

WHEN COUNTRIES GO BUST: PROPOSALS FOR DEBTOR AND CREDITOR RESOLUTION

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I. INTRODUCTION

FOR THE PAST 50 YEARS debt has been the largest source of capital for developing countries. The total external indebtedness of developing countries at the end of 1999 amounted to \$2.6 trillion – representing about 42.5% of their GDP that year. Of this total, governments (and their taxpayers) guarantee 75% or \$2.2 trillion of the long-term foreign debt owed.¹ Despite the enormous sums of money being lent out to the developing world and guaranteed by the governments of wealthy nations, to date, there is no orderly international framework to coordinate sovereign defaults. As such, restructuring is proving to be increasingly costly for both creditors and debtor nations. The need for such a framework is becoming progressively more relevant with the proliferation of sovereigns defaulting on their loans. Without an orderly restructuring framework in place, lenders or investors are holding on to their money and foreign capital is drying up fast for emerging markets.

On December 23, 2002, Argentina's President, Adolfo Rodriguez Saa, declared a moratorium on the country's \$155 billion public foreign currency debt.² Although this sum accounts for the biggest default in history, the Argentinean case is certainly not a new occurrence in international sovereign debt financing nor will it be the last.

In fact, the whole region is in economic trouble; Brazil's default was staved off by a \$30 billion IMF loan in August 2002 (the IMF's biggest loan to date), meanwhile Ecuador and Columbia are both in trouble as well. This economic turmoil has cut off most countries in the region from accessing the international capital markets that once afforded them the largest source of foreign income – albeit by way of loans. As illustrated in Table 1 below, foreign capital is drying up fast: Latin America will only

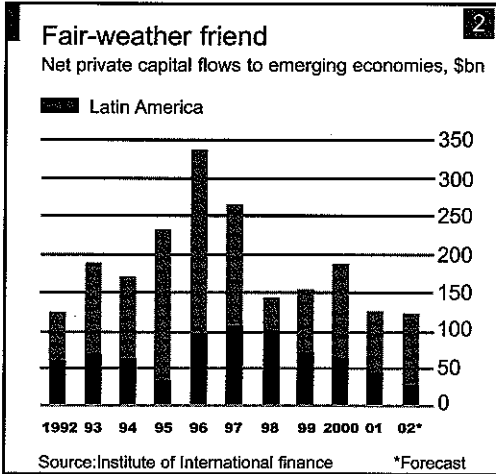
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¹ "Sovereign Debt Restructuring" Economic Strategy Institute and Derivatives Study Center, online: <<http://www.econstrat.org/dsc%20sovdebt.htm>>.

² "Argentina's Default, Foreign Creditors Join The Pyre" *The Economist*, (January 3, 2002).

receive \$29 billion of net private capital inflows for 2002, compared with \$45 billion the previous year and \$106 billion five years ago.³

TABLE 1⁴



incentive takes the form of high interest rate payments. As a result, lenders are forced to increase interest rates to cover potential losses. The reality is that debtors are increasingly unable to pay these creeping interest rates and - as Table 1 illustrates - the result has been that lenders are less willing to part with their money.

Additionally, the nature of creditors and capital markets has changed in the last three decades moving from syndicated bank loans to traded securities held by private investors. A syndicated loan is a commercial bank loan in which a number of banks participate. The loan is negotiated by a small group of "lead banks", which then in effect sell parts of the loan to other banks. As such, syndicated bank loans meant that sovereigns dealt with a manageable number of creditors or "lead banks" in a given legal jurisdiction - commonly operating under U.K. or U.S.⁵ law. With the advent of traded securities, sovereigns increasingly issue debt to

³ "The IMF, Doubts Inside The Barricade" *The Economist* (September 26, 2002).

⁴ Ibid

⁵ This definition is based on David Woodward, *Debt, Adjustment and Poverty in Developing Countries, National and International Dimensions of Debt and Adjustment in Developing Countries*, Pinter Publishers London, 1992 - in association with Save the Children and the World Bank's *Global Development Finance 2000*, online: <<http://www.jubilee2000uk.org/databank/glossary.htm>>.

a diverse and diffuse group of creditors in a range of legal jurisdictions, using a variety of different lending instruments.

Private creditors or bondholders (as compared with syndicated banks) often have different time horizons for their investment, different aversions to risk and will react differently between sovereigns in a debt restructuring process.⁶ Illustrating the diverse nature of bondholders is a group of Italian retail investors who pleaded with the Argentinean economy ministry that their bonds be stretched out over ten years with full principal and interest paid.⁷ The Italian bondholders have a right to repayment of their loans, as do other bondholders. However, not all creditors are similarly situated and the Italian's concerns and restructuring proposal are certainly not the voice of the majority. Yet, if they so choose, they are in a position to hold out for full payment and derail the restructuring process (the mechanics of holdouts is discussed in greater detail below). The potential for "holdouts" or "free riding" is a major obstacle for an efficient sovereign debt restructuring process.

There has been a shift in lenders from capital markets predominantly composed of syndicated banks to one that is composed of bond holders. This shift is a positive development in that it expands sources of sovereign financing and diversifies risk. With the advent of bonds, sovereigns are no longer relegated to obtaining funds from international financial institutions (IFIs) such as the IMF, World Bank and other developed countries. Sovereigns looking to raise money can now (more precisely after the Brady Bond Initiative: discussed in greater detail below) issue bonds to tap individual private investors/lenders around the world. A bond is a form of debt, which is transferable between creditors, and bears interest at a fixed or floating rate. Bonds are generally repaid in a single installment, and are often bought by individuals or by other financial institutions rather than by commercial banks, which have historically tended to prefer other forms of lending, such as syndicated loans.⁸

Furthermore, bonds diversify risk. Private creditors, through bonds, open up alternate financing options for the sovereign. The sovereign no longer relies solely on the IFI for funds; this option lessens the risk of being denied capital when times are tough. Yet, as discussed above, the benefit has also brought new difficulties to sovereign borrowers. Because

⁶ Anne O. Krueger, *A New Approach To Sovereign Debt Restructuring*, (Washington, D.C: International Monetary Fund, April 2002), online: <www.imf.org>.

⁷ Above note 2

⁸ Above note 5

of creditor diversity it has become increasingly difficult to secure collective action and agreement during debt restructurings with sovereigns.

Anne Kreuger, the first deputy manager of the IMF, recently highlighted the need to develop a new approach to sovereign debt restructuring as follows:

There is a growing consensus that the present process for restructuring the debts of a sovereign is more prolonged, more unpredictable and more damaging to the country and its creditors than would be desirable. Exploring ways to improve the sovereign debt restructuring process is a key part of the international community's efforts to strengthen the architecture of the global financial system.⁹

Kreuger contends that a sovereign with unsustainable debts will likely delay a needed debt restructuring, draining its reserves and leaving the debtor and the majority of its creditors worse off. More crucially, she argues that "the absence of a mechanism for majority voting [among creditors] on restructuring terms can complicate the process of working out a complicated debt restructuring process, and even inhibit agreement on a needed restructuring."¹⁰

This paper reviews three prevailing procedures that seek to address these deficiencies. The first proposal is known as the sovereign debt restructuring mechanism (SDRM) and is advocated by the IMF under the leadership of its first deputy manager Anne Kreuger. This paper will also review U.S. Chapter 11 reorganization bankruptcy procedure, which lays the foundation for the SDRM. The second proposal relies strongly on collective action clauses and is supported by the U.S. Treasury department and John Taylor, the head of the Office of International Affairs. Lastly, a proposal advocated by Ann Pettifor, of Jubilee Research, adapts U.S. Chapter 9 municipal bankruptcy laws to the needs of developing countries. All of the three proposals overlap each other in the sense that each share legal and economic mechanisms found in the other. Most importantly, they all strive to reduce transaction costs for both the creditor and the sovereign debtor. Before examining these proposals, however, it is helpful to lay some ground work regarding the history, economics and law surrounding sovereign lending. As such, this paper will first review issues regarding state sovereignty in a commercial setting - a doctrine that is often employed as a defence for sovereigns in default. Secondly, it will dis-

⁹ Above note 4

¹⁰ Ibid

cuss a nation's economic incentives for respecting its debt obligations. Specifically, domestic loss of capital and capital flight, impaired trade, and the vulture fund's effect on distressed economies. A review of the evolution of debt instruments and the creditor-sovereign relationship will then follow. After which, this paper will discuss free-riding, vulture fund case law and the mechanics and legislation surrounding attachment orders.

II. DECLARING SOVEREIGN IMMUNITY IN A COMMERCIAL SETTING

COUNTRIES DEFAULTING ON THEIR LOAN OBLIGATIONS often invoke the doctrine of sovereign immunity to defend their actions and their property situated abroad. On default, creditors often "attach" a sovereign's assets to secure at least part payment arising out of a breach of the loan agreement or bond. Attachment is the legal seizure of assets belonging to a debtor by a creditor in the event of de jure default on a debt owed to the creditor.¹¹ Sovereign debtors can claim in certain circumstances a sovereign immunity defence to protect their foreign assets. So what is sovereign immunity? Sovereign or diplomatic immunity refers to the immunity of a State, its laws, actions, and its property from the jurisdiction of the courts of another State.

The doctrine of sovereign immunity can be traced to the notion that "the king can do no wrong" in the sense that an "attempt by one sovereign to assert jurisdiction over another affects the power and dignity of the latter."¹² However, courts have increasingly reduced the scope of sovereign immunity over time. In the last century, the nature and functioning of sovereigns has dramatically changed. Governments have increasingly entered into private pursuits, which have lead nations to adopt a more restrictive theory of sovereign immunity.

There are two main theories of sovereignty, absolute and restrictive. It is noteworthy that the "absolute theory" of sovereign immunity does not distinguish between the nature of the sovereign's private and public acts and- the sovereign is in all cases absolutely immune. The "restrictive theory" recognizes sovereign immunity for a nation's public acts (i.e. diplomatic function) and not for a nation's private acts or commercial

¹¹ Above note 5

¹² Allan R. Roth, *A Guide to Foreign Investment Under United States Law*, (New York: Law & Business Inc, 1979).

endeavors. The restrictive theory has subsequently been codified in the United Nations articles and United States law.

A. United Nations Draft Articles on Jurisdictional Immunities of States and Their Property

On February 15, 2002, the UN released a "Report of the Ad Hoc Committee on Jurisdictional Immunities of States and Their Property" (the "Committee") which culminated in the *Draft articles on jurisdictional immunities of States and their property* (the "Draft Articles").¹³ The 2003 session of the Ad Hoc Committee described the status of the final version of the Articles as "forthcoming." The final version will fundamentally remain the same as the Draft Articles and as such a review is not without its merits.

As its name implies, the Draft Articles apply to the immunity of a State and its property from the jurisdiction of the courts of another State. As previously mentioned, the Draft Articles codify the restrictive theory to sovereign immunity. In doing so, Article 3 of the Draft Articles discusses the circumstances where a sovereign can employ the sovereign immunity defence in respect of its property. Sovereign immunity protects the following "privileges and immunities enjoyed by a state":

- a) Its diplomatic missions, consular posts, special missions, missions to international organizations or delegations to organs of international organizations or to international conferences;
- b) Persons connected with them; and
- c) Aircraft or space objects owned or operated by a State.

In other words, the Draft Articles recognizes sovereign immunity for a state's public activities.

On the other hand, Part III of the Draft Articles goes on to list proceedings in which state immunity cannot be invoked. Specifically, Article 10, paragraph 1, declares that "if a State engages in a commercial transaction with a foreign natural or juridical person and, by virtue of the applicable rules of private international law, differences relating to the

¹³ *Draft articles on jurisdictional immunities of States and their property* found in the "Report of the Ad Hoc Committee on Jurisdictional Immunities of States and Their Property." online: <<http://ods-dds-ny.un.org/doc/UNDOC/GEN/N02/254/07/PDF/N0225407.pdf?OpenElement>>.

commercial transaction fall within the jurisdiction of a court of another State, the State cannot invoke immunity from that jurisdiction in a proceeding arising out of that commercial transaction." However, according to Article 6, paragraphs 2(a) and 2(b), sovereign immunity can be declared "in the case of a commercial transaction between states or if the parties to the commercial transaction have expressly agreed otherwise." The Draft Articles clearly adopt the restrictive theory of sovereign immunity: immunity is granted for a nation's public diplomatic activities but not for its private commercial endeavors (except for some outlined scenarios).

