INSIDE THE BLACK BOX: HOW SHOULD A SOVEREIGN BANKRUPTCY FRAMEWORK BE STRUCTURED?

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INTRODUCTION

For at least two decades now, commentators have suggested that international policymakers should establish a sovereign bankruptcy regime.[1] The reasoning is quite simple. Given that financially distressed sovereign debtors face many of the same problems that justify personal and corporate bankruptcy, such as the difficulty of coordinating the debtor's widely dispersed creditors, why not consider the same kind of solution in the case of sovereign distress?

Until quite recently, these proposals were viewed as intriguing, but a bit far-fetched. In the past several years, however, everything has changed. Sovereign bankruptcy has suddenly become a front-burner issue in international finance. Nothing epitomizes the extent to which sovereign bankruptcy has entered mainstream discussion so much as the stance of the International Monetary Fund (IMF). In recent years, financially troubled sovereign debtors have come to rely increasingly on IMF loan programs as a

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[1] One of the early articles in this line is Christopher Oechsli, *Procedural Guidelines for Renegotiating LDC Debts: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305 (1981). *See also* Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, 49 IMF STAFF PAPERS 470 (2002) (surveying the history); Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000).

mechanism for addressing fiscal crisis.[2] Although originally somewhat skeptical of the sovereign bankruptcy concept, the IMF's sympathy has increased as the cost of its interventions has dwarfed its resources. In 2002, the IMF explicitly endorsed the sovereign bankruptcy concept. The IMF is now the leading institutional proponent of sovereign bankruptcy and has developed a detailed proposal for what the Fund calls a "Sovereign Debt Restructuring Mechanism" (SDRM).[3] Sovereign bankruptcy has figured prominently in other venues as well, such as the recent meetings of the G-7 and G-10 nations.

The most obvious explanation for the recent interest in sovereign bankruptcy is that the crises of the 1990s, such as the bailout of Mexico in 1995, the Asian crisis in 1997, and the turmoil in Argentina and Brazil thereafter, have cast an unflattering light on the traditional strategies for dealing with financial crisis. The regnant approach has relied largely on the IMF's willingness to "lend into arrears," if necessary, to spearhead a bailout. As the recent crises have made clear, one problem with IMF-led bailouts is simply that the IMF does not have infinite funds at its disposal. The bailout of Mexico in 1995 was a major success, for instance, but the need for substantial outside aid underscored the limits of the IMF's resources. A second problem is that bailouts create a serious risk of creditor moral hazard. If creditors know (or believe) they can count on the IMF to come in and pick up the pieces when a sovereign defaults, they will be much more careless in their lending than would otherwise be the case.

Not everyone has joined the sovereign bankruptcy bandwagon. The most vigorous opponents of an SDRM are the banks and lawyers who underwrite sovereign bonds in New York, together with investors that currently hold them. "We continue to believe that this is not a productive way forward," the head of

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[2] For a useful chronology of the IMF's increasing involvement, see Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103 (2003). Scott points out that IMF debt has increased nearly a hundredfold since 1970, rising from $800 million in 1970 to $78.9 billion in 1999. *Id*. at 105.

[3] *See* INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS (2002) [hereinafter INT'L MONETARY FUND, SDRM DESIGN], *available at* http://www.imf.org/ external/np/pdr/sdrm/2002/112702.pdf. The IMF adjusted this proposal several months later. INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003) [hereinafter INT'L MONETARY FUND, SDRM FEATURES], *available at* http://www.imf.org/external/np /pdr/sdrm/2003/021203.pdf. The new proposal followed several earlier, less detailed IMF proposals that were delivered by Anne Krueger, the IMF's First Deputy Managing Director. *See, e.g.*, Anne O. Krueger, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Address Before Institute for International Economics (Apr. 1, 2002), *available at* http://www.imf.org/external/np/speeches/2002/040102. htm.

the Institute of International Finance (IIF) has complained. "[A]t a time of extreme risk-aversion in emerging markets, when capital flows are falling . . . approaches such as [the IMF plan] add further to uncertainty and investor anxiety."[4] The hostility reflected in statements like this is based in part on principle and in part on obvious self-interest. The principled objection to sovereign bankruptcy is the risk that an SDRM will make it too easy for sovereign debtors to default. Much as bailouts create moral hazard on the part of creditors, sovereign bankruptcy could have a similar effect on debtors. Limiting sovereign debtors' ability to restructure, on this view, encourages sovereigns to repay what they owe. The less principled explanation for the underwriters' and investors' opposition is simply that the existing bailout approach often assures that bondholders will be made whole. If an SDRM replaced bailouts as the strategy of choice, sovereign debt holders could no longer count on a handout when sovereigns encountered financial distress.

Rather than either sovereign bankruptcy or the status quo, some observers, including the U.S. Treasury, have advocated still another, intermediate strategy for addressing sovereign financial distress: sovereign debtors, they argue, could use collective action provisions (also referred to as "CACs" or "majority voting provisions") to restructure sovereign debt.[5] CAC provisions authorize a specified majority, often seventy-five percent, of the holders of an issuance of bonds to agree to restructure the bond's payment or timing terms. Sovereign debt issued under U.K. law, which currently constitutes roughly forty percent of sovereign debt, already includes these provisions, but until recently New York bonds did not.[6] Collective action enthusiasts argue that, if CACs were included in all sovereign debt, these provisions would provide a simpler and less intrusive way to restructure sovereign debt if necessary. Skeptics, on the other hand, have pointed out that collective action provisions are an inadequate

[4] Michael M. Phillips, *Bush Clears Way for Treaty That Eases Bankruptcies for Developing Nations*, WALL ST. J. EUR., Sept. 17, 2002, at A2 (quoting Charles Dallara and describing the IIF as "the research arm of 325 financial institutions and investors").

[5] For a fascinating and ambitious account of the benefits of collective action provisions, see Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002).

[6] In 2003, Mexico registered an issuance of New York bonds that included a voting provision, apparently after strong encouragement by the U.S. Treasury to include the provision. *See, e.g.*, John Authers, *Mexico Sends Strong Signal with Bond Clauses*, FIN. TIMES, Feb. 27, 2003, at 31. Since then, other sovereign issues have followed suit. For discussion, see, for example, Nouriel Roubini & Brad Setser, *The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode*, 1 J. RESTRUCTURING FIN. 1, 6 (2004).

substitute for the benefits of sovereign bankruptcy—benefits such as global rather than ad hoc restructuring and access to interim financing.[7]

Now is an auspicious time to take a closer look at sovereign bankruptcy given the enormous importance of the decision whether to establish an SDRM. The early sovereign bankruptcy proposals were understandably vague; they tended to identify the key attributes of an effective bankruptcy framework without hammering out the specific details.[8] Now that sovereign bankruptcy is no longer simply speculative, the IMF and other policymakers have started venturing inside the "black box" to offer more complete proposals for sovereign bankruptcy. The goal of this Article is to contribute to this discussion by offering both careful analysis and a novel perspective on the key issues.

Perhaps the single most important theme of our analysis—a theme to which we will recur to repeatedly—is the importance of promoting adherence to absolute priority wherever possible.[9] Now, for many critics of sovereign bankruptcy, this is precisely the problem with an SDRM. As discussed above, the most frequent objection to sovereign bankruptcy is that an SDRM would make it too easy for sovereigns to default, thus interfering with creditors' rights and roiling sovereign credit markets. Existing evidence suggests that the complaints are overstated. Sovereigns are reluctant to default on their debt, and do so only as a last resort because of the reputational consequences of default in the event the sovereign wishes to return to the credit markets in the future. Similarly, sovereign debtors value their membership in the IMF and its programs, so they go out of their way to repay their obligations if there is any way they can, lest the sovereign jeopardize its relationship with the IMF.

The more surprising and interesting point, however, is this: sovereign bankruptcy can actually assure greater adherence to absolute priority than the status quo. Because it is often impracticable to lend to sovereigns on a collateralized basis, creditors currently have great difficulty assuring that their priorities will be honored. Even ostensibly collateralized obligations, moreover, may not guarantee priority treatment. When Ecuador faced a debt

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[7] Perhaps in part due to this concern, the U.S. Treasury, a prominent supporter of CACs, has not entirely ruled out a more ambitious approach toward debt restructuring.

[8] The first article to attempt a more extensive analysis was Schwarcz, *supra* note 1.

[9] Absolute priority is the general requirement that higher priority creditors be paid in full before lower priority creditors receive anything. For a recent assessment of the costs and benefits of deviating from absolute priority, see Lucian Arye Bebchuk, *Ex Ante Costs of Violating Absolute Priority in Bankruptcy*, 57 J. FIN. 445 (2002).

crisis in 1999, observers assumed that its collateralized Brady Bonds would have priority over its uncollateralized bonds. But Ecuador opened restructuring negotiations with holders of the collateralized bonds first, and in doing so, effectively undermined the ostensible seniority structure.[10] When push came to shove, the priorities simply collapsed, a result that several prominent commentators think "is likely to drive away potential senior creditors."[11]

We argue in this Article that the classification and voting rules of an SDRM can be used to address this problem. The emphasis on creditor priorities is an important distinction between our proposal and the plan that has been advocated by the IMF. Although the IMF plan, like ours, is designed to solve the ex post collective action problems that interfere with creditors' ability to restructure troubled sovereign debt, the IMF does not systematically consider the ex ante implications of the SDRM. By focusing almost exclusively on ex post considerations, the IMF has not been able to respond satisfactorily to debtors' and creditors' concerns that the SDRM may result in higher costs of borrowing and a lower volume of debt for emerging-market countries. Our proposal remedies this shortcoming by taking the ex ante effects of the SDRM much more fully into account. A central theme of our analysis is that, by promoting adherence to absolute priority, the SDRM could plausibly result in lower costs of borrowing ex ante.

As a baseline, we argue that the SDRM should enforce strict, first-in-time absolute priority. Bonds issued first would have priority over those issued later unless the sovereign and its creditors explicitly contracted around this rule. The only exceptions to first-in-time priority would involve trade debt, which would always be treated as a priority obligation, and collateralized lending (which would be given priority treatment under some circumstances). Against this backdrop, we propose a two-step classification and voting process for confirming a restructuring plan. The debtor would first make a proposal as to how much its overall debt would be scaled back—that is, how large the overall "haircut" to creditors would be. If a majority of all creditors approved the haircut, the second step would simply entail reducing the creditors' claims in

[10] Ecuador apparently negotiated with the collateralized bonds first because the bonds gave the country a thirty-day grace period, during which Ecuador would not technically be in default. *See* BARRY J. EICHENGREEN & CHRISTOF RUEHL, THE BAIL-IN PROBLEM: SYSTEMATIC GOALS, AD HOC MEANS 16-17 (Nat'l Bureau of Econ. Research, Working Paper No. W7653, Apr. 2000), *available at* http://ssrn.com/abstract=228127.

[11] *Id*. at 18.

this amount, starting with the lowest priority creditors and working up the priority hierarchy. This two-step approach not only would reinforce the creditors' priorities within the SDRM, but also would clarify their priorities outside of the restructuring process.

In addition to classification and voting, the Article also offers new insights into four other key issues. The first is whether litigation should be stayed when a sovereign initiates the bankruptcy process. Although the stay is less crucial for sovereigns than with ordinary debtors, since it is difficult to foreclose on sovereign assets, we argue that the SDRM should include at least a limited stay. We propose in particular that the SDRM impose a stay on asset seizures, but that litigation by creditors otherwise be permitted to go forward. As an alternative, sovereigns could be permitted to appeal to the SDRM for injunctive relief in the event creditors obtain a judgment. Both approaches have the virtue of halting potentially destructive creditor collection efforts without interfering with activities that are unlikely to impede the restructuring effort.

The second issue is financing the restructuring process. Every existing SDRM proposal calls for an approach modeled on the debtor-in-possession (DIP) financing provision that authorizes interim financing for U.S. corporate debtors, but the proposals differ significantly in their details. The framework we propose is based on a simple distinction between proposals we categorize as presumptively permissible, and those that are presumptively impermissible. Because of the risk that priority treatment for the DIP lender will encourage overborrowing, we argue that the presumptively permissible category should be limited to the financing of the sovereign's trade debt. In arguing for this restriction, we analogize to the "receiver's certificates" used to finance the equity receivership process that predated Chapter 11, and which eventually gave rise to the current DIP financing rules in U.S. bankruptcy law. Although larger loans would not be prohibited, they would be permitted only if a majority of the sovereign's creditors agreed to the financing.

The third issue is who should oversee the restructuring process. On this question, this Article calls for a sharply different approach than does the IMF or the prior literature. The most prominent recent proposals would vest authority in a panel of experts set up by a new or existing international organization. The problem with this approach is that both the selection process and the panel's decisionmaking would be susceptible to political jockeying. Rather than oversight by committee, we argue that the sovereign debtor should

be permitted to choose, as SDRM decisionmaker, 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 decisionmaking process. The competition would be loosely analogous to the benefits of venue choice for corporate debtors in the United States.

The final major issue we consider is one that has not been addressed at all by prior commentators: whether the SDRM should be mandatory, or whether sovereigns should have the choice of opting out of the framework by crafting their own SDRM provisions. We argue that there are both theoretical and practical reasons to permit opt-out. From a theoretical perspective, opt-out would enhance efficiency by enabling a country to tailor the SDRM to its own circumstances. More practically, the opt-out option might increase sovereign debtors' willingness to agree to an SDRM. We also consider whether provisions that make the SDRM harsher should be precluded. Although sovereigns arguably have too great an incentive to agree to harsh provisions, we conclude, on balance, that opt-out should not be restricted in most cases.

Each of our proposals is designed to take both theoretical and political considerations into account. The framework we propose is entirely new, but it is shaped by the reality that political considerations are likely to rule some theoretically attractive solutions as out of bounds.

Part I of this Article explores the principal alternatives to sovereign bankruptcy—collective action provisions and the status quo—and explains why neither is an adequate substitute for an SDRM. In Part II, we provide a brief overview of the IMF's current proposal and note some of its principal shortcomings—primarily, its inadequate consideration of the SDRM's ex ante effects. Parts III through VII then develop our proposal. Part III takes up the question whether to impose a stay on litigation. Part IV then gets to the heart of the SDRM and outlines the classification and voting scheme. Part V addresses the issue of interim financing. In Part VI, we defend our argument that oversight should be vested in existing bankruptcy and insolvency courts. We then complete the discussion by discussing opt-out in Part VII and tie the analysis together with a brief conclusion.[12]

[12] Because our emphasis in this Article is on the contours of the sovereign bankruptcy framework itself, we do not discuss the question of implementation. A brief note is therefore in order here. Several of our

I. WHY DO WE NEED A SOVEREIGN BANKRUPTCY FRAMEWORK?

Establishing a sovereign bankruptcy framework ranks quite high on just about any scale of intrusiveness one can imagine when it comes to dealing with sovereign debt issues. Now that the IMF has thrown its weight behind the concept, there is more support for some kind of SDRM than ever before. But sovereign bankruptcy would mark a significant departure from existing practice. And many of the central players in the world of sovereign debt—ranging from the Wall Street banks that underwrite much of the debt to some of the sovereign debtors themselves—are opposed to this strategy.

Given this resistance, we begin by asking whether sovereign bankruptcy is really necessary. Both in the literature and in practice, partisans have argued fervently for two kinds of alternatives to a full-blown SDRM. First, some commentators have argued that we should leave things right where they are, not *despite* the difficulty sovereigns have in restructuring their obligations in times of financial distress, but *because of* it. These commentators extol the benefits of tough restrictions on ex post renegotiation. The second option is to rely on majority voting provisions in sovereign debt. Advocates of this approach believe it is necessary to facilitate a restructuring in the event the sovereign encounters financial distress, but they believe that the best way to do this is by including voting provisions in each issue of sovereign bonds.

The discussion that follows briefly considers each of these alternatives. Unfortunately, neither the status quo nor contractual voting provisions are an adequate response to sovereign financial turmoil.

