6-1-2005

Sovereign Workouts: An IMF Perspective

Anne O. Krueger

Sean Hagan

Recommended Citation
Available at: http://chicagounbound.uchicago.edu/cjil/vol6/iss1/13

This Article is brought to you for free and open access by Chicago Unbound. It has been accepted for inclusion in Chicago Journal of International Law by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.
Sovereign Workouts: An IMF Perspective
Anne O. Krueger* and Sean Hagan**

I. INTRODUCTION

Over the past several years, the international community has devoted considerable attention to improving arrangements for resolving financial crises and, in particular, for the restructuring of unsustainable sovereign debt. These efforts have benefited from the active participation of sovereign debtors, market participants, workout professionals, lawyers, economists and the “official sector,” including the International Monetary Fund (“IMF”). As can be expected, perspectives regarding the dimensions of the problem and the direction of reform have varied. Nevertheless, a consensus appears to have been reached on two broad issues. First, there is a recognition that, in circumstances where a sovereign’s debt has become unsustainable, all stakeholders—the sovereign debtor, its creditors, and the system more generally—will benefit from a restructuring process that is more rapid, orderly, and predictable than is currently the case. Second, it is generally accepted that enhancing the effectiveness of the legal framework is critical to the success of any meaningful reform in this area.

Much of the discussion has focused on whether the necessary strengthening of the legal framework can be achieved exclusively through private contract or, alternatively, requires official intervention, perhaps in the form of the IMF’s proposed “Sovereign Debt Restructuring Mechanism” (“SDRM”). Market participants have expressed concern that any form of official intervention would undermine the operation of capital markets in this area and,

---

* First Deputy Managing Director of the International Monetary Fund. The views set forth in this article are those of the authors and do not necessarily reflect the views of the IMF.

** General Counsel and Director of the Legal Department of the International Monetary Fund.

in particular, the quality of emerging market debt as an asset class. In contrast, the premise behind the SDRM has been that official intervention, if appropriately designed, would strengthen rather than weaken the operation of the international financial system. While recognizing the important limits of the analogy, supporters of official intervention have pointed to the critical role that domestic insolvency frameworks play in a market economy.

While there has been considerable support for the SDRM within the official sector, efforts are currently underway to improve the restructuring process through market-based reform and, in particular, through a reliance on the collective action clauses that are found in international sovereign bonds. Whether the official sector turns its attention again to the SDRM will depend, at least in part, on whether these clauses are sufficiently robust to limit the severity of the costs that arise from the restructuring process.

This article provides a brief overview of the key economic, financial and legal issues that have been central to the discussions in this area. Section II identifies the problems faced by a sovereign and its creditors when the restructuring of the sovereign's debt becomes inevitable and, in that context, discusses the assistance the IMF can—and cannot—provide in these situations. Section III sets forth a brief analysis of the two primary proposals for legal reform: collective action clauses and the SDRM. Section IV offers some concluding observations.

II. THE PROBLEM

While a sovereign debtor and its creditors share a common interest in an early and rapid restructuring of unsustainable sovereign debt, developments in the international financial system have conspired to make this a more complicated and time consuming process than it need be. In some respects, the

---

2 See Michael M. Philips, Support Builds for Plan to Ease Debt Loads of Developing Nations, Wall St J A16 (Sept 17, 2002) (quoting Charles Dallara, Managing Director for the Institute of International Finance, as saying "at a time of extreme risk-aversion in emerging markets, when capital flows are falling . . . approaches such as [the SDRM] add further to uncertainty and investor anxiety").

problem is similar to the one confronted by a company and its creditors seeking to maximize value in an environment where debt structures are increasingly complex and creditor interests diverse. Of course, the corporate analogy only holds at a certain level of abstraction. There are a number of distinguishing features that have important effects on the process—most importantly, creditors and corporate debtors engage in the restructuring process in the shadow of liquidation. The "liquidation" alternative shapes not only the debtor-creditor relationship, but also the intercreditor dynamic, given the fact that a liquidation law defines the relative priorities among creditors. Nevertheless, the experience in the corporate context reveals that, as with corporations, once a judgment is made that a sovereign debtor will not be able to service its claims without a reduction in the net present value of the claims, everyone has an interest in initiating the process earlier rather than later. Moreover, all will gain from a process that, once initiated, is rapid, orderly, and predictable.

