Barricades at the IMF: Creating a Municipal Bankruptcy Model for Foreign States

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I first saw them riding into battle on the subway. They gave the car the feel of a time machine, racing back into the Vietnam War era. The scruffy kids had more body piercings than their 1960's counterparts. But most had the same patched jeans, garish shirts, and dangling jewelry that their parents and grandparents wore when they took to the streets. The rest were a smattering of casually dressed retirees, academics, and a few who looked like the usual morning commuters like me. For three days in April 2000 they blocked Washington streets and dodged police with military-like discipline, trying to disrupt the World Bank/International Monetary Fund (IMF) spring meetings. Their medley of placards and voices argued that the push for economic globalization was deepening poverty, increasing indebtedness, and damaging the environment in developing countries.

As I rode the Metro with them each morning, I wondered what motivated these relatively well-dressed and well-fed crusaders to take to the streets. Most have never seen deep, debilitating poverty up close, nor have they been its victims. Their life savings have never disappeared in an instant, the casualty of a distant market panic, or a change in government economic policy. They have not sacrificed their jobs or social benefits for the unfulfilled promise that a market economy would significantly decrease poverty. Yet, they have been the most visible and unlikely voices for poor countries in an intensifying debate over the structure of the international financial system.

More orthodox voices have quietly been making similar points. Felix Rohatyn, former Managing Director of Lazard Freres, recently wrote: "the status quo has many faults."[1] He called for a new Bretton Woods conference to recommend a new operating structure to deal with the problems of developing countries.[2] The former Chief Economist for the World Bank, Joseph Stiglitz, was appalled by policies that, in his view, had deepened the economic crisis in Asia in 1998.[3] Jeffrey D. Sachs of the Harvard Institute for International Development,

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1. Felix Rohatyn, *Back to Bretton Woods*, Fin. Times (London), Aug. 20, 2001, at 17.

2. *Id.*

3. Joseph Stiglitz, *The Insider: What I learned at the World Economic Crisis*, New Republic Online, Apr. 17, 2000.

among others, has echoed this criticism.[4] Anne O. Krueger, First Deputy Managing Director of the IMF, recently surprised many by proposing a bankruptcy code for insolvent countries.[5] The U.S. Treasury followed with a more modest proposal to amend sovereign bond terms to address some of the more dysfunctional aspects of the current system.[6]

James D. Wolfensohn, the World Bank's president, defined the staggering magnitude of the problem: 3 billion people live on under $2 per day in developing countries with $2 trillion in foreign debts.[7] During the past twenty years of significant market reforms, poverty levels have not decreased except in parts of Asia.[8] Government debt loads represent a major roadblock to prosperity. Africa's poorest countries spend 25 percent of their total revenues on interest payments to foreign lenders.[9] In Latin America even the larger and better organized economies—Mexico, Brazil, and Argentina—have had a series of economic crises over the last two decades caused, in part, by the levels of their foreign debts.[10] With such large debt burdens the kinds of investments that would promote economic growth—education, health, and infrastructure—are difficult to afford. Debts have held back development, and each crisis threatens to rock the world economy.

More than a decade ago Congress concluded that the United States is not insulated from these problems. The high burden of international debts, Congress wrote, "[t]hreatens the safety and soundness of the international financial system, the stability of the international trading system, and the economic development of debtor countries."[11] Using language that one of the Washington street protestors might have drafted, Congress said: "Industrial countries . . . have a disproportionate share of the world's capital resources, and bear an additional responsibility for contributing to a viable long-term solution to the debt problem."[12]

While the international financial system has evolved considerably, the problems continue to linger without a systematic, long-term solution. If debtor nations were individuals,

4. *Power Unto Itself*, FIN. TIMES (London), Dec. 11, 1997, at 21; Raymond F. Mikesell, *Bretton Woods—Original Intentions and Current Problems*, 18 CONTEMP. ECON. POL'Y 4, 404 (Oct. 2000); *see also* Jeffrey D. Sachs, *The Wrong Medicine for Asia*, N.Y. TIMES, Nov. 3, 1997, at A23; Congressman Bernie Sanders, Statement on Amendment to De-Link Debt Reduction From Structural Adjustment Programs of the International Monetary Fund (Nov. 3, 1999), *available at* www.house.gov/bernie/statements/1999-11-03-debt.html); Richard Hartung, *Chapter 11 for the Third World? available at* www.motherjones.com/web_exclusives/letters/061801.html (last visited Aug. 15, 2002); Mark Memmott, *Rockin' the Debt Bono Leads Third World Crusade*, USA TODAY, June 15, 2001, at 1A.

5. Anne O. Krueger, Speech at the National Economists' Club Annual Members' Dinner (Nov. 26, 2001), *available at* www.imf.org/external/np/speeches/2001/112601.htm; Anne O. Krueger, Speech at the Indian Council for Research on Int'l Economic Relations, (Dec. 20, 2001), *available at* www.imf.org/external/np/speeches/2001/122001.htm; Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring*, Int'l Monetary Fund, *at* www.imf.org/external/pubs/ft/sdrm/eng/index.htm (Apr. 16, 2002) [hereinafter *Sovereign Debt*].

