Do Sovereign Debtors Need a Bankruptcy Law?

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The idea that there is a "gaping hole" in the architecture of the international financial system that should be filled by a universal bankruptcy tribunal is not credible. For centuries, sovereign debt defaults have been resolved without the benefit of bankruptcy laws. When a financial crisis exposes a sovereign debtor's bankruptcy, it seems wrongheaded to focus on resolving its dishonored obligations rather than expanding efforts on preventing debtors from accumulating excessive obligations.

Implicit in the bankruptcy approach is an assumption that the financial crises that have taken place in emerging markets have been made worse by the difficulties debtor governments have faced when trying to attenuate the commitments they had made to their creditors. But in each of the crises following the Mexican devaluation of 1994, the International Monetary Fund has bailed out creditors, and, to the extent that debt restructuring was involved, that restructuring was not stymied. There has been so much criticism of the moral hazard created by that policy that in the future the IMF may restrain its penchant for bailouts. But even if it does so, its continued sponsorship of a universal bankruptcy law should be questioned. Why would such a law be a higher priority for the IMF than more effective oversight of the economic policies of emerging markets?

The case for setting up an elaborate mechanism for sovereign debt restructuring is weakened to begin with by the IMF's acknowledgment that such an instrument would not be activated often because many countries do not need debt restructuring . Moreover, it is not clear that the absence of a bankruptcy law has produced chaotic conditions in the few countries that have had to settle differences with their creditors. Finally, it is not at all obvious how a sovereign debt

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bankruptcy law, for which there is no precedent, would work or whose benefit it would serve. If the legislation was intended to serve both debtor nations and their creditors, it is remarkable that the IMF did not consult with representatives of either of the parties to learn their wishes before issuing its proposals.[1]

In this paper, I begin by discussing two recent versions of the proposal for bankruptcy arrangements for sovereign debtors, and the status of the proposal in 2003. I then ask if there is extensive demand for such arrangements from debtor countries, private investors, and disinterested observers and find it lacking. Next, I review the alternatives proposed by various opponents of sovereign bankruptcy legislation, the majority of whom prefer a market solution to bureaucratic management of debt-related problems. I conclude with some observations about the IMF's role in the elusive quest for the development of emerging market countries by means of indebtedness.

Proposals for a Bankruptcy Law for Sovereign Debtors

In an address to a Washington audience in November 2001, Anne Krueger—the first deputy managing director of the IMF—presented a proposal for bankruptcy procedures for sovereign debtors to facilitate the orderly restructuring of their debt as if that were the holy grail long sought for the salvation of emerging market countries (Krueger 2001a). The proposal would enable governments to seek legal protection from their creditors by declaring bankruptcy, similar to the way in which Chapter 11 works for companies and Chapter 9 for municipalities under the U.S. Bankruptcy Code.[2]

[1]It is noteworthy that the first reference to consultation with market participants in an International Monetary Fund document on sovereign debt restructuring appears in the November 27, 2002, paper for a meeting in April 2003 to consider an initial draft of the text of the amendment to the Fund's Articles of Agreement (IMF 2002: 3).

[2]Chapter 11 allows companies to continue operating and to repay creditors' claims from future earnings rather than from the proceeds of liquidating their assets. There is a stay on litigation against the company that was initiated before bankruptcy filing and on litigation after the filing. Companies may obtain new loans—debtor-in-possession financing—that are senior to all claims that existed before the filing. For four months after the filing, managers have an exclusive right to propose a reorganization plan that specifies how the claims of each class of creditors will be settled. If the bankruptcy judge ends the period for the managers' proposal, creditors may then offer their own reorganization plan. Each class of creditors must approve the final plan by two-thirds of the amount involved and a majority of the number of claims. When no reorganization plan is adopted, the judge may order liquidation of the company under Chapter 7. Otherwise, the judge may adopt the failed reorganization plan under the procedure known as "cram down." Chapter 9 applies only to

The objectives of sovereign bankruptcy proceedings would be to (1) prevent creditors from disrupting negotiations by seeking repayment through domestic courts,[3] (2) require debtors to negotiate with creditors in good faith and to reform the policies that led to their bankruptcy, (3) encourage lenders to provide new money (known as debtor-in-possession financing) by guaranteeing that their claims would come before the claims of existing private creditors, and (4) persuade minority creditors to participate in restructuring arrangements.[4]

Krueger outlined the proposal again in a speech in Delhi, India, on December 20, 2001, and responded to objections that had been raised (Krueger 2001b). The IMF's executive board gave preliminary approval to the proposal, but at a two-day meeting in March 2002 there was no unanimity among the directors on how to proceed (Krueger 2002a). The subject was not formally on the agenda at the spring meeting. On April 1, 2002, Krueger answered questions at a press conference before giving another speech modifying the proposal (Krueger 2002b).