A. Tough Love: Making It Hard to Restructure Sovereign Debt

The simplest solution of all would be to leave things more or less as they are, and several important commentators have called for precisely this.[13] Advocates of the status quo acknowledge that the sovereign debt restructuring process is highly inefficient under current conditions, but they see the ex post

proposals—such as the proposed standstill and the use of majority voting for the restructuring of a sovereign's debt—would require an amendment to the IMF's Articles of Agreement. Amendment of the Articles of Agreement require the approval of 85% of member-country votes. For a much more detailed discussion, see IMF, SDRM DESIGN, *supra* note 3, at 70-73. Our proposal could be implemented through the same process contemplated by the IMF.

[13] The leading proponent of this view has been Michael Dooley. *See* MICHAEL P. DOOLEY, CAN OUTPUT LOSSES FOLLOWING INTERNATIONAL FINANCIAL CRISES BE AVOIDED? (Nat'l Bureau of Econ. Research, Working Paper No. W7531, Feb. 2000), *available at* http://ssrn.com/abstract=216008.

inefficiency as a virtue rather than a problem. The key benefit of tough restructuring rules, on this view, comes from their ex ante effect. Because sovereign debtors know they cannot easily renegotiate their debt ex post, they will have a powerful incentive to repay the obligations. More flexible renegotiation rules, by contrast, would undermine the sovereign's commitment to repay and would increase the sovereign's ex ante costs of borrowing.

The observation that imposing high ex post renegotiation costs can impose valuable discipline on a borrower is well taken. But this insight assumes that borrowers will respond to these incentives by choosing a level of debt that optimally balances the debtor's ex ante borrowing costs with its ex post costs of financial distress. Sovereign debtors, by contrast, often have built-in incentives to commit themselves to excessively high restructuring costs, rather than optimal ones.[14] In part, these incentives are political. Political leaders are more concerned about short-term issues such as how much they can borrow rather 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. In addition to these political considerations, sovereign debtors who are good credit risks may agree to excessive restructuring costs for signaling purposes, to indicate that they are unlikely to default. The creditors of a sovereign debtor may be similarly anxious for the debtor to, like Ulysses, bind itself to the mast, because high restructuring costs can serve as a form of implicit priority vis-à-vis debt that is less difficult to restructure. 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.

Putting large barriers in the way of restructuring, as current sovereign debt practice does, has important downsides even before any default. Because it is difficult to establish enforceable priorities in sovereign debt, creditors adjust by insisting on priority substitutes such as a rapid repayment schedule.[15]

[14] The analysis that follows draws on Patrick Bolton, *Towards a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, IMF STAFF PAPERS, Sept. 2003, at 41, 61-62.

[15] For a more detailed analysis of this problem, see Patrick Bolton & Olivier Jeanne, Structuring and Restructuring Sovereign Debt: The Role of Seniority (Apr. 2004) (unpublished manuscript, on file with authors).

Inefficiently short maturities can create a rollover crisis when the debt comes due, and the crisis is likely to be exacerbated if there are significant impediments to restructuring.

In sum, although the prospect of high restructuring costs can have beneficial ex ante effects, it is not likely to work well in the sovereign debt context. Sovereign debtors have too great an incentive to include excessively stringent limitations on restructuring. A better approach must provide more flexibility to restructure the sovereign debtor's obligations in the event of financial distress. It must consider the ex post costs of financial distress, such as the perverse effects of debt overhang in the event debt cannot be restructured, rather than just the ex ante costs.

B. Can Majority Voting Provisions Solve the Problem?

The other major alternative to sovereign bankruptcy assumes just this: that sovereign debtors need the flexibility to restructure their debt if they face a financial crisis. Rather than a full-blown SDRM, however, proponents of this view argue that existing bond contracts—perhaps with a few modifications—are fully adequate to the task. The silver bullet, in their view, is to use majority voting provisions (also known as CACs) to restructure troubled sovereign debt. These clauses provide that, if a specified majority, often seventy-five percent, of the bondholders vote to restructure the payment terms of the debt, all of the holders of the bonds in question are bound by the vote. Sovereign debtors already include majority voting provisions in debt they issue under U.K. law—roughly forty percent of all sovereign debt[16]—and they already have been used in a few cases to restructure sovereign debt. Majority voting advocates argue that, if sovereigns included these provisions in all of their debt, CACs could provide most or all of the benefits of sovereign bankruptcy and sidestep the political and administrative obstacles to putting a bankruptcy framework in place.[17]

We should emphasize from the beginning that we share some of the enthusiasm for majority voting provisions. To the extent that CACs enhance the prospects for restructuring, they are an improvement over the unanimous

[16] *See, e.g.*, EICHENGREEN & RUEHL, *supra* note 10, at 2 n.3; *supra* notes 5-6 and accompanying text.

[17] For a fascinating discussion of collective action provisions, and proposals for improving them, see Buchheit & Gulati, *supra* note 5. *See also* William W. Bratton & G. Mitu Gulati, *Sovereign Debt Restructuring and the Best Interest of Creditors*, 57 VAND. L. REV (forthcoming 2004) (analyzing collective action provisions and choice between majority voting and unanimity requirement).

action strictures that have traditionally characterized sovereign debt issued under U.S. law. Moreover, the most elegant defenders of the CAC approach have emphasized that its chief advantages over an SDRM are pragmatic rather than theoretical. CACs are a solution that is well within our grasp, they argue, whereas SDRMs are not.[18] Even if every sovereign debt issue included a CAC,[19] however, there are at least four serious limitations that make the majority voting strategy a poor substitute for sovereign bankruptcy.

The first limitation is that majority voting provisions do not provide for a sufficiently comprehensive restructuring. It is not accidental that the sovereign debtors that have used these provisions to restructure their debt have tended to be small countries with a relatively simple debt profile. Majority voting provisions can work fine if the sovereign has only issued a few different bonds, but the bond-by-bond restructuring strategy is much less effective if there are numerous different bonds, with different maturities and payout terms, to deal with. Moreover, this approach does not provide any mechanism for addressing the sovereign's nonbond debt. In short, CACs are only adequate to the task if the sovereign's borrowings are relatively simple; they are much less useful if the sovereign has a more complicated debt profile.

The historical antecedents of Chapter 11, the U.S. provisions for corporate restructuring, provide a useful illustration of this point. The early U.S. reorganizations known as "equity receiverships" involved the nation's railroads, which had unusually convoluted capital structures. When the reorganizers restructured the railroads, they did not simply restructure the bonds one issue at a time. Rather, the bankers and lawyers formed committees for each class of public stock or debt, negotiated the terms of a restructuring not just for these claimants but for other debtholders as well, and then formed a single supercommittee to effect the reorganization.[20] The actions of individual

[18] *E.g.*, E-mail from Lee C. Buchheit, Partner, Cleary, Gottlieb, Steen & Hamilton, to David A. Skeel, Jr., Professor of Law, University of Pennsylvania Law School (Dec. 11, 2002) (on file with authors).

[19] One of the objections frequently lodged against the campaign for majority voting is that it would not affect the many bonds that have already been issued and do not have CACs. *See, e.g.*, EICHENGREEN & RUEHL, *supra* note 10, at 12 (noting this objection). We put this objection to one side, both because it is a transition problem rather than a permanent limitation, and because CACs could be added to existing bonds through exchange offers if sovereign debtors and their creditors were persuaded of their desirability. For a more skeptical view of the equity receivership analogy, see Stephen J. Lubben, *Out of the Past: Railroads and Sovereign Debt Restructuring*, 35 GEO. J. INT'L L. (forthcoming 2004).

[20] The complexity of the railroads' capital structure, rather than simply negotiability concerns, almost certainly was one of the reasons that U.S. issuers were much less likely than their U.K. counterparts to include CACs in their corporate bonds. *See* David A. Skeel, Jr., *Can Majority Voting Provisions Do It All?*, 52 EMORY L.J. 417 (2002) (responding to Buchheit & Gulati, *supra* note 5).

committees alone would not have sufficed to sort out the financial chaos.[21] Sovereign borrowers need a similarly comprehensive solution to financial distress.

The second problem with CACs is closely related: not only does majority voting fail to provide a comprehensive solution to financial distress, but it also will often leave the sovereign with too much debt.[22] Creditors will trade off the efficiency benefits of debt reductions against the costs in terms of reduced expected debt repayments; as a result, a debt restructuring procedure that is too creditor-friendly may result in inefficiently low debt forgiveness.[23] By contrast, statutory bankruptcy regimes can be adjusted to be more debtor-friendly if this kind of inefficiency is a concern.

Less often recognized, but crucially important, is a third limitation of CACs: the danger that they will undermine absolute priority. Even under the best of conditions, establishing priority and achieving the efficiency benefits of this differentiation are quite difficult in the sovereign debt context. It is harder for sovereigns than for corporate debtors to offer collateral, for instance, and enforcement is quite tricky when the debt does purport to provide security. As a substitute for collateral, sovereigns have relied on differential repayment schedules and implicit priorities. If debt restructuring is left to the market, there is no clear way to guarantee that the parties' agreed-on priorities will actually be respected if the sovereign encounters financial distress. As noted earlier, the restructuring of Ecuador's debt in 1999 is a good illustration.[24] Although some of Ecuador's Brady Bonds were collateralized and thought to have priority, these bonds were actually restructured first, prior to Ecuador's

[21] For a discussion of the formation and activities of sovereign bondholder committees in the early twentieth century, one which points out some of their limitations, see Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors*, *in* CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 3, 28-30 (Barry Eichengreen & Richard Portes eds., 1995).

[22] The discussion that follows is drawn from Bolton, *supra* note 14, at 64. We should emphasize that the point here is relative; even a comprehensive restructuring mechanism can leave debtors with too much debt. *See, e.g.*, Stuart C. Gilson, *Transactions Costs and Capital Structure: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997) (empirical study showing the firms reduce debt more in Chapter 11 than in nonbankruptcy workouts, but that Chapter 11 firms retain a high debt load); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983) (considering factors that may induce the parties to agree to Chapter 11 reorganization plans that do not eliminate enough debt). Bankruptcy, however, is likely to produce a more thorough restructuring than CACs and other nonbankruptcy approaches.

[23] *See, e.g.*, Elhanan Helpman, *Voluntary Debt Reduction: Incentives and Welfare*, *in* ANALYTICAL ISSUES IN DEBT 279 (Jacob A. Frenkel et al. eds., 1989); Kenneth Ayotte, Bankruptcy and Entrepreneurship: The Value of a Fresh Start (Oct. 6, 2003), *available at* http://ssrn.com/abstract=463000.

[24] *See supra* notes 10-11 and accompanying text.

noncollateralized Brady Bonds.[25] The restructuring thus turned the bonds' ostensible priority scheme on its head.

A final shortcoming of majority voting is that it does not address the sovereign's need for new financing. An essential part of U.S. corporate reorganization practice is the possibility of obtaining DIP financing to preserve the going-concern value of the firm. If anything, DIP financing may be even more critical for sovereigns because of their vulnerability to capital flight and exchange rate crises. The IMF's pattern of lending into arrears serves a similar function, but the IMF has not tied its lending to the negotiation of a restructuring agreement between the sovereign and its creditors. As a result, the IMF's lending often has the perverse effect of encouraging creditors to drag their feet, delaying restructuring negotiations in the hope that the IMF will step in and provide new money.[26]

Rather than relying on the IMF, majority voting advocates have argued that bondholders can coordinate among themselves to facilitate DIP financing. If new lending on a priority basis will solve the sovereign's underinvestment problem, they argue, all of the creditors will be better off if they vote to subordinate their own interests in favor of the new lender.[27] But this strategy suffers from several of the same limitations that we have already seen. If the sovereign's debt structure is at all complex, coordinating all of the bonds and holding a vote to pave the way for new financing would be complicated and often unworkable. Moreover, the financing would be further undermined by the difficulty of guaranteeing that the new lender's priority would be honored if the sovereign experienced further financial difficulties down the road.

There are a variety of ways one could structure the DIP financing provisions in an SDRM, and we will explore the alternatives in detail in Part V. The important point for present purposes is that majority voting provisions do not provide a workable solution to the problem of securing financing during the restructuring process. We should emphasize that this does not mean that policymakers should discourage sovereigns from including CACs in their bonds. Even if an SDRM were adopted, some sovereigns could still use majority voting provisions to restructure their obligations outside of the SDRM, just as some corporations restructure their debt outside of Chapter 11

[25] *See, e.g.*, EICHENGREEN & RUEHL, *supra* note 10, at 18.

[26] *See* Jeremy Bulow & Kenneth Rogoff, *Cleaning Up Third World Debt Without Getting Taken to the Cleaners*, J. ECON. PERSP., Winter 1990, at 31.

[27] Buchheit & Gulati, *supra* note 5, at 1348-51.

or other formal insolvency provisions. But, in many sovereign debt crises, CACs are not an adequate substitute for a full-blown SDRM.

II. HALF A LOAF: THE IMF'S PROPOSED BANKRUPTCY FRAMEWORK

The most important development since Anne Krueger put forward the idea of an SDRM, thus signaling the IMF's commitment to that approach, is the more detailed draft proposal outlined by the IMF staff in late 2002, and further adjusted in February 2003.[28] The discussion that follows will provide a brief, critical assessment of the key attributes of the IMF proposal. This discussion will set the stage for our own proposal, to be developed in the Parts that follow.

From our viewpoint, the most notable thing about the proposal is the important inspiration it draws from corporate bankruptcy principles and practice.[29] The general principles underlying the IMF's proposal are the same as those generally advocated by legal scholars and economists for corporate bankruptcy. In particular, the IMF purports to go beyond existing contractual solutions and attempts to set up a comprehensive statutory approach to sovereign debt restructuring.

The IMF's guiding concern is to resolve collective action problems among dispersed creditors in debt restructuring negotiations, while preserving creditor contractual rights as much as possible.[30] Viewed from this perspective, the key element in the IMF's proposed mechanism is a majority vote among creditors on a restructuring plan, which would bind a dissenting minority.[31] With the aim of preserving creditor rights as much as possible, the IMF's plan generally does not envisage a stay on litigation and individual debt collection efforts or a standstill on debt payments.[32] The IMF's main stated justification for not introducing an automatic stay into an SDRM is that sovereign assets are much

[28] IMF, SDRM DESIGN, *supra* note 3.

[29] For an extensive analysis of the relevance of corporate bankruptcy principles to an SDRM, see Bolton, *supra* note 14. *See also* Skeel, *supra* note 20 (response to Buchheit & Gulati, *supra* note 5, analogizing to equity receiverships in U.S. bankruptcy history).

[30] IMF, SDRM DESIGN, *supra* note 3, at 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").

[31] *Id*. at 10 (calling for voting threshold of seventy-five percent of registered and verified claims).

[32] *Id*. at 9-10 (concluding that there should be "no generalized stay on enforcement"). The November 27, 2002, proposal did leave open the possibility of a creditor vote to impose a stay on a specified action, *id*. at 35, and the IMF subsequently suggested that a stay might be imposed if requested by the sovereign debtor and approved by both a creditors committee and the SDRM decisionmaker. IMF, SDRM FEATURES, *supra* note 3, at 11-12.

harder to collect than corporate assets. Lengthy and uncertain litigation may be required and even if the creditor plaintiff prevails, it is likely that a restructuring agreement would already have been approved, which could limit the plaintiff's gain.

The main limitation on plaintiffs' gains envisioned by the IMF is reflected 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.[33] 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 "claw-back" provision. The IMF's original proposal does not allow for such a provision on the grounds that it would be impractical, but the Hotchpot rule was added as a possible option in the final version of the proposal.[34]

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

The voting provision and the Hotchpot rule are the centerpieces of the IMF's proposed plan. The plan also contains many more technical provisions dealing with notification of creditors, registration, and verification of claims.[35] 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, these votes should be ineligible for obvious conflict-of-interest reasons.[36] A related

[33] IMF, SDRM DESIGN, *supra* note 3, at 35-37 (explaining and adopting the Hotchpot rule used for corporate debtors in some jurisdictions).

[34] *Id*. at 37; IMF, SDRM FEATURES, *supra* note 3, at 10-11.

[35] *See, e.g.*, IMF, SDRM DESIGN, *supra* note 3, at 8-9 (summarizing provisions for determining "eligible claims").

