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I. INTRODUCTION

As tar babies go, few have proven stickier for the official sector\(^1\) than the plight of private sector lenders trying to recover their bad loans to foreign governments. Inevitably, these lenders have looked to their own governments for succor and protection against defaulting sovereign debtors. At several points and in several ways over the last two centuries, the official sector has tried to detach itself from this problem, only to discover how relentlessly adhesive it can be.

The motivations for the official sector to involve itself in the affairs of private lenders have changed over this period. During the nineteenth century, the governments of countries in which the private lenders were located ("Creditor Governments") would occasionally champion the cause of their citizen debtholders in response to domestic political pressure from those citizens. In some cases, the Creditor Governments' motives were less benign. Protecting private debtholders, for example, was the ostensible justification for certain Creditor Governments assuming what one scholar has called "the orderly administration of the debtor's fiscal affairs, as by the United States in the Caribbean and by England or the great powers in Egypt, Greece, Serbia, Turkey, and elsewhere."\(^2\) In this context, of course, "orderly administration" meant running all or a portion of the debtor country's finances.

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1 By "official sector," I mean, during the period prior to 1945, the governments of the countries in which the private creditors were located and, during the period after 1945, those governments and the international financial institutions (such as the International Monetary Fund, the World Bank and the regional development banks) of which those governments are members and over which they exercise significant influence.

2 Edwin Borchard, 1 State Insolvency and Foreign Bondholders 236 (Yale 1951).
After the First World War, and accelerating with the establishment of the Bretton Woods institutions following the Second World War, official sector lenders had another reason to promote orderly workouts of private sector claims against distressed sovereign borrowers—the official sector was often itself a lender to those same borrowers. Official sector credits were sometimes extended bilaterally (government-to-government), sometimes multilaterally (through the International Monetary Fund (“IMF”), World Bank and other international financial institutions), and sometimes both. But, in all cases, failure by the sovereign debtor to reach a satisfactory arrangement with its private sector lenders could jeopardize the recovery of those official sector credits.

Finally, the integration of the world’s financial and trading markets has forced the official sector to view a sovereign debt problem in one country as a potential source of disruption elsewhere. The financial and geopolitical consequences of an unmanageable debt crisis can no longer be neatly contained in a single country, or even a single region.

The official sector’s search to find a satisfactory method of resolving private sector claims against distressed sovereign borrowers, right down to the IMF’s proposal in 2002 for a Sovereign Debt Restructuring Mechanism (“SDRM”), can only be understood in light of this history. The official sector is searching for a sovereign debt restructuring policy that will achieve each of the following objectives:

1. Result in an orderly and expeditious readjustment of the claims of private (and bilateral) lenders against financially distressed sovereigns;
2. Ensure that any new funds advanced by the Bretton Woods institutions to a debtor country will be recoverable;
3. Minimize the risk of financial contagion in other debtor countries;
4. Encourage fiscal prudence on the part of the debtor and sound credit decisionmaking on the part of the lenders;
5. Promote, or at least not impair, private credit flows to emerging market borrowers generally; and
6. Shield the official sector from blame for having suffered the existence of rogue creditors or rogue sovereign debtors.

It is a tall order and has not yet been filled.

As the motivations for official sector intervention have changed, so too have the means. The establishment after the Second World War of the Bretton Woods institutions (the IMF, the World Bank, and the regional development banks) gave Creditor Governments an entirely new instrument through which to influence the behavior of sovereign debtors. Exercising influence through these financial institutions had several advantages over traditional government-to-government diplomacy. First, an organization such as the IMF places a useful political cushion between the debtor country and the Creditor Governments. Second, the debtor country is itself a member of the IMF; any scolding of the
debtor or its economic policies has the flavor of a familial dispute rather than an imperial reprimand. Finally, the organization is itself a prospective new lender within its rights to insist on economic adjustment measures as a condition to advancing fresh funds into a distressed situation.

For their part, private sector lenders have shown admirable consistency in their view of official sector intervention in their debt recovery efforts. If official sector pressure helped to induce ill-advised, undisciplined, and shortsighted debtor governments to honor the contracts they signed with foreign lenders, then this intervention was both welcome and wholly justified. But if the official sector even twitched with empathy for a fellow sovereign unable to pay its foreign debts, lenders saw unwarranted interference with normal commercial relationships.

II. OFFICIAL SECTOR RESPONSES

The official sector's role in the recovery of private loans to foreign sovereigns can be divided into at least three historical phases.

