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How to Rethink Sovereign Bankruptcy

A New Role for the IMF?

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Introduction

This chapter is concerned with the issue of how to balance bailouts (or 'lending into arrears') with debt reductions (or 'private sector involvement') in the resolution of sovereign debt crises. It begins by briefly outlining the core underlying economic and legal problems sovereigns and creditors face in a sovereign debt crisis. It continues with a review of recent proposals to facilitate or regulate sovereign debt renegotiations, in particular the proposal for a statutory approach to sovereign debt restructuring. We do not aim to assess the political feasibility of the proposed institutions for the resolution of sovereign debt crises. Instead, we focus on their likely effectiveness. In addition to defending a sovereign bankruptcy framework we have developed in recent work, we propose a major reorientation of the IMF's role in sovereign debt crises.

The motivation for the discussion can be traced back to the Mexican debt crisis of 1994–5, which gave rise to an International Monetary Fund (IMF) bailout of unprecedented size. Since then, there has been a debate raging on how the IMF should handle sovereign debt crises. Despite the successful resolution of the crisis and the quick repayment by Mexico of all the emergency debt, the sheer size of the intervention raised worries that bailouts could cause significant sovereign debt market distortions. These concerns have led to a gradual shift away from the assumption that the IMF can and should act as the de facto international lender of last resort (ILOLR) by arranging bailouts in response to major sovereign debt crises. As is now widely recognized, the

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problem with a purely bailout-based policy is that it requires ever larger funds to be credible and successful. It also invites undesirable policies by debtor countries. The prospect of a bailout encourages sovereign debtors to borrow more than they should, and it tempts them to use highly risky fixed exchange rate policies as a quick fix towards macroeconomic discipline.[1] Of course, the worst debtor misconduct can be controlled to some extent by imposing conditions on the debtor country before granting a rescue program, but more often than not the IMF finds itself in a weak bargaining position at the onset of a debt crisis. How credible is the IMF threat to withhold a financial aid package, when a potentially contagious debt crisis is about to blow up? And once the bailout has been granted, why should the debtor country stick to the conditions it agreed to?

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

The most ambitious overhaul of IMF policy contemplated so far involves the introduction of some form of bankruptcy institution for sovereigns. There was considerable discussion and research of this strategy, which the IMF calls a sovereign debt-restructuring mechanism (SDRM), from late 2001 when the IMF first announced its support for a sovereign bankruptcy framework, up to the meeting of the IMF's International Monetary and Financial Committee (IMFC) in April 2003, when it was decided to shelve the IMF's proposal. Despite all the writing and debates, many open questions were still unresolved, including the role of the IMF in an SDRM regime. No doubt these questions would have received further attention if the SDRM proposal had gone forward. But in the aftermath of the SDRM debate, no clear new role for the IMF has been marked out and no clear rules have emerged to direct the IMF's balancing of bailins and bailouts in future debt crises.

As a result, the IMF now finds itself at a crossroads. Should it be content with the status quo and accept that it will be less and less equipped to deal with major emerging market debt crises? Or, on the contrary, should its size be considerably expanded, possibly by granting a more powerful role to Japan, China, and other East Asian countries that are sitting on massive foreign exchange reserves? Or, even more radically, should the IMF be scaled back and moved entirely out of any form of crisis lending, to confine itself to an

advisory and forecasting role, as Chari and Kehoe, Rogoff, and others have urged?[2]

In this chapter we argue that by establishing an adequate bankruptcy procedure for sovereigns, the international community could both fully address the problem of sovereign debt restructuring and redefine a suitable crisis resolution role for the IMF in the increasingly financially integrated world economy. Far from stepping away from a crisis lending role, we argue that the IMF can enhance its ILOLR role within the framework of a sovereign bankruptcy procedure, and without having to substantially increase the size of the Fund. How do we square this circle?

Corporate bankruptcy provides a useful analogy for describing the new role we envision for the IMF.[3] When a non-financial corporation ends up in financial distress in the USA, it does not, as a rule, seek a bailout from the government. Instead, it files for bankruptcy, thus receiving temporary relief from its creditors. This attribute of the corporate bankruptcy procedure has been emphasized more than any other in the sovereign context. But, in addition to a stay on debt collection, and more significant for our purposes, the distressed firm can also ask the court to approve new priority lending, usually in connection with so-called 'first-day orders' that authorize the company to continue paying its employees and thus preserve its going concern value.[4] When the bankruptcy court grants new priority lending it is not extending its own funds, as the IMF does when it puts together a financing package for a distressed sovereign. All the court does is make way for new lending by the private sector—often the same lenders that have already lent to the distressed firm in the past—by granting the new loans higher priority status.

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

To achieve this restructuring of the IMF's role, the underlying sovereign bankruptcy framework would need to provide coherent, enforceable priority

rules.[5] In earlier work that did not envision this new role for the IMF, we argued that solidifying creditors' seniority rights may be the single most important benefit of establishing a sovereign bankruptcy regime.[6] In this chapter, we take the analysis a step further, to incorporate a reconceptualized role for the IMF—a role that would avoid the increasingly real risk that the IMF might otherwise become obsolete.

The remainder of our chapter proceeds as follows. In the second section, we set the stage by briefly describing the most relevant economic factors relating to sovereign debt and sovereign debt crises. In the third section, we survey and critique the full range of recent policy proposals, ranging from increased use of collective action provisions, to mediation, arbitration, or a full-blown sovereign bankruptcy procedure. We also consider the extent to which the benefits of the procedure we advocate could be achieved through contractual alternatives, and we briefly explore the implications of the recent debt crisis in Argentina. The fourth section maps out the new role for the IMF and explains how IMF actions in debt crises might need to be circumscribed. The fifth section outlines our proposal and the sixth section concludes.

The economics and law of sovereign debt restructuring

A bankruptcy-style restructuring framework can only be justified if proponents can point to serious flaws in the existing approach to sovereign debt finance and restructuring. As a first step toward making that case, we begin by briefly exploring the economics and law of the current strategies for restructuring sovereign debt. In the first section, we describe and critique the argument that existing impediments to restructuring are actually beneficial, rather than problematic. We then consider several contract and market breakdowns that are not adequately addressed by the existing approaches to sovereign debt crises.[7]

The willingness to pay problem

The most dramatic development in private sovereign debt markets over the 1990s and 2000s has been the emergence of widely held bonds as the debt instrument of choice in sovereign debt finance. While bank loans were the dominant source of external finance throughout the 1980s, they were eclipsed by bonds in the early 1990s, and sovereign debtors now borrow three times as much through bonds as from banks. Because the bonds are held by thousands of different investors, this shift has significantly complicated the process of restructuring the sovereign's debt in the event of a subsequent sovereign debt crisis.

Given that sovereign debt already is difficult to restructure, it is not immediately clear why sovereigns have been so willing to issue debt that magnifies these difficulties. Several commentators have argued that sovereigns have

gravitated toward hard-to-restructure financial instruments in order to solve the well-known willingness-to-pay problem.[8] A sovereign's creditors cannot easily collect what they are owed in the event the sovereign is unwilling or unable to pay. They cannot attach local assets, for instance, and most sovereigns have only limited assets outside their borders. Knowing that the deck is stacked against their creditors, the argument goes, sovereign debtors may ask creditors for concessions at the first sign of trouble. Financial instruments that make renegotiation more difficult counteract this problem by making it harder for sovereigns to renege. Sovereigns that protect their creditors in this fashion will be rewarded with lower interest rates and more attractive credit terms.

The suggestion that high *ex post* renegotiation costs can impose valuable discipline on a borrower by discouraging opportunistic renegotiation is well taken. But this insight assumes that sovereign borrowers will choose a level of debt that optimally balances the sovereigns' *ex ante* borrowing costs with their *ex post* costs of financial distress.[9] In reality, sovereign debtors have built-in incentives to commit themselves to excessively high restructuring costs, rather than optimal ones. Political leaders often are more concerned about short-term issues—e.g., how much they can borrow—than long-term ramifications such as the potential consequences of default, since the current administration will usually be gone by the time any repayment difficulties arise. Somewhat similarly, current leaders may borrow to further their own goals even if the effect is to impose inordinate restructuring costs on the country as a whole. Finally, the fact that excessive restructuring costs increase the likelihood of a bailout in the event of financial distress may give the parties another reason to gravitate toward debt that is too difficult to restructure.[10] In short, there is reason to believe that obstacles to restructuring may be more a danger of the increased use of difficult-to restructure debt, than a benefit.

Confidence and liquidity crises

Along with the willingness-to-pay problem, another major concern with sovereign debt is that sovereigns may be prone to confidence and liquidity crises. Just as perfectly solvent banks may be exposed to sudden panic runs by their depositors, reasonably prudent and financially orthodox sovereigns face the risk of a self-fulfilling debt crisis. The panic may be provoked by a contagious failure of another sovereign, as in the Asia Crisis of 1997.[11] Or it may result from skepticism by a subgroup of lenders about the solvency of the sovereign, generally due to a worsening in the country's fundamentals.[12] Even if the sovereign is perfectly solvent it only takes so many skeptical lenders to trigger a run on the country.