A. UNSUSTAINABLE DEBT AND ITS IMPLICATIONS

In the corporate context, a distinction is generally made between "illiquidity" and "insolvency." A company is considered "illiquid" when it is unable to pay its debts as they fall due, but is "insolvent" when the value of its liabilities exceeds the value of its assets. While the former concept focuses on problems arising from the structure of the company's debts, the latter addresses problems relating to the size of the overall stock. This distinction has a number of implications in how the corporate restructuring process will proceed. In either case, however, some form of statutory protection will be needed since, even if

---


5 In the corporate context, the illiquidity standard is also referred to as the "cash flow" or "cessation of payments" standard; see UNCITRAL Legislative Guide on Insolvency Law at 57 (cited in note 4). Regarding insolvency, as a general matter, the United States Bankruptcy Code defines a company as insolvent if "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 USC § 101(32)(A) (2000).
the problem can be resolved by a reprofiling of maturities rather than a reduction of maturities, the inability of a company to make payments will result in an enforcement of legal claims and the dismemberment of the debtor.

The corporate analogy does not translate directly to the sovereign context. A sovereign has choices available to it that are normally unavailable to a company that is facing a liquidity crisis. Among other things, it has the IMF. There will always be circumstances where, as a result of changes in external circumstances (a sharp and unanticipated drop in the price of a key export, for example), a sovereign will find it difficult to service its debt under the original terms. In many cases, the adoption of strong economic policies will provide a sufficient basis for weathering the crisis: even if a reprofiling of maturities is necessary, the net present value of the debt will be maintained and the future debt-to-GDP ratio will stabilize or fall. In these circumstances, the IMF can play a critical "catalytic" role by providing its financial resources in support of strong economic adjustment policies, thereby assisting the country to regain market confidence.

There may be circumstances, however, where, under any reasonable set of circumstances or policies, the sovereign's debt relative to GDP will grow indefinitely. A sovereign will never be "insolvent" in the strict sense: by virtue of its fiscal powers, a sovereign's assets are—at least theoretically—inexhaustible. However, at a certain point, its debt will become "unsustainable." Specifically, as the ratio of debt-to-GDP mounts, real interest rates in the debtor country will rise. While the sovereign may try to increase taxes or take other measures to service its debt, all of these measures will be growth reducing. As growth falters, the debt-to-GDP ratio will rise further. Of course, judgments as to debt unsustainability must be made on a probabilistic basis. There is always the possibility, however remote, that new natural resources will be discovered or that the terms of trade will shift in a country's favor. However, as borrowing continues, the probability of the sovereign being able to continue to service its claims will continue to drop. As lenders see that debt sustainability is increasingly improbable, they will no longer be willing to provide financing—at any price.

In these circumstances, the IMF will not be able to help unless the sovereign takes steps to restructure its debt in a manner that reduces the debt's net present value to a level that assures medium term sustainability. According to

---

A number of commentators have recognized the difficulty of determining when indebtedness is unsustainable in the sovereign context. See Richard N. Cooper, Chapter 11 for Countries?, 81 Foreign Aff 90, 92 (2002); see also Nouriel Roubini, Do We Need a New Bankruptcy Regime?, 1 Brookings Papers on Econ Activity 321, 322 (2002), abstract available at <http://static.highbeam.com/b/brookingspapersoneconomicactivity/march222002/doweneedanewbankruptcyregime/> (visited Mar 24, 2005); Scott, 37 Intl L 103 (cited in note 3).
its charter, the IMF may only make its resources available to member countries if it determines that its assistance will actually assist the member in the resolution of its balance of payments problems.\textsuperscript{7} Moreover, as a financial institution with limited resources, the IMF must have adequate confidence that the member will be in a position to repay the Fund within the relatively short repayment period (normally 3–5 years) that applies to its financing.\textsuperscript{8} But when the IMF has made a judgment that a member’s debt is unsustainable, its financing will only serve to delay—and exacerbate—the resolution of the problem unless efforts are made by the sovereign to both restructure its debt and implement effective adjustment policies that provide for medium term sustainability. In addition, in the absence of a reduction in the net present value of the claims on the sovereign, the IMF will have little basis to conclude that it will get repaid.

