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The Search for Intercreditor Parity

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I. Introduction

Creditors of the same borrower exist in a Hobbesian state of nature. What is good for one creditor—in the form of higher loan interest rates, pledge of collateral, or contractual terms that predispose the borrower to give preferential treatment to that creditor in the event of future trouble—will often be proportionally detrimental for the other creditors. In corporate lending, these Hobbesian tensions have a logical stopping point: bankruptcy. The creditor of an insolvent corporate debtor, who persuades the borrower to make payments or to give security under circumstances that constitute a fraudulent conveyance or a preference, is liable to have those arrangements unwound by a bankruptcy trustee. Moreover, the bankruptcy process will operate in various ways to ensure fair treatment among the various classes of creditors (secured, unsecured, and so forth) and equal treatment among the creditors in each class. Bankruptcy procedures will also prevent dissident creditors within any class from exploiting the process for their own benefit.

Lending to a sovereign borrower, however, is different. Municipal bankruptcy regimes do not apply to sovereign debtors. Thus, a lender who succeeds in extracting a preferential payment from the borrower need not worry about a compulsory disgorgement of the money to a bankruptcy trustee. The debtor and its assets will not be shielded against disruptive legal actions by individual creditors. Dissenting creditors cannot be forced to accept any rearrangement of the debt, regardless of how overwhelming the level of support is from the other creditors.[1] No neutral referee (like a bankruptcy

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1. Some multicreditor debt instruments, however, may provide for a contractual "cram down" on holdout creditors. Bonds governed by English law often contain majority action clauses that permit amendments, even amendments to the payment terms of the instrument, with the support of a super-majority of the bondholders. *See* Lee C. Buchheit, *Majority Action Clauses May Help Resolve Debt Crises*, Int'l Fin. L. Rev., Aug. 1998, at 13.

judge) will intervene to ensure equitable treatment among the various creditor groups. In the sovereign context, therefore, every class of creditor, and every creditor within every class, must look out for itself.

II. Why Parity Is Important

In the absence of the formal protections and procedures contained in municipal bankruptcy codes, how do creditors caught up in a sovereign debt workout manage their relationship with each other? In particular, how do they ensure that the burden of the restructuring does not fall with disproportionate severity on a certain class of creditors, while others enjoy a free ride?

Parity of treatment is important to creditors for two reasons. First, sovereign debt restructurings are, to some extent, a zero-sum game. The debtor will have a limited amount of financial resources to apply toward the servicing of its external debt and those resources. In a sovereign debt workout scenario, the debtor will already have been judged insufficient to pay all creditors the full amount due to them on the scheduled maturity dates. Pay one class of creditors in full, the theory goes, and the other classes must accept harsher financial terms in the restructuring of their debts. But if debt relief can be extracted from the broadest range of creditors, the severity of the restructuring terms imposed on any single class of creditor will thereby be reduced.

Second, these issues can trigger an emotional response in some creditors. No one likes to lose money or defer the repayment of their credits. But the resentment a creditor feels when asked to take these steps can be exacerbated if other creditors manage to escape a similar fate. The search for intercreditor parity in sovereign debt workouts, is thus, both a financial and an emotional imperative for many lenders.

Notwithstanding these pressures to ensure parity of treatment among creditors, the history of sovereign debt restructurings over the last twenty years confirms that certain classes of creditors have indeed been accorded *de facto* senior status (meaning that their claims against the sovereign borrower were either not restructured, or were restructured on terms more generous to the creditor than those given to the holders of medium-term, unsecured debt). The international financial institutions such as the International Monetary Fund, (IMF), the World Bank, and the regional development banks are the best examples of such "preferred" creditors. Other candidates for preferred creditor status have been trade creditors, holders of interbank lines and, for a time (but only for a time), holders of publicly-issued bonds.[2]

Apart from these preferred creditor classes, however, all other lenders to a sovereign debtor undergoing a generalized debt restructuring have been expected to share in the unpleasantness of the restructuring. The current debate centers on how these burden-sharing expectations are to be enforced among the different creditor groups.

III. Equal Treatment Clauses

One way to discourage a sovereign borrower from favoring certain lenders is to obtain contractual undertakings from the debtor against discriminatory treatment. Many

2. *See* Lee C. Buchheit, *Of Creditors, Preferred and Otherwise*, INT'L FIN. L. REV., June 1991, at 12.

international financial agreements with both sovereign and corporate debtors contain clauses designed to serve this purpose. The most common are: (i) the negative pledge clause (a restriction on the borrower's ability to grant security interests in its property to secure other lenders), (ii) the *pari passu* clause (a covenant on the part of the borrower that the debt will always rank equally in priority of payment with the borrower's other unsubordinated indebtedness), and (iii) the sharing clause (a requirement in many syndicated loan agreements that any bank receiving a disproportionate payment share that payment ratably with its fellow lenders).[3] A special type of contractual provision—generically known as an equal treatment clause—is unique to sovereign debt restructurings.