The November 2001 Proposal

The November proposal would have authorized the IMF to grant a government, in response to its application for a temporary standstill on the repayment of its debt, the right to declare bankruptcy. The government would then negotiate a restructuring of its debt with its creditors, a majority of whom would decide the terms for all of them (a feature modeled on British bankruptcy laws). To prevent an outflow of private funds during the negotiations, the IMF would allow governments to impose temporary foreign exchange controls.

To restrict the ability of creditors to enforce their claims in national courts, it would be necessary to establish bankruptcy laws for sovereign debtors in each of the 183 member countries of the IMF.

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cities and other entities that are state creations. A city may file for bankruptcy only after obtaining permission from the state. It must be insolvent and unable to pay ongoing debts. Public officials may not be replaced, as managers may be under Chapter 11. The former have the exclusive right to offer a reorganization plan but a committee of creditors may negotiate with public officials. In theory the judge may offer his own restructuring plan but it has never happened. The voting procedure on a plan is similar to that in Chapter 11 (White 2002: 293–97). Chapter 7 permits consumers and businesses to be freed of most of their unsecured debts. Chapter 13 requires debtors to propose a plan to pay off at least some debt over three to five years.

[3]Litigation has been a feature of sovereign defaults for centuries, but there is no evidence that restructuring has been delayed or disrupted as a result.

[4]A voluntary market-based way of achieving this end is described below.

Otherwise creditors could attempt to enforce their claims in jurisdictions without such laws. Alternatively, an amendment to the Fund's articles—which requires the consent of 85 percent of the shareholders—could create an international law binding all nations and altering terms of all existing and future financial instruments. The IMF would then become the international bankruptcy tribunal, whose job would be to mimic bankruptcy proceedings in domestic corporate workouts. It would give sovereign debtors the benefit of a freeze on creditor lawsuits and the "cram-down" features (meaning compulsory acceptance of a restructuring plan by dissident creditors) of a domestic bankruptcy proceeding. Disputes between a debtor government and its creditors would be adjudicated by an independent tribunal. A majority vote by creditors would bind dissident creditors just as if their bonds included collective action clauses.

The April 2002 Proposal

In April 2002, Krueger modified the original proposal, mainly in response to criticism that the original version aggrandized the IMF's authority to resolve a debtor's negotiations with its creditors. The revised proposal removed the Fund from the restructuring process, leaving decisions on the matter to the debtor and a supermajority of the creditors. As before, an amendment to the IMF's articles would be required, this time to achieve a uniform legal arrangement for collective action. The definition of a supermajority was to be determined at a later date.

A second change from the original proposal was that the validation of the need for a stay or a standstill would be declared by the IMF only at the start of the process but would then be revalidated by a creditors' committee on its formation. A third change required a single supermajority for different creditor claims (bank loans, bonds, trade credits, interbank loans, and other claims), rather than each creditor class, to approve prolonging a stay beyond three months and a final restructuring agreement. If that agreement did not accord with the Fund's view of how much the debt burden needed to be reduced to be sustainable, the IMF could withhold further financing and additional restructuring would be expected.

Current Status of the Proposal

As of spring 2003, no final version of the proposal existed. A 75-page staff memorandum (International Monetary Fund 2002) detailing the status of the proposal addressed unsettled questions for the directors to consider. One such issue is the activation of the mechanism.

Is it necessary to provide an independent confirmation of the member's representation of unsustainability of its debt as a condition for activation and, if so, who should perform the function?

Another unsettled issue is whether creditors should have the opportunity to terminate the mechanism after completion of the verification of the claims of creditors. In the history of the IMF, previous amendments to its Articles of Agreement dealt with major changes to the structure of the Fund with respect to the rights and obligations of its members. What distinguishes the proposed new amendment from earlier ones is that it would affect the contractual rights of private parties.

