Sovereign Debtors, Private Creditors, and the IMF

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Shean Hagan*

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I. Introduction

Even though the International Monetary Fund (IMF) is somewhat accustomed to being at the center of controversy, the steps that it has taken over the past several years to resolve international financial crises have generated an unusually acute level of criticism. Moreover, the objections have come from a particularly diverse array of sources and, if heeded, would pull the institution in very different directions.¹ Many in academia and

* Assistant General Counsel, International Monetary Fund. The opinions expressed are those of the author and do not necessarily reflect the views of the IMF. The author would like to thank François Gianviti, General Counsel of the IMF, and Matthew Fisher, Assistant Director of the IMF’s International Capital Markets Department, for their helpful comments on an earlier draft.

the official sector blame the IMF for having bailed out private creditors during these crises. In their view, the IMF has been effectively shielding creditors from the risks they incur when making investments in emerging market countries, thereby ensuring further reckless lending and, as a consequence, further instability in the international financial system. On the other hand, representatives of private investors argue that the IMF has been encouraging—and, in some cases, forcing—sovereign debtors to default. In their view, it is this disregard for the sanctity of contract that is undermining the stability of the international financial system.

This article does not try to assess these opposing and rather contradictory criticisms of the IMF's activities. Rather, it offers a somewhat different perspective regarding the IMF's objectives and the issues that it has confronted in this difficult area. As will be seen, the IMF's policies are hardly new; their contours were defined during the debt crisis of the 1980s. What has changed, however, is the structure of the international capital markets, and these changes have complicated the crisis resolution process.

II. The Debt Crisis of the 1980s

When the debt crisis erupted in the early 1980s, the IMF was called upon to provide financial assistance to a number of overly-indebted countries with the objective of both resolving the problems of these countries, and averting a broader systemic crisis that loomed because of the over-exposure of the banking sectors of the major industrial countries. In order to understand the approach the IMF took during this period, it is necessary to be aware of the legal basis for the policies that govern the use of its financial resources.

The IMF's Articles of Agreement provide that when the IMF makes its financial resources available to a member country, it must satisfy itself that two conditions are in place. First, since its resources may only be used to help countries resolve their balance of payments problems, the member must be implementing policies that will address—rather than merely delay the resolution of—its external difficulties. Second, the IMF must ensure that "adequate safeguards" are in place to ensure that the member will be in a position to repay the IMF within the relatively short timeframe mandated under the Articles. "Conditionality"—whereby IMF financial assistance is made conditional upon the member's effective implementation of an appropriate economic adjustment program—is the primary tool used by the IMF to ensure that these two conditions are in place. The adoption of corrective policies not only gives the IMF some assurance that the underlying problems are being addressed, but also provides it with the comfort that the member will have adequate foreign exchange to repay the IMF once the program has been implemented.

To ensure uniformity of treatment among its members, the IMF has adopted general guidelines as to how conditionality is to be designed and implemented. The stand-by

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2. Article V, section 3(a) of the Articles of Agreement of the International Monetary Fund.
arrangement is the primary mechanism used to apply this policy, and is relatively straightforward in operation. It constitutes a decision of the IMF's Executive Board to make available an overall amount of resources in support of an economic adjustment program, as described in the letter of intent prepared by the member. Under the terms of this decision, tranches of the committed resources are disbursed on the basis of the member’s observance of targets (“performance criteria”) that have been identified in the letter of intent, and specified by the IMF’s Executive Board.

The amount of financing provided by the IMF has traditionally been relatively modest in comparison with the member’s needs. However, the fact that the IMF has made a judgment that the member’s adjustment program merits its financial support is intended to “catalyze” financial assistance from other sources. This catalytic function not only serves to limit the amount of IMF exposure to any single member (thereby contributing to the “safeguards” required under the Articles), it is also designed to provide a means by which a member can regain access to capital markets, thereby contributing to a lasting resolution to its external difficulties.

During the debt crisis of the 1980s, the above framework defined the approach that was devised to address this systemic problem. Specifically, as a condition for providing financial support under a stand-by arrangement to a country that was willing to implement an adjustment program, the IMF required that the country and its creditor banks reach agreement in principle, on either a rescheduling, or the provision of new money by the banks. Once the agreement had been reached, the country was required to make all interest payments to the banks during the course of the stand-by arrangement.

This approach was designed to address the needs of all the relevant parties. From the perspective of the country, the financing injected by the IMF and the banks was designed to give it the necessary breathing space while it implemented an ambitious adjustment program that would—it was hoped—place it in a position to service its rescheduled debt. For the banks, given the level of their exposure to the country, rescheduling, and even the provision of new money, was acceptable so long as interest payments were made on a timely basis, thereby allowing them to continue to classify the loans as performing for domestic regulatory purposes.

4. Article XXX(b) of the Articles of Agreement of the International Monetary Fund defines the stand-by arrangement as follows:

“Stand-by arrangement means a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount.”

Although a standard form of the stand-by arrangement has been approved by the Executive Board, the conditions (including the performance criteria) vary according to the nature of the economic reform program it supports; see Selected Decisions, supra note 4, at 173.

5. The IMF’s policy on access sets forth the annual and cumulative limits on access. It also establishes the criteria to be applied for purposes of establishing access within these limits; See Selected Decisions, supra note 4, at 209–217.

6. For a detailed discussion of how regulatory issues shaped the strategy that was relied upon during the initial period of the debt crisis, see L. Buchheit, Alternative Techniques in Sovereign Debt Restructuring, U. ILL. L. REV., Vol. 2, 1988.
From the IMF's perspective, the agreement reached between the country and bank provided it with the assurance that the above-stated objectives of conditionality would be met. Even if the member effectively implemented its program, a sustainable resolution of the member's balance of payments problems would require it to regain spontaneous access to capital markets. For a country in arrears, the normalization of its relations with creditors was an important first step in this process. Moreover, gaining access would also ensure following the implementation of the program, that the member would be in a stronger position to repay the IMF. The fact that this agreement required either rescheduling or new money was also important. It both eased the degree of adjustment that needed to be undertaken by the member, but also reduced the amount that needed to be provided by the IMF in order to ensure that the program was financed. As will be seen, this feature of "burden sharing" continues to be a central pillar of the IMF's strategy in this area.

By the late 1980s, however, the above strategy required revision for a number of reasons. First, it was eventually recognized that many of the heavily indebted countries were facing more than just liquidity constraints. Even with the implementation of an effective adjustment program, it became apparent that their debt burden was such that medium-term balance of payments viability could only be achieved through debt and debt service reduction, as opposed to the existing multi-year rescheduling exercise. Second, by this time, the balance sheets of the commercial banks had improved and they had accumulated sufficient loan loss provisions to enable them to write down the value of their loans. With the threat of insolvency reduced, they were unwilling to provide new money, especially since they too, began to realize that there was a growing likelihood that there would eventually need to be some form of debt reduction. Moreover, the bank felt that they had little to lose by delaying the process. Under the IMF's strategy, as described above, banks had an effective veto over the approval of the stand-by arrangement by the IMF—an agreement in principle on a rescheduling between the banks and the country was still a condition for the approval of an IMF-supported program. As a result, the IMF experienced substantial delays in its ability to support strong adjustment programs.

