REDESIGNING THE INTERNATIONAL LENDER OF LAST RESORT

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Abstract

This paper is concerned with the issue of how to balance bailouts (or 'lending into arrears') with debt reductions (or 'private sector involvement') in the resolution of sovereign debt crises. It provides a review of recent proposals to regulate sovereign debt renegotiations under a Sovereign Debt Restructuring Mechanism (SDRM). In addition to defending a sovereign bankruptcy proposal we have put forward in recent work, this article proposes a major reorientation of the IMF's role in sovereign debt crises.

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I. INTRODUCTION

Since the Mexican Debt Crisis of 1994-95, which gave rise to an International Monetary Fund (IMF) bailout of unprecedented size, there has been a raging debate on how the IMF should handle sovereign debt crises. Despite the successful resolution of the crisis and the quick repayment by Mexico of all the emergency debt, the sheer size of the intervention has raised worries that bailouts could cause significant sovereign debt market distortions. These concerns in turn have led to a reconsideration of the prevailing wisdom that the IMF can and should act as the de facto international lender of last resort (ILOLR) by arranging bailouts in response to major sovereign debt crises. As is now widely recognized, the problem with a purely bailout-based policy is that it requires ever larger funds to be credible and successful. It also invites undesirable policies by debtor countries. The prospect of a bailout encourages sovereign debtors to borrow more than they should, and it tempts them to resort to highly risky fixed exchange rate policies as a quick fix towards macroeconomic discipline.[2] Of course, the worst debtor misconduct can be controlled to some extent by imposing conditions on the debtor country before granting a rescue program, but more often than not the IMF finds itself in a weak

[2] The IMF bears its own share of responsibility in recommending such policies. For critical assessments of IMF policy recommendations on macroeconomic stabilization and intervention during the Asia crisis of 1997-98, see PAUL BLUSTEIN, THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLED THE IMF (2001) and JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (2003). For a more sympathetic view, see NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAILINS? (2004). RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES (2004).

bargaining position at the onset of a debt crisis. How credible is the IMF threat to withhold a financial aid package, when a potentially contagious debt crisis is about to blow up? And once the bailout has been granted, why should the debtor country stick to the conditions it agreed to?

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

The most ambitious overhaul of IMF policy contemplated so far involves the introduction of some form of bankruptcy institution for sovereigns and envisions a single forum where the extent of debt reduction and the size of new emergency lending would be decided simultaneously. There was considerable discussion and research of this strategy, which the IMF calls a Sovereign Debt Restructuring Mechanism (SDRM), from late 2001 when the IMF first announced its support for a sovereign bankruptcy framework, up to the G-10 meetings in April 2003, when it was decided to shelve the IMF's proposal. Despite all the writing and debates, many open questions were still unresolved, including the role of the IMF in an SDRM regime. No doubt these questions would have received further attention if the SDRM proposal had gone forward. But in the aftermath of the SDRM debate, no clear new role for the IMF has been marked out and no clear rules have emerged to direct the IMF's balancing of bailins and bailouts in future debt crises.

As a result, the IMF now finds itself at a crossroads. Should it be content with the status quo and accept that it will be less and less equipped to deal with major emerging market debt crises? Or, on the contrary, should its size be considerably expanded, possibly by granting a more powerful role to Japan, China and other East Asian countries that are sitting on massive idle foreign exchange reserves? Or, even more radically, should the IMF entirely move out of any form of crisis lending and confine itself to an advisory and forecasting role, as Chari and Kehoe, Rogoff, and others have urged?[3]

[3] In his powerful analysis of the history of World Bank and IMF lending over the past sixty years, Rogoff argues that "my long-held view is that the Fund would serve better if it made no loans. In a nutshell, the Fund's current resources of $150 billion seem like enough to cause moral-hazard problems (that is, to induce excessive borrowing) without being enough to deal with a really deep global financial crisis. The Fund is just too politicised to be a consistently effective lender of last resort, and if its financial structure is not changed, there are always going to be Argentinas…No, the right future for the Fund, as for the IBRD, is to phase itself out of the lending business. The Fund can still make itself very useful in coordinating the global financial system, in offering technical advice, and perhaps even in issuing debt ratings to countries that request it. If the global community can work its way towards an improved bankruptcy procedure for sovereign borrowers,this path will be far easier. I would recommend it regardless.'' Kenneth Rogoff, *The Sisters at 60*, ECONOMIST, July, 22, 2004. *See also* V.V. Chari & Patrick J. Kehoe, *Asking the Right Questions about the IMF*, FEDERAL RESERVE BANK OF MINNEAPOLIS ANNUAL REPORT ISSUE (1998), who argue that there is no need for an IMF role of ILOLR given that the central banks of the G-7 can already intervene directly in the event of a crisis.

In this paper we argue that by establishing an adequate bankruptcy procedure for sovereigns, the international community could both fully address the problem of sovereign debt restructuring and redefine an ambitious crisis resolution role for the IMF. Far from stepping away from a crisis lending role, we argue that the IMF could enhance its ILOLR role within the framework of a sovereign bankruptcy procedure, and this without increasing the size of its funding. How do we square this circle?

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

[4] First day orders are described in Marvin Krasny & Kevin J. Carey, *Editors Reply to an Anonymous Letter; Why is Delaware the Venue of Choice for Philadelphia-Based Companies?*, THE LEGAL INTELLIGENCER, March 22, 1996, at 9; Marcus Cole, *Delaware is Not a State: Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845 (2002).

lending by the private sector-- often the same lenders that have already lent to the distressed firm in the past-- by granting the new loans higher priority status.