A. Paris Club

The Paris Club of bilateral creditors, for example, is famously fond of a clause it calls "comparable treatment."[4] The purpose of this clause is to force a sovereign debtor that seeks a rescheduling of its bilateral (government-to-government) debt to obtain comparable debt relief from its other creditor groups. The Paris Club's policies in this area have recently become the center of a fierce controversy, not because the Paris Club

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3. *See* Lee C. Buchheit, How to Negotiate Eurocurrency Loan Agreements 76–96 (2d ed. 2000).
4. The current form of the clause, which is included by the Paris Club in all Agreed Minutes with sovereign debtors, reads as follows:

> In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Republic of [______]
>
> - commits itself to seek promptly from all its external creditors debt reorganization arrangements on terms comparable to those set forth in the present Agreed Minute, while trying to avoid discrimination among different categories of creditors.
>
> Consequently, the Government of the Republic of [______]
>
> - commits itself to accord all categories of creditors and in particular creditor countries not participating in the present Agreed Minute, and private sector creditors—a treatment not more favorable than that accorded to the Participating Creditor Countries for credits of comparable maturity.
>
> For the purpose of the comparison between the arrangements concluded by the Government of the Republic of [______]
>
> - with its creditors not listed in the present Agreed Minute on the one hand, and with the Participating Creditor Countries on the other hand, all relevant elements will be taken into account, including the real exposure of the creditor not listed in the present Agreed Minute, the level of cash payments received by those creditors from the Government of the Republic of [______]
> - as compared to their share in of the Republic of [______]
> - as external debt, the nature and characteristics of all treatment applied, including debt buy backs, and all characteristics of the reorganized claims and in particular their repayment terms, whatever forms they take, and in general the financial relations between the Government of the Republic of [______]
> - and the creditors not listed in the present Agreed Minute.

insists that other creditor groups contribute proportionally to a sovereign debt workout, but rather because the Paris Club has rejected, out of hand, any suggestion that it contribute proportionally when other creditor groups are prepared to give the borrower more debt relief than the Paris Club's rigid policies prescribe.[5]

B. Commercial Banks

For their part, the commercial banks whose loans to sovereign borrowers were repeatedly restructured throughout the 1980s and early 1990s, employed their own version of this clause—they called it a "mandatory prepayment" undertaking. Included in virtually all restructuring agreements signed by the banks with sovereign borrowers during this period, this clause required the sovereign borrower to prepay, on a ratable basis, all of its restructured commercial bank debt, if it elected to pay any other creditor holding similar claims on a more accelerated basis. The clause also required the borrower to ratably prepay the banks in the event that it paid off a preferred creditor, or a bilateral creditor, earlier than as called for by the original repayment schedule for a debt owed to that creditor.[6]

In addition, several of the Brady bond exchanges in the 1990s executed under English law contained a covenant on the part of the sovereign issuer that prohibited it from settling with hold-out creditors on more favorable terms, unless the issuer made those same terms available to the creditors that had participated in the Brady exchange. The following language, for example, appears in the term sheet for Poland's 1994 Brady transaction:

> Provision will be included to ensure that in the event that any Obligor enters into, agrees to enter into, or offers to enter into any voluntary arrangement or compromise of any nature relating to Eligible Debt with any Creditor under any Debt Agreement other than pursuant to these Financing Proposals (an "Alternative Proposal"), Poland will, or will procure that the relevant Obligor will, extend such offer or make available to each Creditor whose Eligible Debt is exchanged or bought back on the Exchange Date, the Alternative Proposal in relation to such Eligible Debt on its original terms (subject to any amendments as may be required to enable the acceptance of the Alternative Proposal by all Creditors).[7]

C. Bondholders

The private creditors of an emerging market sovereign borrower today are likely to be bondholders, not banks. As a class, bondholders have not sought to obtain contractual undertakings from their sovereign issuers requiring comparable treatment of other creditor groups in the event of a future rescheduling of the bonds.

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5. *See* Brian Caplen, *Paris Club Comes Under Attack*, Euromoney, Sept. 2000, at 56–58.
6. *See* Mark A. Walker & Lee C. Buchheit, *Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers*, Sovereign Lending: Managing Legal Risk 139, 145–46 (Michael Gruson & Ralph Reisner eds, 1984); Keith Clark, *Sovereign Debt Restructurings: Parity of Treatment Between Equivalent Creditors in Relation to Comparable Debts*, 20 Int'l Law 857, 863–64 (1986).
7. Republic of Poland, 1994 Financing Proposals, 37–38 (May 23, 1994).