It is worth noting that Article 2, paragraph 1(c), defines a commercial transaction as:

- a) Any commercial contract or transaction for the sale of goods or supply of services;
- b) Any contract for a loan or other transaction of a financial nature, including any obligation of guarantee or of indemnity in respect of any such loan or transaction;
- c) Any other contract or transaction of a commercial, industrial, trading or professional nature, but not including a contract of employment of persons.

Accordingly, the Draft Articles severely limit a sovereign's ability to employ a sovereign immunity defence with respect to its commercial activities.

The restrictive theory of immunity can frustrate a sovereign from maintaining control of its property situated outside its borders. As previously mentioned, attachment is the legal seizure of assets belonging to a debtor by a creditor in the event of *de jure* default on a debt owed to the creditor. However, this threat is mitigated because most debtor governments have relatively few assets overseas, and much of what they have is still protected by diplomatic immunity. Additionally, the remaining assets can be protected by financial manipulations such as the layering of corporations, which act as holding companies, and by the transferring of nominal ownership to new agencies unencumbered by foreign debts. Therefore, sovereigns, through financial manipulations, can evade potential losses and defeat the purpose of the Draft Articles.

Interestingly, the UN Committee has possibly given more power to sovereigns practicing these evasive tactics. More specifically, Article 10, paragraph 3, states as follows:

3. Where a State enterprise or other entity established by a State which has an independent legal personality and is

capable of:

(a) Suing or being sued; and

(b) Acquiring, owning or possessing and disposing of property, including property which that State has authorized it to operate or manage,

is involved in a proceeding which relates to a commercial transaction in which that entity is engaged, the immunity from jurisdiction enjoyed by that State shall not be affected.¹⁴

Arguably this article is broad in scope. An "entity" capable of "suing or being sued" and "owning...and disposing property" allows for a host of financial and corporate manipulations that can evade creditors. Sovereigns would be wise to incorporate and stagger corporations in foreign jurisdictions, transfer assets to these holding companies and embark on commercial activities unencumbered by liabilities. It should be noted, however, that the Draft Articles propose to delete paragraph 3 entirely from the final version of the articles on jurisdictional immunities of States and their property.

B. Foreign Sovereign Immunities Act

The UN's application of the restrictive theory of sovereign immunity may have arguably originated from U.S. jurisprudence. In 1952 the U.S. State Department took the position that the restrictive theory should be applied by its courts and in doing so stated that:

...[T]he Department feels that the widespread and increasing practice on the part of the governments of engaging in commercial activities makes necessary a practice which will enable persons doing business with them to have their rights determined in the courts.¹⁵

What emerged was the *Foreign Sovereign Immunities Act of 1976*¹⁶ (the FSIA), which codified the restrictive theory as U.S. law.

Section 1602 Title 28 of the FSIA states:

Under international law, states are not immune from the jurisdiction of foreign courts insofar as their commercial

¹⁴ Ibid

¹⁵ Above note 12, p.231

¹⁶ *Foreign Sovereign Immunities Act of 1976*, 42 Fed. Reg. 6366 (Feb. 2, 1977).

activities are concerned, and their commercial property may be levied upon for the satisfaction of judgments rendered against them in connection with their commercial activities. Claims of foreign states to immunity should henceforth be decided by courts of the United States and of the States in conformity with the principles set forth in this chapter.

Section 1602(a)(2) of the FSIA further provides that foreign states are not immune from U.S. jurisdiction and its courts in cases where,

...The action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States ...

Section 1603(d) defines a commercial activity to mean "either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose."

Accordingly, the FSIA permits creditors to seize commercial assets in satisfaction of their claims. Sovereigns defaulting on their loan obligations are blocked from relying on a sovereign immunity defence to protect foreign assets from creditors. Furthermore, the United States Supreme Court in *Republic of Argentina v. Weltover, Inc.*¹⁷ determined that issuance of a bond constitutes commercial activity for the purposes of the FSIA.

C. Act of State Doctrine

The Act of State Doctrine, like the doctrine of sovereign immunity, is a principle of judicial self-restraint. Sovereign immunity is ingrained in U.S. common law under the Act of State Doctrine (the Doctrine). Just as the FSIA codifies the doctrine of sovereign immunity it too can also be seen as the statutory embodiment of the Doctrine. The Doctrine, like the UN Draft Articles and the FSIA, applies the restrictive theory to sovereign immunity. And likewise, it views a sovereign's commercial activities and

¹⁷ *Republic of Argentina v. Weltover*, 504 U.S. 607 (1992).

assets to lie outside the protection of sovereign immunity.

The U.S. Court of Appeals decision in *Allied Bank International v. Banco Credito Agricola de Cartago*, adopted this restrictive theory to the immunity claim. Accordingly, the court determined that sovereigns could not unilaterally default on their loans and escape their financial and legal obligations by declaring sovereign immunity.¹⁸ The court, in considering the defence's position, went on to clarify the Doctrine by citing the classic statement of the Doctrine as delivered by the U.S. court in *Underhill v. Hernandez*:¹⁹

Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.

Notwithstanding this assertion, the Doctrine offers an almost non-existent defence for states declaring sovereign immunity in a commercial context. The court in *Allied* limited the defence of sovereign immunity by cutting down the scope of the Doctrine.

The salient facts of the case are as follows: Allied Bank International was the agent for a syndicate of 39 creditor banks and the defendants were three Costa Rican banks wholly owned by the Republic of Costa Rica and subject to the direct control of the Central bank of Costa Rica (the "Costa Rica Central Bank"). Allied brought an action to recover on promissory notes issued by the Costa Rican banks. In 1981 the Costa Rican government, through the Central Bank, defaulted on its debt payments to the 39-member bank syndicate. In accordance with the provisions of the agreements, the plaintiff accelerated the debt and sued for the full amount of principal and interest outstanding.

The Costa Rican banks claimed as their defence, among other things, sovereign immunity by invoking the Doctrine. The court, however, denied Costa Rica this defence by limiting the definition or, more accurately, the applicability of the doctrine to the following three circumstances.

1. Diplomatic Relations: Would Adjudication Embarrass or Hinder the Executive?

The court stated that the Doctrine, originally linked with principles of sovereign immunity, has more recently been described as "aris[ing] out of the basic relationships between branches of government in a system of

¹⁸ *Allied Bank International v. Banco Credito Agricola de Cartago*, 757 F.2d 516, 1985 U.S. App. LEXIS 30026, 77 A.L.R. Fed. 281.

¹⁹ *Underhill v. Hernandez*, 168 U.S. 250, 252, 18 S. Ct. 83, 84, 42 L. Ed. 456 (1897).

separation of powers."²⁰ The policy concerns underlying the Doctrine focus on the pre-eminence of the political branches, and particularly the executive, in the conduct of foreign policy. Therefore, the applicability of the Doctrine depends on the likely impact on international relations that would result from judicial consideration of the foreign sovereign's act. The court stated the following rule: "if adjudication [against the sovereign's actions] would embarrass or hinder the executive in the realm of foreign relations, the court should refrain from inquiring into the validity of the foreign state's act."

As such, sovereign immunity does not confer presumptive validity on a nation's activities but rather sovereign immunity depends on whether adjudication (against the sovereigns actions) would embarrass or hinder the executive. In other words, a sovereign must rely on the U.S.'s diplomatic position for its declared immunity. This limitation supports U.S. political and foreign interests above notions of immunity and international law.

2. Territorial Limitations: Where is the Situs of the Property at the Time of the Purported Taking?

The court further limited Costa Rica's defence by attaching territorial boundaries to the doctrine of sovereign immunity. In doing so, the court stated:

The extraterritorial limitation, an inevitable conjunct of the foreign policy concerns underlying the doctrine, dictates that our decision herein depends on the situs of the property at the time of the purported taking. The property, of course, is *Allied's* right to receive repayment from the Costa Rican banks in accordance with the agreements. The Act of State Doctrine is applicable to this dispute only if, when the decrees were promulgated, the situs of the debts was in Costa Rica. Because we conclude that the situs of the property was in the United States, the Doctrine is not applicable.

In short, the Doctrine would apply and protect the disputed property if it exists within the sovereign's territory. On the other hand, if the property is situated outside the sovereign's territory, the state's property is not protected from immunity. Why would a sovereign invoke such a defence

²⁰ Above note 18

if the contested property were within the sovereign's own territory? The sovereign would not – there would be no point because the sovereign can defend its assets within its territory without having to rely on immunity and international law. An immunity defence would only be relied upon in extraterritorial circumstances where the sovereign seeks to prevent appropriation of its property. Therefore, the court's territorial limitation on the Doctrine renders the immunity defence ineffectual.

3. Actions of the Sovereign: Do the Acts of the Sovereign Purport to Have Extraterritorial Effect?

The third limitation on sovereign immunity occurs when the acts of the foreign government purport to have extraterritorial effect. In other words, U.S. courts will not apply sovereign immunity to a sovereign's actions that are in opposition to U.S. jurisprudence or policy. The court in *Allied* stated that "acts of foreign governments purporting to have extraterritorial effect and consequently, by definition, falling outside the scope of the act of state doctrine — should be recognized by the courts only if they are consistent with the law and policy of the United States."

The court determined that Costa Rica's actions were not inline with U.S. legal principles and policy. In making this determination the court contended the following:

The Costa Rican government's unilateral attempt to repudiate private, commercial obligations is inconsistent with the orderly resolution of international debt problems. It is similarly contrary to the interests of the United States, a major source of private international credit. The government has procedures for resolving intergovernmental financial difficulties. With respect to private debt, support for the IMF resolution strategy is consistent with both the policy aims and best interests of the United States.

As a result, sovereigns unilaterally defaulting on their loans would be incapable of protecting their assets from seizure (by pleading sovereign immunity) because a unilateral default is a breach of U.S. contract law principles and thus a repudiation of U.S. jurisprudence.

It is now clear that sovereigns cannot escape creditors by relying on the sovereign immunity doctrine. But what if a sovereign had little or no property abroad to lose - or a sovereign simply chose to reject international legal principles governing commerce? In short, why should the sovereign choose to repay its loans?

III. ECONOMIC INCENTIVES FOR RESPECTING DEBT OBLIGATIONS

BESIDES THE LEGAL IMPLICATIONS surrounding defaults, there are economic incentives for a sovereign to respect its debt obligations. A unilateral default on a loan obligation is a clear sign to domestic and international investors alike that an economic meltdown is just around the corner.

A. Domestic Loss of Confidence and Capital Flight

A default without IMF and creditor assistance would have drastic effects to the sovereign's economy. A unilateral default sends signals to investors that an economic crisis is on the horizon. This leads to loss of reputation triggering capital flight: international and domestic investors would protect what value their assets hold by transferring them into a more stable and secure investment instrument. Nationals of the bankrupt State would sell domestic assets (bonds and securities), withdraw savings and investments from national banks, and subsequently transfer the bulk of their holdings to the more stable currencies of other sovereigns (primarily U.S. dollars). Therefore, capital flight would also intensify self-fulfilling runs on banks that would cripple the sovereign's financial infrastructure and banking system.²¹ This practice would lead to a depletion of capital that is essential for domestic business, investment and continued growth.

Capital flight can be defined as a flow of financial capital which leaves a country other than through legitimate channels. This occurs generally in contravention of capital controls: restrictions on the international transfer of capital through legitimate channels. The major motivations for capital flight include: expectations of substantial exchange rate devaluation, and fears of political instability or of expropriation of savings and investments held domestically. Capital flight is a particular problem because the interest of capital gains and profits on the resulting investments are not generally returned to the country of origin.²²

²¹ Kenneth Rogoff and Jerome Zettlemeyer, "Bankruptcy Procedures for Sovereigns A History of Ideas, 1976 - 2001" (2002) *IMF Staff Papers* Vol. 49 No. 3.

²² Above note 5

B. Impaired Trade

Capital flight arguably weakens a sovereign's banking system and directly impairs trade. Nationals liquidating and transferring assets abroad often do it at the expense of banks. A national would have to close accounts to send assets abroad. Without sufficient funds, banks simply cannot operate: whether it be financing its own obligations or investing in new enterprises.

Additionally, a stable banking infrastructure is essential for the payments and receipts necessary to conduct international trade and business. Without financial agents (banks), exports and imports could not function efficiently. Banks act as financial "middlemen" between domestic buyers and sellers and their foreign counterparts. A weak financial infrastructure would lead to a subsequent loss of exports and severely damage the sovereign's balance of trade.²³ Strong exports provide the sovereign with desperately needed foreign income to support its cash reserves and purchase needed imports.²⁴ Most (if not all) bankrupt sovereigns are not self-sufficient; they are dependant to some extent on imports for the well being of its people. Hence, it can be argued that the largest sufferers are not the creditors but the nationals of the bankrupt sovereign caught in the economic meltdown.