[36] 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 di Brasil, which

difficulty is that for widely dispersed debt structures, many claims may not be registered in time. Given the large number of claims that will fail to 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 clearinghouse.

As the main focus of the IMF's proposed plan is on the resolution of collective action problems among sovereign bondholders, the mechanism is 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 is through the exclusion of several classes of debt from the SDRM. Thus, the plan proposes to exclude privileged claims, obligations to international organizations such as the IMF (multilaterals), and debt owed to other nations (the Paris Club). A first difficulty with this approach is that it implicitly recognizes a higher priority to Paris Club debt as a *fait accompli* and singles out by default private investors as the main target for debt reduction. This difficulty is 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, and the like, from the SDRM.[37] Again, this discretion gives the debtor considerable power to undermine a given priority structure and to cut side deals with particular creditor classes in exchange for an exclusion of the claims from the formal SDRM proceedings. Yet another difficulty is that the plan does not address collective action problems among privileged claimholders, nor does it deal with the incentives of individual bondholders to obtain a lien on an asset through private litigation during the debt restructuring phase.

The plan recognizes some of these difficulties and proposes as an alternative to include Paris Club debt in the SDRM under a separate class.[38] The plan also allows for other forms of classification and gives the debtor discretion to classify under the general requirement that classification does not

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 & Trust Co. v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995) (refusing to intervene to impose implied obligations of good faith and fair dealing). For discussion and criticism, see Bratton & Gulati, *supra* note 17.

[37] *See* IMF, SDRM DESIGN, *supra* note 3, at 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.").

[38] *Id*. at 24-25.

result in "unjustified discrimination of creditor groups."[39] 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, as currently structured, the IMF's plan may well facilitate deviations from absolute priority by giving a veto power, unconstrained by a cramdown or best interest rule, to a junior creditor class.

Just as the IMF's plan does not systematically address the issue of enforcing absolute priority it only gives lip service to the issue of DIP financing. Again, with the objective of preserving creditor contractual rights as much as possible, the IMF's proposed plan only allows for "priority financing" if it is approved by "75 percent of outstanding principal of registered claims."[40] 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.[41] 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 is its proposal to set up an independent Sovereign Debt Dispute Resolution Forum (SDDRF) to oversee the sovereign bankruptcy process.[42] 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 who 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, it is still worth noting that this procedure is not a foolproof method to guarantee such independence.

The court would have more limited powers than a bankruptcy court in the United States. Its powers would be limited to the registration of claims, supervision of the voting, and the final certification of the agreements. In

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[39] *Id*. at 53.

[40] *Id*. at 10.

[41] In the corporate context in the United States, debtors invariably arrange their DIP financing before they even file for bankruptcy. *See, e.g.*, David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. (forthcoming 2004).

[42] The parameters of the SDDRF, as described in the text that follows, are outlined in IMF, SDRM DESIGN, *supra* note 3, at 56-70.

addition, the court would have the power to resolve disputes and to grant injunctive relief subject to the creditors' approval. These are very limited powers, which do not include important powers of U.S. bankruptcy judges such as the power to subpoena and the power to impose sanctions on parties acting in bad faith during the restructuring process. Nevertheless, the SDDRF does have some important powers, such as the authority to exclude evidence and to terminate the process. These powers could be sufficient to enable the court to supervise the restructuring process effectively.

Overall, the IMF plan is an extremely important development in our thinking about how best to address sovereign debt crises. As this brief overview makes clear, however, it also has a variety of limitations. Most importantly, the IMF plan focuses extensively on the ex post issue of solving creditors' collective action problems, but it pays much less attention to the equally important issue of the ex ante effects of an SDRM, particularly, the need to honor creditors' priorities in order to facilitate sovereign credit markets. As we outline our proposal in the Parts that follow, we will place particular emphasis on the possibility of using an SDRM not only to solve creditors' collective action problems, but also to promote absolute priority. We also propose a less cumbersome approach to interim financing and call for a very different SDRM decisionmaker—existing bankruptcy and insolvency courts, rather than an international organization.

III. THE NEED FOR A STAY ON ENFORCEMENT

Having shown the need for a sovereign bankruptcy framework and briefly describing the IMF's proposed SDRM, we now turn to the more complex task of developing our own proposal. This Part begins the analysis by considering whether the SDRM should include a stay on creditors' enforcement activities. After arguing for at least a limited stay, we conclude by briefly addressing the related issue of whether the initiation of sovereign bankruptcy should be voluntary (that is, by the sovereign), involuntary (by creditors), or a combination of the two.

A. The Choice Among Automatic, Conditional, or No Stay

An important function of bankruptcy is to solve creditors' coordination problems. Indeed, this arguably is bankruptcy's most important ex post

function. (Protecting creditors' priorities is, as we have emphasized, the most important ex ante objective.)[43] Bankruptcy enables the debtor's creditors, who may be numerous and widely scattered, to come together and develop a collective response to the debtor's financial distress.[44] With ordinary corporate debtors, lawmakers have long worried that creditors may try to sidestep the collective proceeding, and engage in a "race to the courthouse" or "grab race" in an effort to get their money back before anyone else gets paid. Although this strategy is rational for individual creditors, it can destroy value by, for instance, forcing the piecemeal liquidation of assets that would be worth more as a going concern.

U.S. bankruptcy law addresses the "grab race" concern by providing for an "automatic stay" of creditors' collection activities.[45] From the moment a debtor (or its creditors) files for bankruptcy, creditors must cease and desist from all of their collection activities—no more litigation, no execution on liens, no more angry letters to the debtor's managers. In other nations, the stay is more limited. In England, for instance, secured creditors are not stayed[46] and some bankruptcy systems omit the stay altogether.[47]

The debate as to whether sovereign bankruptcy should include a U.S.-style stay, a lesser stay, or no stay has focused on a crucial distinction between sovereigns and ordinary corporate debtors: it is much harder for creditors to enforce their interests against sovereigns. The sovereign's local assets usually cannot be seized, and most sovereign assets are within the country, which significantly limits a creditor's enforcement options if the sovereign defaults. Some commentators have argued that the obstacles obviate the need for a stay altogether. The "State's unilateral decision to suspend payments would produce virtually the same effect as a stay," according to one commentator.[48] Not only are stays unnecessary, according to this view, but the stay would

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[43] *See, e.g.*, *supra* note 9.

[44] The classic theoretical account of bankruptcy as a solution to collective action problems is THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

[45] 11 U.S.C. § 362(a) (2000).

[46] For an overview of the English insolvency rules, see, for example, John Armour et al., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1736-50 (2002). Secured creditors' rights have been tempered somewhat by the enactment of the Enterprise Act 2002. *See, e.g.*, John Armour & Rizwaan Jameel Mokal, Reforming the Governance of Corporate Rescue: The Enterprise Act 2002 (May 2004) (unpublished manuscript, on file with authors).

[47] For a survey of the presence or absence of a stay in nations throughout the world as part of an assessment of creditors' rights generally, see Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1135 (1998).

[48] Schwarcz, *supra* note 1, at 984.

"likely generate significant litigation on issues including when the stay should apply, when it should end, and what exceptions should be allowed."[49] Based on similar reasoning, as well as creditors' opposition to the inclusion of the stay, the IMF does not call for a stay in its most recent SDRM proposal.[50]

Although we agree that the stay is less critical for sovereign debtors than for ordinary corporations, it is important not to overstate the distinctions. Sovereign debtors may be vulnerable to asset seizures by determined creditors, for instance.[51] Consider a sovereign that has a state-run airline, as many do. If the sovereign defaulted, creditors could seek to attach the sovereign's airplanes after they landed in a country that permitted such actions. In recent years, the sovereign finance community has watched rogue creditors act precisely this way, pouncing on vulnerable assets.[52] Given the amount of money on the table, there is every reason to believe that creditors will continue to devise strategies for collecting their debts if given the opportunity. These risks suggest that it may be important to have at least a limited stay as part of the SDRM.

Rather than eschewing the stay altogether, some commentators have called for an intermediate, scaled-down version of the stay.[53] Proponents of this view acknowledge the need for a stay in many cases, but they argue the stay should not be automatic; rather, it should be conditioned on a majority vote of the sovereign's creditors.[54] Under this approach, if a sovereign defaults and

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[49] *Id*. at 985.

[50] IMF, SDRM DESIGN, *supra* note 3, at 33-39 (arguing that Hotchpot rule obviates the need for a stay, but leaving open the issue whether creditors could vote to enjoin an enforcement action that threatened to undermine the restructuring process).

[51] Jeff Sachs notes, for instance, that during the Russian financial crisis of the early 1990s, "individual creditors [were] free to harass Russia with legal challenges or other forms of pressure," and that Russia responded by "ma[king] side payments to particular banks, in order to avoid harassment or to curry special favors." Jeffrey D. Sachs, Do We Need an International Lender of Last Resort?, Frank D. Graham Lecture, Princeton University 13, 13 n.8 (Apr. 1995) (transcript available at http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf).

[52] The most notorious example was the strategic use of the *pari passu* clause included in most bonds by one Elliott Associates, a vulture investor. When Peru restructured its bonds by exchanging them for new, scaled-down bonds, Elliott declined to tender into the restructuring. It then persuaded a Belgian court to attach funds that were intended for bondholders who had agreed to the restructuring. For an analysis of the Elliott strategy, see, for example, G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635 (2001).

[53] The IMF initially called for something like this approach. In her April 2002 speech, Anne Krueger suggested that the stay be conditioned on creditor approval, although she also noted that it might make sense to impose a limited, automatic stay at the outset of the case. Krueger, *supra* note 3, at 10.

[54] The most recent IMF proposal recommends that the creditor-vote approach be considered, but stops short of formally proposing this strategy. *See, e.g.*, IMF, SDRM DESIGN, *supra* note 3, at 9-10. In order to minimize the need for a stay, the IMF proposes that the SDRM include a version of the European Hotchpot

initiates a restructuring effort under the SDRM, and one or more creditors continue to pursue litigation or other enforcement strategies, another creditor could propose that these enforcement activities be stayed. The request for a stay would trigger a referendum on the proposed stay. If a majority of the sovereign's creditors voted in favor, the stay would go into effect; otherwise, creditors would remain free to attempt to collect the amounts owed to them. Either way, the creditors would negotiate with the sovereign over the terms of a restructuring plan that would then be put to a vote.

It is easy to see why proponents of the conditional stay might find this approach attractive. If the sovereign's debt structure is quite simple, for instance, its creditors might see no need to impose a stay. (Ideally, on this view, no one would even propose a stay; but if they did, the remaining creditors would vote it down). The prospect of eschewing stays in at least some cases would reduce the intrusiveness of the bankruptcy process. There would be no need to fight about the parameters of the stay, and the restructuring process could proceed in much the same way as it does in the absence of an SDRM.

Unfortunately, creditor votes are too cumbersome to ensure a timely stay if one were needed.[55] The vote on the stay would not take place immediately. To the contrary, it would take weeks and possibly several months to determine who all of the sovereign's creditors are, provide notice, and collect votes on a proposed stay. There is a serious risk that delaying the stay this long would amount to closing the barn door after the horses escaped. During the weeks or months before the stay finally issued, vigilant creditors could try to seize airplanes, or, as in the *Elliott Associates* case, attach funds in transit.[56]

rule, under which the payout to a creditor that manages to recover some of what it is owed before the restructuring is completed is reduced to the extent of this earlier payout. *Id*. at 35-38. The goal of the Hotchpot rule is to discourage creditors from trying to collect early. The rule is only likely to prove effective with creditors who might otherwise be able to obtain a limited payment outside of the restructuring. A creditor that could obtain most or all of what it was owed, that is, more than the creditor expects to receive in the restructuring, still has an incentive to jump the gun.

[55] *See generally* David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 940-41 (2003).

[56] It is worth noting that, in bankruptcy systems that either limit or omit the stay, there is generally one or a small group of creditors (usually banks) who have a property interest in the debtor's principal assets. This creditor (or creditors) effectively controls the process, which obviates the need for a stay. Moreover, systems that lack a stay are generally biased toward liquidation. The sovereign debt context does not fit either of these patterns.

Rather than using a creditor vote, a better strategy would be to adopt a targeted stay, which would differentiate between ordinary litigation, on the one hand, and the actual seizure of assets on the other. Because ordinary litigation is unlikely to interfere with the restructuring process,[57] a targeted stay could apply solely to asset seizures. Efforts to obtain assets (whether tangible assets or financial assets such as bank accounts) could be stayed, while the litigation process (up to the point of enforcement through asset seizure) would be permitted to go forward. A targeted stay of this sort would be much less intrusive than a sweeping standstill, yet it would prevent the most troublesome interferences with an SDRM.

An important issue raised by this limited stay concerns the status of a creditor who litigates to enforce its claim and obtains a judgment, but is prevented from enforcing its judgment by the stay. Does this creditor have an enforceable property interest in some or all of the sovereign debtor's attachable assets, such as airplanes located in the jurisdiction of the judgment? Our view is that any judgment obtained *after* the initiation of the SDRM should not give the creditor a property interest unless the restructuring effort later fails. A creditor that obtains a lien or other property interest prior to the initiation of the SDRM would be entitled to a priority interest in any assets covered by the lien, but creditors who obtained a lien during the restructuring process would continue to be treated as general unsecured creditors for the purposes of the restructuring process.[58] Only if the SDRM proceeding were later dismissed would a creditor be treated as a priority creditor and permitted to enforce its property interest. At least at the margin, preventing creditors from parlaying their postfiling collection efforts into an enforceable ownership interest would diminish their incentive to circumvent the bankruptcy proceeding in order to obtain full payment of what they are owed.

[57] Sovereigns are different from ordinary corporate debtors in this regard. Whereas the managers of a corporate debtor are likely to be directly involved in any significant litigation involving the firm, litigation against a sovereign will often be handled by different officials than the ones who participate in the SDRM.

[58] Our proposal thus draws a sharp distinction between judgments obtained up to the point of bankruptcy, and those obtained during the restructuring process. U.S. corporate bankruptcy law takes this principle a step further, and permits the trustee to invalidate liens or other property interests obtained up to ninety days before bankruptcy pursuant to the Bankruptcy Code's preference provision. 11 U.S.C. § 547(b) (2000) (ninety-day reachback for ordinary creditors, extended to one year for insiders). In the interest of keeping our proposal as simple as possible, we have not advocated that U.S.-style preference provisions be implemented in the sovereign bankruptcy context. But our proposal could easily be adjusted to include a preference provision if subsequent experience suggests the need for this kind of reachback.

Let us suggest one additional alternative that could achieve many of the same benefits as our proposed limited stay. Rather than an automatic stay of asset seizures, the SDRM could include a right of appeal from judgments received by a creditor after the SDRM was underway. With judgments that threatened to undermine the restructuring process, the court could impose a stay; otherwise, the court would simply permit the creditor to pursue its remedies.

The most obvious concern with an appeal strategy is that creditor enforcement activities could interfere with the sovereign's restructuring efforts during the period before the appeal. Even a temporary seizure of sovereign assets could have substantial untoward effects. A second, quite different concern is that the appellate process seems to put the court in the awkward position of passing judgment on the courts of the country where the assets are located. An important mitigating factor with respect to the sovereignty concern is that the SDRM court would not need to address the merits of the decision made by a nation's judicial system. Rather than second-guessing the validity of the decision in question, the SDRM court would simply be determining whether a stay is necessary to protect the restructuring process.

Overall, we can imagine an SDRM working effectively even without a formal stay. The stay (with the exception of the need for some kind of capital controls, as we discuss briefly below) is not as essential as the other provisions we will be discussing, such as interim financing. Ideally, however, the SDRM would include at least a limited stay. A stay on asset seizures would prevent the kinds of interventions by rogue creditors that have interfered with several restructuring efforts in recent years. Providing for an appeal from judgments that threatened to interfere with the restructure might have a similar effect.

Throughout this discussion, we have focused on traditional collection activities by creditors. Before moving on, we should note that sovereign debtors face another, somewhat analogous threat as well: the risk of a run on the sovereign's currency. In the face of a debt crisis, investors may withdraw their money from the troubled nation, which can then magnify the sovereign's fiscal crisis. The threat of a currency crisis can sometimes be addressed by capital controls, which function somewhat like the more traditional stay we have described.[59] Capital controls, however, are also fraught with difficulties.

