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CHALLENGES FOR SOVEREIGN DEBT RESTRUCTURING: THE EUROZONE DEBT CRISIS AND BEYOND

Sovereign Debt Restructuring Options:
An Analytical Comparison

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SOVEREIGN DEBT RESTRUCTURING OPTIONS: AN ANALYTICAL COMPARISON

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The recent financial woes of Greece, Ireland, Portugal, and other nations have reinvigorated the debate over whether to bail out defaulting countries or, instead, restructure their debt. Bailouts are expensive, both for residents of the nation being bailed out and for parties providing the bailout funds. Because the IMF, which is subsidized by most nations (including the United States), is almost always involved in country debt bailouts, we all share the burden. Yet bailouts are virtually inevitable under the existing international framework; defaults are likely to have systemic consequences, whereas an orderly debt restructuring is currently impractical. This Article analyzes and compares debt restructuring alternatives to bailouts. Under a free-market option, sovereign debtors and their creditors attempt to consensually negotiate a debt restructuring, aided by collective-action clauses and by exchange offers with exit consents. Under a statutory option, sovereign debtors and their creditors would be bound by an international convention that sets forth a process to facilitate debt restructuring. The absence of any systematic comparison of these options has made it difficult to facilitate country debt restructurings. This Article attempts to provide that comparison.

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INTRODUCTION

The recent financial woes of Greece, Ireland, Portugal, and other nations have reinvigorated the debate over whether to bail out defaulting countries or, instead, restructure their debt. In Greece, for example,[1] the debate has been highlighted by scenes worthy of a Sophoclean tragedy, as protestors fought tear gas and riot police on the streets of Athens.[2] And just days before a June 2011 vote of confidence in parliament, Greek citizens, through a nationwide strike, displayed their indignation at bailout terms imposing harsh austerity measures and requiring their country to sell off state assets.[3] Bailouts are expensive not only in human terms. The initial Greek bailout costing $110 billion in 2010 eventually needed to be supplemented by $85 billion in bailout funds.[4] Although the European Union and the International Monetary Fund (IMF) have been underwriting the Greek bailout, the IMF's payment is funded by all IMF member-nations—the United States, for example, provides 17% of IMF funding[5]—so many nations are sharing in the burden.[6]

A Greek debt bailout was virtually inevitable because a default was believed to have the potential to bring down the world financial system,[7]

[1] Although Greece is a dramatic example of a nation with debt problems, it may not be a representative example. *See, e.g.*, *infra* note 7 (observing two features that make Greece unrepresentative: the widespread exposure of European banks to Greek debt and Greece's inability to devalue its currency due to being part of the Eurozone). This Article engages the question of sovereign debt restructuring more generally. R

[2] *Cf.* Buttonwood, *Greece, Default and Public Unrest: The Cost of Denial*, ECONOMIST (June 16, 2011, 8:17 AM), http://www.economist.com/blogs/buttonwood/2011/06/greece-default-and-public-unrest (but also noting that, despite widespread news coverage of violent protesters, most activists have voiced concerns peacefully).

[3] *See The Euro Crisis: A Second Wave*, ECONOMIST, June 18, 2011, at 29.

[4] *Id.* The predictive value of the historically low default rate on the repayment of bailout loans (at least those made by the IMF) is doubtful because "bad" debt has usually been rolled over rather than being considered in default. *See* Olivier Jeanne & Jeromin Zettelmeyer, *International Bailouts, Moral Hazard, and Conditionality*, 16 ECON. POL'Y 408, 415 (2001).

[5] Sudeep Reddy, *Obama and IMF Step Up Efforts to Contain Debt Woes*, WALL ST. J., Dec. 3, 2011, at A12.

[6] Nor are IMF payments made to bail out IMF member-nations necessarily profitable investments for the other IMF member-nations. Member-nations earn interest on their deposits in the IMF, but repayment by the IMF, although anticipated, is not assured. Furthermore, the IMF pays member-nations less than a market rate of interest on their deposits. *See* Steven L. Schwarcz, *"Idiot's Guide" to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1195–96 (2004) [hereinafter Schwarcz, *Idiot's Guide*].

[7] Two factors exacerbate the potential for systemic contagion from a Greek debt default: the widespread exposure of banks across Europe to Greek debt, *see* Megan Murphy et al., *Greek Contagion Fears Spread to Other EU Banks*, FIN. TIMES, June 15, 2011, *available at* http://www.ft.com/cms/s/0/ac918946-975a-11e0-9c9d-00144feab49a.html, and Greece's inability to devalue its currency due to being part of the Eurozone. *See* Natascha Gewaltig, *Greece's Painful Choice*, BUS. WEEK, Feb. 19, 2010, *available at* http://www.businessweek.com/investor/content/feb2010/pi20100218_722508.htm. But any default of a nation with significant amounts of debt can trigger contagion not only by directly impacting the nation's creditors but also by impacting parties, often unknown ex ante, that have hedged the nation's debt through credit-default swaps and other derivative products. In the case of Greece, for example, derivatives further complicated policymakers' decisions by blurring

whereas an orderly debt restructuring was impractical. This is a growing problem. As global capital markets increasingly (and inevitably) embrace sovereign bonds,[8] the potential for a nation's debt default to trigger a larger systemic collapse increases as these relationships become even more tightly linked.[9]

That in turn gives rise to a phenomenon often viewed as limited to large banks—the problem of "too big to fail." A bank whose default could trigger an economic domino effect is, or at least may be perceived to be, too big to fail. Therefore, it may need to be bailed out by public funds. This can foster moral hazard: anticipating a bailout, the bank may lack incentive to take a prudent economic course.[10] Likewise, nations—even those as small as Greece—can be seen as too big to fail if their default could trigger a wider economic collapse. That too can foster moral hazard; indeed, sovereigns are more likely to engage in morally hazardous behavior than banks, which can be liquidated.[11] The Greek government, for example, did little to impose fiscal austerity even as debts accumulated.[12]

This Article analyzes and compares debt restructuring alternatives to bailouts.[13] This inquiry is important not only because of the current sovereign debt crisis. The problem of sovereign debt constantly reoccurs—for centuries, "repeated sovereign default[s] [have been] the norm throughout

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the consequences of those decisions. *See* Louise Story, *Derivatives Cloud the Possible Fallout from a Greek Default*, N.Y. TIMES, June 22, 2011, at B1.

[8] *See, e.g.*, INT'L MONETARY FUND, PROPOSALS FOR A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003), http://www.imf.org/external/np/exr/facts/sdrm.htm [hereinafter SDRM] ("In recent years countries have turned increasingly from bank loans to bond issues to raise capital. . . . [T]his is beneficial [because] the international capital markets are more diversified and function more efficiently . . . [having] a broader investor base available to provide financing for emerging market sovereigns, which has helped diversify risk.").

[9] Sovereign bonds also greatly increase the number of creditors, which exacerbates the "hold-out" problem described *infra* text accompanying notes 17–23. *See, e.g.*, SDRM, *supra* R
note 8 (observing that the increase in sovereign bonds has caused "private creditors [to] become increasingly numerous, anonymous and difficult to coordinate"). R

[10] Moral hazard more generally refers to the tendency of persons who are protected from the consequences of risky behavior to engage in such behavior.

[11] At least some sovereigns do little to hide their awareness of being seen as too big to fail. Evangelos Venizelos, Greece's finance minister, suggested to European policy makers in late June 2011, for example, that the European market needed an orderly restructuring of Greece's debt much more than did Greece. *See* Charlemagne, *Default Options*, ECONOMIST, June 25, 2011, at 68. Mr. Venizelos' statement poignantly reflects Keynes's astute and oft-quoted aphorism that "'[i]f I owe you a pound, I have a problem; but if I owe you a million, the problem is yours.'" *Id.*

[12] *See, e.g.*, *Greece's Budget Crisis: Papandreou Tries to Prop Up the Pillars*, ECONOMIST, Dec. 19, 2009, at 48.