This capital flight, selling off of assets and loss of investor confidence (domestic and international), often creates spiralling inflation that simply serves to exacerbate the sovereign's loss of reputation. International investors sitting on sovereign bonds and securities are keen to cut their losses short in a sovereign default situation and, as a result, often sell their investment interests at heavily reduced prices. This trend has become more prevalent over the past few years and has given rise to a relatively new investment institution known as "hedge funds" or "vulture funds".

C. Vulture Funds Effect on Distressed Economies

Vulture funds buy up debts owed by countries (or companies) in financial difficulty for a deep discount and then try to get full payment on

²³ Balance of trade is the difference between a country's merchandise exports and imports - that is, its net receipts of foreign exchange from international trade in goods - as per above note 5.

²⁴ Richard Schaffer et al, *International Business Law and its Environment*, 4th ed. (Cincinnati: West Educational Publishing, 1999).

that debt when the country defaults. In the 1990s, a New York Fund, Elliot Associates (Elliot), paid \$11m for Peruvian debt with a face value of nearly \$21m. Peru had a debt problem and agreed to a restructuring with most of its creditors. Elliot sued for full payment and was eventually awarded over \$55m by a US court. However, Elliot could not receive payment or place a lien on any of Peru's assets situated abroad. Therefore, Elliot went on to use a court in Belgium to disrupt the reduced payments negotiated by Peru with its other creditors. That was enough to persuade Peru to pay up in full.²⁵ The legal ramifications of this case will be reviewed in greater detail below but, for the moment, it provides a glimpse of the benefits a sovereign debt restructuring system would afford a sovereign and its creditors.

The future ramifications for both sovereign and creditor would be costly if a sovereign were to choose a unilateral default as its course of action. A non-unilateral default occurs when the sovereign, in cooperation with its creditors and the IMF, agree to a restructuring of the sovereign's debt. Currently, the World Bank and the IMF, do not have a sovereign debt restructuring procedure in place, however, an effective mechanism should have a built-in incentive to keep sovereigns from unilaterally defaulting. An IMF backed procedure may afford sovereigns and their foreign assets protection from vulture funds. However, at present, it seems staving off economic pain and repelling vulture funds are the sole incentives to keep a sovereign from unilaterally defaulting on its loan.

Sovereign financing evolved from syndicated banks and orderly restructuring to vulture funds. What kind of new economic and legal problems do vulture funds pose to the restructuring of a sovereign's debt? In order to understand the current issues we need to look back and examine the evolution of debt instruments and the creditor-sovereign relationship.

IV. EVOLUTION OF DEBT INSTRUMENTS AND THE CREDITOR SOVEREIGN RELATIONSHIP

ALTHOUGH LATIN AMERICA IS ASSOCIATED with debt payment problems, the history of modern sovereign loan defaults can actually be traced back to the developed world. During the Great Depression of the 1930s, both the U.K. and France defaulted on their

²⁵ Andrew Walker, "Solution sought for bankrupt countries". BBC News (September 30, 2002).

Online: <<http://news.bbc.co.uk/2/hilbusiness/228071.stm>>.

debts.²⁶ Ironically, at present, these two countries, along with other western nations, determine the financial destinies of the indebted third world.

In 1956, a group of wealthy industrialized nations met in Paris to resolve Argentinean financial problems. This led to what is now known as the Paris Club (the Club) – an informal arrangement that has reached 347 agreements concerning 77 debtor nations.²⁷

A. The Paris Club

The Club represents the claims of official bilateral creditors²⁸ and not the claims of private creditors such as banks and bondholders. The repayment terms extended by the Club in a rescheduling are the result of a negotiation process. The Club works with IMF policies to develop a repayment schedule that is in the best interest of the creditors and the debtor sovereign.

To receive IMF approval of the repayment schedule - in line with IMF guidelines - Club creditors provide the IMF with an informal indication of their willingness to extend relief to the debtor sovereign. After receiving IMF approval, the Club meets with the debtor sovereign to work out a restructuring. The terms of the restructuring provide a framework for the subsequent negotiation of bilateral agreements between the creditor and the debtor that give full legal effect to the restructurings. The IMF relies on a reached agreement by Club creditors as an assurance for any future financing and elimination of interest in arrears; being interest payments due but not paid. As such, achieving a Club agreement is in the best interest of the sovereign in that it will potentially open up more financing from the IMF, eliminate interest arrears and assure bridge loans from the syndicated banks.²⁹

1. *Comparability Treatment Provision and Free Riding*

Reaching a Club agreement is contingent on the “comparability treatment assumption” (the CTA). This stipulates that the elimination of inter-

²⁶ Above note 1

²⁷ Ibid

²⁸ Official bilateral creditors are composed government creditors and lending institutions such as the World Bank and IMF.

²⁹ Gerd Häusler, François Gianviti and Timothy Geithner, “IMF International Capital Markets, Legal and Policy Development and Review Departments” *Sovereign Debt Restructuring Mechanism - Further Considerations*, (August 14, 2002).

est arrears under the Paris Club program by all official bilateral creditors is contingent on the debtor agreeing to seek restructurings on at least as favourable terms from other non Club-members.³⁰ In other words, the CTA stipulates that the debtor undertakes to negotiate rescheduling on terms no more favourable to creditors on all its other debts (apart from those owed to the IMF and the World Bank).³¹ At first glance, the CTA seems quite onerous to a debtor sovereign seeking to reschedule its debt. However, it was not designed as a barrier to the implementation of a rescheduling agreement. On the contrary, the IMF implemented the CTA to achieve an equitable outcome for both debtor and creditor in that it prevents other creditors from free riding on the Club's agreement. This is intended to prevent the debtor from using the capital it saves through the rescheduling to service its other debts.

For example, if the Club reaches an agreement with a debtor sovereign to eliminate arrears, then the sovereign will take the newly available funds and repay its debt obligation to the free rider. In this situation, Club creditors, by reaching an agreement, are forfeiting their right to payment and instead assisting the sovereign to pay the free rider's debt.

Achieving a Club agreement with a CTA was relatively common up until the 1980's. Sovereign debtors often had significant obligations to both official bilateral creditors and private creditors, predominantly composed of commercial banks. "Debts to both groups of creditors were restructured in broadly the same time frame, which facilitated informal dialogue, while both creditor groups used broadly similar approaches to restructuring."³² As such, it was quite feasible for a debtor sovereign to reach an agreement with all creditors on comparable terms to eliminate the possibility of any "free ridership." However, with the start of the Brady Bond initiative in 1989, coordination between the IMF, Club creditors and private creditors was no longer straightforward.³³

B. The Brady Plan and Economic Liberalization

After the large increase in lending during the mid-1970s, a series of debt crises swept through the developing world starting with Mexico in August of 1982. Mexico – the largest debtor in the developing world – was the first emerging market debt crisis of the 1980s. After the Mexico crisis,

³⁰ "Eurobonds, Testing the Water" *The Economist*, (February 11, 1999).

³¹ Above Note 5

³² Above note 30

³³ Ibid

commercial banks were highly reluctant to extend any new financing and, as a result, capital flow to the developing world dried up.³⁴ The loss of new financing led to exorbitant external debt burdens that strangled economic growth in these economies. "IMF austerity programs, which were implemented to mitigate the problems of the debt-saddled LDCs (lesser development countries), provided short-term aid but caused long-term economic stagnancy (as the name implies, the IMF austerity plans imposed fiscal and monetary tightening on the recipients)."³⁵ The 1980s has thus been referred to as "the lost decade" for emerging market economies because of the lack of economic growth in the region.³⁶ The debt restructuring during this period provided little help to resolve these problems. They provided "short-term *ad hoc* solutions for a persistent and long-term problem".³⁷

The next stage of development in the debt restructuring process was the creation of Brady Bonds.³⁸ The Brady-style restructurings of the early 1990s created secondary markets in emerging-market bond debt and changed the dynamics of sovereign debt restructurings. Before the Brady plan, the restructuring of the debt tended to proceed in a relatively orderly process. "The restructuring of official-sector and private-sector debt to emerging-market sovereign debtors was traditionally contingent upon the acceptance of an IMF structural adjustment program."³⁹ After the sovereign debtor and its Club lenders negotiated a restructuring process for the bilateral debt, the second stage was usually a restructuring of commercial bank loans. The collective group of commercial banks is commonly referred to as the London Club of commercial banks.⁴⁰ However, the London Club has no fixed membership, and no permanent secretariat. It is a general term for rescheduling negotiations on commercial bank debts and is, in effect, a concept rather than an institution.⁴¹

The lending banks had a vested interest in seeing an orderly restructuring. It generally had a long-term interest in emerging market

³⁴ Above note 1

³⁵ John Nolan, "Emerging Market & Debt Vulture Hedge Funds: Free Ridership, Legal & Market Remedies" Economic Strategy Institute and Derivatives Study Center, online: <<http://www.econstrat.org/dsc%20nolan.htm>>.

³⁶ Ibid and Above note 1

³⁷ Above note 35

³⁸ Brady Bonds were named after the former US Treasury Secretary Nicholas Brady who led the debt reduction plans for the LDCs (lesser developed countries).

³⁹ Above note 35

⁴⁰ Ibid

⁴¹ Above note 5

economies and were thus inextricably tied to the economic well-being of the debtor sovereign. It was clearly in the best interest of London Club creditors to cooperate with an IMF and Club led restructuring.

The vested interest found in London Club creditors generally does not exist among private bondholders in that the liquid nature of the bond and similar debt instruments generally attracts short-term investors. Bondholders act more along the lines of short-term investors – like security day traders and hedge funds – than long term lenders like the IMF and World Bank. Secondly, syndicated bank loans were comparably non-liquid and the London Club's agenda was often influenced by government and IMF policy. "The commercial banks involved in the syndicated loans (and thus the financing of the debt) were subject to regulatory oversight in their home countries: the governments of developed countries were able to exert due influence upon the banks when it became necessary."⁴²

Syndicated banks were also influenced by IMF policies. As discussed earlier, the IMF only provided bridge loans to sovereign debtors on the condition that all of the country's creditors provide bridge loans as well – thereby implementing the CTA. It was in the banks' best interest to comply with IMF guidelines to secure IMF financial backing, which facilitated repayment of their sovereign loans.

In addition to the external pressure, the bank creditors would also exert influence upon one another through a regulatory regime. The syndicated banks prevented any dissenting bank from free-riding by contractually forcing them to agree with the restructuring. "All parties were thus dependent upon one another: the banks deemed it essential that the debtor countries implement austerity programs; the debtor countries would not implement austerity programs unless the IMF extended loans; the IMF would not make loans unless the commercial banks extended bridge loans. The result of this triangular dependency was [that] action was either taken collectively or not at all."⁴³

In spite of everything, collective action and the orderly and predictable restructuring process came to a grinding halt with the introduction of the Brady bond initiative. The Brady plan produced two far-reaching problems for sovereign debt restructuring procedures: (1) creditor and debtor moral hazard and (2) a broad base of sovereign debt investors which precipitated in collective action problems, free ridership and vulture funds.

⁴² Above note 35

⁴³ Above note 1

C. Creditor and Debtor Moral Hazard

"Moral hazard is the risk that a certain policy action will, in practice, give economic agents an incentive to act in a way which will make the policy itself ineffective, unworkable or counterproductive."⁴⁴ For example, if a country's debt were written off automatically once it reached a certain level, governments would have an incentive to over-borrow because they would receive the benefit of the loan without incurring the cost of repaying it. Similarly, banks would have an artificial incentive to make high-risk loans if they were automatically 'rescued' when their loans could not be repaid by debtors. In each case, policies with inherent moral hazard would encourage irresponsible behaviour by borrowers and lenders and increase the cost or reduce the effectiveness of the policy itself. Hard-line creditor governments often invoke Moral hazard as an argument against any attempt to reduce the debt burden on developing countries: "to do so, it is argued, would be to reward irresponsible borrowing in the past, and this would encourage similar behaviour in the future."⁴⁵ Moral hazard is a genuine problem, and one that is often considered in proposals that seek to resolve the debt problem.