6. *Grants and Sovereign Debt Restructuring: Two Key Elements of a Reform Agenda for the International Financial Instruments: Hearing Before the Joint Economic Committee* (Feb. 14, 2002) (testimony of John B. Taylor, Under Sec'y of the Treasury), *available at* http://www.ustreas.gov/press/releases/po1016.htm [hereinafter Taylor].

7. Press Conference, James D. Wolfensohn, World Bank Group President (Apr. 12, 2000), *available at* www.worldbank.org/html/extdr/extme/jdwts041200.htm.

8. World Development Indications 2002: World View, WORLD BANK GROUP, *available at* http://www.worldbank.org/data/wdi2002/worldview.htm (last visited Aug. 19, 2002); Mikesell, *supra* note 4.

9. Dean E. Murphy, *In Africa, Debt Relief Has Two Sides*, L.A. TIMES, Jan. 27, 2000, at A1.

10. *E.g.*, Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN J. INT'L L. 305, 311 (Summer 1995).

11. International Debt Management Act of 1988, Pub. L. No. 100-418 (codified in part at 22 U.S.C. § 5322(1) (2000)).

12. Section 5322(10).

corporations, or municipalities, their stories might be very different. By filing bankruptcy petitions, they would have had an established forum and well-defined legal principles for negotiations with their creditors. Bankruptcy laws have developed a careful balance between the rights of creditors and the need to allow distressed debtors to shed unsustainable debts in order to become productive again. The laws of almost all countries recognize good economic reasons for giving bankrupts a fresh start to become economically productive. According to a recent IMF report, "the consistent application of orderly and effective insolvency procedures plays a critical role in fostering growth and competitiveness."[13] Some credit a business culture that is tolerant of bankruptcy with the vitality and resilience of the U.S. economy.[14] A modified municipal bankruptcy system for financially distressed countries would bring order to a system that now frustrates both debtor countries, and their creditors, and is counterproductive for the world economy.

I. History of Sovereign Debt Litigation

The shortcomings in the current system can be seen through the last two decades of lawsuits against foreign countries. Beginning in 1982, more than thirty-four countries in Latin America, Africa, Eastern Europe, and Asia announced they could not pay their debts to international banks.[15] Many of the world's largest banks—familiar household names around the world, such as Citibank, Chase Manhattan Bank, Deutsche Bank, and Bank of Tokyo—had lent amounts many times in excess of their capital to developing countries.[16] If the countries could not pay, the banks could be forced into bankruptcy, which, in turn, could have ravaged the world economy. It was a "bona fide major international financial crisis," according to Gerald Corrigan, then president of the Federal Reserve Bank of New York.[17]

In the midst of this crisis, the United States rejected the bankruptcy model for countries. In November 1981, Costa Rica was one of the first countries to declare a moratorium on foreign debt payments.[18] A consortium of thirty-nine banks, led by Allied Bank International, sued three Costa Rican banks that had borrowed money abroad and lent it to its customers, which were largely local individuals and companies.[19] While the Costa Rican banks had sufficient colónes, the local currency, to make timely payments, they had to convert the colónes to dollars at the Costa Rican central bank.[20] Due to the recession and high international interest rates, the Costa Rican government, however, was running out of dollars to pay its own loans and provide foreign exchange for its citizens.[21] Much like a

13. INTERNATIONAL MONETARY FUND, *Introduction* to ORDERLY & EFFECTIVE INSOLVENCY PROCEDURES 4, 6–8 (IMF Legal Dep't ed. 1999), *available at* http://www.imf.org/external/pubs/ft/orderly/index.htm [hereinafter *Introduction*].

14. *E.g.*, James Surowiecki, *Our Debt to Bankruptcy*, NEW YORKER, Apr. 16, 2001, Fin. P., at 32.

15. H. Erich Heinemann, *Third World's $700 Billion Debt Posing a Threat to Richer Nations*, N.Y. TIMES, July 5, 1983, at A1.

16. Gerald Corrigan, *In Their Own Words*, LATINFIN., July 1998.

17. *Id.* at 43.

18. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp 1440, 1442 (S.D.N.Y. 1983), *rev'd*, 757 F.2d 516 (2d Cir. 1985).