These self-fulfilling crises obviously can impose huge costs on a sovereign. IMF bailouts are generally rationalized as an efficient intervention in sovereign

debt markets to preempt such crises, and when that fails, to soften their impact by stepping in as an ILOLR. The successful resolution of the Mexican debt crisis of 1994–5, thanks to a massive bailout, is often touted as a perfect example of the IMF's role in stabilizing international financial markets.[13] Indeed, its advocates have argued against a move away from large IMF programs towards more private sector involvement on the grounds that private sector participation would undermine the IMF's ability to respond effectively to self-fulfilling panics. Their concerns are well taken if the crisis under consideration is an isolated self-fulfilling liquidity crisis. But they become less pertinent if one is confronted with a potential solvency crisis,[14] or if one looks at the future consequences of an accumulating stock of debt, which is increasingly difficult to service by a financially strapped sovereign. Alas, when a sovereign approaches financial distress there may come a point when the only reasonable solution is to forgive or reschedule some of the debt. Private sector involvement therefore can never entirely be ruled out. As a practical matter, the fundamental policy question for sovereign debt is not whether to involve the private sector, but how to combine bailouts and moratoria. When should the IMF rely primarily on bailouts and when should it involve the private sector?

Collective action failures

If sovereign debt instruments are widely dispersed, several collective action problems may arise when attempting to renegotiate them. A first obvious problem is communication: how to make sure that all creditors are informed about a restructuring proposal. Assuming that everyone has been informed, the second problem is that there are strong incentives for individual creditors to stay out of the restructuring and free ride on the debt forgiveness of others. This is the notorious holdout problem, which takes its most extreme form when individual creditors not only decide to sit out restructuring negotiations, but also attempt to collect debt repayments for themselves through private litigation. When the IMF decided to change its policy orientation, calling for greater private sector involvement as recommended by the Rey Report,[15] there was a natural concern that collective action problems might thwart any attempt at restructuring the widely dispersed debt of the private sector.

Although the early successes in restructuring the debts of Ecuador, Uruguay, Pakistan, and the Ukraine allayed the worst fears about the difficulties in getting the private sector involved, concerns remained about larger sovereign debtors with more complex debt structures, such as Argentina. At the same time, the stunning success of vulture fund Elliott Associates in securing payment from Peru through private litigation in September 2000 raised considerable uncertainty about the extent of future holdout problems.[16] It is these concerns that led to proposals by several countries in the Group of 7 to provide for debt

standstills to facilitate debt-restructuring negotiations and to the call by Anne Krueger of the IMF for the introduction of a statutory debt-restructuring procedure for sovereigns: the SDRM.

Signaling and reputation building

An important step towards the implementation of an SDRM was to be the modification of the IMF Articles of Agreement. In particular, the IMF's plan contemplated mandatory adoption of an SDRM by all members of the Fund, provided that the required supermajority of countries agreed to adopt it. The IMF proposed this politically risky and time-consuming strategy for implementation because IMF officials feared that most countries would simply not choose to adopt the SDRM on a voluntary basis unless they were sure that all others would also adopt it. The thinking was that an individual country if given the option would choose to stay out as a way of signaling its creditworthiness.

Similarly, other commentators have argued that sovereign debtors may choose to structure their debts to make them very costly to renegotiate, as a way of building a reputation for creditworthiness.[17] Only a debtor that expects to be able to repay its debts, according to this theory, would be prepared to incur huge restructuring costs. This logic suggests the structure of many sovereigns' debt is likely to be inefficient and excessively difficult to restructure, thus justifying *ex post* policy interventions that facilitate debt renegotiations and lower the costs of debt restructuring.

Over-borrowing and debt dilution

Just as signaling and reputation building can lead sovereigns to accept to bear excessively high debt-restructuring costs, the lack of seniority protection and debt dilution concerns can also give rise to debt structures that are too costly to restructure.

Creditors may adjust to the inability to establish enforceable priorities by insisting on priority substitutes such as an excessively rapid repayment schedule, for instance.[18] Again, these inefficiencies can be alleviated through a sovereign debt-restructuring mechanism that is designed to legally enforce seniority and thus protect lenders against the risk of over-borrowing and debt dilution, as we have argued in earlier work.

Bailouts, private sector involvement, and moral hazard in lending

Throughout the 1990s, sovereigns and their creditors relied on the IMF's willingness to 'lend into arrears' if necessary—that is, to spearhead a bailout—as the principal response to sovereign debt crises. As discussed above, the IMF is not well suited to serve as an ILOLR, and bailouts are a better response to liquidity

issues than to insolvency concerns.[19] In practice, bailouts also create a serious risk of creditor moral hazard. If creditors know (or believe) they can count on the IMF to pick up the pieces if a sovereign defaults, they will be much more careless in their lending than would otherwise be the case.

Mindful of these problems, the IMF sought to involve the private sector under a 'bailin' strategy.[20] Rather than permitting private creditors to free ride on an IMF credit facility (i.e., a bailout), the IMF made creditor concessions a precondition of its willingness to lend (the bailin). The IMF announced that it will only agree to coordinate a bailout if the private creditors agree to restructure the sovereign's obligations.

Although this strategy is promising in some respects, such as its recognition of the need for private sector participation, it has several serious—indeed, potentially fatal—limitations. First, the strategy requires a significant reorientation of the usual sequence of responses to a sovereign debt crisis. In previous crises, the IMF took the lead, and private creditors relied on the IMF's assessment to shape their responses. Under a bailin, the IMF in some respects plays follower rather than leader.[21] Second, the bailin strategy doesn't address the need for a coherent seniority structure. It provides no guidance on the order in which the sovereign's debt should be restructured, for instance, which leaves open the risk that ostensible priority rankings will be ignored, as in Ecuador's restructuring in 1999.[22] The final, and most important, problem is credibility. It is difficult for the IMF to credibly commit that it will not provide a bailout, particularly at times when there are concerns about contagion. Outside the few cases of very small countries that have been pressured to restructure their debt, there are few instances when the IMF decided to withhold funding, and when it did, it generally only did so following the failure of several previous programs, as with Russia in 1998 and Argentina in 2001. When creditors can reasonably expect such IMF forbearance, they will prefer to gamble on an IMF rescue, as they did in Russia and Argentina, rather than agree to make concessions to avert a debt crisis. And private creditors' intransigence only exacerbates the pressure for the IMF to step in with a bailout.

The question, then, is this: what alternative solutions are available and should be considered? It is to this question that we now turn.

Contracts and ad hoc negotiation: new and existing strategies

The previous section catalogued the principal economic factors bearing on sovereign debt and sovereign debt crises. In this section, we explore the innovations that have been introduced recently and the continuing experiences under the existing market-based approach. We begin with a discussion of the collective action clauses (CACs), followed by concerns about creditor seniority in

restructuring. We end with a discussion of lessons that can be gleaned from the 2001–2 crisis in Argentina.

Collective action provisions (CACs)

By just about any yardstick, the most successful of the proposals for addressing sovereign defaults has been the call to encourage sovereigns to include collective action provisions in the bonds they issue. The bonds governed by UK law have long included voting provisions that permit a specified majority of bondholders to adjust payment or interest terms in the event of a debt crisis. Bonds governed by New York law, by contrast, have traditionally given each bondholder the right to decide whether or not to agree to a restructuring. In the 1990s, an increasing number of commentators concluded that this 'unanimity' approach makes restructuring too difficult. To facilitate coordination among the sovereign's bondholders, and to counteract the threat of holdouts, they argued, sovereign debtors should include CACs in all of their bonds.[23]

Perhaps the most dramatic recent development in international finance has been the stunning success of the campaign to introduce CACs into New York-*governed* sovereign debt. In early 2003, shortly before the IMF formally jettisoned its proposal for a sovereign bankruptcy regime, Mexico very publicly issued New York-registered bonds that permit changes to the payment terms with the consent of 75 percent of the holders. Within a few weeks, several other sovereigns had followed suit, including Argentina and Brazil. Since the end of 2003, nearly every new issuance of sovereign bonds has featured a CAC.[24] Nor have these innovations been limited to the existence of a voting provision alone. The bonds issued by Mexico and CACs introduced by Uruguay when it 'reprofiled' its debt disenfranchised bonds owned by the sovereign issuer and its public sector instrumentalities in order to prevent the sovereign from manipulating the voting process. Even more importantly, the Uruguayan bonds included an aggregation clause that permitted a combined vote of all the classes of bonds that include the clause. The clause was designed to obviate the need for separate votes for each class of bonds by creating the possibility of a single, interclass vote on the terms of a restructuring.[25]

The new collective action clause consensus ushered in a regime that looks much like the world that many commentators had been calling for. If their vision was accurate, there would be no need for significant additional reforms. But there are several reasons to suspect that CAC enthusiasts oversold the virtues of the new clauses. First, CACs are more effective for restructuring one or a small number of classes of bonds than for sovereign debtors with a more complicated capital structure.[26] Uruguay's aggregation provision was designed to counteract this limitation by lumping several bond issuances into a single class for voting purposes. But the provision is untested; it remains to be seen

whether the aggregation strategy will work. Moreover, the aggregation clause, as with CACs generally, seems more promising for restructuring a small group of similar classes of bonds than for a more complicated capital structure.

Second, although CACs counteract the collective action and holdout problems, they leave several other sovereign debt issues untouched. One of the most important shortcomings of the sovereign debt markets is the absence of an enforceable priority structure. As noted earlier, creditors' inability to create enforceable priorities introduces serious inefficiencies, such as the risk of debt dilution. A CAC-based approach does nothing to remedy the priority problem. CACs also do not address concerns such as the need for a standstill while the sovereign debtor is renegotiating its obligations.[27]

Ironically enough, given the hoopla surrounding the widespread inclusion of CACs in New York-governed bonds, it is not entirely clear that CACs will significantly affect the restructuring even of the bonds that now include them. Ecuador's 1999 restructuring showed that sovereign debt can be scaled down through the use of exit consents—that is, an exchange offer that is combined with a vote by the exiting bondholders to alter in detrimental fashion the non-payment terms of any bonds that are not exchanged in the offer.[28] Although exit consents are a strategy for restructuring bonds in the absence of CACs, they have been employed even with bonds that included a voting provision. Thus, in addition to being only a partial solution to the shortcomings of the sovereign debt markets, CACs may not even prove to be the mechanism of choice for restructuring individual classes of bonds.