It was against this background that the IMF revised its debt strategy in 1989 to enable it to "lend into arrears." This revision essentially enabled the IMF to support strong adjustment programs, even though an agreement had not been reached in principle between the debtor and the banks. During the period of the program, not only would the debtor be permitted to accumulate arrears to banks, but the accumulation of these arrears was considered as an essential means—from the IMF's perspective—of providing the necessary financing of the program. These arrears effectively became the substitute for the rescheduling and new money that had been previously provided on a voluntary basis.

It was a policy that entailed significant risks. As noted above, a sustainable resolution of a member's balance of payments problems required regaining access to capital markets,

7. For the text of the IMF's lending into arrears policy of 1989, see Boughton, supra note 1, at 533–36. As will be discussed, this decision was superceded in 1999 by a decisions that effectively extended the IMF's lending into arrears policy to all private creditors, including bondholders; see Selected Decisions, supra note 4, at 199–201.
access that would be placed in jeopardy since the protracted accumulation of arrears was likely to severely undermine relations with creditors. Moreover, in terms of safeguards for the IMF's resources, a lack of access could compromise the ability of the country to repay the IMF. As a means of addressing this issue, each drawing became conditional upon the completion of a review that was specifically designed to monitor progress on the member's negotiations with the banks.

Although some restructurings took time, the revised strategy was largely successful. Led by the IMF and the World Bank, the official sector provided upfront funding to support debt and debt service reduction operations, largely entailing the exchange of bank debt for collateralized bonds (Brady bonds).

While the banks moved slowly in some cases, the process remained orderly and there were few cases of aggressive litigation. Moreover, although the banks reduced their role in emerging markets, the capital they had provided was effectively replaced by financing through the bond market. Indeed, in many respects, and as will be discussed below, the current challenges are attributable to this evolution in the capital markets.

III. The New Environment

Over the past six years, a number of countries have experienced financial crises that, although similar in many respects to the crises of the 1980s, have raised a number of new challenges. The tesobonos crisis of Mexico in 1994, the Asian financial crisis that erupted in 1997, and the crises that led to sovereign debt restructurings in Russia, the Ukraine, Pakistan, and Ecuador, have all been described as the first financial crises of the 21st century.

In some respects, these crises have their origin in the globalization of financial markets that has taken place over the past fifteen years. During this period, emerging market economies have been able to access international global markets directly through the issuance of international securities and, as a consequence, the relative importance of bank loans as a source of financing for these countries has declined considerably.

In some respects, the shift away from bank lending to international bonds was one of the by-products of the debt crisis of the 1980s. Because the amount of outstanding bonded debt was so small during the 1980s, this debt was largely exempted from the type of burden sharing that was imposed upon commercial banks, as described above. The practice of generally exempting bonded debt from the restructuring process had the effect of giving bonds de facto seniority, notwithstanding the fact that, as a legal matter, they ranked equally with all other unsecured debt. Moreover, the emergence of a large and liquid secondary market in Brady bonds provided an important impetus to the development of

8. For a comprehensive description of the Brady plan and the support provided by the IMF for debt-and-debt service reduction operations, see Boughton, supra note 1, at 491–98.
9. A considerable amount of the shift from syndicated loans to bonded indebtedness took place in the first half of the 1990s. International sovereign bond issues by developing and transition economies grew from an average $2.5 billion per year in 1985–90 to $38.1 billion in 1996. At the same time, commitments of medium and long-term bank loans to these sovereigns remained small at around $3 billion in 1996.
the international bond market for emerging market economies. These bonds are held by a wide range of investors and provide a benchmark for the more creditworthy emerging market economies to issue conventional uncollateralized bonds. Finally, developments in information technology have facilitated ready access by all investors to information of economic developments and asset prices, thereby broadening the potential investor base for bonds issued by developing and transition economies.

As a result of the sovereign bond restructurings that have taken place over the past several years—and which will be discussed in greater detail in the next section—international sovereign bonds have lost the "halo" of seniority that they had acquired during most of the 1990s. Nevertheless, these restructurings have demonstrated that a number of the aspects of the process that guided the restructuring of bank debt in the 1980s do not apply. In this regard, the following features are of particular importance.

A. CREDITOR INCENTIVES

Although banks became less cooperative as the debt crisis of the 1980s progressed, the restructuring process was generally an orderly one. Discussions normally took place within a collective framework, with the major creditors negotiating through a steering committee. Perhaps most importantly, although sovereigns were in default under the relevant loans for extended periods, there was relatively little litigation. In retrospect, the orderliness of the process was attributable to the fact that commercial banks had a number of incentives to act in this manner. First, they were typically under the supervision of a central bank and other regulatory authorities. Those authorities sought to persuade syndicate members to agree to an orderly restructuring through a combination of moral suasion, the application of provisioning regulations, and other regulatory benefits. This was particularly effective during the early stage of the debt crisis, when arrears posed a systemic risk to the financial systems of creditor countries. Second, commercial banks, being in the business of extending credit, had an interest in maintaining good relations with sovereign countries. From this perspective, aggressive litigation would be counter to their long terms interests. Third, the terms of the syndicated loan agreements created a disincentive for disruptive action by a single bank. Specifically, if a creditor recovered on any enforcement action, the sharing provisions of the agreements required it to share the proceeds with other members of the syndicate. Bonds do not contain such sharing provisions.

These concerns have increased as a result of the recent success of the litigation strategy employed by a distressed debt purchaser against Peru. The distressed debt

10. For a discussion of the role of the Steering Committee during the debt crisis of the 1980s, see Lee Buchheit, Advisory Committee—What’s in a Name, INT’L FIN. L. REV. (Jan. 1991.)

11. For a more detailed discussion of the design and application of sharing provisions in syndicated loans, see Lee Buchheit, The Sharing Provision as a Litigation Shield, INT’L FIN. L. REV., (Oct. 1990.)

purchaser in question (Elliott), acquired U.S. $20.7 million of commercial loans that had been guaranteed by Peru and, unlike most other creditors, did not accept Brady bonds in exchange for Peruvian debt. Rather than participate in this restructuring, Elliott filed a lawsuit in New York for recovery of the full face value, plus interest, on the loans that it held. After obtaining a judgment against Peru for U.S. $56 million, Elliott utilized creative tactics as a means of collecting on its judgment. Specifically, it targeted interest payments due to be paid by Peru to its Brady bondholders. Not only was it able to obtain a restraining order against the fiscal agent of Peru from making payments, it successfully obtained an order in the Brussels court restraining Euroclear, the clearing agent, from accepting payment or paying out cash from Peru, to pay the interest due on the Brady bonds. Elliott was able to obtain this order without the defendants Euroclear and Peru being given an opportunity to present their counter-arguments. One of the arguments used was that Peru, by paying its Brady bond creditors rather than Elliott, was violating a clause in the loan agreement held by Elliott, which provided that the loan in question ranked equally with all other external indebtedness (the pari passu clause).