19. *See generally id.*

20. *Id.*

21. *Id.*

bankruptcy stay freezes the status quo, the Costa Rican government had issued a decree prohibiting any payments abroad until it could complete negotiations with its foreign lenders for additional dollars.[22]

The Costa Rican banks initially won the lawsuit because they were not at fault for the nonpayment; they were simply complying with local law.[23] The federal appeals court in New York found that the Costa Rican government had issued the law in good faith to prevent a "national fiscal disaster."[24] The plan "is in entire harmony with the spirit of the bankruptcy laws . . . recognized by all civilized countries," the court said.[25] A shocked banking community ran to the U.S. Government, which filed an amicus brief expressing two principal concerns: (1) if sovereign debts were not fully enforceable, governments might too often refuse to pay, discouraging investors from lending or investing in developing countries, and (2) debt relief was considered too risky for the then shaky international banking system.[26] The court reversed itself and awarded judgments against the Costa Rican banks, stating, "The entire [IMF debt] strategy is grounded in the understanding that, while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable."[27]

The *Allied* decision led other courts in the 1980s to respond coldly to pleas of poverty. A.I. Credit Corporation opted out of a negotiated debt rescheduling and brought suit on $10 million in Jamaican debt, likely purchased from the bankruptcy estate of Continental Illinois Bank & Trust Company.[28] As Continental was being relieved of its debts, Jamaica informed a federal judge in New York of the "devastating financial impact" that a judgment would have on its teetering economy, and supported its argument with a letter from the IMF saying that a judgment "could create problems for the implementation of the [IMF's] international debt strategy."[29] The court entered judgment anyway, and in an unusually steely tone stated: "it is not the function of a federal district court . . . to evaluate the consequences to the debtor of its inability to pay nor the foreign policy or other repercussions of Jamaica's default."[30] Shortly thereafter, another New York judge acknowledged that enforcement of a judgment against the Congo was "likely to cause financial difficulties."[31] But the judge went further and added, "This Court is not the appropriate government institution to weigh the harm to the Congo of paying a valid judgment."[32]

II. The Opt Out Problem Develops

Without relief from their debts and cut off from virtually any source of borrowing, the countries stagnated throughout the 1980s. Given breathing space by their regulators, the

22. *Id.*
23. *Id.*
24. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 733 F.2d 23, 27 (2d Cir. 1984), *withdrawn and vacated*, 757 F.2d 516 (2d Cir. 1985).
25. *Id.*
26. Brief of Amici Curiae United States, Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985).
27. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 519 (2d Cir. 1985).
28. *See generally* A.I. Credit Corp. v. Gov't of Jamaica, 666 F. Supp. 629 (S.D.N.Y. 1987).
29. *Id.* at 633.
30. *Id.*
31. Nat'l Union Fire Ins. Co. of Pittsburgh v. People's Republic of the Congo, 729 F. Supp. 936, 945 (S.D.N.Y. 1989).
32. *Id.*; *see also* Banque de Gestion Privee-SIB v. La Republica de Paraguay, 787 F. Supp. 53 (S.D.N.Y. 1992).

banks recovered and the financial system changed. Sovereign debt lending evolved from a small group of large banks, to a much broader market-oriented system with a larger, and more anonymous set of creditors. A new secondary market appeared, at first informally, and later in a more organized fashion.[33] The risks of the sovereign debts were thus spread to a broader base of investors.[34] In 1989, Nicholas Brady, then U.S. Secretary of Treasury, proposed the first program for debt relief for developing countries.[35] Brady bonds replaced bank loans as the principal source of commercial credit, bringing many more and new investors into relationships with developing countries.

These modifications, and the unrelenting court decisions, sparked a new set of problems. Some investors foresaw big profits in suing the world's poorest countries. In 1993, Water Street Bank & Trust Company, Ltd., an offshore fund, developed a simple investment approach: Buy the debts of poor countries at huge discounts and sue for full payment.[36] After all, the *Allied* decision had determined that these debts were fully enforceable.[37] Water Street bought defaulted debt instruments of Poland, Ecuador, Ivory Coast, Panama, and Congo at substantial discounts and filed lawsuits against each of the governments for full payment.[38] Most of the lawsuits were settled for undisclosed amounts.[39] Water Street's lawsuit against Panama, however, was dismissed when it repeatedly violated a court order to disclose the names of its investors.[40] The fund thereafter dissolved, but the problem did not disappear.

In 1994, after three years of negotiations, Brazil reached an agreement with 700 banks and institutional investors to restructure $49 billion in debt, and receive a 25 percent debt reduction.[41] The deal was supposed to mark both an end to loan losses for Brazil's lenders, and a new economic start for Brazil. The restructuring, however, stalled when Dart Capital Corporation, the investment vehicle for the Florida Styrofoam cup billionaires, demanded special treatment.[42] The other creditors refused to close the deal if the Darts got something extra. After purchasing $1.4 billion of Brazilian paper at substantial discounts, the Darts were insisting upon a $360 million profit compared to the $270 million profit they would get from Brazil's offer.[43] In an effort to salvage the deal, then Citicorp Vice Chairman William Rhodes arranged a face-to-face meeting with Kenneth Dart at the Teterboro, New Jersey airport. The polite chat turned into a shouting match within minutes, according to one published report, and Mr. Dart strode to his private jet and flew off.[44]

In the ensuing lawsuit brought by the Darts against Brazil seeking full payment, the U.S. Government filed a brief warning the court about what economists (not clergymen) call the

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33. *See also* Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT'L L.J. 1802 (June 1998).