Changing and enforcing seniority

Although most commentators have focused on collective action problems, an equally important problem is debt dilution and the lack of enforcement of seniority in sovereign debt. That is, in the absence of enforceable priorities, when a debtor country approaches financial distress any new debt it issues is partly at the expense of existing creditors who face a greater risk of default and will have to accept a greater 'haircut' (or debt reduction) in the event of default, since the total resources the debtor can muster towards repayment of its stock of debt will have to be divided pro rata among all its creditors, old and new. In earlier work, we have argued that the lack of enforcement of an absolute priority rule encourages over-borrowing by the sovereign as it approaches financial distress and also raises its overall cost of borrowing.[29]

The shift in IMF policy towards greater private sector involvement, which was first signaled by the IMF during the Russian debt crisis of 1998 when it abandoned its bailout effort, magnified the uncertainty by upsetting market expectations concerning implicit seniority. Two subsequent events roiled the waters still further: the debt restructuring of Pakistan in 1999–2000, and the decision by the Court of Appeals of Brussels in 2000 to grant Elliott Associates, a vulture

fund that had invested in Peruvian debt, a restraining order against Euroclear preventing it from accepting transfers from the Peruvian government towards paying other creditors before Elliott's debt claims on Peru had been honored.[30]

The first event, Pakistan's debt-restructuring agreement of 2000, required for the first time that Eurobond holders be included in the restructuring agreement, thus shattering the market's perception that these debts had higher priority status.[31] The second event, *Elliott Associates* v. *Peru*, alerted the market to the potentially far-reaching possibilities that the traditional interpretation of the standard *pari passu* clause in sovereign bond issues might no longer be valid,[32] and that private litigants could threaten to disrupt the transfer of funds from sovereigns to creditors by obtaining restraining orders in court.

The new uncertainty as to which types of sovereign debt will or won't be subject to restructuring, and as to the meaning of the ubiquitous *pari passu* clause, propelled the issue of priority and debt seniority to the forefront of discussions about sovereign finance. Before examining how debt seniority can best be enforced, we begin by describing the Elliott decision and the legal debate surrounding it in more detail.

Elliott Associates, playing an aggressive holdout strategy, refused to go along with Peru's proposed Brady Plan debt restructuring of 1995. Instead, it attempted to obtain repayment on its debt by initiating a series of lawsuits and eventually prevailed in the Court of Appeals of Brussels in September 2000. Eager to avoid a default on its Brady bonds, the Peruvian government decided to settle following the Court's decision by paying Elliott in full.[33]

Underlying the Brussels Court's decision was a seemingly straightforward interpretation of the *pari passu* clause. The clause states that '[t]he obligations of the Guarantor hereunder [the Peruvian Government] do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon'.[34] The Court interpreted this language as meaning that when the debtor is unable to repay all its debts in full, all claims of equal ranking under the *pari passu* clause should get a pro rata share of the total amount the debtor pays out. Most importantly, the Court deemed that the debtor cannot pay some creditors in full (the creditors who agreed to the restructuring) and default on others (the creditors who held out and retained their original bonds). It is on the basis of this interpretation that the Court granted Elliott Associates a restraining order against Euroclear, the entity to which Peru had wired funds to pay consenting bondholders the scaled-down amounts they had agreed to accept.[35]

The Court's interpretation provoked a torrent of criticism.[36] Most commentators favor an alternative interpretation of the *pari passu* clause, that it is designed to prevent the borrower from issuing new debt that is senior to the existing debt. Which interpretation the courts will end up adopting in the future is still uncertain, although in light of the outpouring of academic writing and briefs following the Brussels Court of Appeals decision, the narrower interpretation favored by legal scholars seems likely to prevail.

Lost in the hand-wringing over the novel interpretation of the boilerplate *pari passu* clause by the Brussels Court of Appeals is the possibility that the Court's remedy could open up a new strategy for the enforcement of sovereign debt payments, with far-reaching consequences that no one had conceived of before. Crucial to this possibility is the fact that the Court granted a restraining order against Euroclear, rather than limiting itself to a judgment against Peru.

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

> What the Brussels decision does is to put a large hammer in the hands of holdout creditors, thereby enabling them to cause even more disruption in restructurings. Those inclined to be holdouts have a stronger position, and it encourages others to hold out. For the sovereigns and, we argue, for the majority of creditors, this is a nightmarish situation.[37]

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

The greater enforcement powers opened up by Elliott-type injunctions have inspired several commentators to outline the contours of a contractual approach to the enforcement of seniority in sovereign debt. One suggestion, put forward by both Zettelmeyer and Gelpern, is for senior creditors to enforce the priority ostensibly granted to them by a sovereign debtor vis-à-vis other, junior creditors pursuant to a 'third party beneficiary' theory. Junior creditors would agree to subordinate their claims, and courts might agree to enforce the subordination, based on the theory that the junior creditors could be construed as beneficiaries of the financing from the senior creditor.[38] Another suggestion, first offered by Wood, is to contractually require the sovereign to include senior creditors as parties in subsequent junior debt issues.[39] If sovereign debtors began to include these kinds of subordination arrangements in their debt contracts, one could conceive of Elliot-type injunctions that courts might grant to senior creditors against a sovereign that later attempted to violate the terms of the earlier agreement. If a sovereign debtor that had agreed to subordinate any subsequent debt failed to do so, a creditor could ask a court to enjoin the new issuance.

While such remedies might conceivably discipline sovereigns and open the way for the contractual enforcement of an absolute priority rule for sovereign debt, the critical issue remains whether the cure is not likely to be worse than

the disease. There is a real potential for nightmarish disruptions to the payment system, and one could imagine a multiplication of costly legal actions between creditors. In addition, this strategy would impose a continuous monitoring burden on the senior creditors. Because any subordination clause included in a creditor's contract with the borrower could not bind a subsequent third party borrower who might be ignorant about the priority arrangement, the senior creditor would be forced to police to make sure that the sovereign included a subordination provision in each subsequent debt issuance.[40]

We do not mean to discourage these contractual innovations. We believe that they represent an important step forward in the effort to improve sovereign debt markets. But it is important to recognize that the contractual approach also brings important risks.

Appraising Argentina's debt-restructuring challenges

It took only three months after a final futile attempt by the IMF to rescue Argentina in September 2001, and after a desperate move by the Argentine government to restructure its domestic debt, for Argentina to face the inevitable and declare a default on its foreign debt. Argentina's dramatic default also pronounced the end of its nearly decade-long *currency board* experiment, resulting in a rapid and substantial depreciation of the peso, which precipitated a systemic bank run. The new government hastily responded with a general freeze on bank deposits that lasted for over half a year, with devastating effects on the economy. The dislocation of the Argentine economy, which had been in recession for forty-five months before the default, was so great that GDP contracted by roughly 20 percent in 2002, with a predictably sharp increase in poverty and unemployment.[41]

Understandably, in the midst of an economic crisis of such magnitude and the associated political turmoil, external debt restructuring was not a priority for the Argentine government in 2002. Creditors were also reluctant to initiate negotiations at a time when the economy and Argentina's perceived ability to repay its external debt were at their lowest.

While Argentina was undergoing the worst economic crisis in its history, commentators in the debate on the SDRM sometimes pointed to Argentina as a test case, which would vindicate advocates of a contractual approach to sovereign debt restructuring and show that it was possible to orchestrate a voluntary debt restructuring successfully in a short period of time. Unlike the few prior cases of successful debt restructuring such as Pakistan, the Ukraine, and Ecuador, the size and complexity of Argentina's external debt-restructuring problem, involving multiple bond issues held by hundreds of thousands of creditors all over the world and adding up to nearly $90 billion total face value of debt, would truly put the contractual approach to the test. Could a voluntary restructuring of such magnitude and involving so many creditors be completed

successfully in a reasonable amount of time? And could Argentina avoid falling prey to holdout creditors and to the uncoordinated legal actions of multiple creditor groups?

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

Their predictions have only partially been borne out by events. The risk of private litigation did indeed turn out to be less important than many commentators had feared. There were fewer lawsuits than expected and the US District Court for the Southern District of New York in particular, where several actions against Argentina were brought, showed considerable restraint and willingness to first give negotiations a chance.[42] The court also ruled in favor of Argentina in limiting creditors' ability to seize Argentine assets in the USA, such as Argentine military assets and Argentine payments to Argentina's embassy.[43] Still, the same court had earlier certified a class action suit by a group of creditors and granted these creditors the right to attach Argentina's commercial assets worldwide. Partly in response to this ruling Argentina had to take several precautionary steps to protect its assets, such as transferring funds to its embassies through channels outside the banking system, and temporarily renationalizing the postal service to preempt the attachment of postal service assets abroad. While clearly disruptive, these steps have not imposed substantial costs on Argentina as could have been feared.

Where the predictions of advocates of an ad hoc approach were confounded is on the likely ease and speed of the voluntary restructuring approach. Argentina's experience in the four years following the declaration of default on its external debt underscored the difficulties and inefficiencies of a contractual approach, and provides support for the more interventionist policy envisioned by the IMF under the SDRM. Indeed, four years passed before Argentina completed an exchange offer to restructure its debt, and uncertainty remains even now due to the fact that a significant percentage of claims rejected the offer.[44] Argentina has vowed not to repay any of the dissenting claims, but the claims technically remain outstanding.