However, the extent of the problem may be over-stated by its more fervent advocates. Specifically, "it is difficult to argue that any debt reduction offered after a long and generally painful adjustment process actually provides an incentive for over-borrowing, particularly if it is conditional on continued adjustment."⁴⁶ Also, in most countries, particularly in Latin America, the present governments are actually the democratic opponents of the non-democratic rulers who were responsible for the over-borrowing. Additionally, it is often argued that the new democracies are those that would benefit most from debt reduction. "It is at least arguable that relieving them of the costs of their predecessors' irresponsibility would not encourage them to over-borrow themselves; and also that forcing them to bear this cost actually discourages the transition to more representative political systems and more responsible governments."⁴⁷ Moral hazard resulted from the 1989 Brady plan. The Brady plan proposed exchanging loans for bonds that traded in financial markets where it would be priced at market value. Under the plan, sovereign debt was no longer held in the hands of IFIs and syndicated banks; it now

⁴⁴ Above note 5

⁴⁵ Ibid

⁴⁶ Ibid

⁴⁷ Ibid

traded in the secondary markets. This transformed sovereign debt into a liquid instrument and created a secondary market for trade in sovereign debt. Furthermore, the value of Brady Bonds was enhanced by the use of U.S. Treasury securities to guarantee part of the interest and principal payments.⁴⁸

The IMF and U.S. government practice of guaranteeing part of a sovereign debtor's interest and principal payments underwrites what would otherwise be unsustainable policies – thus increasing the likelihood of moral hazard. “It also results in excessive risk taking on behalf of creditors because a third party bears the risk. Government officials in developing countries can behave incompetently or criminally and still expect foreign capital inflows.”⁴⁹

The IMF and U.S. government loan guarantees enable foreign investors to target high-return investments, with little regard for the associated risk – thus resulting in creditor moral hazard. “There is also the potential for creating a two-tiered market, in which loans to national governments are distinguished by whether they are likely to be backed by IMF, World Bank or U.S. loan guarantees. The result would be diminished liquidity in some developing countries, investment losses, and fewer willing lenders in non guaranteed markets.”⁵⁰ In other words, markets supported by U.S. loan guarantees will thrive because such guarantees lower the lending risk for creditors. Similarly, markets without loan guarantees cannot guarantee partial repayment in the event of default and will thus continue to shrink in size.

Notwithstanding, moral hazard can be avoided or reduced by framing any debt restructuring scheme in such a way that it:

- (a) clearly cannot be repeated in the future;
- (b) establishes a mechanism to minimise the risk of over-indebtedness in the future (except through circumstances beyond the debtor country's control); or (c) imposes costs on those who were responsible for incurring the original debts.

This strategy for reducing moral hazard will be discussed in greater detail below under the review of sovereign debt restructuring proposals.

⁴⁸ Above note 1

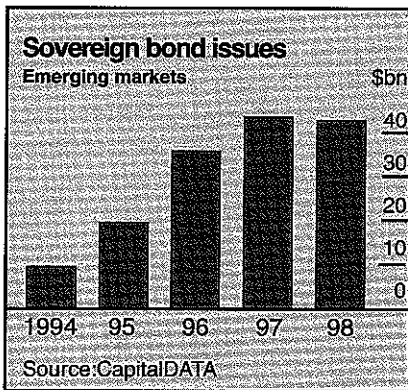
⁴⁹ W. Lee Hoskins and James W. Coons, *Mexico: Policy Failure, Moral Hazard, and Market Solutions*, (Washington D.C: Cato Institute, October 10, 1995). Online: <<http://www.cato.org/pubs/pas/pa-243es.html>>. The Cato Institute is a non profit public policy research foundation headquartered in Washington, D.C.

⁵⁰ Ibid

D. Growth in Lenders: Free Riding and Collective Action Problems

The move from syndicated bank lending to bonds as a source of finance for emerging market sovereigns has made coordination of creditors much more difficult than it was in the 1980's. As mentioned, the majority of private creditors do not have a vested interest in the sovereign and cannot be compelled to act according to IMF guidelines. The diversity of interests among creditors has also created a potential barrier to the restructuring process. Furthermore, the proliferation of Brady bond issuances (as depicted in Table 2 below) has exacerbated the collective action problem that exists in the present sovereign debt restructuring process.

TABLE 2⁵¹



The restructuring process of bonds and loans is subject to the problems of collective representation and collective action. "Collective representation problems refer to the procedural difficulties in organizing dialogue between the debtor and group(s) of creditors."⁵² A sovereign restructuring may require coordination across many bond issues, as well as syndicated loans and trade financing. Above all, it may be especially difficult to formulate a sovereign debt rescheduling mechanism that would be supported by a majority of creditors.

The diversity of bondholder interests heightens the probability of individual creditors free riding in the hope of ultimately receiving payment in line with their original contracts.⁵³ The mechanics of free riding are clarified below in a review of vulture fund case law.

Both the threat of free-riding and inter-creditor inequity may inhibit creditors from agreeing to a proposed debt restructuring. This prolongs the negotiation process, which ultimately reduces the sovereign's chance of reaching financial sustainability. The longer the negotiation process,

⁵¹ "Sovereign Policy" *The Economist*, (February 11, 1999).

⁵² Above note 35

⁵³ Above note 6

the more likely the sovereign will run out of time and money to pay its debt obligations. Ironically, the creditors' own reluctance to a collective agreement increases the probability of non-payment and subsequent default by the sovereign.⁵⁴

Creditor fears of holdouts or free ridership will only dissipate with the implementation of collective action clauses accepted by a qualified majority, which would bind all creditors to the terms of a restructuring agreement. Until such time, the Brady bond initiative will continue to foster free riding because the bond has created a "new creditor class consisting largely of pension and mutual funds, insurance companies, investment firms and sophisticated individual investors."⁵⁵ And, since these Brady bondholders generally do not constitute lending organizations, they are not compelled to follow IMF policies and hence are not obliged to give bridge loans or any additional financing to the sovereign debtor.⁵⁶ In short, these bondholders are not compelled by international financial institutions or syndicated banks to accept terms of any agreed upon reorganization.

As previously illustrated in the Elliot Associates case, individual bondholders have incentives to free ride during the bond restructuring process. Private investors can purchase debt bonds on the secondary market for 30 cents to the dollar (the bonds are priced at steep discounts to reflect the bonds' default risk) and then sue the sovereign, upon default, for payment of the entire debt plus accrued interest.⁵⁷ These types of investors are more likely to pursue their claims by attaching a claim against the sovereign's limited U.S. (or other foreign) assets following a default. As mentioned, they are generally not subject to the political pressures that commercial banks face to participate in restructuring. Even if a debt restructuring is reached in the presence of free riding, both creditors and debtors alike are forced to bear the cost of those recalcitrant creditors who do not participate. These costs will be illustrated in the treatment of vulture fund case law. Free riding and its pernicious effect on creditor collective action is arguably the greatest barrier to an orderly, rapid and equitable debt restructuring process.

⁵⁴ Ibid

⁵⁵ Ibid

⁵⁶ Ibid

⁵⁷ As was seen in the case of *Pravin Banker Associates v. Banco Popular del Peru*, 109 F.3d 850, 1997 U.S. App. LEXIS 5560.

V. FREE RIDING AND VULTURE FUNDS: CASE LAW

THE FOLLOWING THREE CASES involve rogue creditors or vulture funds that attempt to recover full payment on their loans (after a sovereign declares default), by acting against the sovereign's assets through litigation in the United States. It is important to remember that this sort of litigation will most likely occur in the U.S., and specifically New York, because the majority of international asset transfers occur in this jurisdiction. A sovereign, at one time or another, will almost certainly operate its financing through the New York Clearing House Association (NYCHA) which processes in excess of \$1.4 trillion in payments each day for more than 1,300 financial institutions around the world, including the United States.⁵⁸ The NYCHA is, among other things, a financial "middleman" transferring funds from creditors to debtors and vice versa through an enormous number of international banks and other financial institutions.

The assets become vulnerable to vulture seizure once they are transferred from the sovereign to the NYCHA (or any other U.S. bank or similar financial institution) because the NYCHA is legally the sovereign's agent. Consequently, sovereign assets (i.e. funds transferred to service loan obligations and other investments) held by the NYCHA are governed by U.S. law and policy because they are located on U.S. soil. Therefore, litigation in the U.S. is necessary to attach sovereign assets. This explains the proliferation of vulture-fund sovereign debt litigation in New York courts.

Most vulture fund cases, including the three being reviewed, share the following elements:

- a) a vulture fund buys sovereign debt on the secondary market for a substantial reduction;
- b) the vulture fund goes on to free ride the debt by holding out for better terms already agreed to by other creditors in a restructuring;
- c) upon the sovereign defaulting on its loan obligation the vulture fund attaches claims to the sovereign's foreign assets by litigating in the jurisdiction where the assets are located;
- d) the vulture fund is awarded full payment of accrued interest and full payment of principal (although not in the Darts family case); and

⁵⁸ Online: <<http://www.nych.org/payment.htm>>.

e) lastly, the vulture fund walks away with a substantial profit on its initial investment.

The following three cases illustrate the above elements in practice. The case law also illustrates the legal complexity that limits a free rider's ability to undermine the debt restructuring process by suing for full payment and attaching claims to sovereign assets.

A. CIBC Bank and Trust Co. (Cayman) v. Banco Central do Brasil⁵⁹

In 1992, after announcing that it would not be able to service its debt obligations, Brazil announced a Brady Plan securitization of its debt. Brazil's creditors were given different options of bonds, for which they would exchange their existing debt. Through the Brady bond exchange Brazil successfully negotiated with its creditors to accept a huge reduction in the principal amount owed. In 1993 all of Brazil's creditors, except one, accepted these terms.

The rogue creditor was the Darts family known for manufacturing Styrofoam cups. By 1993 the Darts' accumulated \$1.4 billion in Brazilian debt obligations, at discounts of 60% or more, making them the fourth largest holder of Brazilian debt. The Darts rejected the reduction in principal negotiated by Brazil and its creditors and instead chose to free ride the debt by holding out for better terms.⁶⁰

In 1994, the Darts proceeded to sue (with plaintiff acting as the holder of record of the debt) the central bank of Brazil. The plaintiff sued for the accrued but unpaid interest, pursuant to the terms of the original debt agreement, and the right to accelerate the entire principal owed.

This action proved to be very harmful to Brazil's restructuring and could have ultimately undermined Latin American financial stability to such an extent that U.S. government officials filed an *amicus curiae* brief urging the court to dismiss the Darts' suit. As a result, the court rejected the plaintiff's claim for full payment of the principal but it did not dismiss its claims to have the \$60 million in overdue interest paid.

"Although, the Darts' motion to accelerate the principal was blocked, the decision ultimately worked to the Darts' favor."⁶¹ The Darts would still receive payment of their interest under the original debt obligation and

⁵⁹ *CIBC Bank and Trust Co. (Cayman) v. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D. N.Y. 1995) (No. 94 Civ. 4733).

⁶⁰ Above note 35

⁶¹ *Ibid.*

could still recover the full amount of principal (being \$1.4 billion) upon the debts maturity - unlike all other creditors who accepted a reduction in principal. However, the Darts chose to cash out of their position at a substantial profit before the date of maturity by selling their interest at a higher price on the secondary market. The Darts were able to sell the bonds at a higher price because the court's ruling secured payment of interest and full payment of principal thus reducing the risk of the investment / debt instrument. This case illustrates the financial incentives for creditors to choose to free ride and hold-out for a better deal.

Arguably, had the Darts held a smaller percentage of the principal, the U.S. government would not have interfered and the plaintiff would have probably been successful at accelerating the entire principal owed. This contention is based on the court ruling in *Pravin Banker Associates v. Banco Popular del Peru* where the vulture-fund plaintiff was awarded full payment on the interest and principal of the sovereign debt.⁶²

B. Pravin Banker Associates v. Banco Popular del Peru

The plaintiff in *Pravin Banker Associates v. Banco Popular del Peru*, like the Darts, amassed Peruvian debt on the secondary market at a huge discount (27 cents on the dollar). And similarly, the new holder rejected a negotiated settlement and sued the sovereign defendant for the full principal amount, thus undermining the sovereign debt restructuring.

The defendant argued that "because Pravin had purchased Peru's debt at a substantial discount, face value recovery upon default was not contemplated by either party, would constitute unjust enrichment, and would permit Pravin to reap a windfall profit from Peru's economic misfortune."⁶³ Pravin, in response, claimed that under contract law it had the right to sue for full payment of its principal (on breach of contract by the defendant) regardless of the price it had paid for the debt bonds.

These two arguments shed light on two competing policy interests that exist in sovereign debt restructuring. On the one hand the U.S. encourages participation in and advocates the success of IMF foreign debt resolutions under the Brady plan. While on the other hand, the U.S. has a strong interest in "ensuring the enforceability of valid debts under contract law."⁶⁴

⁶² *Pravin Banker Associates v. Banco Popular del Peru*, 109 F.3d 850, 1997 U.S. App. LEXIS 5560.