34. *Id.*

35. Secretary of Treasury Nicholas Brady, Statement (Mar. 10, 1989), *in Treasury News*.

36. Water St. Bank & Trust Ltd. v. Republic of Panama, No. 94 Civ. 2609 (HB), 1995 U.S. Dist. LEXIS 1444 (S.D.N.Y. Feb. 8, 1995).

37. *See supra* text accompanying notes 18–27.

38. *See generally id.*

39. *Id.*

40. *Id.*

41. Thomas T. Vogel, Jr., *Darts Sue Brazil's Central Bank*, WALL ST. J., June 30, 1994, at C1.

42. *Id.*

43. Laurie P. Cohen & Thomas T. Vogel Jr., *Tug of War: Brazil Debt Deal Pits Nation and U.S. Banks Against Dart Family*, WALL ST. J., Nov. 30, 1993, at A1.

44. *Id.*

moral hazard presented by the secondary market. "These creditors," the Justice Department said, "may seek through litigation to benefit from voluntary debt reduction previously agreed to by the commercial banks (which frees up otherwise obligated funds of the sovereign debtor) rather than negotiate a restructuring with the debtor in the orderly manner. . . ."[45] The court, thereafter, would not allow the Darts to accelerate Brazil's debt, which denied them considerable negotiating leverage.[46] After many months of delay the Darts, Brazil, and its other commercial creditors reached an agreement. Yet, despite the views expressed in its brief, the government took no action to change the legal system to reflect the shifting reality in the marketplace. Predictably, more rogue lawsuits followed. The courts, however, began to exercise their discretion to mitigate some of the more extreme consequences of the ill-defined system.

III. The Court Imposed Stay of Proceedings

In 1992, Peru's IMF structural adjustment program called for the privatization of most state-owned banks, including Banco Popular del Peru.[47] After efforts to sell the bank failed, Peru's Superintendent of Banks and Insurance declared the bank insolvent and began liquidation proceedings.[48] In response, Pravin Banker Associates, Ltd., a small investment fund in Miami, filed a $2 million lawsuit against Peru and Banco Popular to recover the full value of Banco Popular obligations that it had purchased at a substantial discount in the secondary market.[49] When Pravin Banker asked the court to enter judgment, Peru argued for a temporary suspension of the lawsuit to give its IMF program time to work, and for it to complete negotiations for a Brady Plan agreement with its commercial creditors.[50] In an unprecedented decision, the court took a different approach from the Jamaica and Congo courts, and ordered a six-month stay of the proceedings.[51] The court determined that Peru was "actively attempting to conform to the mandates of the IMF . . . [which] may be construed to represent American policy interests."[52] "To allow Pravin to activate its claims in this case," the court opined, "would be like letting the tail wag the proverbial dog."[53]

The stay gave Peru time to negotiate a Brady restructuring with its commercial creditors. In October 1995, Peru and a bank negotiating committee publicly announced an agreement in principle for a debt-restructuring plan designed in accordance with the Brady Plan.[54] If Peru's 180 international creditors agreed, the country would get an approximately 45 per-

45. Statement of Interest of the United States in Opposition to the First Amended Complaint, CIBC Bank & Trust Co. (Cayman), Ltd. v. Banco Central de Brasil, No. 94 Civ. 4733 (LAP) (S.D.N.Y.) 15–17.

46. CIBC Bank & Trust Co. (Cayman), Ltd. v. Banco Central de Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995).

47. Pravin Banker Assoc., Ltd. v. Banco Popular del Peru, 165 B.R. 379 (S.D.N.Y. 1994).

48. *Id.*

49. *Id.* [The amount $2 million is an estimate of the principal and interest being claimed at the time the lawsuit was filed. The principal amount was $1,425,000, which appears on page 383 (page 9 of the Lexis version) of the opinion.]

50. *Id.*

51. *Id.* at 389.

52. *Id.*

53. *Id.* at 387.

54. Elliott Assocs., L.P. v. Republic of Peru, 948 F. Supp. 1203, 1205 (S.D.N.Y. 1996).

55. *Id.*

cent reduction on $4.4 billion in commercial debt.[55] In return, the banks would begin receiving regular interest payments again.[56]

After this announcement, the federal district court entered a $2 million judgment for Pravin Banker over Peru's objections.[57] Peru warned that a judgment for Pravin Banker would not only discourage lenders from voting for its Brady proposal, but would also encourage others to sue. This prediction proved all too accurate. Literally within days, a larger fund, Elliott Associates, L.P., appeared.

