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SOVEREIGN DEBT RESTRUCTURING: A BANKRUPTCY REORGANIZATION APPROACH

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SOVEREIGN DEBT RESTRUCTURING: A BANKRUPTCY REORGANIZATION APPROACH

Steven L. Schwarcz[†]

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I

INTRODUCTION

The “pressures and problems that have led to corporate bankruptcy law also operate in the case of a sovereign borrower in financial distress.”¹ Yet legal scholars have never systematically examined sovereign debt restructuring in light of bankruptcy reorganization law principles, which are designed to solve such fundamental problems as the ability of holdout creditors to undermine collective action toward a negotiated settlement. Moreover, absent the bankruptcy reorganization incentives that encourage free market liquidity, multilateral governmental institutions such as the International Monetary Fund (IMF) must act by default as lenders of last resort. This not only forces taxpayers to subsidize foreign governments and their creditors, but also creates problems such as moral hazard: countries anticipating an IMF bailout might have less reason to take a prudent economic course, and lenders expecting protection from the consequences of default might have a greater tendency to take unwarranted financial risks. This Article proposes that an international convention for sovereign debt restructuring based on three fundamental principles of bankruptcy reorganization law could address these problems, without requiring supervision by an international bankruptcy court. The convention also would permit the IMF, through a mechanism of back-to-back nonrecourse lending, to continue its current practice of imposing conditionality on funding without triggering the problems presently associated with IMF lending.

A. The Difficulty of Restructuring Sovereign Debt

This Article addresses the problem of countries, rather than companies, in default.² Sovereign states or countries (“States”), like

1. Jeffrey D. Sachs, Do We Need an International Lender of Last Resort, Frank D. Graham Lecture at Princeton University 8 (Apr. 20, 1995) (unpublished manuscript, on file with author). A copy of this paper can be found at Professor Sachs’s website, <http://www.hiid.harvard.edu/about/people/sachs/jsachs.html>.

2. Indirect relationships exist, however, between companies in default (private-sector default) and countries in default (public-sector default). If companies that a country relies on for tax revenues and employment are in default, the country’s economy may decline, thereby precipitating a public-sector default. *Cf. infra* note 33 (discussing how raising interest rates in certain Asian countries in order to stabilize their economies actually increased defaults on corporate debt, thereby further impairing those countries’ economies). Moreover, although restructuring the foreign debt of companies is usually addressed initially by the company’s domestic legal framework for bankruptcy reorganization (which may be modified by adoption

companies, often must borrow money to pay for imports or to fund projects, such as highways or power plants. The borrower, whether a State or company, is then obligated to repay the debt according to a fixed maturity schedule. If a company fails to pay its debts, a system of corporate bankruptcy or insolvency law usually regulates the relationship between the debtor- company and its creditors.³ In contrast, if a State fails to pay its debts—for example, “[d]uring the 1980s and 1990s, more than 50 countries recorded arrears or multilateral debt restructurings on their external liabilities”⁴—no legal system presently regulates the relationship between the State and its creditors.⁵ This

of the UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (UNCITRAL) MODEL LAW ON CROSS-BORDER INSOLVENCY, available at *United Nations Commission on International Trade* (last updated Apr. 29, 1999) <<http://www.uncitral.org>>, foreign creditors confronting both private- and public-sector default might attempt to link a restructuring of the country's public-sector debt to a restructuring of its private-sector debt. See Alfred Mudge, *Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks*, 23 COLUM. J. TRANSNAT'L L. 59, 69-70 (1984); see also BANK FOR INTERNATIONAL SETTLEMENTS, BIS QUARTERLY REVIEW: INTERNATIONAL BANKING AND FINANCIAL MARKET DEVELOPMENTS 10 (Nov. 1998) (describing the report of the Committee on Payment and Settlement Systems on the advances in reducing foreign debt exchange settlement risk and offering as a “key element” the “ongoing cooperation with existing and prospective private sector groups”); BANCO CENTRAL DO BRASIL, BULLETIN: STATISTICAL TABLES (Mar. 1999) (indicating that in some countries the amount of cross-border debt incurred by the private sector exceeds that incurred by the public sector). This Article focuses on the restructuring of public-sector debt.

3. The terms “bankruptcy law” and “insolvency law” generally are interchangeable. I will refer to bankruptcy law, because the term is more commonly used in the United States.

4. Sachs, *supra* note 1, at 1. The problem of sovereign debt restructuring is becoming so pervasive that Congress recently established the Financial Institutions Advisory Commission to advise on issues of financial institution reform in this context. See E-mail from Jeffrey D. Sachs, Galen L. Stone Professor of International Trade, Harvard University, to Steven L. Schwarcz 1 (Dec. 20, 1999) (on file with author). Of course, a State, like a company, will try to avoid defaulting on its debt. See Benjamin J. Cohen, *A Global Chapter 11*, 75 FOREIGN POL'Y 109, 111 (1989) (observing that “[w]ith rare exceptions, Third World governments have deliberately chosen not to repudiate their debts or otherwise refuse to acknowledge their full contractual obligations”); Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1072 (1997) (noting that only three countries have outright repudiated their foreign debt since the First World War). Default can have an adverse effect on the State's credit ratings and financial reputation. Sometimes, however, default—in the technical sense of “failure of a debtor to make timely payment of interest and principal as they come due,” JOHN DOWNES & JORDON ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 129 (4th ed. 1995)—cannot be avoided.

5. See, e.g., *Mechanism Must Be Found to Avoid Moral Hazard in Crises*, IMF Deputy Says, 69 Banking Rep. (BNA) 623 (Oct. 20, 1997) [hereinafter *Mechanism*] (reporting that IMF First Deputy Managing Director, Stanley Fischer, believes that “[i]n a sovereign crisis . . . there simply is no accepted bankruptcy procedure”). My examination of the relationship between a State and its creditors focuses on its foreign creditors; a State could impose whatever regulation it wishes on domestic creditors.

Article examines whether sovereign debt restructuring should be subject to supranational regulation.

I begin this examination by using the legal framework for corporate bankruptcy as a basis for comparison. In the United States, for example, debtor-companies with inherently good businesses may undergo reorganization, but those with inherently bad businesses are often liquidated.⁶ Courts, the debtor-company, and its creditors all devote significant resources to determining whether the company is worth more reorganized or liquidated.⁷ In contrast, States are not liquidated.⁸ Reorganization is therefore the goal of any sovereign debt restructuring.

The genius of bankruptcy reorganization law is that it provides incentives for debtors and their creditors, notwithstanding their disparate interests, to reach a voluntary agreement on the terms of the restructuring.⁹ Agreement on a plan of reorganization¹⁰ is rewarded,¹¹

6. United States bankruptcy law is governed by Title 11 of the United States Code (the "Code"), 11 U.S.C. §§ 101-1330 (1994 & Supp. IV 1998).

7. In other words, these entities all scrutinize whether the company's value as a going-concern is worth more than the value of its assets sold piecemeal. Under U.S. law, for example, companies in bankruptcy ("debtors") either will be liquidated or reorganized. Although a corporate debtor can choose either option at the outset of a bankruptcy case, most debtors initially attempt reorganization—a process governed by Chapter 11. *See* 11 U.S.C. § 706(a) (1994) (permitting the debtor to convert a liquidation into a reorganization). However, the judge has the power to convert the reorganization into a liquidation for various reasons, including instances when losses continue and no "reasonable likelihood of rehabilitation" exists, *id.* § 1112(b)(1), or when the debtor is unable to "effectuate a plan" of reorganization, *id.* § 1112(b)(2).

8. *See, e.g.,* Sachs, *supra* note 1, at 8 ("[L]iquidation is . . . basically out of consideration for a debt-strapped national government."); *see also* BARRY EICHENGREEN & RICHARD PORTES, *CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS* 7 (1995) ("The fundamental difference between a sovereign state and a firm is the public interest in maintaining a country as a going, indeed a well-functioning concern."); Rory Macmillan, *Towards a Sovereign Debt Work-Out System*, 16 *NW. J. INT'L L. & BUS.* 57, 75 (1995) ("Debates over whether reorganization or liquidation is more efficient for failing corporate debtors are inappropriate in the context of government debtors: there can be no talk of an economically efficient liquidation and distribution of a people's government." (citation omitted)). *But see* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 *U. CHI. L. REV.* 425, 472 (1993) (challenging the Code's assumption that municipal debtors should not be dismembered because "[m]erely to give the city a fresh start, but not to address the fundamental causes of its financial problems, may be no favor"). In a country debt-restructuring context, I show that a State can at least partially address the fundamental causes of its financial problems while preserving its political and geographical integrity. *See infra* Part II. Whether a bankruptcy system *should* allow liquidation of States is a political question beyond this Article's scope.

9. A debtor-company's shareholders also may be involved in the reorganization process. However, because States have no shareholders, they are excluded from this analysis.

failure to agree is penalized.¹² As a result, most corporate restructurings are consensual.¹³ The basis of corporate reorganization law's efficiency rests in the underlying theory of freedom of contract: voluntary contracting maximizes value.¹⁴

Although sovereign debt restructuring is likewise consensual, achieving consensus is a haphazard affair. The conflicting interests of the State and its creditors make it difficult, if not impossible, to reach agreement on a restructuring plan. This difficulty is exacerbated by the collective action problem of reaching agreement *among* creditors¹⁵—a problem that has worsened significantly in recent years as States have shifted their borrowing source from banks to bond invest-

10. The plan of reorganization sets forth both how to reorganize the debtor and how to repay the debtor's creditors. *See, e.g.*, 11 U.S.C. § 1129(a) (1994) (stating the confirmation requirements of a plan of reorganization).

11. Agreement permits both confirmation of the plan of reorganization and payment of creditors; absent agreement (or a non-consensual plan, discussed *infra* note 12), a plan of reorganization cannot be confirmed and therefore creditors cannot be paid. *See* 11 U.S.C. § 1129(a)(8) (requiring acceptance by each class of "impaired" creditor claims for plan confirmation).

12. If the parties cannot reach a consensus, the debtor may be liquidated or, if viable, reorganized under a non-consensual plan that follows the absolute priority rule of liquidation. *Compare* 11 U.S.C. § 1112(b) (granting power to a judge to convert a reorganization case to a liquidation) *with id.* § 1129 (b)(2) (granting power to confirm, or "cramdown," a non-consensual plan only if the plan comports with the absolute priority rule).

13. *See, e.g.*, MARK S. SCARBERRY ET AL., BUSINESS REORGANIZATION IN BANKRUPTCY 839 (1996) ("Most plans are confirmed consensually under section 1129(a) of the Bankruptcy Code.").

14. A consensual plan of reorganization is analogous to voluntary contracting. I qualify the comparison because the plan's voluntariness is subject to legally imposed incentives and disincentives. *See supra* notes 11-12.

15. Creditors themselves may be private entities, such as commercial banks, pension funds, or even individual investors, or public entities, such as other States or multilateral agencies.

In the instance of creditor States, their actions tend to accord with policies and procedures that have arisen through historical precedent, an informal arrangement referred to as the "Paris Club." EICHENGREEN & PORTES, *supra* note 8, at 23. This is in contrast to the "London Club," an informal framework that has arisen through historical precedent for rescheduling claims of commercial banks against States. *Id.* at 26.

Theoretically, the unsecured claims of private and public creditors are equal and ratable (*pari passu*), *see* Alexis Rieffel, *The Role of the Paris Club in Managing Debt Problems*, in INTERNATIONAL BORROWING: NEGOTIATING AND STRUCTURING INTERNATIONAL DEBT TRANSACTIONS 481, 485-88 (Daniel D. Bradlow ed., 3d ed. 1994), and, in practice, are generally treated as comparable. *See* EICHENGREEN & PORTES, *supra* note 8, at 24 (observing that Paris Club agreements commit the debtor-State "to seek debt relief from private creditors as generous as the official relief granted by the Paris Club," a principle referred to as "comparable treatment"). This Article, accordingly, makes no distinctions based on creditor identity, except with regard to the issue of classification of claims for super-majority voting. *See infra* notes 274-89 and accompanying text.

tors in the lower cost capital markets.¹⁶ One or more creditors may hold out, hoping that the need to reach an agreement will induce other parties to buy out their claims or pay them a premium.¹⁷ Consequently, “[a]t each stage of a financial workout, collective action problems plague the readjustment of debt claims, to the detriment of the creditors as well as the debtor.”¹⁸

The recent movie *Waking Ned Devine*¹⁹ playfully illustrates this problem. Devine, an heir-less resident of a rural Irish town, promptly dies from shock after winning a £6.7 million national lottery.²⁰ The fifty-two remaining residents of the town want one of their own to collect the lottery jackpot by impersonating Devine, and subsequently distribute the winnings equally among the residents, yielding each approximately £130,000.²¹ To accomplish this scheme, each resident would have to agree to identify the imposter as Ned Devine to government lottery inspectors.²² Unfortunately, one rather unpleasant

16. See *infra* notes 280-86 and accompanying text (describing this trend, and explaining that the greater number of capital market investors, as compared to banks, and the relatively smaller amounts of their respective investments decreases the likelihood of obtaining creditor consent). Another collective action problem is that creditors that otherwise may favor a negotiated settlement may be motivated to try to enforce their claims against the debtor-State because they fear that other creditors will be the first to enforce their claims against assets that are insufficient to pay all claims—the “creditor grab race.” Sachs, *supra* note 1, at 7. This problem, however, is less significant in a sovereign debt context than in a corporate context because creditors can only attempt to attach the State’s assets that are located in other jurisdictions, and “[u]sually, only limited assets exist outside the debtor country and much of that is legally immune from attachment.” James B. Hurlock, *The Way Ahead for Sovereign Debt*, INT’L FIN. L. REV., July 1995, at 10, 11; see also EICHENGREEN & PORTES, *supra* note 8, at 31 (“While the debtor state may have some assets within the jurisdiction of the courts in another country, it is frequently very difficult to levy execution against such assets, because of the law of sovereign immunity.”); Rory Macmillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT’L L. 305, 353 (1995). But see *Mechanism*, *supra* note 5, at 623 (arguing that “the international community needs to find a mechanism that is ‘legally accepted’ by all countries to ensure private investors share in the risks and costs of dealing with [financially distressed states]”).

17. Scholars also refer to this situation as a holdout problem. For example, a schism recently arose in Russia’s debt restructuring when one of 19 banks broke ranks to announce the creation of a ruble-based investment fund, for which the bank indirectly would be paid a 2% management fee. See Alan Cowell, *More Trouble Seen on Defaulted Russian Debt*, N.Y. TIMES, Mar. 16, 1999, at C4.

18. Sachs, *supra* note 1, at 6. See also Charles Lipson, *Bankers’ Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, in COOPERATION UNDER ANARCHY 200 (Kenneth A. Oye ed., 1986) (providing an overview of the collective action problem for sovereign debt restructuring).

19. WAKING NED DEVINE (Fox Searchlight Pictures 1998).

20. See *id.*

21. See *id.*

22. See *id.*

resident attempts to hold out for a much larger share, threatening to reveal the fraud if her demand is not met.²³ Similarly, in a sovereign debt restructuring context, any lender whose consent is needed for an overall settlement²⁴ could hold out for a disproportionate share on the threat of preventing the settlement. Hence, agreement can take years.²⁵

Attempts by multilateral governmental entities such as the IMF to aid the process of sovereign debt restructuring may have further complicated this situation. The IMF has acted as the lender of last resort to financially troubled States, enabling them to avoid default and its consequences.²⁶ Unfortunately, IMF lending has created a moral hazard risk:²⁷ countries anticipating an IMF bailout might have less reason to take a prudent economic course,²⁸ and lenders that anticipate being protected from default might have a greater tendency to

23. *See id.* In the movie, the holdout could have obtained a 10% government award by revealing the fraud. *See id.* That possibility exacerbates the collective-action problem, but is not a necessary condition for the problem to arise.

24. *Cf. infra* note 278 (explaining why settlements usually require the consent of all lenders).

25. In the 1980s, for example, Brazil sought to restructure its debt by converting it into collateralized bonds. *See* Philip J. Power, *Sovereign Debt: The Rise of the Secondary Market and Its Implications For Future Restructurings*, 64 *FORDHAM L. REV.* 2701, 2745 (1996). Hoping for greater profit, its fourth largest creditor, the Dart family, held out and refused to convert its debt. *See id.* at 2746-48. This led to litigation and an almost decade-long impasse. *See id.* at 2748-54.

26. Since 1982, “almost all debt restructuring agreements of sovereign borrowers . . . have been linked in one way or another with an IMF loan to the debtor country.” Sachs, *supra* note 1, at 2.

27. The term “moral hazard” has various related meanings. In the insurance context, in which the term arose, it means “the deliberate efforts by the insured to bring about the insured event, as when the owner of life insurance commits suicide.” Richard A. Epstein, *Products Liability as an Insurance Market*, 14 *J. LEGAL STUD.* 645, 653 (1985). *See generally* Steven Shavell, *On Moral Hazard and Insurance*, 93 *Q.J. ECON.* 541 (1979) (providing an economic analysis of the standard of care for the insured in the moral hazard context). In a more general economic context, however, the term simply refers to the greater tendency of people who are protected from the consequences of risky behavior to engage in such behavior. *See* Charles G. Hallinan, *The “Fresh Start” Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 *U. RICH. L. REV.* 49, 84 (1986) (relying on the economic definition of moral hazard: debtors and creditors that are protected from the consequences of default “could be expected to increase both excessive borrowing and excessive resort to bankruptcy”).

28. This is not to say that moral hazard is unrestrained. The IMF’s delay in funding Russia during its economic crisis in 1998, and Russia’s resulting default, may have actually reduced moral hazard. *See* Paul Blustein, *IMF Ready to Resume Russia Aid*, *WASH. POST*, Apr. 29, 1999, at E1. Furthermore, even if States anticipate an IMF bailout, they will want to avoid (1) the possibility of default and its associated reputational costs, and (2) the reduced autonomy over their economies that results from conditionality, *see infra* notes 31-36 and accompanying text, imposed by the IMF on its loans.

take unwarranted financial risk.²⁹ Notwithstanding the lack of empirical evidence of the extent, if any, to which the moral hazard risk actually influences the behavior of States or their creditors, the potential for moral hazard figures prominently in the media debate:

Some economists believe that bailouts increase “moral hazard” by rewarding and encouraging bad policies by governments and excessive risk-taking by banks. . . .

. . . .

IMF economists like to argue that these moral-hazard problems are minimal. But consider the case of the recent \$42 billion [IMF] package for Brazil. How did the Brazilians qualify for this support? They did so mostly by not exercising sound fiscal policies. If their policies had been better, they would not be in their current difficulties

Russia is another example. . . . Since [1993], the availability of IMF and other foreign money provided an excuse to avoid making tough political decisions. Instead of cutting public outlays or increasing tax collections, undertaking efficient privatizations or enacting legal reforms, the government counted on foreign bailouts to hold things together.

. . . .

The sequence of unrestrained global bailouts began with Mexico in 1995 [where] the IMF-U.S. lending package was effectively a reward for corrupt and risky bank lending and poor macroeconomic policies. . . .

. . . .

. . . [T]he IMF might consider changing its name to the IMH—the Institute for Moral Hazard.³⁰

The IMF has attempted to reduce moral hazard by imposing conditions of fiscal responsibility on its lending, such as requiring bal-

29. See *Mechanism*, *supra* note 5, at 623.

IMF lending to countries in trouble does create a “moral hazard.” But that hazard does not result because IMF lending encourages countries to “behave recklessly,”

“Instead, the hazard is that the private sector may be too willing to lend, because it knows that a country in trouble will go to the fund rather than default. . . .”

Id. (quoting Stanley Fischer, First Deputy Managing Director of the IMF).

30. Robert J. Barro, *The IMF Doesn't Put Out Fires, It Starts Them*, BUS. WK., Dec. 7, 1998, at 18, 18. When a realistic risk of default exists, creditors have more incentive to monitor their loans. Conversely, if a lender of last resort reduces the chances of default, creditors have less incentive to monitor. IMF loans provided at subsidized interest rates may also increase the risk of moral hazard. See Charles W. Calomiris, *The IMF's Imprudent Role as Lender of Last Resort*, CATO J., Winter 1998, at 275, 277; STAFF OF JOINT ECON. COMM., 105TH CONG., IMF FINANCING: A REVIEW OF THE ISSUES 8 (Comm. Print 1998) [hereinafter IMF FINANCING].

anced domestic budgets and devaluing local currency in order to attain better exchange rates.³¹ This approach is known as conditionality.³² These attempts to alleviate moral hazard, however, sometimes fail.³³ Failure is not surprising given the IMF's history of raising money through taxpayer dollars,³⁴ and the politics of deciding which States should benefit from loans and on what conditions.³⁵ Alternatively, the IMF could attempt to reduce moral hazard by refusing to act as a lender of last resort. This refusal, however, may be politically untenable absent an alternative source of financing.³⁶

Multilateral governmental lending is also problematic to the extent it depends on taxation as a funding source. The IMF, for example, collects money from its member-States in order to make its loans.³⁷ The member-States in turn raise this money directly or indirectly through their taxing power.³⁸ This practice has sparked contro-

31. See Power, *supra* note 25, at 2712 & n.50. These conditions are often called "austerity measures." *Id.*

32. See Claudio Grossman & Daniel D. Bradlow, *Are We Being Propelled Towards a People-Centered Transnational Legal Order?*, 9 AM. U. J. INT'L L. & POL'Y 1, 5 n.17 (1993) (discussing IMF's use of "conditionality").

33. In 1997, for example, the IMF pressured Asian nations to raise their interest rates and impose other austerity measures in return for IMF funding. See Ben Wildavsky, *Curing the Asian Flu: Two Views on the Proper Medicine*, U.S. NEWS & WORLD REP., Dec. 14, 1998, at 43, 43. This strategy could have backfired by raising borrowing costs for many businesses in those States, causing them to default. See *id.* (alleging that World Bank officials feared that austerity measures "would scare off investors [to private companies located in those countries] and make credit so scarce that [those] companies would not get the capital they need to survive").

34. See *infra* notes 37-38 and accompanying text.

35. I later show, however, that the IMF can impose conditionality without these impediments. See *infra* notes 199-204.

36. See, e.g., Marcus Miller & Lei Zhang, *Sovereign Liquidity Crisis: The Strategic Case for a Payments Standstill* (Non-Technical Summary) 2 (Centre for the Study of Globalisation & Regionalisation Working Paper No. 35/99, May 1999), available at <<http://www.warwick.ac.uk/fac/soc/csgr/glob-fin.html>> ("What can the IMF do to avoid being [forced to fund bailouts]?"). I later propose that the private credit and capital markets can constitute this alternative source of funding. See *infra* notes 178-206 and accompanying text.

37. The IMF's primary means of financing is by "capital subscriptions," which represent quotas assessed against each member-State in amounts "broadly determined by its economic position relative to other members." *IMF Quotas and Quota Reviews* (visited July 25, 1999) <<http://www.imf.org/external/np/exr/facts/quotas.htm>> [hereinafter *IMF Quotas*]. In 1999, for example, total quotas assessed increased by 45%, from approximately \$200 billion to \$290 billion. See *id.*

38. A government also could choose borrowing as the funding source. See, e.g., *Foreign Operations, Export Financing, and Related Programs Appropriations for Fiscal Year 1999: Hearings on H.R. 4569/S. 2334 Before a Subcomm. of the House Comm. on Appropriations*, 105th Cong. 93 (1998) [hereinafter *Appropriations Hearings*] (statement of Robert E. Rubin, Secretary of the Treasury) (observing that "over time [the U.S.] Treasury generally needs to

versy over whether taxpayers of wealthier IMF member-States are effectively subsidizing the defaulting States, as well as the defaulting States' creditors. For example, one scholar has criticized the IMF's use of taxpayer funds to bail out foreign commercial banks that invest in debt-strapped nations.³⁹ Another commentator similarly observes that

[f]or all their vigorous rhetoric about the glories of the free market and financial deregulation, the money-center banks would not get out of this mess unless the government stepped in and rescued them. As the IMF lent huge sums to the debtor nations to keep them going, the taxpayers of the United States and other industrial nations were effectively assuming the obligations in behalf of the banks. The more that the public treasuries lent to Mexico and the others, the safer would be the managers and shareholders of Citibank, Morgan Guaranty, Chase and Chemical and the others.⁴⁰

Others argue, however, that dealings with the IMF have not forced taxpayers to bear additional costs. As Robert Rubin asserts, "over the past fifty years, our contribution to the IMF has not cost the taxpayer one dime. There are no budget outlays. Our contribution does not increase the deficit, or divert resources from other spending priorities."⁴¹

increase its issuance of securities to the public [to fund IMF costs]. . . . Any such issuance would increase the national debt and interest payments on it"). Because the national debt and interest thereon ultimately would be paid through taxation, however, the ultimate funding source would be taxes. Cf. Margaret F. Brinig & F.H. Buckley, *The Market for Deadbeats*, 25 J. LEGAL STUD. 201, 214 (1996) (noting that "[u]nder Ricardian equivalence theories, a state's debt load represents anticipated future taxes" (citation omitted)); Neal E. Devins, *In Search of the Lost Chord: Reflections on the 1996 Item Veto Act*, 47 CASE W. RES. L. REV. 1605, 1625 (1997) (arguing that because Congress must usually rely on unpopular tax increases to check the national debt, a statute that places more of the blame on the Executive Branch is very appealing).

39. See *International Economic Issues, and Their Impact on the U.S. Financial System: Hearings Before the House Comm. on Banking, Finance, and Urban Affairs*, 101st Cong. 360-64 (1989) (statement of Jeffrey D. Sachs, Professor of Economics, Harvard University). Professor Sachs asserts that, because international organizations such as the IMF were being "misused as conduits of taxpayer dollars to pay interest to banks," the United States should not support these organizations in the short-term. *Id.* at 362.

40. WILLIAM GREIDER, *SECRETS OF THE TEMPLE* 520-21 (1987).

41. *Implications of Asian Financial Crisis: Before the House Comm. On Banking & Financial Services*, 105th Cong. (1998) (statement of Robert E. Rubin, U.S. Secretary of the Treasury, Jan. 30, 1998). C. Fred Bergsten argues that the American taxpayer incurs zero cost from U.S. contributions to the IMF because every dollar contributed produces an equal amount of U.S. claims to draw currencies from the IMF. See *The International Monetary Fund and the National Interests of the United States: Hearing Before the Joint Economic Comm.*, 105th Cong., 2d Sess. 136-37 (1998) [hereinafter *Hearings on the IMF*] (statement of C. Fred Bergsten, Director, Institute for International Economics). Professor John Head even argues that the

The view that there is no cost to taxpayers appears to rest more on form than substance. Although some characterize IMF capital subscriptions as “investments,” because “member countries earn interest on their deposits in the IMF,”⁴² repayment by the IMF, although anticipated,⁴³ is not assured;⁴⁴ and the IMF pays less than a market rate of interest.⁴⁵ In some cases, this interest rate is even below the member-State’s own cost of funds.⁴⁶ IMF funding therefore does appear to impose a cost on taxpayers.⁴⁷

United States enjoyed a net gain on its IMF deposits during most of the 1980s due to interest accruing to the United States from the IMF’s use of those deposits. See John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, KAN. J.L. & PUB. POL’Y, Spring 1998, at 70, 88-89. I later demonstrate that these types of arguments exalt form over substance. See *infra* notes 42-48 and accompanying text.

42. Stanley Fischer, *The Asian Crisis: A View from the IMF*, Speech at the Midwinter Conference of the Bankers’ Association for Foreign Trade (Jan. 22, 1998) (transcript on file with author). The U.S. Treasury Department similarly characterizes the payment of the U.S. subscription as an investment because of the “equivalent increase in the U.S. reserve position in the IMF.” *Appropriations Hearings*, *supra* note 38, at 92 (statement of Robert E. Rubin, Secretary of the Treasury).