⁶³ Above note 35

⁶⁴ *Ibid*

The court in *Allied Bank International v. Banco Credito Agricola de Cartago* expressed obvious support for the latter policy objective:

The United States has an interest in maintaining New York's status as one of the foremost commercial centers in the world. Further, New York is the international clearing center for United States dollars. In addition to other international activities, United States banks lend billions of dollars to foreign debtors each year. The United States has an interest in ensuring that creditors entitled to payment in the United States in United States dollars under contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law.⁶⁵

Not surprising, the court respected Pravin's rights under contract law and awarded them payment of all accrued interest and full payment of the principal.

Despite the court's award, Pravin still needed to attach to Peru's assets to secure payment. In doing so, Pravin made a motion to attach the property of a Peruvian state-owned company located in the U.S. The court, however, claimed that the company was a separate and distinct legal entity from Peru and subsequently denied Pravin from attaching its claim against Peru to the company's assets. Nonetheless, Pravin and Peru did reach an undisclosed settlement amount.⁶⁶

C. Elliot Associates v. Banco de la Nacion and the Republic of Peru⁶⁷

In the 1990s, Elliot, an investment fund that specializes in "distressed debt", (i.e. debt that has been defaulted upon by the debtor to its creditors) paid \$11 million for Peruvian debt with a face value of nearly \$21 million. Peru had a debt problem and agreed to a restructuring with most creditors. However, Elliot sued for full payment and was eventually awarded over \$55 million by a US court.

⁶⁵ Above note 25

⁶⁶ Above note 35

⁶⁷ *Elliot Associates V. Banco de la Nacion and the Republic of Peru*, 194 F.3d 363, 1999 U.S. App. LEXIS 26370.

Although Elliott was granted its award, it needed to successfully attach its claims to Peru's assets to effectively have their debt holdings paid. In doing so, Elliot tried to intercept interest payments being made on Peru's Brady bond debt by obtaining a restraining order from the New York court against Peru's fiscal agent (Chase Manhattan Bank) who was responsible for disbursing the payments. Peru reacted by temporarily stopping the transfer of funds to its fiscal agent.

Elliott persisted in attaching its claims against Peru's assets by arguing in Brussels Commercial Court for a restraining order to be issued against Euroclear (an international settlement system) to preclude it from either accepting funds from Peru (for the Brady bond interest payment) or from disbursing the interest payment to Peru's creditors. Elliott was basically arguing that the restraining order on the fiscal agent should - as a corollary - also apply to the fiscal agent's bank branches (including foreign ones) at the level of the NYCHA (Euroclear).⁶⁸

The Brussels court subsequently rejected this argument by claiming that one order of attachment cannot be applied to any transfers through a bank's branch offices. However, Elliot appealed this decision and the Court of Appeals of Brussels granted the restraining orders against both the fiscal agent (Chase Manhattan Bank) and Euroclear.

This decision essentially tied Peru's hands. They could no longer pay their Brady bondholders their interest payments without Elliot seizing the disbursements first. Moreover, any financial institution that would accept money from Peru for the payment of interest to the Brady bondholders would face stiff fines. The restraining order on Peru's fiscal agent also had the effect of placing Peru in potential default of its Brady bond obligations: Peru did not make the \$80 million Brady bond interest payment that was to occur on September 7, 2000.⁶⁹

Peru did, however, have a 30-day grace period to make the interest payment. With only three days remaining and the impending risk of a default on its entire stock of Brady debt, Peru decided to reach a settlement with Elliot for \$58.4 million on October 4, 2000. In the end, minus legal fees, Elliott made profits of \$46.7 million on its original \$11.7 million investment (equivalent to about a 400% return).⁷⁰

The outcome in the Elliott case demonstrates that sovereigns have little protection from maverick creditors and that it is possible for a recalcitrant creditor to attach its claims to an interest payment being made on an existing bond. Most importantly, Elliott's success shows that it is pos-

⁶⁸ Above note 35

⁶⁹ *Ibid*

⁷⁰ *Ibid*

sible for a vulture fund to successfully seize the assets of a sovereign debtor thereby undermining a sovereign's debt restructuring efforts.

VI. ATTACHMENT ORDERS

A AS SEEN IN THE ELLIOT CASE, a judgment in favor of the vulture fund is often not enough to secure payment. A plaintiff may be awarded payment of principle and accrued interest but subsequently must find a method to compel (or coerce) the sovereign to pay up. There are a number of statutory and common law tools at the creditors disposal to attach assets in lieu of, or in the pursuit of, collecting the awarded judgment. Below are some international, Canadian and U.S. legal mechanisms that deal with creditor rights and attachment orders.

A. United Nations Draft Articles on Jurisdictional Immunities of States and Their Property⁷¹

Part IV of the Draft Articles enunciate when a creditor may take pre and post judgment measures of constraint against a state's property in connection with a proceeding before a court of another jurisdiction.

1. Pre-judgment Measures of Constraint

Article XY invokes sovereign immunity from pre-judgment measures of constraint, such as attachment or arrest, against a sovereign's property. The Draft Articles state that no such measure may be taken in connection with a proceeding before a court of another State unless and except to the extent that:

(a) The State has expressly consented to the taking of such measures as indicated:

(i) By international agreement;

(ii) By an arbitration agreement or in a written contract; or

(iii) By a declaration before the court or by a written communication after a dispute between the parties has arisen;
or

(b) The State has allocated or earmarked property for the satisfaction of the claim which is the object of that proceeding.

⁷¹ Above note 13

2. Post-judgment Measures of Constraint

Article 18 invokes sovereign immunity from post-judgment measures of constraint such as attachment or arrest, against a sovereign's property. Likewise, Article 18 lists the above-mentioned factors that deprive a sovereign of immunity from measures of constraint. However, Article 18, unlike Article XY (prejudgment measures of constraint), enunciates the following third factor when no such measures may be taken:

(c) It has been established that the property is specifically in use or intended for use by the State for other than government non-commercial purposes and is in the territory of the State of the forum [and has a connection with the claim that is the object of the proceeding or with the agency or instrumentality against which the proceeding was directed].

Lastly, it should be noted that Article 18 and 19 assert that only commercial property may be subject to pre and post judgment orders. Article 19 lists the following "public use" property as being immune from attachment, liens or seizure:

- (a) Property, including any bank account, which is used or intended for use in the performance of the functions of the diplomatic mission of the State or its consular posts, special missions, missions to international organizations, or delegations to organs of international organizations or to international conferences;
- (b) Property of a military character or used or intended for use in the performance of military functions;
- (c) Property of the central bank or other monetary authority of the State;
- (d) Property forming part of the cultural heritage of the State or part of its archives and not placed or intended to be placed on sale;
- (e) Property forming part of an exhibition of objects of scientific, cultural or historical interest and not placed or intended to be placed on sale.

Does this legislation deprive creditors of their rights to pursue their claims? It would seem so. However, the Draft Articles do not deprive creditors entirely of their rights, they simply force creditors to find other means of protecting their interests. Article XY and 18 merely stipulate

that a creditor's rights to attachment depend on whether the right was contracted to between the creditor and the debtor in the loan agreement. The Draft Articles support the debtor and creditor right to contract with each other. As such, creditors would be wise to protect their interests by expressly including a clause, within the bond or loan agreement, granting them the right to take measures of constraint. Collateralized agreements can provide creditors with such protection.

B. Collateralized Lending

Commercial loan agreements are often collateralized, which grant the creditor a right to seize the collateral of a defaulting borrower. Collateral is an asset used to guarantee payment of a loan or the interest on it. If the payment is not made, the ownership of the asset is transferred from the debtor to the creditor. Nevertheless, sovereign loan agreements are almost never collateralized. Loan agreements never contain collateralized terms and creditors would have difficulty negotiating such clauses with a sovereign in any loan agreement. So, it seems that the Draft Articles have forced creditors to protect their own interests by negotiating impossible contractual terms allowing them to take measures of constraint against sovereign property.

Collateralized lending has traditionally been a private law financing instrument, however, it can probably be expanded into the public law domain of emerging markets. "Countries can pledge their natural resource export revenues, for example, when there is no practical way to stop production and export. Mexico successfully pledged a portion of its oil revenues to the United States during the 1995 rescue, and there is no reason why this experience cannot be more common."⁷²

According to the Draft Articles, it follows that creditors can only attach foreign assets if the constraining order is a term in the loan agreement and is property of a private commercial nature. Arguably then, under this legislation, vulture funds would be hard pressed to attach foreign assets and sovereign debt restructuring might not be as vulnerable as the vulture fund case law suggests. The ensuing legislation and common law regulations regarding constraining orders further supports this view.

⁷² Andrei Schleifer, *Will the Sovereign Debt Market Survive?* Online: <http://post.economics.harvard.edu/faculty/schleifer/papers/debt_NBER.pdf>.

C. Foreign Sovereign Immunities Act

The Foreign Sovereign Immunities Act (FSIA) is similar in nature to the Draft Articles reviewed above. Both stipulate that commercial assets are not immune from pre and post judgment constraining orders. Similarly, sections 1609 and 1610 state that the property of a foreign nation used for a commercial activity in the United States, "shall not be immune from attachment in aid of execution, or from execution, upon a judgment entered by a court of the United States or of a State" if:

- 1) the foreign state has waived its immunity from attachment, or
- 2) the property is or was used for the commercial activity upon which the claim is based, or
- 3) the execution relates to a judgment establishing rights in property which has been taken in violation of international law or which has been exchanged for property taken in violation of international law, or
- 4) the execution relates to a judgment establishing rights in property.

Additionally, the FSIA distinguishes the type of property that is immune from attachment and execution as follows:

- 1) property that is of a foreign central bank or monetary authority held for its own account, unless such bank or authority, or its parent foreign government, has explicitly waived its immunity from attachment; or
- 2) property is, or is intended to be, used in connection with a military activity and
- 3) property that is of a military character, or
- 4) property that is under the control of a military authority or defence agency.

The FSIA effect on creditor rights of attachment and enforcement are almost identical to that of the Draft Articles. Under both legislations creditors are forced to protect their interests by including collateralized terms in the loan agreement and, on default, hope that the foreign assets are characterized as being of a public commercial nature.

D. Mareva Injunctions

A Mareva injunction is an equitable remedy for attaching assets before obtaining a judgement. The Mareva injunction originated in English shipping cases where plaintiffs sought to prevent defendants from removing assets out of the court's jurisdiction, thereby defeating the plaintiffs' claim before judgment would be granted.⁷³ Generally speaking, the United Kingdom, United States and Canada apply similar principles and guidelines when granting a Mareva injunction.⁷⁴ The injunction is codified under 101(1) of the *Ontario Courts of Justice Act*,⁷⁵ which states that "an interlocutory injunction or mandatory injunction, may be granted or a receiver and a manager may be appointed by an interlocutory order, where it appears to a judge of the court to be just and convenient to do so."

In *Mareva Compania Naviera S.A. v. Int. Bulkcarriers S.A.*⁷⁶ Lord Denning enunciated the following principle:

If it appears that the debt is due and owing, and there is a danger that the debtor may dispose of his assets so as to defeat it before judgment, the court has jurisdiction in a proper case to grant an interlocutory judgment so as to prevent him disposing of those assets.⁷⁷

Denning, in *Third Chandris Shipping Corp. v. Unimarine S.A.*,⁷⁸ elaborated on the principle by enunciating the following guidelines that applicants must observe when applying for a Mareva injunction.

- 1) The plaintiff should make full and frank disclosure of all matters in his knowledge which are material for the judge to know;

⁷³ Frank Bennet, *Bennett on Creditors' and Debtors' Rights and Remedies* 4 ed. (Ontario: Carswell, 1994).

⁷⁴ David G. Powles, *The Mareva Injunction and Associated Orders* (Oxford Professional Books Ltd.):1985.

⁷⁵ *Courts of Justice Act*, R.S.O. 1990, c. C.43.

⁷⁶ *Mareva Compania Naviera S.A. v. Int. Bulkcarriers S.A.*, [1980] 1 all E.R. 213 (C.A.).

⁷⁷ *Ibid*

⁷⁸ *Third Chandris Shipping Corp. v. Unimarine S.A.*, [1979] Q.B645, [1979] 2all E.R. 972, [1979] 2 Lloyd's Rep. 184.

- 2) The plaintiff should give particulars of his claim against the defendant, stating the ground of his claim and the amount thereof, and fairly stating the points made against it by the defendant;
- 3) The plaintiff should give some grounds for believing that the defendants have assets here;
- 4) The plaintiff should give some grounds for believing that there is a risk of the assets being removed before the judgment or award is satisfied. The mere fact that defendant is abroad is not by itself sufficient;
- 5) The plaintiffs must give an undertaking in damage—in case they fail in their claim or the injunction turns out to be unjustified. In a suitable case this should be supported by a bond or security: and the injunction only granted on it being given, or undertaken to be given.