[59] For a discussion of currency runs, and an argument that capital controls are an essential response, see, for example, Sachs, *supra* note 51, at 10 (arguing that "a temporary peg of the exchange rate, backed by

In the past, they have often been evaded, and it is very difficult to prevent currency runs from occurring as soon as the controls are lifted. Because capital controls are beyond the scope of our inquiry—which concerns the structure of an international bankruptcy framework—we do not take a position on whether or how capital controls could be used to protect against the risk of currency runs. But it is important to note both that capital controls are another significant issue when sovereigns face a debt crisis, and that capital controls could be implemented in tandem with the sovereign bankruptcy framework we propose.

B. A Note on Initiation: Should Involuntary Bankruptcy Be Permitted?

All of the existing sovereign bankruptcy proposals either assume or explicitly state that the sovereign debtor should be the one to initiate the restructuring process.[60] Like the most closely analogous regime, the U.S. provisions providing for municipal bankruptcy, and unlike the corporate bankruptcy laws of most nations, these proposals would not permit a sovereign debtor's creditor to trigger the restructuring process involuntarily. This voluntary-only limitation is grounded in sovereignty concerns. Advocates of the voluntary-only approach point out that the private creditors' ability to throw a sovereign debtor into bankruptcy could be seen as interfering with the sovereign's autonomy.[61] They also worry that the sovereign's creditors might use involuntary bankruptcy strategically, invoking bankruptcy for political rather than economic reasons.

Notwithstanding these concerns, there is greater merit in recommending involuntary bankruptcy than is often appreciated. Under a voluntary-only regime, sovereigns may file for bankruptcy much later than the optimal time. This seems counterintuitive, because commentators often identify moral hazard—the concern that sovereigns will invoke the SDRM opportunistically —as an important downside of sovereign bankruptcy. In practice, however, sovereigns seem to default too late, not too early, due both to the reputational consequences of default, and to their ability to issue new debt, which dilutes the existing stock of outstanding debt and postpones the day of reckoning. Creditor initiation could serve as a corrective, counteracting both the reputational and the overborrowing concerns. Creditor initiation would

adequate foreign exchange reserves, can overcome the problem of self-fulfilling currency flight," but that long-term use of fixed exchange rates is futile).

[60] *See, e.g.*, Schwarcz, *supra* note 1, at 982.

[61] *Id*.

alleviate the sovereign's reputational concerns by suggesting that the filing really was necessary—that is, the sovereign was not trying to use bankruptcy opportunistically.[62] With respect to overborrowing, involuntary initiation would provide a mechanism for creditors to block new debt issues that threaten to dilute their debt. In effect, involuntary initiation could serve as a substitute for dependable enforcement of priorities outside of the SDRM. Not only would this ensure a more timely initiation of the SDRM, but, by protecting creditors' priorities, it also could significantly enhance the functioning of sovereign credit markets ex ante.

Now, an obvious concern with creditor initiation is that one or a small group of rogue creditors might initiate the SDRM opportunistically. The simplest solution is to require that a critical mass of creditors sign on to any involuntary SDRM petition. If the provision included a requirement that at least five percent of the sovereign's creditors participate in any petition, the risk of frivolous filings would largely disappear.[63] The requirement could be further refined by excluding creditors whose debts are not yet in default from participating in the involuntary petition.

Whether sovereign debtors would agree to an SDRM that could be invoked involuntarily, by the sovereign's creditors, is of course an open question. It is important to note, in this regard, that sovereigns are already subject to suit in foreign courts, and have been since they began waiving sovereign immunity in the 1970s.[64] Moreover, creditor initiation would help to offset the perception that sovereign bankruptcy is too lenient on sovereign debtors. In short, from the perspective of both creditors and sovereign debtors, involuntary bankruptcy makes much more sense than is generally thought.

[62] We do not want to overstate this argument. It is certainly possible that a sovereign would collude with some of its creditors in connection with an involuntary bankruptcy filing. But we think this is relatively unlikely, given the consequences of a filing.

[63] Although U.S. bankruptcy law has a much more lenient requirement for involuntary petitions, *see* 11 U.S.C. § 303(b) (requiring three creditors with a total of $11,625 in unsecured claims), the kind of percentage requirement we propose is similar to the rules for creditor initiation under other nations' corporate bankruptcy laws. *See, e.g.*, LaPorta et al., *supra* note 47, at 1135 (listing petition requirements).

[64] *See, e.g.*, Jeremy Bulow, *First World Governments and Third World Debt: A Bankruptcy Court for Sovereign Lending?*, BROOKINGS PAPERS ON ECON. ACTIVITY 2002:1, at 229 (William C. Brainard & George L. Perry eds., 2003) (arguing for a reinstatement of sovereign immunity).

IV. CLASSIFICATION AND VOTING

Besides helping to resolve collective action problems among creditors, the other important function of bankruptcy is to enforce priority of senior claims over junior ones. This is also an important potential role for the SDRM. It is even more so given that it is currently very difficult to enforce a priority claim on a sovereign. With the exception of a small fraction of privileged claims, issued mostly by public entities separate from the sovereign, it is generally impossible for a private creditor to enforce a priority payment. Even if a subordination clause were included in a sovereign bond issue, it would be essentially unenforceable. As a result, enforcement of absolute priority under the SDRM may have even more important effects than enforcement of priority under corporate bankruptcy.[65]

We begin our discussion of classification and enforcement of absolute priority with an illustrative example showing how, in the absence of any enforcement of priority, early creditors are exposed to a risk of dilution of their claim by subsequent debt issues of the sovereign. The example shows how the possibility of dilution gives rise to a "soft budget constraint"[66] for the sovereign, delayed debt restructuring, overborrowing, and higher costs of debt.

A. *Example: Debt Dilution and Overborrowing*

Consider the following situation involving a sovereign borrower. The country borrows 100 to undertake an infrastructure investment in year t=0. In normal circumstances this investment is expected to produce a yearly flow return of 20 in present-discounted (tax) revenues over a period of ten years, starting in year t=1. In other words, the cumulative present-discounted return over the ten years is 200. But, in the event of a crisis, an adverse

[65] Moreover, to the extent there are benefits to permitting at least modest deviations from absolute priority, these benefits are already embedded in the sovereign debt context. Corporate bankruptcy scholars have pointed out that Chapter 11's deviations from absolute priority, and the fact that managers continue to run the business in bankruptcy, may dampen the incentive to take excessive risks on the eve of bankruptcy. *See, e.g.*, Thomas H. Jackson & Robert E. Scott, *On the Nature of the Creditors' Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 169-74 (1989). Because sovereigns cannot be liquidated, and sovereign bankruptcy will not displace the leadership of a country, the benefits (and risks) of a "soft landing" are built into the SDRM process. As a result, it makes sense for the sovereign bankruptcy framework itself to focus on the goal of limiting any further deviations from absolute priority.

[66] The term "soft budget constraint" has been coined by János Kornai to describe the bailouts of loss-making state-owned enterprises in centrally planned economies. *See* János Kornai, *"Hard" and "Soft" Budget Constraint*, 25 ACTA OECONOMICA 231 (1980).

macroeconomic shock, a currency attack, or a political crisis, the maximum present-discounted yearly revenues that can be transferred to creditors are expected to drop to 5. We shall take it that this negative shock may occur in year t=1. If it arises it reduces the sovereign's revenues in year t=1 and all remaining years. Moreover, we shall suppose that these revenues are obtained only if in the event of a crisis the debtor undertakes prompt corrective action by restructuring its outstanding debt obligations immediately. If the sovereign postpones restructuring, then the present-discounted yearly revenues will only be 4 over the next ten periods.

The idea here is that if prompt restructuring is accompanied by immediate new infrastructure investments or more fiscal austerity measures, they will enhance the sovereign's capacity to repay its debts. However, if restructuring is delayed, these measures or new investments will also be delayed, leading to lower potential repayments over a decade.

For simplicity we shall suppose that a negative shock is expected to hit the sovereign in year t=1 with a 50% probability. Consider first the situation where the sovereign can borrow only from one source: a single large, risk-neutral lender issuing a single long-term debt claim. This lender is willing to lend as long as it expects to break even. Under prompt corrective action, this lender can expect to get a present-value return of 50 in the event of a negative shock, so that the minimum face value of the debt at which the lender can expect to break even at the time of issuance will be D_O=150, with a specified total yearly repayment of 15 over the 10-year period. Indeed, with probability 0.5 the sovereign will not be hit by an adverse shock, the lender will then receive a flow-return of 15 over 10 periods amounting to a present-discounted value of 150. But with probability 0.5 a bad shock hits the sovereign, the debtor will be unable to meet the flow interest payments of 15.

What happens then? Since there is only one lender to whom the sovereign can turn, the sovereign is unable to raise new funds from other sources in an attempt to meet the outstanding debt obligations to the lender. The only option open to the sovereign then is to try to reschedule or roll over the lender's debt obligation. But this is a decision for the lender to make. If the lender is unwilling to roll over the debt the sovereign will be forced to default. In other words, the sovereign will be in the hands of the lender and will be *forced* to restructure its fiscal position and outstanding debt promptly when an adverse macroeconomic shock occurs. The lender will agree to a debt reduction as

long as the sovereign commits to undertaking the desired corrective actions and agrees to repay a yearly payment of 5 over the 10 periods.

These repayments add up to a total present-discounted repayment of 50. Thus, in expected terms the lender will get a total repayment of [0.5 x 150 + 0.5 x 50]=100, just enough to cover the initial outlay of 100.

Thus, in the presence of a single lender the sovereign can raise 100 by issuing a total debt with face value of 150 and yearly repayments of 15. The sovereign faces a "hard budget constraint"[67] in the sense that it is unable to borrow itself out of a crisis and thereby delay the required restructuring. When a crisis occurs in year t=1, the sovereign is either forced to default or to promptly restructure its debts.

But when the sovereign can raise new funds from other creditors and absolute priority is not enforced, it no longer faces a hard budget constraint. To see this, suppose that there is another creditor to which the sovereign can turn in year t=1. Suppose in addition that the sovereign government always prefers to delay restructuring if it can. This may be the case, for example, if a new administration is taking office every year and there are net private costs involved for the administration in place in undertaking a major fiscal restructuring effort. Then each administration in office would prefer to have a later administration deal with the problem. Although incentives for procrastination are put in a very stark way in this example, this is hardly an unrealistic description of the behavior of many governments that have let their debt balloon rather than taking prompt corrective action in response to an adverse economic shock.

When there is a single potential lender available, it is not feasible to delay the restructuring, as we have explained above. It has to be dealt with immediately. In other words, the single lender acts as a commitment device for fiscal discipline. But when the sovereign can borrow from another source (at competitive terms) and priority is not enforced, then the sovereign may well be able to borrow itself out of the crisis and postpone restructuring. As a result, the low cost of borrowing under a single exclusive lending relationship is no longer obtainable.

[67] A "hard" budget constraint is the constraint a borrower faces when there are no bailouts or other forms of subsidized lending. *See id.*

To see this, suppose by contradiction that a naïve initial lender is willing to lend 100 in year t=0 in exchange for a face value claim of 150, with a required flow repayment of 15 over 10 periods. Further, consider what the sovereign would do in response to an adverse shock in year t=1 when no subordination priorities or other covenant protections are enforceable in international debt markets, as is currently the case. Then, in the event of a bad shock in year t=1, the sovereign will be able to postpone corrective action for at least one period by issuing new debt, which *dilutes* the old outstanding debt.

To be able to meet the required debt repayment of 15 in year t=1 following an adverse shock, the sovereign needs to raise 11 from another source. Indeed, if the sovereign fails to restructure and take prompt corrective action it will generate yearly revenues of at most 4.

What is the face value of this new debt? Put differently, how much is a new debt claim of D_N with flow repayment d_N over 9 periods worth in the market? Under current *pari passu* rules the new debt will receive a fraction $[d_N/(d_N + 15)]$ of the yearly flow revenue of 4 following restructuring in period t = 2. Therefore, the promised new repayment d_N is worth:

$$4 \text{ x } [d_N/(d_N + 15)] = [4d_N/(d_N + 15)].$$

The sovereign, therefore only needs to set d_N at a level such that:

$$9 \text{ x } [4d_N/(d_N + 15)] = 11.$$

This figure is the amount of new funds the sovereign needs to raise to be able to meet its old debt obligations and postpone corrective action until the next period. In sum, any new debt with a promised yearly repayment of d_N = 33/5 = 6.6 will do the trick!

A central conclusion of this example is that this new debt issue involves a significant *dilution* of the value of the old debt claim. Instead of receiving a flow repayment of 5 over 10 periods in the event of a bad shock the initial lender now receives at most 15 in year t=1 (as the sovereign fully meets the required debt repayment in an attempt to postpone the painful debt restructuring) plus 25 (that is, 9 x 4 – 11) in the subsequent 9 years. That is a total of 40 instead of the previous 50 (when there was no dilution and prompt corrective action).

How much does this risk of dilution affect the cost of borrowing of the sovereign when dilution is anticipated at t=0? To be able to answer this

question one needs to determine the sovereign's total capacity to raise new debt in the event of a negative shock. For any initial outstanding debt D_O the sovereign will be able to raise at most 40 if the new lenders lend on fair terms, given that restructuring does not occur in year t=1. In an attempt to avoid default and thus postpone restructuring as much as possible the sovereign will actually pay out this entire amount to the old lender.

Therefore, when overborrowing is expected in response to an adverse shock, which then dilutes outstanding debt, the face value of the original debt must increase from D_O=150 (with no dilution) to D_O=160. Indeed, by holding a debt claim of D_O=160, with total yearly repayments of 16 over a 10-year period, the initial lender can hope to get:

$$0.5 \times 160 + 0.5 \times 40 = 100.$$

Thus, when lending cannot be excluded, the sovereign faces a higher cost of capital and must promise a total present value of repayments of D_O=160 (instead of D_O=150) to be able to raise 100. The efficient outcome with no overborrowing would be attainable if absolute priority were enforced. Indeed, if the initial lender had priority over new lenders, then the sovereign could not turn to new lenders to raise more funds. These junior lenders would not be able to get any repayment following an adverse shock and would therefore be unwilling to lend.

This example starkly illustrates our main argument that the lack of enforcement of absolute priority results in a higher cost of borrowing for the sovereign. It also illustrates how this lack of enforcement of absolute priority may result in overborrowing and inefficiently delayed restructuring.

As bad as the outcome in the absence of absolute priority is in this example, it is still not the worst possible outcome. Indeed, we have only allowed for overborrowing in the event of a negative shock. But incentives to overborrow are present even when no negative shock occurs. Although in theory the sovereign would always want to issue new debt and dilute all outstanding debt, in our example it is not very plausible that sovereigns would pursue a systematic dilution policy with such guile. This is why we have only allowed for such lending in the event of a bad shock.

Under the current international financial architecture, the only lender that imposes discipline on sovereigns and induces them to undertake painful corrective measures to redress their financial health is the IMF. But the IMF is

in a weak position to effectively fulfill this role, as has been argued in many places and is widely recognized.[68]

Another important inefficiency that may result from the absence of legal enforcement of absolute priority is that lenders may attempt to obtain de facto priority repayment by issuing "dangerous" debt with short maturity and highly dispersed claimholders, which expose the sovereign to both a higher risk of a debt crisis and higher restructuring costs.[69] Thus, as has been widely recognized by legal scholars of corporate bankruptcy, enforcement of absolute priority is likely to provide a major benefit in sovereign debt markets,[70] and the introduction of the SDRM provides an ideal opportunity to lay the foundations of a new legal regime of sovereign debt priorities. The question, however, is how to achieve this.

B. *Classification, Voting, and the First-in-Time Principle*

To determine how best to protect creditors' priorities in the sovereign debt context, it is natural to first briefly enquire how priority is enforced for corporate debt. An important and widely used way of guaranteeing priority for corporate debt in liquidation is to secure a loan with collateral and to perfect the security.[71] In such a case, the secured creditor becomes the sole owner of the collateral in liquidation. Unfortunately, this option is generally unavailable for sovereign debt.