The four years of delay are not entirely attributable to the reluctance by the Argentine government to negotiate. A first offer in September of 2003 to write off 75 percent of the nominal value of the debt had been flatly rejected by

creditors as too low, especially in light of the promising signs of recovery of the economy in the early months of 2003. After the collapse of this first round of negotiations, creditors did not sit still. Many small holders of Argentine bonds, mainly based in Europe, organized themselves under the Global Committee of Argentina Bondholders (GCAB)—a bondholder committee seeking to represent dispersed bondholders in direct negotiations with the Argentine government. But there were never any direct, formal negotiations with the GCAB or any other representative bondholder committee in the two subsequent years.[45] Indeed, with the strong backing of Argentine public opinion and a strengthening economy, the Kirchner government adopted a hard negotiating line and refused to make significant concessions on its first offer. Most of Argentina's costs of default had been incurred in 2002 and were sunk by the time negotiations started, and neither the Argentine economy nor the government was in urgent need of borrowing from international capital markets.

Despite the tough stance taken by the Argentine government and its decision to move forward with a new unilateral, take-it-or-leave-it, debt swap offer, it still took considerable time to put forward a new offer. There were initial hesitations as to the form of the offer and the extent to which early adopters should be favored over later adopters to build in an incentive to accept the exchange.[46] The Argentine government also had great difficulty signing up an investment bank to organize the debt exchange. Finally, following a worldwide road show to advertise the exchange, Argentina still had to receive the approval of a number of national financial regulators in countries like Italy, with a large number of small bondholders.

The swap succeeded, but not because Argentina responded to the bondholders' demands. Rather, after holding on to a tough bargaining stance for four years, Argentina managed to wear down a large fraction of creditors. Many of the original creditors sold their debt to speculators who paid far less than face value. For these buyers, even a 75 percent haircut would mean a significant return on their investment. Also, Argentina benefited from a sharp decline in emerging market debt yields, an unexpected development that has produced a substantial increase in the real value of the debt exchange.

Few observers would describe this experience as vindication of the ad hoc approach. It is even harder to describe Argentina's debt-restructuring experience of the past four years as particularly favorable to creditors. Bondholders could hardly have obtained worse terms had the restructuring taken place under a more formal bankruptcy procedure such as that proposed by the SDRM. In all likelihood, they would have secured a deal a lot sooner and under better terms.

In hindsight, the Argentine experience points to one major advantage of a statutory approach: it can be structured to keep the negotiating process moving forward by specifying hard deadlines for offers to be submitted, as in chapter 11, and by structuring incentives for the parties to come to a quick resolution of the

restructuring process. The Argentine experience also highlights that creditors can be put in a weaker bargaining position under ad hoc negotiations, if the debtor can impose more or less coercive exchange offers, than they would be if final approval depended on some form of supermajority voting, under a statutory procedure.

Structured negotiation and sovereign bankruptcy proposals

In contrast with the emphasis on changing the contractual rights and obligations of debtors and creditors, IMF proposed a new initiative in international law, the sovereign debt-restructuring mechanism. While it did not win enough political support for implementation, it was seriously developed and considered by governments. Other proposals for formal bankruptcy-type mechanisms and informal processes of mediation as well as arbitration have been made to facilitate debt decision making. Given how important it was, we first focus on the SDRM and then discuss a number of the other proposals, setting the stage for our own proposal described in the subsequent part of this chapter.

The IMF's sovereign debt-restructuring mechanism

In late 2001, the IMF stunned the international financial community by calling for a sovereign bankruptcy procedure.[47] The IMF's sovereign bankruptcy initiative was first announced in a November 2001 speech by Anne Krueger. The IMF staff subsequently produced a series of detailed draft proposals outlining the SDRM in 2002 and early 2003. Because the IMF's proposal has been the lightning rod for recent debate over sovereign bankruptcy, we will explore it in some detail before briefly considering several alternatives and then describing the approach we advocate.[48]

The guiding concern of the IMF's proposal was to resolve collective action problems among dispersed creditors in debt-restructuring negotiations, while preserving creditor contractual rights as much as possible.[49] Viewed from this perspective, the key element in the IMF's proposed mechanism was a majority vote among creditors on a restructuring plan, which would bind a dissenting minority.[50] With the aim of preserving creditor rights as much as possible, the IMF's plan generally did not envisage a stay on litigation and individual debt collection efforts or a standstill on debt payments.[51] The main stated justification for not introducing an automatic stay into an SDRM was that it was unnecessary, as sovereign assets are much harder to collect than corporate assets. Lengthy and uncertain litigation might be required, and even if the plaintiff prevailed it was likely that a restructuring agreement would already have been approved in the meantime, which could limit the plaintiff's gain.

The main limitation on plaintiffs' gains that the IMF envisioned mirrors a legal rule in international insolvency law: the *Hotchpot rule*. This rule requires that any payment or asset collected by a plaintiff through litigation must be offset against the plaintiff's claim in the restructuring agreement.[52] That is, any new claim the plaintiff would be entitled to in the restructuring agreement would be reduced by an amount equal to what the creditor obtained through legal action. Should the plaintiff obtain more than what the restructuring agreement specifies then the Hotchpot rule could be supplemented with a *clawback* provision. The IMF's proposed plan did not allow for such a provision on the grounds that it would be impractical.[53]

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

The voting provision and the Hotchpot rule were the centerpieces of the IMF's proposed plan. The plan also contained many more technical provisions dealing with notification of creditors, registration, and verification of claims.[54] As in corporate bankruptcy this can be a lengthy and difficult process. An important additional complication is that the ultimate ownership of a sovereign bond is hard to trace. The court must be able to pierce through the veil of beneficial ownership to be able to ascertain whether the votes on a particular bond are controlled by the sovereign. Should that be the case then these votes should be ineligible for obvious conflict of interest reasons.[55] A related difficulty is that for widely dispersed debt structures many claims may not be registered in time. Given the large number of claims that won't qualify, a requirement that a supermajority of 'registered' claims approve the plan may function more like a simple majority requirement in practice, thus resulting in a weaker protection of creditors. These difficulties underscore the need for a court-supervised restructuring procedure as well as the important benefits that might be available with the establishment of an international clearing house.

As the main focus of the IMF's proposed plan was on the resolution of collective action problems among sovereign bondholders, the mechanism was under-inclusive and incomplete on the two other major facets of a restructuring procedure, the provision of priority financing and the enforcement of absolute priority. The plan's only means of enforcing absolute priority was through the exclusion of several classes of debt from the SDRM. Thus, the plan proposed to exclude privileged claims, obligations to international organizations such as the IMF ('multilaterals'), and debt owed to other nations (the 'Paris Club'). A first difficulty with this approach was that it implicitly accorded a higher priority to Paris Club debt as a *fait accompli* and singled out by default

private investors as the main target for debt reduction. This difficulty was compounded by the discretion given to the debtor under the plan to include or exclude debt claims—such as trade credit, claims on the Central Bank, etc.—from the SDRM.[56] Again, this discretion gave the debtor considerable power to undermine a given priority structure and to cut side deals with particular creditor classes in exchange for exclusion of their claims from the formal SDRM proceedings.

The plan recognized some of these difficulties and proposed as an alternative to include Paris Club debt in the SDRM under a separate class.[57] The plan also allows for other forms of classification and gives the debtor discretion to classify under the general requirement that classification does not result in 'unjustified discrimination of creditor groups'.[58] While classification brings about greater flexibility it is important to understand that it does not guarantee in any way enforcement of absolute priority. To the contrary, the IMF's plan might well have facilitated deviations from absolute priority by giving a veto power, unconstrained by a cramdown or best interest rule, to a junior creditor class.

Just as the IMF's plan does not systematically address the issue of enforcing absolute priority it also only gives lip service to the issue of debtor-in-possession (DIP) financing. Again, with the objective of preserving creditor contractual rights as much as possible, the IMF's proposed plan only allowed for 'priority financing' if it was approved by '75 percent of outstanding principal of registered claims'.[59] The main purpose of DIP financing is to address an immediate cash crisis and allow the debtor to function while the restructuring negotiations are ongoing. Clearly, a creditor vote would be extremely difficult to organize in a timely fashion, making it virtually impossible to organize any such financing.

The last key component of the IMF's plan was its proposal to set up an independent *Sovereign Debt Dispute Resolution Forum* (SDDRF) to oversee the sovereign bankruptcy process.[60] The selection of judges to be appointed to the SDDRF would be delegated to a *selection panel* designated by the IMF's Managing Director and charged with the task of making up a shortlist of candidate judges that might be impaneled when a debt crisis arises. The final shortlist would be subject to approval of the IMF's governing board. The president of the SDDRF would be charged with the selection of the final group of four judges to be impaneled in the event of a crisis. While the plan goes to considerable lengths to guarantee the independence of the SDDRF, and to limit the SDDRF's role, it is still worth noting that this procedure was not a foolproof method to guarantee the full independence of the court.

Overall, the IMF plan was an extremely important development in our thinking about how best to address sovereign debt crises. As this brief overview makes clear, however, it also had serious limitations. Most importantly, the IMF plan focused extensively on the *ex post* issue of solving creditors' collective action problems, but it paid much less attention to the equally important

issue of the *ex ante* effects of an SDRM—in particular, the need to honor creditors' repayment priorities in order to facilitate sovereign credit markets. In addition, the IMF's proposal for interim financing was cumbersome and did not fully address the growing concerns about the nature of the IMF's funding and oversight role. Finally, the creation of an SDDRF by the IMF itself raised independence and conflict of interest concerns.