In October 1995, Elliott had purchased $28.7 million of Panamanian debt for $17.5 million.[58] In July 1996, just as Panama was issuing Brady bonds, Elliott had filed suit and quickly obtained a judgment and attachment order.[59] Panama was forced to settle the lawsuit for close to the full amount claimed. While all of Panama's other commercial creditors were taking a 50 percent discount, Elliott harvested a $40 million profit, a 200 percent return on its investment in less than two years.[60]

After entry of the Pravin Banker judgment against Peru, Elliott purchased $55 million in Peruvian debt instruments on the secondary market for $11 million.[61] According to Elliott's general partner, the fund had an unyielding demand: "Peru would either . . . pay us in full or be sued."[62] Peru, however, refused to give Elliott a special deal. After the other creditors agreed to Peru's Brady terms, Elliott filed lawsuits against Peru. In these suits Elliott sought an order of prejudgment attachment, which would allow it to freeze Peru's New York assets, including the collateral for the Brady bonds that were not yet issued.[63] Just like the Dart case, Peru's other commercial creditors threatened to pull out of the Brady deal if Elliott were paid in full.

The court's opinion described the strong differences between the two sides. "In the well-turned phrase of highly skilled counsel for Elliott," the court wrote, "the prospect of a recalcitrant debtor . . . [forcing protracted litigation] . . . 'makes Wall Street tremble.' "[64] On the other hand, Peru considered Elliott, in the judge's words, "a blackmailer seeking to disrupt the national policies of Peru and the United States as expressed in the Brady [Plan]."[65] The district court exercised its discretion to deny Elliott's motion for prejudgment attachment, saying: "attachment certainly creates an avoidable risk of jeopardizing the [Brady] Agreement" and could "upset the stability of an economy struggling to meet the most basic needs of its people."[66] Another judge in New York denied Pravin Banker's request to execute its judgment against funds that Peru brought into New York to make an interest payment to its other commercial lenders.[67] On the thin thread of two judges' discretion,

56. *Id.*

57. Pravin Banker Assoc., Ltd. v. Banco Popular del Peru, 912 F. Supp. 77 (S.D.N.Y. 1996), *aff'd*, 109 F.3d 850 (2d Cir. 1997).

58. Elliott Assocs., L.P. v. Republic of Peru, 12 F. Supp. 2d 328, 334 (S.D.N.Y. 1998).

59. Elliott Assocs., L.P. Ltd. v. Republic of Panama, 975 F. Supp. 332 (S.D.N.Y. 1997).

60. Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999); Elliott Assocs., L.P. v. Republic of Panama, 96 Civ. 5295. 1996 U.S. Dist. LEXIS 11973 (S.D.N.Y. Aug. 20, 1996).

61. *Elliott Assocs.*, 12 F. Supp. 2d at 331.

62. *Id.* at 335.

63. *Elliott Assocs.*, 948 F. Supp. at 1203.

64. Elliott Assocs., L.P. v. Republic of Peru, 961 F. Supp. 83, 87 (S.D.N.Y. 1997).

65. *Id.* at 88.

66. *Elliott Assocs.*, 948 F. Supp. at 1212.

67. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 912 F. Supp. 77 (S.D.N.Y. 1996). Other judges have exercised discretion in favor of sovereigns in a variety of circumstances. *See, e.g.*, Meridien Int'l Bank Ltd. v. Republic of Liberia, 1996 WL 22338 at *6 (S.D.N.Y.); Morgan Guar. Trust Co. v. Republic of Palau, 702

Peru was able to close its Brady bond offering on March 7, 1997. Peru's 180 commercial creditors accepted Brady bonds or cash payments in exchange for old loan instruments. Only Pravin Banker and Elliott Associates opted out. Pravin Banker eventually accepted Peru's Brady terms when it could not locate any Peruvian property in the United States against which to execute its judgment.

Elliott Associates, however, was not finished; it pressed ahead with its lawsuit. After a protracted legal fight, the district court entered judgment against Peru for $52 million.[68] Peru planned to appeal the judgment but never got the chance. Courts in New York, England, Belgium, the Netherlands, Canada, and Germany entered orders to attach Peruvian assets or to bar Peru from paying interest on its recently issued Brady bonds.[69] Without hearing from Peru, the courts granted Elliott's applications and blocked Peru's interest payments to its Brady bondholders.[70] Peru settled the case for virtually the full amount with interest, $58 million, which after litigation expenses was an almost 300 percent return for Elliott.

IV. The Parameters of the Debate

The *Elliott Associates* victory was hailed by many on Wall Street and criticized by others. One insurance executive told me with passion in his voice that Russia and Ecuador had refused to talk to him, even though his company was one of their largest creditors.[71] During debt restructurings in 1998 and 1999, those countries had refused to talk to their creditors, but instead had successfully imposed terms on a take-it-or-leave-it-basis. The Elliott Associates' success, according to the insurance executive, proved that sovereign debts were enforceable, and he could not be excluded from future debt talks. A short time later, at a Christmas party at the New York Federal Reserve Bank, I related this conversation to another guest who was familiar with Ecuador's strategy. He had a quick retort: "You can't sit down at a table with [vulture funds] and expect to have a rational conversation" about the country's capacity to pay. In his opinion, take-it-or-leave-it was the only way to get the deals done.