From the perspective of the borrower, there comes a point where further delays in the initiation of the restructuring process only exacerbate the economic dislocation that occurs when the crisis arises. Since the debt restructuring process is always a painful one for a sovereign (both economically and politically), governments are often tempted to introduce whatever economic adjustment efforts they think necessary to avoid a restructuring; in other words, they try to “gamble for resurrection.” But after a certain point, these steps only reduce the policy options that are available when the debt restructuring process begins. Moreover, a desperate wave of borrowing from domestic banks when all other sources of credit have dried up only leaves the domestic banking system insolvent when the net present value of the banks’ claims on the government is reduced. The ensuing recapitalization of the banking system places an even greater strain on the sovereign’s fiscal policies.

Finally, there is the perspective of the sovereign’s creditors. Actions taken by the sovereign government to delay the restructuring process and “gamble for resurrection” ultimately reduce value of creditor claims. To the extent that these delays serve to exacerbate the economic dislocation, this will effectively reduce the amounts that are available to service restructured claims. Perhaps even more directly, additional borrowing from the IMF—which, by virtue of its preferred

\textsuperscript{7} See Articles of Agreement of the International Monetary Fund (1944), art V, § 3(a), available online at <http://www.imf.org/external/pubs/ft/aa/aa05.htm> (visited Mar 24, 2005) (hereinafter IMF Agreement) which states:

The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems, that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund.

\textsuperscript{8} Id, art V, § 7(c).
creditor status is excluded from the debt restructuring process—will only further dilute the claims of existing creditors.

B. THE BARRIERS TO RESTRUCTURING

There is usually a brief period between the point at which it is highly probable that a sovereign's debt is unsustainable and the outset of a full blown crisis. This period presents a window of opportunity in which it may be possible to reach an agreement on a restructuring that offers the prospect of restoring sustainability while limiting the scale of economic dislocation and preserving the value of creditor claims. At this point, the net present value of the debtor's primary fiscal surplus will be larger if the debt is restructured since the economy's growth prospects can increase and real interest rates can fall. In these circumstances, an orderly and prompt restructuring can create value for both creditors and the debtor. Moreover, at this juncture, the IMF can provide financing in support of the implementation of strong adjustment policies during the debt restructuring process. Experience demonstrates, however, that there are a number of reasons why the restructuring process, once initiated, is more costly than it need be for the sovereign debtor, its creditors and the system more generally. The two most important reasons are briefly discussed below.

1. The Policies of the Sovereign Debtor

As noted earlier, once the restructuring process is initiated, it is critical that the sovereign formulate and implement a set of economic policies that will provide a basis for achieving medium-term balance of payments viability. In the absence of such policies, creditors will have no confidence in the country's payment capacity and, somewhat understandably, will be unwilling to engage in restructuring negotiations. In addition to these substantive economic policies, it is also critical for the sovereign to take steps to establish a collaborative debt restructuring process with its creditors. Unfortunately, there is a general perception among creditors that sovereign debtors will often eschew a collaborative process and, instead, will launch "take-it-or-leave-it" exchange offers without providing creditors with the information necessary to enable them to make informed decisions. Even where such an approach is successful in attracting a critical mass of support, it risks undermining the operation of the international financial system generally, and the value of emerging market debt as an asset class more specifically. For example, while this approach may be of
benefit to distressed debt purchasers (who buy the debt at a steep discount as uncertainty regarding the restructuring process drives down secondary market prices), it is very problematic for those investors who extended the credit in the first place and continue to hold the claims at face value.  