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

To achieve this restructuring of the IMF's role, the underlying sovereign bankruptcy framework would need to provide coherent, enforceable priority rules.[5] In

[5] At a minimum this new role for the IMF is possible only if higher priority status can be granted to emergency lending. So far the IMF has been able to implicitly enforce higher priority on its own and other IFI loans. However, this de facto priority is partly an illusion

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

The remainder of our article proceeds as follows. In Part II, we discuss the recent policy proposals for a sovereign bankruptcy procedure. We also consider the extent to which the benefits of a statutory procedure could be achieved through contractual alternatives, and we briefly explore the implications of the recent debt crisis in Argentina. Part III maps out the new role for the IMF and assesses how IMF actions in debt crises might need to be circumscribed.

II. INTERVENTION IN DEBT CRISES AND POLICY DEBATES

A wide range of reforms have been proposed as a partial or complete solution to the concerns described in the introduction, including greater use of collective action

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as the IMF has generally accepted to roll over its loans when the sovereign was unable or unwilling to pay. This higher priority status has also recently been tested by Argentina following its default on sovereign bonds. Conceivably, the IMF could already play this new role of granting higher priority to emergency loans from the private sector under the current legal environment. However, de facto, implicit, enforcement of priority is likely to be more difficult to scale up and probably may need to be shored up by legal enforcement through the courts.

[6] Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?* 53 EMORY L.J. 763, 766-67 (2004).

clauses (CAC's) in bonds, a structured mediation or arbitration process for addressing sovereign debt crises, and various forms of sovereign bankruptcy. This section focuses at most length on the IMF's sovereign bankruptcy proposal, and on our own proposed framework, a more expansive alternative to the IMF proposal. [7]

Sovereign bonds governed by U.K. law have long included CACs specifying voting rules that permit a predetermined majority of bondholders to adjust payment or interest terms in the event of a debt crisis. Bonds governed by New York law, by contrast, have traditionally given each bondholder veto power to decide whether or not to agree to a restructuring. In the 1990s, an increasing number of commentators concluded that this "unanimity" approach makes restructuring too difficult.   To facilitate coordination among the sovereign's bondholders, and to counteract the threat of holdouts, they argued, sovereign debtors should include CAC's in all of their bonds.[8]

At its April 2003 meetings the G-10, led by U.S. treasury, have endorsed a policy that strictly limits private sector involvement to only a voluntary inclusion of CACs in sovereign bond issues. Partly to stave off more drastic intervention in sovereign debt

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7 Bolton & Skeel, *supra* note [xx].

8 An early, influential emphasis on CACs came in Barry Eichengreen & Richard Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors, in* CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS 3, 49 (1995).   More recently, Mitu Gulati has written extensively about the use and promise of CAC's. *See, e.g.,* Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002). For a nuanced view of the choice between CAC's and the unanimity approach, see William W. Bratton & G. Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. (2004).

contracts and partly to placate U.S. treasury, issuers have since introduced CACs into every new sovereign bond issue, with Mexico very publicly issuing New York-registered bonds that permit changes to the payment terms of bond with the consent of 75% of the holders in mid-2003, and several other sovereigns following suit, including Uruguay and Brazil.[9]

Despite these encouraging developments, however, there are still several reasons to suspect that CAC enthusiasts have oversold the virtues of the new clauses. First, CAC's are more effective for restructuring one or a small number of classes of bonds, than for sovereign debtors with a more complicated capital structure.[10] Second, although CACs help counteract collective action and holdout problems, they do nothing to remedy any seniority and debt dilution problems as we explain below. CACs also do not address concerns such as the need for a standstill while the sovereign debtor is renegotiating its obligations.[11] Because of these shortcomings we believe that a more interventionist policy, such as the statutory approach advocated by the IMF, is called for.

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[9] Since the end of 2003, nearly every new issuance of sovereign bonds has featured a CAC. Interestingly, the latest Uruguayan bond issues also include an aggregation clause that permits a combined vote of all the classes of bonds that include the clause. The clause is designed to obviate the need for separate votes for each class of bonds by creating the possibility of a single, inter-class vote on the terms of a restructuring. These developments are recounted and analyzed in Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004); and Stephen J. Choi & G. Mitu Gulati [cite to the current draft on these issues].

[10] This point is discussed in more detail in David A. Skeel, Jr., *Can Majority Voting Provisions Do it All?*, 52 EMORY L.J. 417 (2002).

[11] These and additional shortcomings are discussed in Bolton & Skeel, *supra* note [xx], at 773-76.

1. <u>The IMF's Sovereign Debt Restructuring Mechanism</u>

The IMF's sovereign bankruptcy initiative was first announced in a November, 2001 speech by Anne Krueger. The IMF staff subsequently produced a series of detailed draft proposals outlining a Sovereign Debt Restructuring Mechanism (SDRM) in 2002 and early 2003. Because the IMF's proposal has been the lightening rod for recent debate over sovereign bankruptcy, we will explore it in some detail before considering our own proposed alternative.[12]

The guiding concern of the IMF's proposal is to resolve collective action problems among dispersed creditors in debt restructuring negotiations, while preserving creditor contractual rights as much as possible. 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. With the aim of preserving creditor rights as much as possible, the IMF's plan stops short of envisaging a stay on litigation and individual debt collection efforts or a standstill on debt payments. The main stated justification for not introducing an automatic stay into an SDRM is that sovereign assets are much harder to collect than corporate assets. Lengthy and uncertain

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[12] Much of the description and analysis in this section is drawn from Bolton & Skeel, *supra* note [xx], at 776-80. The IMF's first detailed proposal was INTERNATIONAL MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM– FURTHER CONSIDERATIONS (2002)[hereinafter, IMF, DESIGN OF THE SDRM], *available at* http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf. This proposal was subsequently adjusted. *INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003)[hereinafter, IMF,*

litigation may be required and even if the plaintiff prevails it is likely that a restructuring agreement would already have been approved in the meantime, which could limit the plaintiff's gain.