43. See *Appropriations Hearings*, *supra* note 38, at 92 (statement of Robert E. Rubin, Secretary of the Treasury) (arguing that “[t]he likelihood that the IMF would fail to repay the U.S. is extremely remote”). Because the IMF is a financial cooperative, member-States pay capital subscriptions when they join, and theoretically have the right to a return of capital if they ever withdraw as members. See *IMF Quotas*, *supra* note 37.

44. See, e.g., *IMF FINANCING*, *supra* note 30, at 3 (concluding that “[i]t is doubtful that [payment of the U.S. quota subscription to the IMF] will ever be fully recovered”); see also *Hearings on the IMF*, *supra* note 41, at 112, 115 (statement of Dr. Lawrence B. Lindsey, Resident Scholar, The American Enterprise Institute) (observing that “at least one private sector analysis of the IMF balance sheet found that if it were a bank, serious questions could be raised about the IMF’s capital adequacy”). One might question whether the IMF would ever have sufficient funds to repay its largest member, especially at a time when other members are seeking to withdraw their subscriptions or IMF loans are in default.

45. The IMF pays interest on the U.S. reserve position at a rate “determined as the weighted average of representative short-term [government borrowing] rates in the United States, Japan, Germany, France and the United Kingdom.” *Appropriations Hearings*, *supra* note 38, at 93-94 (statement of Robert E. Rubin, Secretary of the Treasury). Unfortunately, that blended rate often is lower than the rate for three-month U.S. Treasury bills, making it not only below-market for U.S. government investments but also below the U.S. government’s cost of funds (i.e., the rate on U.S. Treasury bills). See *Hearings on the IMF*, *supra* note 41, at 69 (statement of C. Fred Bergsten, Director, Institute for International Economics). Only a foolish investor would seek a rate of return that is equal to or less than its cost of funds.

46. See *Hearings on the IMF*, *supra* note 41, at 69 (statement of C. Fred Bergsten, Director, Institute for International Economics).

47. See *IMF FINANCING*, *supra* note 30, at 3. The Joint Economic Committee explains: One diversion in an IMF performance review is the dubious contention that under existing budget rules the IMF appropriation is not a net outlay and therefore involves no taxpayer cost. Although current accounting rules mask the cost of the IMF quota increases to the U.S., economic analysis clarifies the true nature of the transaction:

To be sure, taxpayers benefit indirectly from IMF loans that preserve the integrity of the world's financial system.⁴⁸ But this Article asserts that these same benefits can be achieved by privatizing the funding of sovereign debt restructuring.⁴⁹ Moreover, this type of privatization would avoid the politics of relying on taxation as the source of IMF funding, which can delay funding availability, thereby impairing a debtor-State's restructuring efforts and deepening the crisis.⁵⁰

For all of these reasons, I argue for the adoption of an international convention for sovereign debt restructuring based on bankruptcy reorganization law principles. Such a convention could help to solve the collective action problem, minimize the moral hazard problem, and avoid any taxation problems.⁵¹ Under the convention, financiers of a State's debt restructuring would have priority over claims of other creditors, and creditors would be bound to a plan of reorganization that is agreed to via super-majority voting, whereby an affirmative vote by a specified majority of each class of creditors binds all

real economic resources are transferred at subsidized interest rates from the U.S. economy to other nations.

Id. Taxpayer cost is also exacerbated by the intertemporal nature of taxation and repayment. See OLIVIER JEAN BLANCHARD & STANLEY FISCHER, LECTURES ON MACROECONOMICS 128-29 (1989) (discussing intertemporal reallocation of taxes); DAVID ROMER, ADVANCED MACROECONOMICS 185 (1996) (same). Taxes always create intertemporal distributional issues because taxes are imposed on people today, but create benefits that arise in the future; they always impose burdens and confer benefits on different people. See Richard L. Revesz, *Environmental Regulation, Cost-Benefit Analysis, and the Discounting of Human Lives*, 99 COLUM. L. REV. 941, 1007 (1999). In the present case of IMF quotas, even if a member-State's capital subscription is ultimately repaid, theoretically enabling that State to reduce taxes, the taxpayers who benefit from the reduction are not the same as those who paid the original taxes. The usual justification is that the benefit to future taxpayers counter-balances harm to current taxpayers. See Richard A. Epstein, *Justice Across the Generations*, 67 TEX. L. REV. 1465, 1487-89 (1989) (examining why future generations should receive benefits from past generations). But raising taxes to fund IMF loans lacks this justification: these taxes do not benefit the State's taxpayers, but rather the citizens of foreign debtor-States that borrow from the IMF.

48. See, e.g., Fischer, *supra* note 42.

49. See *infra* notes 178-206 and accompanying text (discussing capital market funding for loans to debtor-States). Therefore, this Article does not attempt to balance the cost to taxpayers against the intangible benefits of funding loans to troubled States. Some scholars also may contend that rich States have an obligation to subsidize poor States. Yet, even that contention would fail in the common IMF funding scenario where the debtor-State uses the loan proceeds to repay its debts, thereby primarily benefitting the debtor-State's creditors.

50. See *infra* note 181 and accompanying text.

51. This solution would also avoid the related politicization that results from having to decide which States should benefit from loans, and on what conditions.

creditors in that class, even those that vote negatively or fail to vote.⁵² In these contexts, I demonstrate that an international convention would be superior to private contracting.⁵³ Contrary to assumptions made in the economic literature, this type of approach should be largely self-executing and would not require supervision by a bankruptcy court. Although occasional scrutiny and monitoring by a neutral international institution such as the IMF would be necessary to ensure that the priority financing does not result in overinvestment, existing institutions could perform that role. By acting merely as a funding intermediary, the IMF could also impose appropriate conditionality, without creating the moral hazard and taxation problems presently associated with direct IMF lending. This approach can best be understood in the context of the current academic debate.

B. The Academic Debate

There are remarkably few scholarly works on sovereign debt restructuring, and none are by bankruptcy law scholars.⁵⁴ This section will briefly survey the current debate, which primarily exists among economists. Professor Sachs, a leading economist at Harvard, argues that “[t]he IMF’s own tactics—and failure to act like a bankruptcy manager—help to breed failures.”⁵⁵ For example, the IMF’s reliance on taxpayer dollars, which may not be immediately available, can render this institution incapable of providing timely financial assistance to a State in order to prevent the collapse of critical governmental functions.⁵⁶ Sachs believes that the IMF could solve this problem by implementing an international legal framework to encourage mar-

52. See *infra* notes 172-74, 274-89 and accompanying text (discussing 11 U.S.C. §§ 364, 1126 (1994)).

53. See *infra* notes 209-11 and accompanying text (analyzing why the priority should be granted under international law) and Part II.C.1 and accompanying text (analyzing why international law must provide for super-majority voting, and why private contracting would fail).

54. The world’s political leaders have also debated the concept of an international bankruptcy system, but have yet to take action. See John H. Chun, Note, “*Post-Modern*” *Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 *FORDHAM L. REV.* 2647 (1996) (evaluating the two proposals for dealing with a sovereign debt crisis offered by the Group of Seven after their summit on June 15-16, 1995, in Halifax, Nova Scotia). The G-7 debated over the creation of an Emergency Financing Mechanism or an International Bankruptcy Agency (IBA). See *id.* at 2651-52. I discuss the IBA proposal *infra* notes 356-58 and accompanying text.

55. Sachs, *supra* note 1, at 13.

56. See *id.* Sachs also discusses the problems of moral hazard and collective action in his condemnation of the IMF. See *id.* at 6-9, 13-14.

ket lending to States, which it could accomplish by “supervis[ing] the extension of ‘administrative priority’ [loans] for new private-market borrowing for a liquidity-strapped member government.”⁵⁷ Consequently, Sachs calls for “the review and harmonization of private-sector bankruptcy practices.”⁵⁸

Professors Miller and Zhang, also economists, argue for legalization of a “standstill” or freezing of claims against a debtor-State by analogizing to the stay of claims⁵⁹ that automatically arises in U.S. bankruptcy cases.⁶⁰ Miller and Zhang claim that the freeze “might be used to stop creditor races and to allow for debt restructuring.”⁶¹ This argument relies on the central assumption that a standstill will necessarily cause creditors to take a “hit” by canceling the payment of interest during the standstill period.⁶² That assumption may be partly flawed, however, because a standstill need only suspend the payment of interest, which would continue to accrue. Indeed, permitting a debtor-State to use the stay to cancel its interest costs invites strategic manipulation by States that ultimately are able to pay those costs, and also would be unfair to creditors of those States. For these reasons, Chapter 11 requires a solvent debtor ultimately to pay interest that accrues during the bankruptcy case, notwithstanding the stay.⁶³ If, similarly, a debtor-State ultimately must pay accrued interest, then the temporary freezing of payment would merely be an annoyance to creditors.⁶⁴

Professor Cohen, a chaired professor of international economic affairs, asserts, without supporting analysis, that there are “five crucial safeguards” to consider in developing a reform plan for sovereign

57. *Id.* at 11-12. According to Sachs, the IMF should play a role “far more like an international bankruptcy court and far less like the lender of last resort to member governments.” *Id.* at 14; *see also id.* at 15 (analogizing the IMF’s role in an international context to the role played by a central bank in a domestic context).

58. *Id.* at 15.

59. This is the automatic stay provided for under 11 U.S.C. § 362 (1994).

60. Miller & Zhang, *supra* note 36, at 18-22.

61. *Id.* at 11.

62. *Id.* at 5, 20.

63. *See* 11 U.S.C. § 726(a)(5) (1994). *See also* Chaim J. Fortgang & Lawrence P. King, *The 1978 Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1151, 1160-61 (1981) (arguing that to disallow the accrual of interest in this situation would be a “patently unjust result” and would permit strategic manipulation).

64. Technically, a temporary payment freeze could reduce a creditor’s effective rate of return if the creditor accrues neither penalty interest nor interest on delayed interest payments. That reduction, however, is likely to be minimal because interest payments constitute only a fraction of a loan’s principal amount.

debt restructuring,⁶⁵ and that Chapter 11's procedures already incorporate those safeguards.⁶⁶ First, he would grant debt forgiveness to States that face "real insolvency."⁶⁷ This Article later argues that limited debt forgiveness, or "discharge," would be appropriate under a sovereign debt restructuring plan that is agreed to by super-majority voting.⁶⁸ Next, Cohen advocates changing or reinterpreting accounting regulations so that creditors could stretch out capital losses for debt reduction.⁶⁹ If this change is necessary, however, it should be implemented in the same manner as are accounting changes generally, through the process established by the Financial Accounting Standards Board (FASB),⁷⁰ and not through a sovereign debt restructuring law.⁷¹ Third, Cohen would make debt relief contingent upon implementation of needed reforms.⁷² Alternatively, this Article argues that privatizing funding under bankruptcy reorganization principles will motivate States to adopt those needed reforms at an earlier stage, when they are more effective.⁷³ Cohen's fourth safeguard is to ensure mutual recognition of rights and obligations of both creditors and the State.⁷⁴ Because any sovereign debt restructuring law would naturally set forth mutual rights and obligations, this proposal is not problematic. Finally, Cohen would preserve a voluntary and market-oriented

65. Cohen, *supra* note 4, at 123. Cohen actually refers to the debt restructuring of less developed countries, but he does not appear to differentiate that from generic sovereign debt restructuring. *See id.*

66. *See id.* at 124.

67. *Id.* at 123. Cohen refers to his proposal as "selectivity." *Id.* (typeface altered). He would not, however, grant debt forgiveness for States that merely face illiquidity. *See id.* To that extent, Cohen and I are clearly in agreement. *See infra* notes 226-33 and accompanying text (discussing liquidity).

68. *See infra* notes 243-55 and accompanying text.

69. *See* Cohen, *supra* note 4, at 123. Cohen labels this proposal "flexibility." *Id.* (typeface altered).

70. *See* FASB, *An Open Decision-Making Process* (visited August 11, 1999) <<http://www.rutgers.edu/Accounting/raw/fasb/facts/fasfact4.html>>.

71. The appropriateness of that change is beyond the scope of this Article. A complete analysis must balance the need to facilitate sovereign debt restructuring with the need for clear disclosure.

72. *See* Cohen, *supra* note 4, at 123. Consistent with IMF terminology for imposing conditions on loan funding, Cohen calls this proposal "conditionality." *Id.* (typeface altered).

73. *See infra* notes 178-81 and accompanying text. Moreover, in this Article, I propose a convention under which the IMF, to the extent necessary, could continue to impose conditionality without causing the problems presently associated with IMF lending. *See infra* notes 197-208 and accompanying text (discussing nonrecourse back-to-back lending).

74. *See* Cohen, *supra* note 4, at 124. He labels his fourth proposal "mutuality." *Id.* (typeface altered).

negotiating framework to avoid further politicization of the debt issue.⁷⁵ Similarly, this Article claims that applying bankruptcy reorganization principles to sovereign debt restructuring will effectively preserve a consensual, market-oriented negotiating framework and, by shifting lending strategies away from tax-based funding, will avoid further politicization.⁷⁶

After articulating these safeguards, Cohen briefly attempts to explain the manner in which Chapter 11 procedures already embody them:

Mutuality and autonomy are preserved by an essentially voluntary and market-oriented negotiating framework based on explicit recognition of respective rights and obligations. Selectivity is maintained in the debtor's right to make the initial decision to seek protection. Flexibility is inherent in the virtually unlimited scope provided for final terms of settlement. And conditionality is reflected in the court's assignment to a supervisory role over the debtor's ongoing operations.⁷⁷

He concludes that "[t]he challenge is to translate [these five safeguards] into a specific design that is likely to be practicable and effective."⁷⁸

Economists Barry Eichengreen and Richard Portes have written perhaps the most comprehensive work on sovereign debt restructuring.⁷⁹ Inspired by the Mexican crisis of 1994-95, they first examine the ways that "financial markets, governments and multilateral institutions respond to" that type of crisis.⁸⁰ After reviewing the history of sovereign debt restructuring,⁸¹ Eichengreen and Portes then examine how to make the process of restructuring, which often "take[s] years to complete,"⁸² more efficient.⁸³ In this context, they consider the feasibility of "a 'bankruptcy court' and procedure modelled on Chapter 11."⁸⁴ These scholars conclude, however, that "there are significant

75. *See id.* Cohen refers to his final proposal as "autonomy." *Id.* (typeface altered).

76. *See infra* notes 178-80 and accompanying text.

77. Cohen, *supra* note 4, at 124.

78. *Id.* For example, he assumes that instituting these safeguards on an international level would require a supranational institution analogous to the Chapter 11 bankruptcy court, or at least a mediator. *See id.* at 124-25. I later argue that the creation of a new institution may not be necessary. *See infra* notes 361-86 and accompanying text.

79. *See* EICHENGREEN & PORTES, *supra* note 8.

80. *Id.* at xv.

81. *See id.* at 19-28.

82. *Id.* at 4.

83. *See id.* at 28-46.

84. *Id.* at 42.

obstacles” to feasibly implementing such a reform, and that those obstacles are “insurmountable for the foreseeable future.”⁸⁵ Nonetheless, Eichengreen and Portes make several other useful recommendations,⁸⁶ including the establishment of a “mediation service for conciliation and voluntary arbitration.”⁸⁷

Although Chapter 11 inspires the arguments of Miller and Zhang⁸⁸ and of Cohen,⁸⁹ little normative rationale supports their assertions. Eichengreen and Portes base their arguments on certain economic assumptions about bankruptcy theory,⁹⁰ but they do not systematically explore the normative basis of Chapter 11 itself, which is only partly economic.⁹¹ The task of applying bankruptcy reorganization principles to sovereign debt restructuring, however, would appear to be primarily normative:

There is considerable confusion as to how the principles of bankruptcy should translate to the case of sovereign borrowers Therefore, the question is mostly a normative one—how should international practice, and specifically IMF practice, be arranged in view of the lessons of bankruptcy law.⁹²

This Article now turns to that task and to the more general analysis that it engenders.

II

ANALYSIS

This Article outlines a conceptual basis for sovereign debt restructuring by examining the conceptual basis of Chapter 11—including in that examination other related chapters of the Code, such as Chapter 9 which focuses on municipal government reorganiza-

85. *Id.* (referring to obstacles such as the “great divergences that exist among national perspectives and laws on the best ways of dealing with problems of bankruptcy”). As this Article will show, I disagree that such obstacles are insurmountable. *See infra* Part II.C.

86. *See* EICHENGREEN & PORTES, *supra* note 8, at 48-51. One of their recommendations is for the creation of official bondholders’ committees. *See id.* at 48. I later argue, however, that official creditors’ committees are unnecessary. *See infra* notes 271-73 and accompanying text.

87. EICHENGREEN & PORTES, *supra* note 8, at 49.

88. *See* Miller & Zhang, *supra* note 36.

89. *See* Cohen, *supra* note 4.

90. *See* EICHENGREEN & PORTES, *supra* note 8, at 8-11.

91. *See infra* Part II.A (analyzing the normative basis of Chapter 11).

92. Sachs, *supra* note 1, at 8.

tion⁹³—and then by analyzing how that conceptual basis should be modified to address sovereign debt restructuring and its problems. This Article then uses that modified conceptual basis to propose model rules for an international convention on sovereign debt restructuring. Finally, it examines possible ways to implement those rules. Contrary to the assumptions that many scholars make in economic literature, this Article illustrates that sovereign debt restructuring based on principles of Chapter 11 reorganization would not require a bankruptcy court's supervision.

This analysis does not assume that Chapter 11 is always a perfect system for debt restructuring.⁹⁴ Some scholars have criticized Chapter 11, most notably Michael Bradley and Michael Rosenzweig who advocate its repeal.⁹⁵ They claim that agency costs make Chapter 11 inefficient by prolonging management and by allowing companies that should liquidate to attempt reorganization.⁹⁶ In place of Chapter 11, Bradley and Rosenzweig would institute a market solution requiring residual claimants to either cure the defaults of more senior claimants, such as by raising money in the capital markets to repay the company's debt, or risk losing their claims to the next-most senior claimants.⁹⁷ Regardless of whether these criticisms are valid in a corporate context,⁹⁸ they have little application to sovereign debt struc-

93. See *infra* notes 146-47 and accompanying text. Unless the context otherwise requires, references in this Article to Chapter 11 or to principles of Chapter 11 reorganization shall also include those other related Chapters of the Code.

94. Cf. EICHENGREEN & PORTES, *supra* note 8, at 14 (cautioning that "proponents of an international Chapter 11 must recognize that Chapter 11 is seriously criticized in the United States").

95. See Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

96. See *id.* at 1076, 1078.

97. See *id.* at 1078-86. In effect, their proposal gives residual claimants the option of buying out the senior creditors in order to retain their residual claim. See *id.* at 1081. The process continues until either a class of residual claimants buys out the senior creditors or the most senior creditors become the residual claimants. See *id.* at 1081-82.

98. See Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437 (1992) (challenging the Bradley and Rosenzweig thesis). Professor Warren argues, among other things, that the data do not prove Bradley and Rosenzweig's case and that plausible alternative hypotheses may explain many of their statistical findings. See *id.* at 440-67. She also counters that Bradley and Rosenzweig focus only on bankruptcy's goal of preserving value for public shareholders and bondholders, thereby omitting its distributional goals. See *id.* at 467-77. She concludes that Congress should not repeal Chapter 11 because, "thus far, no one has come up with a good substitute." *Id.* at 478.

turing because liquidation is not an option.⁹⁹ Further, their proposed market solution would also be inapplicable because States have no residual claimants or owners.¹⁰⁰

This Article's methodology nonetheless risks being incomplete in two ways: (1) the conceptual basis of corporate reorganization under one or more foreign insolvency laws might be better suited to sovereign debt restructuring than Chapter 11, or (2) the matters compared are too dissimilar to be meaningful.¹⁰¹ With respect to the first risk, my examination of corporate reorganization under several foreign insolvency laws reveals that the conceptual basis of those laws is remarkably similar to that of Chapter 11.¹⁰² Four of those countries' laws are actually based on Chapter 11 or its antecedent statutes in the United States, and the one law not actually based on Chapter 11 is based on principles that are remarkably similar to those of Chapter 11.¹⁰³ Moreover, preliminary research also suggests that

99. See *supra* note 8 and accompanying text (discussing why sovereign States are not liquidated).

100. See *supra* note 9 (observing that States have no shareholders).

101. See Cass R. Sunstein, Commentary, *On Analogical Reasoning*, 106 HARV. L. REV. 741, 744 (1993) ("For analogical reasoning to work well, we have to say that the relevant, known similarities give us good reason to believe that there are further similarities and thus help to answer an open question.").

102. With the help of LL.M. students Ori Demb from Israel, Mike Perry from Canada, Yasuto Hashinaga from Japan, Tomas Allende from Argentina, and Till Hafner from Germany, I examined corporate reorganization under the bankruptcy and insolvency laws of their countries. Although this group is not a statistically meaningful sample, it does represent a range of both civil and common law States on different continents.

103. Japan modeled its corporate reorganization law, *Kaisha k_sei h_* [Corporate Reorganization Act], Law No. 172 of 1952, after Chapter X of the U.S. Bankruptcy Act of 1898, as amended—the predecessor statute to Chapter 11. See HAJIME KANEKO ET AL., JOKAI KAISHA KESEI HO, (JO) 11, 14 (1973). Like the most important sections of Chapter 11 that I will discuss, see *infra* notes 172-234 and accompanying text, Law No. 172 gives priority to loans made in order to enable a company to continue in business, see Law No. 172 of 1952, arts. 119-3, 208, 209, and also provides for super-majority voting of creditors, see *id.* art. 205. For a general discussion of Law No. 172, see Tasuku Matsuo, *Corporate Reorganization*, in 7 DOING BUSINESS IN JAPAN §§ 8.01-.06 (Zentaro Kitagawa ed., 1999).

Chapter 11 forms the basis of the essential elements of German corporate reorganization law as well. See MICHAEL BLATZ & ANDREA K. BUTH, *RESTRUKTURIERUNG, DANIERUNG, INSOLVENZ* 84 (1998). Further, the Canadian Bankruptcy and Insolvency Act (BIA) was influenced by, and is largely reflective of, Chapter 11. See, e.g., L. Shorten, *BIA: Help or Hindrance*, 17 CAN. LAW. 37 (1993) (characterizing the 1992 amendments to Canada's BIA as "Canada's Chapter 11"); Jacob S. Ziegel, *The Modernization of Canada's Bankruptcy Law in a Comparative Context*, 33 TEX. INT'L L.J. 1 (1998) (discussing the substantive and procedural similarities of Canada's BIA and Chapter 11).

The reorganization provisions ("Concurso Preventivo") of Argentina's insolvency law, Law No. 24522, Aug. 7, 1995, [LV-D] A.D.L.A. 4381, also are based on Chapter 11. See, e.g.,

[for countries that] have market economies and share the same assumptions and broad objectives for formal reorganization, it [is] highly likely, if not inevitable, that [those] countries [will] develop [bankruptcy] reorganization systems that function in essentially the same way . . . [because] [t]he functional aspects of these systems [are] shaped not by culture or politics, but by necessity.¹⁰⁴

In contrast, scholars may assert that existing differences between national bankruptcy systems could make a bankruptcy reorganization approach to sovereign debt restructuring impractical.¹⁰⁵ But those differences may be less significant than at first perceived. A national bankruptcy system must address both companies that liquidate and those that reorganize. From this perspective, the differences between national bankruptcy systems are significant because some favor liquidation while others favor reorganization.¹⁰⁶ As previously discussed,

Julio C. Otaegui, *Commentario del Artículo 48 de la Novisima Ley de Concursos en Homenaje al Maestro Raymundo L. Fernandez*, in *DERECHO EMPREDARIO ACTUAL* 799, 803-04 (Osvaldo R. Gomez Leo ed., 1996) (observing that the Argentine Congress expressly took U.S. Chapter 11 as the model for corporate rehabilitation). Thus, it includes what I show to be Chapter 11's two most important contributions to sovereign debt restructuring: super-majority voting (binding each class of creditors to a reorganization plan by a vote of holders of a majority in number and at least two-thirds by amount of the claims, under Concurso Preventivo Art. 45) and priority financing of the reorganization (at least in a limited form under Concurso Preventivo Art. 13).

Israeli reorganization law, codified in Companies Ordinance Chapter 10, sections 233, 333-34, 307(a), & 300, 1983, is the only one that does not appear to be based on Chapter 11; nonetheless, its principles, as interpreted by the courts, are remarkably similar to those of Chapter 11. The Israeli Supreme Court has found the Ordinance to advance three reorganization goals: (1) rehabilitation of viable debtors, including abrogation of the traditional "absolute priority" rule in order to encourage consensual plans of reorganization; (2) equality of distribution for creditors; and (3) economic efficiency. *See* C.A. 217/88, Hapoalim-Bank v. Trustee of the Scheme of Arrangement Between the Encyclopedias Publishing Firm et al., 44(2) P.D. 698, 703. These goals are remarkably similar to U.S. bankruptcy reorganization norms. *See infra* notes 115-44 and accompanying text (discussing the same norms under Chapter 11). Furthermore, section 233(b) of the Ordinance provides for a form of super-majority voting—each class of creditors is bound to a reorganization plan by a vote of a majority of those present holding at least three-quarters by amount of the claims. *See also* C.A. 700/71, Otzar Kablanim Ltd. v. Sherf, 27(1) P.D. 561, 564 (confirming section 233(b)'s power to override contrary contractual voting provisions).

104. Lynn M. LoPucki & George G. Triantis, *A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies*, 35 *HARV. INT'L L.J.* 267, 342 (1994).

105. *See, e.g.*, E-mail from Richard Portes, Distinguished Global Visiting Professor, Haas School of Business, University of California at Berkeley, to Steven L. Schwarcz 1 (October 24, 1999) (on file with author) (stating that the differences between national bankruptcy systems constitute "one of the bases for our [Portes & Eichengreen's] conclusion that an international bankruptcy procedure of the type you [Schwarcz] suggest will not be acceptable").

106. *See, e.g.*, Julian R. Franks et al., *A Comparison of US, UK, and German Insolvency Codes*, *FIN. MGMT.*, Autumn 1996, at 86, 93-94.

however, States do not liquidate.¹⁰⁷ Therefore, a broad comparison of bankruptcy systems would highlight differences that are not applicable to debtor-States. Because they always reorganize, the more precise comparison for debtor-States would be between national bankruptcy *reorganization* systems. My analysis already compares five of those systems and concludes that they are conceptually similar to Chapter 11.¹⁰⁸ Furthermore, I focus on those aspects of Chapter 11 that come into play once a debtor decides to reorganize.

Additionally, even if national bankruptcy reorganization systems were not conceptually similar, the analogy to Chapter 11 serves only as a starting point for inquiry. Absent an overarching theory of sovereign debt restructuring, which does not exist because sovereign debt restructuring is purely a matter of contract negotiation¹⁰⁹ thus rendering each situation unique,¹¹⁰ analogy can help suggest rational legal outcomes.¹¹¹

Turning to the second risk, I believe that the matters being compared under this analogy are indeed similar enough to be meaningful. Although sovereign States and non-sovereign corporations are fundamentally different, this Article's analysis takes into account the reorganization of sovereign entities by examining municipal reorganiza-

107. See *supra* note 8 and accompanying text.

108. See *supra* notes 102-03 and accompanying text. Professor Portes states that the primary article that he and Professor Eichengreen relied on for their conclusion that a bankruptcy reorganization approach to sovereign debt restructuring is impractical was Franks et al., *supra* note 106, which compares U.S. and U.K. bankruptcy law to German insolvency law. See E-mail from Richard Portes, *supra* note 105 (stating such reliance). Nonetheless, the corporate reorganization part of the new German insolvency law, Insolvenzordnung (InsO), v. 5:10.94 (BGB1. I S.2866) (eff. Jan. 1, 1999), is not only based on U.S. Chapter 11, see BLATZ & BUTH, *supra* note 103 but also includes super-majority voting and priority financing provisions similar to what I propose for the Convention. See InsO §§ 244, 264, 55II, 56, 80.