2. Collective Action Problems

Even where the sovereign is implementing appropriate policies and is intent on engaging with its creditors in a collaborative manner, its ability to attract a critical mass of support among creditors may be undermined by problems of collective action. Specifically, creditors who would otherwise be willing to reach an agreement with the debtor will hesitate to do so out of concern that other creditors will hold out and, after the agreement has been reached, press for full payment on the original terms. Increased uncertainty as to whether a critical mass of creditors will support the restructuring will, in turn, make a sovereign even more reluctant to initiate the process, leading to further delays and, accordingly, a further loss of economic value.

The magnitude of collective action problems currently facing a sovereign have increased with the evolution of capital markets over the past twenty years. During the 1980s, the claims being restructured were largely held by commercial banks in the form of syndicated loans. The debt restructuring process, while protracted, was relatively orderly, with negotiations being led by bank steering committees. Although these banks were not always cooperative, the official sector was generally successful in influencing their behavior through the subtle—and sometimes not so subtle—use of regulatory authority. Moreover, given the extensive business that these banks had with the debtor governments and their residents, they understood that aggressive tactics would only undermine these long term relationships.

Over the past fifteen years, however, emerging market sovereigns have been able to access capital markets directly though the issuance of international...

---


securities and, as a result, the relative importance of the commercial bank loans as a source of financing has declined significantly. While the process of disintermediation has resulted in a very large source of external financing for these countries, it also presents considerable challenges if and when the unsustainability of a sovereign’s debt necessitates a restructuring. A debtor is confronted with a relatively atomized creditor community, holding bonds issued in a number of different jurisdictions. Perhaps even more importantly, the interests of these creditors are often diverse. While retail investors and some institutional creditors may hold the instruments at face value, others have purchased the instruments at a steep discount. Many of these creditors are unregulated and few have the type of long term relationship with the sovereign that will guide their behavior. Rather, they pursue a strategy of maximizing the value of their claims. In some circumstances, they may determine that this strategy is best implemented by participating in the debt restructuring. In other circumstances, however, they may choose to hold out.

The nature of the holdout problem depends on whether the debt restructuring precedes or follows a default. There are good reasons why a sovereign may seek to restructure unsustainable debt prior to a default. A default can trigger a crisis that causes major economic dislocation. For example, where the banking system holds a considerable amount of sovereign debt, the plunge in the secondary market of these claims caused by a default may result in an insolvent banking system. Fear of such insolvency may also result in massive capital flight, which only exacerbates the problem. For all these reasons, creditors have a similar interest in engaging in a predefault restructuring. Not only does the avoidance of a full blown crisis limit the decline in the value of their claims, but it also increases the amount of resources available to the sovereign to service its claims once they are restructured. Having to recapitalize an insolvent banking system places an extraordinary amount of strain on the sovereign’s fiscal position.

Notwithstanding the commonality of interests among the sovereign and its creditors, the holdout problem may be particularly acute in these circumstances; a creditor contemplating a holdout strategy may calculate that, as long as a critical mass of creditors accept the offer, the sovereign may be in a position to service the original claims of those creditors that did not participate in the restructuring—and may be tempted to do so as to avoid the reputation damage

that a default may create. However, because of this possibility, creditors who otherwise would have been interested in engaging in the restructuring may decline to do so out of intercreditor equity considerations.

In the event that the restructuring process takes place after a default, the credibility of the holdout strategy—and the degree to which it will undermine the restructuring process—depends on the ability of the holdout to enforce its claims against a sovereign. Enforcing one’s claim against a sovereign, however, is hardly a straightforward task. Although a sovereign borrowing in the international capital markets is no longer protected by the concept of “absolute sovereign immunity”—at least under the laws in those jurisdictions that typically govern international debt instruments: usually New York state law or English law—there are still considerable obstacles confronting a creditor that is seeking recourse through the court system.\textsuperscript{13} In particular, while obtaining a judgment may be relatively easy, collecting on such a judgment has traditionally been very difficult. In circumstances where the government itself is the borrower, the assets of state-owned enterprises are normally not available for attachment. Similarly, the reserves of the central bank are normally also immune from attachment, provided that the central bank itself is not liable under the claim.