A. ENTER THE DIPLOMATS

For most of the last two hundred years, disappointed private lenders to foreign sovereigns had very few options other than to seek the help of their own governments. The prevailing sovereign immunity rules of this era—the doctrine of “absolute” sovereign immunity—meant that sovereigns could not be sued in foreign courts without their express consent. An unpaid bondholder was thus, for want of better options, likely to be an importunate bondholder. The Foreign Office, the State Department, and their equivalents in other countries were the recipients of these pleas for intercession with defaulting foreign sovereigns.

Public international law, of course, provided a legal basis for this intercession: a state had a legitimate interest in seeing that its subjects were not mistreated by foreign states. The failure to honor foreign debts owed to one's subjects was regarded as an example of such mistreatment.

As a general rule, Creditor Governments resented being importuned by their citizen bondholders, and did not relish the political pressure that those bondholders could bring to bear. The most famous expression of this impatience is to be found in a January 1848 Circular sent by Lord Palmerston to Her Majesty's representatives in foreign states. Palmerston robustly asserted the British Government's legal authority to “interfere authoritatively” in support of “the unsatisfied claims of British subjects who are holders of public bonds and

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4 See Borchard, 1 State Insolvency and Foreign Bondholders at 230–31 (cited in note 2).
money securities” of foreign states. Nevertheless, the question of whether to exercise that authority in any particular case was wholly a matter of government discretion. The private lenders—tinctured as they were by the unpatriotic act of having invested their money abroad rather than at home—were admonished not to expect Her Majesty’s sympathy.

It has hitherto been thought by the successive Governments of Great Britain undesirable that British subjects should invest their capital in loans to foreign Governments instead of employing it in profitable undertakings at home, and with a view to discourage hazardous loans to foreign Governments who may be either unable or unwilling to pay the stipulated interest thereupon, the British Government has hitherto thought it the best policy to abstain from taking up as international questions, the complaints made by British subjects against foreign Governments which have failed to make good their engagements in regard to such pecuniary transactions.

For the British Government has considered that the losses of imprudent men who have placed mistaken confidence in the good faith of foreign Governments would prove a salutary warning to others, and would prevent any other Foreign Loans from being raised in Great Britain except by Governments of known good faith and of ascertained solvency.5

In a few instances in the late nineteenth and early twentieth centuries, Creditor Governments did not just intercede verbally on behalf of their aggrieved bondholders—they intervened physically in the debtor countries themselves. Foreign powers compelled Egypt, the Ottoman Empire, Greece, Haiti, and several other countries to accept the “orderly administration” of their fiscal affairs.6 Occasionally, the threat of military force, and even more occasionally actual force, was employed to vindicate the rights of aggrieved bondholders.7 The most notorious such incident occurred in 1902 when British and German warships fired on Venezuelan coastal fortifications and threatened to occupy Venezuelan territory until debts to their subjects had been satisfied.

The cynical but realistic explanation of these interventions is that the Creditor Governments used their citizens’ unsatisfied claims as a pretext for achieving political objectives. This produced a famous doctrinal backlash. The Argentine jurist Luis Drago, writing in 1907, voiced what became known as the

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6 See Borchard, 1 State Insolvency and Foreign Bondholders at 286–96 (cited in note 2).

7 Id at 269–71.
Drago Doctrine: the public debt of a country cannot occasion armed intervention or actual occupation of the territory of the sovereign debtor.\(^8\)

While the United States remained a debtor country—from its inception through the nineteenth century—it rarely had to confront these issues. But after the First World War, America became a net lender to other countries. At this point, the Executive Branch of the US Government felt that it needed to supervise loans made by private sector investors to foreign governments, particularly the European countries attempting to recover from the effects of the war. It was a regrettable, and later regretted, decision.

In what became known as the “Rule of March 3, 1922,” President Harding and Secretary of State Charles Evan Hughes announced publicly that the State Department wished to be consulted before American bankers extended loans abroad. The Rule was not a formal legal requirement, but most bankers understood that compliance was not wholly discretionary. Although the text of the Rule of March 3, 1922 was very careful to warn that the State Department “[would not] pass upon the merits of foreign loans as business propositions, nor assume any responsibility whatever in connection with loan transactions,”\(^9\) this warning was widely discounted by the market. Many investors believed that if the State Department had cleared the loan in the first place, then State Department assistance should be expected if the loan went into default.