With insufficient time to appeal the orders obtained by Elliott, Peru decided to settle with Elliott in order to avoid default on the Brady bond payments.

There is a general perception that the strategy employed by Elliott has enhanced the leverage of creditors in the restructuring process.\(^3\) Previously, the strategy of a creditor wishing to take legal action following a sovereign default, was directed at locating and attaching sovereign assets, a strategy that was countered by the efforts of countries to hide their assets in a number of different countries or, in some cases, with agencies that were protected by immunities. The strategy employed against Peru was designed to use Peru's need to maintain relations with other creditors as a means of exerting pressure. The fact that this strategy was implemented rapidly in a number of different jurisdictions, without the opportunity for Peru to challenge the underlying merits of Elliott's legal arguments, is also significant.

The success of the above strategy has not only increased the risks for a sovereign in default, it may have also reduced the incentives for creditors to agree to debt reduction for at least two reasons. First, given the ability of a distressed debt purchaser to extract full payment in this case, the strategy has exacerbated the free rider problem. Potentially more cooperative creditors will be less willing to agree upon significant debt reduction if they believe that less cooperative creditors will be able to effectively press for full payment through litigation. Secondly, since the source of pressure used by Elliott was the possible interruption of Peru's payments on restructured debt, creditors will be concerned that a sovereign may not be able to service any debt that they agree to restructure.

Notwithstanding the above, it is not clear whether all legal aspects of this disruptive strategy will withstand challenge in future cases. The expansive interpretation given to the pari passu provision would suggest, for example, that a creditor who has received a payment from a debtor that is in default to other creditors has the obligation of sharing this payment pro rata with other creditors, even in the absence of any "sharing" provision in the underlying contract.\(^4\)

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13. See e.g., Goldman, supra note 13.
14. The interpretation given to the pari passu clause in the Elliott litigations is extensively criticized by Gulati and Klee in supra note 13.
More generally, there is inadequate evidence that bond restructuring will always be accompanied by litigation, or that such litigation, when it does occur, will disrupt the restructuring process. Litigation is expensive, and secondary market purchasers may often find that, provided that they purchase their claims at a sufficient discount, they can still reap a significant profit by agreeing to the terms of a restructuring. It is noteworthy that, with respect to the restructuring that took place in Pakistan, Ukraine, and Ecuador, there has not yet been any litigation.

B. Organizational Difficulties

As noted earlier, during the debt crisis of the 1980s, negotiations between the sovereign debtor and the creditor banks took place within a collective framework, a key element of which was the steering committee. The steering committee played an important role in facilitating an orderly restructuring process in a number of respects. First, it provided a useful means of forging a common position among the major creditors. The reliance on a single financial and legal advisor contributed to this process. Second, it was relied upon by creditors to assess the restructuring proposals made by the debtor. Although the committee could not legally bind the general creditor body, one of the reasons why its recommendations were accepted is that creditors assumed that any proposal made by the debtor regarding a restructuring that had been recommended had been effectively vetted, to ensure that it was both equitable and appropriate. For example, once established, the committee would generally create a subcommittee that was charged with studying the relevant financial information regarding the debtor and assessing the extent of its problems. Third, as a general principle, a debtor and its creditors will be reluctant to engage in meaningful negotiations unless they have some assurance that sensitive information, including tentative restructuring proposals, will remain confidential. A steering committee made up of a limited number of banks provided an effective means of ensuring such confidentiality.

Perhaps most importantly, a steering committee helped facilitate the provision of new financing during the restructuring process. Since the committee was made up of the principal creditor banks, their agreement to exclude new financing provided by other private creditors after a specified date from any future rescheduling constituted an important inducement for creditors to provide new money.

Unfortunately, the growing number and diversity of creditor interests that have arisen during the last ten years have made the operation of the type of collective framework described above far more difficult. Trying to obtain adequate representation of major creditors at a committee in circumstances where the debt is widely held in the form of bonds represents a serious challenge. Although some bonds provide for a trustee to represent the interests of bondholders generally, concerns regarding their own liability often limit the willingness of trustees to represent bondholders in the context of restructuring discussions.

15. See Bucheit supra note 11.

16. To address this problem, proposals have been made to provide more authority—and protection—to trustees. One such proposal would entail the introduction of provisions into bonds that would facilitate the ability of the trustee to participate in discussions with the
The problem is complicated further by the emergence of financial engineering techniques that result in the re-packaging of financial claims, such as credit derivatives or asset-backed securities. These techniques may entail the separation of the lender of record, who retains the legal interest, and the end-investor, who holds the beneficial interest. In the context of restructuring negotiations, the lender of record may find it difficult to speak on behalf of the end-investors, particularly where the end-investors are widely dispersed, or where their interests are in conflict with each other. Different but related problems arise with respect to more traditional investors, such as pension or mutual funds, where the economic interests of the investors are managed by professional money managers who have a fiduciary relationship that requires them to protect the interests of these investors. Not surprisingly, these managers feel they have little latitude to negotiate a restructuring on their client's behalf.

The fact that relatively small investors can purchase a significant amount of debt on the secondary market also raises concerns regarding the maintenance of confidentiality. As noted earlier, members of a creditors' committee may receive confidential information and, to the extent that the securities are publicly traded, may be subject to criminal penalties if they trade on the basis of this information. Unlike commercial and investments banks, a number of the investors that purchase sovereign debt are too small to implement the type of internal walls that are designed to ensure confidentiality. In a number of restructuring negotiations, including, most recently, the restructuring of Ecuador's sovereign debt, concern was expressed that small institutions could not provide credible assurances that the sensitive information disclosed during the negotiations would be kept confidential.

debtor and other creditor representatives as early as possible in the restructuring process. The trustee would have no authority to legally bind the bondholders to any proposal. He would still be required to present the proposal to bondholders for consideration. While the provision would only establish a procedure, it could be a useful one. When a bondholder's meeting is called the trustee would be able to present a proposal—or progress towards a proposal, and will also be able to inform bondholders that representatives of all other creditors participated in the discussions. For more discussion of this issue, see Lee Buchheit, The Collective Representation Clause, INT'L FIN. L. REV., (Sept. 1998).


18. Problems relating to confidentiality and trading on the basis of such information are not entirely new issues in the context of emerging market debt; see, e.g. David Zornow and Thomas Obermaier, The LDC Debt Market, BANKING AND FINANCIAL SERVICES, Nov. 23, 1993; see also The LDC Debt Market: It's a Jungle Out There, BUS. WEEK, Mar. 15, 1993.