The main limitation on plaintiffs' gains that the IMF envisions mirrors a legal rule in international insolvency law: the *Hotchpot* rule. This rule requires that any payment or asset collected by a plaintiff through litigation must be offset against the plaintiff's claim in the restructuring agreement. 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, but the IMF's proposed plan excludes such a provision on the grounds that it would be impractical.

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 and proposes that the judge could have authority to stay specific legal actions on request of the debtor and subject to approval of creditors.

PROPOSED FEATURES], available at
http//www.imf.org/external/n/pdr/sdrm/2003/021203.pdf.

The voting provision and the Hotchpot rule are the center-pieces of the IMF's proposed plan. The plan also contains many more technical provisions dealing with notification of creditors, registration and verification of claims. As in corporate bankruptcy this can be a lengthy and difficult process. An important additional complication is that the ultimate ownership of a sovereign bond is hard to trace. The court must be able to pierce through the veil of beneficial ownership to be able to ascertain whether the votes on a particular bond are controlled by the sovereign. Should that be the case then these votes should be ineligible for obvious conflict of interest reasons.[13] A related difficulty is that for widely dispersed debt structures many claims may not be registered in time. Given the large number of claims that won't qualify, a requirement that a supermajority of "registered" claims approve the plan may function more like a simple majority requirement in practice, thus resulting in a weaker protection of creditors. These difficulties underscore the need for a court supervised restructuring procedure as well as the important benefits that might be available with the establishment of an international clearing house.

As the main focus of the IMF's proposed plan 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

[13] 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 had participated in a syndicated loan agreement, Brazil managed to thwart an effort by other holders of the debt to accelerate the amounts due under the loan. CIBC Bank and Trust Company v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995)(refusing to intervene to impose implied obligations of good

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, etc - from the SDRM . 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.

The plan recognizes some of these difficulties and proposes as an alternative to include Paris club debt in the SDRM under a separate class. The plan also allows for other forms of classification and gives the debtor discretion to classify under the general requirement that classification does not result in "unjustified discrimination of creditor groups." 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.

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faith and fair dealing). For discussion and criticism, see Bratton & Gulati, *supra* note

Just as the IMF's plan does not systematically address the issue of enforcing absolute priority it also only gives lip service to the issue of 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." The main purpose of DIP financing is to address an immediate cash crisis and allow the debtor to function while the restructuring negotiations are ongoing. Clearly, a creditor vote would be extremely difficult to organize in a timely fashion, making it virtually impossible to organize any such financing.

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

[xx].

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 serious 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– in particular, the need to honor creditors' priorities in order to facilitate sovereign credit markets. In addition, the IMF's interim financing proposal is cumbersome and does not fully address the growing concerns about the nature of the IMF's funding and oversight role. Finally, the creation of an SDDRF within the IMF itself raises independence and conflict of interest concerns.

2. Enforcing seniority

Although the IMF plan focuses on collective action problems, an equally important problem is debt dilution and the lack of enforcement of seniority in sovereign debt. In the absence of enforceable priorities, when a debtor country approaches financial distress any new debt it issues is partly at the expense of existing creditors who face a greater risk of default and will have to accept a greater "haircut" (or debt reduction) in the event of default, since the total resources the debtor can muster towards repayment of its stock of debt will have to be divided *pro-rata* among all its creditors, old and new. In earlier work, we have highlighted how the lack of enforcement of an absolute priority rule encourages over-borrowing by the sovereign as it approaches financial distress and also raises its overall cost of borrowing.[14]

Under the old IMF bailout-based policy the enforcement of an absolute priority rule was not a burning issue, since typically private creditors could expect to be repaid in full. But the shift in IMF policy towards private sector involvement following the Russian debt crisis of 1998 has brought to light the issue of priority in repayment and introduced new uncertainty in sovereign debt markets by upsetting market expectations concerning seniority. Two subsequent events roiled the waters still further: the debt restructuring of Pakistan in 1999-2000, and the decision by the Court of Appeals of Brussels in 2000 to grant Elliott Associates, a vulture fund that had invested in Peruvian debt, a restraining order against EUROCLEAR preventing it from accepting transfers from the Peruvian government towards paying other creditors before Elliott's debt claims on Peru had been honored.[15]

The first event, Pakistan's debt restructuring agreement of 2000, required for the first time that Eurobond holders be included in the restructuring agreement, thus shattering the market's perception that these debts had higher priority status.[16] The

[14] Bolton and Jeanne, *supra* note [xx], provides a formal analysis of optimal debt structure in the absence of any legal enforcement of seniority. They show that creditors attempt to achieve higher priority *de facto* by making their debt difficult to restructure. Overall this results in an excessively high cost of financial distress.

[15] Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999).

[16] See Jeromin Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* (IMF, Research Department, Working Paper draft, Sept. 29, 2003); Anna Gelpern,

second event, Elliott Associates vs. Peru, alerted the market to the potentially far-reaching possibilities that the traditional interpretation of the standard *pari passu* clause in sovereign bond issues might no longer be valid,[17] and that private litigants could threaten to disrupt the transfer of funds from sovereigns to creditors by obtaining restraining orders in court.

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

Elliott Associates, playing an aggressive hold-out strategy, refused to go along with Peru's proposed Brady Plan debt restructuring of 1995. Instead, it attempted to obtain repayment on its debt by initiating a series of lawsuits and eventually prevailed in the Court of Appeals of Brussels in September 2000. Eager to avoid a default on its Brady bonds, the Peruvian Government decided to settle following the Court's decision by paying Elliott in full.[18]

Building a Better Seating Chart for Sovereign Restructurings, 53 EMORY L.J. 1115 (2004).

[17] The competing interpretations of the *pari passu* clause are described below. *See supra* notes [xx]-[xx] and accompanying text.

[18] Gulati & Klee, *supra* note [xx], at xx.