[13] This Article presumes that the sovereign debt in question has been legitimately incurred and that repayment is not based on any determination of the morality of the debt. *Cf.* Caroline M. Gentile, *The Market for Odious Debt*, 73 LAW & CONTEMP. PROBS. 151, 151 (2010) (describing odious debts as "debts incurred by a dictatorial regime for its own benefit with the knowledge of the creditors, but without the consent of the nation's citizens," which, on that basis, may later be declared "unlawful" and thus not require repayment).

every region in the world"[14]—sometimes with devastating consequences for the defaulting nation[15] and sometimes for the world.[16]

I. Alternatives to Bailouts

A. Debt Restructuring

There are at least two potential debt restructuring alternatives to bailouts, one contractual, or "free market," and the other statutory. To understand these alternatives, it is necessary to understand the hold-out problem. This is a classic collective action problem: in any debt restructuring, one or more creditors may strategically hold out from agreeing to a reasonable debt restructuring plan. The hold-outs hope either that they will receive full payment of their claims or that the imperative of other creditors to settle will persuade those creditors to allocate the hold-outs more than their fair share of the settlement.[17]

At least in the sovereign debt context, courts have upheld this type of hold-out behavior. In *Allied Bank International v. Banco Credito Agricola de Cartago*,[18] 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.[19] The court granted summary judgment in favor of the hold-out bank on the basis that the loan was clearly due and payable, notwithstanding Costa Rica's unilateral regulation suspending its external debt payments.[20] Similarly, in *Elliott Associates v. Banco de la Nacion*,[21] the hold-out was a vulture fund (a fund that invests in distressed debt) that had bought debt of two government-guaranteed Peruvian banks at a deep discount. The fund then received, but

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[14] Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises* 5, 53 (Nat'l Bureau of Econ. Research, Working Paper No. 13882, 2008), *available at* http://www.nber.org/papers/w13882 (also observing that it "may be premature" to "celebrat[e]" the view that nations and creditors have learned from past mistakes).

[15] *See id.* at 12 (observing that, due to debt defaults, Newfoundland lost its sovereignty and ultimately became a province of Canada, and Egypt became a British protectorate).

[16] *See supra* text accompanying notes 7–9 (discussing the risk of global financial contagion from a sovereign debt default); s*ee also* Mardi Dungey et al., *International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse* (Int'l Monetary Fund Working Paper, No. WP/02/74, 2002), *available at* http://www.imf.org/external/pubs/ft/wp/2002/wp0274.pdf (discussing the feared systemic consequences if, precipitated by the 1998 Russian Federation debt default, Long-Term Capital Management collapsed). R

[17] *See* Schwarcz, *Idiot's Guide*, *supra* note 6, at 1193. A hold-out may also hope that other creditors will purchase the hold-out's claim. *Id.* The average hold-out is more likely to want a settlement than to want to ultimately litigate for full payment because of the high cost of litigation, especially against a sovereign debtor. Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. Rev. 59, 60 n.2 (2000). R

[18] 757 F.2d 516 (2d Cir. 1985).

[19] *See id.* at 519.

[20] *See id.* at 522–23.

[21] 194 F.3d 363 (2d Cir. 1999).

refused to participate in, an offer to exchange that debt for new bonds. When Elliott Associates sued Peru for payment, Elliott was granted judgment on appeal, but the parties ultimately settled.[22]

The hold-out problem can severely impede a "bilateral" debt restructuring, that is, one negotiated between a sovereign debtor and its creditors. On a practical level, the hold-out problem motivates creditors to refuse in the first instance to agree to a reasonable restructuring plan. Perhaps more significantly, the very existence of hold-outs can undermine the willingness of other creditors to agree to a reasonable restructuring plan.[23] The first task of any sovereign debt restructuring scheme should therefore be to help solve the hold-out problem.[24]

Both free-market and statutory options for sovereign debt restructuring can address the hold-out problem. Under a free-market debt restructuring option, the hold-out problem would be addressed through the inclusion of so-called "collective-action clauses" (CACs) in financing agreements. Any bilateral debt restructuring plan[25] is likely to need to include changes to essential payment terms, such as delaying debt repayment maturities, reducing amounts of principal, or reducing interest rates.[26] Financing agreements often require unanimous consent of the parties to make these types of changes.[27] The essential payment terms of financing agreements that include CACs can be amended, however, with the consent of a supermajority, as opposed to all, of the creditors party to that agreement.[28] Hold-outs are thus bound to terms

[22] Schwarcz, *Idiot's Guide*, *supra* note 6, at 1193 n.14. R

[23] *See, e.g.*, John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. Chi. L. Rev. 1207, 1223 (1991) ("One bondholder's opportunistic behavior may dissuade the other bondholders from engaging in collective action because they fear they will be exploited by those that hold out or otherwise defect from their coalition.").

[24] There are indications that Eurozone sovereign debt is not currently subject to a significant hold-out problem because most of the debt is now being held by the European Central Bank and large German banks. *See* John Dizard, *Why Speculators Shun Euro Sovereign Debt*, Fin. Times, Feb. 28, 2011, at 5. That situation could change rapidly, though, if (for example) one or more existing holders sell their debt to more aggressive investors. Moreover, this Article engages the sovereign debt problem in a context broader than the current Eurozone.

[25] Unless the context requires otherwise, references in this Article to free-market debt restructuring will mean bilateral free-market debt restructuring, as opposed to a technically "free market" debt restructuring unilaterally imposed by a debtor nation.

[26] *See* Schwarcz, *Idiot's Guide*, *supra* note 6, at 1193. R

[27] Barry Eichengreen & Ashoka Mody, *Do Collective Action Clauses Raise Borrowing Costs?*, 114 Econ. J. 247, 247–48 (2004) (noting that financing agreements governed by U.S., German, or Japanese law, which constitute approximately two-thirds of emerging market debt, usually require unanimous consent for modification of essential payment terms, whereas financing agreements governed by U.K. or Luxembourg law often have collective-action clauses for modification of essential payment terms).

[28] *See, e.g.*, Barry Eichengreen, Towards a New International Financial Architecture: A Practical Post-Asia Agenda 65–70 (1999); Christopher Greenwood & Hugh Mercer, *Considerations of International Law*, *in* Crisis? What Crisis? Orderly Workouts for Sovereign Debtors 110 (Barry Eichengreen & Richard Portes eds., 1995); Buchheit & Gulati, *supra* note 17, at 68. R

negotiated by that supermajority, making it much easier to successfully negotiate a bilateral debt restructuring plan.[29]

CACs can be included in sovereign financing agreements at the time they are originally executed. When CACs are not already included, a sovereign debtor can attempt to later include them by engaging in exchange offers with exit consents—effectively replacing existing debt claims with debt securities governed by CACs.[30]

Because no international convention establishing a statutory framework for sovereign debt restructuring currently exists,[31] current sovereign debt restructuring efforts take place entirely under the free-market option.[32]

Under a statutory debt restructuring option, the hold-out problem would be addressed by an international treaty or convention (the terms being synonymous)[33] that binds sovereign debtors and their creditors to a process to facilitate debt restructuring. The most well-known example is the so-called sovereign debt restructuring mechanism (SDRM), proposed by the IMF.[34] A predecessor sovereign debt restructuring convention (SDRC) has also been proposed in the academic literature.[35] Because neither the SDRM nor the SDRC (nor any other international debt restructuring convention) has yet been put into force under international law, no sovereign debt restructuring efforts have yet taken place under the statutory option.[36]

Scholars and commentators have not yet been able to agree on which sovereign debt restructuring option—free-market or statutory—is preferable.

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[29] *See* Schwarcz, *Idiot's Guide*, *supra* note 6, at 1197–98. R

[30] *See* Buchheit & Gulati, *supra* note 17, at 65–66. For further detail on how exchange offers with exit consents would work, *see infra* text accompanying notes 65–73. R R

[31] Article 2.1(a) of the Vienna Convention on the Law of Treaties defines a treaty as "an international agreement concluded between States in written form and governed by international law . . . *whatever its particular designation*." Vienna Convention on the Law of Treaties, art. 2.1(a), May 23, 1969, 1115 U.N.T.S. 331 (emphasis added). *Cf.* HOLGER SCHIER, TOWARDS A REORGANISATION SYSTEM FOR SOVEREIGN DEBT: AN INTERNATIONAL LAW PERSPECTIVE 49 (2007) (using the terms convention and treaty interchangeably).

[32] SCHIER, *supra* note 31, at 49 (citing Rudolf Dolzer, *Staatliche Zahlungsunfahigkeit: Zum Begriff und zu den Rechtsfolgen im Völkerrecht*, *in* DES MENSCHEN RECHT ZWISCHEN FREIHEIT UND VERANTWORTUNG [*State Insolvency: Concept and Legal Consequences in International Law*, *in* HUMAN RIGHTS BETWEEN FREEDOM AND RESPONSIBILITY] 540 (Jürgen Jekewitz ed., 1989). R

[33] *See supra* text accompanying note 31. R

[34] *See* SDRM, *supra* note 8. Because a formal statutory version of the SDRM was never finalized, references in this Article to provisions of the SDRM will refer to the "Proposed Features of a Sovereign Debt Restructuring Mechanism" in the Attachment to INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM (2003), http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf. R

[35] *See* Schwarcz, *Idiot's Guide*, *supra* note 6, app. 1, at 1215–18 [hereinafter SDRC]. The SDRC was itself based on the Proposed Model Convention in Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 1020–22, app. 1 (2000) [hereinafter Schwarcz, *Bankruptcy Reorganization Approach*]. R

[36] *See supra* note 32.

The lack of consensus can be explained, at least in part, by the paucity of systematic comparison of these options.[37] This Article seeks to fill that gap.