The process of amending the Articles is cumbersome. First, a final version of the bankruptcy mechanism's design would have to be in hand. The Executive Board would then have to decide by a majority vote to propose a draft text for adoption by the Board of Governors. The Board of Governors in turn would have to approve the proposed amendment by a majority vote. Finally, only after acceptance of the amendment by three-fifths of the members possessing 85 percent of the voting power, would the mechanism enter into force. Adoption of the mechanism would probably also require changes in domestic laws of the members.

In view of the adverse political climate the bankruptcy proposal faced, it is no wonder that the IMF did not pursue the subject further at its April 2003 meeting in Washington.[5]

Who Favors Sovereign Bankruptcy Proceedings?

Neither sovereign countries nor private-sector investors have been clamoring for a sovereign country bankruptcy law. If anything, sovereign debtors have shunned previous plans—such as preapproved credit lines and contingency clauses in bonds stipulating steps to be taken in case of default—to signal to markets that their countries had responsible policies. Countries with emerging markets have regarded such devices as an indication of financial weakness and feared that adopting them would induce creditors to exact an interest premium on loans. Sovereign debtors might well have a similar reaction to the IMF's proposal. Nonetheless, the proposal has some support among academics.

Jeffrey Sachs, now at Columbia University, has long advocated a

[5]In late March 2003, at a closed-door meeting at the Harvard Business School, Krueger conceded that the IMF proposal, although not dead, had little political support to move forward (Blustein 2003).

universal bankruptcy law (Sachs 1995). In 1995 he made the case for giving insolvent countries the same protection from creditors as insolvent firms. His sympathies were with the sovereign debtors, not the creditors. Sachs's views were rejected in the report of an official working group issued after the Mexican crisis of 1994–95. That report, which received the endorsement of the major industrialized countries, favored debt workouts rather than massive official bailouts and stressed the importance of market discipline (Group of 10 1996).

In a paper that Sachs prepared for a Brookings conference in 2001 on debt restructuring, he relegated the bankruptcy court proposal to the periphery of his argument. He was more concerned with using grants and debt forgiveness to facilitate a greater flow of resources from richer countries to heavily indebted poorer countries (Sachs 2002).

Initially, Kenneth Rogoff (1999) offered a skeptical perspective on sovereign bankruptcy proceedings. He differentiated between a domestic bankruptcy court, which can seize physical assets and fire a company's board of directors, and an international bankruptcy court, which is unlikely to enter a debtor country and seize physical assets, much less fire the country's government. For Rogoff, municipal government bankruptcies, in which outside boards run the city's day-to-day finances, are no more convincing examples for sovereign government bankruptcies. Federal governments, in his view, would not tolerate a comparable level of outside interference. Rogoff concluded that the main problem with an international bankruptcy court is that it could not enforce its decrees in debtor countries. Moreover, in the event of a default, if lenders could not turn to national courts, which would be superseded by an international court, the volume of lending would diminish.

When Rogoff was appointed director of research at the IMF, his position on a bankruptcy law for sovereign debtors changed. In his June 28, 2002, remarks on the Joseph Stiglitz book, *Globalization and Its Discontents,* Rogoff reversed himself. He stated, "there is a need for a dramatic change in how we handle situations where countries go bankrupt." He saluted Krueger for having "forcefully advocated a far-reaching IMF proposal." He taunted Stiglitz for having first sharply "criticized the whole idea" at a Davos panel in February and later taken credit "as having been the one to strongly advance it first" (Rogoff 2002).

Michelle White of the University of California at San Diego believes that a bankruptcy court or some equivalent may be needed to rein in rogue creditors, provide private-sector financing that has seniority over earlier claims against countries during debt restructuring,

and compel dissenting groups of creditors to accept a restructuring plan. She cautions, however, that such a procedure may "dry up the sovereign bond market completely" (White 2002: 316).

Who Opposes Sovereign Bankruptcy Procedures?

The opponents of the IMF's proposal include former as well as present government officials and academics. Their criticisms and alternative recommendations vary. In the concluding section, I note the opposition of spokesmen for international investors and debtor countries.