109. See, e.g., Mudge, *supra* note 2, at 59 ("Sovereign debt restructure is contractual agreement between individual debtor and individual creditor with respect to the debt in question, and nothing more.")

110. See *id.* at 60 ("Each restructure is negotiated separately in its own factual context There are no general rules, and the solution to yesterday's problem is not the answer to today's question. The solution for the Kingdom of Oz simply will not work for the Republic of Zo. . . . Each situation is *unique* . . ."); see also Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 966 (1991) (expressing "distrust of any all-embracing, formal model of bankruptcy law and policy").

111. See Sunstein, *supra* note 101, at 767 (arguing that when there is insufficient information to agree on an overarching theory to deduce the "right" outcome, analogy can help produce a rational legal outcome). *But see* RICHARD A. POSNER, *OVERCOMING LAW* 518-22 (1995) (arguing that although "[a]nalogies can be suggestive, even illuminating," their use should not exclude attempts to find facts and policies for deciding the case at hand).

tion under Chapter 9 of the Code.¹¹² Although bankruptcy judges supervise Chapters 9 and 11 cases (whereas equivalent judicial supervision may be impractical for sovereign States), this fact does not weaken the analogy because those matters that require judicial supervision are inapplicable to States.¹¹³

A. Deriving a Normative Framework for Regulation

In deriving a normative framework for regulation, I first examine the conceptual basis of Chapter 11 and then analyze possible modifications that address sovereign debt restructuring problems.¹¹⁴ The first analysis is complicated, but also universalized, by disagreement on Chapter 11's normative underpinnings.

Traditionally, Chapter 11 attempts to advance two overall goals: to rehabilitate viable debtors and to ensure equality of distribution among creditors.¹¹⁵ Some scholars, however, argue that the only nor-

112. See *infra* note 147 and accompanying text.

113. See *infra* notes 359-74 and accompanying text (observing that bankruptcy courts do not play a role in debt negotiations in the United States—the parties themselves do the negotiating—and that while certain administrative oversight functions are delegated to a U.S. trustee, those functions do not appear relevant to sovereign debt restructuring).

114. My analysis does not necessarily differentiate between short-term and long-term debt. Although short-term debt may be a greater problem for States than long-term debt, see, e.g., Miller & Zhang, *supra* note 36, at 8 (arguing that short-term debt is the “Achilles heel” of recent countries in crisis), a default on short-term debt almost always permits holders of long-term debt to accelerate their maturities, essentially converting it into short-term debt. Moreover, covenant breaches in long-term debt may permit acceleration—irrespective of the short-term debt. Finally, the claims of holders of long-term and short-term debt generally are *pari passu*.

115. See Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 542-43 (1999). A third, lesser, goal is efficient administration of the bankruptcy process. See *id.* at 543. Other scholars, however, have proposed different articulations of bankruptcy's traditional goals. See Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 343-73 (1993). Professor Warren, for example, has argued that there are four such goals: to “enhance the value of [the] failing [debtor],” *id.* at 344; to provide for equality of distribution (except for deliberate deviations from equality); to “constrain externalization of business losses to parties not dealing with the debtor,” *id.* at 361; and to create reliance on private monitoring; see also *id.* at 370 (arguing that “[t]he debtor is typically the only party with access to full information about its outstanding obligations, future business plans, and income projections,” and thus is “usually best able to assess how successful the business is likely to be in meeting its continuing obligations, and to determine whether bankruptcy provides an opportunity to enhance the value of the business”). Professor LoPucki has argued that Chapter 11 addresses four problems: liquidity, so that assets are not disposed of at bargain prices; communication and coordination among all interested parties; relief from contract provisions that depress the value of the estate; and oversight of shifts in management and ownership that accompany insolvency. See Lynn M. LoPucki, Correspondence, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig*, 91 MICH. L. REV.

mative goal of bankruptcy reorganization law should be economic efficiency.¹¹⁶ These contrasting views represent two distinct, and possibly irreconcilable, philosophies of corporate reorganization.¹¹⁷

Traditionalists believe that bankruptcy law plays a unique role that “advances substantive goals that are both important and distinctive.”¹¹⁸ In contrast, scholars who follow principles of economic efficiency (“free marketers”) believe that “a coherent bankruptcy law must recognize how it fits into both the rest of the legal system and a vibrant market economy.”¹¹⁹ A dean of American bankruptcy jurisprudence, Professor Douglas Baird, suggests that the differences between traditionalists and free marketers arise out of their different starting axioms.¹²⁰ I therefore examine the disputes over these axioms in an attempt to understand which axioms might apply to sovereign debt restructuring.

79, 100-06 (1992). Both Warren and LoPucki’s goals, however, are included within the goals of debtor rehabilitation and equality of distribution. See Schwarcz, *supra*, at 544 n.168.

116. See, e.g., THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 1-6 (1986); Barry E. Adler, *Finance’s Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1107-11 (1994); Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1159-65 (1994).

117. See Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573, 595-99 (1998). Professor Baird concludes that these two philosophies cannot be reconciled by empirical data because the split “is at bottom normative.” *Id.* at 596. Therefore, “[b]ridging the gap between [these philosophies] . . . ‘must ultimately dissolve into a study of aesthetics and morals.’” *Id.* at 599 (quoting R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 43 (1960)); see also Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75, 76 (1996). Professor Korobkin observes that

[b]ankruptcy scholars are profoundly divided over the proper direction of bankruptcy law. One school—the ‘free-market critics’—argues that the law of corporate reorganization frustrates the voluntary choices of commercial actors and therefore should be replaced with various proposals designed to maximize allocative efficiency. The other school—the ‘traditionalists’—defends the basic structure of current law, while also attacking free-market proposals as ill-conceived and impractical.

Id. (footnotes omitted). For an approach to bankruptcy law analysis that accommodates both of these philosophies, see Schwarcz, *supra* note 115, at 523 (considering each philosophy separately before advocating a hybrid approach, thereby allowing readers with a pristine philosophical bent to focus on their own perspectives).

118. Baird, *supra* note 117, at 576. Legal scholars have described these goals as debtor rehabilitation, equality of distribution, and minimizing cost of administration. See, e.g., Schwarcz, *supra* note 115, at 542-43.

119. Baird, *supra* note 117, at 577. Professor Baird uses the term “proceduralist” in lieu of the term “free marketer.” *Id.* The latter term, however, is more commonly used in the literature. See, e.g., Schwarcz, *supra* note 115, at 523.

120. See Baird, *supra* note 117, at 575.

Baird identifies three disputes.¹²¹ The first addresses the rehabilitative role of bankruptcy law, questioning the role the law should play in “keeping a firm intact as a going concern.”¹²² Free marketers contend that bankruptcy law’s only role is “determining whether keeping the firm intact makes economic sense.”¹²³ A firm that has a sound business, but that is likely to fail because of the amount of debt in its capital structure,¹²⁴ should be kept intact.¹²⁵ But a firm with an inherently unsound business should be allowed to fail “to ensure that [its] assets are put to their best use.”¹²⁶ Traditionalists, on the other hand, argue that bankruptcy law “serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail. Jobs would be lost and communities damaged, economically and otherwise, if the protections that bankruptcy law provides were unavailable.”¹²⁷

This dispute over rehabilitation applies, however, only indirectly to sovereign debt restructuring. At least in the present world order, sovereign States are not liquidated and their assets then redistributed for more valuable economic uses.¹²⁸ Thus, there is no need to determine whether keeping the State intact makes economic sense, nor am

121. *See id.* at 576-80.

122. *Id.* at 577.

123. *Id.* Thus, free marketers posit that “[a]ll bankruptcy can do is ensure that fights among creditors and other investors of capital do not accelerate a firm’s liquidation.” *Id.* at 578. As part of their focus on economic efficiency, free marketers would oppose rules that allow parties “to take actions without bearing their full costs.” *Id.* at 583.

124. Such a firm is sometimes referred to as a “good company, bad balance sheet.” *See Debtor-in-Possession Loan Rating Criteria*, DEBTOR-IN-POSSESSION LOANS SPECIAL REPORT (Fitch Investors Service Inc., New York, N.Y.), Mar. 25, 1991, at 4 (stating that Fitch favors rating loans to such bankrupt companies). Professor Baird describes such a firm as having financial but not economic distress. *See Baird, supra* note 117, at 580-81.

125. *See, e.g., Baird, supra* note 117, at 581-82 (observing that “[f]or the [free marketer], bankruptcy law exists to solve the problem of *financial* distress” and further that “[t]he mission of bankruptcy is to ensure that firms do not fail simply because they have creditors they cannot pay”).

126. *Id.* at 582. Professor Baird illustrates this re-use of assets by the example of a restaurant in a large city: “If a bad restaurant is replaced by a much better one, employment levels in the city may even increase. Keeping a bad restaurant in business postpones the inevitable and delays a desirable shift of labor and capital to somewhere the inputs can be put to better use.” *Id.* at 580.

127. *Id.* at 577. Professor Baird says that traditionalists “do not distinguish sharply between economic and financial distress.” *Id.* at 582. Whether or not that is true, the parties participating in the bankruptcy case do make such a distinction. For example, lenders are reluctant to advance debtor-in-possession financing to bankrupt firms with inherently unsound businesses. *See Debtor-in-Possession Loan Rating Criteria, supra* note 124.

128. *See supra* note 8.

I advocating that such a determination be made. The only goal here is rehabilitation, and any sovereign debt restructuring scheme should facilitate, or at least not impede, that goal.

Professor Baird next identifies the debate over whether bankruptcy law should be a closed or an open system.¹²⁹ Free marketers believe that bankruptcy should be an open system, and that consequently its rules should “be crafted with an eye to the way they affect the incentives of those who are involved with firms that are not in bankruptcy and have no immediate prospect of getting there.”¹³⁰ Their concern is that “[s]ubstantive rules implemented exclusively in bankruptcy are suspect because of the effects they may have on investment beforehand. . . . Inconsistency may do more harm than good”¹³¹ Traditionalists, on the other hand, believe that bankruptcy is a self-contained, closed system, because “the breathing space that bankruptcy law gives distressed firms and the other costs it imposes on the participants have only a modest effect on how creditors and others behave *ex ante*.”¹³² Thus, traditionalists justify the goal of avoiding certain preferential but nonfraudulent prepetition transfers,¹³³ because this avoidance advances the goal of equality of

129. See Baird, *supra* note 117, at 578.

130. *Id.*

131. *Id.* at 578 (footnote omitted); *cf.* *Butner v. United States*, 440 U.S. 48, 55 (1979) (reasoning that “[u]niform treatment of property interests [inside and outside bankruptcy] serves to reduce uncertainty, to discourage forum shopping, and to prevent a [debtor] from receiving ‘a windfall merely by reason of the happenstance of bankruptcy’” (quoting *Lewis v. Manufacturers Nat’l Bank*, 364 U.S. 603, 609 (1961))). Because of the problems associated with differing incentives, free marketers argue that economic forces should operate in bankruptcy just as they do outside of bankruptcy. See Baird, *supra* note 117, at 578. Therefore, the burden should rest on traditionalists to justify bankruptcy rules that are different from nonbankruptcy rules. See *id.* at 590 & n.50.

132. Baird, *supra* note 117, at 578. Baird also observes that “[t]raditionalists are able to pay *ex ante* effects so little heed because of the sheer difficulty of identifying these effects with any certainty. Hard evidence that these [effects] matter is elusive.” *Id.* at 589.

133. See 11 U.S.C. § 547(b) (1994). Section 547(b) states in relevant part:

- [T]he trustee may avoid any transfer of an interest of the debtor in property—
- (1) to or for the benefit of a creditor;
 - (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
 - (3) made while the debtor was insolvent;
 - (4) made—
 - (A) on or within 90 days before the date of the filing of the petition . . .
 - . . . and
 - (5) that enables such creditor to receive more than such creditor would receive if—

distribution¹³⁴ while, they argue, only modestly affecting prepetition dealings between the debtor and its creditors.

This dispute appears more directly relevant to sovereign debt restructuring. States, unlike corporations, require less “breathing space” because their sovereignty already provides that. Therefore, States have less need for special bankruptcy rules. Alternatively, ex post modification of creditors’ rights by “[s]ubstantive rules implemented exclusively in bankruptcy” can have adverse effects such as increasing sovereign borrowing costs.¹³⁵ Sovereign debt restructuring rules should therefore be crafted to minimally affect the incentives of those who negotiate with nonbankrupt States.

Baird’s third dispute concerns the implementation of bankruptcy law and focuses on the judge’s role in the bankruptcy process.¹³⁶ Free marketers “see the judge as a disinterested arbiter”¹³⁷ in a system in which parties make their own decisions, and the judge acts simply “to ensure that the biases of the parties are taken into account and all relevant information is gathered and disclosed.”¹³⁸ Those biases, for example, include the desire of institutional creditors to liquidate the firm and the agency costs of the shareholders.¹³⁹ In contrast, traditionalists believe that “[i]mplementing the goals of bankruptcy requires investing the judge with broad discretion to ensure that bankruptcy’s goals are vindicated,”¹⁴⁰ a belief that free marketers may consider “hopelessly sentimental.”¹⁴¹

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Id.

134. See Schwarcz, *supra* note 115, at 578 (“The dominant expression of equality of distribution under bankruptcy law is found in Section 547(b) . . .”).

135. Baird, *supra* note 117, at 578.

136. See *id.* at 579.

137. *Id.*

138. *Id.*

139. See *id.*

140. *Id.*

141. *Id.* at 593 (explaining that free marketers disagree with giving judges broad discretion because the court-administered bankruptcy process would impose even more unnecessary costs). Indeed, giving the judge equitable discretion, coupled with the concomitant vagueness in bankruptcy rules, “merely gives the parties more cause for litigation and hence increases the cost of the reorganization without providing any offsetting benefit.” *Id.* at 595.

This dispute is also relevant to sovereign debt restructuring. Granting judicial arbiters broad discretion to bind sovereign States may simply be politically unacceptable.¹⁴² Accordingly, any framework for sovereign debt restructuring should minimize adjudicatory discretion.¹⁴³

Hence, a supranational legal framework for sovereign debt restructuring has at least three normative underpinnings: (1) it should foster, or at least not impair, the State's ultimate economic rehabilitation; (2) it should minimally affect nonbankruptcy incentives; and (3) it should require only minimal adjudicatory discretion in its administration.¹⁴⁴ Moreover, any complete framework must take into account the following major problems associated with sovereign debt restructuring: collective action, moral hazard, and taxation. Thus, a complete framework requires that any international convention for sovereign debt restructuring foster the three normative underpinnings above as well as attempt to relieve the major problems associated with sovereign debt restructuring.

The next section of this Article attempts to use this framework to model a system of rules for an international sovereign debt restructuring convention (the "Convention"). I begin by identifying the provisions of the Code that might be relevant to sovereign debt restructuring and then analyze those provisions in light of the proposed framework.

B. Modeling Regulatory Rules for an International Convention

The only provisions of the Code that might be relevant to sovereign debt restructuring are included in Chapter 11, which governs corporate reorganization, and in the Code's related chapters: Chapter 9, which governs adjustment of debts of municipal governments;

142. See Chun, *supra* note 54, at 2677 n.237 ("A sovereign cannot realistically be expected to submit to a court-like entity who [sic] can issue binding rulings.").

143. Undeniably, judicial arbiters should not have the power to interfere with the State's political or governmental powers, property or revenues, or use or enjoyment of income-producing property. See, e.g., 11 U.S.C. § 904 (1994) (prohibiting the bankruptcy court from interfering with "(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property"). The Convention I propose does not purport to interfere with these powers or rights. See *infra* notes 360-70 and accompanying text.

144. Adjudicatory power would be based on consent of the State, as expressed through an international convention. See *infra* note 323 and accompanying text.

Chapter 3, which governs administration of the bankruptcy case;¹⁴⁵ and Chapter 5, which contains provisions concerning the relationship between creditors and the debtor. (At first, I considered focusing on Chapter 9 because it contains the Code's only provisions for reorganization of a political entity; analysis showed, however, that Chapter 9 adds little to the other Chapters because it primarily incorporates their provisions by reference¹⁴⁶ and contains few provisions that are unique to municipal debtors.¹⁴⁷) I analyze these provisions in light of the proposed framework.¹⁴⁸

Commencing the Case: Sections 301 and 303 of the Code set forth the procedures for initiating a bankruptcy case.¹⁴⁹ Under § 301, a debtor has the discretion to voluntarily file a bankruptcy petition without being insolvent or meeting other requirements, except those discussed below. The rationale behind this Section is that a debtor knows best when bankruptcy protection is appropriate.¹⁵⁰ Courts,

145. See 11 U.S.C. §§ 301, 303 (1994).

146. See *id.* § 901.

147. Those few provisions are obvious anyway. For example, unless a municipal debtor consents or the reorganization plan provides otherwise, a court may not interfere with a municipal debtor's political or governmental powers, property or revenues, or use or enjoyment of income-producing property. See *id.* § 904. Municipal debtors are the only parties allowed to file a plan for adjustment of their debts. See *id.* § 941 (varying 11 U.S.C. § 1121's authorization of judicial modification of the debtor's exclusive right to file a plan). Further, the court may confirm municipal plans only if any needed regulatory or electoral approval either has been obtained or its being obtained is an express condition of the plan. See *id.* § 943(b)(6). Perhaps the only non-obvious provision provides, apparently to protect the common municipal financing technique of issuing tax-exempt, nonrecourse industrial revenue bonds, that "special revenues" acquired by a municipal debtor after the commencement of its bankruptcy case remain subject (after subtraction of any operating expenses needed to generate the special revenues) to pre-bankruptcy liens. See *id.* § 928. That result would be obvious but for the special provision in 11 U.S.C. § 552 cutting off many pre-bankruptcy liens of corporate debtors.

148. Relevant provisions under these Chapters include §§ 301, 303 (providing procedures for instituting a bankruptcy case); §§ 362, 922 (automatically staying actions against the debtor); § 364 (c), (d), (e), (f) (obtaining credit); § 365 (assuming or rejecting contracts); § 507 (a)(1) (providing priority to certain creditor claims); §§ 524 (a)(1) & (a)(2), 727, 1141(d) (discharging unpaid debts); §§ 547, 549 (avoiding preferences); § 1102 (creating committees to represent creditors); § 1123 (setting forth contents of plan of reorganization, other than irrelevant subsections (a)(6), (a)(7), (c), and (d)); § 1126 (providing for acceptance of plan of reorganization, other than subsection (d) because a State has no equity owners); and § 1129 (setting forth confirmation standards for a reorganization plan).

149. *Id.* §§ 301, 303.

150. See, e.g., Warren, *supra* note 115, at 370 (arguing that "[t]he debtor is typically the only party with access to full information about its outstanding obligations, future business plans, and income projections," and is thus "usually best able to assess how successful the business is likely to be in meeting its continuing obligations, and to determine whether bankruptcy provides an opportunity to enhance the value of the business").

however, have imposed the requirement that a debtor must file any voluntary petition in good faith.¹⁵¹ Creditors may only file an involuntary bankruptcy case against debtors under § 303 in limited circumstances, such as when a debtor is generally not paying its debts when due. This requirement prevents creditors from using the threat of bankruptcy to harass ordinary debtors.¹⁵² This rationale applies even more strongly to municipal debtors, and hence the Code flatly prohibits creditors from filing involuntary bankruptcy cases against municipalities.¹⁵³

Curiously, however, § 109(c) of the Code allows municipalities to file a bankruptcy petition only if they are insolvent on a cash flow basis, which means that the municipality is “generally not paying its debts as they become due [or is] unable to pay its debts as they become due.”¹⁵⁴ Unfortunately, a cash flow insolvency standard

almost certainly makes both creditors and debtor worse off in those cases actually culminating in bankruptcy [because it] postpones the day of reckoning, while the city continues to pile on new debt at ever-increasing interest rates, further burdening the municipal budget and guaranteeing that each creditor will receive less value in bankruptcy. The problem is not easy to solve, because the insulation of municipal assets from seizure and sale makes the idea of balance sheet insolvency meaningless, and there is no obvious alternative.¹⁵⁵

Absent an insolvency requirement for filing, the foregoing approach for commencing a bankruptcy case appears sensible for sovereign debt restructuring. Few States would willingly subject themselves to a Convention under which creditors could force the State into involuntary bankruptcy. Moreover, in a case in which creditors might want to subject the State to the Convention’s rules, the State itself

151. See 2 COLLIER ON BANKRUPTCY ¶ 301.04[1] (15th ed. rev. 1996) [hereinafter COLLIER]. In a municipal bankruptcy, § 921(c) of the Code explicitly permits a court to dismiss a bankruptcy petition not filed in good faith. Cf. McConnell & Picker, *supra* note 8, at 460-61 (questioning why the good faith requirement is explicit only for municipal bankruptcy filings).

152. See ROBERT L. JORDAN ET AL., BANKRUPTCY 224 (5th ed. 1999).

153. See 11 U.S.C. § 901(a), which makes § 303 (involuntary bankruptcy) inapplicable to municipalities; see also *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 225 (Bankr. N.D. Cal. 1991) (noting that permitting involuntary filings against municipalities “may constitute an invasion of State sovereignty contrary to the Tenth Amendment, and would constitute bad policy” (quoting H.R. REP. NO. 95-595, at 321 (1977))).

154. 11 U.S.C. § 101(32)(C) (defining insolvency for a municipality). This test “reflects the pre-Code common law view, which treated the municipal debtor as having few physical assets available for creditors and instead focused almost exclusively on the ability of the debtor to generate revenues through property taxes.” McConnell & Picker, *supra* note 8, at 456.

155. McConnell & Picker, *supra* note 8, at 456-57.

would have an equal or greater interest in choosing those rules.¹⁵⁶ Identification of the interests of the State and its creditors would therefore obviate the need for creditors to act as “monitors and instigators of outside intervention.”¹⁵⁷ Furthermore, imposing an insolvency requirement could be counter-productive—discouraging the Convention’s use by States that wish to avoid being branded as insolvent.¹⁵⁸ Thus, this protocol should empower only the State itself, and not its creditors, to commence the case. Further, provided that the State files its case in good faith,¹⁵⁹ the filing should be upheld. As discussed above, imposing other filing requirements might prevent the State from taking advantage of bankruptcy protection when the State needs it the most,¹⁶⁰ thereby harming both the State and its creditors.

This approach to commencing a case appears neutral from the standpoints of collective action and taxation. Although the approach might appear to foster moral hazard to the extent external observers cannot reliably ascertain whether a State is acting in good faith when commencing a case, the substantive rules of the Convention that I later propose are themselves neutral from the standpoint of moral hazard.¹⁶¹ Therefore, commencing a case in order to implement those

156. Under the Convention, financiers of the State’s debt restructuring would have priority over claims of other creditors. Also, the Convention would bind all creditors to a plan of reorganization that is agreed to by super-majority voting of creditors and, upon such agreement, the Convention would discharge debts not provided for in the plan. *See infra* notes 241-54 and accompanying text. A creditor might want the first rule to apply in order to provide liquidity to the State. However, if the State needs liquidity and cannot obtain it elsewhere, the State would want to file. Likewise, a creditor who is frustrated by unanimity requirements in loan agreements might want the second rule to apply in order to achieve an overall debt restructuring plan. Similarly, the State would be frustrated by its inability to reach such a plan and, therefore, would want that rule to apply.

157. McConnell & Picker, *supra* note 8, at 478.

158. Indeed, the Convention does not differentiate between exogenous and endogenous factors that lead to default (except to the limited extent that irrational exogenous factors would justify IMF temporary liquidity to a State that is otherwise economically sound, *see infra* notes 224-34 and accompanying text). Differentiation would be counter-productive because political leaders that might be blamed for the economic failure would be reluctant to have their States use the Convention.

159. I later discuss, however, the possibility of disputes arising out of a good faith filing requirement. *See infra* text accompanying note 385.

160. A balance sheet insolvency test for States, as for municipalities, also would be meaningless because “the solvency of a country is not well defined.” EICHENGREEN & PORTES, *supra* note 8, at 14.

161. Each of these rules having been selected in part for their neutrality from that stand point, if not their potential to reduce moral hazard. *See infra* notes 179-80 and accompanying text (arguing that shifting the source of funding to priority funding in private markets would reduce moral hazard), p. 148 (arguing that any increase in State moral hazard resulting from

rules would not foster moral hazard. Depending on the applicable bankruptcy rules,¹⁶² the approach could potentially foster economic rehabilitation; moreover, except in the presumably rare case in which creditors allege a bad faith filing, application of this approach eliminates adjudicatory discretion. The only potential disadvantage to this approach is that rules that operate only in bankruptcy could adversely affect nonbankruptcy incentives. The magnitude of that effect, however, depends on the substantive nature of the rules, and this Article proposes bankruptcy rules that do not materially adversely affect nonbankruptcy incentives.¹⁶³ Thus, the Convention should provide that the debtor-State alone may commence the case.

Stays: Section 362 of the Code in a non-municipal context, and § 922 in a municipal context, provide that commencement of the bankruptcy case automatically stays the enforcement of all lawsuits and claims against the debtor, as well as any other actions to obtain possession of the debtor's property.¹⁶⁴ Would a stay also make sense in the context of sovereign debt restructuring? After weighing the relevant criteria, I propose that the Convention not include a stay.

A stay's net effect on moral hazard may be neutral. A stay would increase moral hazard to the extent that a State protected by the stay will be less careful to avoid default. It would reduce moral hazard, however, to the extent that creditors fearing the stay will be more careful when extending credit. Thus, in the context of moral hazard, these counterbalancing effects may cancel each other out. Further, a stay's effect on taxation would also be neutral.

A stay could provide some modest benefits. It could minimize part of the collective action problem by preventing an enforcement race among creditors. This problem, however, loses significance in the sovereign-debtor context because creditors could only attempt to attach the State's relatively few assets located in other jurisdictions.¹⁶⁵ A

discharge would be offset by a decrease in creditor moral hazard), p. 155 (arguing that supermajority voting would be neutral from the standpoint of moral hazard).

162. I discuss these rules *infra* notes 164-312 and accompanying text.

163. Adoption of explicit bankruptcy rules would even reduce the impact on non-bankruptcy incentives to the extent creditors, *ex ante*, have greater certainty of *ex post* bankruptcy events. See EICHENGREEN & PORTES, *supra* note 8, at 77-78.

164. See 11 U.S.C. §§ 362, 922 (1994).

165. See Hurlock, *supra* note 16, at 11. Potentially a stay could avert the "rush to grab foreign exchange reserves by selling domestic currency or redeeming foreign-currency obligations issued by the government or domestic firms." EICHENGREEN & PORTES, *supra* note 8, at 16. The Convention may better address this type of grab race, however, by providing emergency liquidity to inherently viable States. See *infra* notes 226-33 and accompanying text.

stay could also theoretically foster economic rehabilitation by permitting the State to suspend payments while attempting to restructure its economy. However, the State's unilateral decision to suspend payments would produce virtually the same effect as a stay,¹⁶⁶ except with respect to the relatively few assets located in other jurisdictions.¹⁶⁷

The costs of a stay, however, would outweigh these benefits. Application of a stay will likely generate significant litigation on issues including when the stay should apply, when it should end, and what exceptions should be allowed.¹⁶⁸ Furthermore, the possibility of a

The only drawback is that short-term creditors could attempt to grab the liquidity to satisfy their maturing debt. See, e.g., Barry Eichengreen, *Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management*, 23 FLETCHER WORLD AFF. 57, 57 (1999) (observing that the Mexican "government used its U.S. and International Monetary Fund (IMF) loans to retire its short-term, dollar-indexed debt obligations at full value as they matured"); E-mail from Richard Portes, *supra* note 105 ("Providing emergency liquidity simply permits short-term creditors to grab it all."). States can reduce that drawback, however, by limiting their short-term debt exposure. See Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 14 AM. U. INT'L L. REV. 1571, 1622-29 (1999) (arguing that a grab of emergency liquidity by short-term creditors can be avoided by restricting the issuance of short-term debt). States indeed will have less incentive to issue short-term debt once the IMF ceases acting as a lender of last resort.