Such a comparison will better inform the question of whether sovereign debt restructuring efforts should continue to take place entirely under the free-market option or whether there should also be an effort to promote an international convention that could facilitate the statutory option as a supplement to, or a replacement for, the free-market option.[38]

B. Other Alternatives

This Article focuses on bilateral debt restructuring and thus does not examine in depth other possible alternatives to bailouts. For example, a sovereign nation could attempt to unilaterally restructure its debt—effectively defaulting on its debt while dictating new payment terms to creditors. Unlike corporations and other non-sovereign debtors, which generally cannot unilaterally avoid their debt obligations without enforcement consequences a sovereign nation can, and sometimes does, de facto refuse to pay a debt or at least defer its payment to a later date.[39] The nation may well suffer reputational consequences, and any national assets (such as ships or airplanes) outside the nation's jurisdiction might be able to be seized.[40] But there cur-

[37] *See, e.g.*, Leszek Balcerowicz, *Sovereign Bankruptcy in the European Union in the Comparative Perspective* 10–12 (Peterson Inst. for Int'l Econ., Working Paper No. WP 10-18, 2010) (observing that arguments put forward by proponents of the statutory option "are rarely based on a careful comparative analysis of the proposed SDRM with the other already existing debt resolution mechanisms"). The comparative analyses are few. *See, e.g.*, Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, 50 IMF ECON. REV. 41 (2003) (arguing that key elements of various corporate bankruptcy codes offer useful insights applicable at the global sovereign level and discussing whether a statutory option such as the SDRM or a more market-based contracts option is preferable); Jonathan Sedlak, *Sovereign Debt Restructuring: Statutory Reform or Contractual Solution?*, 152 U. PA. L. REV. 1483 (2004) (comparing statutory and market-based options for sovereign debt restructuring in light of U.S. resistance to a statutory option). Previously, I have written a partial comparative analysis and a fanciful comparative analysis. *See*, respectively, Schwarcz, *Idiot's Guide*, *supra* note 6, at 1203–06; Steven L. Schwarcz, *Looking Forward: 2005–2010 A Sovereign Debt Restructuring Reverie*, 6 U. CHI. J. INT'L L. 381 (2005). R

[38] *Cf.* Natasha Brereton, *BOE: Debt Woes Need "Comprehensive" Solution*, WALL ST. J., Dec. 17, 2010, *available at* http://online.wsj.com/article/SB10001424052748704034804576025100276111250.html (observing that the Bank of England has called for a comprehensive approach to sovereign debt restructuring).

[39] *See, e.g.*, Allied Bank Int'l. v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985) (referencing Costa Rica's unilateral regulation suspending its external debt payments); *Sovereign Default and Recovery Rates 1983–2009*, MOODY'S INVESTORS SERVICE ex. 7, app.1 (2010), http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_124389 (documenting various unilateral refusals to pay or payment deferrals of sovereign debt, including by Argentina in 2001 and by Russia in 1998). *Cf.* Schwarcz, *Bankruptcy Reorganization Approach*, *supra* note 35, at 1020 (observing that the power of a nation to force a unilateral debt restructuring represents an implicit threat that is likely to motivate creditors to engage in a consensual restructuring). R

[40] Sovereign nation funds often cannot be located or easily identified, forcing creditors to creatively seek out other assets that can be seized outside the debtor nation. David Bosco, *The*

rently is no international law mechanism designed to enforce payment of the debt if the nation's internal legal system fails to honor foreign enforcement efforts, nor do there appear to be any economic or other sanctions that can effectively be imposed on the nation.[41]

Because unilateral debt restructuring is merely default cloaked in semantics, it could pose the same threat of systemic risk as any other manifestation of default. Furthermore, given anticipated creditor opposition, any unilateral restructuring attempt could well be disorderly, generating multiple lawsuits.[42] I therefore regard unilateral debt restructuring by a sovereign debtor as a normatively undesirable alternative to a bailout.[43]

Another way to avoid bailouts is to institute a sovereign debt system that ex ante minimizes the chance of default.[44] How such a system might be structured, however, is beyond this Article's scope.[45]

The Article next focuses on comparing the free-market and statutory options for sovereign debt restructuring.[46]

Debt Frenzy, 161 Foreign Pol'y 36, 40–41 (2007). These efforts, however, have largely been unsuccessful. *See, e.g.*, Seijas v. Republic of Argentina, 391 F. App'x. 901, 902 (2d Cir. 2010) (failed attempt to seize U.S.-located airplanes of a nationalized commercial airline).

[41] Schier, *supra* note 32, at 203–05 (discussing potential sanctions and their limitations). R
Although some creditors have attempted to use foreign court judgments against a debtor nation as leverage, *see infra* note 111, that has proved relatively ineffective as a means of forcing R
debtor nations to pay those creditors. Faisal Z. Ahmed et al., *Lawsuits and Empire: On the Enforcement of Sovereign Debt in Latin America*, 73 Law & Contemp. Probs. 39, 42–46 (2010).

[42] *See* Anna Gelpern, *What Bond Markets Can Learn from Argentina*, 24 Int'l Fin. L. Rev. 19, 21 (2005) (noting that Argentina faced thousands of lawsuits, including dozens in New York and over a hundred in Europe, during and after its unilateral debt restructuring).

[43] The ultimate power of a nation to force a unilateral debt restructuring nonetheless represents an implicit threat that, like a consensual debt restructuring in the shadow of bankruptcy law, is likely to motivate creditors to engage in a consensual debt restructuring. *Cf.* Schwarcz, *Bankruptcy Reorganization Approach*, *supra* note 35, at 1020 (comparing corporate debt re- R
structuring under the "shadow of bankruptcy law" with sovereign debt restructuring).

[44] Balcerowicz, *supra* note 37, at 13. R

[45] For an assessment of ex ante and ex post approaches to financial regulation, see generally Steven L. Schwarcz, *Ex Ante Versus Ex Post Approaches to Financial Regulation*, Chapman L. Rev. (forthcoming 2012), *available at* http://ssrn.com/abstract=1748007 (providing an overview of the ex ante versus ex post regulatory dichotomy).

[46] These are the primary bilateral sovereign debt restructuring options. Although commentators have advanced other options, they do not purport to be nearly as comprehensive. For example, Banque de France and the International Institute of Finance have suggested that sovereign nations and their creditors could attempt to restructure debt pursuant to voluntary codes of conduct. *See* Nouriel Roubini & Brad Setser, Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform 10 (2003) (unpublished manuscript), http://www.iie.com/publications/papers/roubini-setser0303.pdf. These codes could set forth aspirational goals, such as facilitating early and regular dialogue between nations and their creditors, sharing of information, treating creditors fairly, conditioning any debt restructuring on economic reform, and mediating disputes. *See* Bertrand Couillault & Pierre-François Weber, *Towards a Voluntary Code of Good Conduct for Sovereign Debt Restructuring*, 2 Fin. Stability Rev. 154, 157–60 (2003). Similarly, some have proposed that nations could include arbitration clauses in their debt contracts to resolve debt restructuring disputes. Allan L. Gropper, United States Bankruptcy Judge, S.D.N.Y, Presentation at the Eleventh Annual Conference of the International Insolvency Institute (June 13, 2011) (on file with author). Because arbitration clauses would be limited to consenting credi-

II. Analysis

A. *Defining the Options*

In order to compare free-market and statutory options, one must first clearly define each option. As previously discussed, the free-market option is contractual. It attempts to address the hold-out problem through CACs—whether those clauses are originally included in financing agreements or later included through exchange offers with exit consents.[47]

The statutory option has at least two possible models: the SDRM and the SDRC.[48] The main provisions of the SDRM and the SDRC are nonetheless functionally equivalent. Both attempt to address the hold-out problem through supermajority voting.[49] Both also attempt to address the funding problem of sovereign debt restructuring[50]—that a nation is likely to need to borrow new money to pay critical expenses during the debt restructuring process, but no lender is likely to be willing to lend such funds unless its right to repayment has priority over existing debt claims.[51] Furthermore, both allow debtor nations to voluntarily decide whether to apply the provisions to their debt problems.[52]

These key similarities should not be a surprise: the SDRM is based on the same research that generated the SDRC.[53] Differences between the SDRM and the SDRC are mostly in the details. For example, the SDRM excludes claims from foreign governments,[54] whereas the SDRC allows such claims but provides that such claims each constitutes its own separate class.[55] The SDRM requires the debtor nation to decide in advance which debts to restructure thereunder and which debts, if any, to either not restructure or to restructure outside the SDRM,[56] whereas the SDRC allows the debtor nation

tors, they would effectively only bind, at most, a debtor nation and its principal creditors. *Id.* Moreover, arbitration clauses do not, by themselves, set forth the principles pursuant to which the debt should be restructured. *Id.*

[47] *See supra* text accompanying notes 18–30; *see also* Schier, *supra* note 32, at 19 (observing primary reliance of promoters of the contractual option on CACs and exit consents). R

[48] *See supra* text accompanying notes 34–35. R

[49] *See* SDRM § 9; SDRC Art. 7.