The two exchanges illustrate both the good and bad that have come from the last two decades. The insurance executive represents a much broader group of investors in developing countries. While only a small number of large banks were lending in the 1980s, a much more diverse and sometimes vibrant market now exists for investing in developing countries.[72] This new investment activity is a necessary element in alleviating poverty. On the other hand, the insurance executive's anger and the quick retort are symptomatic of a dangerous alienation among debtor nations, their commercial creditors, and international organizations like the IMF. The debt process is riddled with conflicting policies and concerns that have never been adequately resolved, and have changed over time. For instance, the U.S. Treasury and IMF used to worry that countries would default too easily, thus scaring away future lenders and

F. Supp. 60, 66 (S.D.N.Y. 1988), *vacated*, 924 F.2d 1237 (2d Cir. 1991); Interpetrol Bermuda Ltd. v. Trinidad & Tobago Oil Co., 513 N.Y.S.2d 598, 604–05 (1987).

68. Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.R.D. 116 (S.D.N.Y. 2000).

69. *See, e.g.*, Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 Bus. Law. 635 (Feb. 2001).

70. *Id.*

71. *See, e.g.*, Int'l Monetary Fund, Involving the Private Sector in the Resolution of Fin. Crises—Restructuring Int'l Sovereign Bonds 7 (2001).

72. *See The Winner is . . . Mexico*, LatinFin., Feb. 1, 2000, at 43.

investors. More recently, the IMF reportedly encouraged Ecuador and Ukraine to default to force private investors to share the burden of emerging market economic problems.[73] Officials argue that repeated bailouts create the moral hazard that investors will invest imprudently.[74] The fear that countries would default too easily subsided with the recognition that defaults carry a heavy price in economic and social disruption.[75]

The legal system has not adjusted to the vast changes in market realities since the 1980s. No mechanism has replaced the bank negotiating committees of the 1980s to give investors and countries a forum to talk rationally about their mutual interests. Investors complain that they are being denied adequate information and a role in economic decisions that affect them. Some worry about yet another moral hazard that countries may take actions affecting the value of their debt and repayment terms. Others contend that debt relief would simply reward corrupt or inefficient governments. The free rider problem is the target of the recent Treasury and IMF proposals to change bond terms.[76] The current system has no mechanism to prevent some creditors from holding out from a debt restructuring and insisting upon full payment on their contracts.[77]

While some creditors say countries that borrow money should pay it back, that has never been the universal rule. LTV Corporation, for instance, one of the world's largest steel producers, has sought bankruptcy court protection twice since the mid-1980s.[78] Continental Airlines, Texaco, Macys, and many other companies survive today and presumably are more efficiently run after bankruptcy reorganizations.[79] Such household names as Eastern Airlines, Ben Franklin Stores, and Penn Central Railroad have gone bankrupt and disappeared because they could not adapt to changing economic conditions.[80] Even Orange County, California, one of the nation's richest counties, had to reorganize its debts after an ill-fated investment in junk bonds.[81] Bankrupt companies or counties are, by definition, no longer efficient as they are then organized. There certainly are numerous examples of companies that were felled by corruption or illegal conduct. Inefficiency and corruption do not prevent companies and counties from receiving bankruptcy relief because of the overall benefits to our economy.

With bankruptcy, companies, county resources, and employees can be dispersed to more economically efficient activities. By relieving these distressed entities of insurmountable

73. Mary Anastasia O'Grady, *Ecuador's Brady Bonds Are IMF Guinea Pigs*, WALL ST. J., Sept. 15, 1999, at A15; Arkady Ostrovsky, *An Uneasy Share of the Debt Burden: Private Sector Creditors are Increasingly Becoming Involved in Troubled Country Bond Restructurings*, FIN. TIMES, Mar. 15, 2000; *Troubled Sovereigns Won't Benefit from Restructuring with Exit Consents*, MOODY'S REP., Mar. 27, 2001.

74. Michael M. Chamberlin, *The Brady Plan—The First 10 Years and Beyond*, LATINFIN., Feb. 1, 2000, at 60.

75. *Sovereign Debt*, *supra* note 5, at 2.

76. *See id*; Taylor, *supra* note 6.

77. *Sovereign Debt*, *supra* note 5, at 7–8.

78. *LTV Files for Bankruptcy*, NEW STEEL ¶ 1 (Feb. 2001), *available at* http://www.newsteel.com/2001/news/nw010202.htm (last visited Aug. 15, 2002).

79. *See* Lori Calabro, *Lawrence W. Kellner—Continental Airlines, Inc.*, CFO MAGAZINE, Oct. 1, 1999, *available at* http://www.cfo.com/printarticle/0,5317,1354/,00.html; Stephanie Strom, *Creating a Retailing Empire: The Deal*, N.Y. TIMES, July 15, 1994, at A1; Laura Zinn, *Catastrophe on 34th Street*, BUS. WEEK, Dec. 9, 1996.

80. Tom Nicholson & Tom Joyce, *Now, ConRail Chugs Into View*, NEWSWEEK, Mar. 10, 1975, at 64; Scripps-Howard News Service, *Once Shaky Conrail Back On The Track*, SAN DIEGO UNION TRIBUNE, June 11, 1984, at A13; Leslie Wayne, *Conrail: Wall St. Gets Aboard*, N.Y. TIMES, Jan. 14, 1982, at D1.