Underlying the Brussels court's decision was a seemingly straightforward interpretation of the *pari passu* clause. The clause states that "[t]he obligations of the Guarantor hereunder [the Peruvian Government] do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon."[19] The court interpreted this language as meaning that when the debtor is unable to repay all its debts in full, all claims of equal ranking under the *pari passu* clause should get a pro rata share of the total amount the debtor pays out. Most importantly, the court deemed that the debtor cannot pay some creditors in full (the creditors who agreed to the restructuring) and default on others (the creditors who held out and retained their original bonds). It is on the basis of this interpretation that the court granted Elliott Associates a restraining order against EUROCLEAR, the entity to which Argentina had wired funds to pay consenting bondholders the scaled down amounts they had agreed to accept.[20]

The court's interpretation provoked a torrent of criticism.[21] Most commentators favor an alternative interpretation of the *pari passu* clause, that it is designed to prevent the borrower from issuing new debt that is senior to the existing debt. Which

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[19] *See* Elliott Assocs., L.P. v. Banco de la Nacion, 2000 U.S. Dist. LEXIS 14169 (S.D.N.Y. Sept. 29, 2000) and Elliott Assocs., L.P. v. Republic of Peru, 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000)

[20] In effect, Elliott claimed that it was entitled both to claim its share of the payments being made to consenting bondholders, and (unlike the consenters) to continue to insist on payment of the full face amount of its bonds.

[21] For critiques of the Elliott ruling, *see, e.g.*, Gulati & Klee, *supra* note [xx]; William W. Bratton, Pari Passu *and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2004); Lee C. Buchheit and Jeremiah S. Pam, *The* Pari Passu *Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004).

interpretation the courts will end up adopting in the future is still uncertain, although in light of the outpouring of academic writing and briefs following the Brussels Court of Appeals decision, the narrower interpretation favored by legal scholars seems likely to prevail.

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

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

> What the Brussels decision does is to put a large hammer in the hands of holdout creditors, thereby enabling them to cause even more disruption in restructurings. Those inclined to be holdouts have a stronger position, and it encourages others to hold out. For the sovereigns and, we argue, for the majority of creditors, this is a nightmarish situation.[22]

The restraining order does indeed amount to a big stick for creditors, which plausibly should not be put in the hands of holdout creditors. Interesting new possibilities, however, can be imagined if one thinks of this stick as potentially applying to the enforcement of debt payments and seniority more generally. If creditors' inability to seize assets and a sovereign's limited capacity to issue collateralized debt interfere with a

[22] Gulati & Klee, *supra* note [xx], at xx.

sovereign's ability to borrow, then an effective way of relaxing the sovereign's borrowing constraint may be to give creditors the means to credibly threaten to shut out a defaulting sovereign from international financial markets by preventing it from paying off new creditors.

The greater enforcement powers opened up by Elliott-type injunctions have inspired several commentators to outline the contours of a contractual approach to the enforcement of seniority in sovereign debt similar to the CAC-based approach to the resolution o collective action problems. One suggestion, put forward by both Zettelmeyer and Gelpern, is for senior creditors to enforce the priority ostensibly granted to them by a sovereign debtor vis-à-vis other, junior creditors pursuant to a "third party beneficiary" theory. Junior creditors would agree to subordinate their claims, and courts might agree to enforce the subordination, based on the theory that the junior creditors could be construed as beneficiaries of the financing from the senior creditor.[23] Another suggestion, first offered by Wood, is to contractually require the sovereign to include senior creditors as parties in subsequent junior debt issues.[24] If sovereign debtors began to include these kinds of subordination arrangements in their debt contracts, one could conceive of Elliot-type injunctions that courts might grant to senior creditors against a sovereign that later attempted to violate the terms of the earlier agreement. If a sovereign debtor that had agreed to subordinate any subsequent debt failed to do so, a creditor could ask a court to injoin the new issuance.

[23] Zettlemeyer, *supra* note [xx]; Gelpern, *supra* note [xx].

[24] PHILIP R. WOOD, THE LAW OF SUBORDINATED DEBT (1990).

While such remedies might conceivably discipline sovereigns and open the way for the contractual enforcement of an absolute priority rule for sovereign debt, the critical issue remains whether the cure is not likely to be worse than the disease. There is a real potential for nightmarish disruptions to the payment system, and one could imagine a multiplication of costly legal actions between creditors. In addition, this strategy would impose a continuous monitoring burden on the senior creditors. Because any subordination clause included in a creditor's contract with the borrower could not bind a subsequent third party borrower who might be ignorant about the priority arrangement, the senior creditor would be forced to police the debtor to make sure that the sovereign included a subordination provision in each subsequent debt issuance.[25]

We do not mean to discourage these contractual innovations, which may be the only realistic way forward in the absence of a renewed effort on the part of major debtor and creditor nations to introduce a sovereign bankruptcy procedure. But it is important to recognize that the contractual approach brings important risks which could be largely avoided under an expanded statutory debt restructuring mechanism, as we now explain.

3. Our Proposal

The SDRM either ignores or does not satisfactorily address the issues of the absence of a coherent priority scheme, the need for an interim financing strategy that

[25] If the priority arrangement were somehow deemed to be binding on a subsequent creditor, the higher 'due diligence' burden would fall on new lenders, who would need to determine what the stock of outstanding senior debts was before making a loan. Short of setting up a central register of senior debt that could be easily accessed by new lenders this would often be an impossible task.

refines and alters the role of the IMF, and the need for an independent decision maker to oversee the sovereign bankruptcy framework. In earlier work, we have explained how an expanded sovereign bankruptcy framework might handle each of these issues.[26]

With respect to priority, the sovereign bankruptcy framework should include a straight first in time priority framework, together with voting procedures that call for absolute priority treatment– that is, the assurance that higher priority creditors will be paid in full, and that any haircut will be aimed first at lower priority creditors. Under our proposal, priority would be based on the time that the credit was extended, with the debt of any given year taking priority over debt issued in a subsequent year. Based on this priority, the sovereign debtor would divide its creditors into classes at the outset of a two tier voting process for restructuring the sovereign's debt. For the purposes of the first vote, the debtor would make a proposal as to how much of its overall debt would be discharged– that is, how large the overall haircut to creditors would be.[27]

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[26] Bolton & Skeel, *supra* note [xx].