[50] *See* SDRM § 10; SDRC Arts. 8–10.

[51] *See, e.g.*, Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 Chi. J. Int'l L. 177, 186–87 (2005) (explaining the difficulty a nation has obtaining financing during a debt restructuring).

[52] Article 3(1) of the SDRC triggers that convention's application by the debtor nation "filing a voluntary petition for relief." SDRM § 4 states that "[c]onsistent with the principle of sovereignty, the mechanism could only be activated at the initiative of a member."

[53] *See, e.g.*, Bolton, *supra* note 37, at 41 (observing that "[t]he IMF's (2001 and 2002) recent proposals for the introduction of [the SDRM] . . . build on perceptive early policy proposals by academics"); Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001*, 49 IMF Econ. Rev. 470 (2002) (discussing the conceptual origins of the SDRM). R

[54] SDRM § 3(d)(vi).

[55] SDRC Art. 7(3)(b).

[56] SDRM § 5.

to decide how to restructure its debts at the time that it files its debt restructuring plan.[57] The only superficially significant difference is that the SDRM, unlike the SDRC, includes a procedure that could implement a temporary stay on litigation against the sovereign.[58] This stay does not appear essential, however, because of the sovereignty of debtor nations and the limited ability of creditors to seize national assets, even those that may be located outside of a debtor nation.[59] Even the IMF's principal advocate for the SDRM admitted that a temporary stay was not essential to prevent a "grab race" against a debtor nation's assets.[60]

Because of the key similarities between the SDRM and the SDRC, I will define the statutory option as one in which sovereign debtors and their creditors are bound by an international convention that sets forth a process to facilitate debt restructuring by addressing the hold-out problem and the funding problem.[61] To this end, Appendix I suggests a Model Sovereign Debt Restructuring Convention (hereinafter, the "Model Convention"). Articles 5–7 of the Model Convention attempt to address the hold-out problem through supermajority voting. Articles 8–9 of the Model Convention attempt to address the funding problem. And Article 3 of the Model Convention allows debtor nations to voluntarily decide whether to apply the Convention's provisions to their debt problems. Appendix II sets forth a highly simplified illustration of how the Convention might be applied.

B. Analysis of the Free-Market Option

The free-market option focuses on solving the hold-out problem. Under the most straightforward model of this option, sovereign debtors and their creditors would include CACs in their financing agreements, allowing even

[57] SDRC Art. 6(2).

[58] SDRM § 7; *see also* Anne O. Krueger, Int'l Monetary Fund , A New Approach to Sovereign Debt Restructuring 15–16 (2002), *available at* http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf (proposing a temporary stay).

[59] *See supra* text accompanying note 40 (observing that creditor efforts to seize national assets located outside of debtor nations have been largely unsuccessful). Commentators also have suggested other possible variations for a statutory approach. *See, e.g.*, Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 Int'l L. 103, 108–09 (2003) (advocating using a cram-down mechanism, minimizing the role of the IMF, and instituting a floor debt valuation that could not be passed in the restructuring). R

[60] Krueger, *supra* note 58, at 15–16. Dr. Krueger, who was First Deputy Managing Director of the IMF from 2001–2006, argued for a temporary stay primarily on the basis that litigation could inhibit negotiations while a state was making use of the SDRM. *Id.* R

[61] In response to the recent European sovereign debt problems, commentators have proposed adoption of a European Sovereign Debt Restructuring Mechanism ("E-SDRM"). *See, e.g.*, Jacob Funk Kirkegaard, *Will It Be Brussels, Berlin, or Financial Markets that Check Moral Hazard in Europe's Bailout Union? Most Likely the Latter!* 13–15 (Peterson Inst. for Int'l Econ., Pol'y Brief. PB 10–25, 2010); Shahin Vallée & Jérémie Cohen-Setton, *Towards a Eurozone Governance Overhaul*, Fin. Times (Jul. 16, 2010, 10:02 PM), http://ftalphaville.ft.com/blog/2010/07/16/289421/guest-post-towards-a-eurozone-governance-overhaul. But the E-SDRM would be conceptually similar to the SDRM (and thus to the SDRC). *See* Kirkegaard, *supra*, at 13.

essential payment terms in a financing agreement to be changed through supermajority, as opposed to unanimous, voting of the creditors.[62] There are, however, two fundamental limitations to CACs. The first is that CACs are not always included in sovereign financing agreements. In the Greek debt crisis, for example, ninety percent of the total debt was *not* governed by CACs.[63] Indeed, since 2003 there has been a "quiet revival of unanimous consent," with at least four nations issuing sovereign debt requiring unanimous consent to change certain significant provisions.[64]

Although parties could consider agreeing during (or at the outset of) a crisis to include CAC clauses in their financing agreements, that can be difficult to accomplish.[65] The most viable means of accomplishing this is for a sovereign debtor to engage in exchange offers with exit consents.[66] The sovereign would, for example, offer its creditors the option of exchanging their debt claims for new debt securities that include CACs. To try to induce all creditors to agree to the exchange, consenting creditors would be required to waive any covenant protections in their financing agreements that can be waived without unanimous creditor consent.[67] Creditors who do not submit to the exchange might therefore find those covenant protections gone if a sufficient majority of creditors consent.[68]

Ecuador, for example, used this strategy in its 2000 debt restructuring,[69] reducing its bond debt by approximately forty percent.[70] In at least one bond issue, "holders of approximately 97% of the eligible existing bonds had agreed to tender their bonds in the exchange."[71] The consenting bondholders

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[62] *See supra* text accompanying note 28. **R**

[63] Stephen J. Choi et al., *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism* 2, 12 (Univ. of Chi., John M. Olin Law & Economics Working Paper No. 541, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1713914.

[64] Anna Gelpern & Mitu Gulati, *Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003*, 4 CAP. MKTS. L.J. 85, 99 (2008).

[65] Schwarcz, *Idiot's Guide*, *supra* note 6, at 1203. **R**

[66] *See* Buchheit & Gulati, *supra* note 17, at 82–83. **R**

[67] Although a sovereign might offer payment as an incentive to persuade creditors to agree to the exchange, the exit consent route has been the most viable method of compelling an exchange agreement. *Id.* at 72–73. Using payment as an incentive, however, would be unlikely to raise the enforceability questions associated with exit consents. *Compare infra* text accompanying note 73, *with* Kass v. E. Air Lines, Inc., No. 8700, 1986 Del. Ch. LEXIS 486 (Nov. 14, 1986) (upholding changes to a nonpayment term in bond indentures when borrower offered payments to bondholders who voted for the amendment). **R**

[68] *See* Buchheit & Gulati, *supra* note 17, at 65–66. **R**

[69] MOODY'S INVESTORS SERVICE, SOVEREIGN RESTRUCTURINGS: PUTTING TOO MUCH FAITH IN EXIT CONSENTS 11 (2001).

[70] Lee C. Buchheit, *How Ecuador Escaped the Brady Bond Trap*, 19 INT'L FIN. L. REV. 17, 19 (2000) (stating that this strategy enabled Ecuador to reduce its "aggregate Brady bond and Eurobond debt stock . . . by about 40%" in net present value and par value terms). The exchange "resulted in cash-flow savings . . . of approximately $1.5 billion over the first five years" compared to the original bond terms. *Id.*

[71] *Id.*

signed exit amendments to remove covenants and cross-default clauses from the bond indentures, thereby prejudicing bondholders who did not consent.[72]

Questions remain, however, of the extent to which this strategy (i.e., penalizing creditors who do not submit to an exchange offer) represents unenforceable coercion.[73] Furthermore, exchange offers are not always successful.[74] Although the successful completion of exchange offers in the Ukraine, Pakistan, and Ecuador "is often cited as providing support" for the contractual option,[75] these exchange offers "took place in small countries with extremely simple debt structures" and thus are not regarded as necessarily representative of exchange offers engaged in by larger countries with more debt or more complex debt.[76] Ecuador, for example, had $6 billion in outstanding debt during its 2000 restructuring,[77] whereas Greece's debt burden in 2011 was over $300 billion.[78] The success of those exchange offers also stands in contrast to the failure of a proposed exchange offer in Russia.[79]

The second limitation to CACs is that even if every sovereign financing agreement included CACs, whether ab initio or through exchange offers, such clauses (being contractual) would most likely work on an agreement-by-agreement basis.[80] Therefore, any one or more syndicate of banks or group of bondholders that fails to achieve a supermajority vote would itself be a hold-out vis-à-vis other creditors.[81] For example, assume that State X has a $300 million bank-lending syndicate, a $400 million bond issue, and a $500 million bond issue. Assume the bank-lending syndicate's credit agree-

[72] *See id.* at 20.