IV. Recent Experience and Policy Issues

When providing assistance over the past six years to countries that have confronted financial crises, the IMF has had to apply its policies, including the policy of burden sharing with the private sector, in a manner that pays adequate regard to the types of changes in the international capital markets described above. In some respects, it has been an evolutionary and iterative process. With each crisis, the IMF has achieved a greater understanding of the impact that these changes can have on the causes and resolution of crises, with the lessons of each experience being incorporated into the policy matrix.

This section discusses some of the key policy issues that have arisen during this period. It should be emphasized at the outset that, notwithstanding a recognized need to adjust policies to the new environment, there has been considerable continuity in the objectives and principles that have guided the IMF’s approach. In particular, the principles are the same as those that guided it during the 1980s. Specifically, by providing financial support for strong economic adjustment programs, the IMF’s “first best” solution has been to try to assist a member to resolve its balance of payments problems in a manner that avoids any disruption in its relations with its creditors. Consistent with its traditional catalytic role, the IMF always hopes that support of a member’s forceful and prompt implementation of policy adjustments in the face of emerging pressures will generate market support in the form of new money. However, in circumstances where the private sector has not provided new financing on a voluntary basis, and the amount of financing needed has been too large to be filled by a combination of policy adjustment or financing from the official sector, there has been a recognition that this “financing gap” would need to be filled through a restructuring of the member’s indebtedness. Where a restructuring has been considered necessary, the IMF has urged its members to approach its creditors and agree to a restructuring through a collaborative dialogue. But, when a restructuring agreement could not be reached on a voluntary basis, a member may have no choice but to default on its obligations. As during the 1980s, the imperative of supporting strong policy adjustment in a manner that provides adequate safeguards for the IMF’s resources meant that, as a last resort, the process of securing a contribution from the private sector would be a coercive one.

20. The approach is effectively summarized in a Communiqué issued by the International Monetary and Finance Committee of the IMF during the IMF’s Annual Meetings in Prague in September 2000. The relevant portion of the Communiqué reads as follows:

“The approach adopted by the international community should be based on the IMF’s assessment of a country’s underlying payment capacity and prospects of regaining market access. In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly. The Committee agrees that reliance on the catalytic approach at high levels of access presumes substantial justification, both in terms of its likely effectiveness and of the risks of alternative approaches. In other cases, emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems. In yet other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile. This includes the possibility that, in certain extreme...
While the IMF has played a lead role in providing assistance during this period, it has not acted alone. Other official creditors, including bilateral official creditors (the "Paris Club") have also provided financing in the form of rescheduling. As a condition for providing such support, these creditors have often emphasized the need for adequate participation by the private sector for broader systemic reasons. Specifically, many creditor governments have expressed the concern that, unless private creditors are forced to bear the cost of the risks that they incur when lending to emerging market countries, they will continue to make imprudent lending decisions and, thereby, will precipitate future crises. Although the IMF has also been sensitive to such "moral hazard" concerns, it has also recognized that it would be entirely inappropriate to try to force a country to disrupt its relations with its private creditors for the sole purpose of sending a signal to the market. The IMF's mandate is to assist members resolving their balance of payments problems, and not to use them as a means to punish private creditors.

A. Extending the Lending into Arrears Policy

When the lending into arrears policy was established in 1989, it only applied to arrears to commercial banks. As discussed earlier, because there was so little bonded debt outstanding during the debt crisis, it was generally excluded from the restructuring process. In 1999, the IMF extended its lending into arrears policy to cover arrears to all private creditors, including bondholders. By enabling the IMF to support members in default that were forcefully implementing adjustment programs, this extension was designed to send a clear signal that the IMF was not willing to allow bondholders to exercise a de facto veto over IMF lending. Several aspects of this decision are worthy of note. First, as in the case of the 1989 lending into arrears policy, the new policy sets forth conditions as to when the IMF may lend into sovereign arrears. Specifically, such lending can only take place where: (1) prompt IMF support is considered essential for the successful implementation of the member's adjustment program, and (2) the member is pursuing appropriate policies, and is making a good faith effort to reach a collaborative agreement with its creditors. Consistent with the 1989 policy, the new policy also provides that all disbursements would be subject to a review that would provide the IMF the opportunity to consider whether adequate safeguards remain in place for the use of the IMF's resources. Partly out of a concern that litigation by bondholders could undermine the effective implementation of the program (including the debt restructuring process), the decision provides that these periodic reviews "would provide a basis to assess whether the member's adjustment efforts are considered to be undermined by developments in creditor–debtor relations."

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22. Id. at 201.
Second, the policy also authorized the IMF to provide financing in cases where non-sovereign entities were in arrears to private creditors as a result of the imposition of exchange controls. Although this aspect of the decision is also consistent with the 1989 policy, it took on particular importance in light of the lessons of the Asian crisis. Specifically, even in circumstances where the external debt of the sovereign itself is not significant, the events of 1997–1998 in Asia demonstrated that a financial crisis can arise because of the over indebtedness of the banking and corporate sectors which, when coupled with a loss of creditor confidence, leads to a sudden and rapid depletion of foreign exchange reserves. Although exchange controls were not relied upon during the Asian crisis, the 1999 policy recognizes they are need for a temporary period and that, to the extent that they interrupt the ability of residents to service their external debt, such controls will give rise to arrears. Under the 1999 policy, the conditions that must be in place for the Fund to lend into nonsovereign arrears are broadly similar to those that apply to sovereign arrears.

The IMF's experience in applying the 1999 policy has been limited. In the sovereign debt context, Pakistan was able to restructure its debt through a bond exchange in late 1999 without having to default upon the outstanding bonds. In the case of the Ukraine, which also restructured its debt through a bond exchange in early 2000, arrears emerged during the process, but only for a very limited period. Although the Ukraine went into default while the exchange period was still open, bondholders did not accelerate their claims or initiate legal action; rather, they decided to participate in the exchange.

In the case of Ecuador, however, the IMF did apply its lending into arrears policy in the context of the first default on Brady Bonds and Eurobonds that were widely traded in secondary markets, which occurred in September 1999. The IMF approved a standby arrangement for Ecuador in May 2000, and Ecuador finally launched an exchange offer in July 2000. Although bondholders voted to accelerate the bonds, no litigation was initiated. Upon the expiration of the exchange offer, 97 percent of the bondholders agreed to participate in the exchange offer.

In all of the above cases, it was possible to obtain agreement on restructurings that provided both immediate cash flow relief and contributed toward putting the member's debt onto a basis that was consistent with a return to medium-term viability. Moreover, participation rates were very high. As will be discussed below, the existence of certain provisions in the bond instruments contributed to the success of the operation.

23. Various studies have been published regarding the causes of the Asian financial crises and the design of the economic reform programs that were supported by IMF; see, e.g., The Asian Financial Crisis: Origins, Implications, and Solutions (William C. Hunter et al. eds., 1999); see also Timothy Lane et al., IMF-Supported Programs in Indonesia, Korea, and Thailand—A Preliminary Assessment, IMF Occasional Paper 178, 1999 [hereinafter IMF—Supported Programs].