166. See, e.g., BARRY EICHENGREEN, TOWARDS A NEW INTERNATIONAL FINANCIAL ARCHITECTURE 92 (1999) (questioning "whether there really is the need to create [an international bankruptcy court] with the ability to impose a standstill, because governments can already declare a unilateral moratorium"). Two differences exist between a stay and a State's unilateral decision to suspend payments. First, a State's unilateral decision to suspend payments would not prevent the State from later making preferential payments to certain creditors, whereas a formal stay imposed on the State would prevent the State from doing so. Addressing this preference problem separately, however, may be more efficient. See *infra* notes 256-67 and accompanying text. Second, States may be hesitant to unilaterally suspend payments "for fear that they will jeopardize their future credit market access [whereas] a government which received [de jure] approval for its standstill would suffer relatively little damage to its reputation." EICHENGREEN & PORTES, *supra* note 8, at xvii. If States adopt the Convention, however, its implicit assumption that States will unilaterally suspend payments should provide a measure of de jure justification therefor.

167. In this context, some scholars have argued that a stay might help to mitigate damage to the reputation of a State that unilaterally suspends its debt payments. See EICHENGREEN & PORTES, *supra* note 8, at 40. Even then, however, "[r]eputation will be preserved only if the markets believe that financial distress was not the debtor's 'fault'"—a determination that is difficult to make. *Id.* Moreover, if the problem was the debtor's fault, then "a standstill might still be justifiable, but then the debtor's reputation *should* suffer." *Id.* at 41.

168. See DAVID G. EPSTEIN ET AL., BANKRUPTCY § 3-1, at 63 (1993). According to Epstein, Nickles, and White,

[e]very year there are hundreds of reported proceedings that implicate [the stay under] section 362 [of the Code]. More often the difficulty is deciding the facts required to apply section 362 rather than construing the law that it states. . . . Also, [the stay] is stretched and pulled by many unusual circumstances and by very many clever lawyers. The tension regularly produces novel issues of interpretation and application.

stay could adversely affect nonbankruptcy incentives: for example, creditors anticipating the possibility of non-payment during the restructuring period might charge the State higher interest rates.

Moreover, the policy reasons supporting a stay in the corporate bankruptcy context do not apply to sovereign debt restructuring. There are two rationales for a stay: (1) the belief that stopping creditor collection efforts will “accomplish the orderly and even administration of the debtor’s property and financial affairs,”¹⁶⁹ and (2) the hope that preventing a grab race among creditors intent on seizing assets will promote equality of distribution.¹⁷⁰ As discussed above, however, a State itself can prevent creditor collection efforts or a grab race even without a stay, except with respect to the few assets located outside its borders.¹⁷¹

Thus, although a stay could provide benefits to a State, that State’s unilateral decision to suspend payments would have much the same effect without incurring the costs of implementing a formal stay. As a result, I propose that the Convention not include a stay.

Reorganization Financing: Section 364 of the Code outlines a procedure for a debtor to obtain financing for its reorganization from the credit and capital markets.¹⁷² This financing is commonly referred to as debtor-in-possession (DIP) financing. In order to attract DIP financing, the Code gives priority to lenders and investors that provide such financing.¹⁷³ Without this priority, financing would likely be unavailable because the information asymmetry between the State and potential financiers may be large (a bankrupt company rarely has

Id.

169. *Id.* § 3-1, at 59. Professor Baird describes this as a “mechanism to preserve the status quo while we sort out the affairs of the debtor.” DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 193 (rev. ed. 1993).

170. *See* EPSTEIN, ET AL., *supra* note 168, § 3-1, at 60-61.

171. *See supra* notes 166-67 and accompanying text.

172. The capital markets are “markets where capital funds—debt and equity—are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges.” JOHN DOWNES & JORDAN ELLIOT GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 59 (3d ed. 1991). The term “credit markets” refers to banks, finance companies, and other traditional institutional lenders. All of these are private, free-market sources of funds.

173. *See* 11 U.S.C. § 364(a) (1994). Moreover, if the priority scheme laid out in § 364(a) is inadequate to attract sufficient financing, the judge may authorize the granting of collateral. *See id.* § 364(c), (d). If necessary, the judge may even authorize the obtaining of credit secured by a senior lien on property already pledged as collateral if the original secured party is adequately protected. *See id.* §§ 364(d), 361 (defining adequate protection).

full financial transparency)¹⁷⁴ and also because new financiers will not want to be “taxed” by the claims of existing creditors.

The technique of granting priority in order to attract credit and capital market financing may be even more compelling in a sovereign than a corporate debt restructuring context. In both cases, access to funding is critical to economic rehabilitation: a financially troubled State will need “fresh working capital during restructuring, so that critical governmental functions don’t collapse.”¹⁷⁵ Without a priority, however, States could not obtain credit and capital market financing for the same reasons such financing would be unavailable in a corporate context: the information asymmetry between the State and potential financiers may be large—indeed, there may be even less transparency for sovereign debtors, which are not ordinarily subject to financial reporting and whose officials might not be held accountable under national law for providing misinformation—and new financiers will not want to be taxed by existing claims.¹⁷⁶ Financially troubled States therefore can presently look only to the IMF as lender of last resort, creating the taxation and moral hazard problems described earlier.¹⁷⁷

Shifting the source of funding from the IMF to private credit and capital markets would help to solve these problems. This shift to private markets would eliminate the need for taxpayers to pay for the funding and would avoid politicizing the decisions of when and to whom the IMF should make funding available.¹⁷⁸ The shift would also

174. Section 1125 of the Code attempts to address this problem for bankrupt companies by replacing the transparency requirement of the federal securities law with a more pragmatic standard of “adequate information,” which considers the type and detail of information that is “reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records.” *Id.* § 1125(a)(1).

175. Sachs, *supra* note 1, at 13.

176. See EICHENGREEN & PORTES, *supra* note 8, at 15 (arguing that granting a priority prevents under-investment and therefore “is desirable if the implications for moral hazard can be contained”).

177. See *supra* notes 27-53 and accompanying text (describing the moral hazard and taxation problems arising out of IMF funding). Despite these problems, I later argue that the IMF nonetheless should remain as a lender of last resort for fundamentally sound States that merely have liquidity problems. See *infra* notes 314-15 and accompanying text.

178. Professor Sachs additionally argues that this shift would enable States to remain in contact with the private markets, thereby enabling them to make a “rapid transition back to market borrowing once the panic had subsided,” and would impose “a market test on each loan . . . (albeit a weak test, since the new loans would be supported by the assignment of . . . priority over existing debts).” Sachs, *supra* note 1, at 12.

significantly reduce the problem of moral hazard.¹⁷⁹ Although the size of the credit and capital markets is large enough to accommodate the legitimate financing needs of restructuring States,¹⁸⁰ a State will have no assurance that private credit will be available. The risk of potential default will make the State more careful when obtaining credit, and arguably more disciplined in its economic planning. Existing creditors will face that same risk of default and will find their claims subordinated even if private credit is available. Therefore, those creditors will lend more carefully.

Furthermore, the shift to private markets could significantly shorten a State's time frame for obtaining credit. Private financiers can usually arrange credit within weeks, whereas the IMF can sometimes take months to arrange funding. As a result, "IMF loans are usually too little, too late[;] [b]y the time they arrive, the government may have lost control of the situation."¹⁸¹

In giving priority to the financiers of a sovereign debt restructuring, this framework potentially could adversely affect nonbankruptcy incentives by effectively subordinating the State's unsecured creditors. However, this potential drawback helps to reduce moral hazard, and no other adverse effects appear likely.¹⁸² Furthermore, the adverse effect on nonbankruptcy incentives should not be excessive. From the State's standpoint, granting priority should only mini-

179. An interesting inverse relationship exists between priority and moral hazard. Although granting priority to new lenders helps to ensure that the debtor-State can obtain funding, subordinating prior creditors to that funding increases the likelihood that, if the restructuring ultimately is unsuccessful, the prior creditors will suffer losses.

180. See, e.g., Moisés Naím, *Mexico's Larger Story*, 99 FOREIGN POL'Y 112, 122-23 (1995) ("Today, the magnitude of the funds controlled by private investment managers makes the volumes typically supplied by the IMF and the World Bank almost irrelevant."); Chun, *supra* note 54, at 2671 n.185 (observing that "the amount of money controlled by bondholders and mutual fund managers dwarfs a typical loan granted by the IMF").

181. Sachs, *supra* note 1, at 14; see also EICHENGREEN, *supra* note 166, at 61 & 61 n. 4 (arguing that "international assistance as currently constituted" cannot protect debtor-States from "serious damage," because "[a]ll too often, IMF-led rescues are ineffective in containing a panic because the Fund's resources are limited and doled out a drop at a time," and that "this is inevitably the case"); Sachs, *supra* note 1, at 13-14 (comparing the three weeks needed for Macy's Department Store to obtain funding in Chapter 11 with the year needed for Russia to obtain IMF funding).

182. Granting a priority appears neutral from the standpoint of collective action. Private lenders are less likely to demand collateral in a sovereign context than a corporate context because the amount of corporate assets available to pay creditors is fixed, see 11 U.S.C. § 726(a) (1994), whereas States have indefinite existence and taxing power and are therefore more likely to pay creditors in the long term. Because they are less likely to demand collateral, less need should exist for adjudicatory discretion in deciding if and when to grant it.

mally affect ex ante availability and cost of credit; this is because granting priority will not lower the State's debt rating,¹⁸³ and also because an IMF loan already has de facto priority over other claims.¹⁸⁴ My proposal only privatizes the source of the funding. From a creditor's standpoint, the adverse effect on nonbankruptcy incentives similarly will be minimal, at least on a relative basis, because current policy already de facto subordinates creditor claims to IMF loans. Even on an absolute basis, that effect may be minimal. I have argued that, in a corporate lending context, permitting debtors to grant priority to attract new money credit "tends to create value for unsecured creditors," even though those creditors' claims are subordinated to the new money.¹⁸⁵ The availability of new money credit increases a debtor's liquidity, thereby reducing its risk of failure and increasing the expected value of unsecured claims.¹⁸⁶ Likewise, permitting a debtor-State to grant priority in order to increase liquidity will reduce the risk of economic failure¹⁸⁷ to that extent.¹⁸⁸

Despite the advantages of new investment, new money credit could decrease value to unsecured creditors if overinvestment occurs.¹⁸⁹ In a corporate lending context, I have argued elsewhere that

183. See *infra* note 338 and accompanying text (referring to discussions with Standard & Poor's, a leading rating agency).

184. See EICHENGREEN & PORTES, *supra* note 8, at 24 (stating that the IMF is regarded as a preferred creditor).

185. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 425 (1997). Although this Article deals with secured lending priorities, its argument applies equally to any set of lending priorities that arise merely by operation of law.

186. See *id.* at 430. Without liquidity, the debtor-State cannot order crucial imports, purchase equipment, or continue with modernization. The effect can be similar to an economic boycott.

187. Although not dispositive, one can make an empirical argument for the beneficial effect of priority lending on a State's unsecured creditors by analogy to the response of trade creditors in a corporate context. Suppliers to bankrupt companies often refuse to extend trade credit until those companies enter into loan agreements with third parties, such as banks or finance companies, to enable them to borrow postpetition. See *id.* at 470-71. Those loan agreements are all made on a priority basis under Chapter 11 of the Code. See 11 U.S.C. § 364 (1994); Schwarcz, *supra* note 185, at 471. Once debtors obtain these lending commitments, suppliers generally re-extend trade credit to the debtor. See Schwarcz, *supra* note 185, at 471.

188. The extent to which liquidity will reduce the risk of a State's, as opposed to a corporation's, economic failure is unclear. Because there is likely to be a difference, I caution that one cannot simply apply the numerical analysis used in my earlier work to debtor-States. See Schwarcz, *supra* note 185.

189. In this context, overinvestment means that a debtor invests proceeds of the new money credit in a project that is less valuable than the proceeds. Cf. *id.* at 436 & n.45 (discussing how debtors can misuse loan proceeds). Scholars sometimes refer to overinvestment as "excessive investment." EICHENGREEN & PORTES, *supra* note 8, at 11. In contrast to overinvestment,

monitoring and inherent disincentives limit the risk of overinvestment.¹⁹⁰ Those disincentives would not apply in a sovereign or DIP financing context, however, because they arise out of imperfections in the corporate bankruptcy process¹⁹¹ that do not affect either of these situations.¹⁹² In a DIP financing context, therefore, the Code compensates by allowing creditors that are concerned about overinvestment to scrutinize and object to an excessive amount of DIP financing and, where appropriate, to monitor its use.¹⁹³

Unfortunately, creditors of a State have no similar mechanism to protect their rights. Creditors cannot rely on the new lender to protect their rights because the new lender's priority claim usually ensures repayment notwithstanding overinvestment. Therefore, in order to prevent overinvestment,¹⁹⁴ a sovereign debt restructuring scheme might utilize a neutral entity to scrutinize and object to excessive amounts of new priority financing and to monitor its use when appropriate.¹⁹⁵ The IMF, which is already "the central coordinating institution of sovereign debt,"¹⁹⁶ could potentially serve in this role.

underinvestment refers to a situation in which insufficient credit is available to permit investment in a valuable project. *See id.* For example, Professors Eichengreen and Portes observe that the United Kingdom receivership code, under which the equivalent of DIP lending priority is possible only with the permission of existing creditors, has been criticized for leading to underinvestment. *See id.*

190. *See* Schwarcz, *supra* note 185, at 436-40 (describing the benefits and limitations of monitoring); *id.* at 455-62 (examining disincentives). A rational corporate debtor is also economically motivated to avoid granting priority prematurely because of the costs associated with doing so. *See id.* at 446-49.

191. *See id.* at 456-58.

192. Those imperfections are irrelevant because sovereign debt restructuring is not governed by the Code, *see supra* notes 5-8 and accompanying text, and DIP financing is governed by special bankruptcy rules that transcend those imperfections, *see* Schwarcz, *supra* note 185, at 470-71 & nn.206-07.

193. *See* 11 U.S.C. §§ 364(c), 1109(b) (1994) (permitting DIP financing only after notice and a hearing, at which creditors have the right to appear and be heard). As a practical matter, however, creditors rarely object. *See infra* note 426 and accompanying text.

194. *Cf. infra* Part II.C (discussing further the IMF's potential role in implementing the rules proposed in this Article). The recent Russian experience has shown that even the IMF cannot absolutely protect against overinvestment or misuse of loan proceeds. If those problems occur, however, they should be no worse for loans made under the Convention than for loans from the IMF's own funds.

195. For example, a neutral entity could serve a monitoring role by imposing conditionality on disbursement of the financing. *See supra* notes 26-28 and accompanying text. My proposal enables the IMF to continue to impose conditionality as appropriate. Furthermore, if a State were to misuse loan proceeds or fail to comply with loan terms it could be in breach of the loan agreement, and thus in immediate default—a situation the State will want to avoid.

196. Chun, *supra* note 54, at 2692.

That neutral entity—here, the IMF—could most effectively perform the tasks of scrutiny and monitoring by acting under the Convention as an intermediary funding source. The IMF would borrow funds from the capital markets on a nonrecourse basis¹⁹⁷ and re-lend those funds to the debtor-State.¹⁹⁸ Simultaneously, the IMF would assign the debtor-State's priority loan to the capital market lenders as collateral. As a credit matter, the lenders thus would be in the same position as if they had made the loan directly to the State.¹⁹⁹

[INSERT DIAGRAM OF THIS STRUCTURE]

Although the IMF would continue to involve itself in the transaction, this intermediary funding approach would avoid many of the moral hazard and taxation problems presently associated with direct IMF funding. By acting solely as an intermediary, the IMF would reduce its dependence on taxation because loan funding would come from the capital markets,²⁰⁰ and not from the IMF's capital subscrip-

197. In the present context, the term nonrecourse means that “the obligation to repay borrowed money is secured by specific assets of the debtor [in this case, the IMF's right to repayment of the loan made to the debtor-State], but the [capital market] creditor does not have general recourse to the debtor's [i.e., the IMF's] remaining assets.” Schwarcz, *supra* note 185, at 462-63; see also BLACK'S LAW DICTIONARY 1057 (6th ed. 1990) (defining nonrecourse debt as “[d]ebt secured by the property that it is used to purchase”).

198. I will refer to this process as “nonrecourse back-to-back lending.”

199. The lenders are entitled to proceeds of the collateral—the debtor-State's promise to repay the IMF loan on a priority basis—but have no claim against the IMF or its assets. Structuring the loan in this manner entails slightly higher, but still relatively de minimis, transaction costs.

200. Capital market investors have widely accepted the use of nonrecourse financing, especially in the context of securitization, which is similar to the type of nonrecourse financing I propose. See Schwarcz, *supra* note 185, at 463 (discussing the “widespread use of non-recourse debt” in “project financing, securitization, and other forms of structured finance”). In a securitization, capital market investors advance funds to a “bankruptcy-remote” intermediary (the special purpose vehicle, or SPV), which simultaneously transfers the funds on a nonrecourse basis to a company (the originator). See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135-36 (1994). As consideration for the funds, the originator assigns its right to receive payments at future dates (receivables) to the SPV. See *id.* Because the investors' sole claim is against these receivables, they “are concerned only with the cash flows coming due on these receivables, and care little about the originator's financial condition.” *Id.* at 136. Nonrecourse financing using the IMF—an institution not subject to bankruptcy—as an intermediary is similar to securitization. Capital market investors would advance funds on a nonrecourse basis to the IMF, which represents the SPV because it is a bankruptcy-remote intermediary. However, the IMF also represents the originator because it originates the receivable—the debtor-State's obligation to repay the IMF loan—by simultaneously (1) lending the funds to the debtor-State to create the receivable, and then (2) assigning the receivable to the investors. Because their sole claim is against the receivable, the

tions.²⁰¹ By borrowing on a nonrecourse basis, the IMF would avoid liability for the debtor-State's potential default, thereby reducing moral hazard, because capital market lenders could look only to their collateral—the debtor-State's assigned loan—for repayment.²⁰² Moreover, the intermediary funding approach would enable the IMF to continue its current practice of imposing conditionality on funding.²⁰³ The IMF's role as intermediary would also be neutral from the standpoint of the other considerations discussed in this Article, and might even facilitate the administration of the debt restructuring.²⁰⁴

The only drawback to the intermediary funding approach is that the IMF would bear administrative costs for acting as an intermediary. The IMF could pay these costs out of its normal budget or it could require States that are parties to the Convention to ratably share these costs. Alternatively, the IMF could recoup these costs by charging a higher rate on the loan to the State than is payable to the capital market lenders,²⁰⁵ although the State would then be paying more interest than it would if borrowing directly from the capital markets. Because of these administrative costs, the intermediary approach may not be quite as efficient as facilitating direct debtor-State access to capital market funding. Nonetheless, the continuing in-

investors should care little about the IMF's financial condition. As a credit matter, the real difference between a securitization and this type of nonrecourse financing is that investors in the former will typically look to a statistically large number of receivables, *see id.* at 135, whereas investors in the latter would look to a single receivable due from the debtor-State. Nonetheless, the priority status of that receivable and the fact that its obligor is a sovereign State should compensate for that difference.

201. *Cf.* IMF FINANCING, *supra* note 30, at 9 (suggesting that the IMF consider alternative sources of funding, such as borrowing from the capital markets).

202. Thus, a State's ability to obtain capital market financing and the interest rate thereon would depend entirely on the credit of the State, not of the IMF.

203. For a discussion of the IMF's practice of imposing conditionality on its lending, see *supra* notes 31-32 and accompanying text. The IMF is well situated to impose conditionality; by agreeing to keep the information confidential, it maintains the most comprehensive financial information on its member-States. *See* International Monetary Fund, *Country Information* (visited March 26, 2000) <<http://www.imf.org/external/country/index.htm>>. This Article assumes that economic efficiency guides the IMF's imposition of conditionality. The extent to which such conditionality reflects political rather than economic considerations is a topic for further study.

204. *See supra* notes 34-35 and accompanying text.

205. Once the State repays those lenders, the IMF would be entitled to surplus collections constituting the interest differential. *See* U.C.C. § 9-608(a)(1)(A) (1998).

volvement of the IMF may make the intermediary approach more practical.²⁰⁶

Whether a State secures funding directly or through an intermediary, even unsecured creditors should want the State to have access to priority credit once a neutral entity undertakes to monitor and prevent overinvestment.²⁰⁷ Thus, the Convention should authorize a priority in order to attract financing from the credit and capital markets, while also mandating that a neutral entity such as the IMF scrutinize and object to an excessive amount of new priority financing, monitor its use as appropriate, and potentially act as a nonrecourse funding intermediary.²⁰⁸

Although one might argue that the priority need not be granted under supranational law, I believe that it should. First, a State that gives priority to particular lenders under its internal law could later change that law, creating uncertainty for lenders.²⁰⁹ A supranational law, however, could penalize States that grant and then attempt to reverse these priorities.²¹⁰ Second, giving priority to later creditors under a State's internal law might offend nonpriority creditors, thereby impairing that State's access to future private credit. In contrast, an

206. Some scholars have queried whether the IMF would need to co-lend in order to maintain its incentive to monitor. For example, the IMF might participate in 10% of each private market loan. Although co-lending is possible, it is unnecessary because the IMF already has a significant reputational stake in sovereign debt restructuring. Furthermore, co-lending has costs: it would (1) require financing from taxation, and (2) increase moral hazard to the extent that it reduces the amount private market sources must finance. *See supra* notes 27-28 and accompanying text.

207. *See supra* text accompanying notes 185-206; *see also infra* Part II.C (discussing implementation of these constraints).

208. Section 507(a)(1) of the Code similarly establishes priority for the actual, necessary costs and expenses of preserving the debtor's estate. *See* 11 U.S.C. §§ 507(a)(1), 503(b) (1994). I analogize the ability to grant this priority, which permits a State to obtain goods and services on credit, to the ability to grant priority in order to obtain lending credit. *See supra* note 187 and accompanying text. Therefore, the Convention might provide a priority for the actual and necessary costs and expenses of preserving the State.

209. Conceivably, a State might even mislead lenders by a bait-and-switch tactic—give priority in order to attract financing, and subsequently unilaterally reverse the priority.

210. For example, the Convention could subject a State that repudiates a priority granted under the Convention to a monetary penalty. That State would be subject to an additional reputational cost, including impairment of its future ability to borrow. If the IMF acts as a supervisory authority under the Convention, it also could take steps to enforce the priority in the same manner that it presently enforces obligations among its member-States, such as by using peer pressure, publicity, denial of membership benefits, and potentially even expulsion from membership. *See* Robert M. Barnett, *Exchange Rate Arrangements in The International Monetary Fund: The Fund As Lawgiver, Adviser, and Enforcer*, 7 TEMP. INT'L & COMP. L.J. 77, 89-93 (1993).

international convention would gain legitimacy through the very process of its adoption as well as the normative reasons advanced in support thereof.²¹¹

Granting the priority under supranational law in order to attract private funding will reduce moral hazard only if multinational governmental entities such as the IMF will allow the market to work, and avoid acting as de facto lenders of last resort. This goal is an independent good regardless of whether the Convention is ratified.²¹² Eliminating a multinational lender of last resort creates a risk, however, that even by offering priority, a State might sometimes be unable to obtain private market funding at any cost, thereby forcing the State into default. On balance, though, allowing default in those circumstances may be the best means of reducing moral hazard: “[T]he IMF approach is seriously flawed because . . . [it] wrongly assumes that a debt default or moratorium is unacceptable. The main problem with this [assumption] is that it creates moral hazard. . . . Prospective loss keeps the banks careful, and if that entails default by country debtors, so be it.”²¹³ Default can therefore have a positive long-term effect.²¹⁴ A defaulting State and its creditors may attempt to negotiate a restructuring plan,²¹⁵ but any consensual plan would require conces-

211. Cf. 1 JÜRGEN HABERMAS, *THE THEORY OF COMMUNICATIVE ACTION: REASON AND THE RATIONALIZATION OF SOCIETY* 264 (Thomas McCarthy trans., 1984) (arguing that the justification for legal norms derives from “principles whose validity could in turn be criticized”). Moreover, DIP financing and its priorities enjoy widespread legitimacy in the United States. See, e.g., SCARBERRY ET AL., *supra* note 13, at 204-14 (discussing the importance of DIP financing to a corporate reorganization).

212. To the extent IMF funding would not foster moral hazard, that funding should be able to co-exist with the private funding discussed in this Article. Cf. *infra* notes 224-31 and accompanying text (proposing that the IMF continue to offer liquidity in limited circumstances).

213. HAL S. SCOTT & PHILIP A. WELLONS, *INTERNATIONAL FINANCE* 1243 (5th ed. 1998).

214. Even the IMF now appears to prefer default to a bailout. See *Emerging Market Bonds, A Crash Course in Default*, EUROMONEY, Oct. 10, 1999, at 47, 50 [hereinafter *Emerging Market Bonds*] (noting that permitting default is a new approach by creditor-States and the IMF). Thus, the IMF suggested to Romania that it may have to renegotiate at least 80% of its eurobond payments falling due in May and June 1999 in order to obtain IMF funding. See *From Bail-Out to Bail-In*, ECONOMIST, Mar. 27, 1999, at 71, 71. But see Richard Waters, *Concern Over Emerging Market Rescue*, FIN. TIMES (LONDON), Apr. 14, 1999, at 4 (arguing against a bail-in policy); Deepak Gopinath, *Who's Afraid of the Big Bad Bail-In?*, INSTITUTIONAL INVESTOR, June 1, 1999, at 79, 79 (arguing that default could jeopardize a State's access to financial markets at a time when it most needs money); Belinda Rabano, *Tired After Asia, Russia and Brazil, Lenders Seek Private "Bail-Ins"*, ASIAN WALL ST. J., Sept. 27, 1999, at 25 (arguing that higher costs effectively could shut off access to international capital markets for States rated “B” or lower).

215. Perhaps this plan might implement the super-majority voting provisions of the Convention. See *infra* notes 287-93 and accompanying text.

sions on both sides. Consequently, the State may have to impose the austerity measures that it sought to avoid,²¹⁶ and its creditors might have to lower interest rates, extend maturities, or write-off some of their claims. These sacrifices would ultimately eliminate moral hazard; the State bears the cost of not having taken a prudent economic course, and its creditors bear the cost of having taken unwarranted financial risk.

Nonetheless, commentators have argued that default can “trigger failures of foreign banks,” and therefore must be avoided.²¹⁷ Whether or not that risk was once realistic, it is no longer a significant concern.²¹⁸ For example, in the recent Asian financial crisis, the loans from U.S. and Japanese banks to Korea represented merely six percent and nine percent of the capital of those banks respectively,²¹⁹ which is “small potatoes even assuming an extremely improbable default on all debt.”²²⁰ Even in the worst case scenario, when default is likely to trigger the failure of smaller, regional banks, the solution should not be to subsidize all banks but only those in need:

Even when one considers the problem as regional, the numbers are manageable. . . . In the worst case, the few foreign banks at serious risk could receive targeted support from their own central banks—it is foolish to funnel funds through debtor countries so all foreign banks get aid [whether or not they need it].²²¹

In the future, the risk of bank failure should diminish even further as bank loans are increasingly replaced by bonds.²²² The risk of States defaulting on their bonds does not create the same systemic risk as does the risk of bank failures.²²³

216. By the same token, States that are too poor even to attempt to impose austerity measures should continue to receive IMF (and World Bank) assistance because it would not increase moral hazard. Thus, the Convention should not restrict such programs as the World Bank’s Heavily Indebted Poor Country (HIPC) Debt Initiative which gives debt relief to “poor countries with good policy performance,” such as Bolivia, Guyana, Mozambique, and Uganda. See *The HIPC Debt Initiative* (visited Jan. 18, 2000) <<http://www.worldbank.org/hipc/about/hipcbr/hipcbr.htm>> (describing this program).