[73] *See, e.g.*, Michael M. Chamberlain, At the Frontier of Exit Consents, Remarks at the Bear Stearns & EMCA Sovereign Creditors Rights Conference (Nov. 8, 2001) (noting that "[s]ome bond terms (notably governing law, right of acceleration for non-payment, waiver of sovereign immunity, and submission to jurisdiction) seem so fundamental to a sovereign bondholder's payment rights that they should not be changed without its consent," and that the likelihood that "courts will uphold such fundamental changes by exit consent as within the intent of the parties is doubtful but remains to be seen."); Schwarcz, *Idiot's Guide*, *supra* note 6, at 1203. *But cf.* Oak Indus. v. Katz, 508 A.2d 873 (Del. Ch. 1986) (upholding a corporate exchange offer with exit consents). R

[74] *See, e.g.*, Bolton, *supra* note 37, at 50 (observing, in the corporate context, that "[b]etween 1977 and 1990 only 73 exchange offers were successful out of 156 cases of distressed bond issuers"). R

[75] *Id.* at 60.

[76] *Id. But cf.* Mitu Gulati & Lee Buchheit, *How To Restructure Greek Debt* 4–5 (Duke Univ. Sch. of L., Working Paper No. 47, 2010), *available at* http://scholarship.law.duke.edu/working_papers/47 (noting that Greece's debt structure is similar to that of Ecuador and Uruguay insofar as it is overwhelmingly in the form of bonds).

[77] Buchheit, *supra* note 70, at 17. R

[78] *The A-Team, Greece and Mud Volcanoes*, ECONOMIST (May 24, 2011 1:23 PM), http://www.economist.com/blogs/freeexchange/2011/05/greeces_debt_crisis.

[79] *See* Bolton, *supra* note 37, at 60. R

[80] *See* Schwarcz, *Idiot's Guide*, *supra* note 6, at 1205. Although a few nations appear to have "master CAC" provisions that would envision cross-agreement supermajority voting, that voting only extends across bonds issued as part of a continuing series. *See* Lee C. Buchheit & Mitu Gulati, *Drafting a Model Collective Action Clause for Eurozone Sovereign Bonds*, 6 CAP. MKTS. L.J., 317, 319–22 (2011). R

[81] *See* Bolton, *supra* note 37, at 63 (observing that there "may be hold-out behavior across [debt] issues"). R

ment and each indenture evidencing a bond issue includes CACs. Even if a supermajority of the banks and a supermajority of holders of the $500 million bonds vote to approve a debt restructuring plan, that plan would be stymied if less than a supermajority of holders of the $300 million bonds vote to approve.[82] A debtor nation will ordinarily have many such agreements evidencing its debt,[83] and any failure of parties to one or more such agreements to approve the debt restructuring plan will make such parties hold-outs to the debt restructuring plan vis-à-vis other creditors.

Because of these limitations, it is unlikely that CACs can ever completely resolve the hold-out problem in sovereign-debt restructuring.[84]

C. Analysis of the Statutory Option

Recall that under the statutory option, sovereign debtors and their creditors are bound by an international convention that sets forth a process to facilitate debt restructuring by addressing the hold-out problem and the funding problem.[85] In both the SDRM and the SDRC, the hold-out problem is addressed by subjecting sovereign debtors and their creditors to a form of supermajority voting on sovereign debt restructuring plans. The vote by the overwhelming majority of similarly situated creditors would legally bind dissenting creditors.[86]

Although this might at first appear to be unfair to dissenting creditors, such supermajority voting has been proven to operate fairly in the corporate insolvency law context.[87] Because only similarly situated creditors can vote to bind dissenting creditors, and because any outcome will bind all such creditors alike, the outcome of a vote should benefit the claims of hold-outs and dissenters as much as the claims of the supermajority.[88] To the extent creditors voting in the supermajority are found to have conflicts with other

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[82] *Cf.* Bosco, *supra* note 40, at 40; Gelpern, *supra* note 42, at 20–21 (noting that when Argentina was trying to negotiate debt restructuring terms in 2001, several hedge funds, together with groups of individual investors, refused Argentina's proffered "draconian" restructuring proposal and litigated even though seventy percent of bondholders had already agreed to the proposal). R

[83] For example, Argentina had 152 types of bonds, issued in seven different currencies and governed by the laws of eight different countries, during its 2001 restructuring. Daniel K. Tarullo, *Neither Order Nor Chaos: The Legal Structure of Sovereign Debt Workouts*, 53 EMORY L.J. 657, 684 (2004).

[84] *See* Scott, *supra* note 59, at 129 (concluding that "[t]he insertion of collective action clauses in sovereign bonds is an exercise in futility"). R

[85] *See supra* text accompanying note 61. R

[86] *See supra* text accompanying note 49. R

[87] *See, e.g.*, David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 77 VA. L. REV. 461, 490 (1992) (suggesting non-consenting minority creditors receive more than adequate protection in the Chapter 11 supermajority voting scheme because all creditors of the same class are bound to the majority's decision).

[88] *See* Schwarcz, *Bankruptcy Reorganization Approach*, *supra* note 35, at 1005–06. R

creditors voting in their class, the conflicted creditor votes could be disallowed.[89]

The statutory option can also help to solve the funding problem—that a nation would likely need to borrow new money to pay critical expenses during the debt-restructuring process but no lender would likely be willing to lend such funds unless its right to repayment has priority over existing debt claims.[90] An international convention can provide for the legally enforceable granting of a first priority right of repayment to loans of new money made to enable a nation to pay critical expenses during the debt-restructuring process.[91] Existing creditors can be protected by giving them the right to object to a new-money loan if its amount is too high or its terms are inappropriate.[92] Existing creditors should also be further protected because a nation that abuses new-money lending privileges would likely face difficulty receiving supermajority creditor approval for a debt restructuring plan.

The foregoing analysis of the statutory option assumes that sovereign debtors and their creditors are bound by an international convention,[93] calling into question how and to what extent they would be bound. Creditors from nations signing the convention would be bound because, once a nation ratifies the convention, it would be directly bound, and creditors within that nation would be bound by the nation's enactment of the convention's rules into national law.[94] Most nations should want to ratify such a convention in order to address the hold-out and funding problems, and also possibly to reduce reliance on the painful conditionality sometimes associated with a bailout[95]—as illustrated by the recent Greek unrest in response to IMF and European Union bailout conditions.[96] Although some nations nonetheless

[89] *Cf.* 11 U.S.C. § 1126(e) (2006) (providing this).

[90] *See supra* text accompanying notes 50–51. R

[91] *See, e.g.*, Model Convention Art. 9.

[92] *See, e.g.*, Model Convention Art. 8 (providing for notice to the debtor nation's known creditors and a hearing as a condition to priority lending).

[93] *See supra* text accompanying note 61. R

[94] *See* Anthony Aust, Modern Treaty Law and Practice 187–95 (2d ed. 2007).

[95] Conditionality is not necessarily problematic. *See, e.g.*, Morris Goldstein, *IMF Structural Conditionality: How Much is Too Much?* 9–10 (Peterson Inst. For Int'l Econ., Working Paper No. 01-04, 2000), *available at* http://ideas.repec.org/p/iie/wpaper/wp01-4.html (noting the IMF-imposed conditionality during the Asian financial crisis was, in many cases, reform that domestic policymakers had been trying unsuccessfully to implement for years). Nonetheless, conditionality sometimes can be inappropriate or excessive. *See id.* at 66 (concluding that IMF-imposed conditionality during that crisis was, at least in some cases, "excessive").

[96] *See supra* text accompanying notes 2–3. *Cf.* Ariel Buira, *An Analysis of IMF Conditionality* (United Nations Conference on Trade and Dev., G-24 Discussion Paper Series No. 22, 2003), *available at* http://www.unctad.org/en/docs/gdsmdpbg2420033.pdf (discussing IMF-imposed conditionality). Even a new-money lender for the restructuring period may, of course, impose its own form of conditionality. *See* Model Convention Art. 10(1) (enabling the Supervisory Authority to condition new-money loans); *Cf.* Janis A. Emmanouilidis, *Adding Pieces to the European Economic Governance Puzzle* 5 (European Policy Centre Post-Summit Analysis, Dec. 20, 2010), http://www.epc.eu/documents/uploads/pub_1207_post-summit_analysis_-_20_december_2010.pdf (noting conditionality provisions of the IMF's proposed ESM). But the relatively small amount of funding needed, compared to a bailout, and the consequent R

may oppose a convention, there should be little basis to oppose the type of convention proposed by this Article.[97]

Creditors from non-signatory nations also may be bound to the extent they are parties to financing agreements governed by the law of a signatory nation.[98] Because most financing agreements with sovereigns explicitly state their governing law,[99] and New York or United Kingdom law is typically chosen,[100] the United States and the United Kingdom should have substantial control over the convention's effectiveness.