A distressingly large number of those foreign loans did in fact go into default after the stock market crash of 1929 and the ensuing depression. As a presidential candidate in 1932, Franklin D. Roosevelt fiercely condemned the Rule of March 3, 1922 and declared that, were he elected president, “it will no longer be possible for international bankers...to sell to the investing public of America foreign securities on the implied understanding that these securities have been passed on or approved by the State Department or other agency of the Federal Government.”\(^10\)

When Mr. Roosevelt became President, he quickly moved to distance the Executive Branch from any direct involvement in the negotiation of settlements of private loans to foreign governments. The operative word in the prior sentence is “direct.” In 1933, the Roosevelt Administration encouraged the formation of the Foreign Bondholders Protective Council (“FBPC”). This organization, modeled on the Corporation of Foreign Bondholders of Great Britain (which had been operating with some success since the 1860s), had the

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\(^10\) Id at 441.
self-appointed task of negotiating with defaulting sovereign debtors in the hope of arranging settlements that could be recommended to American bondholders. The FBPC was set up as a private, not-for-profit corporation, but it openly carried the blessing and support of the US Government in its discussions with foreign governments. By encouraging the formation of the FBPC in 1933, the American authorities hoped that they had pushed the foreign debt problem off of their political plates.11

And, for a while, they did. But by the late 1930s, in the face of a deteriorating political situation in Europe and a perception that the FBPC was losing its effectiveness, the US State Department decided that it again had to intervene directly in debt settlement negotiations with foreign governments. In part, this was done in order to regularize the debtor countries' relations with existing private creditors so that bilateral US aid could flow to those countries. After less than a decade of private sector efforts to shift the responsibility for negotiating foreign debt settlements to actors such as the FBPC, the tar baby was again clinging to the fingers of the Executive Branch of the US Government.12

B. ENTER THE JUDICIARY

Historically, Creditor Governments took responsibility for representing their citizen bondholders' interests because, absent such diplomatic pressure, the bondholders lacked any other effective remedy beyond feeble threats to boycott future debt issuances by the country concerned. By the middle of the twentieth century, however, a number of important creditor countries concluded that the absolute theory of sovereign immunity was outdated. If foreign sovereigns participated in commercial affairs beyond their own borders, this view held, why should they not be answerable in foreign courts for their commercial conduct? Under this "restrictive" theory of sovereign immunity, the judiciary would have principal responsibility for hearing the claims of disappointed creditors of foreign sovereign borrowers, thus relieving diplomats of this disagreeable task.

In the United States, this restrictive theory of sovereign immunity was first formally acknowledged as State Department policy in 1952.13 In 1976, the

11 See Gene A. Sessions, Prophecying upon the Bones: J. Reuben Clark and the Foreign Debt Crisis, 1933–39 32 (Illinois 1992) ("[A]fter the October 1933 conference [that led to the formation of the FBPC], the administration felt that the problem of people who held foreign bonds was out of its hands and good riddance.").
13 See Jack B. Tate, Letter Addressed to Acting Attorney General Philip B. Perlman by the Department’s Acting Legal Adviser, 26 Dept State Bull 984–85 (June 23, 1952) (stating that “it
restrictive theory of sovereign immunity was codified in the United States by the passage of the Foreign Sovereign Immunities Act ("FSIA"). Two years later, the United Kingdom enacted the State Immunities Act 1978.

If the official sector thought that it had permanently shifted the private creditor problem onto the judiciary, it was mistaken. Just six years after the passage of the FSIA, in August 1982, Mexico declared a moratorium on the repayment of most categories of its commercial bank debt. When many other debtor countries followed Mexico’s lead over the next 18 months, a truly global debt crisis ensued. It would last for another decade.

The official sector—including at this point both Creditor Governments and the multilateral financial institutions to which they belonged—were intimately involved at every stage of the global debt crisis of the 1980s and early 1990s. They had no choice. The commercial banks that had lent hundreds of billions of dollars to emerging market sovereigns formed a crucial part of the domestic financial systems in the creditor countries. Most of those lending institutions also benefited from government-sponsored deposit insurance programs. Had the debt crisis spun out of control, the domestic financial systems of the Creditor Governments would have been seriously undermined.

Apart from those domestic financial concerns, there was the obvious geopolitical angle. Mexico, to take just one example, aside from being a major trading partner of the United States, had 70 million citizens in close geographical proximity to the US border. The United States could not view with equanimity the prospect of economic, social, or political instability in Mexico as a result of a mishandled foreign debt crisis.

Significantly, this direct and intensive involvement of the official sector in the workout of private sector loans to sovereign borrowers during the 1980s was not intended to displace the availability of legal remedies conveyed by the FSIA and equivalent laws in other countries. Creditors could always resort to the judiciary if they were disposed to do so, they were just strongly encouraged not to will hereafter be the Department’s policy to follow the restrictive theory of sovereign immunity in the consideration of requests of foreign governments for a grant of sovereign immunity.