81. *In re County of Orange*, 1995 Bankr. LEXIS 729 (Bankr. C.D. Cal. 1995).

debts, their investors were permitted the opportunity to make an economic contribution in another area.[82] The market imposed discipline on both investors and creditors, forcing them to be prudent when incurring debts or lending, and take losses for their misjudgments.[83] The same market forces that punish companies and imprudent investors for corruption or inefficiency should serve to discipline sovereigns. With environmental, antitrust laws, and a complex social safety net in the United States, we are long past accepting unregulated markets as the sole judge of good public policy. Market-based rules in the United States include significant debt relief from bankruptcies when appropriate. Many debtor countries were never allowed to put themselves back on sound financial footings after the international debt meltdown of the 1980s. Too much of today's debt is unpaid interest accumulating from that time period.

V. The Municipal Bankruptcy Model

Many of the conflicting moral hazards have been resolved in corporate and municipal bankruptcy rules, but so far no consistent set of rules or a forum has been established for distressed foreign states. Municipal bankruptcies differ from corporate ones because States, like foreign countries, have sovereign immunity. Municipal bankruptcy rules thus provide for a voluntary process that offers a forum for the municipality and its creditors to negotiate an adjustment plan, with a referee, a federal judge, to resolve disputes and a stay of legal proceedings to allow breathing space for the process to succeed. Similar sovereign bankruptcy rules would resolve many of the problems with the current system.

Due to the Tenth Amendment's guarantee of sovereign immunity for the states, the Supreme Court has severely limited the extent to which a court can interfere in the activities of the municipality during a bankruptcy proceeding.[84] After rejecting a municipal bankruptcy statute in *Continental Bank*, the Supreme Court accepted an amended version in *Bekins* because "[t]he statute is carefully drawn so as not to impinge upon the sovereignty of the State. The State retains control over its fiscal affairs."[85] Section 904 of the U.S. Bankruptcy Code, therefore, provides:

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—

(1) any of the political or governmental powers of the debtor;
(2) any of the property or revenues of the debtor; or
(3) the debtor's use or enjoyment of any income-producing property.[86]

Under this provision, the court cannot interfere with the operation of the debtor, or the debtor's use of its revenues or property. The petitioner's day-to-day activities are not subject to a court approval, the court cannot appoint a trustee, or convert the action to a liquidation proceeding.[87]

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82. *Introduction*, *supra* note 13, at 6–8.

83. *Id.*

84. United States v. Bekins, 304 U.S. 27 (1938); Cont'l Ill. Nat'l Bank v. Chicago, R.I. & P. Ry. Co., 294 U.S. 648 (1935).

85. *Bekins*, 304 U.S. at 51.

86. 11 U.S.C. § 904 (1993).

87. *See* Pub. L. No. 95–598, 92 Stat. 2622 (1978) (amended 1993).

Foreign states have similar sovereign immunity protections, which are codified in the Foreign Sovereign Immunities Act.[88] To succeed in the international arena, a bankruptcy code would have to leave the foreign state with operational control over its financial decisions. Developing countries, however, are already subject to considerable economic oversight. An IMF structural adjustment program is a precondition to most forms of international lending. Under a sovereign bankruptcy regime, the IMF process would continue to serve its oversight function and provide creditors with independent assurance that the sovereign is adequately disclosing its financial condition, and acting in good faith to resolve its financial problems.[89]

In other respects, the familiar elements of municipal bankruptcies would work equally well for distressed sovereigns. The proceedings would commence with a petition that would set forth facts to establish that the sovereign could not pay its debts as they come due.[90] The sovereign would have to identify its debts, notify its creditors, and disclose essential facts concerning its financial condition.[91] Petitions would only be voluntary.[92] The conditions for filing would be limited to ensure that the process is used sparingly and only when debts become unsustainable. In a municipal bankruptcy, the petition must allege that the petitioner (1) is insolvent; (2) desires to effect a plan to adjust such debts; and (3)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter, (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter, (C) is unable to negotiate with creditors because such negotiation is impracticable, or (D) reasonably believes that a creditor may attempt to obtain a preferential transfer.[93] Similar appropriate conditions would be established for foreign states.

Objections to a municipality's petition can be filed to challenge the good faith of the petitioner.[94] The bankrupt must file a plan of adjustment.[95] The court must review and approve the plan if it meets the statutory conditions.[96] Sovereign bankruptcies could have similar rules.

Important elements of any bankruptcy are a stay of proceedings, and appropriate cram down procedures.[97] The stay stops the creditor rush to attach assets and the cram down rules allows the court to impose an adjustment plan on dissenting creditors.[98] The *Pravin Banker* and *Elliott Associates* cases demonstrate the potentially disruptive effects of free riding creditors that seek to litigate during the negotiation process, and opt out of reorganization plans, in order to seek full payments on their contracts. Similar rules would be an essential element of a sovereign bankruptcy regime.