III. Comparison

The Article next generally compares the free-market option with the statutory option. Part of this comparison is ex ante—examining how these options can influence the behavior of nations (e.g., the extent of their morally hazardous behavior) and their creditors (e.g., the extent to which risk premiums on financing might be affected). The other part of the comparison is ex post—examining how effectively these options can actually influence resolution of sovereign debt distress. The comparison will, of course, reveal tradeoffs: an option that allows for quicker or easier debt restructuring might lead, for example, to increases in risk premiums (although any such increases must themselves be balanced against the cost increases that would result from a default).

A. The Hold-out Problem

Both the free-market option and the statutory option address the hold-out problem of sovereign debt restructuring, but the latter does it much more effectively and predictably. This increase in predictability should be more efficient from a market perspective.[101] Markets do not function efficiently when investors are uncertain what will happen.[102] Also, by making it more likely that a debtor nation can consensually restructure its debts, the statu-

greater availability of funding sources should lessen the conditions that a new-money lender will be able to impose.

[97] *See infra* text accompanying notes 103–118. R

[98] To the extent creditors from non-signatory nations are not parties to agreements containing governing law clauses, international law principles hold that the legal relationship between a nation and those creditors should be governed by the law of that nation. *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).

[99] Greenwood & Mercer, *supra* note 28, at 106. R

[100] *See, e.g.*, Gelpern & Gulati, *supra* note 64, at 86–87; Rory Macmillan, *The Next Sovereign Debt Crisis*, 31 Stan. J. Int'l L. 305, 315 (1995). R

[101] *Cf.* Douglas Gale, *Standard Securities*, 59 Rev. Econ. Stud. 731, 731 (1992) (arguing that investors will charge an "uncertainty premium" on unfamiliar securities).

[102] In response to growing uncertainty over Greece, for example, markets around the world have responded in kind to alternating signals of hope and despair. *See, e.g.*, Steve Russolillo, *U.S. Stocks Rise on Hopes for Greece*, Wall St. J. (June 21, 2011), http://online.wsj.com/article/SB10001424052702303936704576399194268368876.html; *Asian Stocks*

tory option would not only minimize the cost of bailouts but also reduce the potential for the nation to engage in morally hazardous behavior.

A major source of opposition to the statutory option has been concern that "excessive power given to debtors to cancel or reduce their debts [would] undermine debtor countries' ability to commit to repay their debts and thus lead to higher borrowing costs."[103] The statutory option, however, need not—and indeed, as contemplated in this Article, would not—give debtor nations such excessive power. To the contrary, from the standpoint of a given bond issue, the supermajority voting of the statutory option contemplated by this Article is not materially different than the supermajority voting contemplated by CACs,[104] and there is "no evidence that bond issues with CACs trade at a discount."[105] Furthermore, debtor nations that act in bad faith could be excluded from using the statutory option.[106]

Although the statutory option's ability to more predictably bind creditors might increase funding costs as compared to CACs,[107] any such increase would likely be marginal because a debt restructuring under the statutory option would be largely consensual.[108] After the restructuring, the debtor nation should therefore be able to borrow new money at attractive rates. In the non-sovereign context, for example, lending rates to companies with consensually restructured debt are much lower than rates charged before the restructuring.[109] Admittedly, the lower rates in part reflect that companies have

Fall on Greek Debt Worries, FIN. TIMES, June 15, 2011, *available at* http://www.ft.com/intl/cms/s/0/9c487e3e-9708-11e0-aed7-00144feab49a.html#axzz1iLOWcRGv.

[103] Bolton, *supra* note 37, at 49. Some couch this concern as needing inefficiency in a debtor nation's ability to restructure its debt as a "disciplining device to induce the sovereign debtor to repay its debts." *Id.* at 61. That concern appears misguided, however, given the other costly consequences of default. *Cf. id.* at 62 (listing "loss of reputation and the ensuing increase in the cost of future borrowing" as "even more important deterrents" against default). R

[104] *But cf. infra* text accompanying note 109 (observing the statutory option's ability to more predictably bind creditors). R

[105] Bolton, *supra* note 37, at 61 n.12. *But compare* Michael Bradley et al., *The Market Reaction to Legal Shocks and Their Antidotes: Lessons From the Sovereign Debt Market*, 39 J. LEG. STUD. 289, 301 (2010) (finding that the inclusion of collective action clauses in sovereign bond indentures, enabling supermajority voting to change essential payment terms, did not measurably increase sovereign borrowing costs), *with* Eichengreen & Mody, *supra* note 27, at 262 (finding that "[c]ollective-action provisions tend to reduce borrowing costs for more credit-worthy issuers while raising them for less credit-worthy issuers."). R R

[106] *Cf.* Model Convention Art. 3(2) (enabling the Supervisory Authority to dismiss a filing under that Convention "for lack of good faith").

[107] The mere entry of a nation into an international debt restructuring convention should not, however, lower the nation's debt rating. *See* Schwarcz, *Bankruptcy Reorganization Approach*, *supra* note 43, at 1014 n.338 (recounting a telephone interview with the Senior Managing Director, General Counsel, and Chair of the Ratings Policy Board of Standard & Poor's, confirming this). R

[108] In contrast, a free-market debt restructuring would be less consensual insofar as CACs are imposed through exchange offers with exit consents, prejudicing creditors who choose not to exchange their debt claims. *See supra* text accompanying note 73. R

[109] Regardless of its form, a key objective of debt restructuring is "enabling the timely restructuring of debt and access to sufficient financing to sustain viable firms," and a successful restructuring will "often be accompanied by operational restructuring." Thomas Laryea, *Approaches to Corporate Debt Restructuring in the Wake of Financial Crises* 7 (Int'l Monetary

a more conservative capital structure after restructuring their debt. After a statutory debt restructuring, however, a sovereign debtor should have less of a debt-service burden and thus should be less likely to default or try to unilaterally reduce its debt in the future.

Even if the statutory option results in a marginal cost increase, that increase must be balanced against the much more significant cost increases that would result from a default (or, effectively the same thing, an attempt by a nation to unilaterally restructure its debt).[110] For example, Argentine sovereign bond spreads rose 6,000 basis points after Argentina's 2001 announcement that it would unilaterally restructure its debt.[111] Moreover, a sovereign debt default could create a risk of systemic contagion, although it is difficult to assess the likelihood or cost of such contagion.[112] By more effectively enabling a debtor nation to restructure its debt, the statutory option is more likely than the free-market option to reduce the risk of default.[113]

In the foregoing context, it should be observed that the term "default" can be broadly interpreted. Moody's, for example, defines default to include certain "distressed" debt restructurings, as well as certain debt restructurings "imposed by the sovereign."[114] A nation's use of the statutory option to restructure its debt to avoid payment default would be deemed by Moody's to be a "default" if, as almost certainly would be the case, one or more creditors receive in the restructuring "a new debt instrument of diminished

Fund, Staff Position Note No. SPN/10/02, 2010), *available at* www.imf.org/external/pubs/ft/spn/2010/spn1002.pdf. Creditors should be given an opportunity to coordinate and contribute to restructuring proposals in out-of-court restructurings. *Id.* at 17–18 (citing the INSOL International Statement of Principles for a Global Approach to Multi-Creditor Workouts). Creditor support—shown through actual consent and implied consent through participation—combined with operational restructuring and the avoidance of a fire sale is viewed favorably by the market, resulting in more favorable lending terms for a restructured corporation.

[110] A bailout might prevent a default, but that would have its own high costs (in the form of cash outflows by the IMF and any nations engaging in the bailout as well as any conditionality imposed on the bailed-out nation). *See supra* text accompanying notes 1–6. R

[111] Marcus Miller & Dania Thomas, *Sovereign Debt Restructuring: The Judge, the Vultures and Creditor Rights*, 30 WORLD ECON. 1491, 1502 (2007). Although Argentina's sovereign bond spreads ultimately returned to near-market levels in 2005 when its debt restructuring was completed, *id.*, court judgments that allowed for the seizure of Argentine bond payments in several foreign jurisdictions effectively precluded Argentina from subsequently borrowing in international markets. *See* Jonathan Stempel, *NY Court Hands Argentina Setback Over Bond Default*, REUTERS (June 30, 2011), http://www.reuters.com/article/2011/07/01/argentina-bonds-idUSN1E75T0PY20110701; s*ee also* Jane Croft, *NML in UK Court Victory on Argentine State Debt*, FIN. TIMES, July 7, 2011, at 16 (reporting that, despite Argentina's efforts to negotiate with vulture funds, decisions in the UK recognizing New York court judgments continue to prevent Argentina from borrowing in international markets).