Edwin Truman, a former Federal Reserve and Treasury Department official, is entirely opposed to bankruptcy proceedings, as he made clear in a speech in New York on December 10, 2001 (Crooks 2001). He believes that there is no consensus among policymakers and commentators to make a sovereign bankruptcy proceeding politically feasible.[6] He faults payments standstills, which, in his view, are likely to worsen crises. Instead of focusing on debtor insolvency, as does a sovereign bankruptcy procedure, he favors the provision of adequate liquidity to the world financial system. He proposes a new fund for the IMF to be raised by an annual fee of 0.1 percent on international investment until it reaches a value of, say, $300 billion. Countries in financial difficulties could draw on the fund. In effect, Truman's approach is a better financed continuation of the IMF's previous response to financial crises, possibly including bailouts.

In opposition to the tax that Truman advocates, Charles Dallara, managing director of the Institute of International Finance, which represents international banks and other investors, disputes the need to raise more resources for the IMF (Crooks 2001).

The U.S. Treasury Department's response to the IMF proposal was negative. John Taylor, under secretary of the Treasury for international affairs, told the congressional Joint Economic Committee that a decentralized approach that relies on collective action clauses would be superior to the proposal (Taylor 2002a). He elaborated on that approach in a subsequent speech (Taylor 2002b). It would involve adoption by sovereign debtors and their creditors of a majority-action

[6]In discussing the three papers presented at the Brookings 2001 conference on an international bankruptcy court, Truman (2002: 342) reiterates his view that it is not now feasible "because the intellectual and political foundations have not yet been laid." The reasons are (1) no consensus exists on whether such an institution should seek to maximize the return to creditors or to give debtors a fresh start and (2) the world is not ready to give a supranational body the right to make such judgments.

clause to bind all creditors to an agreement between the country and the creditor representatives. A second clause on procedures would stipulate that each class of creditors would have its own representative and would require the debtor to provide the creditor representatives with necessary data. Each creditor representative on instruction by a specified fraction of creditors would have the exclusive right to initiate litigation. A third clause would allow deferral of debt payments and bar litigation for long enough to permit creditors to choose their representative. The three clauses would be included in bank and bond debt instruments. Any country seeking an IMF loan would have to include those clauses in its debt instruments.[7] The IMF could also promote use of the clauses by lowering the charge for its loans for countries that did so.[8]

The Joint Economic Committee of the U.S. Congress also rejected a new role for the IMF in supervising sovereign bankruptcies. One explanation for the launch of the bankruptcy court proposal has been offered by Chairman Jim Saxton (R-N.J.) who said, "I can't help thinking that its default supervision proposal would have the effect of compensating the IMF for the reduction in its influence arising from a more restricted policy toward international bailouts" (Joint Economic Committee 2002). The JEC instead supported Taylor's decentralized approach. It also released a study by Adam Lerrick and Allan Meltzer (2002) of Carnegie Mellon University further documenting how the private sector can resolve bankruptcy without a formal court.

The study shows how the absence of majority action clauses in outstanding debt can easily be remedied. Exchange offers containing majority action clauses could be swapped for old debt. To execute those offers, Lerrick and Meltzer advocate a series of auctions. To encourage participation in the exchange offers, exit consent amend-

[7]The legal framework outlined by Taylor was endorsed by the finance ministers of the Group of Seven industrial countries at a meeting in Washington at the end of September 2002 (Andrews 2002). Earlier that month the Treasury presented the plan to a gathering of senior economic officials from the Group of Seven, large private investors, and representatives from several nonindustrial countries (Phillips 2002c).

[8]An observer might have concluded that Treasury opposition to the Krueger proposal effectively ended its prospects. Such a conclusion was spiked by a statement made by U.S. Secretary Paul O'Neill at the International Monetary and Financial Committee meeting of the IMF on September 28, 2002: "The United States strongly welcomes the significant progress being made on the contractual approach to sovereign debtor restructuring. We are particularly encouraged by the broad support expressed by both borrowers and creditors for the implementation of this approach." However, he also said, "We strongly support the continued pursuit of the statutory approach." Does the Treasury favor both approaches? More dubious is O'Neill's claim that both borrowers and creditors have given broad support for these approaches. See contrary statements by these parties in the conclusion.

ments could be used. Those amendments added to the terms of old instruments destroy the value of any instruments held by holdouts. When a bond issue includes the amendment, voted by a supermajority of holders, it becomes binding on the remaining holders.