24. Since the arrears are not those of the sovereign, the role of the sovereign in the negotiations with creditors is somewhat different. For this reason, as a condition for providing financing, a determination must be made that the member is making a good faith effort to facilitate a collaborative agreement between private debtors and their creditors, and a good prospect exists for the removal of exchange controls. See Selected Decisions, supra note 4 at 200.
With respect to nonsovereign arrears arising from imposition of exchange controls, the most volatile period of the currency crisis in Asia preceded the establishment of the 1999 policy and, in any event, these countries managed to avoid using exchange controls through the adoption of strong adjustment measures and an unprecedented level of financial support from the official sector and, in particular, the IMF. Indeed, a number of critics of the IMF’s policies point to this episode as being a prime example of where the IMF undermined the stability of the financial system by bailing out the private sector with large amounts of official financing. A closer look at the crisis demonstrates, however, that the private sector did not come away totally unscathed. In particular, those investors holding equity or long-term debt suffered considerable losses and, as the IMF-supported programs evolved, increasing emphasis was place on developing legal and institutional frameworks that would ensure that this debt was restructured in a transparent manner. With respect to short-term investors, however, it is true that the provision of substantial amounts of liquidity by the IMF enabled them to either exit without suffering any losses, or roll over their exposure at higher interest spreads.

In many respects, however, the most difficult problem presented by the Asian crisis was not the fact that some investors were able to exit unscathed, but that the amount of IMF resources that was required vastly exceeded amounts that had ever been provided in the past. Under the IMF’s access policies, which provide guidance as to the amount of financing that the IMF will normally provide to its members, the annual limit is set at the equivalent of 100 percent of a member’s quota. A member’s quota also determines its voting rights in the IMF, and is calculated on the basis of the relative size of the member’s economy in the world economy. While, under “exceptional circumstances,” the IMF’s access policy enables it to provide financing in excess of this amount, prior to the crisis in Mexico in 1994 this provision had been only rarely invoked. The amount provided during the Mexican crisis was the equivalent of 688 percent of quota. Financial support during the Asian crisis set new records: when calculated as a percentage of the quota of the country in question, the arrangements approved for Thailand, Indonesia, and Korea were 600 percent, 490 percent and 1,939 percent, respectively.

The level of financing provided by the IMF largely reflected the nature of the problems that fueled these crises. As discussed earlier, as result of the globalization of capital markets, emerging market economies have relied heavily on external market borrowing. However, a build up in the stock of short-term debt through such borrowing creates the potential of massive capital outflows in circumstances where changes in market perceptions make investors unwilling to rollover their credit. Given the magnitude of the financing needs, considerable strain is placed on the IMF. On the one hand, its mandate

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is to support strong adjustment programs that are designed to address these crises. On the other hand, the requirement that its resources be safeguarded requires that it limit its exposure towards any single country. For this reason, burden sharing with the private sector has become an essential element of the IMF's crisis resolution strategy.26

B. THE USE OF COLLECTIVE ACTION CLAUSES

As noted earlier, the sharing provisions of syndicated loans acted as a disincentive for a single bank to pursue legal action against a sovereign in default during the 1980s. Although international bonds do not contain such provisions, some of them contain terms that effectively enable a qualified majority of creditors to ensure that the minority of creditors cannot disrupt the restructuring process. Such collective action clauses facilitated some of the sovereign debt restructurings that have taken place over the past several years and the official sector, including the IMF, has actively promoted their inclusion in all future emerging market international bond issuances. While these provisions have an important role to play, there are several reasons why these provisions will not, in and of themselves, resolve the free rider problem that undermines the effectiveness of any burden sharing strategy.

For analytical purposes, the types of collective action clauses that are found in some—but certainly not all—international sovereign bonds can be divided into two categories. The first may be described as “majority restructuring” provisions, which enable a qualified majority to legally bind a minority to the terms of a restructuring agreement they have reached with the debtor, either before or after a default. The operation of such a provision effectively provides the majority with the assurance that, should they agree to a reduction in the value of their claims, the minority of holdout creditors will not be able to subsequently press for full payment, through litigation or otherwise. As such, they further encourage potentially cooperative bondholders to agree to a restructuring and reduce the leverage of less cooperative creditors during the restructuring negotiations. The second type of provisions can be described as “majority enforcement” provisions, in that they enable the majority to limit the ability of the minority to enforce their rights following a default, thereby giving the debtor the opportunity to agree upon a restructuring agreement. Although these provisions address collective action problems from an inter-creditor perspective, their existence also increases the leverage of the debtor, since it makes it easier for the debtor to influence creditor behavior during the restructuring process.

26. A question that has arisen in the context of the Fund’s support for Mexico and Asian economies has been the applicability of article VI, section 1 of the IMF’s Articles, which provide that “[a] member may not use the Fund’s general resources to meet a large or sustained outflow of capital.” Notwithstanding the fact that all of these crises were precipitated by a large outflow of private capital, the IMF’s resources were provided to help build up the reserves of the country in question, not to continue to finance these outflows. For a discussion of this issue in the context of the Mexican crisis, see F. Gianviti, The IMF and the Liberalization of Capital Markets, 1 Hous. J. Int’l L., 19:3 (1997).
Majority restructuring provisions are generally found in international sovereign bonds governed by English law, with the relevant voting threshold required to modify the bond terms typically being between two-thirds and three-fourths of the bond issue that is represented at the bond meeting. In contrast, most international sovereign bonds governed by New York law do not contain these provisions. This is significant given the relatively large proportion of sovereign bonds outstanding that are governed by New York law. The exclusion of such provisions has arisen out of practice, and neither New York nor U.S. law would prohibit their inclusion in future international sovereign issuances.

In contrast, majority enforcement provisions are not restricted to bonds that are governed by English law. For example, bonds governed by either New York or English law will often require a minimum value of the bond issue, normally 10 percent but sometimes as high as 25 percent, to declare the full amount of the bond due and payable following an event of default. They often also permit a majority of the value of the bond issue to reverse such acceleration. In addition, bonds that are issued under trust deeds governed by English law limit the right of individual bondholders to initiate litigation. Under the terms of these bonds, the right to initiate legal action is effectively delegated to the trustee, who is only required to initiate proceedings if it is requested to do so by the requisite percentage of bondholders (typically between 20-25 percent).

Collective action clauses have contributed to recent sovereign debt restructurings in a variety of different ways. For example, in the case of the Ukraine, the majority of restructuring provisions contained in several of the outstanding bond issuances were

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27. For purposes of the analysis contained in this article, an international sovereign bond is a bond that is: (1) issued or guaranteed by the state or the central bank, and (2) subject to the jurisdiction of a foreign court. The jurisdiction of a foreign court is critical given the fact that the ability of an individual bondholder to disrupt the orderly resolution of a financial crisis will depend, in large part, on whether it can enforce its claim in a foreign court.