Other sovereign bankruptcy proposals

Although the IMF's sovereign bankruptcy proposal received a great deal of attention, it was far from the first effort to introduce bankruptcy principles into sovereign finance. Starting with Christopher Oeschsli in the early 1980s, a series of commentators have developed proposals for a sovereign bankruptcy scheme.[61] This section briefly considers four representative examples: a proposal by Jeff Sachs in 1995, followed by the schemes defended by Steven Schwarcz, the Jubilee movement, and Lerrick and Meltzer after the turn of the new century. Although the proposals differ in major respects, they share similar limitations.[62]

A much discussed speech by Jeff Sachs did more than any other proposal to introduce the concept of sovereign bankruptcy into sovereign finance circles.[63] Writing in the immediate aftermath of the Mexican liquidity crisis, Sachs called for a sovereign bankruptcy regime that would include a standstill on creditors' collection efforts and provision for interim financing based on the special priority provided in US chapter 11 for financing corporate reorganizations. Sachs's proposal was not designed to offer a fully developed sovereign bankruptcy regime. An important limitation of the proposal, particularly as viewed through the lens of subsequent developments, is that it did not provide any criteria for when interim financing should be allowed and how the amounts might be limited. As we have seen, these are increasingly critical issues given the constraints on the IMF's funding. The proposal also did not provide any mechanism for inducing the parties to reach agreement in the event their negotiations broke down—no proxy for the role that the threat of liquidation and cramdown play in chapter 11.

Five years after Sachs, Steven Schwarcz outlined a more elaborate sovereign bankruptcy regime.[64] Like Sachs, Schwarcz advocated priority for interim financing, but he differed from Sachs in his view that it was unnecessary to impose a standstill in the sovereign context.[65] Schwarcz concluded that only the sovereign debtor should be permitted to initiate the proceeding, and he explicitly rejected the use of a cramdown procedure. For present purposes, the most important flaws in Schwarcz's proposal, as with Sachs's, were the absence of any principle for defining when interim financing should be permitted and the absence of a mechanism to induce agreement.

A third proposal, introduced by Adam Lerrick and Allan Meltzer, was based on the view that sovereign debt crises very frequently are caused by runs on the sovereign's currency and securities.[66] Like Sachs's, their proposal emphasized the need for a standstill and for fresh interim financing during the debt crisis. In Lerrick and Meltzer's proposed regime, the IMF would provide new funding in unlimited amounts in order to stabilize the price of the sovereign's debt in secondary markets. Even if Lerrick and Meltzer were correct to focus on liquidity concerns, their proposal founders on its assumption that the IMF has the capacity to provide unlimited funding in the event of a sovereign debt crisis.

The final sovereign bankruptcy proposal came from a very different source. Since the late 1990s, the Jubilee movement, which was inspired by religious leaders and churches, has campaigned for debt relief and aid to developing countries. To resolve sovereign debt crises, Jubilee called for a 'fair and transparent arbitration process' that was explicitly based on chapter 9 of the US bankruptcy laws, the chapter that covers municipal bankruptcy.[67] The five key elements of the Jubilee proposal are: a neutral decision-making body; a comprehensive procedure that includes all claims; the right of all stakeholders to be heard; an emphasis on protecting the social needs of the sovereign's citizens; and imposition of a standstill. While the Jubilee proposal introduced important considerations that are often neglected in sovereign debt discourse, it had many of the same limitations as the other proposals. Once again, there was no stick—no effective proxy for cramdown—to put pressure on the parties to reach agreement.[68] The Jubilee proposal also did not address the appropriate role and limitations of the IMF nor the need for consistent, enforceable priorities in sovereign debt markets.

Mediation approaches

A related strategy that has generated interest in some circles is reliance on structured mediation.[69] Perhaps the most fully developed of these proposals was Richard Gitlin's call for a dispute resolution forum that would include a registry of creditors' claims.[70] Under Gitlin's approach, the creditors whose claims were recognized would participate in a global mediation process designed to reach agreement on the terms of a restructuring. A recent proposal by Joe Stiglitz takes this approach approach a step further. In Stiglitz's regime, which he refers to as an intermediate or 'soft law' approach, a mediator would oversee the sovereign debtor's negotiations with its creditors and issue a report evaluating the sovereign's proposed restructuring plan.[71]

The principal virtues of mediation inhere in its intermediate status: as with CAC's, mediation could theoretically be implemented without amending the IMF's articles or relying on treaties to put the framework in place; and like a full-blown sovereign bankruptcy regime, it would take all of the sovereign's creditors into account, rather than just individual bondholders. Mediation also has

several serious limitations, however. Like CACs, the existing mediation proposals do not address the need for an enforceable priority framework. In theory, this deficiency could be solved by including a priority scheme in the mediation framework, although the resulting regime would look more like sovereign bankruptcy than mediation. The other shortcoming of mediation is that it does not provide any 'stick' to induce the sovereign and its creditors to reach agreement. The sovereign debt mediator would not have the authority to impose the terms of an agreement on the parties, nor is there any other mechanism to push the parties toward a resolution. As a result, the process would simply break down if there were an impasse between the sovereign and one or more of its constituencies.

Rethinking sovereign bankruptcy and the role of the IMF

The chief benefits of the existing sovereign bankruptcy proposals are their effectiveness in solving the problem of creditor coordination and their provision for a single, comprehensive forum for resolving a sovereign debt crisis. But the existing proposals either ignore or do not satisfactorily address pressing issues such as the absence of a coherent priority scheme, the need for an interim financing strategy that refines and alters the role of the IMF, and the need for an independent decisionmaker to oversee the sovereign bankruptcy framework. In earlier work, we have explained how an expanded sovereign bankruptcy framework might handle each of these issues.[72]

The 'Bolton–Skeel' proposal

With respect to priority, the sovereign bankruptcy framework should include a straight first in time priority framework, together with voting procedures that call for absolute priority treatment—that is, the assurance that higher priority creditors will be paid in full, and that any haircut will be aimed first at lower priority creditors. Under the Bolton–Skeel proposal, priority would be based on the time that the credit was extended, with the debt of any given year taking priority over debt issued in a subsequent year. Based on this priority, the sovereign debtor would divide its creditors into classes at the outset of a two-tier voting process for restructuring the sovereign's debt. For the purposes of the first vote, the debtor would make a proposal as to how much of its overall debt would be discharged—that is, how large the overall haircut to creditors would be.[73]

If a majority of all creditors approved the haircut, the debtor would submit a restructuring plan to the creditors outlining the proposed treatment of each class of creditors for a second, class-by-class vote.[74] If the requisite majority of each class voted yes, the plan would be implemented according to its terms. In

the event that one or more classes rejected the plan, on the other hand, the court would reduce the creditors' claims in the amount of the agreed upon haircut, starting with the lowest priority creditors and working up the priority hierarchy.

This two-step approach has several crucial virtues. Perhaps most importantly, it would clarify creditors' priorities outside of bankruptcy and sharply reduce the risk of debt dilution. The first-in-time priority scheme would apply outside of, as well as in, sovereign bankruptcy, because creditors would know that any subsequent bankruptcy would be governed by the first-in-time priority scheme.[75] For sovereigns that actually invoked the procedure, the two-step voting structure would provide a mechanism for pushing the parties towards a resolution even if bargaining breaks down, much as the threat of liquidation and or cramdown do in ordinary corporate bankruptcies under US chapter 11.[76]

The principal exception to absolute priority in our sovereign bankruptcy framework comes with its second key feature, interim financing. As with corporate debtors in chapter 11, our framework would provide first priority for interim financing in order to counteract the debt overhang problem that otherwise might discourage lenders from financing the restructuring process. Because of the risk that priority treatment would encourage over-borrowing, however, we distinguish between two categories of loans. Loans to finance the sovereign's trade debt would be presumptively permissible,[77] whereas larger loans would be permitted only if a majority of the sovereign's creditors agreed to the financing. This strategy would effectively cabin the size of interim loans. In addition to minimizing the risk of over-borrowing, it also would reduce the impact on the IMF's budget if it continued to serve as interim financer.[78]

Two leading scholars, Nouriel Roubini and Brad Setser, have recently critiqued the first-in-time priority scheme of the Bolton–Skeel proposal.[79] They argue that the proposal would complicate the construction of a sovereign yield curve, since 'a new five-year bond would be worth less (because of its lower position in the pecking order) than a ten-year bond that was issued five years ago'.[80] They argue that junior creditors would insist on short maturity in order to evade the effects of their low, later-in-time priority; that the rule would require exceptions, such as special priority for interim financing; that it would require supplemental rules to prevent evasion; and that it would give rulers of a sovereign that has little debt an incentive to go on a borrowing 'binge', presumably to take advantage of the cheaper financing made possible by priority for early creditors.[81] On inspection, none of the objections is worrisome. First, as Roubini and Setser acknowledge, 'the markets could adjust' to the valuation effects of a shift to a meaningful priority scheme.[82] Second, as far as use of short maturities to evade the effects of the priority scheme, this danger is far greater in the current regime, which lacks either enforceable priorities or a sovereign bankruptcy framework. Third, we have already discussed the importance of providing an exception to the first-in-time scheme for interim financing.

Once again, a first-in-time scheme with one key exception—a combination that has long been central to US domestic bankruptcy law—would greatly improve on existing sovereign finance. Similarly, while supplemental rules might be useful to protect the integrity of the priority scheme, the scheme would improve sovereign finance even without additional adjustment. Finally, we doubt that the proposal would increase borrowing binges by low debt sovereigns (low debt sovereigns can binge even absent first-in-time priority), and the proposal would significantly reduce the ability of high debt sovereigns to postpone default by taking on more debt.