88. 28 U.S.C. § 1602 (1994).
89. *See Sovereign Debt, supra* note 5, at 21–23.
90. 11 U.S.C. §§ 101(32), 301, 901.
91. *Id.* §§ 923–24.
92. *Id.* §§ 301, 901(a).
93. *Id.* § 109(c).
94. *Id.* § 921(c).
95. *Id.* § 941.
96. *Id.* § 943(b).
97. *Id.* §§ 362(a), 901(a), 922, 1129.
98. *Id.*

Several difficult questions have arisen in the discussion of sovereign bankruptcies. What creditors should be included? Sovereigns have commercial creditors, such as banks, bondholders and suppliers, but they also have official creditors that include other countries (the Paris Club creditors) and international organizations, such as the World Bank and IMF. Traditionally, these different classes of creditors have discussed their debts separately with a distressed sovereign. Some bondholders would like to see all creditors at the same negotiating table.

One of the principal voids in the current system is the lack of a creditors committee or similar group with which the sovereign can discuss its financial problems and the terms of an adjustment plan. In a municipal bankruptcy, the United States trustee appoints a creditors' committee.[99] But who should appoint a similar committee, and who should be on it, are key questions in sovereign bankruptcies. When banks were the principal lenders, loan agreements provided the sovereign would appoint a bank advisory committee consisting of a representative group of banks. The same approach could be used in sovereign bankruptcies. Other creditors could appeal to the referee to ensure that the sovereign acted in good faith in appointing a representative creditors' committee.

That leaves the perplexing question of a forum and referee. National courts of one foreign state appear unsuitable to discharge another foreign state. The International Centre for Settlement of Investment Disputes (ICSID), however, already exists as a forum where investors and 134 sovereigns resolve their business differences.[100] ICSID has grown rapidly as it has established credibility as a neutral forum for investors and sovereigns. With relatively minor modifications to its charter, ICSID could serve as the forum for sovereign bankruptcies. An ICSID panel could resolve objections to the petition, appoint a committee of creditors, and resolve disputes among creditors and with the sovereign.

VI. Conclusion

The street protestors have made several noisy appearances at international meetings. They provoked a crackdown by Swiss police at the Davos world economic conference last year, and a statement of support from South African President Thabo Mbeki, who called for reform of global institutions.[101] The Genoa demonstrations of the G-8 meeting saw the first tragic death among the protestors. While it may be hard to understand the motivation of relatively wealthy protestors disrupting international meetings, the protests portend serious difficulty for market-based reforms in developing countries. Increasingly, populist policies are regaining popularity as market-based reforms fail to lift developing countries out of poverty.

The strangely silent parties in the debate have been the governments of the developing countries. In the early days of the debt crisis, Peru's then Finance Minister Javier Silva Ruete tried to organize a unified position among Latin American governments. His effort failed and has not been openly repeated. As a result, the interests of developing countries were not effectively represented when international policy makers first took steps to protect

99. *Id.* §§ 901, 1102(a).

100. ICSID, 2001 Annual Report 4, *available at* http://www.worldbank.org/icsid/pubs/2001ar/main-eng.htm (last visited Aug. 15, 2002).

101. Neal E. Boudette & Ian Johnson, *Swiss Police Crackdown on Protestors Is Criticized*, Wall St. J., Jan. 29, 2001, at A20.

threatened banks, and later came forward with incomplete and inadequate programs for debt relief.

History appears to be continuing along the same course. Until the Argentine crisis, major governments would bail out ailing countries for fear that a default would devastate the world economy. The bailouts, however, destroyed the market discipline that is essential to create efficient economies.[102] The United States, joined by the IMF and other industrialized governments, now refuse to bail out Argentina until it meets stringent financial conditions. This approach, however, is not a complete solution. It is inflicting considerable pain in Argentina, while leaving the country without a clearly defined institutional solution to its crisis.

Twenty years ago, more than thirty developing countries defaulted on their foreign debt. They did not all suddenly become inefficient or corrupt. The international financial system failed in a catastrophic way. Since then, reforms have been slow and piecemeal while the countries remain burdened with unsustainable debts. John B. Taylor, Under Secretary for the Treasury for International Affairs, recently said:

> At the moment, there is a great deal of uncertainty about the process involved in [debt] restructurings. It is important to find a way such that when a sovereign debt restructuring occurs, it does so in a more orderly manner that treats debtors and creditors fairly and reduces the scope for arbitrary, unpredictable official action.[103]

Thus, the need for change is widely recognized. A sovereign bankruptcy code would bring much needed order and balance to the system.

102. *E.g.*, Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 961–65 (2000).

103. John B. Taylor, Under Secretary of the Treasury for International Affairs, Statement Before the Senate Banking Comm. Subcomm. on Int'l Trade and Fin. (Feb. 28, 2002), *available at* http://www.ustreas.gov/press/releases/po1055.htm (last visited Aug. 15, 2002).