217. SCOTT & WELLONS, *supra* note 213, at 1244.

218. *See id.*

219. *See id.*

220. *Id.*

221. *Id.*

222. *See infra* notes 280-81 and accompanying text.

223. For example, bond market investment is not regulated, whereas bank investment is heavily regulated. See, e.g., JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 73-85 (2d ed. 1997) (asserting that banks are among the most regulated industries and discussing the basic rationales for bank regulation).

Nonetheless, the balance between default and moral hazard might shift when the debtor-State has been economically and financially prudent, and the factors causing default are largely exogenous. In that case, IMF funding would not foster moral hazard. Whether the IMF or other nonmarket entities should provide funding in these circumstances depends on political considerations,²²⁴ as well as the ability of administrators to assess whether a given default is caused by exogenous or endogenous factors.²²⁵

Although this assessment sometimes may be difficult, the IMF or some other multilateral entity almost certainly should consider acting as a lender of last resort when a default would result from irrational exogenous factors, such as a financial panic, even though the State is economically sound.²²⁶ IMF funding then would not foster moral hazard,²²⁷ and the debtor-State should be able to repay the IMF when the panic subsides.²²⁸ The IMF would merely provide a form of temporary “liquidity,”²²⁹ and would not assume a credit risk that a State taking

224. For example, political considerations might enter the IMF funding decision if a State allocates significant resources to social programs which it cannot objectively afford, and consequently faces default.

225. In comparison, the Code, which presumes that corporate bankruptcies generally result from exogenous factors, relies solely on private-market funding and does not contemplate governmental funding.

226. The Mexican financial crisis of 1994-1995 exemplifies such a liquidity crisis to some extent. Because of market volatility, Mexico was unable to roll over its \$28 billion in short-term bonds and—with only \$6 billion in foreign reserves—was unable to pay those bonds. See Eichengreen, *supra* note 165, at 57. Some commentators argue that Mexico was healthy, but for the market volatility. See Chun, *supra* note 54, at 2656, 2659, 2664-65 (arguing that the 1994-95 Mexican crisis was one of liquidity rather than solvency, in contrast to the Mexican financial crisis in 1982).

227. Critics nonetheless might argue that even liquidity funding fosters moral hazard. See, e.g., U.S. GEN. ACCOUNTING OFFICE, INTERNATIONAL FINANCIAL CRISIS—EFFORTS TO ANTICIPATE, AVOID, AND RESOLVE SOVEREIGN CRISES (1997) (GAO/NSIAD/GGD 97-168); Naim, *supra* note 180, at 128 (arguing that the 1994-95 “Mexican bailout sent the wrong signal to governments and investors . . . that the potential losses of private investors eventually could be absorbed by governments and multilateral financial institutions, thus blurring the principle that both governments and investors should enter the game of portfolio investments at their own risk”).

228. See SCOTT & WELLONS, *supra* note 213, at 1244 (“[I]f . . . the contagion were irrational (like a bank run panic), the IMF should lend funds as international lender of last resort. Once the runs stopped, the loans could be repaid.”).

229. The IMF’s organizers originally envisioned this role at Bretton Woods in 1944. See Chun, *supra* note 54, at 2696-97. The IMF already may be offering this type of liquidity: “[A]s of April [1999], the Fund instituted so-called contingent credit lines. The idea is to provide financing for up to a year to countries that have sound economic fundamentals but are faced with a sudden loss of confidence in the markets.” Laura Cohn & David Fairlamb, *Will the IMF Get a Dose of Its Own Medicine?*, BUS. WK., Oct. 4, 1999, at 36, 37.

prudent fiscal measures²³⁰ would have been able to avoid.²³¹ Moreover, liquidity would help solve the so-called multiple equilibrium problem that Sachs identified: the value of assets in financial markets often depends on market expectations, which in turn depend on asset values.²³² For example, if depositors have confidence in the ability of a bank to repay their deposits, they will keep their money on deposit, and accordingly the bank will repay those deposits in the normal course. But depositors who suspect that others are about to withdraw their money may panic and attempt to withdraw their money first. The result is a bank run, which can create problems even for healthy and solvent banks. The same problem could arise in a sovereign context:

Assume a government which can maintain service on its debts as long as its creditors renew their maturing obligations. In the absence of expectations of substantial redemptions, each creditor is willing to renew maturing obligations. But if the number of creditors refusing to roll over their maturing obligations reaches a critical threshold, the government will lack the resources needed to redeem them and also maintain service on its other debts. In this setting a run on the debt can be self-fulfilling.²³³

Liquidity would assure investors that fundamentally healthy States will be able to forestall this type of response *ab initio*.

Finally, I recognize that leaving the funding decision to the markets removes that decision from the foreign relations arena, a result that may or may not be politically acceptable. The ultimate balance of

230. Thus, a State that incurs short-term debt without regard to the source of repayment should not be entitled to liquidity if a default on such debt is primarily endogenous—the result of imprudent financial management. *Cf.* Canova, *supra* note 165, at 1622-29 (arguing that a grab race for emergency liquidity by short-term creditors can be avoided by restricting the issuance of short-term debt).

231. This distinction between liquidity and credit enhancement is well established in the capital markets. For example, a rating agency, such as Standard & Poor's or Moody's, usually will not provide a rating on short-term debt securities unless creditworthy third parties, such as banks, ensure timely payment. *See* Schwarcz, *supra* note 200, at 140. Those third parties, however, do not expect to suffer losses. They only provide liquidity to creditworthy companies, and therefore expect repayment as soon as the company receives the cash that it would otherwise use to pay the securities. *See id.* This minimal risk is reflected in the fee that third parties charge for providing liquidity, which is typically much lower than the fee that would be charged for credit enhancement.

232. *See* Sachs, *supra* note 1, at 3-6.

233. EICHENGREEN & PORTES, *supra* note 8, at 16-17. Eichengreen and Portes explain that even if all creditors would be better off by rolling over their maturing debt, the suspicion that some creditors will redeem their debt may cause other creditors to seek repayment first. *See id.*

political and economic interests, however, is beyond the scope of this Article.²³⁴

Executory Contracts: Section 365 of the Code permits a debtor in bankruptcy to assume or reject certain executory contracts and leases, subject to court approval.²³⁵ This provision fosters debtor rehabilitation by allowing the debtor to choose between continued performance of beneficial contracts and termination of burdensome contracts.²³⁶ In the latter case, a debtor that rejects the contract or lease is deemed to breach that contract as of the date immediately preceding the bankruptcy petition.²³⁷ Accordingly, any claim arising out of the breach is treated as a prepetition, and therefore nonpriority, claim, which is *pari passu* with other prepetition claims against the debtor.²³⁸ The debtor may thus be able to settle that prepetition claim for a fraction of its face amount.²³⁹

These rights are likely to be less important in a sovereign than a corporate debt restructuring context. The first right—to elect to continue performance of beneficial contracts—is unnecessary in a sovereign context because nothing in the Convention would restrict a debtor-State from continuing to perform its contracts. The second right—to elect to terminate burdensome contracts—is also unnecessary. If a debtor-State wishes to terminate a contract, it may do so according to standard international contract law doctrine: any party to a

234. For example, the IMF, an inherently political body, might decide to provide loans—were private-market funding unavailable—to an economically imprudent State with a large nuclear arsenal in order to preserve the political stability of the State. Also, States sometimes might decide to act as lenders of last resort to States that are strategic partners. See EICHENGREEN, *supra* note 166, at 60 (observing that the “rationale for the [1997] South Korean [loan] package [led by the United States and the IMF], in security circles at least, was that the Korean Peninsula is too important geopolitically for [its] economy to be left unaided”).

235. See 11 U.S.C. § 365(a) (1994). A contract is executory where the “obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

236. See David S. Kupetz, *The Bankruptcy Code Is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 BUS. LAW. 55, 61 (1998).

237. See 11 U.S.C. § 365(g)(1).

238. See *id.* (assuming such other claims are unsecured); see also 11 U.S.C. § 726(a) (describing the order of distribution of claims).

239. “[I]n the United States, general unsecured creditors can expect to receive nothing in bankruptcy 80% of the time and an average of 4-5 cents on the dollar 20% of the time.” Schwarcz, *supra* note 185, at 455 n.130 (quoting Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 886 n.107 (1996)).

contract may breach the contract.²⁴⁰ The breaching party simply assumes liability on a nonpriority basis for damages caused by the breach.²⁴¹ Because the Convention does not give priority to such a claim for breach, a debtor-State's liability for contract breach would be *pari passu* with other nonpriority claims against the State. This mirrors the result under § 365, whereby a corporate debtor's liability for contract breach would be *pari passu* with other nonpriority claims against the corporation. Thus, § 365's primary benefit to a corporate debtor—the ability to terminate a burdensome contract without incurring a priority claim—is unnecessary in a sovereign context.²⁴²

Discharge: Sections 524, 727, and 1141 of the Code address the discharge, or nullification, of a corporation's debts.²⁴³ Corporate debtors that are liquidated are not discharged from their debts.²⁴⁴ The rationale for disallowing discharge is that the corporate form is artificial, and hence assets should be re-applied to their highest uses.²⁴⁵ The Code discharges reorganized corporate debtors, however, from debts that are not provided for in the plan of reorganization.²⁴⁶ The rationale is that “the debtor corporation . . . may continue in business after confirmation of the plan. If its debts were not discharged, typi-

240. See, e.g., PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS Art. 7.1.1 (UNIDROIT 1994) [hereinafter PRINCIPLES] (defining non-performance); OSCAR SCHACHTER, INTERNATIONAL LAW IN THEORY AND PRACTICE 311 (1991) (“It can now be said that it is widely agreed that a breach of a contract by a State in itself is not a violation of international law. . . . A private party does not obtain remedies on the international law level against a State that has breached the contract.”); cf. RESTATEMENT (SECOND) OF CONTRACTS § 235 (1981) [hereinafter RESTATEMENT] (setting forth the general principle of breach upon non-performance of a contract).

241. See PRINCIPLES, *supra* note 240, at Art. 7.4.1; see also RESTATEMENT, *supra* note 240, § 346 (describing the same right to damages).

242. From the standpoint of the framework I use to test the neutrality of other Code sections, the right to assume or reject executory contracts does not affect the outcome of the analysis, and therefore is generally neutral. This right could, however, marginally increase the need for judicial discretion. See *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 1993) (observing that “[i]n reviewing a trustee’s or debtor-in-possession’s decision to assume an executory contract . . . a bankruptcy court sits as an overseer of the wisdom with which the bankruptcy estate’s property is being managed by the trustee or debtor-in-possession”); Warren, *supra* note 115, at 352 (noting the discretion of bankruptcy courts to decide whether to permit a debtor to assume executory contracts).

243. See 11 U.S.C. §§ 524, 727, 1141 (1994).

244. See *id.* § 727(a)(1) (prohibiting discharge of non-individual debtors in liquidation).

245. See, e.g., Douglas G. Baird, *A World Without Bankruptcy*, LAW & CONTEMP. PROBS., Spring 1987, at 173, 182-83.

246. See 11 U.S.C. § 1141(d) (discharging only those debts not provided for in the plan of reorganization).

cally it would immediately be in financial distress.”²⁴⁷ For the same reason, the Code discharges municipal governments from all debts except those provided for in the plan of reorganization.²⁴⁸

By analogy, a sovereign debt restructuring plan should discharge a reorganizing debtor-State, which does not liquidate, from debts that are not provided for in its plan of reorganization. Discharge would be neutral from the standpoints of collective action and taxation. Although it might increase a State’s moral hazard by excusing repayment under certain circumstances, to some extent that increase would be offset by the decrease in creditor moral hazard. Discharge, however, could have a significant effect on a State’s economic rehabilitation, to the extent it permits a State that is greatly overburdened with debt to attempt to cancel at least a portion of those debts.

The arguments against discharge appear to be minor. It might seem that a process of discharge would require an arbiter to exercise discretion,²⁴⁹ but that discretion arises primarily in the case of an individual debtor, not a corporate or municipal one.²⁵⁰ Also, it might seem that discharge would radically undermine nonbankruptcy incentives of creditors. Those creditors would be protected, however, by the requirement of super-majority voting by classes of claims, which I later show gives veto power to each voting class, thereby preventing a State from devising a plan to harm creditors.²⁵¹ The same rationale justifies corporate discharge:

Where the plan does not provide for creditors to be paid 100% of their claims, creditors may initially think that it is unfair for the chapter 11 debtor to receive a discharge of prepetition debts. However, creditors can require that all of the value of the debtor’s assets be distributed to them by voting against the plan; if a class of unse-

247. SCARBERRY ET AL., *supra* note 13, at 956.

248. See 11 U.S.C. § 944(b), (c). Section 901(a) also makes § 524(a)(1) and (a)(2) applicable to municipal bankruptcies by reference. There is a technical difference between corporate discharge and municipal discharge: The former binds all creditors, whereas the latter does not bind creditors that “had neither notice nor actual knowledge of the [bankruptcy] case.” *Id.* § 944(c)(2). This Article expresses no view as to which result should apply to the discharge of debtor-States.

249. The questions of whether a debtor should apply its assets to payment of creditor claims before discharge and, if so, which assets should be applied, can be controversial. See, e.g., 11 U.S.C. §§ 522, 523 (listing exemptions and exceptions to discharge).

250. See *id.* § 522(b) (restricting exemptions to individual debtors); § 523(a) (restricting exceptions to discharge to individual debtors).

251. See *infra* notes 274-93 and accompanying text (discussing super-majority voting by classes of claims).

cured claims does not accept the plan, then . . . the plan cannot be confirmed²⁵²

Indeed, from this perspective, one can view discharge as a corollary of the super-majority voting requirement: there would be no need for this voting requirement if creditors were paid in full.²⁵³

The Convention therefore should discharge debts not provided for in an approved plan.²⁵⁴ This limited discharge would not, however, restrict programs such as the World Bank's HIPC Debt Initiative which gives general debt relief to the poorest countries.²⁵⁵

Avoiding Powers: Sections 547 and 549 of the Code address the avoidance of preferential payments and other transfers under certain circumstances.²⁵⁶ Should preferential payments by debtor-States also be subject to avoidance? To analyze this question, one must distinguish between payments made prior to the filing of a bankruptcy petition (prepetition payments), which are governed by § 547,²⁵⁷ and payments made after filing (postpetition payments), which are governed by § 549.²⁵⁸

The avoidance of *prepetition* preferential payments would be neutral from the standpoint of taxation, and would marginally reduce creditor moral hazard and collective action by reducing the chance that a creditor could keep any prepetition payments. On the other hand, avoidance would marginally impair economic rehabilitation by reducing the likelihood that a State's suppliers of goods and services will extend trade credit.²⁵⁹ It would also increase the need for an arbi-

252. SCARBERRY ET AL., *supra* note 13, at 956.

253. *Compare* 11 U.S.C. § 1126(f) (deeming creditors who are paid in full under a plan to have accepted the plan).

254. *Compare* Kordana, *supra* note 4, at 1038-39, 1090, 1096-99 (favoring discharge of bankrupt municipalities on the basis that investors are wealthier than average municipal citizens and are able to diversify their investments).

255. *See supra* note 216 and accompanying text.

256. *See* 11 U.S.C. §§ 547, 549. Section 547(b)(4)(A) avoids payments or other transfers made by an insolvent debtor filing within 90 days prior to filing for bankruptcy, to the extent that such payments enable a creditor to receive more than it would be entitled to in the event of the debtor's liquidation. Section 549 is designed to avoid unauthorized payments or other transfers the debtor made while in bankruptcy.

257. *See* 11 U.S.C. § 547(b)(4)(A).

258. *See id.* § 549(a)(1).

259. To address this concern, § 547(c)(2) of the Code provides that preferential pre-petition payments made to corporate debtors in the ordinary course of business, and on ordinary business terms, cannot be avoided. *See id.* § 547(c)(2). This exception, however, is the subject of much litigation. *See, e.g.,* Jeff Bohm & David B. Young, *Preferences and Fraudulent Transfers: A Lender's Perspective*, in 2 18TH ANNUAL CURRENT DEVELOPMENTS IN

ter to exercise discretion when deciding which prepetition payments to avoid, and it would impair nonbankruptcy incentives by making creditors uncertain about whether they can retain prepetition payments. Moreover, from a policy standpoint, the need to avoid preferential payments appears less significant in a sovereign than in a corporate context. The vast majority of corporate debtors in bankruptcy are liquidated,²⁶⁰ in which case unpaid creditors remain unpaid. However, sovereign States are not liquidated, and therefore a State is more likely to repay its creditors over time.²⁶¹ The Code implicitly recognizes that ultimate repayment of creditors should excuse avoidance of an otherwise preferential payment.²⁶² I therefore propose that the Convention need not avoid prepetition preferential payments.

The avoidance of *postpetition* preferential payments²⁶³ would be neutral from the standpoints of moral hazard and taxation, and would have no effect on nonbankruptcy incentives. It would marginally reduce the postpetition collective action problem by discouraging creditors from attempting to gain an advantage over other creditors. To that extent, however, such avoidance would marginally impair economic rehabilitation by preventing a debtor-State from using a divide-and-conquer tactic of paying creditors that agree to the State's restructuring conditions. Furthermore, it would increase the need for an arbiter to exercise discretion when deciding which postpetition

BANKRUPTCY AND REORGANIZATION 95, 142 (PLI Com. L. & Practice Course Handbook Series No. A-737, 1996) ("One of the most frequently litigated defenses to a preference action is the ordinary course of business exception established by 11 U.S.C. § 547(c)(2)."). Therefore, its adoption would significantly increase the need to exercise adjudicatory discretion.

260. See CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 2 (1997).

261. Because the Convention permits discharge, there is no assurance that a State's creditors always will be repaid. Any discount on payment will be subject, however, to super-majority voting of the State's creditors. See *infra* notes 274-93 and accompanying text. Thus, creditors always will be repaid unless they *voluntarily* agree, voting on a class by class basis, to a discount. (The foregoing result assumes that any securities exchanged for debt as part of a restructuring plan yield their anticipated value. I also recognize that some States could refuse to pay their debts indefinitely, see, e.g., Robert Plehn, *Securitization of Third World Debt*, 23 INT'L LAW. 161, 180 n.92 (1989) (referring to defaults by successor governments on bonds issued by Czarist Russia and pre-revolutionary China), and that unless repayment includes accrued interest, creditors would lose the time value of their money. Those cases, however, are the "rare exceptions." See *supra* note 4.)

262. See 11 U.S.C. § 547(b)(3) (allowing a solvent debtor to make preferential payments).

263. Technically, § 549 permits a debtor to avoid any unauthorized postpetition payment, whether or not that payment is preferential. See *id.* § 549. The real goal of that section, however, appears to be to avoid preferential or fraudulent postpetition transfers. Cf. 5 COLLIER, *supra* note 151, ¶ 549.02, at 549-4 (stating that the section's purpose is to allow avoidance of transfers that would deplete the estate).

payments to avoid.²⁶⁴ One can argue that avoiding postpetition preferential payments enhances economic rehabilitation by preventing a debtor-State from using the proceeds of priority new money credit to repay existing creditors, thereby preventing the transfer of wealth to those creditors at the cost of reducing the debtor-State's liquidity.²⁶⁵ However, a rational debtor-State would not choose to squander its liquidity by repaying existing creditors.²⁶⁶ Finally, from a policy standpoint, sovereign debtors are more likely than corporate debtors to repay creditors,²⁶⁷ again making avoidance of postpetition preferential payments less important in a sovereign than a corporate context. I therefore conclude that the Convention need not avoid either pre- or postpetition preferential payments.

Creditors' Committees: Section 1102 of the Code authorizes the appointment of at least one committee of creditors holding unsecured claims that are "representative of the different kinds of claims to be represented."²⁶⁸ The costs and expenses of committee members are paid from the debtor's estate.²⁶⁹ The committees' purpose is to make the representation of creditors in the reorganization process economically feasible, because few creditors would have claims large enough to justify the cost of participating on an individual basis.²⁷⁰

264. See, e.g., 5 COLLIER, *supra* note 151, ¶ 549.05, at 549-11 (discussing protection of postpetition transfers).

265. See *supra* notes 182-99 and accompanying text (discussing the importance of priority new money credit).

266. Although a State might repay creditors if doing so would enable the State to meet its remaining commitments over the long term and thereby avoid a liquidity crisis—a strategy that itself can enhance the State's economic rehabilitation. Reputational concerns about the reaction of the unpaid creditors should similarly influence the State to avoid selective repayment of existing creditors. The fact that debtor-States sometimes use the proceeds of IMF loans to repay existing creditors does not undermine my argument, because future application of the Convention would significantly reduce the moral hazard that has encouraged such repayment.

267. See *supra* notes 260-61 and accompanying text (observing that the vast majority of corporate debtors in bankruptcy are liquidated, in which case unpaid creditors will remain unpaid; whereas sovereign States are not liquidated, and therefore creditors are more likely to be repaid over time).

268. 11 U.S.C. § 1102(b)(7) (1994). The committee does not include secured creditors because their claims are not at risk to the same extent as are unsecured claims.

269. See *id.* § 503(b)(3)(F) (providing for payment of the actual and necessary expenses, other than compensation, that committee members incur in the performance of the committee's duties).

270. Because of this role, the committee has the right to retain the expertise of attorneys, accountants, or other agents such as investment bankers. See *id.* § 1103(a). These experts' costs are paid from the debtor's estate. See *id.* § 328(a).

Official creditors' committees do not appear to be necessary in sovereign debt restructuring cases. Although the appointment of a committee would be neutral from the standpoints of collective action, moral hazard, and taxation, and might even foster economic rehabilitation by institutionalizing creditor involvement in the reorganization, the appointment of committees would affect nonbankruptcy incentives by increasing administration costs, perhaps significantly.²⁷¹ Moreover, official committees appear unnecessary because the claims against a State are so large that many creditors, or at least a de facto committee of creditors chosen consensually, should find it economically feasible to participate in the restructuring process.²⁷² Thus, the Convention does not provide for the formal appointment of committees.²⁷³

Super-Majority Voting: Sections 1123, 1126, and 1129 of the Code govern the contents, acceptance, and court confirmation of the

271. The debtor typically pays these costs in priority to creditors' claims. See *id.* §507(a) (granting priority to such claims over general unsecured claims).

272. Moreover, as a practical matter, "out of pocket expenses of [these creditor] advisory group[s] are frequently paid by the debtor[-State]." Mudge, *supra* note 2, at 65. Another reason not to appoint a formal committee is to avoid the need for adjudicatory discretion in administering the appointment of the committee and in monitoring the reasonableness of their ongoing costs and expenses. *But see* EICHENGREEN & PORTES, *supra* note 8, at 48 (arguing in favor of formal bondholders' representative committees on the basis that "a confusing proliferation of committees can spring up in the absence of official accreditation").

273. Professor Eichengreen argues, however, that "[e]stablishing a standing committee of representatives from the various classes of creditors—bondholders, banks and other institutional investors—that meets regularly with [sovereign] borrowers would open lines of communication and help overcome information problems." Eichengreen, *supra* note 165, at 69. His argument recognizes that the "shift from bank to bond finance," which I have already observed, will make it harder for creditors to coordinate their efforts. *Id.* at 70. Historically, "standing committees of creditors were precisely the channel for disseminating information and for organizing negotiations the last time bond financing was important, from the late nineteenth century through World War II." *Id.* I do not reject out of hand the potential need for these committees, because future circumstances might warrant them. If so, however, there would appear to be greater flexibility in creating standing committees under national, as opposed to international, law (the Convention being the latter). Bondholders of a particular State could be represented by a standing bondholder committee consisting of representative investors from that State. States such as the United States, in which large numbers of institutional investors reside, might want to create a standing bondholder committee. Consequently, those States would bear the committee's cost (or pass that cost on to the protected investors); States that do not have a significant number of institutional investors would bear no cost. In fact, that is precisely what occurred during the period of time which Professor Eichengreen describes. See *id.* at 70-71 (describing the Corporation of Foreign Bondholders created under the law of Great Britain in 1868 and the Foreign Bondholders Protective Council similarly created under U.S. law).

debtor's reorganization plan.²⁷⁴ Its analogy in the context of present-day sovereign debt restructuring is the de facto workout plan between the State and its creditors. There is, however, a very significant difference between these approaches.

Section 1126(c) provides for a form of super-majority voting that supersedes contractual or statutory voting restrictions. For example, large loans are often made by groups, or syndicates, of institutional lenders such as banks or insurance companies.²⁷⁵ These loan agreements typically require unanimous consent of the lenders in order to alter essential lending terms such as the amount of principal, the rate of interest, or the maturity schedule.²⁷⁶ Section 1126(c) overcomes this collective action problem by providing that an affirmative vote by creditors holding "at least two-thirds in amount and more than one-half in number" of the claims binds *all* creditors—even those who vote negatively or failed to vote.²⁷⁷ In contrast, sovereign debt restructurings that change essential lending terms still require unanimous creditor approval,²⁷⁸ which is difficult and sometimes impossible to achieve. Therefore, "efforts [by States] to organize significant concessions by [creditors] have foundered on the notorious free-rider problem."²⁷⁹

274. 11 U.S.C. §§ 1123, 1126, 1129.

275. See Joseph J. Norton, *International Syndicated Lending: The Legal Context for Economic Development in Latin America*, NAFTA: L. & BUS. REV. AM., Summer 1996, at 21, 21-24.

276. See EICHENGREEN & PORTES, *supra* note 8, at 26.

277. 11 U.S.C. § 1126(c); cf. TABB, *supra* note 260, at 7 (observing that "[o]ne primary reason that workouts do not succeed [outside of bankruptcy] is that dissenting creditors cannot be bound to the restructuring agreement").

278. Although a debtor-State could theoretically attempt to settle with creditors individually notwithstanding their contractual protection of unanimity, that settlement would not bind other creditors, who could then sue the State on the original claims. See *infra* note 430 (discussing *Allied Bank Int'l v. Banco Credito Agricola*, 757 F.2d 516 (2d Cir. 1985), in which a member of a bank syndicate that refused to join a restructuring agreement that a debtor-State proposed, successfully sued for repayment of its defaulted loan). The right of such holdout creditors to recover their original claims could undermine the willingness of other creditors to settle their claims. Also, if the State must grant significant concessions to induce the settlement, it may only want to settle on an overall basis.

279. Cohen, *supra* note 4, at 110; see also Miller & Zhang, *supra* note 36, at 18-20 (arguing that the lack of an orderly procedure for resolving sovereign liquidity crises de facto forces the IMF to bail out troubled States). The existence of a few holdouts with relatively small claims should not sabotage a sovereign debt restructuring. If other creditors are willing to agree to the restructuring, a State could choose to structure a deal around the holdouts and simply let them sue. However, that approach is inefficient because it fails to achieve an overall settlement. Even more troublesome is that bond issues increasingly dominate a State's borrowings, and their

In recent years, this problem has become even more intractable. Whereas sovereign debt restructurings in the 1980s and early 1990s primarily involved bank debt, the advent of Brady Bonds²⁸⁰ in the mid-1990s began a trend in which States obtained financing through the public issuance of bonds in the lower-cost capital markets.²⁸¹ Bondholders that invest in a particular State tend to have smaller individual investments and therefore are more numerous than banks that lend to the same State.²⁸² Bondholders are also less likely than banks to agree to any accommodations in order to maintain a commercial relationship with the State.²⁸³ Moreover, because bonds are actively traded, the identity of bondholders constantly changes.²⁸⁴ These characteristics of sovereign debt restructuring make the re-

unanimity requirement makes them almost impossible to restructure. *See infra* notes 280-86 and accompanying text.