As Lerrick and Meltzer note, the market is familiar with exchange offers. In the period before Argentina defaulted in December 2001, it made extensive use of exchange offers to fulfill a condition the IMF attached to the $40 billion loan Argentina obtained in 2000 from a consortium of donors, including the IMF. The condition was to implement a voluntary, market-based operation to improve the country's debt profile. The technique Argentina adopted was an exchange offer of debt instruments for existing maturing bonds, without the use of exit consent agreements. The new debt instruments provided for longer maturities and higher interest rates than did the original bonds. In 2000 and 2001, Argentina made exchange offers to foreign bondholders, presumably after consultation with investment advisers on what the market would accept. However reluctantly, Argentina's bondholders accepted the exchange. Nominally the exchange offer improved the terms of existing bonds, but the market rating of the bonds imposed substantial losses on the bondholders.[9]

Lerrick and Meltzer show how debt contracts can replicate the protections of a sovereign bankruptcy court. A trust indenture, for example, provides for a trustee to control all action against the sovereign on behalf of all bondholders. In order to continue debt service in a liquidity crisis, the equivalent of debtor-in-possession financing can be arranged by subordinating outstanding claims to interim lenders. The authors dispute the IMF's contentions that it is difficult to coordinate increasing numbers of anonymous creditors holding a great variety of debt instruments and that holdout creditors are likely to sue a country.[10] As they note, a creditors' committee was formed in November 2001 before Argentina defaulted, which indicates that it is not so difficult to access a broad spectrum of investors in such situations. Lerrick and Meltzer also argue that their proposal for

[9]Before the default, further exchange offers were expected in 2002 but were never made. Two suits have been filed against Argentina—one by German investors, the other by Americans seeking class action certification. Four other suits have been filed for small amounts. Argentina is defending all.

[10]The reason that there is no obstacle to organizing creditors is that these days all bonds are registered. The debtor or fiscal agent who distributes interest can distribute a note to creditors stating that they are all invited to a meeting that will be held on a designated date. In the same way, creditors can organize themselves whether in a corporate or a sovereign context.

exchange offers and exit consent agreements preclude the ability to sue and extract preferential treatment by holdouts.[11]

Peter Kenen of Princeton University dissents from the IMF proposals and the Taylor position on the ground that they

> fall short of resolving the problem encountered during the Asian crisis, which involved the liquidation of short-term foreign claims on Asian banks and firms, rather than claims on Asian governments. . . . Suspension of payments and stays of litigation may be required by *all* debt-related crises, not merely those requiring restructurings of sovereign debt [Kenen 2002: 38–39].

Kenen would reinforce Taylor's proposals by two further measures: he would include collective action clauses in all standardized debt contracts of both the private sector and governments and a 90-day rollover option in all standardized debt contracts. He would require debtors to exercise that option if a country's government made a formal finding that the country faced a financial emergency. Coverage of private sector debt would be limited to debts denominated in foreign currency.

The advantage of including private debt, according to Kenen, is that it might obviate the need to impose exchange controls. Under the IMF plan, if a government imposed exchange controls, the private sector might have to suspend debt payments, but the IMF would sanction a stay of litigation against private sector debtors only if a country faced a sovereign debt problem. Kenen believes that his plan avoids this problem but admits that private sector suspension of debt payments, not backed by exchange controls, might motivate debtors to buy foreign currency before the end of the 90-day rollover period to provide the means to resume debt payments after the end of the period.

Because it will take years to amend the Fund's Articles of Agreement and the proposal is apt to provoke opposition from the private

[11]In a 2001 paper, Lerrick and Meltzer proposed an approach to debt restructuring quite different from their 2002 proposal. The earlier approach required a debtor to declare default that would prompt the IMF to provide a stand-by line of credit. The line of credit would allow any creditor to sell its defaulted claim for a fixed cash price that the IMF would set—an official floor of support—significantly below the debt's anticipated restructured value during a brief period. During this period, the country would offer to restructure its debt through an exchange for new bonds, fixing a maximum write-down. Negotiations between the debtor and creditors during the restructuring period would presumably set the final restructured value above the official floor of support (see Lerrick and Meltzer 2001). The authors promote this approach as a way of minimizing the IMF's outlays for rescuing a troubled sovereign debtor. The approach is objectionable, however, for IMF intrusion into a matter that the market is fully competent to solve, as the authors' 2002 proposal demonstrates.

sector, lacks Treasury support, and may be opposed by some emerging market countries, Kenen (2002: 42) favors his own comprehensive contractual approach as "the most expeditious second-best way to go."