[112] There was, for example, little contagion from the bond default by Argentina. *But cf.* Dungey, *supra* note 16, at 4 (discussing the potential contagion from Russia's bond default). R

[113] Opponents to the statutory option nonetheless believe "that an administrative intervention in sovereign debt restructuring is bound to be misguided [and therefore] will undermine sovereign bond markets." Bolton, *supra* note 37, at 59. The statutory option contemplated by this Article, however, does not contemplate administrative intervention. R

[114] MOODY'S INVESTORS SERVICE, MOODY'S DEFAULT DEFINITION AND ITS APPLICATION TO SOVEREIGN DEBT 1 (2011).

economic value in exchange."[115] Similarly, a nation's use of the statutory option to restructure its debt might be a restructuring "imposed by the sovereign," at least from the standpoint of dissenting creditors bound by supermajority voting. These broad definitions of default are neutral to this Article's comparative analysis, however, because a successful debt restructuring under the free-market option would have precisely the same impact,[116] whereas an unsuccessful debt restructuring under the free-market option would, absent a bailout, lead to an actual payment default.

Finally, a nation might oppose the statutory option simply because of its effectiveness and instead desire a bailout (by the IMF or regional nations, such as the bailouts by the European Union and the IMF of Greece, Ireland, and Portugal). That perverse incentive could—and as recent conditions have shown, almost certainly will[117]—be addressed by imposing conditionality on bailouts in order to make the restructuring option more attractive than a bailout.[118]

B. *The Funding Problem*

The statutory option also addresses the other essential problem of sovereign debt restructuring—that of enabling a sovereign debtor to obtain funding to pay critical expenses during the debt restructuring process. Absent such funding, "a sovereign debt crisis coupled with an exchange rate and banking crisis can result in substantially higher costs than a situation of financial distress for a corporation."[119] In contrast to the statutory option, the free-market option does not purport to address the funding problem.[120]

Although there are ways to attempt to address the funding problem outside of the statutory option—and thus potentially in conjunction with the free-market option—they may not be as effective. In any such attempt, the debtor nation would have to grant a legally enforceable first priority right of repayment to new-money loans made to enable it to pay critical expenses during the debt restructuring process.[121] As the discussion below shows,

[115] *Id.* at 2; *cf.* Marc Jones, *Rating Agencies Might Classify Greek Rollover as Default*, Reuters (June 7, 2011), http://www.reuters.com/article/2011/06/07/greece-rollover-agencies-idUSLDE7560AX20110607 (reporting that rating agency officials had said they "might well classify a [Greek debt] rollover as a default").

[116] *Cf.* Pierre-Hugues Verdier, Credit Derivatives and the Sovereign Debt Restructuring Process 79 (Apr. 27, 2004) (unpublished LL.M. Paper, Harvard Law School), *available at* http://www.scribd.com/doc/55717623/32/Collective-Action-Clauses-and-the-ISDA-Definitions (observing that the use of either a collective action clause or the SDRM would be considered a debt restructuring under ISDA-governed derivatives contracts).

[117] *See supra* text accompanying notes 95–96. R

[118] Ideally, organizations and nations that might potentially provide a bailout should signal in advance their intention to require such conditionality.

[119] Bolton, *supra* note 37, at 58. R

[120] *Cf.* Bolton, *supra* note 37, at 63 (observing that "contractual and market approaches [such as CACs] do not explicitly deal with DIP financing"). R

[121] *See supra* text accompanying notes 90–91. R

however, questions remain about the extent to which any priority so granted would be sufficient, absent an international convention, to encourage new-money funding.

A debtor nation could, absent an international convention, grant a first priority right of repayment either pursuant to its national law or by contract. If the priority were granted pursuant to national law, it should be enforceable against the debtor nation. There is a risk, however, that the debtor nation could change its law to take away the priority after it receives the funding.[122] Prior to the Great Depression, for example, many nations had issued sovereign debt that purported to give priority to its holders.[123] None of these priorities were ultimately honored, however.[124] The cost of honoring the priorities apparently outweighed the reputational cost of not honoring them.[125]

A debtor nation could also attempt to contractually grant a first priority right of repayment by including the priority in the new-money loan agreement. The question then would be whether the priority was enforceable under the law governing the loan agreement. If that law was the debtor's national law and such national law permitted the priority, the priority should be enforceable against the debtor nation. However, there would still be the aforementioned risk that the debtor nation could change its law to disallow the priority after it receives the funding. If, on the other hand, that law were foreign law that permitted the priority—i.e., one that enforces subordination of existing claims without creditor consent[126]—the priority should be enforceable against the debtor nation as a matter of law; there would still, however, be a risk that the debtor nation might breach its contract.[127]

Alternatively, a debtor nation could attempt to contractually create a first priority for new-money lenders by including subordination provisions in all of its financing agreements, thereby subordinating the creditors party to

[122] *Cf.* Choi, *supra* note 63, at 17 (observing that a debtor nation could change its domestic law to the detriment of foreign creditors). R

[123] *See* Edwin Borchard, State Insolvency and Foreign Bondholders: General Principles xx–xxiii (1951) (noting instances of sovereign debt issuance where default resulted in losses to foreign bondholders).

[124] *Id.* Borchard notes that, in some specific instances, foreign governments have provided official aid to its bondholder citizens, particularly when "specific revenues assigned as security for the payment of bondholders have been willfully diverted to other uses." *Id.* at xxiv.

[125] Borchard notes that holders of defaulted bonds from foreign sovereigns generally "have had to rely upon their own negotiations with the debtor," with the limited exception where their governments have been willing to intervene. *Id.* at xxiii–xxiv. However, Borchard writes that "a powerful and persuasive weapon to help bring a delinquent debtor to terms" exists in stock exchange rules that permit refusal of a listing to any new issue by a defaulting state. *Id.* at xxiv. This suggests that defaulted governments may not fear particular reputational costs from simply not honoring their debt obligations, but rather require additional external incentives to take on the cost of honoring their obligations.

[126] United States bankruptcy law effectively allows this, for example. *See* 11 U.S.C. § 507 (2010).

[127] Although the debtor nation would then be liable for contract-breach damages, those damages might not have priority over other claims against the debtor nation.

those agreements to the claims of any new-money lenders (defined as such in those agreements). The extent to which these types of subordination provisions would actually be included in a debtor nation's financing agreements would be subject, however, to at least the same uncertainty as would the extent of inclusion of CACs.[128]

Finally, a debtor nation could effectively create a first priority for new-money lenders by granting them collateral. However, because the debtor nation could change its law to take away the collateral after it receives the funding, granting new-money lenders collateral may not be a practical solution. Furthermore, the significance of taking domestic collateral (i.e., collateral located within the nation) from a sovereign nation, including the ability to foreclose, is itself uncertain.[129]

The above discussion focuses on the obligation of a debtor nation to pay new-money priority creditors before paying other creditors and thus on the rights and duties between the debtor nation, on the one hand, and its creditors, on the other hand. But what would happen if a debtor nation *in fact* pays new-money priority creditors pari passu with the nation's other creditors? Under U.S. legal principles of subordination and priority, the new-money priority creditors would have claims against the other creditors to recover a sufficient portion of their payments to put the new-money priority creditors into the same position they would be in if they had been paid in priority to the other creditors.[130] This raises two legal questions: (i) whether under the law governing the new-money loan agreement, new-money priority creditors would likewise have claims against the other creditors; and (ii) whether international law would respect those claims. This also raises practical questions, such as whether the new-money priority creditors would be able to obtain jurisdiction over a sufficient number of the other creditors and whether the amounts owed by individual creditors to the priority creditors would justify the litigation costs.

Admittedly, a debtor nation could likewise violate an international convention by paying new-money priority creditors thereunder pari passu with the nation's other creditors. But the reputational cost of dishonoring the convention, and thereby undermining the international sovereign debt restructuring scheme, would presumably be high.[131]

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[128] Although a debtor nation could later attempt to use exchange offers with exit consents to include subordination provisions, creditors might be more resistant to subordinate their claims than to agree to adding CACs.

[129] *But cf.* Gillian Tett, *Lisbon Move May Signal the End of Risk-free Sovereigns*, FIN. TIMES, Jan. 21, 2011, at 20 (discussing Portugal's recent decision to start posting collateral on derivatives trades as a way to reduce borrowing costs).

[130] *See, e.g.*, AM. BAR FOUND., COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 559 (1971) (explaining that although "so far as the debtor is concerned, subordinated debt is just as truly debt as is the senior debt," under subordination provisions "the holders of the subordinated debt are not entitled to retain payments or distributions thereon" to the extent they receive more than their subordinated share thereof).

[131] *Cf.* Harold Hongju Koh, *Why Do Nations Obey International Law?*, 106 YALE L.J. 2599, 2599 n.2 (1997) (noting empirical evidence showing that nations almost always comply

In short, even though a debtor nation could attempt to address the funding problem outside the statutory option, questions remain about the extent to which those attempts would be sufficient, absent an international convention, to encourage new-money funding.

In some scenarios, debtor nations may face less of a funding problem because another nation or group of nations may be politically or economically motivated to provide the funding. This could occur, for example, when the debtor nation is part of a regional confederacy like the European Union, or part of a sovereign nation, like a state within the United States, or even possibly part of a regional sphere of interest.[132] Furthermore, the IMF itself may, in appropriate circumstances, provide that funding.[133] Debtor nations cannot always rely, however, on these types of safety nets.