28. Based on a 1999 survey of 600 outstanding international sovereign bonds issued by emerging markets, 296 were governed by New York law, 120 were governed by English law eighty-two were governed by German law and fifty-seven were governed by Japanese law.

29. The practice of excluding majority restructuring provisions in international sovereign bonds governed by New York law is attributable to the treatment of nonsovereign bonds offered to the U.S. public. Specifically, the U.S. Trust Indenture Act, enacted in 1939 requires that the terms of such bonds not allow the impairment of rights of any bondholder to receive payments due (or to sue to cover the missed payments) without his consent, except that terms allowing a 75 percent majority to agree to a postponement of interest for up to three years are permitted. Although these limitations do not apply to any sovereign bonds, sovereign bond documentation governed by New York law has generally followed the documentation of nonsovereign bonds, and as a consequence, has not included majority restructuring provisions.

30. Under the terms of these trust deeds, the trustee is only required to initiate proceedings if (1) it is requested to do so by the requisite percentage of bondholders (typically 20 percent and 25 percent, and (2) if it has received adequate indemnification. An individual bondholder will only be able to initiate proceedings if the trustee fails to initiate proceedings after both these conditions have been met.
activated as a means of ensuring that any bondholders that did not participate in the bond exchange would be left holding bonds with terms that were identical to the new bonds. In the case of Ecuador, the ability of a majority of bondholders to reverse the acceleration that had occurred shortly after default may have been one of the reasons why there was no litigation during the restructuring discussions. Interestingly, however, although Pakistan's bonds contained majority restructuring provisions, they were not activated in the context of the exchange.

The successful use by Ecuador of bond provisions, other than those described above, as a means of facilitating a restructuring has attracted considerable attention. Although Ecuador's bonds did not include majority restructuring provisions, they did contain provisions that allowed for bondholders to amend nonpayment terms by a simple majority. The terms of the exchange offer required that each bondholder who agreed to tender any defaulted bond in the exchange, consent to a list of amendments of nonpayment terms of such bonds. The amendments included the deletion of: (1) the requirement that all payment defaults be cured as a condition for condition to any reversal of acceleration and, (2) the negative pledge clause (which limited Ecuador's ability to provide security for other indebtedness), and (3) the provision that restricted Ecuador from purchasing any of the Brady bonds while a payment default is continuing. Such "exit consents" were designed to make the old bonds less attractive, thereby inducing bondholders to accept the new bonds.

Over the past several years the official sector, including the IMF, has been encouraging emerging market economies to include majority restructuring and majority enforcement provisions in new bond issuances, in recognition that these provisions can facilitate an orderly restructuring process. There are a number of reasons, however, why collective action clauses cannot be relied upon as the "silver bullet" that will guarantee that restructurings will always be orderly.

First, a large portion of outstanding bonds with long maturities do not contain such provisions. Second, since the provisions are contractual, whether they will be included will depend on whether the sovereign perceives that they will be acceptable to creditors. As is evidenced, for example, by the terms of the bonds recently issued by Argentina (which did not include collective action clauses), sovereign debtors facing a crisis actually prefer to exclude such clauses as a way of demonstrating to creditors their firm commitment to pay on the original terms. In some respects, the attention placed by the official community on the benefits of collective action clauses as an element in the private sector involvement strategy may have contributed to this dynamic. Third, collective action clauses only bind holders of the same bond issuance, and are of more limited use when a sovereign needs to engineer a broad restructuring that includes a large variety of instruments, including for example, private placements and commercial bank loans.

31. For further discussion of the use of these provisions in the debt restructurings that occurred in the Ukraine, Ecuador, and Pakistan, see Involving the Private Sector in the Resolution of Financial Crises—Restructuring International Sovereign Bonds, supra note 25.


C. Creditor/Debtor Dialogue

As has been discussed, the restructuring of the bonds of Pakistan, the Ukraine, and Ecuador was achieved through an exchange of instruments. However, prior to the exchange, the process relied upon by the sovereign to determine whether the terms of the offer would be acceptable varied, depending on the country in question. In the cases of Pakistan and Ukraine, the process was informal but relatively collaborative. With respect to Ecuador, however, the process was somewhat more complicated. Although a "consultative group" of creditors was formed, consisting of eight institutional holders, Ecuador was reluctant to engage in negotiations with this group. Some of the creditors were of the view that Ecuador was not acting in good faith with them. They also expressed concern that the IMF, by continuing to lend into arrears in these circumstances, was effectively sanctioning this behavior in contravention of its lending policy. As noted earlier, one of the conditions for continued IMF support when a sovereign is in arrears, is a determination by the IMF that the member is making a "good faith effort to reach a collaborative agreement with its creditors." For its part, Ecuador emphasized that, given the structure of the indebtedness and the diverse interests of the creditor group, it would be impossible to hold 1980s-style negotiations. Not only was Ecuador doubtful of the feasibility of putting together a truly representative group of creditors, but there were also concerns that, since a number of the investors did not have internal firewalls to safeguard confidential information, the type of sensitive information that is normally provided during negotiations could not be shared with them.

Partly out of frustration with the process that unfolded during the Ecuador restructuring, a group of private sector participants, organized under the auspices of the Council of Foreign Relations, have proposed certain nonbinding principles that could be used as best practices for the conduct of negotiations between a sovereign debtor and its private creditors (CFR Principles). In many respects, the CFR Principles draw upon best practices that have been established in the restructuring of nonsovereign debt, where creditors and debtors have also had to address the developments in the capital markets when designing a collective framework for negotiation. Consistent with the approach relied upon during the 1980s, the CFR Principles provide that the sovereign would negotiate a restructuring of its debt with a steering committee that is made up of a representative group of its major creditors. Confidential information that is necessary for the creditors to make informed decisions would be shared with the committee. During the period of the negotiations, creditors would agree to a standstill on the enforcement of their claims. The box set forth below includes the full text of the CFR Principles.

34. For a discussion of the investors’ concerns regarding the process that was relied upon in Ecuador to restructure its bonds, see The Buy Side Bites Back, supra note 32.
35. Selected Decisions, supra note 4, at 200.
36. During the period from October 1999 through September 2000, the Council of Foreign Relations convened a Roundtable on Country Risk in the Post-Asia Crisis Era. The principles are contained in the Key recommendations of the Working Group Discussions. The Working Group included participants from a broad range of private financial institutions (including managers of investment funds, secondary market traders, investment and commercial bankers), financial advisors and lawyers who specialize in debt restructuring. Staff from the IMF (including the author) Bank for International Settlements, Federal Reserve Board, the U.S. Treasury, the Bank of England and Banco do Brazil attended as observers.
Box 1. Principles for Sovereign Bond Restructurings.¹

**Organization of creditors.** When a sovereign encounters financial difficulties triggering or likely to trigger a debt default, it should encourage a process of dialogue with affected creditors. Major private creditors may choose to initiate the formation of an *ad hoc* Steering Committee to be representative of all major, relevant private creditor groups. Within this Steering Committee, significant creditor groups, such as bondholders, may elect to form a subcommittee from their group as the vehicle for participating in the Steering Committee. Where one or more committees have been formed, all references in these Principles to the Steering Committee should be deemed also to constitute references to any subcommittees. Thus, a Principle urging the provision of financial information to the Steering Committee should be construed as also urging contemporaneous provision of the same information to each subcommittee.