Confronted with the difficult task of finding assets of the sovereign to attach, judgment creditors have recently sought to extract a recovery from a sovereign by threatening to undermine the sovereign’s relationship with its other creditors. Relying on a court’s injunctive power, creditors have sought—and obtained—court orders that effectively preclude a debtor from servicing its claims on its restructured debt unless it makes simultaneous and ratable payments to the judgment creditor. This strategy was first used successfully by a distressed debt purchaser against the Republic of Peru and has now been replicated in other contexts.\textsuperscript{14} There continues to be considerable uncertainty regarding the legal basis of this strategy, in large part because there is doubt as to whether the provision in the underlying agreement that has been used by the distressed debt purchasers to effect this strategy in most, but not all, of the cases—the pari passu clause—should, in fact, be interpreted to require simultaneous and ratable payments.\textsuperscript{15} Nevertheless, this strategy has exacerbated

\textsuperscript{13} For a discussion of the barriers confronting a creditor wishing to enforce its claim against a sovereign, see Sean Hagan, Designing a Legal Framework to Restructure Sovereign Debt, 36 Georgetown J Intl L (forthcoming 2005) (manuscript at 11-15, on file with author).

\textsuperscript{14} Id at 12-15.

\textsuperscript{15} For an analysis of why it would be unreasonable to interpret the pari passu provision as limiting payments, see Lee C. Buchheit and Jeremiah S. Pam, The Pari Passu Clause in Sovereign Debt Instruments, 53 Emory L J 869 (2004). See also Philip R. Wood, Pari Passu Clauses—What Do They Mean?, Butterworths J of Intl Bank & Fin L (Nov 2003); Gulati and Klee, 56 Bus Law 635 (cited in note 12). The successful action taken by a distressed debt purchaser against Peru involved an
the collective action problem facing a sovereign and its creditors in at least two respects. First, to the extent that holdouts have a credible postdefault holdout strategy, creditors who are otherwise willing to engage in the debt restructuring process may be more reluctant to do so because of concerns regarding intercreditor equity. Second, creditors contemplating whether to accept a restructuring offer will clearly be concerned that the holdout strategy may be used to interrupt payments to them once the debt has been restructured.

III. REFORMING THE LEGAL FRAMEWORK

In recognition of the above problems, efforts have been made over the past several years to strengthen the legal frameworks to restructure sovereign debt. Two principal models have been pursued: one based on contract, the other on a treaty-based framework that could be established through an amendment to the IMF's Articles of Agreement. While there are important differences between these two approaches, they are similar in important respects. First, both place a priority on the resolution of collective action problems in a manner that does not shift the leverage from creditors to the sovereign. Rather, they are designed to shift the leverage from individual creditors to creditors as a group. Second, both frameworks seek to enhance the predictability and quality of the dialogue between the sovereign and its creditors during the restructuring process. Third, by seeking to make the process orderly, predictable and rapid, both frameworks are designed to enhance the quality of emerging market debt as an asset class. Finally, neither purports to be a panacea. In the final analysis, the success of any restructuring process will ultimately depend on the quality of the economic policies being pursued by the sovereign.

A. COLLECTIVE ACTION CLAUSES

Notwithstanding the attention that collective action clauses have recently received over the past several years, they are hardly a novel feature of international sovereign bonds. Two types of provisions have been prevalent for many years. The first is a provision that enables a qualified majority of bondholders (typically 75 percent) to bind bondholders within the same issuance
to the payment term of the restructuring. This provision, normally referred to as "majority amendment provisions" is a common feature in bonds governed by the laws of England and Japan. Until recently, however, they have not been included in bonds governed by the laws of New York. The second type of provision, referred to as a "majority enforcement" provision, is designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default but prior to a restructuring agreement. Elements of this provision can already be found in bonds governed by laws of New York and England. Although experience with restructuring sovereign bonds has been limited, the evidence suggests that collective action clauses can play a valuable role in facilitating the resolution of financial crises. They were successfully relied upon by the Ukraine in 1999 (in bonds governed by English law) and Uruguay in 2003 (in bonds governed by the laws of Japan).