Another less commonly used option is to insert a subordination clause in the debt contract requiring all subsequent debt to be subordinated. The difficulty with this approach lies in the enforcement of this subordination clause, as it contractually binds only the creditor and debtor who sign the contract. Should the debtor issue future debt with higher or equal priority without the knowledge of the initial lender and should the debtor go bankrupt, the initial lender may be unable to enforce its priority claim. To be able to effectively enforce a subordination clause, the initial lender then needs to

[68] *See* GROUP OF TEN, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES (1996), *available at* http://www.bis.org/publ/gten03.pdf; PETER B. KENEN, THE INTERNATIONAL FINANCIAL ARCHITECTURE: WHAT'S NEW? WHAT'S MISSING? (2001).

[69] For discussion of this response, and the inefficiencies it creates, see Bolton & Jeanne, *supra* note 15.

[70] For a recent review of the benefits of absolute priority and the effects of deviation from it in the corporate context, see Bebchuk, *supra* note 9.

[71] Perfected property interests, including security interests in personal property and mortgages on real estate, are given priority in bankruptcy as to the collateral pursuant to 11 U.S.C. § 725 (2000).

continuously monitor the debtor and stop the debtor from issuing new equal or higher priority debt by filing an injunction.

In Chapter 11, secured creditors' actions to appropriate their collateralized assets are stayed.[72] Although commentators have long suspected that secured creditors are not fully protected in Chapter 11, the bankruptcy laws provide a variety of protections designed to ensure that secured creditors' priority is respected.[73] In the Chapter 11 plan confirmation process, absolute priority is enforced by a combination of three elements: (1) classification of secured and unsecured creditors in separate classes,[74] (2) veto power of each class over the proposed restructuring plan,[75] and (3) the "best interest" and "cramdown" rules.[76]

Each of these elements is essential to enforce absolute priority. To see why classification by priority together with a unanimity requirement across classes is necessary to enforce absolute priority, consider the hypothetical rule under which only a (super)majority requirement across classes is needed to approve a plan. It is easy to see that in this case the debtor, who has agenda-setting power at least during the first 120 days of the bankruptcy case,[77] can single out one or several classes for special unfair treatment and hope to win approval from the other classes. By playing one class against another, the debtor may thus be able to secure approval by the required majority of classes of a plan that is very favorable to the debtor. But, worst of all, in the absence of any other protection the debtor can get a plan approved which does not respect the priority ranking of the claims in any systematic way. Thus, in the absence of a unanimity rule across classes, basic creditor protections would be undermined by classification, because any form of classification would permit deviations

[72] *Id*. § 362(a).

[73] *See, e.g.*, *id*. § 362(d)(1) (creditor entitled to relief if it lacks "adequate protection").

[74] *Id*. § 1122 (requiring classification of claims and interests).

[75] The veto power of each class stems from the fact that a consensual reorganization plan cannot be confirmed unless the proper majorities of every class approve the plan. *See id*. § 1129(a)(8) (requiring approval by all classes).

[76] Under § 1129(a)(7), the "best interest of the creditors" rule, a plan can only be confirmed if every dissenting creditor or equity holder will receive at least as much as they would receive in a liquidation. The "cramdown" rule comes into play if all of the requirements for a consensual reorganization under § 1129(a) are met except § 1129(a)(8), the requirement that every class approve the plan. If one or more classes dissent, the plan can be confirmed nonconsensually—as a "cramdown"—under § 1129(b) if, among other things, it satisfies the absolute priority rule with respect to every dissenting class. *See id*. § 1129(a)-(b). These rules are discussed in more detail *infra*. *See also* David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992) (explaining and analyzing the Chapter 11 voting process).

[77] *See* 11 U.S.C. § 1121 (giving the debtor-in-possession a 120-day "exclusivity period").

from equal treatment among all creditors and thus make it easier for a majority of creditors to expropriate a minority.

Under the unanimity requirement, each class, and in particular, each class of secured debt holders, has at least the basic protection given by their veto power. Note, however, that this protection by itself does not guarantee enforcement of absolute priority. Indeed, to the extent that junior classes also have a veto right they can block any restructuring agreement which is not to their liking, even if under a strict enforcement of absolute priority they should not be entitled to anything. In other words, junior creditor classes (and shareholders) also sit around the bargaining table and are as critical as any other class in securing an agreement. They are therefore able to extract some concessions in the restructuring negotiations and thereby may violate the priority ranking of claims.

This is why the third element of the cramdown option and best interest protection is essential. Under the cramdown, the court can enforce a restructuring plan even if a junior class opposes it, if the court finds the plan to be "fair and equitable," which includes a requirement that the plan satisfy the absolute priority rule with respect to any dissenting class.[78] That is, the court can approve the plan if it finds either that the dissenting junior class is paid in full, or that no lower priority class will receive anything under the plan. The best interest rule provides another protection. If the reorganization plan gives less to a class than it would get under liquidation, a unanimous agreement among the creditors in the class is required for the class to approve the plan.[79] The best interest protection and the threat of a cramdown are essential for senior creditors to ensure that the restructuring agreement does not deviate too much from absolute priority. While courts have been reluctant to use a cramdown in the past,[80] it has become a much more common practice in recent years. Accordingly, deviations from absolute priority are now significantly smaller.[81]

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[78] *Id*. § 1129(b).

[79] *Id*. § 1129(a)(7). Unanimity would be required because any creditor in the class can raise an objection alleging that it is not receiving as much as in a liquidation.

[80] *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) (noting courts' and bankruptcy lawyers' reluctance to use cramdown).

[81] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 692 (2003) (noting that "equityholders typically get wiped out" in current bankruptcy cases).

Interestingly, one could envision an extreme form of cramdown procedure, where the court determines by absolute priority the value of the reorganized firm and the allocation of claims on the reorganized firm to creditors. Under such a procedure, there would in principle be no need for a cumbersome classification of claims and a unanimity rule among classes. However, as one can easily imagine, such a procedure is likely to put too heavy a burden on the court's ability to value a reorganized firm. The court is also likely to lack the information required to reliably classify claims by priority. The debtor is in a much better position to determine which claims should be classified together in a separate class. This is presumably why the law gives discretion to the debtor, within limits, to classify similar claims together.[82]

Our proposal for enforcement of absolute priority under the SDRM mirrors some of the key elements of Chapter 11 by taking into account the specific practical difficulties related to sovereign debt. More so than for firms, judges are unlikely to have the expertise to make a reliable determination as to the sustainability of a sovereign's debt. The judge might seek the expert opinion of the IMF, but the IMF's evaluation of the level of debt that is likely to be sustainable may be seen as politically biased. Creditors and the debtor are likely to also retain experts and to produce widely differing estimates, which may not facilitate the judge's task.

This is why we propose to leave the determination of what is a reasonable reduction of a sovereign's overall indebtedness to the collective decision of the creditors in a two-step procedure. Once all debt claims have been identified and classified into priority classes or separate classes involving a distinctive common interest (like trade credit), we propose to have the following two steps:

(1) First, the sovereign puts an overall debt reduction proposal to a vote of all creditors in a single class, voting in proportion to their individual debt holdings. The majority rule would be specified in such a way as to fairly balance creditor and debtor interests. Although we will argue for a simple majority approach below, a two-thirds majority may seem reasonable, or even

[82] 11 U.S.C. § 1122 (permitting similar claims to be classified in the same class). Admittedly, the process of enforcing absolute priority under Chapter 11 is not perfect. Several ingenious alternative procedures have been proposed to improve on current practice but they have not yet been tested. *See, e.g.*, Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992) (auction involving options); Lucian A. Bebchuk, *A New Approach to Corporate Reorganization*, 101 HARV. L. REV. 775 (1988) (options-based alternative to Chapter 11).

the seventy-five percent requirement used in most CACs for sovereign debt issue in London.[83]

(2) Once a debt reduction has been agreed on, the sovereign would propose a reorganization plan specifying the treatment of each class of claims. Concretely, all creditor classes would vote on the proposed distribution of claims to the different classes. As under Chapter 11, each class would require a supermajority, say of two-thirds, of the face value of the total debt in the class, and unanimity among the classes would be required. Should one class vote against the proposed allocation of new claims then, as in Chapter 11, a cramdown could be enforced by allocating claims directly in order of absolute priority.

The first step would serve the purpose of determining a sustainable level of debt for the sovereign and solve the collective action problem among creditors. The second step would be directed toward the enforcement of absolute priority. A number of obvious questions arise concerning this scheme. We discuss each one in detail below.

(a) How will creditors vote? A creditor's vote will depend to a large extent on how high in the priority ranking the creditor's claim is. If the claim is senior, then the creditor would be in favor of a significant haircut, since the cost of the haircut would fall primarily on the more junior debt classes and since the new claim is more likely to be repaid in full if the sovereign's reorganized debt burden is lower. By the same logic, a junior claimholder would be opposed to significant haircuts. For junior claims, the incentive is to maintain the existing level of debt and "gamble for resurrection." Thus, there will be a "pivotal" creditor or creditor class, which will decide the outcome.[84] Any proposed haircut that is higher than what the pivotal creditor wants will be defeated in a vote, and any haircut that is lower will be approved. The sovereign will then obviously propose the highest possible haircut that is acceptable to the pivotal creditor.

One potential concern with our proposed two-step procedure is that if a large fraction of creditors are junior claimholders they will be able to block any reasonable haircut. Our restructuring procedure would then result in too little

[83] We discuss the extent to which sovereigns should be permitted to tailor the sovereign bankruptcy framework in detail *infra* Part VII. Tailoring is clearly appropriate in the context of specific voting rules.

[84] For an argument that Chapter 11's voting rules have this effect, see Skeel, *supra* note 76, at 480 n.69 (analogizing the effect to the predictions of median voter theory).

debt reduction. The most extreme such situation would be one where all creditors are junior creditors and would therefore be required to give up some of their debt claims. In such a situation, the creditors would only agree to a haircut that is no greater than what they would agree to in a workout. Such a haircut might be too small for the reasons we have already evoked and it might be desirable to build an incentive for junior creditors to accept greater haircuts into the restructuring procedure. One way of building in such an incentive might be to give higher priority status and greater protection against default to the restructured junior debt. Alternatively, in situations where there are several different priority classes, it might be desirable to reduce the power of junior creditors by using a simple majority voting rule in the first round, rather than two-thirds or seventy-five percent.

(b) What happens when a proposed haircut is rejected in a vote of all creditors? In the event of a negative vote in the first round, it is reasonably straightforward to determine what should be done next. There are two options. One is to terminate the restructuring procedure and force the sovereign and creditors to find a restructuring agreement outside the SDRM through a workout. The other is to let the sovereign and/or creditors put a new haircut to a vote. The first option would serve as a threat to the sovereign to avoid excessively high haircuts. It would also offer added protection to creditors, who could always collectively guarantee that debt restructuring take place outside the SDRM by voting down any restructuring proposal. The second option is clearly more debtor-friendly. It would be justified if debt restructuring outside the SDRM is seen to result in too little debt forgiveness. Which of these two options is more desirable requires a careful balancing of creditor and debtor interests, which we are not in a position to do.

(c) What happens when a proposed allocation of new claims to creditors is rejected by one or more classes in the second round? Here again one could envision one or multiple new proposals by the debtor or creditors being put to a vote. As in Chapter 11, however, eventually this process has to end. We propose that the judges supervising the restructuring proceedings may decide at their own discretion or at the request of a creditor class to initiate a cramdown procedure, whereby the newly reduced stock of debt is allocated on an absolute priority basis.

(d) How is priority determined and how are claims classified? This is by far the most important and difficult issue, and it demands a somewhat more detailed discussion than the ones we have just covered. Two points require

examination. The first one is how the contracting parties can define a priority claim. The second is how the different claims are classified. Who has the authority to classify and what should be the underlying principles?

Most lending to sovereigns can only be in the form of unsecured debt.[85] Thus, specifying a separate priority class for only secured debt and for debt issued by multilateral institutions would provide no more than a very limited form of priority enforcement. To enable enforcement of a more comprehensive form of absolute priority structure and to limit dilution of outstanding debt by new debt as much as possible, we would favor a "first-in-time" rule for unsecured debt. Such a rule would guarantee repayment of debt issued earlier over debt issued later and would come closest to the ideal of guaranteeing maximum protection against dilution through overborrowing, as has been recognized by legal and finance scholars.[86] Concretely, the way this rule would work is that when a sovereign files for debt restructuring under the SDRM, all unsecured debts would be classified by date of issue and earlier issues would have higher priority over later issues.

The priority scheme we envision would operate as a default rule that could be altered by contract. Subordination agreements between classes of creditors would be enforced. In theory, a sovereign that was concerned about the possibility of a subsequent liquidity crisis could include a provision giving it the right to issue a specific amount of priority debt in each of its contracts with current creditors.[87]

If there are many different issues it may be impractical to have a separate class for every date at which an issue was made. To avoid the creation of too many classes, it may then be desirable to require that each class be of a minimum size in value relative to the total value of outstanding debt. Alternatively, another way of limiting the number of classes may be to lump issues within any given fiscal year together in a single class.

[85] Jeromin Zettelmeyer, Int'l Monetary Fund, The Case for an Explicit Seniority Structure in Sovereign Debt (Sept. 29, 2003) (unpublished working paper, on file with authors).

[86] *See* EUGENE F. FAMA & MERTON H. MILLER, THE THEORY OF FINANCE 150-52 (1972); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979); Michelle J. White, *Public Policy Toward Bankruptcy: Me-First and Other Priority Rules*, 11 BELL J. ECON. 550 (1980).

[87] As Anna Gelpern notes, this would require foresight and the political will to defer borrowing. Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1119, 1149 (2004).

There are two other concerns with the first-in-time rule. First, it may impose substantial risk on new lenders, because they would inevitably be at the bottom of the queue unless they are able to obtain some form of security or other privilege. Of course, exposing new lenders to this risk is desirable to the extent that it forces new lenders to make the economically efficient lending decision: whether to lend the marginal dollar or cut the sovereign off from any new lending given that its existing stock of debt has grown too large. However, inefficiencies may arise if it is difficult for the new lenders to determine exactly how indebted the sovereign is. If the sovereign can easily hide or misrepresent its total indebtedness, new lenders may be excessively reluctant to extend a loan for fear of discovering after the fact that the sovereign's stock of debt is much higher than anticipated. Such an inefficiency can be considerably reduced if a global clearinghouse were established to keep a public record of all outstanding sovereign debt, as was proposed at the Monterrey Summit in 2002 by Norway and the Ford Foundation.[88] With such a clearinghouse it would be a simple matter for a new lender to monitor a sovereign's outstanding debt and to make an efficient lending decision under a first-in-time rule.

The other concern with the first-in-time rule is that new lenders may try to leapfrog the priority ranking by either insisting on a privileged claim or by shortening the maturity of their loan so as to be paid back before the other older debt. This is unlikely to be a major problem, because secured lending is generally difficult to obtain. Also, new short-maturity debt only involves a limited form of dilution of outstanding debt. Should creditors be concerned by this form of dilution, they could in principle get protection through covenants specifying lower limits on the maturity of new debt issues. With the exception of trade credit, which generally can only be of very short maturity, it may be desirable to enforce such covenants. Again, enforcement of such covenants would be considerably facilitated by the existence of a global clearinghouse.

This brings us to our second point on classification of claims into different classes. Classification of claims by priority is easy to understand in theory but difficult to implement in practice. What is worse, there are likely to be important additional considerations besides priority specific to sovereign debt. For example, it seems reasonable to think of Paris Club debt as a separate

[88] *See* BARBARA SAMUELS, II, STRENGTHENING INFORMATION AND ANALYSIS IN THE GLOBAL FINANCIAL SYSTEM: A CONCRETE SET OF PROPOSALS, U.N. Doc. ST/ESA/2002/DP.23 (U.N. Dep't of Econ. & Soc. Affairs, Discussion Paper No. 23, 2002), *available at* http://www.un.org/esa/esa02dp23.pdf; The Global Information Clearinghouse, *at* http://globalclearinghouse.org (last updated Sept. 15, 2003).

class. Similarly, multilateral debt and trade credit may belong to a separate class. One might also argue that bank loans ought to be classified separately from mark-to-market bond issues. Within the category of sovereign bonds a case could be made for classifying the bonds by the financial center where they were issued. Indeed, these centers may represent different clienteles with different economic interests.