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

Transforming the IMF's role

In the mid-2000s, the IMF's place in the international financial architecture became more uncertain than it had been since the collapse of the Bretton Woods framework in the 1970s, and possibly even since the IMF's inception in 1944. No developed economy country had sought Fund assistance in over a quarter of a century. Moreover, since the recovery from the spate of financial crises in the late 1990s, the size of the Fund relative to international financial markets and to the stock of foreign reserves held by Central Banks around the world had shrunk to the point where it could no longer envision playing a credible role as lender of last resort for emerging economies. Instead, the Fund tried to redefine its mission as international leadership on macroeconomic policy assistance for developing and transition economies, with an increasing focus on the poorest countries. It was not clear that the Fund had the ability to fill this new role effectively and there was a risk that it might have ended up being marginalized.

One obvious way of restoring the Fund's original role, advocated by some countries in the Group of 7, is to substantially increase the size of the Fund. But even if this enlargement were feasible, the history of past interventions would still raise major concerns about the potential distortions large bailout packages can introduce into sovereign debt markets. Another way forward, advocated by several leading economists, is to move in the opposite direction, further scaling

back the size of the fund, phasing out IMF programs entirely, and confining the IMF to a purely advisory role.[83]

We believe that neither of these two options is desirable. If the IMF were no longer a major source of emergency lending for distressed sovereigns, as advocates of a scaled back IMF propose, why should sovereign governments pay any attention to its advice? Even advice offered for free would not be welcome and the IMF would be doomed to irrelevance. More importantly, once the IMF exited the lending business it could no longer play its role as catalyst to help resolve liquidity crises and debt panics.[84] The alternative solution, a much larger but unreformed and highly political institution, would give rise to moral hazard in lending and other distortions.

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

The proposal is quite simple. Instead of acting like a Central Bank that provides liquidity to a bank facing a bank run, the IMF would function like a bankruptcy court charged with granting first-day orders and other DIP financing. In practice, not much change would be required in the way the IMF operates. A distressed sovereign would still begin by approaching the Fund with a request for an assistance package. The size of the loan and its conditionality would still be negotiated between the Fund and the sovereign behind closed doors, albeit with potential providers of DIP financing able to make an input (see below). The loan agreement would still have to be approved by the IMF's Board. But under the new role we envision, the IMF would put together a funding package that would include priority lending from the private sector along with its own funds and any other public funding it can assemble. Over time, the IMF would need to rely on a greater and greater contribution from the private sector.[85]

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

coordination between private lenders and the IMF's role as ILOLR is an important benefit of our proposed system.

Another important benefit of the new model is that it would gradually shift from taxpayer to private sector money and would be subject to more and more market discipline. If the private sector viewed a proposed rescue package as just more money down the drain it would in all likelihood refuse to extend new lending even if the new loans had higher priority status.[86] Similarly, if the sovereign were a repeat offender it would over time have less and less access to emergency lending and would risk being shut out of the international credit markets.[87] The reason is simply that following each crisis the sovereign would have accumulated a larger stock of still outstanding priority debt and would be less and less able to secure new DIP financing, particularly if, as we propose below, prior DIP loans have priority over any subsequent DIP financing.[88]

While the new role we envision calls for a radical departure from existing policy, it would not fundamentally change the process by which the larger crises are currently handled. Consider, for example, how the IMF managed South Korea's debt crisis in 1997. After a substantial rescue package was put together on December 3, 1997, it quickly became clear that the funds promised to the South Korean government would be insufficient.[89] The package had not adequately reassured markets, and banks continued to pull out of Korean sovereign debt, refusing to roll over their short-term loans, something they had never objected to doing in the past. Faced with an impending crisis, the US Treasury and Federal Reserve resolved as a last resort to convene a meeting with the major lenders under the auspices of the New York Fed on December 22, 1997, and managed to wring an informal agreement from those present to continue rolling over their loans.[90] The only way the Treasury and Fed could entice the banks to show up at the meeting, and then to cooperate by agreeing to roll over their loans, was *moral suasion* bolstered by the fear of a major financial crisis should banks refuse to follow the IMF's lead. As several commentators have observed, moral suasion is a rather weak inducement to rely on to deal with a crisis of such proportions, and it would be foolish to depend on such a policy to maintain international financial stability. It is not difficult to imagine a different outcome to the Korean Crisis, with some major banks deciding not to attend the meeting at the New York Fed, for example, and others unwilling to go along with the IMF or unable to agree on how the cost of rolling over their debts should be shared.

Now imagine the same situation, but with the IMF wielding new powers to grant priority status to banks' new emergency lending. In contrast to the situation at the time, under this new regime banks would have had an incentive to attend the meeting, since this might have given them an opportunity to obtain higher priority status for their new loans, which, one should keep in mind, mainly rolled over maturing old loans. The higher priority would have put them in a stronger position than the banks that did not attend the meeting

if the rescue plan failed and Korea defaulted on its existing debts. In addition, for those banks attending the meeting, the IMF would have been able to secure their cooperation much more easily by granting seniority status to their new loans.[91]

While the potentially huge benefits of this new role for the IMF are obvious, there also are several potential concerns. A first issue is whether a highly politicized institution like today's IMF would abuse its new powers and grant priority lending too liberally. This was a constant worry in the early days of chapter 11, with courts permitting debtors to drag out cases for years, and generally deviating too easily from enforcement of absolute priority.[92]The history of IMF bailouts suggests that similar problems could undermine the framework we have described unless the ability to grant priority status to emergency lending were constrained in important respects. One such protection might be to require joint creditor approval of the DIP loans, if the loans are beyond a certain size or involve a high proportion of new lenders.[93]

There is a delicate balancing here, however, as any approval required by creditors before the DIP financing is granted could undermine the IMF's ability to respond quickly and quietly to a crisis. Announcing to all creditors that a sovereign is seeking their approval for new DIP financing is tantamount to broadcasting the sovereign's financial distress to the world and may well do more harm than good. Therefore, unless the sovereign were already in default and had suspended debt payments, and short of reforming the governance of the IMF, a more practical protection would be to either put *ex ante* limits on the size of DIP financing (such as a maximum percentage of outstanding debt) or to allow for the possibility that courts could reverse the priority status of the most egregious forms of DIP financing *ex post* if the sovereign subsequently invoked the bankruptcy procedures once again. This latter possibility would instill some market discipline on the DIP lenders and limit the worst forms of abuse of DIP financing, although at the cost of introducing additional uncertainty into the lending markets.[94]

A second concern is whether a priority rule for sovereign debt could be enforced at all. How would the IMF be able to enforce priority? How should a recalcitrant sovereign be dealt with? So far the IMF has on the whole been able to enforce the higher priority of its own funds.[95] The IMF's success can be traced to a major carrot and stick the IMF can apply to enforce its priority status. Compliant sovereigns continue to have access to IMF programs at favorable rates, whereas a recalcitrant sovereign risks losing its membership and facing some form of exclusion from sovereign debt markets. There is no reason a priori to expect that the IMF's enforcement powers would disappear if the loan were made by the private sector with the IMF's blessing. But, should the stock of senior debt become so large that the sovereign might be tempted to default and to ignore the priority status in a restructuring, one could still envision enforcement of priority through the courts via Elliott-style remedies.

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

Fourth, how would Paris Club debt and other bilateral government debt be treated? Ideally, Paris Club creditors would be subject to the same restructuring process as other creditors. It is highly unlikely, however, that sovereign lenders would agree to put themselves under the authority of the IMF or a sovereign bankruptcy regime. The most plausible approach for handling Paris Club debt would be to treat it as a priority obligation. Although this poses the risk that Paris Club loans will dilute the interests of private creditors, one benefit is the possibility that an alternative source of emergency lending to sovereigns would be available that could serve the role of a safety valve in cases where the IMF fails to intervene, perhaps for political reasons.

The final issue is implementation: what changes would need to be made to restructure the IMF's role as we have described? Advocates of a sovereign bankruptcy regime have proposed a variety of implementation strategies. One commentator suggests that sovereigns could unilaterally adopt a sovereign bankruptcy regime.[96] Under this approach, a model law could be drafted by UNCITRAL or another international organization, and the legislatures of sovereign debtor states could pass legislation based on the draft law. In effect, the bankruptcy framework would set the parameters of the debtor's obligations to its creditors. A second strategy would rely on treaties among the creditor and debtor nations or a convention ratified by the legislatures of the various affected countries.[97] Still another strategy centers on an amendment of the IMF's articles, which would require majority approval by the IMF and approval of three fifths of the Fund's members.[98] Members would then be expected to take appropriate steps to implement the change under their domestic law. This third approach is the strategy the IMF planned to use to implement its SDRM.[99]

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

Adjusting the IMF's role is, by itself, an incomplete solution to the shortcomings in the existing international financial architecture; most importantly,

it would not address the need for a coherent, enforceable priority scheme—a need that we have stressed throughout the chapter. But even in the absence of a more complete reform such as sovereign bankruptcy, the reconfigured IMF role offers two hugely important benefits: it would address the IMF's funding limitations and would bring the private sector into the heart of the debt-restructuring process. More generally, the reconfigured role would preserve the IMF's relevance for the sovereign debt markets of the new century. These benefits suggest that it would make sense to adopt the new approach now, without waiting for more sweeping reforms such as implementation of a sovereign bankruptcy regime.