[27] At first glance, it may appear that the first step vote would invariably lead to a 49% haircut under a simple majority voting rule, since a bare majority of creditors would form a coalition to cut off the remaining creditors, thus increasing the likelihood of repayment for the winning creditors. But the minimum winning coalition intuition only applies if there are numerous, same-sized classes of creditors. If there were only one large creditor class, for instance, the class would presumably agree to whatever haircut optimizes its repayment, based on the sovereign debtor's financial condition. In the real world, the capital structure of a sovereign debtor will fall somewhere between the two extremes of numerous, same-sized classes and a single giant class. The first stage vote will also be affected by other factors, such as the sovereign debtors interest in seeking only as much of a haircut as is necessary, in order to preserve its access to sovereign debt markets after the bankruptcy.

If a majority of all creditors approved the haircut, the debtor would submit a restructuring plan outlining the proposed treatment of each class of creditors for a second, class-by-class vote.[28] If the requisite majority of each class voted yes, the plan would be implemented according to its terms. In the event that one or more classes rejected the plan, on the other hand, the court would reduce the creditors' claims in the amount of the agreed upon haircut, starting with the lowest priority creditors and working up the priority hierarchy.

This two step approach has several crucial virtues. Perhaps most importantly, it would clarify creditors' priorities outside of bankruptcy and sharply reduce the risk of debt dilution. The first in time priority scheme would apply outside of, as well as in, sovereign bankruptcy, because creditors would know that any subsequent bankruptcy would be governed by the first-in-time priority scheme.[29] For sovereigns that actually invoked the procedure, the two step voting structure would provide a mechanism for pushing the parties towards a resolution even if bargaining breaks down, much as the threat of liquidation or cramdown do in ordinary corporate bankruptcies under U.S. Chapter 11.[30]

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[28] Our proposal does not specify the required voting percentage, as the voting rule could be tailored by each sovereign when the bankruptcy framework was adopted. But we speculate that many would require a two-thirds supermajority, as under U.S. Chapter 11. Bolton & Skeel, *supra* note [xx], at 797

[29] Sovereigns could still try to game the system and to dilute earlier debt by issuing debt with very short maturities as their finances deteriorated, of course. They would have difficulty finding buyers for such debt, however, because investors would know that their interests would be wiped out if the sovereign debtor nevertheless filed for bankruptcy.

[30] Under Bankruptcy Code sec. 1112(b), creditors can propose that the case be converted to Chapter 7 in order to liquidate the debtor; and sec. 1129(b) provides a

The principal exception to absolute priority in our sovereign bankruptcy framework comes with its second key feature, interim financing. As with corporate debtors in Chapter 11, our framework would provide first priority for interim financing in order to counteract the debt overhang problem that otherwise might discourage lenders from financing the restructuring process. Because of the risk that priority treatment would encourage overborrowing, however, we distinguish between two categories of loans. Loans to finance the sovereign's trade debt would be presumptively permissible,[31] whereas some form of approval, such as from a majority of the sovereign' s creditors would be required for larger loans. This strategy would effectively cabin the size of interim loans. In addition to minimizing the risk of overborrowing, it would also reduce the impact on the IMF's budget if it continued to serve as interim financer.[32]

The final issue is who should oversee the sovereign bankruptcy framework. Unlike earlier proposals, which would vest authority in a panel of experts set up by a new or existing international organization, our proposal would permit sovereign debtors to file their case in the bankruptcy or insolvency court of any jurisdiction where the sovereign

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mechanism for "cramming" down a reorganization plan despite the objection of one or more classes of creditors. Although sovereign debtors cannot be liquidated and the absence of a liquidation option makes cramdown difficult, the two-tiered voting regime is designed to achieve a similar effect.

[31] For a description of the contours of trade debt financing, see, e.g., IMF, *Trade Finance in Financial Crises: Assessment of Key Issues* (Dec. 9, 2003).

[32] Our earlier article contemplated that the IMF would continue to play this role. In Part III of this Article, we propose a new strategy for interim financing that entails a restructuring of the IMF's role.

has issued bonds. (Currently, this is likely to mean New York, London, Frankfurt or Tokyo). Not only would judges make better decision makers than the experts selected by a bureaucratic process, but giving sovereigns a choice would promote jurisdictional competition and, as a result, further enhance the decision making process. The competition would be loosely analogous to the benefits of venue choice for corporate debtors in the U.S.

4. Appraising Argentina's Debt Restructuring Challenges

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

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

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

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

Their predictions have only partially been borne out by events. The risk of private litigation did indeed turn out to be less important than many commentators had feared. There have been fewer law suits than expected and the U.S. District Court for the Southern District of New York in particular, where several actions against Argentina have been brought, has shown considerable restraint and willingness to first give negotiations a chance. The court also ruled in favor of Argentina in limiting creditors' ability to seize Argentine assets in the US, such as Argentine military assets and Argentine payments to Argentina's Embassy.[33] Still, the same court had earlier certified a class-action suit by a group of creditors and granted these creditors the right to attach Argentina's commercial assets worldwide. Partly in response to this ruling Argentina had to take several precautionary steps to protect its assets, such as for example transferring funds to its Embassies through channels outside the banking system, and temporarily re-nationalizing the Postal service to preempt the attachment of Postal service assets abroad. While clearly disruptive, these steps have however not imposed substantial costs on Argentina as had been feared.