Once a restructuring begins, however, the sovereign debtor may find it necessary to forswear preferential side deals in order to ensure widespread acceptance of its restructuring offer. Two of the countries that undertook sovereign bond exchanges in the 1999–2000 period, for example, felt it prudent to give their bondholders an assurance that no special deals would be made with hold-out creditors. Pakistan included this language in the Offering Circular relating to its exchange offer in November 1999:

> The [Islamic] Republic [of Pakistan] does not propose to make any offers to holders of the Existing Notes other than this Exchange Offer. Accordingly, the Republic does not propose to settle amounts due under the Existing Notes with holders who do not participate in this Exchange Offer on terms which are more favorable than those contained in this Exchange Offer.[8]

The Ukraine included the following admonition in its February 2000 bond exchange offer:

> In light of the severity of the liquidity crisis confronting it, Ukraine is not in a position to, and will not, make any offer to holders of the Existing Notes other than this Exchange Offer. Ukraine will not entertain any settlement with holders of Existing Notes who elect not to participate in this Exchange Offer on terms which are more favorable than those contained in this Exchange Offer.[9]

D. Limitations

Contractual provisions are a relatively crude mechanism to achieve parity of treatment among different classes of creditors. Only certain creditor groups (namely, the Paris Club and commercial banks) have attempted to rely on these clauses as a means of enforcing the principle of equal treatment of creditors. Bondholders have not, to date, tried to include parity of treatment provisions in their bonds or indentures.

The clauses do not work well in practice. Words like "comparable" are too imprecise to be given a strict legal meaning. Some creditor groups have historically been given preferred status. Even among the not-preferred, an endless debate can rage over whether a particular type of creditor should be given some special treatment. One group will argue that they lent short-term; another group will point out that they kept credit lines open while the faint-hearted lenders fled the country; a third might remind the borrower that they took losses sometime in the past while other creditors are still awaiting their first haircut, and so forth and so on. Only a truly unimaginative or inarticulate creditor will fail to come up with some plausible reason why it, above all the others, deserves a gentler treatment in the restructuring.

If the clauses have any effect on a sovereign borrower's behavior, it is *in terrorem*. A borrower that actually makes a preferential payment in violation of a parity of treatment clause—and acknowledges doing so (a rare occurrence, for the reasons described above)—will probably not have the resources to make a ratable payment toward its other

8. The Islamic Republic of Pakistan, Offer to Exchange U.S. Dollar 10 Per Cent. Notes Due 2002/2005, at A-5 (Nov. 15, 1999).
9. The Cabinet of Ministers of the Ukraine, Offers to Exchange Euro 10 Per Cent. Amortizing Notes Due 2007 or U.S. Dollar 11 Per Cent. Amortizing Notes Due 2007 (Feb. 9, 2000).

types of debt. Violations of these clauses, if admitted by the sovereign borrower, therefore, produce borrower scolding rather than cash recoveries by the aggrieved creditors.

E. Conditional Participation

The only potent sanction open to a creditor group that believes itself to have been the victim of discriminatory treatment in a sovereign debt workout is to refuse to accept any rearrangement of its own claims unless a more equitable burden sharing is implemented. Commercial banks, for example, routinely conditioned each phase of the restructuring of their loans in the 1980s on a corresponding disbursement under the debtor country's IMF standby program and a corresponding restructuring of Paris Club debt.[10] In addition, the banks sometimes linked their restructuring packages to a satisfactory treatment of trade credits, interbank lines, domestic debt, or other material liabilities of the debtor in question. This remedy, of course, risks a stalemate. Thus, one recalcitrant group of creditors can stop an entire debt restructuring program in its tracks.

IV. The IMF's Role in Intercreditor Debates

Sovereign debt restructurings proceed on two assumptions. First, all creditors must be convinced that the debtor will address the structural problems in its economy that had contributed to the crisis. Second, no one creditor class—however generous it may be in giving debt relief to the sovereign borrower—will be in a position on its own to restore the debtor to a position of sustainable debt service. Thus, contributions (to use a Clintonesque word) will be required from creditor groups and someone, other than the debtor, must decide who should contribute and how much.

As things now stand, the IMF is the only player that can pretend to prescribe economic medicine for the wayward sovereign debtor. The commercial banks tried to do this in Peru in 1976, with unhappy consequences.[11] The IMF has more information than any other creditor, greater access to government decision-makers, and a broader peripheral vision in terms of the effects of measures on neighboring countries. It also occupies a building that is infested with economists who profess sublime diagnostic and prognostic powers. Unless something changes, the IMF is the only one to play this role.