Conclusion

The necessary shift in orientation of IMF policies on crisis resolution and prevention towards greater *private sector involvement* called for in the 1996 Rey Report led almost inevitably to the debate on the *SDRM*, and on the way in which the private sector should be involved, a few years later. Unfortunately, however, this debate quickly turned into a somewhat narrow discussion on the merits of *collective action clauses*. The broader implications of this shift in policy for the IMF's new role in sovereign debt crises have been lost. The decision by the IMFC at its meetings in April 2003 to shelve the IMF's proposed SDRM has left the future of IMF policy and the form of private sector involvement in the uncertain state where the adoption of collective action clauses is a purely voluntary decision by sovereigns and their creditors, with no real IMF involvement, and where the implications of these clauses for future crisis resolution remain highly uncertain.

One possible way in which future debt crises may unfold, which we believe would be highly undesirable, is for a repeat of Argentina-type scenarios. As we have argued in this chapter, the experience of a *laissez-faire* approach to sovereign debt restructuring we have witnessed for Argentina in the past four years cannot easily be spun as a ringing success of this approach. On the contrary, the long delays in getting a deal hammered out that would be acceptable to a large majority of creditors and the extremely weak protections offered to creditors under this approach point to the merits of a more structured, statutory, method of sovereign debt restructuring.

An important advantage of the statutory approach that we have emphasized here and in earlier articles is also that it makes way for the enforcement of a seniority structure for sovereign debt. The enforcement of an absolute priority rule would not only help mitigate debt dilution problems and concerns of overborrowing when a sovereign approaches financial distress; it also, as we have argued here, would restore the effectiveness of the IMF in its central role as lender of last resort, without imposing new financial burdens on taxpayers. Again, corporate bankruptcy provides the natural analogy for describing the

new role for the IMF we have outlined here under a regime of private sector involvement. The IMF's new powers would be the same as those of a bankruptcy court in the case of a corporate bankruptcy, and would simply be to oversee emergency lending by the private sector (when this is desirable) by granting the new loans higher priority status.

Ours is a simple proposal, which easily fits in with current practice and may not even require a radical revision of the IMF's Articles of Agreement. We have outlined how the IMF would fulfill its role in practice and we have highlighted the important economic benefits of this new approach. Obviously, there are also concerns about this new policy, some of which we have discussed above. One important concern about the IMF that we have not touched on is the governance of the Fund, its accountability, and the current highly politicized nature of its decision making. A discussion of this issue is beyond the scope of this article but is clearly relevant for our proposal. Indeed, an unreformed highly politicized institution could well do more harm than good in pursuing a policy of private sector involvement as we have proposed here.

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Notes

1. The IMF bears its own share of responsibility in recommending such policies. For critical assessments of IMF policy recommendations on macroeconomic stabilization and intervention during the Asia Crisis of 1997–8, see Blustein, 2001; Stiglitz, 2003. For a more sympathetic view, see Roubini and Setser, 2004.
2. In his powerful analysis of the history of World Bank and IMF lending over the past sixty years, Rogoff argues that 'my long-held view is that the Fund would serve better if it made no loans. In a nutshell, the Fund's current resources of $150 billion seem like enough to cause moral-hazard problems (that is, to induce excessive borrowing) without being enough to deal with a really deep global financial crisis. The Fund is just too politicized to be a consistently effective lender of last resort, and if its financial structure is not changed, there are always going to be Argentinas' (Rogoff, 2004). See also Chari and Kehoe, 1998, who argue that there is no need for an IMF role of ILOLR given that the Central Banks of the G7 can already intervene directly in the event of a crisis.
3. Several recent commentators have emphasized similarities between sovereign and personal bankruptcy, such as the fact that sovereigns and individuals, unlike corporations,

cannot be liquidated. See, e.g., Rasmussen, 2003; Gelpern, 2004a. Although these points are well taken, we believe the similarities to corporate reorganization to be closer in many respects. Like the managers of a corporation, for instance, a sovereign's political leadership often changes through time.

4. First-day orders are described in Krasny and Carey, 1996: 9; Cole, 2002.
5. At a minimum this new role for the IMF is possible only if higher priority status can be granted to emergency lending. So far the IMF has been able to implicitly enforce higher priority on its own and other international financial institution (IFI) loans. However, this de facto priority is partly an illusion as the IMF has generally accepted to roll over its loans when the sovereign was unable or unwilling to pay. This higher priority status has also recently been tested by Argentina following its default on sovereign bonds. Conceivably, the IMF could already play this new role of granting higher priority to emergency loans from the private sector under the current legal environment. However, de facto, implicit, enforcement of priority is likely to be more difficult to scale up and probably may need to be shored up by legal enforcement through the courts.
6. Bolton and Skeel, 2004: 766–7.
7. For a useful, succinct summary of many of the concerns discussed in this section, with a particular emphasis on the realities of decision making by international institutions, see Tarullo, 2004.
8. The leading advocate of hard-to-restructure debt as a solution to the willingness-to-pay problem has been Michael Dooley. See, e.g., Dooley, 2000.
9. The critique in this paragraph draws from Bolton and Skeel, 2004: 771.
10. Yet another reason sovereigns may over borrow is for signaling and reputation purposes, as discussed in section on Signaling and Reputation Building.
11. For in-depth discussion of the Asian crisis, see Blustein, 2001; Stiglitz, 2003; Rieffel, 2003: 203–8.
12. Since the publication of Morris and Shin's pathbreaking article (1998), it is widely accepted that currency and debt crises are due to a combination of deteriorating fundamentals and partially self-confirming speculator beliefs about an impending crisis. In more recent work, Haldane et al. (2003) have shown how the incidence of such crises may be reduced when sovereign debt restructuring is facilitated.
13. See, e.g., Rieffel, 2003: 198–202.
14. In a pure liquidity crisis, the sovereign has sufficient assets to repay its obligations but is roiled by a self-fulfilling run on its currency. In a solvency crisis, by contrast, the sovereign has more debt than it can realistically repay. As the analysis of Morris and Shin (1998) emphasizes, it is often impossible to clearly distinguish a solvency from a liquidity crisis in practice, as liquidity crises tend to be precipitated by concerns about a sovereign's solvency.
15. Group of Ten, 1996 (known as the Rey Report after Jean-Jacques Rey, a Belgian Central Bank deputy and chair of the working group that produced the report).
16. The Elliott litigation is discussed in section on Appraising Argentina's Debt Restructuring Challenges.
17. See e.g., Eichengreen, 2003: 75.
18. Bolton and Jeanne (2005) provide a formal analysis of inefficient de facto seniority achieved through debt that is difficult to restructure.

19. See above, section on Confidence and Liquidity Crises.
20. The bailin strategy is described in detail in Roubini and Setser, 2004; and Eichengreen and Ruehl, 2000: 16–17.
21. For a discussion of the problems with this reorientation, see Eichengreen and Ruehl, 2000.
22. Ecuador subverted the ostensible priority of its collateralized Brady bonds by negotiating to restructure these bonds first, before turning to its other debt. Ibid. 16–17.
23. An early, influential emphasis on CACs came in Eichengreen and Portes, 1995: 49. More recently, Mitu Gulati has written extensively about the use and promise of CACs. See, e.g., Buchheit and Gulati, 2002: 1317. For a nuanced view of the choice between CACs and the unanimity approach, see Bratton and Gulati, 2004: 57.
24. These developments are recounted and analyzed in Choi and Gulati, 2004: 929; 2006: 1129.
25. For a brief description of the Uruguay provision, see Gulati and Skeel, 2003.
26. This point is discussed in more detail in Skeel, 2002: 417.
27. These and additional shortcomings are discussed in Bolton and Skeel, 2004: 773–6.
28. The exit consent strategy was described in Buchheit and Gulati, 2000: 59. Buchheit served as counsel for Ecuador in the restructuring shortly after the article was initially drafted.
29. Bolton and Skeel, 2004: 791–3. Bolton and Jeanne (2005) provide a formal analysis of optimal debt structure in the absence of any legal enforcement of seniority. They show that creditors attempt to achieve higher priority de facto by making their debt difficult to restructure. Overall this results in an excessively high cost of financial distress.
30. *Elliott Assocs. LP* v. *Banco de la Nacion*, 194 F.3d 363, 366 (2d Cir. 1999).
31. See Zettelmeyer, 2003; Gelpern, 2004b: 1115.
32. The competing interpretations of the *pari passu* clause are described below. See below, nn. 36–8 and accompanying text.
33. Gulati and Klee, 2001: 635.
34. See *Elliott Assocs. LP* v. *Banco de la Nacion*, 2000 US Dist. LEXIS 14169 (SDNY Sept. 29, 2000) and *Elliott Assocs. LP* v. *Republic of Peru*, 2000 US Dist. LEXIS 368 (SDNY Jan. 18, 2000).
35. In effect, Elliott claimed that it was entitled both to claim its share of the payments being made to consenting bondholders, and (unlike the consenters) to continue to insist on payment of the full face amount of its bonds.
36. For critiques of the Elliott ruling, see, e.g., Gulati and Klee, 2001; Buchheit and Pam, 2004: 869. For a somewhat more sympathetic interpretation, see Bratton, 2004: 823.
37. Gulati and Klee, 2001: 638.
38. Zettelmeyer, 2003; Gelpern, 2004b.
39. Wood, 1990.
40. If the priority arrangement were somehow deemed to be binding on a subsequent creditor, the higher 'due diligence' burden would fall on new lenders, who would need to determine what the stock of outstanding senior debts was before making a loan. Short of setting up a central register of senior debt that could be easily accessed by new lenders this would often be an impossible task.
41. The case is treated in detail in Damill, Frenkel, and Rapetti, this volume.