Where the predictions of advocates of a *laissez-faire* approach have been confounded is on the likely ease and speed of the voluntary restructuring approach.

33 *US Judge Limits Scope Of Discovery On Argentine Assets*, US Dow Jones Capital Markets Report, 05/13/2004.

Argentina's experience in the four years following the declaration of default on its external debt has if anything underscored the difficulties and inefficiencies of a contractual approach, and provides support for the more interventionist policy envisioned by the IMF under the SDRM. Indeed, four years have now passed and there still has not been a restructuring agreement. These four years of delay are not entirely attributable to the reluctance by the Argentine government to negotiate. A first offer in September of 2003 to write off 75 per cent of the nominal value of the debt had been flatly rejected by creditors as too low, especially in light of the promising signs of recovery of the economy in the early months of 2003. After the collapse of this first round of negotiations, creditors did not sit still. Many small holders of Argentine bonds, mainly based in Europe, organized themselves under the Global Committee of Argentina Bondholders (GCAB) – a bondholder committee seeking to represent dispersed bondholders in direct negotiations with the Argentine government.

Although a new debt-swap offer that is expected to be accepted by a 70 or 75% majority of creditors is presently on the table, there have never been formal direct negotiations between the GCAB or any other representative bondholder committee in the past two years.[34] Indeed, with the strong backing of Argentine public opinion and a strengthening economy, the Kirchner government adopted a hard negotiating line and refused to make significant concessions on its first offer. Although Argentina's ability to repay its debts significantly improved over the past two years, its willingness to pay has if

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34 *Argentina seeks to ease creditor concerns on Debt Clause*, By ADAM THOMSON Financial Times, January 15, 2005.

anything decreased. Most of Argentina's costs of default had been incurred in 2002 and were sunk by the time negotiations started and neither the Argentine economy nor the government was in urgent need of borrowing from international capital markets. With the GCAB insisting that Argentina's ability to repay should be the only criterion for determining the size of a reasonable haircut, there was little room for a mutual understanding between the two parties.

Despite the tough stance taken by the Argentine government and its decision to move forward with a new unilateral, take-it-or-leave-it, debt-swap offer, it still took considerable time to put forward a new offer. There were initial hesitations as to the form of the offer and the extent to which early adopters should be favored over later adopters to build in an incentive to accept the exchange[35]. Then the Argentine government had great difficulty signing up an investment bank to organize the debt-exchange. And finally, following a worldwide road-show to advertise the exchange, Argentina still had to receive the approval of a number of National Financial Regulators in countries like Italy, with a large number of small bondholders.

The reason why there is now a greater chance of successful completion of the swap is not that Argentina has come around to the bondholders' demands. Rather, after holding on to a tough bargaining stance for four years, Argentina has managed to wear down a large fraction of creditors. Also, Argentina has benefited from a sharp decline in

35 According to Dow Jones Newswire, the Argentine Government eventually decided to abandon initial plans to include "exit consent" clauses in Argentina's debt-swap offer as a

emerging market debt yields, an unexpected development that has produced a substantial increase in the real value of the debt exchange.

At the time of writing it is not possible to say whether there will indeed be a sufficient number of creditors agreeing to the exchange currently under offer. It is also not clear what would happen to the holdouts if more than 70% of the debts are exchanged. Will their bargaining position be strengthened or weakened? Will they prevail in court against attempts by the Argentine government to stay in default on those bonds? Although four years have already passed since Argentina defaulted it is still not clear, even under the best scenario, how successfully the voluntary debt restructuring process will play out. Few observers would describe this experience as vindication of a *laissez-faire* approach. It is even harder to describe Argentina's debt restructuring experience of the past four years as particularly favorable to creditors. Bondholders could hardly have obtained worse terms had the restructuring taken place under a more formal bankruptcy procedure such as that proposed by the SDRM. In all likelihood, they would have secured a deal a lot sooner and under better terms.

In hindsight, the Argentine experience points to one major advantage of a statutory approach: it can be structured to keep the negotiating process moving forward by specifying hard deadlines for offers to be submitted, as in Chapter 11, and by structuring incentives for the parties to come to a quick resolution of the restructuring process. The Argentine experience also highlights that creditors can be put in a weaker

way of avoiding potential future litigation and securing approval of the plan with some countries' financial regulators, *Dow Jones, 5 November 2004* bargaining position under *laissez-faire* than they would be under a statutory procedure where final approval depends on some form of super-majority voting, if the debtor can impose a coercive exchange offer.

III. TRANSFORMING THE IMF' S ROLE AS A LENDER OF LAST RESORT

The IMF's place in the international financial architecture is now more uncertain than it has been since the collapse of the Bretton-Woods framework in the 1970s. The size of the Fund relative to international financial flows and to the stock of foreign reserves held by central banks around the world has been shrinking to the point where it can no longer envision playing a credible leadership role as lender of last resort for any but the smaller emerging market borrowers. As a result the Fund has increasingly been drawn to focus on emerging market countries and to redefine its mission as one of macro-assistance to developing nations and to poverty reduction, a role traditionally performed by the World Bank. It is not clear that the Fund always has the expertise to fill this new role effectively and there is a risk that it may end up being marginalized by the World Bank and other development aid agencies. But more importantly, this new mission that has been pressed onto the IMF due to lack of funding is not the one it has been set up to pursue.