280. Debtor-States have issued Brady bonds in connection with U.S. plans for sovereign debt reduction. These plans encourage banks to exchange their debt claims for lower amount (usually below-market interest), 30-year U.S. dollar-denominated bonds (“Brady Bonds”) issued by the debtor-State. Usually, the bonds are secured by 30-year U.S. Treasury securities that the debtor-State purchases, using the proceeds of IMF loans. Banks relying on this collateral typically do not need to write off the principal amount of their investments. Because Brady Bonds are tradeable securities, banks often choose to sell them to other investors, thereby reducing their sovereign debt exposure. *See Macmillan, supra* note 16, at 313-15.

281. *See Chun, supra* note 54, at 2664 (“In the 1990s, large volumes of highly mobile international bonds and portfolio investment replaced relatively stable syndicated bank loans to developing economies.” (footnotes omitted)). For example, *Business Week* reported that during the period from mid-March to mid-April 1999, Mexico and Argentina each issued \$1 billion in bonds, and Panama issued \$500 million; moreover, Brazil may be about to issue an additional \$1 billion of bonds. *See Ian Katz & Geri Smith, The Latins Are Back in the Game, BUS. WK., Apr. 26, 1999, at 54, 54. See generally Power, supra* note 25, at 2702-03 (describing the sovereign debt crisis in Latin America).

282. *See Ruth Rosauer, Emerging Market Debt Instruments Play Siren Song for Pension Plans, 7 MINN. J. GLOBAL TRADE 211, 225 & n.123 (1998).* Bondholders will therefore find it much more difficult, if not impossible, to achieve the type of creditor solidarity that banks have sometimes achieved. *See Robert Gertner & David Scharfstein, A Theory of Workouts and the Effects of Reorganization Law, 46 J. FIN. 1189, 1193 (1991)* (observing that “bank debt restructurings . . . are substantially easier to organize than public debt [i.e., bond] restructurings”); *see also Power, supra* note 25, at 2711-12 & n.44 (detailing the number of banks involved in the Mexican and Brazilian debt restructurings).

283. *See, e.g., Neela Banerjee, Russian Arrears Deepening On Debts to Foreign Group, N.Y. TIMES, June 1, 1999, at C3* (discussing the conflict of interest between investors, who increasingly want to vote to accelerate the debt, and bank lenders, who “want future business with Russia” and therefore “may be unwilling to pressure the Government on the [debt] arrears”).

284. *See, e.g., Enrique R. Carrasco & Randall Thomas, Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis, 34 COLUM. J. TRANSNAT'L L. 539, 542 n.3 (1996)* (noting the highly volatile nature of portfolio investments).

quired unanimous bondholder consent much more difficult to obtain.²⁸⁵ Solving the collective action problem is therefore essential to successful sovereign debt restructuring.²⁸⁶

Super-majority voting can solve this problem. This voting scheme is neutral from the standpoints of moral hazard and taxation. To the extent that it permits a debtor-State and its creditors to agree more rationally on a settlement of claims, this voting technique fosters economic rehabilitation. It might also be applied without exercising adjudicatory discretion. The only potential drawback under the framework is that super-majority voting would affect nonbankruptcy incentives by modifying voting procedures that require unanimity. However, that impact should be economically insignificant if, as under the Code, the super-majority voting is done by classes of claims that are “substantially similar to the other claims . . . of such class.”²⁸⁷ The presumption is that a vote by holders of the requisite super-majority that benefit their claims will also benefit holders of substantially similar claims.²⁸⁸ Thus, the Convention might provide for super-majority voting that binds all parties.²⁸⁹

285. See Trust Indenture Act of 1939, § 316(b) (codified as amended at 15 U.S.C. § 77ppp(b) (1994)) (requiring consent of holder of indenture security for changes in payment terms); see also Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250-51 (1987) (discussing the prohibition of “modification by majority action of any core term of the bond”). Bondholders who are not institutional investors may also be more willing than banks (which maintain ongoing institutional relationships with each other) to hold out for a special deal. *But cf.* PAUL L. DAVIES, *GOWER’S PRINCIPLES OF MODERN COMPANY LAW* 733 (6th ed. 1997) (noting that an issuance of bonds under the law of the United Kingdom may provide for “the variation of the holder’s rights with the consent of a prescribed majority of the holders or an extraordinary resolution of the holders”). Thus, issuing bonds under U.K. law could mitigate the collective action problem.

286. The collective action problem renders the imposition of comparability on bondholders so difficult that it has not even been attempted until recently. The first effort was an ultimatum in February 1999 by the Paris Club, requiring Pakistan to renegotiate \$620 million in Eurobonds as part of any agreement to reschedule their \$3.3 billion of debt owed to creditor States. See Gopinath, *supra* note 214, at 79. Ultimatums, however, are likely to lead to default, as exemplified by Ecuador’s September 28, 1999 default on its Brady Bonds. See *Emerging Market Bonds*, *supra* note 214, at 47.

287. 11 U.S.C. § 1122(a) (1994); see also *id.* § 1126(c) (requiring voting by classes of claims).

288. *Cf.* Barbara J. Houser et al., *Plan Issues: Classification, Impairment, Subordination Agreements*, in CHAPTER 11 BUSINESS REORGANIZATIONS 317, 328 (ALI-ABA Course of Study Materials S024, 1998) (noting that the proper classification of claims ensures that voting on the plan will result in an equitable distribution among creditors).

289. Compare *infra* notes 347-48 and accompanying text (showing why recent proposals to institute super-majority voting by contract, as opposed to international convention, are unlikely to be successful).

A discussion of how the Convention should divide claims into classes for super-majority voting purposes is beyond the scope of this Article. I simply note here that courts have interpreted substantial similarity under the Code to mean that claims have the same priority in bankruptcy,²⁹⁰ and in a sovereign debt context all unsecured claims appear to have the same priority.²⁹¹ Nonetheless, the Code does not require that all claims of the same priority be classed together; it merely prohibits claims from being classed together unless they have the same priority.²⁹² Thus, *pari passu* claims could be classed separately if there was a rationale for separate classification. If the Convention followed a similar approach, each claim of a State or multilateral agency could have its own classification. Additionally, private foreign creditors could be classified separately from private domestic creditors. Separate classification may be appropriate because domestic creditors have no jurisdiction outside the debtor-State in which they can sue, and consequently possess weaker remedies.²⁹³

Cramdown: Finally, § 1129 of the Code sets the standards for confirmation of a restructuring plan.²⁹⁴ Most significantly, it implements the super-majority voting provisions of § 1126 by requiring acceptance of the plan by each class of claims.²⁹⁵ However, § 1129 also recognizes that a class of claims might sometimes vote to reject the plan, and therefore it provides an exception: the plan may still be confirmed if creditors in each class receive value under the plan equal to the amount of their claims, or if creditors whose claims are junior in

290. See, e.g., *In re Bloomingdale Partners*, 170 B.R. 984, 998 (Bankr. N.D. Ill. 1994) (holding that a tort-based claim is substantially similar to a contract-based claim for purposes of plan classification).

291. See *supra* note 15.

292. See *In re Mastercraft Record Plating, Inc.*, 32 B.R. 106, 108 (Bankr. S.D.N.Y. 1983), *rev'd*, 39 B.R. 654 (S.D.N.Y. 1984).

293. See EICHENGREEN & PORTES, *supra* note 8, at 16 (discussing the effects of jurisdictional issues on sovereign debtor cases).

294. See 11 U.S.C. § 1129 (1994).

295. See *id.* § 1129(a)(8). To some extent, § 1129(a)(7)(A) protects objecting creditors whose class has accepted the plan by super-majority voting. This subsection requires that objecting creditors receive value under the plan at least equal to the amount they would receive if the debtor were liquidated and its assets distributed according to the absolute priority rule. Because sovereign States are not liquidated and have an indeterminate liquidation value, I do not propose that objecting creditors of sovereign debtors receive the same protection. Rather, they must rely on the fairness of the classification of their claims. See *supra* notes 287-92 and accompanying text (discussing classifications of claims for voting purposes).

priority receive nothing.²⁹⁶ This rule is referred to as “cramdown,”²⁹⁷ and incorporates the principle of absolute priority.²⁹⁸

Cramdown indirectly provides creditors with an incentive to reach agreement on a plan. In order to confirm a cramdown plan, it is necessary to value the debtor as a going-concern to ensure that distributions are made in accordance with the absolute priority rule.²⁹⁹ That valuation, however, entails some cost and delay.³⁰⁰ Consequently, senior creditors may be willing to “give something to [junior creditors], enough to gain [their] consent and avoid cramdown.”³⁰¹ Moreover, “[v]aluation of the company is something that sophisticated participants in any significant chapter 11 reorganization avidly desire to avoid.”³⁰²

A cramdown rule may not be appropriate for sovereign debt restructuring, however. Although the benefits of such a rule include minimizing the collective action problem and fostering economic rehabilitation,³⁰³ the rule is extremely difficult to apply to sovereign States.³⁰⁴ Valuation of a corporation as a going-concern is complex,

296. See 11 U.S.C. § 1129(b).

297. See generally Steven L. Schwarcz, *Basics of Business Reorganization in Bankruptcy*, J. COM. BANK LENDING, Nov. 1985, at 36, 43-44 (discussing the cramdown valuation costs that parties can avoid by a consensual plan). Professor Baird describes cramdown as the “most important” right in the event that consensual agreement cannot be reached. BAIRD, *supra* note 169, at 18.

298. Absolute priority mandates the distribution of a liquidating debtor’s estate in accordance with the strict priority of claims. See 11 U.S.C. § 726. Confirmation of a plan of reorganization under Chapter 11 does not, however, require absolute priority except to the extent that it is incorporated through cramdown. Absolute priority is dispensed with elsewhere in order to maximize flexibility when negotiating a plan of reorganization. Increased flexibility makes it easier to reach a successful plan and thereby preserve the debtor’s value as a going-concern. See, e.g., *In re Atlas Pipeline Corp.*, 39 F. Supp. 846, 848 (W.D. La. 1941).

299. See Schwarcz, *supra* note 297, at 43; see also Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 452-53 (1984) (describing the absolute priority rule and its effect on secured creditors, unsecured creditors, and equity holders).

300. See Broude, *supra* note 299, at 453.

301. *Id.* at 453.

302. *Id.* at 454.

303. A cramdown rule would provide these benefits by creating an incentive for creditors and the State to reach agreement on a restructuring plan, in order to avoid a valuation of the State. The rule would also be neutral from the standpoints of moral hazard, taxation, and non-bankruptcy incentives.

304. Cf. McConnell & Picker, *supra* note 8, at 464-65 (concluding that the incorporation of cramdown into municipal bankruptcy law is ineffectual).

but it nonetheless is feasible.³⁰⁵ However, merely conceiving of a method by which to value a State is difficult.³⁰⁶ Any attempted valuation would therefore be inherently speculative and likely to generate costly disputes and protracted litigation. Thus, the threat of invoking cramdown would lack credibility, and creditors would have little incentive to reach a consensual plan solely to avoid that threat.

Nonetheless, a potentially simplifying but flawed assumption exists that would make valuation of States possible, and would therefore make cramdown feasible as well. Unlike a corporation, a State has the power to tax its citizens. One therefore might assume that a State can always generate sufficient tax income in the future to pay its claims over time. That assumption is problematic, however, because at some point an increase in the tax rate will cease to raise tax revenues.³⁰⁷ Furthermore, a cramdown rule based on that assumption would invite abuse. The State would be able to cram down, over creditor objections, a restructuring plan that pays creditors in full according to debt maturities that are extended over time.³⁰⁸ Such a plan would adversely affect prebankruptcy incentives.

This abuse does not occur in a corporate context because in that context cramdown is a double-edged sword: it harms the corporation's shareholders as well as its creditors.³⁰⁹ Hence, a debtor, whose managers often own stock, will be reluctant to impose a cramdown plan if there is any realistic chance of a negotiated settlement. This reluctance stems from the fact that, in such a settlement, shareholder claims always receive some recovery in order to induce shareholders

305. See generally Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419 (1996) (discussing the complexities of valuing companies in cramdowns).

306. Cf. EICHENGREEN & PORTES, *supra* note 8, at 75 ("If it is difficult to establish the net worth of a firm, it is almost impossible to do it for a country."); Kordana, *supra* note 4, at 1057 (concluding it is problematic "to apply the absolute priority rule to a bankrupt municipality"). Even the extent to which the valuation should take into account a State's power to tax its citizens is unclear. See McConnell & Picker, *supra* note 8, at 466-67 (noting the uncertainty of whether, and to what extent, a bankrupt municipality's valuation should include potential tax revenues).

307. A tax increase may reduce economic output, and citizens might also be unable or unwilling to pay the increase. See McConnell & Picker, *supra* note 8, at 466 (discussing the difficulty of "identifying the tax-maximization point on this implicit 'Laffer Curve'").

308. My analysis assumes that debtors will make payments on a present value basis; otherwise, the adverse impact on creditors will be even greater.

309. If the corporate debtor is insolvent, its shareholders, being the most junior claimants, will receive nothing. In contrast, if the corporate debtor is solvent, potential litigation costs arising out of a cramdown would reduce the recovery to shareholders before affecting any creditors. See Schwarcz, *supra* note 297, at 242-44.

to accept the settlement.³¹⁰ In contrast, a State has no true residual claimants who would lose in a cramdown.³¹¹

Theoretically, one could minimize the potential for abuse by imposing restrictions on cramdown, such as permitting its use only when the State is unable to pay its debts and negotiations to consensually restructure those debts have failed. This type of condition, however, would add considerable uncertainty to the restructuring process and would greatly expand the need to exercise adjudicatory discretion. One also must place the need for a cramdown provision into perspective: the Convention's goal is not necessarily to eliminate problems inherent in sovereign debt restructuring, but to mitigate those problems. From that perspective, even if the absence of a cramdown provision means that consensual agreements cannot always be reached, the Convention will accomplish its goal if, through super-majority voting, it makes consensual agreements more feasible. Accordingly, I propose that the Convention not include a cramdown provision unless experience later demonstrates that debtor-States and their creditors cannot reach consensual agreements without it.³¹²

Proposed Convention: In summary, I propose that the Convention comprise the following rules: (1) only a State itself, and not its creditors, may commence the restructuring case, and must do so in good faith; (2) financiers of the debtor-State's debt restructuring have priority over claims of other creditors, but the IMF (or another neutral multilateral institution) has the right to scrutinize and object to an excessive amount of new priority financing, to monitor its use as appropriate in order to prevent overinvestment, and potentially to act as a nonrecourse funding intermediary; and (3) all creditors be bound to a plan of reorganization that is agreed to by super-majority voting by

310. *See id.*

311. *Cf. McConnell & Picker, supra* note 8, at 465 (concluding that, in a municipal bankruptcy context, "[t]he incorporated Chapter 11 cramdown standard is . . . of cold comfort to unsecured creditors," and asserting that unsecured creditors "would instead look for protection to § 943(b)(7), which requires the court to determine that the plan is in the 'best interests of creditors and is feasible'"). However, even the requirement that objecting creditors receive at least as much from the plan as they would receive in a liquidation of the debtor under Chapter 7, "could not be the standard under Chapter 9 because municipalities are not liquidated in bankruptcy." *Id.* Some courts have therefore reinterpreted the best-interests test to simply require that creditors receive all they could reasonably expect under the circumstances. *See id.* at 465-66. This reinterpretation, "however, leaves considerable room for judicial discretion and municipal gamesmanship." *Id.* at 466.

312. *Cf. infra* notes 360-82 and accompanying text (analyzing the potential self-execution of sovereign debt restructuring negotiations by comparing corporate bankruptcy negotiations with the effect of bankruptcy law incentives).

classes of claims, and, upon such agreement, debts not provided for in the plan be discharged. The Convention would also require each ratifying State to enact the Convention's rules into national law.³¹³

Implicit in these rules lies the assumption that entities such as the IMF will allow the market to work and will no longer act as de facto lenders of last resort in a way that fosters moral hazard.³¹⁴ Nonetheless, the IMF should act as a lender of last resort in order to provide liquidity in cases where the debtor-State is economically and fiscally sound, but a default would result from irrational exogenous factors, such as a financial panic. This liquidity funding is needed to avoid a multiple equilibrium problem, and will not foster moral hazard; furthermore, the debtor-State should be able to repay the IMF once the panic subsides.³¹⁵

Appendix I proposes a possible model of the Convention. I do not claim this model is the only, or even the best, model logically consistent with the framework; it is merely a rational model that exhibits this consistency. Another model, for example, could add an automatic stay,³¹⁶ or could adopt a "menu approach," making the rules optional in order to permit the debtor-State to avoid costs.³¹⁷ The pri-

313. See *infra* Appendix I.

314. Specifically, the IMF should not discriminate against States that adopt these rules, such as by cutting off funding for adopting States but holding out the possibility of funding for other States. The IMF may therefore wish to gradually eliminate funding for all States in order to motivate States to adopt the rules and adapt to capital market funding.

315. See *supra* notes 226-33 and accompanying text.

316. For example, after observing that the "problem with most sovereign debt restructurings . . . has been the failure to apply the lessons learned long ago in the private bankruptcy process," another commentator advocates "three principles governing the bankruptcy process that should be incorporated into sovereign restructurings": the ability to "regain liquidity by borrowing funds" on a priority basis, the automatic stay to give "the breathing space needed to return a debtor to economic health," and avoiding control of the "rogue creditor" by permitting "a reorganization plan to be adopted by less than a unanimous vote of the creditors." Hurlock, *supra* note 16, at 10.

317. Professor Rasmussen partly inspired a menu approach when he first observed, in the context of corporate bankruptcy, that a one-size-fits-all rule is inefficient where bankruptcy covers a wide range of companies and creditors. See Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 66-67 (1992) (arguing that companies should be able to choose from a menu of standardized bankruptcy options at the time when they are formed). For example, binding creditors to super-majority voting could anger dissenting creditors whose rights and remedies, but for the law, could not be affected without their consent. A State may want the right to decide whether the benefits of this provision outweigh its costs. The rules might even include the option of a stay. See *id.* at 106. A menu approach, however, is likely to generate high transaction costs. See *id.* at 100-21 (discussing the menu approach and addressing potential problems with this scheme).

mary goal of this Article is to illustrate the importance of imposing conceptually sound rules on sovereign debt restructuring to address existing problems, not to propose definitive rules.

Next, I analyze implementation of the Convention and address issues raised thereby.

C. Implementing the Convention

Implementing the Convention in an international law context raises at least three issues: (1) how the Convention should bind States and their creditors; (2) how the Convention should be administered; and (3) how questions arising under the Convention should be adjudicated.³¹⁸

1. *Binding States and Their Creditors to the Convention*

The diminishing distinction between public and private international law provides an interesting perspective from which to analyze how States and their creditors should be bound by the Convention. Traditionally, public international law dealt with rules between States, whereas private international law was concerned with private entities to the extent their activities crossed national borders.³¹⁹ Thus, one can view the recently proposed United Nations Commission on International Trade Law (UNCITRAL) draft Convention on As-

If States follow a menu approach, questions arise with respect to when the State should choose its restructuring options, and whether those options may later be changed. Presumably, the choice should be made when the State becomes party to the restructuring law. *See, e.g.*, Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. (forthcoming 2000) (draft on file with the author) (examining a corporation's ability to choose venue for bankruptcy filing). Because investors would price their financing based on the State's choice of options, the options should be fixed thereafter. *See id.* at 5-6 (arguing that allowing managers to choose where to file for bankruptcy when the corporation is financially distressed produces ill-effects, because by that time the interests of managers have diverged from the interests of the firm as a whole; alternatively, selecting the bankruptcy forum "prior to when the firm has to seek capital in the financial markets [would give] the managers . . . an incentive to select the venue which promises to maximize the value of the firm as a whole").

318. The analysis of implementation in this Part is broader than Professor Baird's analysis of the dispute over how bankruptcy law should be implemented. *See supra* notes 136-43 and accompanying text. While Baird primarily focuses on the role of the judge in the bankruptcy process, this analysis also examines jurisdictional, enforcement, and compliance issues.

319. *See* BARRY E. CARTER & PHILLIP R. TRIMBLE, *INTERNATIONAL LAW* 19 (3d ed. 1999) ("In contrast to the public international law of rules between states, there has long been private international law dealing with the activities of individuals, corporations, and other private entities when their activities crossed national borders.").

signment in Receivables Financing as a private international law convention because it would regulate cross-border receivables financing between citizens of different States.³²⁰

In recent years, however, “[t]he distinctions between public and private international law have become increasingly artificial as many states and their instrumentalities have entered the marketplace in a major way . . . and as commerce and foreign policy have become increasingly intertwined.”³²¹ A sovereign debt restructuring convention based on the Convention would further blur the distinction between public and private international law by regulating the relationship between a debtor-State and its creditors that are private citizens of other States.³²²

If all of these States ratify the Convention, the debtor-State would be directly bound, and its creditors would be bound by their own States’s ratification of the Convention and enactment of its rules into national law.³²³ If the Convention were given retroactive effect, it would bind even existing creditors.³²⁴ The importance of retroactivity

320. The convention aims to enhance the viability of cross-border receivables financing and to reduce its cost. See Spiro V. Bazinas, *An International Legal Regime For Receivables Financing: UNCITRAL’s Contribution*, 8 DUKE J. COMP. & INT’L L. 315, 358 (1998) (noting that the convention’s “work may considerably facilitate the flow of lower-cost credit to a number of countries where such credit is currently not available”).

321. CARTER & TRIMBLE, *supra* note 319, at 19-20.

322. Foreign commercial banks and private investors in foreign capital markets primarily fund sovereign lending.

323. This statement assumes that the States have also incorporated the Convention as part of their national law; therefore, the Convention should require each ratifying State to enact the legislation necessary to make the Convention’s provisions part of the State’s national law. Alternatively, Greenwood and Mercer have argued in a different context that States might use Article VIII(2)(b) of the existing IMF Articles of Agreement to deny dissenting private creditors access to foreign courts. See Christopher Greenwood & Hugh Mercer, *Considerations of International Law, in CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS*, *supra* note 8, at 103, 111-12. Article VIII(2)(b) provides in part that “[e]xchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.” *Id.* at 111 (typeface altered). According to Greenwood and Mercer’s argument, a broad interpretation of the term “exchange contracts” would include loan agreements payable in foreign currency; hence, “where a state suspended repayment of its debt in foreign currency in order to protect its reserves, and did so with the approval of [super-majority voting by] the IMF, a debt contract which required payment to be made in a foreign currency would be contrary to that state’s exchange control regulations.” *Id.* The authors nonetheless conclude that because courts have interpreted Article VIII(2)(b) narrowly, “[i]t seems unlikely . . . that any reliance can be placed upon the text as it stands.” *Id.* at 112.

324. Even without retroactivity, however, the Convention would be valuable by binding future creditors.

extends equally to the sovereign debt restructuring context because of the need to address the rights of existing creditors:

It is a familiar canon of statutory construction that statutes normally only operate prospectively. Bankruptcy laws, however, test this canon, because by their very nature such laws usually affect the pre-existing rights of creditors, in order to provide relief to troubled debtors with respect to preexisting obligations.³²⁵

Legal retroactivity might appear controversial in an international law context,³²⁶ but it is permitted so long as it is neither discriminatory nor arbitrary.³²⁷ None of the substantive provisions of the Convention—super-majority voting, discharge, and the granting of priority to financiers of the State's debt restructuring—would fail under this test. None discriminates based on the nationality of the bondholders; the rights of nationals and aliens holding bonds would be equally affected. And none is arbitrary because all are essential to a debtor-State's ability to restructure its debt.

Where retroactivity amounts to expropriation, however, the State would be liable under international law to compensate the injured parties.³²⁸ Nonetheless, lawful State actions “may affect foreign interests considerably without amounting to expropriation.”³²⁹ For example, “foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas [may be imposed], or

325. TABB, *supra* note 260, at 680-81.

326. On the other hand, alternative sovereign debt restructuring proposals, such as the inclusion of collective action clauses in bonds, *see infra* notes 334-36 and accompanying text, raise controversy themselves. *See, e.g.*, Diane Coyle, *IMF Moves to Get Tough on Private Creditors in Crisis-Hit Economies*, THE INDEP. (London), Oct. 4, 1999, at 17 (observing that there is little prospect that emerging-market States will permit collective action clauses in their bond indentures unless developed States do likewise, because of fear that doing so will signal that they are more likely to default); Martin Wolf, *How to Avoid the Debtors' Prison*, FIN. TIMES (London), Oct. 20, 1999, at 27 (citing William Rhodes, vice-chairman of Citigroup, as arguing that imposing these clauses selectively would “reduce private capital flows to both public and private sector borrowers in the emerging markets” (internal quotation marks omitted)).

327. *See* 1 OPPENHEIM'S INTERNATIONAL LAW 918-921 (Sir Robert Jennings & Sir Arthur Watts eds., 9th ed. 1992) (discussing retroactivity in the context of expropriation and confiscation).

328. In international law, the terms “expropriation” and “confiscation” have “no precise accepted technical meaning. ‘Expropriation’ conveys in a general sense the deprivation of a former property owner of his property, and is equivalent to a ‘taking’ of property; ‘confiscation’ usually connotes an expropriation without compensation. . . .” *Id.* at 916 n.9.

329. IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 535 (5th ed. 1998). Some judicial authorities even hold, under the so-called principle of national treatment, that “an alien cannot complain provided he receives the same treatment as nationals.” *Id.* at 538. This principle, however, is not universally followed. *See id.*

measures of devaluation” may be taken without constituting expropriation.³³⁰ Non-discriminatory “taxation or other fiscal measures” also need not be compensated.³³¹ Indeed, in the context of breaching a contract, only “the situation in which the state exercises its executive or legislative authority to *destroy* the contractual rights as an asset comes within the ambit of expropriation.”³³² The rationale excusing compensation appears to be that contracting private parties should be aware of the possibility that a State may retroactively alter its contracts by changing its national law, and therefore the private party should assume the risk of such changes occurring.³³³

Imposing super-majority voting (and its corollary, discharge) or granting priority to financiers of a State’s debt restructuring is unlikely to destroy the contractual rights of the bonds as an asset. In the former case, any change in the underlying terms of the bonds, such as interest rate, maturity, or even principal amount (discharge being merely a change that reduces the principal amount), would be subject to super-majority consent of the bondholders.³³⁴ The only contractual right that would be destroyed is an individual bondholder’s right to hold out for greater gain by threatening to veto a plan desired by other bondholders. But legal systems would not likely protect such an unreasonable private expectation.³³⁵ In the latter case, I have shown that by increasing the availability of new money credit, grant-

330. *Id.*

331. *Id.* at 538.

332. *Id.* at 550 (emphasis added).

333. See SCHACHTER, *supra* note 240, at 311-24; see also F.V. Garcia-Amador, *State Responsibility in Case of “Stabilization” Clauses*, 2 J. TRANSNAT’L L. & POL’Y 23, 24, 33-34 (1993) (arguing that, in general, a State may exercise its sovereign right to alter or repudiate its contractual obligations, possibly subject to constitutional limitations, and that such alteration or repudiation does not automatically constitute a breach of international law unless such a failure is confiscatory or discriminatory in nature). Stabilization clauses—under which a State “undertakes neither to annul the agreement nor to modify its terms, either by legislation or by administrative measures”—are sometimes included in contracts to respond to this risk. BROWNLIE, *supra* note 329, at 554. However, the “legal significance of such clauses is inevitably controversial,” and it is an “unsettled question” whether they are effective under international law. *Id.*; see Thomas W. Waelde & George Ndi, *Stabilizing International Investment Commitments: International Law Versus Contract Interpretation*, 31 TEX. INT’L L.J. 215, 236 (1996) (noting that a stabilization clause is “an attempt to bind the state to a greater extent than a normal contract would seem to do”). In our case, the question only would become relevant as to those bond indentures that contain stabilization clauses.

334. Recall that super-majority voting gives the creditors veto power over a plan, and hence over discharge. See *supra* notes 276-86 and accompanying text.

335. Compare *infra* note 350 (similarly arguing that retroactively imposing super-majority voting would not constitute a “taking” under U.S. constitutional principles).

ing priority may actually increase the expected value of existing claims notwithstanding their subordination to the new money.³³⁶ Accordingly, making the Convention retroactive would not appear to cause expropriation.