14 Foreign Sovereign Immunities Act, Pub L No 94-583, 90 Stat 2891 (1976), codified at 28 USC §§ 1330, 1332(a), 1391(f), 1441(d), 1602–1611.


16 The most memorable expression of this policy appears in an amicus curiae brief filed by the US Government in a lawsuit in the mid-1980s. This brief told a federal court that "[t]he United States supports the cooperative and negotiated resolution of international debt problems . . . within a context in which legal principles require enforcement of international loan agreements." Brief of Amicus Curiae United States, Allied Bank Intl v Banco Credito Agricola de Cartago, 757 F2d 516 (2d Cir 1985) (No 83-7713).
do so. When this encouragement originated from a commercial bank regulator and was directed at a regulated commercial bank, it carried force.

Debtor countries could also feel the sting of official sector disapproval if they toyed with unilateral measures that purported to interfere with the legal position of their foreign lenders. During the 1980s and early 1990s, the official sector ran the sovereign debt restructuring business much like Wyatt Earp ran Tombstone, Arizona on a Saturday night: there could be as much shouting and blaspheming as you wanted, but everybody had to check their guns before they came into town.

Official sector propaganda during this period warned that litigation could not resolve large sovereign debt defaults. The only effective path, they argued, was negotiated settlement by the debtor and its creditors encouraged, when necessary, by an official sector boot to the uncooperative posterior. But the official sector strongly believed that the availability of legal remedies to the creditors served a therapeutic *in terrorem* function; they reinforced the message to the debtor that however disagreeable negotiations with creditors may be, the alternative was much nastier. The result was widespread forbearance from litigation by commercial bank creditors during the 1980s and early 1990s. But this, in turn, left in doubt whether legal remedies in national courts would effectively ensure recoveries by private lenders in future sovereign debt workouts if more cooperative restructuring techniques failed.

In 2001, Argentina’s default on approximately $100 billion of its bond indebtedness removed that doubt. Argentina did not offer to restructure its indebtedness for another three years, and in this time hundreds of lawsuits were filed against the country. As of the date of this writing, some of those lawsuits have resulted in court judgments, but few, if any, have produced financial recoveries for the creditors. In the light of this experience, the markets now seem to believe that legal remedies alone are unlikely to be a satisfactory recourse for private sector debtholders, at least if the sovereign default is large enough or persists long enough.

Separately, the official sector has, since the Mexican devaluation crisis of 1994–95 and the Asian debt crisis of 1997, devoted much of its effort toward exploring possible changes to credit documentation and debt restructuring techniques that would facilitate orderly sovereign debt workouts.\(^{17}\) The most notable success achieved in this area has been the widespread incorporation of collective action clauses in sovereign bonds governed by New York law. The official sector’s motive in encouraging these reforms has had obvious elements of self interest. If the private lenders and their sovereign borrowers can find

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\(^{17}\) These brainstorming exercises are described in Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* 220–59 (Brookings Inst 2003).
contractual techniques to expedite the debt restructuring process, there will be less occasion for official sector intervention in the process, and therefore less occasion for criticism of the official sector. In addition, market-based debt restructuring techniques were seen as the alternative to the official sector bailout technique of the 1990s; a technique that invited hand wringing about moral hazard.

C. ENTER THE IMF

The most significant change in the official sector response to this problem over the last twenty years has resulted from the evolving role of the IMF. Ever since the start of the global debt crisis in 1982, the IMF has played multiple functions in sovereign debt workouts. It acted, at least during the early 1980s, as something of a master of ceremonies directing all involved parties—the debtor, the private lenders and the bilateral creditors—toward their assigned roles.18

Usually, the IMF is also a lender in its own right. Because it is advancing funds into an already distressed situation, the IMF has the negotiating leverage to require the debtor to implement economic adjustment measures and to require other lenders to defer or moderate their claims against the debtor to produce a sustainable debt profile. Viewed historically, this represents a major advance over earlier methods by which the official sector attempted to influence the behavior of errant sovereigns. In the nineteenth century, the historical equivalent of today’s G-7 may have simply taken over the running of a debtor country’s fiscal affairs. In the twenty-first century, the same result can sometimes be accomplished through the less intrusive tool of IMF conditionality.