In assessing the legitimacy of the Mareva injunction, the Ontario Court of Appeal in *Chitel v. Rothbart*⁷⁹ adopted the above guidelines and further concluded that the plaintiff must establish that it has a strong *prima facie* case on the merits. "This criteria clearly elevates the threshold test from requiring the defendant to make out a good arguable case."⁸⁰ It should be noted however, that, as a general rule, the court has no jurisdiction to protect a creditor before judgment.⁸¹

The Supreme Court of Canada examined the concept of the Mareva injunction in *Aetna Financial Services Ltd. v. Feigelman* and concluded that, along with Denning's guidelines, the plaintiff had to show that there was a genuine risk that the assets would be transferred to another country and not just to another province.⁸²

1. Mareva Injunction: Applied to Sovereign Defaults

Lastly, the Mareva injunction does not grant the plaintiff any priority or rights to the defendant's assets. The purpose of the injunction is to prevent the defendant from committing a fraud on the court by disposing of the assets or removing them from the jurisdiction of the court before a judgment is rendered. However, the injunction does not remove any of the

⁷⁹ *Chitel v. Rothbart*, (1982), 39 O.R. (2d) 513 (C.A.)

⁸⁰ Above note 73

⁸¹ Above note 72

⁸² *Ibid*

defendant's rights in the assets or rights to carry on business.⁸³

Attaining a pre-judgment order with a Mareva injunction coupled with the FSIA and the Draft Articles requires a creditor to meet very onerous requirements. Under these legislations creditors must demonstrate a long list of requirements in order for a Mareva injunction to be granted. A creditor must state the grounds of the claim made against the sovereign and the amount thereof, as well as, fairly state the points made against it by the sovereign. A creditor must also provide reasonable proof that would support his reasons for believing that the sovereign has assets in the jurisdiction of the court. If the creditor can prove the latter, the sovereign can invoke immunity, under the FSIA or the Draft Articles, to protect its foreign assets. The sovereign must show however that the assets in question are of a public non-commercial nature. Whereas, the creditor would argue otherwise; the property is of a private commercial nature and is in no way used to service the sovereign's diplomatic function.

Additionally, the creditor must prove sufficient grounds for believing that there is a risk of the assets being removed from the jurisdiction of the court. Even after meeting the above requirements, creditors must still establish a strong *prima facie* case on the merits, because the general rule is that the court has no jurisdiction to protect a creditor before judgment. An additional comment should be made with respect to Lord Denning's fifth requirement as enunciated in *Third Chandris Shipping Corp. v. Unimarine S.A.*:⁸⁴ an injunction should only be granted if the plaintiff gives an undertaking in damages (supported by a bond or security), in order to protect the defendant in the event that the plaintiff's claim fails or the injunction turns out to be unjustified. This requirement can be seen as a "put your money where your mouth is" gamble for creditors who are already suffering shortfalls. This obligation is arguably the creditor's greatest barrier to attaching to a sovereign's foreign assets. A creditor would be quite reluctant to deposit large sums of money as security in case their claim is without merits. Notwithstanding the requisite cost-benefit analysis that would accompany such an undertaking, creditors would be understandably reluctant to have "good money chasing bad money." Additionally, creditors chasing multi-million dollar outstanding loans might not be in a financial position to relinquish large amounts of cash. In essence, this requirement favors sovereign debtors and to a lesser extent large lenders who have the financial clout to make large undertakings.

⁸³ Ibid

⁸⁴ Above note 78

Arguably then, a creditor's best strategy to attach sovereign assets would be to pursue a post-judgment order of constraint (as opposed to a pre-judgment order). Post judgment orders, however, require the creditor to enter into a collateralized lending agreement with the sovereign. And, as previously mentioned, collateralized agreements are quite rare in sovereign debt agreements. A collateralized agreement would guarantee a creditor a secured interest in the defaulting sovereign's assets – thus upgrading the creditor from an "unsecured creditor" to a "secured creditor." If successfully negotiated, the creditor would be able to attach to the sovereign's foreign assets in the event of default on the loan agreement. As a secured creditor, a lender would be entitled to attach assets according to the federal *Companies' Creditors Arrangement Act*⁸⁵ (CCAA), the *Bankruptcy and Insolvency Act*⁸⁶ (BIA) and the provincial *Personal Property Security Act*.⁸⁷

It should be stressed that most – if not all – sovereign debt holders are unsecured creditors and as such have no power to seize assets. "Because the borrowers in the sovereign debt markets are, well, sovereign, creditors have virtually no rights. Creditors cannot grab assets in the country – the most they can do is seize planes or barges of oil, which does not get them far except as a strategy of harassment."⁸⁸

A number of commentators contend that the sovereign debt market can be improved if creditors' rights were strengthened. The following proposals for a new sovereign debt-restructuring regime seek to accomplish the latter by addressing this inequality of bargaining power.

VII. SOVEREIGN DEBT RESTRUCTURING PROPOSALS

TAKING INTO ACCOUNT THE ASSOCIATED PROBLEMS with Brady bonds, vulture funds and free riding, what can the IMF and other organizations do to make the sovereign debt restructuring process more predictable, orderly and rapid? The following three proposals are the prevailing ideas on how to address these issues.

A. Sovereign Debt Restructuring Mechanism (SDRM)

In April 2002 the IMF, under the leadership of Anne Krueger, investigated a "twin-track" approach to solving the sovereign debt-restructuring

⁸⁵ *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-25

⁸⁶ *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3

⁸⁷ *Personal Property Security Act*, R.S.O. 1990, c. P.10

⁸⁸ Above note 72.

problem. The first, a statutory approach, which would create a legal framework that would allow a qualified majority of a sovereign's creditors to approve a restructuring agreement, which would be binding on all other creditors. The second approach would incorporate collective action clauses (found in sovereign bond contracts) in debt instruments to limit the ability of dissident creditors to holdout or free ride.⁸⁹

A large component of the SDMR is modeled after U.S. Chapter 11 corporate insolvency law. However, unlike bankrupt countries, when companies default on their debts there is a clear procedure to guide a restructuring. In formulating the SDRM, Krueger highlighted the following core concepts that operate in a corporate restructuring:

- a) A stay on creditor enforcement during the restructuring negotiations;
- b) Measures that protect creditor interests during the period of the stay;
- c) Mechanisms that facilitate the provision of new financing during the proceedings; and
- d) A provision that binds all relevant creditors to an agreement that has been accepted by a qualified majority.⁹⁰

These core concepts lay the foundation for Krueger's SDRM proposal. Subsequently the four core features of the SDRM are: (1) majority rule in restructuring decisions (as opposed to unanimous consent), (2) a legal stay against claims by creditors, (3) protection of creditor interests, and lastly, (4) priority financing. It is important to note that the SDRM attempts to provide the necessary incentives, for both creditors and debtor, to reach a debt restructuring agreement. "To the extent that the insolvency system is well-developed, most restructurings take place "in the shadow" of the law, that is, without the need - and expense - of actually commencing formal court-administered proceedings."⁹¹

1. Majority Restructuring

A mechanism that allows a qualified majority of creditors to bind a dissenting minority to the terms of a restructuring agreement is claimed

⁸⁹ "Strengthening The International Financial Architecture: Sovereign Debt Restructuring Mechanism (SDRM)" IMF External Relations Department (August 2002), online: <<http://www.imf.org/external/np/exr/facts/sdrm.htm>>.

⁹⁰ Above note 6.

⁹¹ Ibid

by Krueger to be the most important element of any new restructuring framework. This mechanism is designed to bind all creditors, including free riders who could otherwise press for full payment after an agreement is reached. For the majority of creditors, this mechanism is essential to prevent free riders who not only "raise inter-creditor equity issues, but also reduce the ability of the debtor to service the newly restructured debt"⁹² (as seen in the Elliot Associates case). The sovereign also benefits because resolving collective action issues makes reaching an early agreement with creditors more likely. The mechanism also helps eliminate the threat of disruptive litigation by free riders after restructuring takes place. The majority rule approach, as a restructuring feature, also addresses the collective action problems that arise from the very diverse private creditor community that currently exists. Such a mechanism would need to apply to all forms of sovereign private debt; furthermore, Krueger emphasizes private credit because bilateral credit is dealt with under the Paris Club framework. An effective restructuring mechanism cannot aggregate all private credit. Doing so would result in creditor inequality and discrimination because not all creditors are similarly situated. Aggregating private credit would create a risk that "a minority of creditors with a certain type of claim will be unfairly treated by a qualified majority."⁹³ An example would be where "a majority of unsecured creditors could vote on restructuring terms that can effectively strip the collateral from a minority of secured creditors."⁹⁴

Krueger remedies this minority protection problem by advocating the creation of separate classes of creditors, on a case-by-case basis, where each class of creditors would be determined by whether they were secured or unsecured or bilateral or private creditors.⁹⁵ Another approach would be to pre-specify certain classes in the text of the treaty and allow for the creation of additional classes in individual cases based on predefined parameters.

A class system would work as follows. A qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. Votes would be aggregated across instruments (reducing the leverage of holdouts) and there would be no aggregation of votes across different classes. "However, since all classes would be required to approve the overall restructuring, each creditor class would

⁹² Ibid

⁹³ Above note 30

⁹⁴ Ibid

⁹⁵ Above note 6

have effective veto power over the terms offered to other classes.⁹⁶ But creditors would only have veto power if their claims were being restructured under the SDRM. With this approach in place creditors similarly situated would be in a single class and would receive the same restructuring terms. Put another way, creditors with different interests would be separated by different classes and would receive appropriately different restructuring terms. The IMF has even proposed the creation of a single separate class for Paris Club creditors to represent their interests in an SDRM framework.

2. Stay on Creditor Enforcement

This mechanism would enable the debtor to get a stay from creditor litigation if an agreement could not be reached prior to a default. It would essentially create a window for further negotiations. Krueger, in drawing an analogy to corporate insolvency, states that a stay on litigation is also intended to enforce collective action "by preventing a rush to the court house and a 'grab race' that could undermine the ability of a company to continue functioning, to the detriment of the debtor and its creditors (the value of whose claim is maximized when the company remains a going concern)."⁹⁷ A stay on litigation is a necessary feature to protect sovereign and creditor assets in a post-default scenario.

3. Protecting Creditor Interests

Creditor protection during the restructuring period would be accomplished in two ways: the debtor nation would be prohibited from making payments to non-priority creditors; and the debtor would be prohibited from adopting policies that would be detrimental to asset values.

4. Priority Financing

Priority financing is a feature essential to ensuring that the debtor receives new money during the stay. The provision protects the new creditors' interests by treating their loan as senior to any pre-existing debt. It would also serve to "limit the degree of economic dislocation and thereby help preserve the member's capacity to generate the resources for meeting debt-service obligations" and cover such things as trade credit.⁹⁸ This

⁹⁶ Ibid

⁹⁷ Above note 6

⁹⁸ Ibid

security feature is vital for providing new money to the sovereign during the stay.

Krueger proposes that the SDRM framework requires both a statutory change as well as the creation of a new institution that would act as an intermediary in discussions between the debtor and creditors.

5. Dispute Resolution Forum (DRF)

Krueger proposes establishing a DRF by amending the IMF's Articles of Agreement which amount to a treaty obligation. The DRF would have exclusive jurisdiction over all disputes arising between the sovereign and its creditors as well as disputes arising between creditors. The need for a DRF becomes clear when looking at the alternative: reliance on domestic jurisprudence which often leads to a fragmented process because different claims are subject to the jurisdictions of different national courts. A DRF enacted by a treaty or change to the Articles would ensure a universal legal framework and uniformity in interpreting a world of competing jurisdictions.⁹⁹

The IMF asserts that the creation and operation of the DRF would be guided by four basic principles: independence, competence, diversity and impartiality.¹⁰⁰ The DRF would be an arbiter in the debt restructuring process and would simply interpret and apply the framework for an SDRM. The accepted debt restructuring procedure will largely depend upon a majority vote by creditors and, therefore, the "certification" of the process would not be based on the panel's discretion."¹⁰¹ However, the creation of a DRF is controversial for 2 reasons:

- 1) The DRF does expand the IMF's relative powers in the following ways:
 - a) The IMF would need to endorse a request or an extension of a stay by a debtor nation.