The foregoing analysis assumes that the relevant debtor-State and each relevant creditor's State have all ratified the Convention. In many cases, that may well occur because most States will likely want to ratify the Convention. Its rules generally benefit States by providing incentives for new credit and by imposing super-majority voting to minimize the collective action problem.³³⁷ Some States nonetheless may fear that the priority and super-majority voting provisions of the Convention might decrease the availability of credit or make it more expensive. Although the ultimate effect of the Convention on availability and cost of credit is an empirical determination, that effect should be minimal as long as the Convention's ratification does not lower the rating of the State's debt securities. Discussions with Standard & Poor's Ratings Services, a leading rating agency, suggest that ratification would not lower these ratings.³³⁸ Additionally, one should not expect ratification of the Convention to increase costs because an IMF loan today has *de facto* priority over other claims,³³⁹ and my proposal only privatizes the source of the funding. Nonetheless, some

336. See *supra* notes 184-88 and accompanying text.

337. States have an interest similar to that of corporations residing in countries with undeveloped, or inconsistent, commercial laws: these States welcome advances toward clarity and uniformity in the law because they increase the ability to obtain credit. See, e.g., Steven L. Schwarcz, *Towards a Centralized System for Cross-Border Receivables Financing*, 20 U. PA. J. INT'L ECON. L. 455, 476 (1999) (concluding that a centralized registration system for perfection and priority of receivables financing would increase corporate access to lower cost credit by increasing clarity and uniformity).

338. See Telephone Interview with Joanne W. Rose, Senior Managing Director, General Counsel and Chair of the Ratings Policy Board, Standard & Poor's Ratings Services (June 10, 1999) (notes on file with author). Ms. Rose said that ratification of the Convention should not affect Standard & Poor's ratings—which are based on the likelihood of default and not on the amount of recovery expected in default—because the Convention does not affect the likelihood of default. See *id.* Thus, a State whose debt was rated investment grade would not experience a ratings change as a result of ratifying the Convention. Ms. Rose suggested, however, that a sovereign debt analyst might be tempted to slightly reduce the rating of a financially troubled State that had ratified the Convention, such as from “B” to “B-.” See *id.* Incidentally, although I previously observed that allowing the markets to work creates a risk that a State might default because it will be unable to obtain private market funding, that risk of default does not arise from the Convention per se, but rather from the IMF's determination to stop lending in a way that fosters moral hazard. That determination is an independent good, regardless of whether the Convention is ratified.

339. The debtor-State will not dare to default on its IMF loan lest it lose access to future emergency funding. See, e.g., *Appropriations Hearings*, *supra* note 38, at 92.

States may choose not to ratify the Convention. I therefore consider below the Convention's effect on creditors from nonsignatory States.

In some cases, the Convention would bind creditors from nonsignatory States that make loans to a signatory State. Under international law principles, the law of the State—in this case, the Convention—may well apply to contracts between the State and foreign private parties absent a contractually chosen governing law.³⁴⁰ The rationale is that a sovereign entity “cannot be presumed to have made the substance of its debt and the validity of the obligations accepted by it in respect thereof, subject to any other law than its own.”³⁴¹

Realistically, however, any financing agreement is likely to specify its governing law.³⁴² If the law chosen is other than that of the debtor-State, the Convention alone would not bind creditors from nonsignatory States. For example, New York or United Kingdom law governs many existing sovereign bond issues.³⁴³ A State that wishes to ensure the Convention will apply to such creditors therefore might try to include a provision in its new financing agreements that contractually binds its creditors to the Convention's rules, and also might try to amend existing financing agreements similarly.³⁴⁴ A contractual ap-

340. See Derek W. Bowett, *Claims Between States and Private Entities: The Twilight Zone of International Law*, 35 CATH. U. L. REV. 929, 931-32 (1986); Rainer Geiger, *The Unilateral Change of Economic Development Agreements*, 23 INT'L & COMP. L.Q. 73, 80 (1974) (referring to contracts between a State and foreign private investors and observing that if contracting parties do not refer to a particular legal system, “the contract, as a general rule, will be governed by the internal law of the host state”). For cases dealing with the role of the host-State's law in foreign investment contracts, see *Serbian and Brazilian Loans Cases*, 1929 P.C.I.J. (ser A) No. 20 at 42, No. 21 at 121, and *Saudi Arabia v. Arabian American Oil Comp. (ARAMCO)*, 27 I.L.R. 117, 167 (1958) (Sauser-Hall, Ref.) (explaining the Arbitration Tribunal's decision to adopt “the law of the country with which the contract has the closest natural and effective connection” when no governing law is explicitly expressed by the contracting parties). *But cf.* Michael E. Dickstein, *Revitalizing the International Law Governing Concession Agreements*, 6 INT'L TAX & BUS. L. 54, 65-67 (1988) (asserting that an increasing number of contracts have recently been found to be “internationalized,” i.e., not subject to the law of the contracting State).

341. *Serbian & Brazilian Loans Cases*, 1929 P.C.I.J. at 42, 121. This principle especially applies where the State is bound by its own laws to contract in accordance with a convention. See Bowett, *supra* note 340, at 931-32. Thus, a State that wishes to maximize the binding effect of the Convention on creditors could adopt a law providing that all borrowing and other financing arrangements to which the State is a party shall be governed by the Convention unless the State specifically provides otherwise.

342. See Greenwood & Mercer, *supra* note 323, at 106.

343. See Macmillan, *supra* note 8, at 87.

344. Alternatively, the debtor-State could attempt to require its own law to govern financing agreements. However, a State's private creditors often insist that their own State's law or the

proach, however, would only bind consenting creditors. Existing creditors might refuse to consent, and involuntary creditors, such as tort creditors,³⁴⁵ would not have the opportunity to consent.³⁴⁶

These limitations illustrate why recent proposals to contractually solve the collective action problem in bonds by introducing super-majority voting clauses in new bond issues³⁴⁷ are unlikely to be successful. Absent an international convention, *all bondholders would be in the position of creditors from nonsignatory States*; hence, only consenting bondholders would be bound. As a result, a State cannot rely on a contractual approach to bind holders of the large stock of existing long-term bonds, much less future creditors that choose not to consent and involuntary creditors that have no opportunity to consent.³⁴⁸ In contrast, the Convention would effectively solve the collective action problem for all creditors from signatory States.

Because New York and United Kingdom law governs so many bonds, it also might be feasible to bind the nonconsenting bondholders (even those from non-signatory States) to the Convention's provisions.³⁴⁹ Those jurisdictions could legislatively provide that their na-

law of a major financial center such as the United States or the United Kingdom apply. See Greenwood & Mercer, *supra* note 323, at 106.

345. States are unlikely, however, to have many involuntary creditors because of sovereign immunity.

346. See Greenwood & Mercer, *supra* note 323, at 110. A contractual approach nonetheless gained support when the Group of Seven ("G-7") Heads of State endorsed a report by G-7 Finance Ministers that encourages clauses in international bond issues permitting re-negotiation after default in order to help solve the collective action problem. See *G-7 Chairman's Statement at the Birmingham Summit* ¶ 8 (visited March 29, 2000) <<http://equity.stern.nyu.edu/~mrpibomo/asia/g7birmingham.html>>; see also EICHENGREEN & PORTES, *supra* note 8, at 30-34 (proposing that sovereign loan agreements include clauses explicitly permitting a specified majority of creditors to have the right to alter terms of the loan after default).

347. See, e.g., EICHENGREEN, *supra* note 166, at 65-70 (proposing that loan contracts contain clauses requiring a form of super-majority voting); Greenwood & Mercer, *supra* note 323, at 110; Peter Cook, *The Next Inevitable Debt Crisis*, GLOBE & MAIL, Oct. 20, 1999, at B2 (noting that collective action clauses would allow for an orderly restructuring of a country's bond debt, thereby shifting some of the burden from the IMF to the private sector); Wolf, *supra* note 326, at 27 (calling inclusion of collective action provisions a "modest step" towards the necessary goal of making it easier to reschedule loans); *Diminishing Returns: There Are Scores of New Designs for the International "Financial Architecture,"* ECONOMIST, Oct. 9, 1999, at 98 (advocating collective action clauses for all sovereign bond contracts, in accordance with recommendations by the Council on Foreign Relations).

348. See EICHENGREEN, *supra* note 166, at 70 (cautioning that loan contract clauses are "no panacea" because private placements would not be affected, and it would be difficult to add these clauses to existing loan contracts).

349. Some bonds which are governed by U.K. law already may contemplate some form of super-majority voting. See E-Mail from Michael Buchanan, Capital Account Issues Division,

tional law apply the Convention's provisions in cases where a State files for relief under the Convention. This legislation, even if retroactive, should be enforceable under the legal systems of both New York (including, to the extent applicable, that of the United States)³⁵⁰ and the United Kingdom.³⁵¹ Nonetheless, whether New York (or the

PDR, International Monetary Fund, to Steven L. Schwarcz (Oct. 22, 1999) (on file with author) (stating that bonds issued under U.K. law "(nearly) all have some form of majority restructuring provision"; see also DAVIES, *supra* note 285, at 733 (noting that bonds issued under U.K. law may provide for super-majority voting).

350. If the United States Congress enacts this legislation, it would preempt New York law. Such legislation would be enforceable provided the retroactivity is not unconstitutional. In a bankruptcy context, retroactivity should be constitutionally permitted; that was the effect, for example, when 11 U.S.C. §§ 364, 1126, & 1141 were enacted as federal law, which granted priority to DIP financing and imposed super-majority voting in both bankruptcy and discharge regardless of unanimity requirements in state law contracts. *Cf.* *Eastern Enterprises v. Apfel*, 524 U.S. 498, 528 (1998) (holding that Congress generally has the power to affect contractual obligations between parties); *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181 (1902) (holding that Congress has power under the Bankruptcy Clause of the U.S. Constitution to retroactively impair contractual obligations); James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 987 (1983) (arguing that secured creditors know, or should know, of U.S. bankruptcy law's restrictions on their rights, and therefore take their rights subject to those restrictions).

If New York State enacts the supplemental legislation, it would likewise face the retroactivity challenge. See *People v. Martello*, 93 N.Y.2d 645, 650-51 (1999); *Americorp Securities, Inc. v. Sager*, 656 N.Y.S.2d 762, 764 (1997). The constitutional issue is somewhat more complex because the retroactivity is imposed by a state legislature, not by Congress. Nonetheless, retroactive legislation is constitutional so long as it does not constitute a "taking" by completely destroying property rights in a way that the affected parties could not have anticipated. See *Eastern Enterprises*, 524 U.S. at 528-29 ("[L]egislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability . . ."); *United States v. Riverside Bay Homes*, 474 U.S. 121, 128 n.5 (1985). If the legislation did constitute a taking, it still would be constitutional if adequate compensation was paid, but that would impose a cost on the state. See *id.* at 128. The consensual relinquishment of rights—a plan being subject to super-majority voting—should not constitute complete destruction of the bonds. The only right that is completely destroyed is an individual bondholder's right to hold out for greater gain by threatening to veto a plan desired by other bondholders; that right, however, is an unreasonable private expectation that would not be protected. See Jan G. Laitos, *Legislative Retroactivity*, 52 WASH. U. J. URB. & CONTEMP. L. 81, 100 (1997). Further, granting priority to a financier of the State's debt restructuring may actually increase the expected value of existing claims, much less completely destroy their value.

351. See, e.g., 44(I) LORD HAILSHAM OF ST. MARYLEBONE, HALSBURY'S LAWS OF ENGLAND para. 1283, at 764 (4th ed. reissue 1995) ("[A]n amending enactment may say, expressly or by implication, that its effect is retrospective."); R.J. WALKER, THE ENGLISH LEGAL SYSTEM 99 (6th ed. 1985) ("Parliament is sovereign and statutes may be, and occasionally are, expressed to be retroactive even where this operates to deprive a person of a vested right in property.").

United States) and the United Kingdom would enact such legislation is a political question.³⁵²

2. *Administering the Convention*

Scholars assume that a neutral international institution is necessary to administer a sovereign debt restructuring case, especially the debt negotiations. For example, Professor Cohen stated that “[e]mulating [a Chapter 11] model at the international level would first require the establishment of an institution authorized to play a role in [sovereign] debt negotiations comparable to that of the bankruptcy court in the Chapter 11 procedure.”³⁵³ He suggests that a multilateral convention create such an institution as a “wholly new and independent entity to underscore its impartiality and objectivity.”³⁵⁴ States that apply to this intermediary for relief would “commit themselves irrevocably” to the process.³⁵⁵

Creating international institutions that are costly to maintain or that impinge on State sovereignty is politically tenuous, however, and recent experience is not promising. Attempts by financial officials of the Group of Seven (“G-7”) industrial nations³⁵⁶ to create an authority to regulate world markets, for example, have achieved little success:

Deeply divided about the best way to tame violent swings in world financial markets, finance ministers from the world’s biggest industrial nations agreed here [Bonn, Germany] today [February 20,

352. If those jurisdictions were prepared to enact the necessary legislation, they theoretically could do so without reference to the Convention. That does not, however, eliminate the need for the Convention. Different laws may govern some bond issues and other types of creditor claims. The Convention also would provide legitimacy and a model for uniform legislation that is explicitly negotiated and agreed upon, eliminating the selectivity feared by emerging-market States, *see supra* note 326 and accompanying text, as well as providing an international mechanism of oversight, *see generally infra* Part II.C.3 (discussing adjudication and enforcement under the Convention).

353. Cohen, *supra* note 4, at 124. Cohen’s rationale is that “[i]f creditors and [sovereign] debtors were to be persuaded to accept the risks of an alternative debt relief strategy, some impartial intermediary would have to exist that could assure both sides that their rights and needs would be respected.” *Id.* at 124-25.

354. *Id.* at 125. Cohen also suggests calling the institution the “International Debt Restructuring Agency,” and proposes that it could be a joint subsidiary of the IMF and the World Bank (International Bank for Reconstruction and Development). *Id.*

355. *Id.*

356. The G-7 nations consist of the United States, Japan, Germany, France, the United Kingdom, Italy, and Canada. *See* Bob Davis, *G-7 Summit Expected to Boost Support for Proposals to Help Insolvent Nations*, WALL ST. J., June 13, 1995, at A4.

1999] to create a modest forum to consult on the problem more closely.

... [T]he plan is notable more for what it would not do than what it would.

In a flat rebuttal to demands by German and French political leaders for a broad new “architecture” or “highway code” for world markets, the plan would merely establish a new forum for top regulators that would meet twice a year to consult and look for ways to improve the quality of financial information.³⁵⁷

Previous attempts by the G-7 nations to create an international bankruptcy agency have also failed.³⁵⁸

I do not agree, however, with Professor Cohen’s proposition that an administrative institution would be needed to “play a role in [sovereign] debt negotiations.”³⁵⁹ Cohen mistakenly believes that the bankruptcy court plays this role in the United States, while in actuality, Congress prohibits courts from playing such a role.³⁶⁰ The experience of corporate debt restructuring confirms that the parties themselves—debtors and their creditors—do the negotiating: “[M]ost U.S. bankruptcies are self-executing in that creditors, in concert with the debtor, collectively determine the economic terms upon which the enterprise will be restructured.”³⁶¹ Cohen’s confusion may arise from the fact that, prior to adoption of the Code in 1978, “the bankruptcy judge was required to be intimately involved in all aspects of every

357. Edmund L. Andrews, *Major Powers Agree to Take Modest Steps on Economy*, N.Y. TIMES, Feb. 21, 1999, at 21.

358. See generally Chun, *supra* note 54, at 2677-84 (discussing the proposal to create the IBA).

359. Cohen, *supra* note 4, at 124.

360. See, e.g., *In re UNR Indus., Inc.*, 72 B.R. 789, 793 (Bankr. N.D. Ill. 1987).

As the majority explained,

[i]t has been suggested that this Court should take an active role in the [plan] negotiations. This course of action, however, should and will be avoided by this Court. With the enactment of the Bankruptcy Code in 1978, Congress sought to remove the administration of bankruptcy cases away from bankruptcy judges [to achieve impartiality and]... to limit the evils that occurred as a result of the bankruptcy judge’s administration of business reorganization cases.

Id.

361. Hurlock, *supra* note 16, at 12; see also EPSTEIN ET AL., *supra* note 168, § 10-2, at 734 (“It would be wrong to think of the Chapter 11 process as primarily a litigated, judged-ruled adversarial process. Plans proposed and adopted in Chapter 11 almost always have been produced by negotiation, not by litigation.”). These negotiations take place in the shadow of bankruptcy law provisions discussed in this Article. See *id.* (observing that plan “negotiations go on very much in the shadow of bankruptcy law”). This Article later analyzes the phenomenon by comparing incentives for negotiation under the Code with those contemplated by the Convention. See *infra* notes 371-84 and accompanying text.

case. Virtually all of the administrative, supervisory and clerical functions were the responsibility of the bankruptcy judges”³⁶² This role for a judge, however, “was in marked contrast to [a judge’s role] in most litigation, in which the parties themselves largely manage the progress of the case.”³⁶³ A significant goal of the Code’s adoption was therefore “to remove the bankruptcy judges from their role in the administration of bankruptcy matters, assigning them a purely judicial role.”³⁶⁴ The Code achieved this objective by limiting bankruptcy courts to an adjudicatory function, and by delegating administrative functions to a separate official referred to as a United States trustee.³⁶⁵ However, the Code did not mandate United States trustees to perform particular administrative activities.³⁶⁶ Rather, their role is “purely oversight . . . , [and U.S. trustees should] limit[] their activity to fostering creditor involvement and review of disclosure statements and fee applications.”³⁶⁷ These activities are not relevant to sovereign debt restructuring, where dollar amounts are large enough to stimulate creditor involvement, and disclosure statements³⁶⁸ and fee applications³⁶⁹ are irrelevant.³⁷⁰ Moreover, the presence of a supervisory official such as a U.S. trustee may be unappealing to States, making them reluctant to ratify the Convention.

362. 1 COLLIER, *supra* note 151, ¶ 6.30[3], at 6-103.

363. *Id.*

364. *Id.* ¶ 6.30, at 6-101.

365. See 28 U.S.C. § 581 (1994). The United States trustee is an executive official, appointed by and under the supervision of the United States Attorney General, *see id.* § 582, and should not be confused with a trustee in bankruptcy, the generic term given to the debtor under the Code.

366. The Code did delegate certain appointment responsibilities to the U.S. trustee that are not relevant to this discussion. See 1 COLLIER, *supra* note 151, ¶ 6.20, at 6-78 to -86; *see also* 28 U.S.C. § 586 (setting forth duties of United States trustees).

367. 1 COLLIER, *supra* note 151, ¶ 6.17[1], at 6-69. The Executive Office for United States Trustees issued a policy statement on March 8, 1990, concluding, that this protocol concerning trustees’ responsibilities “is a reasonable and workable approach.” *See id.* at 6-70.

368. A disclosure statement is a written statement containing information intended to enable creditors to make an informed judgment about a proposed plan of reorganization. See 11 U.S.C. § 1125(b).

369. A fee application is an application by a party for payment or reimbursement from the debtor. See 11 U.S.C. § 503.

370. The original rationale for widespread judicial involvement under the Code’s bankruptcy statute predecessor focused on concern over bankruptcy’s “potential for fraud, self-dealing, and diversion of funds.” 1 COLLIER, *supra* note 151, ¶ 6.30[3], at 6-103 (internal quotation marks and citation omitted). However, this reasoning does not compel judicial supervision because sovereign States appear less likely than private businesses to attempt to commit these types of fraud.

Nonetheless, corporate bankruptcy negotiations in the United States may be self-executing because they take place under the shadow of bankruptcy law. To what extent, therefore, can we expect sovereign debt negotiations to be similarly self-executing? To answer this, this Article compares the incentives for negotiation under the Code with those contemplated by the Convention.

From the debtor's standpoint under the Code, bankruptcy [law] offers the debtor a number of powerful aids in its negotiations, notably:

1. the automatic stay and the breathing room it brings [and the motivation for creditors to negotiate a plan in order to obtain payment],
2. the possibility of adopting a plan that will legally bind all creditors even though a minority reject it, and
3. the turnover and avoiding powers, which can greatly augment the assets available and provide powerful leverage over certain creditors.³⁷¹

A State already enjoys the first negotiation aid as a result of its sovereign status.³⁷² The Convention incorporates the second negotiation aid through super-majority voting. The third aid, which focuses on a bankruptcy trustee's power to avoid preferential payments to creditors and fraudulent transfers, is less important in a sovereign than a business context.³⁷³ Hence, under the Convention, a debtor-State enjoys substantially the same "powerful aids in its negotiations"³⁷⁴ as a corporate debtor enjoys under the Code.

The Code also provides negotiation aids for creditors. First, creditors can threaten the debtor with liquidation if they do not reach a negotiated plan of reorganization.³⁷⁵ This threat, however, is not always compelling. Under the Code, a judge may convert a reorganization case to a liquidation only "for cause," such as "continuing loss[es] and . . . [the] absence of a reasonable likelihood of rehabilitation," "inability to effectuate a plan [of reorganization]," or "unreasonable

371. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 476 (3d ed. 1996).

372. *See supra* notes 164-71 and accompanying text (discussing the automatic stay).

373. *See supra* notes 256-67 and accompanying text (discussing §§ 547 & 549 of the Code and avoidance of preferences).

374. WARREN & WESTBROOK, *supra* note 371, at 476.

375. *See id.* at 477 (observing that creditors can threaten the debtor with liquidation under Chapter 7 of the Code, "even though both [sides] really want to avoid it"). Creditors also can threaten the debtor with a plan of liquidation if the debtor's exclusive period to file a plan terminates. *See* 11 U.S.C. § 1121 (1994).

delay by the debtor that is prejudicial to the creditors.”³⁷⁶ The burden of proof for showing “cause” is on the creditor moving for conversion, not the debtor.³⁷⁷ Even if the creditor satisfies that burden, the judge ultimately has discretion to decide whether or not to convert the case to liquidation.³⁷⁸ As a result, the threat of liquidation can be unrealistic, especially for large debtors:

[Liquidation of a large company] would occur only when the bankruptcy system malfunctioned. The ordinary outcome would be for the firm to discharge its . . . debt in bankruptcy while continuing its operations. Empirical evidence shows this to have been universally the case for the past twenty years with regard to large public company bankruptcies.³⁷⁹

Thus, large debtors, which are most analogous to debtor-States, almost always reach consensual plans in the absence of any realistic liquidation threat, thereby rendering that threat an unnecessary negotiation aid. Accordingly, the absence of a creditor’s ability to threaten liquidation of a debtor-State should not undermine the self-executing nature of sovereign debt negotiations under the Convention.

The other creditor negotiation aid is a senior creditor’s threat to cram down a plan of reorganization over a junior creditor’s objection.³⁸⁰ Although cramdown is not presently part of the Convention, this Article proposes that the Convention ultimately adopt a cram-down procedure if experience demonstrates that it is needed to make sovereign debt negotiations self-executing.³⁸¹

Therefore, the Convention would effectively provide roughly the same incentives for cooperation in sovereign debt negotiations that the Code imposes on corporate bankruptcy negotiations. To the extent that corporate bankruptcy negotiations are self-executing, sovereign debt negotiations should similarly be self-executing, and the parties would not need an institution generally to administer or supervise

376. 11 U.S.C. § 1112(b).

377. See 7 COLLIER, *supra* note 151, ¶ 1112.01[2][a], at 1112-7.

378. See *id.*

379. Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55, 63 (1999); see also *In re UNR Indus., Inc.*, 72 B.R. 789, 790 (Bankr. N.D. Ill. 1987) (refusing to terminate the debtor’s exclusive right to file a plan of reorganization, which would permit creditors to file a liquidating plan, even though “[n]early five years have passed since the commencement of the UNR bankruptcy case” and “progress toward the confirmation of any plan of reorganization in the UNR bankruptcy is not in sight”); EPSTEIN ET AL., *supra* note 168, § 10-2, at 734-35 (observing that the Chapter 11 of a “big business usually leads to some form of reorganization”).

380. See *supra* notes 294-304 and accompanying text.

381. See *supra* notes 302-14 and accompanying text.

the process.³⁸² However, the Convention could authorize the IMF or another neutral multilateral institution that monitors priority funding³⁸³ to perform any administrative tasks that arise on a case-by-case basis.³⁸⁴

Finally, a sovereign debt restructuring process does not need an administrative institution to prevent strategic manipulation: the narrowly circumscribed provisions of the Convention are already designed to prevent manipulation. If, for example, an economically healthy State files under the Convention in an attempt to take opportunistic advantage of its creditors, these creditors could challenge the filing as lacking good faith.³⁸⁵ Further, even if the creditors lose their challenge, the State would have little ability to manipulate the Convention unfairly to their disadvantage. Existing creditors would not be harmed if the State borrows on a priority basis because the State, being economically healthy, would be able to repay all of its creditors. (The State also would have little incentive to borrow on a priority basis because granting a priority would be unlikely to reduce borrowing costs in those circumstances.³⁸⁶) Also, whether or not economically healthy, a State would be unable to manipulate the use of loan proceeds because priority loans are monitored under the Convention to prevent overinvestment.³⁸⁷ And the requirement of super-majority voting by classes of claims gives veto power to each voting class, thereby preventing a State from devising a plan to harm existing creditors or using the Convention in an attempt to divide and conquer legitimate creditor opposition.³⁸⁸

382. The Convention's self-executing nature is further reinforced, of course, by the fact that it incorporates only three substantive provisions of bankruptcy reorganization law.

383. This institution might also impose conditionality when appropriate. *See supra* notes 194-204 and accompanying text (discussing the possibility of utilizing the IMF in this role).

384. Thus, the Convention might designate the IMF as the location where States file their debt-restructuring cases.

385. *See supra* notes 151-60 and accompanying text (discussing the good faith filing requirement).

386. *See* Schwarcz, *supra* note 185, at 448 (“[T]he debtor often gains no interest rate advantage from a secured [priority] loan if the lender would be comfortable making an unsecured [non-priority] loan.”).

387. *See supra* notes 189-93 and accompanying text (discussing prevention of overinvestment).

388. *See supra* notes 274-93 and accompanying text (discussing super-majority voting by classes of claims).

3. *Adjudication and Enforcement*

The remaining implementation issue is enforcement of the Convention and adjudication of issues arising thereunder. Relatively little precedent exists for a body to adjudicate disputes between a State and its creditors.³⁸⁹ Outside of expropriation cases, few disputes arise between sovereign States and foreign private parties.³⁹⁰ Established international courts, such as the International Court of Justice, are only competent to hear cases between States.³⁹¹ Although a State has the right to bring a lawsuit against a foreign State on behalf of one of its nationals, it may be reluctant to do so for political reasons.³⁹² Moreover, although a creditor could attempt to sue a debtor-State directly, the litigation would be governed by the debtor-State's local law and may therefore be biased in favor of the debtor-State.³⁹³

Possible solutions to this adjudication issue include a United Nations amendment to the Statute of the International Court of Justice. Such an amendment would permit the court, or a lesser judicial body formed under its auspices, to hear disputes between a State and its

389. See PAUL E. COMEAUX & N. STEPHAN KINSELLA, *PROTECTING FOREIGN INVESTMENT UNDER INTERNATIONAL LAW* 36 (1997). As the prior discussion of the increasingly artificial distinction between public and private international law hinted, "the traditional view of state responsibility is that it runs only to sovereign states. Meaning, in a debtor-creditor context, that a debtor-State would have no responsibility to a private creditor, although it may have a responsibility to that creditor's State." *Id.* However, "[a]s a practical matter . . . this view of international law has been superseded by modern practice." *Id.* For example, the ICSID Convention, see *infra* notes 397-417 and accompanying text, "firmly establishes the capacity of a private individual or a corporation to proceed directly against a State in an international forum, thus contributing to the growing recognition of the individual as a subject of international law." ARON BROCHES, *SELECTED ESSAYS: WORLD BANK, ICSID, AND OTHER SUBJECTS OF PUBLIC AND PRIVATE INTERNATIONAL LAW* 198 (1995); see also IGNAZ SEIDL-HOHENVELDERN, *COLLECTED ESSAYS ON INTERNATIONAL INVESTMENTS AND ON INTERNATIONAL ORGANIZATIONS* 374 (1998) ("The ICSID Convention attempts to encourage foreign investors to invest in developing countries by granting to them, in case of a dispute with the host country, a status equal to that enjoyed by that State."). Seidl-Hohenveldern continues by explaining that the "Convention intends to grant to these foreign investors access to international adjudication organs . . . on an equal footing with the State concerned." *Id.*

390. Sovereign immunity has historically blocked many of these disputes.

391. See EICHENGREEN & PORTES, *supra* note 8, at 38-39.

392. See Susan Choi, Note, *Judicial Enforcement of Arbitration Awards Under the ICSID and New York Conventions*, 28 N.Y.U. J. INT'L L. & POL. 175, 177 (1995-1996).