Over the past nine years, most of the efforts of the official community in this area have been devoted to promoting the inclusion of majority amendment provisions in bonds governed by New York law, which continue to constitute the largest share of instruments used by emerging market sovereigns. Although there are no legal impediments to the introduction of majority amendment provisions in these bonds, there has been, until recently, very little appetite for them in the private sector. The breakthrough came in early 2003, when Mexico included such a provision in its New York law-governed bonds. Since then, these provisions have become a standard feature of bonds issued under New York law. How does one explain this reversal? As has been observed by some commentators, market participants were finally willing to embrace collective action out of a recognition that, unless progress was made regarding the adoption of these clauses, the official sector was likely to press ahead with the SDRM.

While the inclusion of these clauses in bonds governed by New York law represents a major step forward, there is room for further progress. In a 2002 report issued by a working group formed by the G-10 ("G-10 Working Group Report"), two recommendations were made regarding the design of collective action clauses that have yet to be fully implemented. While the first relates to the use of trust deeds, the second involves the introduction of "representation"

---

17 The US Trust Indenture Act of 1939 prohibits any impairment of a bondholder's right to receive payments due (or to recover the missed payments) without its consent, except that it allows a majority of bondholders with 75 percent of outstanding principal to postpone interest payments for up to three years. See 15 USC § 77 (2000). However, this limitation does not apply to sovereign bonds. For further discussion, see Buchheit and Gulati, 51 Emory L J at 1326–30 (cited in note 16).

provisions. With respect to the first recommendation, certain bonds governed by English law are issued under trust deeds, which give the trustee the right to initiate legal proceedings on behalf of all bondholders.\textsuperscript{19} The trustee is only required to act if, among other things, it is requested to do so by the requisite percentage of bondholders (typically more than 25 percent).\textsuperscript{20} Moreover, any amounts recovered by the trustee must be distributed pro rata among all bondholders.\textsuperscript{21} Such a de facto sharing provision creates an important disincentive for a minority of bondholders to initiate litigation, even if they control a sufficient amount of the bond issue to force the trustee to take action. Unfortunately, however, the use of trust structures in the sovereign context is still relatively uncommon for bonds governed by New York law.\textsuperscript{22} The second recommendation—the adoption of the representation provision—is designed to facilitate an early dialogue between bondholders and the sovereign in the context of an emerging crisis.\textsuperscript{23} Specifically, the provision would enable bondholders to elect a representative with the authority to enter into restructuring discussions. This representative would not have the authority to bind bondholders to the terms of a restructuring agreement, however.\textsuperscript{24} To date, such “representation” provisions have yet to become a common feature of international sovereign bonds.

\textbf{B. THE SDRM}

The SDRM proposal developed by the IMF during the period from November 2001 through April 2003 envisages the resolution of collective action problems through a treaty-based framework.\textsuperscript{25} As with collective action clauses, the SDRM would enable a debtor and a qualified majority of its creditors to make decisions that would be binding on the minority, including decisions regarding the acceptance of the final restructuring terms. Unlike collective action clauses, however, the SDRM envisages that, for voting purposes, claims would

\begin{itemize}
\item Id at 6.
\item Id.
\item Id.
\item The bonds issued by Uruguay in the context of its recent debt restructuring represent a welcome exception to this rule. See Ben Maiden, \textit{Uruguay Faces up to Challenges of Emerging Market Debt}, 22 Intl Fin L Rev 10 (May 2003).
\item Id at 3.
\item The details of the final SDRM proposal are set forth in the attachment to IMF, \textit{Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism} (Apr 8, 2003), available online at \textless \texttt{http://www.imf.org/external/np/omd/2003/040803.htm} \textgreater{} (visited Mar 24, 2005).
\end{itemize}
be "aggregated" across different instruments, even in the absence of a contractual framework that links these different instruments. Accordingly, the majority needed to effect a restructuring that would be calculated on the basis of all of the claims that would be covered by the restructuring, subject to rules regarding classification. This approach draws on the design of corporate insolvency laws where claims are also aggregated for voting purposes. In an environment where a sovereign has issued a multiplicity of different debt instruments in a variety of different jurisdictions, aggregation prevents creditors from disrupting the restructuring process by, for example, establishing a controlling position in a single bond issuance.26