Jeremy Bulow (2002) of Stanford University sets the right priorities for dealing with the problem of sovereign debt: first, control the extent of borrowing by sovereigns, and, second, downgrade the need for bankruptcy procedures. Bulow regards emerging market economies as being prone to create budget deficits owing to corruption by many of their policymakers and their willingness to borrow for socially inefficient projects. The sovereign has an incentive to default not because of inability to pay but unwillingness to pay. Bulow would limit borrowing by sovereigns to their own legal jurisdictions rather than allow them to issue debt in major foreign centers. The problem with a bankruptcy court, Bulow contends, is that it would facilitate default and debt restructuring. However, the capital market for loans to emerging market economies would shrink as a result. In Bulow's view, that is a desirable outcome.

Andrei Schleifer (2003) shares Bulow's doubts that the debt market will survive under the IMF's bankruptcy arrangement for sovereigns. Unlike domestic bankruptcy laws, he notes, which are required to operate "in the best interests of the creditors," the IMF fails this test. Unlike Bulow, however, Schleifer would deplore the demise of the sovereign debt market.

Changing the Culture of Debt-Based Development

The opposition to the IMF's original and modified proposals is varied and substantive. Even apart from the chorus of dissent, there is reason to believe that the IMF will not succeed in enacting its unwieldy and overly complex program. It would take years for the membership to adopt the changes set forth in the program or for the Fund to be in a position to amend its articles. It is doubtful that the Fund will be able to convince the U.S. Treasury to vote for an amendment, which requires the consent of 85 percent of the Fund's shareholders. The U.S. vote is more than 17 percent of the total.

There are serious challenges to at least three of the premises on which the proposal for a bankruptcy court is based:

1. *It is difficult to assemble committees of creditors who hold bearer bonds of various maturities.* Today, all bonds are registered so there is no problem in identifying holders and organizing committees of homogeneous claimants.
2. *A rogue creditor poses a threat to the successful conclusion of a*

restructuring. As Nouriel Roubini (2002: 329) has remarked: "Rogue creditors do not jeopardize the completion of an exchange offer; their incentive to start litigation is triggered by a successful offer, not a failed one. Only after a majority of creditors have accepted a deal does a rogue have the incentive to obtain a full claim."[12]

3. *Official intervention is needed to facilitate restructuring.* Market solutions already exist and have been used to renegotiate the outstanding debt of troubled emerging sovereign debtors. IMF intervention is a solution to a problem that does not exist.

At stake if the IMF proposal for a sovereign bankruptcy procedure or any of its variants is implemented is that investors will view the new conditions with a jaundiced eye and retreat from lending to emerging market countries. Indeed, the borrowers are well aware of this pitfall. That is the message that both creditors and debtors have expressed in response. Charles Dallara, a spokesman for international banks and other investors, contends that various types of contractual provisions for international bonds will enable orderly restructuring to proceed without the need for the IMF to oversee a country's debt restructuring.

At recent IMF–World Bank meetings, former Brazilian finance minister Pedro Malan said that he was unconvinced that the benefits of statutory debt restructuring would be greater than the potential costs. Mexico has expressed similar doubts. The costs to which Malan referred are higher interest rates that lenders will require if either the contractual or the statutory approaches ever materialized (Phillips 2002a, 2002b, 2002c; Andrews 2002).

That might not be such a deplorable result. Lenders have not exercised due diligence in extending loans to those countries, and the IMF has fostered a culture that encourages borrowing not only from creditors in the world capital market but also from the international financial institutions. Although the objective of such institutions has been to promote development, looking back on what that culture has achieved over the past 50 years, one has to conclude that their record is unimpressive. Perhaps the time has arrived to abandon debt-based development; to encourage the conversion of debt to equity; to set countries on a different path than one that leads to unsustainable debt, crises, and debt restructuring; and to rely on equity investment for development.

[12]I fail to see why rogue creditors who, after all, demand only fulfillment of the terms of a contract, are excoriated in the literature.

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