One obvious way of restoring the Fund's original role, advocated by some G-7 countries, is to substantially increase the size of the Fund. But even if this enlargement were feasible, the history of past interventions would still raise major concerns about the potential distortions large bailout packages can introduce into sovereign debt markets. Another way forward, advocated by several leading economists, is to move in the opposite direction, further scaling back the size of the fund, phasing out I.M.F. programs entirely, and confining the I.M.F. to a purely advisory role. [36]

We believe that neither of these two options is desirable. If the IMF were no longer a major source of emergency lending for distressed sovereigns, as advocates of a scaled back IMF propose, why should sovereign governments pay any attention to its advice? Even advice offered for free would not be welcome and the IMF would be doomed to irrelevance. More importantly, once the IMF exited the lending business it could no longer play its role as catalyst to help resolve liquidity crises and debt panics.[37] The alternative solution, a much larger but unreformed and highly political institution, would give rise to moral hazard in lending and other distortions. Perpetuating the status quo is equally undesirable, since it would be equivalent to condemning the institution to a slow death.

Rather than any of these alternatives, we believe that the IMF's role should be reconfigured in a very different way, as part of a sovereign bankruptcy framework that

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[36] *See* Rogoff, *supra* note [3]; [cite Chari & Kehoe (1997).

establishes an enforceable priority system for sovereign debt. The role we envision would strengthen the IMF's ability to act as an ILOLR in emerging market liquidity and confidence crises. It also would strengthen the IMF's hand in resolving sovereign debt insolvency crises. Yet it would not require any new public funding.

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

To secure this sovereign debt version of DIP financing, the negotiations would therefore involve the private sector as well as the IMF, since few private lenders are anxious to lend on a sight-unseen basis. In practice, the private sector involvement would be an important benefit of the new model we envision. Currently, when a package is put

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[37] *See* Corsetti, Guimaraes & Roubini, *The Tradeoff Between an International Lender of Last Resort to Deal with Liquidity Crisis and Moral Hazard Distortions: A Model of the IMF's Catalytic Finance Approach* (Discussion Paper, Yale University 2003).

together the private sector does not participate in the negotiations and essentially must take the deal the IMF has worked out with the sovereign as a *fait accompli*. This process not only makes it more difficult to involve the private sector, but also encourages free riding by private lenders on the IMF's emergency lending. Under our proposed new system, private lenders would be directly involved in the negotiations; private sector involvement would thus automatically be tied to the rescue deal. The coordination between private lenders and the IMF's role as ILOLR is an important benefit of our proposed system.

Another important benefit of the new model is that it would gradually shift from taxpayer to private sector money and would be subject to more and more market discipline. If the private sector viewed a proposed rescue package as just more money down the drain it would in all likelihood refuse to extend new lending even if the new loans had higher priority status.[38] Similarly, if the sovereign were a repeat offender it would over time have less and less access to emergency lending and would risk being shut out of the international credit markets.[39] The reason is simply that following each crisis the sovereign would have accumulated a larger stock of still outstanding priority

[38] This intuition is buttressed by the experience in U.S. Chapter 11 cases. The existing empirical evidence suggests that DIP financers more likely to lend to debtors that have a significant chance of successfully reorganizing, than to more precarious firms. *See, e.g.*, Maria Carapeto, *Does Debtor-in-Possession Financing Add Value?* (unpublished manuscript, 2003)(debtors that received interim financing more likely to reorganize); Sandeep Dahiya et al, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259 (2003)(same).

[39] Our approach would not preclude debt reduction initiatives for Highly Indebted Poor Countries (HIPCs). These initiatives would just take a different form. Instead of forgiving previously granted official multilateral debt the international community would buy private debt in the secondary market and then retire it.

debt and would be less and less able to secure new DIP financing, particularly if, as we propose below, prior DIP loans have priority over any subsequent DIP financing.[40]

While the new role we envision calls for a radical departure from existing policy, it would not fundamentally change the process by which the larger crises are currently handled. Consider, for example, how the IMF managed South Korea's debt crisis in 1997. After a substantial rescue package was put together on December 3, 1997, it quickly became clear that the funds promised to the South Korean Government would be insufficient.[41] The package had not adequately reassured markets, and banks continued to pull out of Korean sovereign debt, refusing to roll over their short-term loans, something they had never objected to doing in the past. Faced with an impending crisis, the U.S. Treasury and Federal Reserve resolved as a last resort to convene a meeting with the major lenders under the auspices of the New York Fed on December 22, 1997, and managed to wring an informal agreement from those present to continue rolling over their loans.[42] The only way the Treasury and Fed could entice the banks to show up at the meeting, and then to cooperate by agreeing to roll over their loans, was *moral suasion* bolstered by the fear of a major financial crisis should banks refuse to follow the IMF's

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[40] *See infra* notes [xx]-[xx] and accompanying text.

[41] A total of $55 billion, of which a portion of $21 billion was contributed by the IMF, was promised the South Korean Government. This represented the highest amount the IMF had ever lent to a single country and exceeded by a multiple of six the normal quota *See* BLUSTEIN, *supra* note [2].

[42] Six U.S. banks-- Citibank, J.P. Morgan, Chase, Bank of America, Bankers Trust and Bank of New York-- attended the first New York meeting, which kick-started a series of negotiations with international banks that eventually led to a rescheduling agreement of $22 billion in short-term loans in exchange for a sovereign bond, with the Korean government on January 28, 1998. *Id.* at 177-205.

lead. As several commentators have observed, moral suasion is a rather weak inducement to rely on to deal with a crisis of such proportions, and it would be foolish to depend on such a policy to maintain international financial stability. It is not difficult to imagine a different outcome to the Korean crisis, with some major banks deciding not to attend the meeting at the New York Fed for example, and others unwilling to go along with the IMF or unable to agree on how the cost of rolling over their debts should be shared.

Now imagine the same situation, but with the IMF wielding new powers to grant priority status to banks' new emergency lending. In contrast to the situation at the time, under this new regime banks would have had an incentive to attend the meeting, since this might have given them an opportunity to obtain higher priority status for their new loans. The higher priority would have put them in a stronger position than the banks that did not attend the meeting if the rescue plan failed and Korea defaulted on its existing debts. In addition, for those banks attending the meeting, the IMF would have been able to secure their cooperation much more easily by granting seniority status to their new loans.[43]

While the potentially huge benefits of this new role for the IMF are obvious, there also are several potential concerns. A first issue is whether a highly politicized institution like today's IMF would abuse its new powers and grant priority lending too liberally.