The SDRM would also establish a comprehensive framework designed to enhance the quality of dialogue during the restructuring process: both from the debtor-creditor and intercreditor perspective. During the restructuring negotiations, the sovereign debtor would be required to provide detailed information to its creditors regarding both nature of its indebtedness and how it intends to treat such indebtedness.27 In addition, the SDRM envisages the creation of a representative creditors committee that would provide a focal point for such negotiations.28

The premise behind the SDRM proposal was that, to the extent its operation was sufficiently predictable, it would create incentives for debtors and creditors to reach an agreement without having to rely on its actual use. The aggregated voting provisions would encourage early creditor organization, thereby laying the foundation for structured negotiations. Potential holdouts would realize that, unless they were sufficiently flexible, the debtor and the majority of creditors could use the mechanism to bind them to the terms of an agreement. Ideally, the restructuring process would take place prior to a default, thereby protecting asset values for the benefit of both the sovereign debtor and its creditors. In both these respects, the SDRM could operate in a manner that is similar to the "prepackaged bankruptcy proceedings" that are relied upon in the corporate context in the United States.29

---

26 In terms of the resolution of collective action problems, the SDRM would also be more comprehensive than collective action clauses by virtue of the fact that it would bind judgment creditors: those creditors whose claims are no longer subject to the provisions of the underlying contract by virtue of the fact that they had received a judgment against the sovereign from a court of competent jurisdiction.


28 Id at § 8.

29 Under the US Bankruptcy Code, the votes for a plan may be solicited and obtained prior to the commencement of reorganization proceedings. 11 USC § 1126(b) (2000). For a discussion of prepackaged and prenegotiated plans under Chapter 11, see Stephen H. Case and Mitchell A.
C. THE ROLE OF THE IMF

As the SDRM proposal was developed, a number of complex design issues were identified and, for the most part, resolved. Among those issues that attracted the most attention were those that related to the role of the Fund in the operation of the SDRM.

From the outset of the discussions regarding the design of the SDRM, it was recognized that, given the central role the Fund currently plays in the resolution of financial crisis, the IMF would be involved at each stage of the SDRM’s operation. A country facing debt service difficulties normally approaches the Fund for financing in order to avoid a debt restructuring and the associated economic, social and political disruption. As noted earlier, however, when the Fund determines that a member country’s debt is unsustainable, it is precluded from providing financial support in the absence of adequate assurances that the member’s debt will be restructured in a manner that provides for medium term sustainability. Consequently, the Fund’s own decisions regarding the availability of its resources often have a significant impact on whether and when a member will initiate the restructuring process. To the extent that the SDRM was successful in reducing the costs associated with the debt restructuring process, it was recognized that establishing it would allow the Fund to more easily resist the pressure to provide financing in those cases where there was a very high likelihood that the member’s debt was unsustainable.

Once the debt restructuring process begins, the negotiations between the debtor and its creditors often take place against the backdrop of an IMF-supported program. Depending on the circumstances, this program may shape the dialogue between the sovereign debtor and its creditors in two respects. In terms of “process,” where the member has already defaulted on its external obligations, the Fund’s policy on “lending into arrears” requires it to make a determination, as a condition for future financing, that the member is making good faith efforts to reach an agreement with its creditors. Regarding substance, the program supported by the Fund typically—but not always—specifies the fiscal and external adjustment path that provides the basis for

---


30 For a detailed discussion of the design of the SDRM proposal, see Hagan, Designing a Legal Framework to Restructure Sovereign Debt at 30–75 (cited in note 13).