393. See *id.*; see also BROCHES, *supra* note 389, at 259 (arguing that "[i]f international disputes [involving non-governmental foreign nationals] are brought before national courts the 'foreign' party is likely to consider itself to be at a disadvantage on several counts").

creditors on an ad hoc basis.³⁹⁴ Another option is to create a new international arbitral tribunal competent to adjudicate disputes between States and private creditors.³⁹⁵

In that regard, a relatively low-cost and unbureaucratic procedure presently exists under international law for adjudicating certain disputes between States and nationals of other States that might serve as precedent for the new tribunal.³⁹⁶ The International Centre for Settlement of Investment Disputes (ICSID), an autonomous body created under the auspices of the World Bank, provides facilities for arbitration of investment disputes between contracting States and nationals of other contracting States.³⁹⁷ A small Secretariat, consisting of a secretary-general, one or more deputy secretary-generals, and an administrative staff,³⁹⁸ manages ICSID and maintains a panel of mul-

394. To the extent that clauses contained in a State's financing agreements implement the Convention, those clauses could also specify an appropriate tribunal to adjudicate disputes. Each State's internal laws would determine whether those clauses would bind the state as a matter of contract.

395. See BROCHES, *supra* note 389, at 259 (referring to earlier similar proposals). Eichengreen and Portes argue that such an international arbitral tribunal could be formed under IMF auspices, or could be independent. See EICHENGREEN & PORTES, *supra* note 8, at 39. Regarding an IMF-sponsored tribunal, their argument focuses on an administrative, as opposed to adjudicative, role for this tribunal, such as "help[ing] creditors and the debtor to negotiate a debt restructuring," specifically by "examining the economic and financial situation of the country, . . . [and] consult[ing] with representatives of the creditors" *Id.* However, these administrative roles are unnecessary, and the only required role is the adjudication of disputes.

396. As Comeaux and Kinsella explain, "[t]he cost of an ICSID arbitration [discussed below] is relatively low compared to other private arbitration institutes such as the International Chamber of Commerce." COMEAUX & KINSELLA, *supra* note 389, at 205; cf. EICHENGREEN & PORTES, *supra* note 8, at 42-43 (suggesting that an independent agency along the lines of ICSID could be created).

397. See Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, *opened for signature* Mar. 18, 1965, art. 1, 17 U.S.T. 1270, 575 U.N.T.S. 159 [hereinafter ICSID Convention]. The ICSID Convention is sometimes known as the Washington Convention, although this Article does not use that term. Many authors have focused on the general background of ICSID and ICSID arbitration. See BROCHES, *supra* note 389, at 161-356; COMEAUX & KINSELLA, *supra* note 389, at 199-212; SEIDL-HOHENVELDERN, *supra* note 389, at 371-82; Choi, *supra* note 392, at 177; Antonio R. Parra, *The Role of ICSID in the Settlement of Investment Disputes*, 16 ICSID NEWS, Winter 1999, at 5; International Centre for the Settlement of Investment Disputes, *About ICSID* (visited Aug. 17, 1999) <<http://www.worldbank.org/icsid/about/main.htm>> [hereinafter *About ICSID*]. See generally MOSHE HIRSCH, *THE ARBITRATION MECHANISM OF THE INTERNATIONAL CENTRE FOR THE SETTLEMENT OF INVESTMENT DISPUTES* (1993) (describing the International Centre for the Settlement of Investment Disputes, its jurisdiction, and the applicable law).

398. See ICSID Convention, *supra* note 397, at arts. 9-11. An Administrative Council composed of one representative of each contracting State elects the secretary-general and any deputy secretary-generals. See *id.* at arts. 4, 10.

tinational arbitrators³⁹⁹ with recognized competence in the fields of law, commerce, industry, and finance.⁴⁰⁰ ICSID covers expenses by charging for use of its arbitration facilities.⁴⁰¹

The arbitration itself is straightforward. The arbitral tribunal consists of one or more arbitrators upon whom the parties agree,⁴⁰² or absent agreement, three arbitrators.⁴⁰³ A Secretariat staff lawyer serves as the tribunal's secretary and acts as a channel of communication between the parties.⁴⁰⁴ The parties agree to rules of law, according to which the tribunal decides disputes by majority vote.⁴⁰⁵ Absent party agreement on such rules, the tribunal relies on the law of the contracting State and any applicable rules of international law.⁴⁰⁶ Decisions are binding on the parties and not subject to appeal.⁴⁰⁷

The ICSID arbitration procedure is also well established. At least 147 States are signatories to the ICSID Convention, and 131 of those States (including the United States) have ratified it.⁴⁰⁸ Provisions for ICSID arbitration are "commonly found" in investment contracts between States and nationals of other States.⁴⁰⁹ States have consented in advance to submit their investment disputes to ICSID arbitration in approximately "twenty investment laws and in over 900 bilateral investment treaties."⁴¹⁰ Further more, ICSID arbitration is "one of the main mechanisms for the settlement of investment dis-

399. ICSID also maintains a Panel of Conciliators. *See id.* at art. 12.

400. *See id.* at arts. 13-14. Panel members are also representative of the principal legal systems of the world. *See id.* at art. 14.

401. *See id.* at art. 61. Member States, however, are ultimately liable for shortfalls. *See id.* at art. 17. The Secretariat's ordinary operating expenses are financed by the World Bank's budget. *See About ICSID, supra* note 397.

402. *See ICSID Convention, supra* note 397, at art. 37. The parties could even choose a single arbitrator. *See id.* at art. 37, para. 2.

403. *See id.*

404. *See Parra, supra* note 397, at 2.

405. *See ICSID Convention, supra* note 397, at art. 48, para. 1.

406. *See id.* at art. 42, para. 1. The tribunal is also authorized to require the parties to produce documents or other evidence and to conduct appropriate inquiries. *See id.* at art. 43.

407. *See id.* at art. 53. Contracting States are required to "recognize an award rendered pursuant to this [ICSID] Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State." *Id.* at art. 54.

408. *See ICSID List of Contracting States* (as of Oct. 1, 1999) (visited March 1, 2000) <<http://www.worldbank.org/icsid/constate/c-states-en.htm>>.

409. *About ICSID, supra* note 397, at para. 7.

410. *Id.*

putes under four recent multilateral trade and investment treaties,⁴¹¹ including the North American Free Trade Agreement (NAFTA).⁴¹² As of February 2000, ICSID has concluded thirty-eight cases,⁴¹³ and thirty cases are pending.⁴¹⁴

Thus, ICSID is a useful model to the extent that a tribunal is needed to resolve sovereign debt restructuring disputes.⁴¹⁵ A tribunal based on that model could maintain a panel of neutral arbitrators having recognized competence in bankruptcy and insolvency law. Rules could require panel members to have different nationalities, and to be representative of the principal bankruptcy and insolvency law systems of the world. Similarly, the tribunal's expenses could be met by charging a fee for the arbitration.⁴¹⁶ Finally, the arbitration could follow ICSID's simple format: it would involve a panel of up to three arbitrators who decide disputes by majority vote in accordance with applicable rules of international law, and who render decisions that are binding and not subject to appeal.⁴¹⁷

411. *Id.*

412. *See id.*

413. *See ICSID List of Concluded Cases* (visited March 1, 2000) <<http://www.worldbank.org/icsid/cases/conclude.htm>>.

414. *See ICSID List of Pending Cases* (visited March 1, 2000) <<http://www.worldbank.org/icsid/cases/pending.htm>>. This relatively small number of concluded and pending cases actually belies ICSID's importance. As Seidl-Hohenveldern asserts:

[i]t would, however, be a fallacy to conclude from the small number of awards that the ICSID Convention is of only small practical importance. The link between ICSID and the World Bank appears to be so formidable that host States endeavour to avoid as much as possible disputes with a foreign investor that may cause the host State adverse publicity in circles which may have to decide on that State's creditworthiness. The ICSID arbitration clauses thus are just as effective by their mere existence as the British Navy was during the 19th century. The 'fleet in being' kept the peace on the oceans without having to fight any spectacular battles.

SEIDL-HOHENVELDERN, *supra* note 389, at 373; *see also* HIRSCH, *supra* note 397, at 156 ("The small number of disputes that have been addressed to [ICSID] does not necessarily attest to its failure, for the aim of the founders of the Centre was not to increase activity in the area of dispute settlement, but rather, to promote international investments.").

415. Surveys of the world's important arbitral institutions, for example, conclude that ICSID arbitration is preferable to other forms of arbitration. *See* HIRSCH, *supra* note 397, at 155-56 (reviewing those surveys). Clearly, ICSID "is a truly international institution, which is independent of municipal systems of law. The major international commercial arbitration institutions (the International Chamber of Commerce and the American Arbitration Association) are subject to the laws of the states in which they operate, and the enforcement is sought." *Id.* at 158; *cf.* BENJAMIN J. COHEN, *DEVELOPING-COUNTRY DEBT: A MIDDLE WAY* 31-32 (Essays in Int'l Fin. No. 173, 1989) (discussing ICSID as a possible "referee" of negotiations between a debtor-State and its creditors).

416. Unpaid expenses might have to be paid out of the IMF's budget.

417. Similar to the rules under the ICSID Convention, one of the new organization's staff lawyers could also be appointed to serve as the tribunal's secretary, and to act as a channel of

Distinctions would exist between ICSID and a sovereign debt restructuring tribunal, but those distinctions should not prevent ICSID from being used as a model. For example, the ICSID Convention does not necessarily bind contracting States to submit any particular dispute to arbitration; only disputes that the disputing parties agree to submit to ICSID are subject to its jurisdiction.⁴¹⁸ In a sovereign debt restructuring context, however, an unresolved dispute between a creditor and the debtor-State might disrupt an overall settlement among all creditors. To facilitate prompt settlement, the Convention should therefore provide that ratifying States thereby subject themselves to the jurisdiction of the new tribunal. This requirement should not be overly controversial: at least thirty States have already enacted legislation automatically submitting investment disputes with nationals of other States to ICSID arbitration.⁴¹⁹

Another possible distinction is that ICSID primarily arbitrates disputes between contracting States and nationals of other contracting States, whereas in a sovereign debt restructuring context the large number of creditors suggests that some may be nationals of States that have not ratified the Convention. Should the new tribunal adjudicate a dispute between the debtor-State and a creditor from a non-contracting State? As discussed earlier, an unresolved dispute between a creditor and the debtor-State might disrupt an overall settlement among all creditors; I therefore propose that the Convention authorize the new tribunal to arbitrate disputes between contracting States and any creditor that subjects itself to the tribunal's jurisdiction. Most creditors would prefer this scenario to the alternative of suing the debtor-State directly.⁴²⁰ ICSID has actually taken this same approach since 1978 by authorizing the arbitration of investment disputes between contracting States and nationals of noncontracting States that consent to arbitration.⁴²¹

communication between the State and its creditors. The tribunal could also be authorized to require the parties to produce documents or other evidence and to conduct appropriate inquiries.

418. See ICSID Convention, *supra* note 397, at art. 25, para. 1. However, once the parties do consent to jurisdiction, the ICSID arbitration will exclude any other remedy. See *id.* at art. 26.

419. See Parra, *supra* note 397, at 3.

420. See *supra* note 393 and accompanying text (explaining that a creditor would be prejudiced in a lawsuit directly against the debtor-State).

421. See *About ICSID*, *supra* note 397, at para. 5.

Another concern under the ICSID arbitration model is the difficulty ICSID has had in enforcing some awards against recalcitrant States.⁴²² Nonetheless, even ICSID's critics concede that "most arbitral awards are satisfied through voluntary compliance of the parties."⁴²³ Moreover, in a sovereign debt restructuring context, the Convention could provide compelling remedies against a recalcitrant State, such as depriving it of the benefits of the Convention, assessing money damages, or making the State's failure to pay an arbitral award an event of default under its new money financing agreement.

Thus, to the extent that a need exists for a tribunal to adjudicate sovereign debt restructuring disputes, the ICSID model is compelling. That need should be minimal, however, because disputes should rarely occur in a sovereign debt context. The Convention's rules are narrowly crafted, following the axiom that the rules should minimize adjudicatory discretion.⁴²⁴ The only interpretative disputes that might arise would concern either the good faith requirement for filing or the right of creditors to object to an excessive amount of new money financing. Nonetheless, disputes over whether bankruptcy filings are made in good faith are extremely unusual even in a corporate context.⁴²⁵ Also, corporate creditors "very rare[ly]" object to an amount of DIP financing as excessive,⁴²⁶ and in a sovereign debt restructuring, the need to object should be equally rare because of the public scrutiny involved. A tribunal would therefore be required to settle interpretive disputes only in very limited circumstances.

422. See Choi, *supra* note 392, at 180-81 (noting that although contracting States are bound to recognize ICSID arbitral awards, execution of the award is governed by the State's own law, which might give sovereign immunity against execution). Choi explains that as a result, "[i]n two of the three cases in which enforcement of an ICSID award was sought, parties were unable to receive payment of the award because the funds they attached did not qualify for execution under national laws." *Id.* at 181. In a sovereign debt context, execution is unlikely to become a significant issue because enforcement of the underlying debt claim is outside the scope of the Convention.

423. *Id.* at 175.

424. See *supra* notes 136-43 and accompanying text. That axiom has not, however, made the Convention's rules inappropriately narrow. A review of this Article's analysis of each Code section reveals that minimizing adjudicatory discretion was only a marginal factor in determining which section's rules should become part of the Convention. See *supra* Part II.B.

425. See Ponoroff & Knippenberg, *supra* note 110, at 927-42 (observing that bankruptcy filings made by public corporations are never dismissed for lack of good faith, but noting that courts are more likely to dismiss certain filings involving single-asset cases and tax fraud, which would not appear to be relevant to sovereign debt restructuring).

426. Telephone Interview with Lester M. Kirshenbaum, Bankruptcy Partner, Kaye, Scholer, Fierman, Hays & Handler (May 28, 1999).

It also is unlikely that creditors or debtor-States will need a tribunal to enforce the Convention. Debtor-States should want to adhere to the Convention because its provisions are largely for their benefit and also because their reputations—necessary to regain access to capital market funding at a later date—will depend on compliance.⁴²⁷ If a creditor located in a nonsignatory State objects to a restructuring plan achieved through super-majority voting or to another creditor's new money priority, its only remedy would be to sue the debtor-State. If the creditor brings the suit before the new tribunal, however, the tribunal would simply adhere to the rules of the Convention. The objecting creditor could attempt to bypass the tribunal, perhaps by suing in a foreign court⁴²⁸ outside the debtor-State.⁴²⁹ However, even if the objecting creditor wins that lawsuit,⁴³⁰ the only

427. See ABRAM CHAYES & ANTONIA HANDLER CHAYES, *THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS* 10, 27 (1995) (observing that in the increasing world climate of interdependence, States are prone to comply with their treaty obligations in order to preserve their international reputation). More reliable ways to ensure State compliance exist, although they do not appear necessary. For example, each signatory State could be required to deposit money into an international escrow account, equal to a percentage of the State's sovereign borrowings. The State would forfeit the money if it subsequently breached the Convention. A State that *ex ante* does not intend to breach should be prepared to make this deposit, provided that the escrow account bears a market rate of interest and is small enough to not impair the State's liquidity.

428. This scenario assumes that the objecting creditor has a proper jurisdictional basis to commence such a lawsuit. Sovereign immunity would not impede such a suit if, as is typical, the doctrine is waived as a defense in the financing agreement. See Greenwood & Mercer, *supra* note 323, at 106; see also Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 245 (1998) ("Requiring the company to waive sovereign immunity may be a solution to [the sovereign immunity defense] problem."). As a practical matter, private creditors might be reluctant to commence such expensive litigation.

429. To prevent this, the Convention might provide that all lawsuits commenced outside the tribunal should be moved to the tribunal.

430. A court might uphold the objecting creditor's claim. For example, in *Allied Bank Int'l v. Banco Crédito Agrícola de Cartago*, 757 F.2d 516, 519 (2d Cir. 1985), a member of a bank syndicate that refused to join a restructuring agreement between Costa Rican sovereign debtors and other syndicate members sued in the United States for repayment of its defaulted loan. See *id.* The court granted summary judgment in favor of the objecting bank on the basis that the loan was clearly due and payable, notwithstanding Costa Rica's unilateral regulation suspending its external debt payments. See *id.* at 522-23. The court held that the U.S. act of state doctrine, which provides that "the courts of one country will not sit in judgment on the acts of the government of another done within its own territory," was inapplicable; the court found that the situs of the property in question—the objecting bank's right to receive payment from the Costa Rican debtors—was New York, where the debt was payable. *Id.* at 520-21. Costa Rica's unilateral suspension of debt payments was "inconsistent with the orderly resolution of international debt problems . . . [and] contrary to the interests of the United States." *Id.* at 522. This case does not suggest, however, that an objecting creditor will always be able to work mischief. The court might have decided the case differently if the restructuring agreement was

practical remedy is to attach the debtor-State's foreign assets,⁴³¹ a remedy that is inconsequential in most cases.⁴³²

In sum, implementing the Convention should be relatively straightforward. States themselves should want to become signatories to the Convention because its primary goal is to foster the State's ultimate economic rehabilitation in a time of crisis. Under the Convention, debt negotiations should be self-executing, although a neutral multilateral institution such as the IMF will be necessary to monitor and impose conditionality on priority financing. That same institution could also serve as a nonrecourse funding intermediary, or could perform other administrative functions that may arise. To the limited extent that disputes between a State and its creditors require adjudication, hearings could occur on an ad hoc basis before an existing international judicial body, or the Convention could establish a new low-cost tribunal based on the ICSID model.

CONCLUSION

Sovereign debt restructuring currently gives rise to various problems. The conflicting interests of the State and its creditors, as well as the collective action problem among creditors, make it difficult to reach agreement on a restructuring plan. The increasing shift from bank to bond financing exacerbates this difficulty. Multilateral entities such as the IMF have attempted to aid the process of sovereign debt restructuring, but may have worsened matters: their efforts create a risk of moral hazard and, to the extent that IMF funding is derived from member-States, foster taxpayer subsidy of foreign States and their creditors. This Article has examined whether supranational legal regulation based on principles of bankruptcy reorganization law could effectively address these problems.⁴³³

reached in accordance with an international convention to which the United States was a party. Moreover, courts in other States, faced with the same facts, might have reached a different outcome.

431. *Cf., e.g.,* *Felixstowe Dock & Ry. Co. v. U.S. Line Inc.*, 1989 Q.B. 360 (permitting U.K. creditors to freeze a U.S. corporate debtor's assets in the U.K. notwithstanding a contrary order of the U.S. bankruptcy court).

432. *See supra* note 422-23 and accompanying text.

433. In March 2000, concurrently with the final editing of this Article, the International Financial Institution Advisory Commission, created by the United States Congress in November 1998 to study the future role of the IMF, issued its report (the "Report"). *See* International Financial Institution Advisory Commission, *Report* (visited March 29, 2000) <<http://phantom-x.gsia.cum.edu/IFIAC/USMRPTDV.html>>. To the extent there is overlap, the conclusions in the Report turn out to be consistent with the conclusions in this Article, including that the IMF

Although regulation should have normative underpinnings, no existing scholarship purports to offer a normative legal theory of sovereign debt restructuring. I have attempted to do so by examining how the conceptual basis of bankruptcy reorganization law can be adapted to sovereign debt restructuring. Disputes over the conceptual basis of bankruptcy reorganization law complicate, but at the same time universalize, my examination. Some scholars argue that bankruptcy reorganization law should advance traditional goals; other scholars argue that the only goal of bankruptcy reorganization law should be economic efficiency. The disputes reflect the different initial axioms scholars use.

First, this Article analyzed these disputes in an attempt to understand which axioms should apply to sovereign debt restructuring. Next, it used those axioms to derive a normative framework for regulation. The Article then completed this framework by accounting for the previously identified problems of sovereign debt restructuring and used the framework to model a simple but arguably effective system of rules for an international convention on sovereign debt restructuring. In so doing, the framework effectively blurred the distinction between public and private international law.

Under my proposed Convention, financiers of a State's debt restructuring would have priority over claims of other creditors. Also, the Convention would bind all creditors to a plan of reorganization that classes of claims agree to by super-majority voting and, upon such agreement, would discharge debts not provided for in the plan. This benefits debtor-States by providing incentives for new credit and by minimizing the collective action problem. States therefore should find it in their interest to ratify the Convention.

Appendix I sets forth a proposed model form of the Convention. To preserve the dignity of States seeking the protection of this Convention and to avoid discouraging its use, the Convention does not speak in terms of bankruptcy or insolvency, nor does it require a State to be insolvent to seek protection thereunder or otherwise dif-

should restrict its lending to providing liquidity loans to economically sound States that are facing default because of irrational exogenous factors, such as financial panics. *See id.* at 2, 5. There nonetheless might appear to be an inconsistency: the Report criticizes the "detailed conditionality . . . that has burdened IMF programs in recent years," *id.* at 6, whereas this Article contemplates that the IMF would continue to impose conditionality. *See supra* notes 31-32, 203 and accompanying text. This Article does not analyze, however, whether conditionality should continue; it merely assumes that conditionality will continue. To the extent conditionality is inappropriate, nothing in this Article requires its continuance.

ferentiate between exogenous and endogenous factors that lead to default.⁴³⁴ Although this construction increases the potential for strategic manipulation, the Convention's provisions are narrowly circumscribed to prevent opportunistic behavior.

Contrary to assumptions made in the economic literature, the Convention would be largely self-executing and would not require supervision by a bankruptcy court. Only occasional monitoring is needed to ensure that the priority financing does not result in overinvestment. A neutral international institution such as the IMF could perform that monitoring, without raising the problems associated with direct IMF funding. To the limited extent disputes must be adjudicated under the Convention, that task could be performed by establishing a low-cost arbitration procedure, perhaps based on the ICSID model. Furthermore, by acting as an intermediary funding source, the IMF or other institution could continue the current practice of imposing conditionality on funding without causing the problems presently associated with IMF lending.

434. An exception is the limited extent that irrational exogenous factors could justify IMF funds for maintenance of temporary liquidity.

APPENDIX I
PROPOSED MODEL CONVENTION⁴³⁵

Chapter I: Scope, and Use of Terms

ARTICLE 1: SCOPE

This Convention applies to debt restructurings between sovereign States and their creditors.

ARTICLE 2: USE OF TERMS

For purposes of this Convention:

- (1) "Contracting State" means a sovereign State for which this Convention is in force;
- (2) "creditor" means an entity that has a claim for payment against a Contracting State;
- (3) "debtor-State" means a Contracting State that has filed for relief under this Convention;
- (4) "Plan" means a debt restructuring plan;
- (5) "Supervisory Authority" means the [International Monetary Fund].

Chapter II: Invoking the Convention

ARTICLE 3: PETITION FOR RELIEF

- (1) A Contracting State may invoke application of this Convention by filing a voluntary petition for relief with the Supervisory Authority.
- (2) Immediately after such a petition for relief has been filed, and so long as such filing has not been dismissed by the Supervisory Authority for lack of good faith, the provisions of this Convention shall apply to the relationship between the Contracting State and its creditors.

435. The author acknowledges with appreciation the assistance of Adam Munson in drafting this model. I intend this model to be illustrative rather than definitive. Therefore, I have simplified its provisions and omitted technical matters such as approval of claims and voting disclosure.

ARTICLE 4: NOTIFICATION OF CREDITORS

Within 30 days after filing its petition for relief, the debtor-State shall notify all of its known creditors of its intention to negotiate a Plan under this Convention.

Chapter III: The Debt Restructuring Plan

ARTICLE 5: SUBMISSION OF PLAN

- (1) The debtor-State may submit a Plan to its creditors at any time, and may submit alternative Plans from time to time.
- (2) No other person or entity may submit a Plan.

ARTICLE 6: CONTENTS OF PLAN

A Plan shall:

- (1) designate classes of claims in accordance with Article 7(3);
- (2) specify the proposed treatment of each class of claims; and
- (3) provide the same treatment for each claim of a particular class, unless the holder of a claim agrees to a less favorable treatment.

ARTICLE 7: VOTING ON THE PLAN

- (1) A Plan shall become effective and binding on the debtor-State and its creditors when it has been submitted by the debtor-State and agreed to by each class of such creditors' claims. Thereupon, the debtor-State shall be discharged from any debt then in existence,⁴³⁶ except as provided in the Plan.
- (2) A class of claims has agreed to a Plan if creditors holding at least [two-thirds] in amount and more than [one-half] in number of the claims of such class [voting on such Plan⁴³⁷] [entitled to vote on such Plan] agree to the Plan.
- (3) Each class of claims shall consist of claims against the debtor-State that are pari passu in priority, provided that (a) pari passu claims need not all be included in the same class, and (b) claims of governmental or multi-governmental entities each shall be classed separately.

436. [Alternatively, the Convention could except discharge of debts owed to entities that neither had notice nor actual knowledge of the Plan.]

437. [The Plan can be more easily approved if this alternative is selected, but reliable notice to creditors then becomes more important.]

Chapter IV: Financing the Restructuring

ARTICLE 8: TERMS OF LENDING

The Supervisory Authority shall have the right, but not the obligation, to lend money to a debtor-State on such terms and conditions as the Supervisory Authority deems appropriate, taking into account the debtor-State's use of the loan proceeds.

ARTICLE 9: PRIORITY OF REPAYMENT

- (1) Debtor-States must repay loans made by the Supervisory Authority prior to paying any other claims.
- (2) Such priority of payment shall extend to any assignee of the Supervisory Authority.

ARTICLE 10: NONRECOURSE BORROWING BY SUPERVISORY AUTHORITY

- (1) To finance its lending to a debtor-State, the Supervisory Authority may borrow on such terms and conditions as it may negotiate, provided that neither the Supervisory Authority nor its assets shall be liable, contingently or otherwise, for repayment of such borrowing except as set forth below.
- (2) As collateral for a borrowing, the Supervisory Authority may assign as security its right to payment under the loan made from the proceeds of such borrowing.
- (3) The Supervisory Authority may borrow on a general recourse basis in order to make loans to debtor-States whose financial distress results primarily from factors that are [unforeseeable and] beyond their control.

Chapter V: Adjudication of Disputes

[This Chapter could follow the model of ICSID's convention, except that States ratifying this Convention would thereby subject themselves and their nationals to submit all disputes arising under the Convention to the jurisdiction of the adjudicatory tribunal.]

Chapter VI: Ratification

ARTICLE 11: PROCEDURES

- (1) This Convention shall enter into force upon ratification or other approval by at least [three] sovereign States.
- (2) On or before ratifying or otherwise approving this Convention, each Contracting State shall undertake such legislation or other measures as may be necessary for making this Convention effective as national law in its territories.

ARTICLE 12: EFFECT OF RATIFICATION

Ratification of this Convention shall be binding on each Contracting State and on each national thereof, irrespective of contractual provisions that are inconsistent with the provisions of this Convention or the date that a national's claim against a Contracting State arose.