The second function (allocating proportional contributions to the overall workout) is more problematic. Many people in the private sector claim to have a clear vision of how this should be done. It is true, they would acknowledge, that the IMF has access to more information about the debtor country's economic and financial condition. That information could be shared with the private sector and, in any event, judgments about burden sharing among creditor groups are not just a function of arithmetic. Such judgments, the private sector would argue, must also be forward-looking. They must accurately predict the effect of any measures taken today on the market's willingness to finance the sovereign borrower tomorrow. Finally, the IMF is owned by governments.

10. *See* Walker & Buchheit, *supra*, note 6, at 150–51.
11. *See* Marmorstein, Note, *Responding to the Call for Order in International Finance: Cooperation Between the International Monetary Fund and Commercial Banks*, 18 Va. J. Int'l L. 445, 454 (1978).

The private sector lenders worry that IMF pronouncements about burden sharing will inevitably be influenced by the geopolitical objectives of the owners of the IMF. In short, the argument concludes, burden sharing decisions are best left to financiers, not economists or politicians.

Like it or not, however, the IMF is inevitably drawn into making these judgments in the context of sovereign debt restructurings. One cannot construct an economic recovery program for a debtor country without making assumptions about how much fresh money will come into the country in the form of new credits, and how much will be allocated toward servicing existing liabilities. Although all of this can be expressed in bloodless numbers, the practical implications are obvious. Some creditors will have to lend more, and some receive less, if the recovery program is to be financed. The numbers, therefore, reflect potentially controversial judgments about burden sharing among the various creditor groups. The sovereign debtor is thereafter left to approach its various creditor groups (Paris Club, bondholders, commercial banks, trade creditors, and so forth) to seek their cooperation in a program whose genetic DNA was embedded in the assumptions and targets of the IMF standby arrangement.

The IMF occasionally tries to disavow this implication. It is up to the debtor country, the IMF will say, to decide who to pay and who not to pay, and the debtor country is always theoretically free to take other measures—such as laying on even more taxes—that might obviate the need for a debt restructuring altogether. But few people are fooled—the hand that writes the standby, rules the restructuring.

The IMF openly embraced this master-of-ceremonies role at the outset of the global debt crisis in 1982. The then Managing Director of the IMF, Jacques de Larosiere, is reported to have told Mexico's commercial bank lenders in November 1982 that they must come up with five billion dollars of new loans for Mexico, or the IMF would refuse to participate in a stabilization program for the country.[12] This set a precedent for the IMF's role as intercreditor coordinator in future sovereign debt workouts.[13]

If indeed the important decisions about intercreditor relations are made at the time that the IMF negotiates a stabilization program with the sovereign debtor, the obvious question is how the views of the soon-to-be affected creditors can be brought into those discussions at a point when they may influence the outcome. Neither the debtor nor the IMF, of course, will be wildly enthusiastic about inviting more cooks into an already crowded (and probably overheated) kitchen. IMF standby programs often involve contentious negotiations between the IMF and the country's financial authorities; negotiations in which economics and domestic politics both play important parts. The IMF will worry that private creditors, if invited to contribute their views at this stage, will

12. *See* Norman A. Bailey & Richard Cohen, The Mexican Time Bomb, 26–27 (1987).

13. At the time, the IMF recognized that it had crossed something of a Rubicon in holding itself out as an honest broker between sovereign debtors and their creditors. An IMF official, writing in 1984, observed that "[d]escribed in the most succinct terms, the role of the IMF as an honest broker between debtor countries and their creditor banks consists of serving as ultimate judge of the appropriate mix between the magnitude of a heavily indebted developing country's adjustment effort, and the commitment to it of new external finance for its remaining balance of payments deficit." E. Walter Robichek, *The International Monetary Fund: An Arbiter in the Debt Restructuring Process*, 23 Colum. J. Transnat'l. L. 143, 146 (1984).

only second guess the IMF's economic judgments. The politicians will worry that private creditors may second guess their political assessments. Both will worry that private creditors may turn the exercise into a game of three billy goats gruff—with each creditor group trying to shift the full weight of the restructuring onto the shoulders of some other group.

Without wishing to minimize these difficulties, denying private creditors such a voice may no longer be an option. Over the last two years, bondholders have been given a glimpse of how future sovereign debt restructurings will be handled. No one should expect bondholders to remain bovinely impassive, as their fate in these restructurings is settled by economists employed by multilateral financial institutions. "No taxation without representation"—or something sounding very much like it—may become the rallying cry of the private bondholders caught up in these affairs.