**Cooperation of the sovereign.** The sovereign should cooperate with the Steering Committee. Such cooperation should include: (i) providing to the Steering Committee information and analysis regarding the current financial situation of the sovereign and its economic prospects, (ii) holding discussions with the Steering Committee with regard to financial solution, including the mechanism to be used to accomplish the solution, and (iii) providing information to the Steering Committee regarding any proposed additional debt.

**Retention of Professional Advisers.** The Steering Committee (including each subcommittee) may retain legal advisers and financial advisers to assist in the discussions and in the development of financial and economic analyses. Where feasible, financial advisers should be jointly retained by the Steering Committee and each subcommittee in order to develop consistent analyses. The sovereign should pay the reasonable fees and expenses of these professionals, and should reimburse members of the Steering Committee for their out-of-pocket expenses.

**Coordination with the Paris Club.** The Paris Club and the Steering Committee should consult, including sharing of financial and economic analyses with regard to the sovereign and discussing respective creditor contributions to a solution to the sovereign’s difficulties.

**Sharing of information.** Information should in most circumstances be provided to the entire investment community, whether or not a Steering Committee has yet been formed. If it is necessary to protect confidential sovereign information or market-sensitive information, the sovereign should not be required to share such information except with Steering Committee and subcommittee members, and/or their professional advisers, who enter into appropriate confidentiality agreements.

**Participants in a restructuring.** Unless otherwise agreed, all relevant private and Paris Club debt should be included in any restructuring in a manner that fairly represents each such creditor group’s position with respect to the sovereign. As to omitted creditor groups, normally the sovereign bears the burden of persuading the Steering Committee that such groups are not relevant to any restructuring.

**Voluntary stay of legal action.** Creditors should refrain from taking legal action or advancing any pending lawsuits, provided the sovereign is engaging in conduct, including good faith negotiations, in accordance with these Principles.

**Changes in bond documentation.** Consideration should be given to changing bond documentation, to the extent possible, to assist in the implementation of these Principles, including insertion of collective action clauses (requiring supermajorities, i.e., 90 percent of principal, excluding bonds owed directly or indirectly by the sovereign) and provision for the appointment of Trustees to assist in the early formation of committees, preferably prior to a default.

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Since the principles were proposed in late 2000, there have been no sovereign bond restructurings. Accordingly, it is not yet clear whether creditors will insist that they be followed in a specific case. Nor is it clear that such a collective framework could be feasibly implemented, given the developments that were described in an earlier section.
of this article. While these practices are routinely followed in large nonsovereign restructurings, the backdrop of the insolvency law provides important incentives for creditors and debtors to negotiate within the type of collective framework that is imposed once formal rehabilitation proceedings are commenced. Such a backdrop does not exist in the sovereign context. Notwithstanding the above, the principles represent an important development in this area for a number of reasons.

First, the principles evidence a significant evolution in creditor thinking. In light of the various sovereign debt restructurings that have taken place over the past several years, the principles demonstrate that creditors have shifted from away from the issue of whether a restructuring of bonds will ever take place, to the question of how such a restructuring will be conducted. This emphasis on process further highlights the diverse nature of creditor interests. For those investors who extended credit in the first place, or who purchased the bonds at near or face value, they fear that a disorderly process characterized by a lack of dialogue and minimum information will only serve to reduce the value of their claims on the secondary market. However, for those investors that specialize in purchasing claims on the secondary market at a steep discount, the absence of a predictable and orderly process may present an opportunity to purchase the debt at steeper discounts, with the possibility of reaping profits in the context of an exchange or through litigation.

Second, for the sovereign, the type of process envisaged by the principles raises important questions of the relative advantages and disadvantages of negotiating with creditors within an organized framework. Assuming that the objective of a sovereign debtor is to obtain the best possible terms, sovereigns may be of the view that they need to keep the initiative by avoiding negotiations with an organized group of creditors, and limiting the flow of information. To the extent that creditors remain isolated and have limited knowledge of the circumstances of either the debtor or their fellow creditors, there may be a perception that they will be willing to participate in a “take it or leave it” exchange offer. Once creditors organize, however, debtors may be concerned that they will be in a better position to exercise leverage. Indeed, it is possible that one of the reasons why Pakistan did not activate the collective action clauses in their bond instruments was out of a fear that any meeting called for voting purposes would have provided a vehicle for creditor organization.

On the other hand, there are a number of reasons why sovereign debtors may find that reliance on an organized framework is in their interests. First, now that the private sector has focused on issues of process, it is possible that investors may be less willing to participate in restructurings in the future, unless they are preceded by some form of meaningful negotiation. Even if a restructuring is achieved, the sovereign may find it more difficult to access the markets in the future. Indeed, creditors have complained that the absence of a fair process may taint emerging market debt in general, and could result in a reduced flow of capital to these countries. Second, there are features of the principles that may be of benefit to the sovereign during a crisis. For example, to the extent that creditors agree to a voluntary standstill during the negotiations, this may reduce the likelihood of litigation. Moreover, as during the 1980s, a decision by

37. See generally, The Buy Side Bites Back, supra note 32.
the creditors’ committee to exclude new financing provided to the sovereign from the restructuring process, may facilitate new financing during the restructuring process.

Finally, the principles raise important issues for the IMF. Although their primary focus is the sovereign’s relations with its creditors, they also specifically call upon the IMF to support them through its lending into arrears strategy. The preamble provides that “to the extent that the major private creditors of a sovereign choose to act upon the principles set forth below, the sovereign’s willingness to negotiate within the framework established by the principles will be of relevance to the IMF when it makes its judgment to provide financing.”\(^3\) In short, the principles propose that debtor adherence to them be used as evidence as to whether a member “is making a good faith effort to reach a collaborative agreement with its creditors” within the meaning of the 1999 policy.\(^3\)

The principles were reviewed by the IMF’s Executive Board in early 2000 and, consistent with the IMF’s policies on transparency, a summary of the conclusions reached at that meeting have been made publicly available.\(^4\) Some directors expressed concern that a rigid application of the framework envisaged under the principles might put a sovereign debtor at a disadvantage in its negotiations with its creditors, possibly increasing the difficulty of reaching an agreement that could secure a return to medium-term viability. Nevertheless, directors generally welcomed the attention given by the private sector to process issues that arise in restructuring operations, and noted that the principles generally provided for flexibility in the modalities of individual restructurings. With respect to the lending into arrears strategy, they noted that the principles could provide one of a number of approaches to reaching a collaborative agreement. Most directors stressed, however, that the responsibility for debt negotiations rests squarely with the debtor and its creditors and, for that reason, declined to endorse the principles.