⁹⁹ Above note 30

¹⁰⁰ The article "Sovereign Debt Restructuring", cited above in note 1, reviews the IMF's 5-step procedure for the setting up and operation of the DRF as follows: (1) each of the 183 members of the IMF nominates a candidate for the DRF; (2) Out of this list 21 members will be chosen to serve terms (recommended at 4 to 5 years); and (3) these members would, amongst themselves, chose a "Presiding Member"; (4) the group would then be permanent members of the DRF, and (5) at the request of a debtor nation an SDRM process would be enacted and the Presiding Member would "impanel" 3 members to work as part of the SDRM.

¹⁰¹ Above note 1

b) The IMF would also first determine whether the debt is sustainable and whether appropriate policies are being or will be pursued.

c) The IMF would additionally need to approve of the restructuring agreement, which would essentially entail whether it guarantees debt sustainability, something that the DRF could not oppose.

2) The IMF is in a biased position because it too is a creditor that seeks full payment on its loan.

6. Administrative Powers

The DRF would perform both administrative and procedural functions to facilitate the voting process and facilitate the administration of claims.¹⁰²

The salient administrative powers performed by the DRF would include:

1) Notification to creditors including notices regarding:

a) The request for activation by the debtor;

b) The identification of and listing of claims submitted by creditors; and

c) Dates, place and procedure for voting by creditors on a restructuring procedure.

2) Administration of the voting process including the organization of meetings where voting would take place and the recording of votes that have been cast.

7. Procedural Powers

Moreover, the salient procedural powers performed by the DRF would include:

1) The verification of claims regarding both the validity and value of creditor claims. This would help prevent the creation of fictitious claims that could be used to manipulate the voting process. Disputes may also arise regarding the

¹⁰² The following discussion on the DRF's procedural and administrative powers was largely taken from the IMF article, "Sovereign Debt Restructuring Mechanism - Further Considerations," cited above in note 18.

value of claims and the collateral that secures the claims.

2) Ensuring the integrity of the voting process by preventing collusion between the sovereign debtor and certain creditors, including the task of preventing "vote buying": a sovereign might provide financial incentives to a qualified majority in return that the qualified majority would approve a specific debt restructuring plan. With respect to domestic creditors (and, to a lesser extent, international creditors) the DRF would also resolve disputes as to whether a creditor is in fact under the sovereign's control. In short the DRF would resolve disputes in such a manner to prevent fraud.

3) As discussed earlier, creditor classes may be created on a case-by-case basis. The DRF would resolve disputes regarding the creation of creditor classes.

Both the procedural and administrative rulings of the DRF regarding a sovereign debtor and a qualified majority of its creditors would have the legal effect of binding all member countries. Thus, a domestic court could not enforce a claim of a minority creditor – a free rider – under the original bond or debt agreement.

B. Collective Action Clauses (CACs)

The second proposal requires collective action clauses for loan and bond covenants and is supported by the U.S. Treasury department under John Taylor, the head of its Office of International Affairs. Including CACs in bond and loan contracts would prevent a minority of creditors from blocking negotiations with the debtor. CACs would bind minority creditors and any vulture funds into a restructuring by enabling a majority vote (usually a supermajority of 60% to 75%) to determine the outcome of a sovereign debt restructuring agreement. This is a decentralised market-oriented approach, as opposed to the centralised non-market approach of the SDRM.¹⁰³ Nonetheless, relying solely on CACs in bond and loan contracts presents several shortcomings.

1. Restricted Application

For starters, CACs can only be included in future debt, and the enormous amount of currently outstanding debt would not benefit from their inclusion. As such, CACs will only function once the entire current stock of debt is repaid or rolled-over into new bonds that have CACs in place.

¹⁰³ Above note 1

Consequently, a small minority of dissenting creditors holding old bonds not bound by CACs can still cause havoc in a system that relies entirely on CACs. The use of CACs alone can only resolve collective action problems and free riding if they are universally employed in bond and loan contracts and this may take up to 10 years or more.

2. Jurisdictional Problems

Even if CACs are employed in all debt issuances (new and old bonds alike), jurisdictional problems still render their sole use unworkable. Without a statutory framework in place, there is no uniform interpretation of the CACs. Bonds are issued in a large number of jurisdictions and it will be up to local courts to interpret the clauses, if enacted, according to their domestic law.¹⁰⁴

3. Diminished Reputation

Moreover, if CACs make both borrowers and creditors better off, why have sovereign debtors or private creditors not been willing to voluntarily include them in their new debt contracts? "The answer is that clauses describing default are an unattractive prospect when a country issues debt: about as romantic, as one debt lawyer puts it, as a prenuptial agreement."¹⁰⁵ Sovereign debtors fear CACs would raise their borrowing costs while creditors and underwriters fear that CACs imply a risk that would scare off future investment interest. However, empirical evidence suggests the opposite: CACs do not make bonds less attractive for buyers or make a significant impact on borrowing costs.¹⁰⁶

In spite of all these deficiencies, why does the U.S. government support this approach over the IMF's SDRM? Perhaps the U.S. rejects the SDRM system because it confers more power on the IMF regarding how much money a country can borrow. The U.S. might prefer a more flexible, non-accountable, international finance regime because it can use money as a major political tool. Under the SDRM, the U.S. would have been precluded from offering huge "strategic bail-outs" to both Turkey and Pakistan. The U.S. views both countries as important allies in the current battle against global terrorism.¹⁰⁷ Politics aside, the IMF's "twin-track" strategy may facilitate an orderly, predictable and equitable sovereign debt restructuring procedure.

¹⁰⁴ Above note 1

¹⁰⁵ "Sovereign Bankruptcies" *The Economist* (April 4, 2002).

¹⁰⁶ Barry Eichengreen and Ashoka Mody, "Bail-Ins, Bailouts, and Borrowing Costs" *IMF Staff Papers* Vol. 47, Special Issue, 2001.

¹⁰⁷ *The Economist*, April 18, 2002, America and the IMF/World bank. What leadership?

Politics in play, sovereigns and creditors better hope that the debtor is of strategic importance, in American eyes, to qualify for further bailouts.

C. Chapter 9 Municipal Bankruptcy Model

A third proposal modelling itself after U.S. Chapter 9 municipal bankruptcy law has also been advocated. The Chapter 9 bankruptcy model has been endorsed by Ann Pettifor of Jubilee Research; a self proclaimed "radical think-tank" and successor to Jubilee 2000. Jubilee Research contends that the Chapter 9 model protects the rights of taxpayers and employees to participate in, and if necessary object to, the outcome of the governmental insolvency process. Anne Krueger and the IMF argue, however, that such an approach is laden with deficiencies when applied in an international setting.

1. Chapter 9 Municipal Bankruptcy and Chapter 11/CCAA Reorganization

Chapter 9 municipal bankruptcy is similar to Chapter 11 reorganization and the Canadian CCAA equivalent. As such, any discussion on the Chapter 9 regime should include a discussion on Chapter 11 and CCAA principles. Chapter 9 is based on Chapter 11, except for the following differences:¹⁰⁸

- 1) Municipal officials must voluntarily file for bankruptcy and the state must authorize the municipality to do so.
- 2) Municipalities must be insolvent on a cash flow basis in order to file for bankruptcy, i.e., unable to pay their debts as they come due. Before filing, municipalities must attempt to work out a restructuring plan, although they can file for bankruptcy if the attempt fails.
- 3) Public officials—unlike managers of corporations—can never be replaced in bankruptcy, on the grounds that doing so would interfere with state sovereignty.
- 4) Lastly, public officials always have the exclusive right to

¹⁰⁸ The following analysis on U.S. Chapter 9 municipal bankruptcy is taken from Michelle J. White's article "Sovereigns in Distress: Do They Need Bankruptcy?" Prepared for the *Brookings Panel on Economic Activity* (April 5, 2002). Online: <http://econ.ucsd.edu/~miwhite/BPEA_White.pdf>.

offer the restructuring/reorganization plan. Creditors have the right to form a committee to negotiate with the public officials, but cannot propose their own plans.

Reorganization plans are adopted by a voting procedure, under which all classes of creditors and equity must approve the plan. Pursuant to Chapter 11 and the BIA, a voting margin is implemented where each class of unsecured and secured creditors must have a majority in number and at least two-thirds in value for the proposal to succeed. For example, if there are 100 creditors totaling \$100,000 in claims, the formula provides that there must be at least 51 creditors with claims of at least \$66,666 voting in favor of the reorganization plan. Once accepted by the creditors and approved by the court it binds all unsecured and secured creditors, including those who voted against the proposal, to the terms of the plan.¹⁰⁹ In a sovereign bankruptcy context this binding mechanism is imperative for resolving free riding and the proliferation of vulture funds.

The approved plan should give each class of creditors a return equivalent to at least what the class would have received if the firm liquidated under Chapter 7 or the BIA. Reorganization plans are worth pursuing if a company in operation can generate greater value than the likely proceeds generated from its own liquidation. The "excess" funds resulting from the reorganization are then shared among classes of creditors and equity.

However, what happens if divisive creditors cannot agree on a reorganization plan? An important aspect of bankruptcy reorganization is the procedure that is followed when no reorganization plan is adopted by vote. It is often argued that an effective sovereign bankruptcy structure requires an alternate procedure to be followed in the event that negotiations between the country and its creditors break down.¹¹⁰ The alternate procedure in a Chapter 9 municipal bankruptcy regime is ambiguous because municipalities are never subject to liquidation. Conversely, under U.S. Chapter 11 and Canadian CCAA reorganization, a procedure is in place when a plan is not adopted by vote or a breakdown arises. In such a case the bankruptcy judge can:

- 1) Make a decision to liquidate the firm (either piecemeal or as a going concern) with creditors paid according to the

¹⁰⁹ Above note 73

¹¹⁰ *Ibid*

absolute priority rule;¹¹¹ or

2) Adopt the reorganization plan anyway, using a procedure called "cramdown."¹¹²

Two requirements need to exist to institute a cramdown: at least one class of impaired creditors must meet the voting margin for adoption of the plan and the plan must pass the "best interest of creditors" test. As is the case with sovereign bankruptcies, where all creditors have equal priority the test requires that all classes of creditors get at least what they would have received in liquidation.

A "cramdown" approach to adopt a restructuring plan cannot be used in Chapter 9. However, an alternate cramdown procedure in a Chapter 9 scenario may exist. Bankruptcy judges may formulate their own restructuring plans and order municipalities to "raise taxes, sell assets, cut expenditure, reject collective bargaining agreements, or whatever else is necessary to pay for the plan. This has never happened under Chapter 9, but could in theory."¹¹³ Likewise in a sovereign bankruptcy context a judge operating with a Chapter 9 framework can formulate their own restructuring plan for sovereigns and creditors. However, a cramdown procedure has yet to be implemented in a Chapter 9 municipal bankruptcy and the lack of a clear alternate procedure (to be followed if negotiations do break down) is also a problem with sovereign debt restructuring proposals.

2. Chapter 9 Municipal Bankruptcy Applied to Sovereign Bankruptcy

Ann Pettifor argues in favor of using Chapter 9 as a model for an international insolvency court. Pettifor and Kunibert Raffer further argue that international treaty arrangements on an ad hoc basis can be used to set up such a system. There are two main precedents for this. The first

¹¹¹ As per White's article cited above "the proceeds are distributed among creditors according to the absolute priority rule (APR). Under the APR, administrative expenses of bankruptcy are paid first, unsecured creditors second, and, if anything is left, equity receives the rest. Each class of creditors is paid in full before any lower ranking class is paid anything. Unsecured creditors' claims may be subdivided into classes if their contracts with the firm contain subordination agreements, but otherwise all of their claims are in a single class. Secured creditors are outside the priority ordering and, in liquidation; they reclaim the assets securing their loans."

¹¹² Above note 108

¹¹³ Ibid.

was the 1953 agreement whereby the German government negotiated a 50 per cent debt reduction relating to its Versailles and Nazi era debts. The second precedent was a similar cut in 1971 whereby Indonesia negotiated its debt reduction. In each instance the parties involved would appoint members of the court and a small number of arbitrators.¹¹⁴

a. Principles of Fairness and Justice

Pettifor lists the key principles of Chapter 9 as follows:¹¹⁵

- 1) The process should be based on the application of justice and reason and not be viewed as an act of mercy.
- 2) Any process should protect the human rights, and the human dignity of the debtor, as well as the rights of creditors.
- 3) Neither creditors nor the debtor can control the court of bankruptcy, or decide on their own claims or payments. The judge has to be independent of both debtor and creditors, and to resolve the crisis within a framework of justice that recognizes the human rights of the debtor.
- 4) Citizens affected by a debt crisis, have a legal right to have their voices heard in the resolution of that crisis. In other words, freedom of information, transparency of process and accountability to the public must be central to an international insolvency framework.
- 5) There should be democratic participation in the resolution of a crisis; the prevention of future crises and the development of a 'new financial life' for the country as a whole.