Assuming a debtor nation is otherwise able to obtain new-money funding to pay critical expenses during its debt restructuring, existing creditors—whose claims will be subordinate to that funding—might want an opportunity to object to the funding. To protect those creditors, new-money funding could be conditioned on notice to existing creditors of the proposed funding and a hearing at which they shall have the right to object.[134]

Conclusion

As finance becomes more globally intertwined, sovereign debt defaults will become even more likely to trigger larger systemic collapses. That, in turn, will make many (if not most) nations too big to fail. Debt restructuring

with international law); Chris Brummer, *How International Financial Law Works (and How it Doesn't)*, 99 Geo. L.J. 257, 263 (2011) (claiming that reputational constraints and market discipline are particularly effective for ensuring compliance with international financial law). The SDRM envisioned the IMF using its standard financial sanctions on member nations to further ensure compliance. *See* SDRM Art. 13.

[132] *See, e.g.*, Vinod K. Aggarwal & Brigitte Granville, Sovereign Debt: Origins, Crises and Restructuring 23 (Vinod K. Aggarwal & Brigitte Granville eds., 2003) (observing that during Mexico's 1994 "Tequila Crisis," the U.S. Government engineered a significant bailout of Mexican sovereign debt because Mexico was an important trading partner within the North American Free Trade Agreement (NAFTA) and U.S. business interests were significantly affected by Mexico's debt problems).

[133] Balcerowicz notes that "[a] government may be unwilling to take sufficient sociopolitical risks while claiming that it is incapable of introducing the necessary adjustment because of the sociopolitical constraints [it] faces," making it difficult to determine whether a sovereign debtor is actually unable to repay its debt or simply unwilling to do so. Balcerowicz, *supra* note 37, at 4. Such a problem is exacerbated by situations where a "perceived danger of 'contagion'" exists to support additional funding in regional confederacies such as the Eurozone. *Id.* at 16. **R**

[134] *Cf.* Model Convention Art. 8(2) (providing this protection). The Model Convention provides that the hearing will be held before a "Supervisory Authority." *Id.* Although identification of the Supervisory Authority would ultimately be a political choice, such Authority should ideally be neutral while not raising concerns over national sovereignty. The Model Convention suggests the "International Monetary Fund or other neutral multilateral organization" for this role. *Id.* at Art. 2(5). Whether the IMF is sufficiently neutral is beyond this Article's scope. *Cf.* Scott, *supra* note 59, at 126 (suggesting the IMF is not sufficiently neutral due to its position as a priority lender and an instrument of major economic powers). **R**

alternatives are therefore needed to avoid sovereign bailouts, which are not only costly but also foster moral hazard on the part of nations that lack the political will or ability to be fiscally responsible.

At least two options can help to minimize bailouts. Under a free-market option, sovereign debtors and their creditors could attempt to consensually negotiate the debt restructuring, aided by collective-action clauses and exchange offers with exit consents. Under a statutory option, the sovereign debtor and its creditors would be bound by an international convention that sets forth a process to facilitate debt restructuring.

The absence of any systematic comparison of these options has made it difficult for scholars and other observers to thoughtfully examine, much less agree on, which of these options is preferable. This Article provides such a comparison in order to better inform the question of whether the free-market option to sovereign debt restructuring should be supplemented, or even replaced, by an international convention that could help to facilitate the statutory option.

The comparison reveals that the statutory option for sovereign debt restructuring should supplement the free-market option. The free-market option only addresses the hold-out problem of sovereign debt restructuring, and indeed it addresses this problem imperfectly. In contrast, the statutory option not only resolves the hold-out problem but also addresses the other essential problem of sovereign debt restructuring—that of enabling a sovereign debtor to obtain funding to pay critical expenses during the debt-restructuring process.

This is not to say that supplementing the free-market option with a statutory option would be costless. By more predictably binding creditors, the addition of a statutory option might lead to higher sovereign borrowing costs for financially troubled nations. Any such increase would likely be marginal, however, because a debt restructuring under the statutory option—at least, the statutory option contemplated by this Article—would be largely consensual. Any cost increase must also be balanced against the cost increases that would result from an outright default, which would be more likely absent the statutory option. Furthermore, the discussion above compares borrowing costs of financially troubled nations that do not restructure their debts. A nation that actually restructures its debts will have less of a debt-service burden and thus should be able to borrow new money at attractive rates.

APPENDIX I—MODEL SOVEREIGN DEBT RESTRUCTURING CONVENTION

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; and
(5) "Supervisory Authority" means the International Monetary Fund or other neutral multilateral organization.

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.

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,[135] 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 Plan][136] [entitled to vote on such Plan][137] 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.

Chapter IV: Financing the Restructuring

ARTICLE 8: TERMS OF LENDING

(1) 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 and any objections raised by creditors pursuant to Article 8(2).
(2) Any loan by the Supervisory Authority under Article 8(1) shall be made only after notice to the Debtor-State's known creditors of the intention to make such loan and the proposed terms and conditions thereof and after a hearing at which those creditors shall have the right to object to the loan.

[135] Alternatively, the Model Convention could except discharge of debts owed to entities that neither had notice nor actual knowledge of the Plan.
[136] The Plan can be more easily approved if this alternative is selected, but reliable notice to creditors then becomes more important.
[137] To assure fairness, the Model Convention could disallow the vote of any creditors in the class who are found to have conflicts with other creditors of that class. *See supra* text accompanying note 89. R

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 such loans.

ARTICLE 10: NONRECOURSE BORROWING BY SUPERVISORYAUTHORITY

(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. This Chapter would not, however, grant the adjudicatory tribunal jurisdiction over sovereign debt restructuring issues that the Convention does not cover.][138]

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.

[138] For example, this Chapter would not give the adjudicatory tribunal jurisdiction to determine whether a foreign creditor obtaining a judgment against a Debtor-State not involving enforcement of the Model Convention may attach assets located within that State.

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.

Appendix II—Illustration of Highly Simplified Application of Model Convention

Country X, facing a budget shortfall that would prevent it from paying principal and interest on its debt and also maintaining essential government services, considers its options, which might include the following:

- Raising taxes, which might do more harm than good if the economy is already slowing down.
- Accepting emergency bailout funds, but it is unclear who would provide the funding and what conditions may be attached.
- Unilateral debt restructuring, but that would impair credibility and could make it difficult to later borrow in the capital markets.
- Inserting collective-action clauses (CACs) into loan documents lacking them; but it is difficult to impose CACs and, in any event, they would not operate across different bond issues or different debt sources (i.e., bank debt, foreign government lending, and trade credit).
- Invoking application of the Model Convention.

Country X, as a signatory to the Model Convention (or after becoming a signatory), chooses to invoke the Convention to address its debt problem.

Invoking Application of Convention: Country X files petition for relief with Supervisory Authority (and Supervisory Authority does not dismiss petition for lack of good faith).

Notification: Within 30 days of filing petition, Country X notifies its known creditors of its intention to negotiate a Plan under the Model Convention.

The Plan: Country X submits a Plan designating (pari passu) classes of claims and proposed repayment terms for each class:

- Class 1: Maturity dates extended 3 years.
- Class 2: Maturity dates extended 3 years and interest rates reduced by 2.5%.
- Class 3: Principal amount reduced 10%.
- Class 4 (Foreign Government Creditor): Principal amount reduced 5% and maturity dates extended 5 years.

Voting: Classes 1 and 2 vote to approve but Classes 3 and 4 disapprove (i.e., less than the requisite supermajority of Class 3 creditors approve and Class 4 Foreign Government Creditor disapproves).

The Updated Plan: Country X revises and resubmits plan:

- Class 1: Maturity dates extended 3 years.
- Class 2: Maturity dates extended 3 years and interest rates reduced by 2.5%.
- Class 3: Maturity dates extended 5 years and interest rates reduced by 2%.
- Class 4 (Foreign Government Creditor): Principal amount reduced 5% and maturity dates extended 3 years.

Agreement: Requisite supermajority of creditors in each Class vote for approval. The Updated Plan becomes binding on all creditors (i.e., Classes 1, 2, 3, and 4).

Financing: After discussions between Supervisory Authority and Country X, Supervisory Authority proposes to lend $Y to Country X to help maintain liquidity and pay current expenses during debt restructuring.

Supervisory Authority notifies Country X's known creditors of intent to make loan and proposed terms and conditions thereof.

Supervisory Authority holds hearing at which creditors may object to new lending.

Taking into account Country X's use of loan proceeds and any objections from creditors, Supervisory Authority agrees on revised terms with Country X.

Supervisory Authority borrows $Y on a non-recourse basis from private and/or government lenders, on-lends the loan proceeds to Country X, and pledges first-priority right to payment from Country X as collateral to such lenders.