To the extent that the treasury department of the sovereign government is likely to have the most detailed knowledge of the country's debt structure and the inner working of the different credit markets they tap, it seems reasonable to leave the debtor discretion over classification, but to constrain the debtor's freedom to classify by requiring that only similar claims can be classified within the same class. If there is sufficient ambiguity about how similar claims must be to belong to a given class and if creditors are concerned that the debtor is "gerrymandering," then it should be possible for the creditors to prevent such classification, ex ante by including a covenant in the contract that precludes claims that are considered to be different from being classified with other types of debt, and ex post by appealing the debtor's proposed classification.

(e) What should be the priority and maturity structure of the new claims? The discussion so far has been cast in terms of substituting a complex existing maturity and priority debt structure with a single new type of claim on the sovereign. While debt restructuring is often an opportunity to considerably simplify the existing debt structure, it is clearly overly simplistic to think of substituting a single new type of claim for all the different types of claims. Our proposal does not depend in any way on such a radical restructuring. Indeed, when it comes to the second stage of allocating new debt claims to the different classes it may be helpful to think of a swap of old claims for new claims of a similar type, with only possibly a reduced face value and an extended maturity.

V. INTERIM FINANCING FOR THE RESTRUCTURING PROCESS

Having discussed the need for a stay and how the sovereign bankruptcy voting rules should be structured, we turn now to the issue of interim financing. Once again, corporate bankruptcy experience will provide several useful analogies as we develop a framework for the sovereign bankruptcy context.

For corporate debtors, access to interim financing is a crucial determinant of the outcome of the restructuring process. Corporate debtors are nearly always starved for cash when they file for bankruptcy. Both intuition and empirical evidence suggest that those with access to interim financing are much more likely to reorganize than those that lack this access.[89] In the United States, lawmakers have provided sweeping protections for interim lenders in order to facilitate this financing. Under § 364 of the Bankruptcy Code, bankruptcy judges are authorized to give a variety of protections to DIP lenders, including a superpriority lien that gives the DIP lender priority over all of the debtor's other creditors.[90]

Now, to say that the DIP financing provisions are central to the U.S. framework, and that DIP financing encourages a renegotiation of the debtor's obligations, does not necessarily make such a practice desirable for corporate or sovereign bankruptcy. To determine whether DIP financing is desirable and should be adopted, in whole or in part, as part of an SDRM, we must first confront two threshold questions: first, why is a policy that facilitates new borrowing by a distressed debtor required?; and second, should a court be left to decide whether to approve priority interim financing?

With corporate debtors, it is not inherently obvious that paving the way to a restructuring is the optimal strategy in the event of financial distress. There may be good reasons for liquidating rather than reorganizing troubled companies. If the company is not viable as a going concern, for instance, reorganization may simply be postponing the inevitable. Moreover, even if DIP financing brings about a more efficient ex post outcome, it is still not obvious that it is a desirable form of new lending viewed from an ex ante perspective. We have argued in the previous Part that enforcement of absolute priority is efficient from an ex ante perspective.[91] Thus, is there not a contradiction in also contending that DIP financing is an important element of any efficient debt restructuring procedure? After all, the superpriority lien granted to DIP financing involves a violation of the absolute priority rule. So, why make room for DIP financing?

The apparent contradiction between priority lending to facilitate debt restructuring and the absolute priority rule is resolved when one takes into account the collective action problems faced by creditors in any restructuring.

[89] For a brief survey of the existing empirical data, see Skeel, *supra* note 55, at 936 n.66.
[90] 11 U.S.C. § 364 (2000).
[91] *See supra* Part IV.A (discussing debt dilution).

Just as it is desirable to prevent a destructive run on the assets following a default, it is also preferable to avoid destructive "freeriding" by creditors in granting new funding aimed at reducing the overall costs of the debt crisis. Any new injection of funds can be seen as a new asset that is left up for grabs by other creditors. If the new funding has the same priority as the debt held by existing creditors, some or all of the funding may simply go to paying the existing creditors, thus reducing the likelihood that the new funding will be repaid. Therefore, to ensure that new value-increasing lending is forthcoming, higher priority status must be granted to the new loans. In other words, in the absence of higher priority DIP financing, there may be no new lending even if it is value-increasing because of the "overhang" of existing debt.[92]

The obvious concern with higher priority interim financing is that it also opens the door to value-reducing lending and debt dilution. We can put the same point in terms of under- and over-investment. When a debtor has a great deal of debt, new lenders will be reluctant to lend because some or all of the new cash will simply subsidize repayment to the existing creditors. Priority treatment of the new loan solves the under investment problem—it assures that the new lender gets paid first—but it creates the risk of overinvestment, that is, that the lender, because it is protected, will make the loan even if it should not be made.[93]

In corporate bankruptcy it is up to the court to determine whether the new funding increases the firm's capacity to meet its existing debt obligations.[94] Under current U.S. bankruptcy practice, bankruptcy courts—following the approach developed in Delaware during the 1990s—generally approve the initial financing immediately, in connection with other so-called "first day orders" that are designed to enable the debtor to keep operating with as little disruption as possible. Delaware bankruptcy judges hold a more formal hearing several weeks later and reserve the authority to withdraw or adjust their approval if they later determine that the terms of the loan are inappropriate.[95] There is often considerable time pressure in evaluating and

[92] For a discussion of inefficient lending due to "debt overhang," see Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

[93] For a good discussion of these issues in the corporate bankruptcy context, see George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993).

[94] *See* 11 U.S.C. § 364(c) (providing that "the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt").

[95] *See* Judge Peter J. Walsh, Open Letter from Judge Peter J. Walsh to the Delaware Bankruptcy Bar Regarding First-Day DIP Financing Orders (Apr. 2, 1998), *reprinted in* Marcus Cole, *"Delaware Is Not a*

granting DIP financing. This is why a court's reputation in handling requests for new DIP financing quickly and efficiently appears to be an important determinant of distressed firms' decisions on where to file for bankruptcy.[96]

Although debt dilution is an important concern for sovereign debtors, the case for DIP financing to facilitate restructuring by a distressed sovereign is perhaps even stronger than for corporations. Indeed, even more than corporations, sovereigns may require immediate financial backing to stave off a possible run on the currency or the banking system. More generally, privileged lending aimed at reducing the costs of a severe temporary budget crisis and helping the sovereign's economy to grow out of a recession and thus to meet its future debt obligations is highly desirable. The difficulty lies mainly in devising a procedure for DIP financing that balances the benefits of new lending and the risks of further debt dilution.

Unfortunately, when the debtor is a sovereign rather than a private corporation, it is far less obvious that a court is well situated to rule on DIP financing. Delicate sovereignty issues are involved in giving a court the authority to approve or reject new privileged lending to a government. In addition, even an experienced corporate bankruptcy judge is unlikely to have the expertise required to assess a country's public finances. To determine whether to approve a proposed financing arrangement, a bankruptcy judge must consider whether the new loan is likely to alleviate a temporary budget or foreign exchange crisis without exacerbating the country's debt burden. Although the relevant issues, such as the extent of debt overhang, are not entirely outside of the court's expertise, the bankruptcy judge is likely to be poorly informed about the state of the country's public finances and the political constraints weighing on government expenditure and taxation. Especially at the outset of the crisis, when the initial determination is made, bankruptcy judges are likely to have only a limited understanding of the urgency and extent of the sovereign's short-term financial needs. That is not to say that regulation of DIP financing by a court is a clearly unworkable solution. But, before envisioning such a role for courts, it is important to explore whether other perhaps less intrusive alternatives are available.

State": Are We Witnessing Jurisdictional Competition in Bankruptcy?, 55 VAND. L. REV. 1845, 1910, app. A (2002).

[96] In the corporate bankruptcy context, confidence that the court would make an immediate determination on the debtor's DIP financing was one of the major reasons that many large corporate debtors filed for bankruptcy in Delaware in the 1990s. *See, e.g.*, David A. Skeel, Jr., *Bankruptcy Courts and Bankruptcy Venue: Reflections on Delaware*, 1 DEL. L. REV. 1, 2 (1998).

One alternative to the judge is, as recommended by the recent IMF proposal, to vest decisionmaking authority in the debtor's creditors.[97] This fits well with the objective of keeping the restructuring process in the hands of the creditors and responds to the concerns about the SDRM's heavy-handedness. It is also likely that at least some of the larger institutional creditors will be better informed about the debtor's financial position and political constraints. In addition, creditors have a direct financial stake in the debtor's fortunes, which gives them a strong incentive to make the right decision. Although this suggests that creditors might make better decisionmakers, they too face an important limitation: creditors generally are not well coordinated at the outset of the case, which makes creditor decisionmaking difficult when faced with issues that need to be decided early on. With DIP financing, the benefits of a better decision are likely to be overwhelmed by the adverse consequences of waiting to set up a creditor vote.[98]

From this perspective, the U.S. approach is arguably still a defensible compromise. The court is given primary authority, despite its shortcomings, because the judge can make an immediate determination. Before making its decision, however, the court must entertain any objections from creditors, who are better but slower decisionmakers. To characterize this approach as defensible is not to say that it cannot be improved, however. Given a court's limitations as a decisionmaker, it is important to consider whether there are ways to channel or constrain its role more effectively. The most sensible strategy, in our view, would be to more carefully distinguish between interim financing that is presumptively enforceable and financing that the court or other decisionmaker should presumptively prohibit.[99]

As we translate these insights into the sovereign debt context, we need to take one more key issue into account: the role of the IMF. The IMF already functions very much like a DIP lender when sovereigns encounter financial distress. As with most DIP lenders, the IMF usually has worked closely with the sovereign prior to any formal default, and has better information than private creditors about the sovereign's financial status. These informational

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[97] *See* IMF, SDRM DESIGN, *supra* note 3, at 45-47.

[98] This problem is closely related to the problem of holding a creditor vote to determine whether to impose a stay on litigation, which we discussed earlier. *See supra* Part II.A.

[99] To a certain extent, U.S. courts have begun to develop somewhat analogous distinctions themselves. Most now treat cross-collateralization—that is, the use of collateral to secure not just the new financing by a DIP lender, but also earlier, unsecured obligations owed to the same lender—as presumptively unenforceable. *See, e.g.*, *In re* Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992). Our proposal calls for much more stringent restrictions in the sovereign debt context.

advantages make the IMF an obvious choice to supply new funds. Moreover, IMF loans, like DIP financing, enjoy priority status, at least in theory. In practice, a strong norm that these loans will not be renegotiated has also worked in favor of the IMF.[100]

There are, however, two major concerns with IMF lending. First and foremost, a central impetus behind policy initiatives to reform the process of sovereign debt restructuring is the recognition that unchecked IMF lending may result in "moral hazard" in lending. Thus, unlike for private sources of DIP financing, the main concern with unchecked IMF lending is not so much that it may dilute the stock of outstanding debt as that it will give rise to too much repayment of existing debt obligations. In other words, the political pressures the IMF is under to extend huge programs to distressed countries and, thus, to bail out the private sector, while helping to alleviate the costs of a debt crisis ex post, may only give rise to greater ex ante inefficiencies in the form of renewed reckless lending. So, IMF lending needs to be reined in, not to avoid over-investment and dilution, but to prevent a wasteful bailout.

A second, closely related concern in the case of crisis-prone countries like Argentina is that the perceived priority of IMF loans is an illusion, which persists only as long as IMF loans are being rolled over. Should the IMF thus inadvertently lose its priority status, it would be lending at too favorable terms. This risk gives the IMF an incentive to keep lending even when the lending would not otherwise be justified.

Although the reasons for regulating IMF lending are different from those for regulating private DIP financing, it is interesting to note that the same institution, perhaps a bankruptcy court, could conceivably serve the dual role of keeping both forms of lending in check. In other words, even if this may appear to be a politically unrealistic idea, it is worth pointing out that an important hidden benefit of delegating the decision to grant DIP financing to an international bankruptcy forum may be that it provides just the kind of institutional commitment power that is needed to credibly restrain the worst

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[100] The IMF argues that its priority is justified, and must be protected, because it is "not a commercial organization seeking profitable lending opportunities," lending instead "at precisely the point at which other creditors are reluctant to do so." Krueger, *supra* note 3, at 11. For a discussion of the current failure to honor the priorities of other creditors, see *supra* notes 9-10, 24 and accompanying text.

In addition to these similarities to a DIP lender, the IMF has another valuable attribute as well. Whereas private creditors tend to focus solely on their own loan, the IMF takes systemic risk into account—a crucially important factor given the risk of contagion when a sovereign debtor defaults. Together, these qualities argue for the IMF to continue serving as the focal point for interim financing during a restructuring.

temptations of the IMF to bail out the private sector. Just as an independent central bank is a cornerstone of a credible monetary policy targeting inflation, an independent international bankruptcy court may be the best guarantee against excessive bailouts.[101]

It is interesting to observe in this respect that the plan proposed by the IMF for an SDRM entirely excludes IMF loans and programs from the SDRM. In other words, IMF lending will remain completely unchecked. There may well be strong political considerations behind this decision. While giving a bankruptcy court authority to grant DIP financing may be seen as an important encroachment on a debtor's sovereignty, it may be perceived as an equally unacceptable limitation of the power of the governing board of the IMF. Whatever the reasons behind the proposal to exclude IMF lending may be, this issue underscores the concerns expressed by many commentators about the credibility and authority of an SDRM forum that is not fully independent of the IMF.[102]

Based on the analysis thus far, we can start sketching the outlines of a financing scheme that would adapt the benefits of U.S.-style DIP financing to the sovereign bankruptcy framework. Based on financial considerations alone, the financing provisions should assure priority status to the DIP lender, but the court or other decisionmaker's discretion to authorize this priority should be restricted rather than unfettered. In many, perhaps most, cases, the IMF should serve as the initial lender. But IMF lending should ideally be subject to the same restrictions as interim financing by other lenders.

The framework we propose is quite simple. The SDRM decisionmaker should be instructed to distinguish between two categories of proposed priority lending, loan packages that are presumptively permissible and those that are

[101] One might be tempted to argue that, just as a fixed money supply rule is the best guarantee against inflation, an even better guarantee against bailouts is to reduce the budget of the IMF, so that it will not have the means to pursue such a policy. But just as a fixed money supply rule has been dismissed as an excessively crude macroeconomic policy, it would be overkill to cut the financial wings of the IMF (or possibly shut it down as some have advocated) just to avoid the still rare occurrence of an excessive bailout.

[102] Interestingly, a more restrictive approach to DIP financing could alleviate a problem that is closely related to the IMF's preference for large lending packages. Because it usually cannot provide all of the financing that its plans call for, the IMF has often required sovereigns to secure additional funds from private lenders in addition to any IMF lending. When the IMF has required the private funds to come first, before the fund will agree to lend, the results have been quite discouraging. *See, e.g.*, EICHENGREEN & RUEHL, *supra* note 10, at 27 ("Requiring countries seeking IMF assistance to first raise new money is unrealistic, given the palpable reluctance of investors who do not already have a stake in the crisis country to lend into uncertain conditions."). An SDRM, coupled with limited DIP financing, would avoid these kinds of problems.

presumptively impermissible. The distinction would be based on the magnitude of the proposed loan, and tied in particular to the sovereign debtor's current trade debt needs. Funds that are needed to finance a sovereign debtor's general trade debt should be approved.[103] Larger loans, on the other hand, would be presumptively impermissible and would require approval by the court or some other decisionmaker. The effect would be to authorize enough lending to meet the sovereign's current cash flow needs after a default, while minimizing the risk that the loan's priority status would lead to overborrowing.