As such, Pettifor advocates for a bankruptcy court comprised of an ad hoc body, with appointees nominated by the debtor and creditor and a judge agreeable to both sides. Pettifor stresses the independence of the court as being essential. There is emphasis on having a process which would ascertain whether the debt was contracted legitimately. As in

¹¹⁴ Jonathan P. Thomas, "Bankruptcy Proceedings for Sovereign State Insolvency" United Nations University/World Institute for Development Economics and Research, Discussion Paper No. 2002/109, November 2002.

¹¹⁵ Anne Pettifor, Chapter 9/11? Resolving International Debt Crises – the Jubilee Framework for International Insolvency, NEF Report. London: New Economics Foundation. Online: <www.jubilee2000uk.org/analysis/reports/jubilee_framework.html>.

Chapter 9, parties affected could participate in the process and citizens would be able to have their responses heard.

The guiding principle is justice, including the protection of fundamental human rights, in addition to the rights of creditors. The debtor should emerge from the process “with reasonable prospects of financial stability and economic viability.”¹¹⁶ “An appealing feature of this proposal is that it is in line with current international policy thinking on grassroots participation (‘bottom-top approach’) and ownership of economic policies.”¹¹⁷

b. Chapter 9 Applied: A 3-Step Process

Step One: Declaring Insolvency

The “Jubilee Framework” applies the Chapter 9 bankruptcy procedure in a 3-step process. In step one, the sovereign determines at what point repayment of foreign debts are being made at a cost to the human rights or dignity of the people of that country. If repayment of debts is in this sense unpayable, then the debtor would negotiate a debt reduction with its creditors. If a breakdown in negotiations fail, a sovereign would petition for a ‘standstill’ on debt payments. Pettifor states that a sovereign’s petition for a standstill would be subject to the court’s consent.

The Jubilee Framework allocates a large monitoring role for civil society.” Organizations would “monitor the government’s borrowing policies on a continuous basis and determine the countries ability to pay. If civil society organizations determine that debt payments are being made at the expense of the citizenry’s human rights and dignity, it should “assert loudly and clearly” and petition the government to file for a standstill on debt.

Step Two: Petitioning for a Standstill and Seeking Creditor Protection

Under a Chapter 9 procedure, the sovereign debtor would file for creditor protection with an insolvency court. Currently there is no such international bankruptcy court, however, Pettifor argues that there is no need for one. Instead, she argues for the use of the ad hoc court mechanism discussed above. The Jubilee Framework also includes a provision for

¹¹⁶ Ibid

¹¹⁷ Above note 114

securing new loans or working capital, provided by the IMF, during any standstill period.

Step Three: Responsibilities of the Court

Under the Jubilee Framework courts are entrusted with a large number of responsibilities during the debt restructuring. Additionally, the framework has civil society playing an active role alongside the court in shaping a debt-restructuring plan that seeks to ensure justice and fairness for all involved. The following is a list of court responsibilities under a Chapter 9 framework.

1) The court will determine whether sovereign debts were legally and properly contracted. All claims would be verified loan-by-loan, ensuring that the sovereign debtor contracted all outstanding claims legitimately. Jubilee research contends that "such a process would dismiss some of the debts contracted illegally and fraudulently by Argentina's military during the period of 1976- 1983 – debts for which no formal records remain. This process would involve civil society."¹¹⁸

2) The court would determine whether debts have been retroactively nationalized. In making this case Pettifor states "governments have been forced by creditor cartels like the Paris Club to retroactively assume losses from private lending – initially undertaken without any government guarantees or involvement." Pettifor attaches responsibility for these "dubious legal practices" to the IMF and the World Bank who must declare these 'nationalized' private debts null and void.

3) The court would ensure symmetrical treatment of creditors and reject a multi-class system for debt payments. Pettifor contends there "is no reason why any particular class of creditors, and in particular public creditors like the IMF and World Bank, should be given preferential treatment in an insolvency process."¹¹⁹ Pettifor targets the IMF and World Bank for the following reasons:

"Multilaterals have strongly influenced the use of loans, and exerted massive influence on their debtors' economies." "In other words, IFIs take economic decisions, but refuse to participate in the risks involved. IFIs insist on full repayment, even if damages caused by negligence of their staff occur, damages, which have to be repaid by the borrower.... The

¹¹⁸ Above note 115

¹¹⁹ Ibid

striking contrast between free-market recommendations made by IFIs and their own protection from market forces, must be abolished. Symmetrical treatment of creditors is more than justified."¹²⁰

4) The court will support the debtor government to take measures to prevent rich nationals from exporting their assets via the Central Bank, in the form of capital flight. The IMF has also recently indicated that imposing exchange controls for a temporary period of time would protect creditor and debtor interests during a restructuring.

5) The court is entrusted to develop a debt workout plan that protects the human rights of the sovereign debtor's citizens. In doing so, Pettifor mentions the Chapter 9 principle that money to service a country's debt should not be raised by destroying "basic social services, fundamental to the defence of human rights." Instead, it is argued that "subsidies and transfers necessary to guarantee these minimum rights for the poor, must be defended and maintained."

6) The court would have to bind all creditors (and the debtor) to a debt reduction agreement, in which losses would be shared and human rights would be given precedence over other monetary claims. The Jubilee Framework places great importance on an active role for civil society in shaping the final debt workout plan. Based on a Chapter 9 model, "representatives of government employees and taxpayers of the sovereign debtor nation should be given the right to comment on the soundness of the final plan binding the government and the creditors; and to object to the final debt workout." Binding all creditors to a debt restructuring agreement would in effect resolve creditor free riding and vulture fund problems.

3. Critique

A number of deficiencies exist with respect to the Jubilee Framework. For starters, a framework that assesses insolvency based on whether debt payments are made at a cost to the human rights and the dignity of a country's people is fraught with ambiguity. How can a government determine when its citizenry's human rights and dignity is being undermined? At what point do the debt payments outweigh human costs and, would the same formula apply to all nations?

Additionally, activating this mechanism would lead to a floodgate of sovereign nations claiming default and subsequent standstills in the name of "justice and fairness" for their people. Issues of impartiality

¹²⁰ Ibid

might also arise with a mechanism that has sovereigns and civil society determining when insolvency should be pursued. Although this concern is somewhat allayed because any insolvency would be subject to a court acceding to it.

The Jubilee Framework also risks creating debtor moral hazard. The framework is debtor soft in that it makes it easy for sovereigns to declare bankruptcy; receive a standstill and a stay on litigation; and collect new financing on a secured priority basis. Arguably, sovereigns are awarded too much protection under this regime in the sense that governments can borrow recklessly without having to account for any of the costs of repayment. This regime allows sovereigns to "wipe the slate clean" – the only parties that suffer are the creditors and the domestic population. This regime might reduce foreign capital and investment because it makes default relatively painless and as such potentially frequent. Hence, the citizenry suffers because less money is flowing into the country. Albeit Pettifor does argue that the threat of moral hazard is mitigated by the fact that bankruptcy "limits access to new capital and damages reputations for sound economic management," but is this deterrent sufficient?

The Jubilee Framework advocates a strong involvement on the part of civil society in the debt restructuring process. This approach has some inherent weaknesses. First, it does not address countries that do not allow a civil society to participate in governmental matters. China, Venezuela, Singapore and much of the Middle East comes to mind. As such, the notion of societal involvement and public debate can be regarded as quite "western-centric." Secondly, involving civil society in a debt restructuring process that is already slow and cumbersome will only exacerbate the bureaucracy. Debt restructuring is a protracted undertaking often taking up to two years; societal involvement and public debate, although democratic, will increase transaction costs for both debtor and creditor. Similarly, the longer the restructuring time the greater the risk that market forces will devalue sovereign assets.

VIII. CONCLUSION

A MAJOR SOURCE OF REVENUE for a large number of lesser-developed countries is in the form of multilateral loans and syndicated bank loans. Sovereigns negotiating a debt restructuring with these lenders have a relatively predictable framework to work with. Sovereign debtors are able to negotiate with multilateral lenders through the Paris Club framework, which represents all multilateral creditors – save the IMF and World Bank. Likewise, syndicated banks are uniformly represented as London Club creditors. Sovereigns negotiating with either Paris

or London Club creditors can facilitate a restructuring without having to worry about a multitude of interests.

This framework, although often protracted, enables governments to negotiate with one voice. Additionally, Paris and London Club creditor interests are intertwined: they are all "in bed together" in the sense that an agreement binds dissenting or minority creditors. As such, the risks of free riding or holdouts are minimal.

In the 1980's a relatively new financing instrument emerged, known as Brady bonds, which changed the uniformity that accompanied debt restructuring under the Paris/London Club regime. Brady bonds converted sovereign debt into a liquid debt instrument that was tradable on secondary markets. Government debt was now traded like any other security and a large secondary market of sovereign debt emerged. Thus, it is no longer possible for sovereigns to negotiate with single interests. The multitudes of trading bonds are now represented by a multitude of diverse interests.

To make matters worse, these individual investors do not share a vested interest in the indebted sovereigns - as is often the case for multi-lateral creditors. Individual creditors are outside the Paris/London Club framework and as such are not compelled to accept restructuring terms negotiated by the multilaterals. What often emerges, to the detriment of indebted governments, during and after negotiations, are creditor holdouts. A holdout or free riding is the risk that the benefit derived from a restructuring with one group of creditors will be used to pay another group of creditors who do not partake in the restructuring. As such, creditors are on the whole reluctant to negotiate a settlement only to incur a further loss that benefits other creditors.

Sovereign debt bonds are also responsible for the emergence of a new investment vehicle known as vulture funds. Vulture funds operate by purchasing heavily discounted sovereign debt on the secondary market for as low as 30 cents on the dollar. The vulture fund goes on to free ride the debt by holding out for better terms already agreed to by other creditors in a restructuring. Upon the sovereign defaulting on its loan obligation, the vulture fund attaches claims to the sovereign's foreign assets by litigating in the jurisdiction where the assets are located. The vulture fund creditor is then awarded full payment of accrued interest as well as full payment of the principal amount of the debt. Lastly, the vulture fund walks away with a substantial profit on its initial investment. As was seen in the Elliot case, vulture funds can create havoc for sovereigns attempting a debt restructuring. Nonetheless, sovereigns can protect their private non-commercial assets by invoking the sovereign immunity doctrine under the Draft Articles and the act of state doctrine.

Mechanisms have developed to resolve these holdout risks. For one, the Paris Club relies on a "comparability treatment provision." Another mechanism known as a collective action clause is built in the actual debt bond or debt agreement and binds all creditors under the bond to a restructuring that has been approved by a supermajority (60% to 75%) of bond holders. However, these mechanisms cannot be applied across all sovereign debt instruments.

As such, a number of sovereign debt restructuring proposals have emerged. The International Monetary Fund's sovereign debt restructuring mechanism (SDRM) is a "twin-track" approach, part statutory and part contract. It applies Chapter 11 reorganization principles (such as a stay on creditor enforcement, interim creditor interest protection, securing senior financing and supermajority provisions) to a sovereign debt restructuring. Additionally, the IMF advocates the creation of an international "Dispute Resolution Forum."

Another approach advocated by the U.S. Treasury Department relies exclusively on collective action clauses. These mechanisms, described above, can be effective but fail to address past bond issuances and jurisdictional issues.

Jubilee 2000 advocates an approach that shares a few similarities to the SDRM put forth by the IMF. The "Jubilee Framework" applies a Chapter 9 municipal bankruptcy model to sovereign debt restructuring. This regime emphasizes fairness and justice as being key features of any plan. It also advocates an active role for civil society in the debt restructuring process. However, this framework may arguably lead to debtor moral hazard and a protracted cumbersome restructuring process.

The proposals, although different, are quite similar in nature in that they employ similar mechanisms such as "cramdowns" and "collective action" provisions. These regimes are also formulated to target similar deficiencies that exist in the sovereign debt restructuring process. Namely, collective action problems such as holdouts and free riding; damaging vulture fund activity; debtor and creditor moral hazard; debtor and creditor "softness"; protracted and costly negotiations and subsequent asset devaluations; a lack of fairness and justice for the bankrupts' citizenry; and among others, a predictable alternative to a non approved restructuring plan.

In the meantime, creditors seeking to secure their investment through attachment must often contend with the sovereign right to immunity – albeit for non-commercial public property. And conversely, sovereigns must contend with the threat of rogue creditors, vulture funds and holdouts. It is lamentable that sovereign debtors and their creditors have no other choice but to continue to negotiate without an efficient and predictable framework in place.