[43] Although the size of the bank loans would often be quite large, there is no reason to suspect that this would jeopardize the financing process we propose. In ordinary

This was a constant worry in the early days of Chapter 11, with courts permitting debtors to drag out cases for years, and generally deviating too easily from enforcement of absolute priority.[44] The history of IMF bailouts suggests that similar problems could undermine the framework we have described unless the ability to grant priority status to emergency lending were constrained in important respects. One such protection might be to require creditor approval of the DIP loans, if the loans are beyond a certain size or involve a high proportion of new lenders.[45]

There is a delicate balancing here, however, as any approval required by creditors before the DIP financing is granted could undermine the IMF's ability to respond quickly and quietly to a crisis. Announcing to all creditors that a sovereign is seeking their approval for new DIP financing is tantamount to broadcasting the sovereign's financial distress to the world and may well do more harm than good. Therefore, unless the sovereign were already in default and had suspended debt payments, and short of reforming the governance of the IMF, a more practical protection would be to either put ex ante limits on the size of DIP financing (such as a maximum percentage of outstanding debt) or to allow for the possibility that courts could reverse the priority status of the most

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corporate bankruptcy cases, bankruptcy courts have overseen major loans—such as the $1.5 billion DIP loan to United Airlines—without a hitch.

[44] *See, e.g.,* Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WISC. L. REV. (documenting the increased length of Chapter 11 cases).

[45] The possibility of a creditor vote on financing in the corporate context is considered and critiqued in George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 915-16 (1994). Our previous article proposed that financing in amounts sufficient to cover a sovereign's trade debt should presumptively be approved, without a creditor vote. Bolton & Skeel, *supra* note [xx], at xx.

egregious forms of DIP financing ex post if the sovereign subsequently invoked the bankruptcy procedures once again. This latter possibility would instill some market discipline on the DIP lenders and limit the worst forms of abuse of DIP financing, although at the cost of introducing additional uncertainty into the lending markets.[46]

A second concern is whether a priority rule for sovereign debt could be enforced at all. How would the IMF be able to enforce priority? How should a recalcitrant sovereign be dealt with? So far the IMF has on the whole been able to enforce the higher priority of its own funds.[47] The IMF's success can be traced to a major carrot and stick the IMF can apply to enforce its priority status. Compliant sovereigns continue to have access to IMF programs at favorable rates, whereas a recalcitrant sovereign risks losing its membership and facing some form of exclusion from sovereign debt markets. There is no reason a priori to expect that the IMF's enforcement powers would disappear if the loan were made by the private sector with the IMF's blessing. But, should the stock of senior debt become so large that the sovereign might be tempted to default and to ignore the priority status in a restructuring, one could still envision enforcement of priority through the courts via Elliott-style remedies.

Third, what happens when a sovereign repeatedly runs into financial distress and accumulates senior loans from past DIP financing? Wouldn't new DIP financing risk

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[46] Under U.S. bankruptcy law, a court's initial decision on DIP financing generally cannot be reversed so long as the credit was extended in good faith, a protection that is justified as necessary to assure certainty. *See* 11 U.S.C. sec. 364(e).

[47] *See* Zettelmeyer, *supra* note [xx].

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

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

The final issue is implementation: what changes would need to be made to restructure the IMF's role as we have described? Advocates of a sovereign bankruptcy regime have proposed a variety of implementation strategies. One commentator suggests that sovereigns could unilaterally adopt a sovereign bankruptcy regime.[48] Under this approach, a model law could be drafted by UNCITRAL or another international organization, and the legislature of sovereign debtor states could pass legislation based on the draft law. In effect, the bankruptcy framework would set the parameters of the debtor's obligations to its creditors. A second strategy would rely on treaties among the creditor and debtor nations or a convention ratified by the legislatures of the various affected countries. Still another strategy centers on an amendment of the IMF's articles, which would require majority approval by the IMF and approval of three-fifths of the Fund's members.[49] Members would then be expected to take appropriate steps to implement the change under their domestic law. This third approach is the strategy the IMF planned to use to implement its SDRM[50]

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

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48 Christoph G. Paulus, *A Legal Order for Insolvencies of States* (unpublished manuscript), *6-7, available at* http://www.dse.de/ef/sdrm/paulus.htm.

49 More precisely, amendment of the IMF Articles requires three steps: 1) the Executive Board votes on a proposed amendment, and it is approved by a majority of those who vote; 2) the amendment is approved by a majority of the Board of Governors who vote; and 3) it is approved by three-fifths of the members of the Fund, with at least eighty-five percent of the total voting authority. *See, e.g.*, IMF, DESIGN OF THE SDRM, *supra* note [xx], at 71-72 (describing the amendment process).

50 Christoph G. Paulus, *A Legal Order for Insolvencies of States* (unpublished manuscript), *6-7, available at* http://www.dse.de/ef/sdrm/paulus.htm.

in a sovereign debt crisis. In our view, the ease with which the proposal could be adopted is one of its signal attractions.

Adjusting the IMF's role by itself, however, is an incomplete solution to the shortcomings in the existing international financial architecture; most importantly, it would not address the need for a coherent, enforceable priority scheme—a need that we have stressed throughout the Article. But even in the absence of a more complete reform such as sovereign bankruptcy, the reconfigured IMF role offers two hugely important benefits: it would address the IMF's funding limitations and would bring the private sector into the heart of the debt restructuring process. More generally, the reconfigured role would preserve the IMF's relevance for the sovereign debt markets of the new century. These benefits suggest that it would make sense to adopt the new approach now, without waiting for more sweeping reforms such as implementation of a sovereign bankruptcy regime.