31 Originally established in 1989, the lending into arrears policy enables the IMF to provide balance of payments support to countries that are implementing a strong economic adjustment program but have not yet reached agreement with their private creditors. As a condition for providing financing in these circumstances, the IMF must make a determination that the member is making a “good faith effort to reach a collaborative agreement with its creditors.” See Selected Decisions and Selected Documents of the International Monetary Fund 305–11 (2003).
medium term sustainability. This adjustment path determines, in rather broad terms, the amount of resources available for debt service during the program period. Accordingly, the terms of any debt restructuring would need to be consistent with these program assumptions.

As the SDRM proposal was developed, the question arose as to whether the central role that the Fund typically plays in the restructuring process should be effectively codified under the new legal framework. In particular, would a sovereign debtor’s ability to activate the SDRM be made conditional upon the IMF’s determination that the member’s debt was, in fact, unsustainable? On the one hand, the need for some form of “gate keeper” was motivated out of a concern regarding debtor moral hazard. There was a perceived risk that the availability of an internationally sanctioned restructuring framework would increase the domestic political pressure on governments to utilize it, even where the member’s debt was sustainable. On the other hand, concerns were expressed about any framework that would enhance the Fund’s legal authority in this area. In the end, it was decided that IMF approval would not be a condition for commencement. The moral hazard risk arising from a country’s ability to activate the SDRM on a unilateral basis was mitigated by the fact that, once activated, the SDRM would not necessarily enhance the debtor’s leverage over its creditors. In particular, and unlike domestic insolvency laws, any stay on legal enforcement would require creditor support, consistent with the approach relied upon in collective action clauses. 32

CONCLUSIONS

Ever since the Mexican, Asian, and Russian crises in the mid 1990s, efforts have been underway to find means for more effective prevention of financial crises. Much has been achieved in this area: exchange rate flexibility is much

32 A separate issue regarding the role of the IMF under the SDRM proposal relates to the dispute resolution process. It was recognized from the outset that the aggregation of claims for voting purposes would necessitate the establishment of some centralized dispute resolution process that would oversee the implementation of the SDRM. As in the corporate context, it is inevitable that the disputes would arise between the debtor and its creditors—or among creditors—regarding the value or validity of claims being submitted. However, while the SDRM would be established through an amendment of the IMF’s Articles of Agreement, there was a consensus that the existing organs of the IMF—and, in particular, the IMF’s Executive Board—could not perform this function. It was agreed that a new, independent organ would be established to administer the SDRM, called the Dispute Resolution Forum (“DRF”). Drawing on the considerable precedent in the international law area, the members of the DRF would be selected through a process that relied upon external associations and institutions with demonstrated expertise in this area, thereby ensuring both their qualifications and independence. See IMF, Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism, § 8 (cited in note 25). See also Hagan, Designing a Legal Framework to Restructure Sovereign Debt (cited in note 13).
greater than it was and there is increased transparency and improved oversight of the financial system. More generally, greater attention is paid to unsustainable policy stances. But no matter how much is done, crises will, on occasion, continue to occur. Moreover, these crises will always be painful for the sovereign, irrespective of the success of any reform efforts. Nevertheless, it has become clear that, as result of developments in the capital markets over the past twenty years, the restructuring process has become more painful than it need be. In particular, uncertainties created by problems of collective action give a sovereign with unsustainable debt an additional reason to delay the initiation of the debt restructuring process. However, such delays only exacerbate the economic dislocation that eventually occurs, while further eroding the value of creditor claims. Accordingly, the objective of any reform of the legal framework is to create incentives for a sovereign and its creditors to initiate the restructuring of unsustainable debt as early as possible. For the moment, the international community is focusing on solutions that are based on contract. Our experience with future crises will tell us whether more robust, statute-based reform, is necessary. Whichever approach is adopted, the success of any restructuring exercise will ultimately depend on the ability of sovereigns to formulate and implement effective economic policies during this difficult period. The IMF’s role will continue to be that of providing timely financial support for such policies.