuring Proposal may not be a workable solution, as the double unilateral exchange offer would only dilapidate time and resources. Further, Argentina’s situation is critical and the authors of the proposal themselves recognize that “developing the appropriate documentation might take some time.”²⁰⁹

As it stands now, the Republic of Argentina is facing unsustainable financial difficulties in servicing its existing external debts, and “the official sector lenders have been increasingly reluctant to pour fresh money into a country only to see those funds flush out again to repay in full and on time, private sector creditors.”²¹⁰ Therefore, we propose the solution has to be founded on the status quo Voluntary Contractual Approach combined with creative improvisations of alternate techniques and analogous mechanisms. Specifically, the restructuring should be done through a Voluntary Contractual Approach by the use of CACs and exit consents as was done in the cases of the Ukraine and Ecuador. Due to the time elapsed, Argentina has no other choice than to perform an exchange offer using the hybrid mechanism and exit consents developed in restructuring the sovereign debt of the Ukraine and Ecuador, respectively. Moreover, in the event that DIP financing could be obtained, it would prevent moral hazard and would develop an inter-creditor relationship. The Argentine Government and bondholders should bear in mind that it is not the principal, but the interest payments that are causing the debt unsustainability problem. Therefore, we are of the opinion that interest rates should be computed by a mechanism such as the one proposed in this article, which would ensure debt sustainability and prevent future defaults.

208. BUCHHEIT, *supra* note 3.

209. BARTHOLOMEW ET AL., *supra* note 26, at 4.

210. Buchheit & Gulati, *supra* note 15.

V. CONCLUSION

In conclusion, we are of the opinion that the innovative use of the voluntary and contractual terms of the bonds, in conjunction with the alternate techniques (used in syndicated loans or Chapter 11 of the U.S. Bankruptcy Law) of calculating interests and DIP financing as described above, would serve the same objective of an orderly restructuring as proposed by the SDRM, and thereby preserve the mechanisms of an independent market. The aim of sovereign debt restructuring is to protect creditors and achieve debt sustainability by means of an orderly process. Thus “[a]n issue that now confronts the international community is whether there is a case for trying to establish broad parameters concerning the process by which bonds are restructured”²¹¹.

The current Argentine proposal of a 75 percent hair-cut in the nominal value is not a workable solution. Additionally, if the Argentine Government persists with its original proposal of paying only 25 percent of the nominal value it would not obtain the required majorities under New York law to amend the terms of the bonds and the whole restructuring would not be achieved. Argentina’s default and reluctance to restructure its debt led so far to two landmark developments.

First, the certification of the class action that we have previously mentioned, and second pertains to the interpretation of the *pari-passu* clause. In 2000, Elliot Associates L.P. obtained a restraining order from a Brussels’ Court of Appeals²¹² for preventing the payments that were going to be done by Peru, grounded on the violation of equal treatment (*pari passu* clause). In 2003, another court in Brussels ruled in a similar way against Nicaragua.²¹³ On January 13, 2004, upon the memorandum of law of Argentina and the plaintiffs, the US Statement of Interest and the *amicus curiae* briefs filed by the Federal Reserve Bank of New York and the New York Clearing House, a New York court was asked to resolve the *pari passu* issue for the first time in the US. Should the Argentine Government continue paying international organisations such as the IMF or other non-defaulted unsecured creditors as the holders of domestic bonds? Although the court did not resolve the *pari passu* issue, the plaintiffs had to sign an agreement giving the court 30 days notice before filing papers intended to stop such payments under the *pari passu* clause. Although the core issue was not resolved, an order was issued by the court ordering Argentina to divulge information about government property outside the country that is used for commercial purposes: a

211. IMF RESTRUCTURING INTERNATIONAL SOVEREIGN BONDS, *supra* note 59.

212. Elliot Associates, L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000).

213. LNC v. Republic of Nicaragua, a French version is available at www.emta.org/ndevelop/nicaragua.htm (last visited Nov. 7, 2003).

discovery measure.

Not having restructured Argentina's debt, the international agenda has already started focusing on Iraq's debt. After Iraq, there would be another sovereign default and then another one, so it is our challenge to create innovative solutions to restore liquidity and to protect investors.