By tying presumptively permissible DIP financing to the sovereign's trade debt needs, we do not mean to suggest that larger loans could never be given the special DIP financing priority. Larger loans would be presumptively impermissible, not forbidden per se. There might be good reasons for a larger interim financing arrangement, and sovereigns should, in our view, be able to get DIP financing beyond trade credit, but then the loan should be subject to approval by the bankruptcy court or some other decisionmaker. Whether the court or a majority of the creditors should have ultimate discretion to approve large DIP financing arrangements involves a delicate balancing of efficiency and political considerations.

In all likelihood, large-scale DIP financing could only be arranged in a truly timely fashion if a court had authority to grant it. To provide a safeguard against excessively profligate judges, creditors could be given the right to challenge a court decision approving extensive DIP financing. The advantage of court approval with a right of creditor challenge is that it would avoid the delays that would attend an alternative such as creditor voting.

Conversely, giving a court the power to approve DIP financing may not be politically feasible. Neither creditors, nor sovereign debtors, nor the IMF may be prepared to give up so much power to a court restructuring sovereign debt. In that case, it is clearly preferable to allow for DIP financing that is approved by a majority vote of all of the sovereign's creditors, rather than to ban it altogether. On balance, we believe that requiring a creditor vote on extensive DIP financing proposals is the most plausible strategy. Although delays such as the time necessary to identify the claims eligible for voting would

[103] As of December, 2003, for example, Peru's current trade debt was $3.7 billion, according to World Bank statistics. To put this in perspective, Peru's outstanding bank debt was $4 billion; its outstanding bonds totaled $2.5 billion, its Brady Bonds $2.5 billion, and its multilateral debt (that is, debt to other countries) $6 billion. World Bank, Joint BIS-IMF-OECD-World Bank Statistics on External Debt: Peru (May 28, 2004), *available at* http://www.oecd.org/dataoecd/54/55/31604166.pdf.

discourage debtors from proposing such financing, this approach is the most politically feasible, and the chilling effect may in fact be desirable in many contexts.

To summarize: under our proposal, the SDRM would divide interim financing into two categories, based on presumptions as to what is and is not permissible. The decisionmaker would simply approve loans that were tied to the sovereign's reasonable trade debt needs. Priority financing for larger loans, however, may have to be approved by a majority of the sovereign's creditors. This approach would have the virtue of significantly constraining the SDRM decisionmaker's discretion, and it would minimize the risk of overborrowing.

VI. WHO SHOULD THE INSTITUTIONAL DECISIONMAKER BE?

One of the most hotly contested questions in the debate over sovereign bankruptcy is who the decisionmaker should be. Most existing proposals recommend one of three choices: the IMF, an existing international organization, or a hypothetical new international organization. We begin this Part by briefly considering each of the proposed decisionmaking institutions and by pointing out the serious shortcomings of all of these alternatives. We then propose a very different decisionmaker: existing corporate bankruptcy courts. As we shall see, existing bankruptcy or insolvency courts offer several intriguing advantages over the competing choices.

A. Shortcomings of the IMF and Other International Institutions

The most obvious choice as overseer of a new SDRM is the IMF itself. In effect, the IMF already serves as a gatekeeper, since IMF approval is often a prerequisite to restructuring or otherwise addressing a sovereign debt crisis. The IMF's close involvement also gives it much better information about a sovereign's financial predicament than any outside decisionmaker would have. Given that the IMF is already intimately involved in these issues, and that SDRM oversight could be added to the IMF's job description without altering its mission, one can easily imagine the IMF as the principal bankruptcy decisionmaker.[104]

[104] Not surprisingly, the IMF's first sovereign bankruptcy proposals have taken this view. In outlining the IMF's case for an SDRM, for instance, Anne Krueger emphasized that amending the "Fund's Articles [to implement an SDRM] . . . would not entail a significant transfer of legal authority to the institution." Especially is this so, she argued, given that "the essential decision-making power would be vested in the debtor and a super-majority of its creditors." Krueger, *supra* note 3, at 9-10.

For all its benefits, however, IMF oversight has two major drawbacks: first, the IMF would have a significant conflict of interest. As lender of last resort, the IMF is a likely to be a creditor of the sovereign debtor. As decisionmaker, on the other hand, its responsibility would be to mediate impartially among the various constituencies of the sovereign debtor. The second concern is political. IMF decisionmaking has in some instances been driven more by political pressures by the United States or other G-7 members than by the economics of the crisis in question. As decisionmaker in a restructuring, its motives and impartiality may continually be questioned, making it ultimately an ineffective administrator of the restructuring process.

Once again, we do not have to look far to find a useful analogy to the dilemma posed by a regulator who acts both as an arbiter among creditors and as one of the creditors. In U.S. banking law, the Federal Deposit Insurance Corporation (FDIC) wears the same two hats. Because the FDIC guarantees the safety of bank deposits, it steps into the shoes of bank depositors if the bank runs into financial distress, which in essence makes the FDIC a bank's largest unsecured creditor. At the same time, the FDIC decides how to dispose of a bank's assets, and determines the treatment of the bank's creditors. During the banking crisis of the 1990s, the FDIC's dual role created or magnified conflicts in a variety of contexts.[105]

The FDIC's special concern with avoiding a costly bank run when a bank encounters financial distress is closely related to the IMF's concern with avoiding currency runs and contagious debt crises. Because of the risk of a bank run, banks cannot be reorganized in the same way as other companies. When insolvent banks are small they are invariably liquidated rather than reorganized, usually through deposit transfers or sales to third parties, and the entire process is arranged by the FDIC in secret before it is announced. The need for speed, secrecy, and regulatory approval all point to the FDIC as the logical overseer.

Secrecy and speed may be just as important in the early stages of a sovereign debt restructuring, and the IMF is well positioned to keep things quiet. But, when it comes to large sovereign debt crises, the IMF may be

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[105] *See, e.g.*, Samantha Evans, Note, *An FDIC Priority of Claims Over Depository Institution Shareholders*, 1991 DUKE L.J. 329 (criticizing FDIC assertion of priority over shareholders in pursuing claims against directors and officers). An even bigger complaint was that bank regulators waited too long to declare banks insolvent. For discussion, see David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723 (1997).

reluctant to impose aggressive discipline, much as banking regulators are tempted to forbear when a troubled bank is viewed as "too big to fail." Furthermore, the IMF cannot achieve the other benefits that justify FDIC control of bank insolvency proceedings. Unlike bank insolvencies, for instance, sovereign debt restructurings cannot be resolved by a single decisive transaction such as a liquidation or sale of assets. The process is more complicated and necessarily involves the input of other parties such as the sovereign's major creditors. The IMF will of course play a central role in the restructuring process. But given the IMF's conflicting interests, and its susceptibility to political pressures, it makes more sense to place oversight authority in a more disinterested decisionmaker.

In addition to the IMF, the other leading option for SDRM oversight is to vest this authority in a new international decisionmaking body or, in the alternative, to expand the scope of an existing organization. The IMF's most recent approach is a hybrid between IMF oversight and establishing a new SDRM decisionmaker;[106] thus, we will focus on the possibility of a newly created decisionmaker in the discussion that follows. As should be evident, however, looking to an existing international organization would raise precisely the same concerns as those we identify above.

Under the IMF's most recent proposal, an independent committee would select the members of a selection committee, and the selection committee would then pick the judges for the decisionmaking body, the SDDRF.[107] Unlike the IMF, the SDDRF would not have a financial stake in the decisions it makes, and all of its judges would be selected with their independence in mind. The most obvious selling point of the new body is this independence. Unfortunately, even the carefully structured nomination procedure in the IMF's proposal provides no real guarantee of independence. Just reciting the layers of process (e.g., the committee that selects a committee) gives a sense of how susceptible to political pressure the selection process may be. When it comes to actual SDRM decisions, there is a real risk that the SDDRF would not be an impartial decisionmaker and that the new board's deliberations, like the selection of its members, would be undermined by political considerations.

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[106] IMF, SDRM DESIGN, *supra* note 3, at 56-70 (proposing a new Sovereign Debt Dispute Resolution Forum that would be "an organ of the Fund" but would "operate . . . independently of the Fund's Executive Board, Board of Governors, management and staff"); *see also* Benjamin J. Cohen, *A Global Chapter 11*, 75 FOREIGN POL'Y 109, 125 (1989) (arguing that a "wholly new and independent entity" should be created, in order "to underscore . . . impartiality and objectivity" in the decisionmaking process).

[107] *See supra* note 42 and accompanying text.

One could respond to these concerns by adding further guarantees of the tribunal's independence,[108] but the suspicion of political interference is likely to remain. In short, with both the IMF's proposals and those of others to rely on an international decisionmaking body, there is a serious risk that politics may influence the tribunal's deliberations.

Another potential concern with the proposed SDDRF as currently envisioned is that it may not have sufficient powers to be able to administer the debt restructuring process efficiently. As currently contemplated, the court's strongest sanction is that it may decide to avoid the process entirely and throw the parties back to the current status quo where they must renegotiate the debt without the help of a majority vote binding on a dissenting minority. But wielding such a strong weapon may often not be plausible, and in the absence of any other sanctions it may be difficult for the court to reprimand a sovereign or a creditor that deliberately attempts to slow down the process, submits false claims, or abuses the judicial process in other ways.

B. Tapping the Expertise of Existing Bankruptcy Courts

As we chronicle the flaws of existing proposals to vest authority over sovereign bankruptcy in the IMF or an international tribunal, we must be careful not to lapse into utopian despair. The fact that a proposal falls short of perfection does not necessarily mean it should be rejected. An imperfect decisionmaker may be the best option we have in the real world. In this case, however, there may be a better alternative.

We argue in this section that authority over the SDRM process should be vested in existing corporate bankruptcy or insolvency courts. Existing courts are not perfect either, but they offer several striking advantages as compared to the IMF or an international organization. In the discussion that follows, we begin by briefly outlining the contours of our proposal. We then will address a series of potential objections to this strategy.

[108] In a proposal that seems to have influenced the IMF's own recommendation on this issue, Steve Schwarcz argues, for instance, that the International Centre for Settlement of Investment Disputes be used as a model for a new decisionmaking tribunal. Schwarcz, *supra* note 1, at 1024-30; *see also id*. at 1024 (suggesting that the jurisdiction of the International Court of Justice could be expanded to include SDRM disputes). A tribunal based on this model would rely on a panel of neutral arbitrators who would "have different nationalities," and would include "representative[s] of the principal bankruptcy and insolvency law systems of the world." *Id*. at 1026.

Our proposal is simple: rather than looking to a supranational decisionmaker, sovereign debtors should be permitted to file for bankruptcy in the courts of any foreign jurisdiction whose law governs a portion of the sovereign's private debt. To avoid the problem of "home court" favoritism, sovereign debtors or creditors should not be allowed to file in the sovereign's own courts, but the sovereign could select the bankruptcy arbiter of any jurisdiction where it issued bonds or bank debt. Under current practice, the majority of sovereign debt is issued in New York and is subject to New York law. The other major source of bond issues is London, with Tokyo or Frankfurt issuing a much smaller share.[109] This means that most sovereigns could choose from among one or more of these four jurisdictions. A sovereign that followed its New York debt would file in the bankruptcy court for the Southern District of New York; a London case would go to a judge with insolvency jurisdiction over administrative receiverships; and Frankfurt or Tokyo cases would be handled by the bankruptcy courts in those locations.

There is one small qualification. To assure that sovereign debtors did not issue debt in a jurisdiction on the eve of default solely for the purpose of gaining access to the jurisdiction's bankruptcy courts, a sovereign's venue choice should be limited to jurisdictions where it had issued debt at least eighteen months before bankruptcy.[110] Other than this timing limitation, however, together with a minimum amount requirement, sovereigns could file wherever they issued their debt.

Perhaps the most important benefit of this approach, as compared to employing the IMF or an international body, is that it relies on an existing decisionmaker and legal community who already have the relevant expertise and authority to conduct the judicial process. In each of these courts, moreover, initial decisions are made by a single judge. As a result, courts would be well positioned to make immediate decisions on issues like interim financing; there would be no need to wait until, say, an arbitral panel was assembled to oversee the case. In addition, the bankruptcy or insolvency judge would be much less likely than the IMF or the SDDRF to be subject to political

[109] *See* Anthony J. Richards & Mark Gugiatti, The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers (Jul. 11, 2003) (unpublished manuscript), *available at* http://ssrn.com/abstract=443840.

[110] U.S. law provides an analogous (though shorter) reachback provision for corporate debtors. The U.S. bankruptcy venue provision permits a corporation to file in the district of its domicile, residence, principal place of business, or principal assets for the majority of the 180 days before bankruptcy. *See* 28 U.S.C. § 1408(1) (2000). In effect, this requires that the venue requirement be met for a minimum of ninety-one days.

pressures. In short, the conflict-of-interest concerns that would bedevil each of the other proposed decisionmakers do not loom nearly as large for bankruptcy courts.

The first and most obvious objection to our proposal is that giving sovereign debtors a choice of filing locations will enable them to shop for the laxest forum and perhaps lead to a race to the bottom, with courts exacerbating debtors' moral hazard by making it too easy for sovereigns to shed their debt.[111] This is the same kind of complaint that has been lodged against the U.S. corporate bankruptcy framework. In the United States, most corporate debtors have a variety of filing options, and several courts—most prominently Delaware and New York—have attracted a disproportionate number of the biggest cases.[112] Critics complain that the judges in these jurisdictions have undermined the bankruptcy process by rushing cases along, being too generous in paying attorneys' and bankruptcy fees, or by favoring debtors and their managers—the allegations vary—in order to attract these reputation-enhancing cases.[113]

Rather than undermining the case for giving sovereign debtors a choice of bankruptcy court, the forum-shopping analysis actually proves on inspection to underscore its attractions. To see this, note first that even with corporate debtors, the venue-shopping complaints are largely misguided. Although critics complain that Delaware is too friendly to managers or their attorneys, for instance, this does not explain the fact that creditors often are the ones who insist that the case be filed in Delaware.[114] Bankruptcy lawyers who have handled cases in Delaware usually attribute Delaware's popularity to the speed

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[111] This complaint is a variation of the longstanding criticism of Delaware's prominence in U.S. corporate law, and its antecedents in the corporate restructuring context date back at least to the 1930s. The classic account of the "race to the bottom" thesis in corporate law is William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). For a brief history of debates over Delaware's role in corporate reorganization, including the complaints made during the New Deal era, see Skeel, *supra* note 96, at 5-16.

[112] Chicago may also be earning a place on this roster. Prominent recent cases filed in Chicago include the Kmart, United Airlines, and Conseco bankruptcies. *See, e.g.*, Amy Merrick, *Chicago Court Adeptly Attracts Chapter 11 Cases*, WALL ST. J., Dec. 10, 2002, at B1.

[113] The most frequent critic has been Lynn LoPucki. *See*, *e.g.*, Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933 (2002); Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom*,*"* 54 VAND. L. REV. 231 (2001).

[114] *See* David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309, 315 (2001). Stated differently, creditors' enthusiasm for Delaware suggests that, to the extent Delaware's willingness to pay bankruptcy lawyers New York rates was a factor, this cannot be the only reason debtors sought out the Delaware bankruptcy court in the 1990s.

of Delaware cases and the expertise of its bankruptcy judges. This is consistent with the existing empirical data, which suggests that Delaware cases were much faster than cases in other jurisdictions in the 1990s, and that debtors were most likely to file in Delaware rather than their "home court" (that is, the jurisdiction where the company's headquarters or principal assets were located) if the home court was inexperienced or the case was especially complex.[115]

Sovereigns can be expected to take similar considerations into account when they select a filing location. A sovereign that wishes to restructure its obligations quickly and return to the capital markets will pay especial attention to the expertise of the respective bankruptcy courts, and the courts, in turn, have an incentive to demonstrate efficiency and expertise if they wish to attract important cases. It is also worth noting that tying the choice of courts to the location of the sovereign's debt—New York, London, Frankfurt, or Tokyo for most sovereign debtors—assures that the case will be overseen by a jurisdiction that is likely to be sympathetic to the sovereign's creditors. Requiring the case to be filed in a creditor jurisdiction provides a useful counterbalance to the sovereign debtor's advantages—in particular, its rights to invoke the SDRM and to select the filing location. In short, jurisdiction shopping is a significant virtue of, not a problem for, the proposal.