42. Miller and Thomas (2006) argue that the US federal judge who handled much for the litigation cleverly orchestrated the process that led to Argentina's eventual exchange through his sequence of decisions, several of which are described in the text. In our view, Miller and Thomas overstate the extent to which larger objectives motivated the court's decisions. But we agree that the judge was sensitive to the dangers of interfering with Argentina's negotiations with its creditors.
43. *Dow Jones*, 2004.
44. See, e.g., Alfaro, 2006, in which Alfaro notes that the exchange had 'a 76% participation rate, under the usual rate of above 90% in other restructurings worldwide'.
45. See, e.g., Thompson, 2005.
46. According to *Dow Jones Newswire*, the Argentine government eventually decided to abandon initial plans to include 'exit consent' clauses in Argentina's debt swap offer as a way of avoiding potential future litigation and securing approval of the plan with some countries' financial regulators. (*Dow Jones Newswire*, Nov. 5, 2004).
47. In advocating sovereign bankruptcy, the IMF seems to have taken its cue from a statement made by Treasury Secretary O'Neill in congressional testimony (see Setser and Gelpern, this volume; Gulati, this volume).
48. Much of the description and analysis in this section is drawn from Bolton and Skeel, 2004: 776–80. The IMF's first detailed proposal was IMF, 2002. This proposal was subsequently adjusted as IMF, 2003a.
49. IMF, 2002: 7, suggesting that the SDRM provisions should resolve 'a critical collective action problem' but do so 'in a manner that minimizes interference with contractual rights and obligations'.
50. Ibid. 10, calling for voting threshold of 75% of registered and verified claims.
51. Ibid. 9–10, concluding that there should be 'no generalized stay on enforcement' but leaving open the possibility of a creditor vote to impose a stay on a specified action. The IMF's subsequent proposals contemplated a stay in some, limited circumstances. See, e.g., IMF, 2003a: 11–12, stay if bond creditors committee and SDRM decision-maker approve.
52. IMF, 2002: 35–7, explaining and adopting the Hotchpot rule used for corporate debtors in some jurisdictions.
53. Ibid. 37.
54. Ibid. 8–9, summarizing provisions for determining 'eligible claims'.
55. The problem of sovereign control of key claims, and through these claims, of a vote by creditors, figured prominently in a sovereign debt dispute involving Brazil in the 1990s. Through Banco do Brasil, which had participated in a syndicated loan agreement, Brazil managed to thwart an effort by other holders of the debt to accelerate the amounts due under the loan. *CIBC Bank and Trust Company* v. *Banco Central do Brasil*, 886 F. Supp. 1105 (SDNY 1995), refusing to intervene to impose implied obligations of good faith and fair dealing. For discussion and criticism, see Bratton and Gulati, 2004.
56. IMF, 2002: 13. 'A debtor may decide to exclude certain types of claims from a restructuring, particularly where such exclusion is needed to limit the extent of economic and financial dislocation.'
57. Ibid. 24–5. Because the Paris Club resisted any inclusion in the SDRM, the IMF ultimately left open the possibility that the Paris Club would be excluded altogether.

58. Ibid. 53.
59. Ibid. 10.
60. The parameters of the SDDRF are outlined ibid. 56–70.
61. Oeschsli, 1981: 305.
62. Nearly all of the sovereign bankruptcy proposals made as of 2001 are surveyed in Rogoff and Zettelmeyer, 2002: 470.
63. Sachs, 1995.
64. Schwarcz, 2000: 101.
65. We share Sachs's view that sovereign bankruptcy should include at least a limited stay. Bolton and Skeel, 2004: 780–6, suggesting that enforcement of judgments should be stayed, though litigation up to this point could go forward.
66. Lerrick and Meltzer, 2001.
67. See, e.g., Jubilee, n.d. The Jubilee's FTAP is drawn from the work of Austrian economist Kunibert Raffer.
68. Interestingly, chapter 9, which is an important inspiration for the Jubilee proposal, does include cramdown provisions: 11 USC sec. 901 (incorporating parts of 11 USC sec. 1129(b)). In the chapter 9 context, cramdown is generally seen as requiring that the plan be fair, equitable, and flexible. What is not clear is whether a municipality must raise new tax revenues to satisfy this standard. The chapter 9 approach would require too much judicial discretion to function effectively in the sovereign context; perhaps this is one reason why Jubilee did not include cramdown as one of their five key provisions. In the next subsection, we outline a two-step voting procedure that would function like cramdown without requiring nearly as much judicial oversight. See section on Changing and Enforcing Seniority.
69. The mediation approaches are somewhat similar to the arbitration strategies proposed by Jubilee and several commentators. The Jubilee proposal is discussed in section on Changing and Enforcing Seniority.
70. See, e.g., Gitlin, 2002.
71. Stiglitz, this volume.
72. Bolton and Skeel, 2004.
73. At first glance, it may appear that the first step vote would invariably lead to a 49% haircut under a simple majority voting rule, since a bare majority of creditors would form a coalition to cut off the remaining creditors, thus increasing the likelihood of repayment for the winning creditors. But the minimum winning coalition intuition only applies if there are numerous, same-sized classes of creditors. If there were only one large creditor, for instance, the creditor would presumably agree to whatever haircut optimizes its repayment, based on the sovereign debtor's financial condition. In the real world, the capital structure of a sovereign debtor will fall somewhere between the two extremes of numerous, same-sized classes and a single giant creditor. The first stage vote will also be affected by other factors. For example, sovereign debtors might seek only as much of a haircut as is necessary, in order to preserve their access to sovereign debt markets after the bankruptcy.
74. The proposal is developed in much more detail in Bolton and Skeel, 2004. Our proposal does not specify the required voting percentage, as the voting rule could be tailored by each sovereign when the bankruptcy framework was adopted. But we

speculate that many would require a two thirds supermajority, as under US chapter 11. Bolton and Skeel, 2004: 797.

75. Sovereigns could still try to game the system and to dilute earlier debt by issuing debt with very short maturities as their finances deteriorated, of course. They would have difficulty finding buyers for such debt, however, because investors would know that their interests would be wiped out if the sovereign debtor nevertheless filed for bankruptcy. This could help short-circuit the final and pointless surge in debt before the creditors deny any new credit and the debtor defaults.
76. Under Bankruptcy Code sec. 1112(b), creditors can propose that the case be converted to chapter 7 in order to liquidate the debtor; and sec. 1129(b) provides a mechanism for ‘cramming’ down a reorganization plan despite the objection of one or more classes of creditors. Although sovereign debtors cannot be liquidated and the absence of a liquidation option makes cramdown difficult, the two-tiered voting regime is designed to achieve a similar effect.
77. For a description of the contours of trade debt financing see, e.g., IMF, 2003b.
78. Our earlier article contemplated that the IMF would continue to play this role. In the following section of this chapter, we propose a new strategy for interim financing that entails a restructuring of the IMF’s role.
79. Roubini and Setser, 2004: 280–2.
80. Ibid. 280.
81. Ibid. 280–1.
82. Ibid. 281.
83. See Rogoff, 2004; Chari and Kehoe, 1998.
84. See Corsetti, Guimaraes, and Roubini, 2003.
85. Our proposal thus differs sharply from Schwarcz’s suggestion that the IMF should borrow from the capital markets to fund a sovereign’s interim financing needs. See Schwarcz, 2000: 986–93.
86. This intuition is buttressed by the experience in US chapter 11 cases. The existing empirical evidence suggests that DIP financers are more likely to lend to debtors that have a significant chance of successfully reorganizing, than to more precarious firms. See, e.g., Carapeto, 2003 (debtors that received interim financing more likely to reorganize); Dahiya et al., 2003: 259.
87. Our approach would not preclude debt reduction initiatives for Highly Indebted Poor Countries (HIPCs). These initiatives would just take a different form. Instead of forgiving previously granted official multilateral debt, the international community would buy previously issued private DIP debt in the secondary market and then retire it.
88. See text following n. 95, below.
89. A total of $55 billion, of which a portion of $21 billion was contributed by the IMF, was promised the South Korean government. This represented the highest amount the IMF had ever lent to a single country and exceeded by a multiple of six the normal quota. See Blustein, 2001.
90. Six US banks—Citibank, J. P. Morgan, Chase, Bank of America, Bankers Trust, and Bank of New York—attended the first New York meeting, which kick-started a series of negotiations with international banks that eventually led to a rescheduling

agreement of $22 billion in short-term loans in exchange for a sovereign bond with the Korean government on January 28, 1998. Ibid. 177–205.

91. Although the size of the bank loans would often be quite large, there is no reason to suspect that this would jeopardize the financing process we propose. In ordinary corporate bankruptcy cases, bankruptcy courts have overseen major loans—such as the $1.5 billion DIP loan to United Airlines—without a hitch.
92. See, e.g., LoPucki, 1993, documenting the increased length of chapter 11 cases.
93. The possibility of a creditor vote on financing in the corporate context is considered and critiqued in Triantis, 1994. Our previous article proposed that financing in amounts sufficient to cover a sovereign's trade debt should presumptively be approved, without a creditor vote. Bolton and Skeel, 2004: 808.
94. Under US bankruptcy law, a court's initial decision on DIP financing generally cannot be reversed so long as the credit was extended in good faith, a protection that is justified as necessary to assure certainty. See 11 USC sec. 364(e).
95. See Zettelmeyer, 2003.
96. Paulus, n.d.
97. See, e.g., Schwarcz, 2000: 1011–17, describing a hypothetical international convention.
98. More precisely, amendment of the IMF Articles requires three steps: (1) the Executive Board votes on a proposed amendment, and it is approved by a majority of those who vote; (2) the amendment is approved by a majority of the Board of Governors who vote; and (3) it is approved by three fifths of the members of the Fund, with at least 85% of the total voting authority. See, e.g., IMF, 2002: 71–2, describing the amendment process.
99. Paulus, n.d.