The IMF’s desire to safeguard its own lending has provided the principled justification for the Fund’s involvement in debtor countries’ dealings with private creditors. As a matter of policy, the Fund will not lend into a situation in which the debtor has built up arrears to its other creditors unless the IMF can be reasonably confident that the country will be able to reach an accommodation with all or most of its other lenders. This “lending into arrears” policy19 has allowed the Fund to monitor and, in some cases, visibly influence a debtor country’s debt management strategy. It has also thrust the IMF into the uncomfortable position of being seen by some private creditors as the anointed

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official sector instrument of reprimand and correction for wayward sovereign borrowers.20

In the more recent sovereign bond restructurings, the IMF's role has been poorly understood. When negotiating a debtor country's economic recovery program—a precondition to most Fund lending—the Fund staff must make a projection about the country's future debt servicing capacity. This projection identifies the amount of money that the country can be expected to devote toward the servicing of all classes of its debt. Remove from this figure the resources needed to service the debtholders (like the IMF itself) that will not be expected to restructure their credits, and what is left will define the genetic code, the financial DNA, of the ensuing debt restructuring for the country's private and bilateral creditors. A sovereign debtor cannot agree to pay materially more than the programmed amounts to its creditors (unless it is prepared to raise taxes or tax other offsetting measures) without placing its entire IMF arrangement in jeopardy. Of course, no creditor is ever bluntly deprived of the illusion of free will and independence in negotiating with the sovereign debtor the terms of its own restructuring, but behind the scenes a Calvinistic predestination has already been at work. When private sector lenders finally understand this feature of modern sovereign debt restructuring (not many seem to understand yet), they may be even less fond of the official sector.

III. CONCLUSION

For nearly two centuries, the official sector has tried to distance itself from direct responsibility for the fate of private sector lenders to sovereign debtors. The latest effort came in 2002 when the management of the IMF proposed a formal Sovereign Debt Restructuring Mechanism that would have established an independent framework for handling future sovereign debt problems along the lines of a transnational bankruptcy code.21 The SDRM was intended to accomplish what the diplomats, gunboat captains, administrators, and judges of the last two hundred years failed to achieve: an effective method by which the official sector could encourage orderly workouts of private sector claims against distressed sovereigns without shoudering the full moral, political, and financial responsibility for these workouts.

20 As exemplified by the comment of a large European bank following the closing of Argentina's bond exchange offer in February 2004: "We do believe that Argentina could afford to service better terms than are provided by the current offer...[but] with the international community apparently unwilling to apply any significant pressure on Argentina to improve the terms, bondholders are left with little leverage." Craig Karmin and Mark Whitehouse, Argentina's Hardball May Pay; Majority of Bondholders Expected to Take 30 Cents on Dollar, Wall St J C16 (Mar 3, 2005) (quoting Deutsche Bank's "client note advocating the [proposed] deal").

For reasons described elsewhere in this volume, the SDRM proposal did not prosper. Curiously, the private markets' main fear seems to be that SDRM would become a more efficient medium through which the geopolitical wishes of the G-7 governments could be imposed on private sector lenders. There are grounds for believing, however, that this was precisely what the SDRM was intended to avoid. One way of explaining the SDRM proposal is to view it as an effort to establish a rule-based framework for processing sovereign debt workouts with a minimum of official sector interference. The charm of SDRM in the eyes of its sponsors, and the fervent hope of those sponsors, was that by channeling these matters into an institutional framework, the official sector might escape the relentless pressure and criticism it has received for over two centuries for its role in sovereign debt workouts.

The Argentine bond exchange offer that closed at the end of February, 2005 poignantly demonstrates the official sector's uncomfortable position in these affairs. Throughout the three years of default that preceded Argentina's offer to exchange its approximately $100 billion of outstanding bonds, the official sector (principally in the form of the US Government and the IMF) appeared to be unusually detached from the process. It did not openly support, nor did it openly criticize, Argentina's approach to the debt restructuring. Unlike most prior sovereign debt workouts, the official sector refrained from carrying out its customary functions as referee and drover.

Some of the bondholders viewed this restraint as an abdication of official sector responsibility. Other commentators, however, praised the official sector's new found policy of abstention, arguing that the Argentine case showed that "borrowers and lenders can work out bond defaults on their own." This judgment would no doubt strike some of the bondholders as a bit like concluding that World War I stands for the proposition that, left on their own, nations can work out their differences. Thus, unable to let go, unwilling to take charge, and historically incapable of striking a happy compromise between the two, the official sector's role in future sovereign debt workouts will remain ad hoc and unpredictable.

23 See, for example, the anguished comment of a holder of Argentine bonds following the closing of that country's bond exchange offer in February, 2005: "The IMF has relinquished its role as protector of the financial markets." Argentina: Investors Throw in the Towel, Intl Fin Rev 76 (Feb 26, 2005).