A second possible concern is that ordinary courts cannot handle cases that have such large international implications as would a sovereign bankruptcy proceeding. Only an arbiter with international credentials, on this view, could oversee an SDRM.[116] Before the late 1970s, when sovereigns first started routinely waiving their traditional immunity from litigation,[117] this objection would have carried more weight. But we now have a much more extensive track record of domestic courts resolving issues involving sovereigns. Certainly, sovereign bankruptcy is a more elaborate proceeding than most legal issues, but the court's oversight role is also quite constrained under the

[115] KENNETH M. AYOTTE & DAVID A. SKEEL, JR., WHY DO DISTRESSED COMPANIES CHOOSE DELAWARE? AN EMPIRICAL ANALYSIS OF VENUE CHOICE IN BANKRUPTCY (Univ. of Pa., Inst. for Law & Econ. Research Paper No. 03-29, May 2003), *available at* http://ssrn.com/abstractid=463001.

[116] A related but different question is the issue of how the outcome of the SDRM would be enforced. What would keep the sovereign from simply refusing to honor the terms of the court's restructuring? The short answer is that the same interests—the desire to retain membership in the IMF and to have access to the credit markets—that induce sovereigns to try to repay their obligations in the first instance would also give them an incentive to honor the terms of the restructuring. Moreover, a sovereign that participated in the SDRM, and proposed a restructuring plan, is particularly unlikely to simply thumb its nose at the outcome.

[117] *See, e.g.*, Buchheit & Gulati, *supra* note 5, at 1334 (describing the waiver trend).

framework we have proposed, which leaves much of the process to be worked out by the parties. Nor should the magnitude of the cases be cause for alarm. New York and London courts already have experience handling huge bankruptcies. The bankruptcies of companies such as Maxwell, Polly Peck, WorldCom, and Global Crossing, for instance, involve larger amounts of outstanding debt than most sovereign debt restructuring cases. Particularly if the cases are brought in major economic centers like New York, London, or Tokyo, a commercial bankruptcy or insolvency judge will be equal to the oversight task.

A final, somewhat similar objection focuses on a court's difficulty in implementing sovereign bankruptcy rules that differ markedly from the jurisdiction's domestic bankruptcy or insolvency rules. Once again, there is much less to this objection than meets the eye. Given the similarities between the SDRM and U.S. Chapter 11, this objection would worry about judges in London or Tokyo, whose bankruptcy systems are much less oriented toward reorganization. But there is no reason to believe that London or Tokyo judges would find the SDRM disorienting, either. The framework is quite simple, and courts have managed to apply unfamiliar rules in other contexts.[118] Moreover, London bankers and lawyers have been strong advocates of sovereign bankruptcy, and the SDRM is in many respects simply an elaboration of the collective action provisions that are already included in the sovereign debt governed by London law. It is hard to imagine that London judges will find sovereign bankruptcy, with its strong London influence, uncongenial.

To summarize, vesting SDRM authority in domestic bankruptcy judges avoids the politicization that would undermine international decisionmakers. Decisions would be made promptly, and the threat of political meddling or conflicts of interest would be much lower. Giving the sovereign debtor a choice to file in any jurisdiction where it has issued debt would reinforce these virtues by creating healthy interjurisdictional competition among bankruptcy courts. A court that wished to attract sovereign bankruptcy cases would need to establish a reputation for efficiency and expertise, and the competition to do so would enhance the quality of all of the courts where a sovereign debtor might file.

[118] Cross-border insolvency cases pose somewhat similar challenges in the bankruptcy and insolvency context. For a survey of recent efforts by the IMF, World Bank, and other organizations to develop reforms in this area, see, for example, Frederick Tung, *Is International Bankruptcy Possible?*, 23 MICH. J. INT'L L. 31 (2001).

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Indeed, the attractions of jurisdictional competition raise the question whether we might want to go even further, and instruct sovereigns to specify their SDRM location ex ante. Under this ex ante (or pure jurisdictional choice) approach, each sovereign would pick a single jurisdiction as its filing location in the event it later invoked the SDRM. This ex ante choice strategy, which has been advocated in the international insolvency and corporate bankruptcy contexts,[119] has significant theoretical attractions. Since sovereigns would pick a jurisdiction before they borrowed additional new funds—and their choice would be limited to a single court—their cost of credit would fully reflect the merits or demerits of the court they selected. Sovereigns that selected an inefficient (e.g., excessively prodebtor) decisionmaker would (in theory) face higher credit costs. This would give the sovereign a strong incentive to seek, and courts an incentive to provide, efficient SDRM oversight.

While we recognize the virtues of a pure jurisdictional choice strategy, linking the SDRM decisionmaker to the sovereign's issuance of debt is preferable for several reasons. Perhaps the most important problem with precommitting to a particular jurisdiction is the difficulty of making midstream corrections. Once a debtor has made its choice, it is very difficult to change its selection later if subsequent events make the original choice ill-advised.[120] The debtor is in a much better position to select a filing location at the time of filing than it is when there is no filing in prospect. Second, there may be sovereignty concerns about a sovereign's precommitting to a particular nation's bankruptcy or insolvency courts in the event of a future sovereign bankruptcy filing. Third, the prospect that a sovereign could choose any jurisdiction in the world as the filing location, even one with no ties to the debtor or any of its creditors, could provoke political resistance to the SDRM. As a practical matter, we suspect that most sovereigns would select New York, London, Tokyo, Zurich, or Frankfurt as their filing location, even if they had unbridled discretion ex ante, since sovereigns who chose a potential lax jurisdiction would pay the price for this choice in the credit markets. But,

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[119] *See, e.g.*, Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000).

[120] Advocates of pure jurisdictional choice for corporate debtors have proposed that debtors who wish to change their selection should be permitted to do so if they hold a vote of all of their creditors and a majority of the creditors approve. *See, e.g.*, Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1399-1402 (2000). The global vote would be quite cumbersome, however—rather like a bankruptcy proceeding in itself—and the effort to switch jurisdictions could have adverse signaling effects for the debtor. *See, e.g.*, Skeel, *supra* note 114, at 328 n.61.

given the practical and political concerns we have just noted, the best way to structure the jurisdictional choice is to give sovereigns the ex post option to file for bankruptcy in any location where they have issued sovereign debt.

VII. SHOULD DESIGNER SDRMS BE PERMITTED?

Throughout our analysis, we have assumed that the sovereign bankruptcy framework will use a one-size-fits-all approach. Policymakers will develop a single set of provisions dealing with the issues we have discussed—the standstill, classification, voting, and so on—and the framework will then be implemented through a treaty process. As a conceptual matter, adopting a uniform, mandatory set of SDRM provisions obviously is the simplest approach. But it is not the only way to proceed. An alternative strategy might permit sovereigns to design a sovereign bankruptcy framework that fits their own particular circumstances.

This Part argues that sovereigns should be given precisely this kind of flexibility. We begin by pointing out that there is both theoretical support and, more intriguingly, historical precedent for permitting designer SDRMs. We then briefly explore how sovereigns might tailor the bankruptcy framework, and conclude by considering whether sovereigns should be prevented from adopting provisions that make restructuring more, rather than less, difficult.

Some of the most innovative work in the legal literature on corporate bankruptcy in recent years has focused on the possibility of designing bankruptcy provisions by contract. According to proponents of bankruptcy contract, if courts did not prohibit companies from waiving their right to file for Chapter 11 in the United States, a company and its creditors could improve on the existing statutory framework by devising their own bankruptcy rules to address central issues such as managers' choice whether to reorganize or liquidate the firm.[121] Critics, however, have questioned whether tailored bankruptcy provisions would be cost-justified for a healthy company and whether they could be effectively adjusted to take account of the debtor's borrowing arrangements with subsequent creditors.[122] Even if one views the most optimistic claims for a bankruptcy contract with skepticism, this literature

[121] Alan Schwartz has been the principal proponent of bankruptcy contract. *See, e.g.*, Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

[122] *See, e.g.*, Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999). For Schwartz's response, see Alan Schwartz, *Bankruptcy Contracting Revisited*, 109 YALE L.J. 343 (1999).

underscores the virtues of giving a debtor and its creditors the right to opt out of the existing statutory framework if they wish.

Interestingly, the possibility of a tailored approach to bankruptcy—or at the least, to some of its key terms—is not simply hypothetical.[123] In order to pass the first truly permanent U.S. bankruptcy law at the end of the nineteenth century, bankruptcy proponents were forced to make a series of compromises with Southern and Western lawmakers who opposed the legislation.[124] Particularly important was a provision permitting each state to determine what property debtors in that state could exempt from their creditors if the debtor filed for bankruptcy. The beauty of this compromise was that it enabled state lawmakers to adjust their exemptions in accordance with local norms as to what (and how much) property a debtor should retain in order to facilitate a "fresh start" after bankruptcy. Bankruptcy law was federal, but it was (and still is) tailored in significant respects on a state-by-state basis.

This historical precedent has direct implications for sovereign bankruptcy. Although proponents of an SDRM have not recommended that sovereigns be permitted to tailor the provisions in any way, we suspect this may simply be because they have not yet focused on the issue. Once we shine the spotlight on the question, the case for at least limited opt-out is compelling. To see this, suppose that a nation had the same kinds of concerns for its citizens' welfare that Southern and Western states had in the United States in the nineteenth century. One manifestation of this might be social welfare protections that the sovereign debtor wished to guarantee to its citizens even in the event of financial distress. Permitting the sovereign debtor to include this protection in its version of the SDRM would provide the same benefits as did the exemptions compromise in U.S. bankruptcy law: not only would opt-out permit sovereign debtors to tailor the SDRM to local norms, but it could also have the political benefit of increasing their willingness to adopt a sovereign bankruptcy framework.

To be sure, if every sovereign adopted a different SDRM, this might complicate creditors' efforts to price sovereign debt. But the pricing of sovereign debt is already complex and nation-specific; it is unlikely that a tailored SDRM would add significantly to this complexity. Moreover, we suspect that the kind of provision we have described would be the exception

[123] The illustration in this paragraph develops an application first made in Bolton, *supra* note 14, at 65-66.

[124] For discussion, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 41-42 (2001).

rather than the rule. Most sovereigns would hesitate to add provisions which, as with a social welfare opt-out, softened the effect of financial distress and thus interfered with the priority of the sovereign's creditors. Sovereigns that included such provisions would face higher credit costs ex ante. Only if there were an extremely strong local commitment to the protection in question would a sovereign soften the framework rather than sticking with the status quo.

But what about opting out of the SDRM to add *harsher* provisions, rather than softer ones? Here, things get a bit trickier. Given their desire to maximize access to credit and minimize its costs, sovereign borrowers have a greater incentive to adopt harsh bankruptcy provisions rather than soft ones. Recall from our discussion at the outset of the Article that sovereigns may in fact agree to make restructuring *too* difficult, since, among other things, current political leaders enjoy the benefits of a lower cost of credit but are not likely to be around to bear the consequences of any problems this causes down the road.[125] Under these circumstances, contractual flexibility may not always lead to an efficient result. The question, then, is this: should sovereigns be precluded from adopting amendments to make restructuring more rather than less difficult?

Despite the risk that an opt-out may include inefficiently harsh terms, we believe, on balance, that sovereigns should be given at least some limited flexibility to opt (or not opt) out of aspects of the SDRM as they see fit. For example, some sovereigns may have acquired a solid reputation of creditworthiness at the cost of strict and prolonged fiscal discipline. These sovereigns may fear that their reputational capital will be watered down by the introduction of the SDRM and may therefore be opposed to its adoption. If these sovereigns are prepared to support the SDRM only if they can opt out of some provisions—for example, if they can strengthen the supermajority rule required to approve a restructuring plan—this may be a small political price to pay to be able to implement an SDRM procedure.

Once again, as with our case for opt-out in general, our defense of full flexibility rests in part on theoretical considerations and in part on political ones. The theoretical case for flexibility is quite simple. Although there is a real risk of inefficiently harsh terms, some sovereigns may have legitimate reasons to tinker with the framework in ways that make restructuring more

[125] *See supra* note 14 and accompanying text.

difficult. We are hesitant to cut off an alternative that might make sense for some sovereign debtors. But the political factors point in the opposite direction and, in our view, outweigh the virtues of flexibility. We suspect that both sovereign debtors and their creditors would be hostile to a sovereign bankruptcy proposal that could be softened but not tightened. Creditors would complain that this approach encourages moral hazard and easy default, and sovereigns would worry about the effect on their access to credit. If sovereigns are permitted to tailor the SDRM to fit their needs—and we think they should be—they should therefore be given the flexibility to adopt provisions that make the framework harsher rather than softer if they so choose.

This is not to say that complete flexibility to opt out should be allowed. Clearly, an opt-out of the entire scheme would not achieve any gain relative to the current status quo. Thus, all members should be subject to the broad main provisions of the SDRM, but they should also be allowed to strengthen or weaken somewhat specific provisions like the majority rule, stay, DIP financing, and classification provisions to reflect their specific circumstances in light of how they affect the balance between the interests of creditors and those of the sovereign.[126]

CONCLUSION

We have argued in this Article that neither the existing approach to sovereign debt crises—ad hoc efforts to restructure, together with the prospect of an IMF-led bailout—nor increased use of collective action provisions is an adequate response. Because of their short-term focus, sovereign decisionmakers may agree to excessively harsh conditions on restructuring, and the prospect of bailouts creates serious moral hazard on the part of creditors. Collective action provisions might facilitate restructuring in some cases, but they will only be effective if the sovereign debtor has a relatively

[126] As suggested in the text, one concern one may have with letting sovereigns opt out of the SDRM with harsher provisions is that, as helpful as these opt-outs are in giving the sovereign credibility up front, they may also in some circumstances lead to inefficient restructuring procedures should the sovereign end up in financial distress. If that is the case, it may be desirable at that point to go back on the opt-out clauses. Of course, if investors anticipate that when push comes to shove these harsher provisions will not be enforced, there will be no point in letting sovereigns opt out in the first place. Clearly, a delicate balancing act is required here, which conceivably the court could be charged with. It could be required to enforce the general principle that, if the circumstances under which the sovereign is led to default on its debt could be reasonably anticipated by investors, then opt-out clauses should be enforced, but if they could not, then the court may allow the sovereign (with possibly some minimal support of creditors) to remove the harsher provisions or to let debt restructuring to take place under the standard SDRM.

simple capital structure; and this strategy may not scale down the sovereign's debt enough to fully resolve its financial crisis.

The IMF's proposed SDRM is an important step forward. Not least of the benefits of a sovereign bankruptcy framework is that it would enable the IMF to credibly commit not to bail out troubled sovereigns. Rather than bailouts, sovereigns would need to look to the SDRM. Unfortunately, the IMF framework is flawed in important respects. Although it would help to solve the coordination problems faced by sovereign debtors and their creditors, it does not adequately address the issue of creditors' priority. Under current conditions, it is very difficult for the parties to create enforceable priorities, a dilemma which creates a great deal of uncertainty in sovereign credit markets. We have argued that a sovereign bankruptcy framework can and should be used to remedy this problem. By adopting a strict first-in-time priority scheme, and adhering to absolute priority in the classification and voting process, the SDRM could enhance sovereign credit markets ex ante, as well as providing a mechanism for resolving sovereign debt crises ex post.

Our proposal also includes a variety of other significant features, including a special but limited priority for interim financing that analogizes to the approach used in railroad receiverships in the United States in the late nineteenth and early twentieth centuries. Unlike other commentators, who propose that a new or existing international body oversee the sovereign bankruptcy process, we argue that decisionmaking authority should be vested in the existing bankruptcy or insolvency courts of any jurisdiction where the sovereign has issued debt. We also argue that sovereigns should be permitted to tailor the bankruptcy framework in many respects.

No proposal is perfect, of course, and ours could no doubt be improved in various ways. But a proposal along these lines would address many of the problems that have bedeviled the existing responses to sovereign debt crises. Our hope is that this Article will contribute to the current discussions over whether a sovereign bankruptcy regime should be put in place and shed light on how such a regime should be structured.