In many respects, competing considerations that are evidenced by the above discussion of the IMF’s Executive Board are very reminiscent of the issues that were confronted when the lending into arrears policy was established in 1989. On the one hand, there was recognition that assurances regarding effective and sustainable balance of payments adjustment—and, thereby assurance regarding the adequate safeguards for the IMF’s resources—required not only the implementation of corrective polices, but also the normalization of debtor/creditor relations. On the other hand, there was a concern that it would be dangerous for private creditors to have too much leverage in determining the need for and scope of adjustment.

D. A Mandatory Approach

Over the past several years, there has been limited but meaningful discussion of the merits of establishing a mechanism that would enable the IMF to impose a temporary stay on the enforcement of creditor claims against the sovereign during the period when the sovereign is negotiating a restructuring agreement with its creditors.\(^4\) In the event

41. See, e.g. Involving the Private Sector in Forestalling and Resolving Financial Crises 23 (1999).
that nonsovereign arrears arise because of the imposition of exchange controls, the stay would also apply to these arrears. Although this issue was discussed during the 1980s, it gained new momentum in the late 1990s with the realization that, given the evolution of the capital markets, there was a greater risk that creditor litigation could derail the restructuring process and, more generally, undermine the sovereign's ability to implement effective adjustment policies. To ensure that, during the period of the stay, the member implemented appropriate policies, a condition for its activation and maintenance would be the sovereign's adherence to an IMF-supported program.

The establishment of such a temporary stay would represent a major change in the international financial and legal architecture. It would require the resolution of a number of complex legal and policy issues, a number of which are discussed below.

1. Legal Considerations

A threshold issue that has arisen during discussion of the feasibility of such a mechanism is whether the IMF already has the authority to impose such a stay under article VIII, Section 2(b) of its Articles of Agreement, which reads as follows:

Exchange contracts which involve the currency of any member, and which are contrary to the exchange control regulations of that member, maintained or imposed consistently with this Agreement, shall be unenforceable in the territories of any member.

The meaning of article VIII, section 2(b) has not been interpreted uniformly by the courts of the IMF's various members. Under the narrow interpretation, which prevails in the United States and the United Kingdom, the term "exchange contracts" has been interpreted in such a way that article VIII, section 2(b) is not applicable to credit agreements. Under the broad interpretation that prevails in a number of other jurisdictions, the IMF's temporary approval of restrictions that fall within its jurisdiction on current payments (interest payments and moderate amortization of principal of loans), will result in an automatic stay on creditor actions relating to the arrears arising from such restrictions. Such a stay would lapse upon the expiration of IMF approval.

Uniformity of interpretation under the existing Articles could be achieved through an authoritative interpretation adopted by the IMF under article XXIX. However, even if the IMF were to adopt the broad interpretation described above, there are several reasons why the existing provision would not be an effective means of implementing a temporary stay on creditor litigation.

First, with respect to sovereign arrears, an objective interpretation of article VIII, section 2(b) based on the IMF's understanding of what constitutes exchange controls, would not support the conclusion that a sovereign debtor's default on its external debt

42. See id. for general discussion of litigations risks following either default on sovereign bonds, or following the imposition of exchange controls.
43. Article VIII, section 2(b) of the IMF's Articles of Agreement.
is an "exchange control regulation" that would be protected by this provision. This is because sovereign defaults have been treated by the IMF as proprietary acts rather than regulatory measures of general applicability. For this reason, governmental defaults are not treated as exchange "restrictions" under article VIII, section 2(a), do not give rise to a breach of a member's obligations under the articles, and are not subject to IMF approval.

Second, with respect to arrears arising from the imposition of exchange controls, IMF approval of these controls could not be used as a means of imposing a temporary stay on the capital portion of the arrears (for example, the bullet repayment of principal). There are only two ways in which this capital portion could be treated under an authoritative interpretation. Controls on capital repayments could be considered as always being "consistent" with the Articles—regardless of the IMF's views on the appropriateness of the control—by virtue of the fact that the Articles specifically give members the right to maintain such controls under article VI, section 3. Alternatively, the term "consistent" with the Articles could be interpreted more narrowly, as only including restrictions on current payments and transfers. Under this interpretation, therefore, controls on capital repayments would never be "consistent" with the IMF's Articles. Neither of these interpretations would enable the fund to apply article VIII, section 2(b) in such a way that would enable capital arrears to be temporarily protected on a selective basis, i.e., only in situations where the IMF judged that arrears in question were justified while other corrective actions were being implemented.

2. Policy Considerations

As a result of the above constraints, the establishment of such a mechanism would require an amendment of the IMF's Articles of Agreement. The question then arises as to whether such a mechanism, from a policy perspective, would facilitate the restructuring of sovereign debt.

Viewed from the perspective of both the creditors and the sovereign debtors, the shortcoming of the proposal, ambitious as it may be, is that it only provides an incomplete legal framework. Specifically, creditors have expressed legitimate concern that during the period of the stay, the debtor could take actions that would undermine creditor interests. By analogy, in the context of formal corporate reorganization proceedings, the stay on creditor enforcement is generally accompanied by measures that ensure that the debtor cannot dissipate assets or make payments to preferred creditors or insiders. In the context of arrears on sovereign debt, this problem could be mitigated, at least in part, by the existence of an IMF conditionality that would ensure that appropriate policies are in place and that, for example, the country's reserves are not being dissipated. However, in circumstances where the arrears are those of a nonsovereign entity that stems from the imposition of exchange controls, creditors would have no assurance that, during the period of the stay, the debtor is not diverting assets that will undermine its ability to

45. Under Article VIII, Section 2(a) of the Fund's Articles, the only exchange controls that are subject to the IMF's approval are restrictions on the making of payments and transfers for current international transactions. By contrast, Article VI, Section 3 of the IMF's Articles provides, in part, that members may exercise such controls as necessary to regulate international capital movements.
service the debt once the controls have been lifted. To address this issue, it is recognized that some mechanism would need to be in place to ensure that the nonsovereign debtor preserves the local currency counterpart of the payments during the period when the exchange controls are in place.

From the perspective of the debtor, the framework would be incomplete in an entirely different sense. To the extent that the primary concern is the risk of disruptive litigation that could be brought by vulture creditors, and the effect that this free rider problem may have on more cooperative creditors, a temporary stay would not resolve the problem. As in the case of the strategy used in the litigation against Peru, the potentially disruptive creditor would merely wait until the stay is lifted and then press his claim. The fact that a litigant could try to attach future payments to cooperative creditors that have agreed to the restructuring would exacerbate the concerns of such creditors. In order to address this issue, the stay would need to be accompanied by a mechanism that enabled the debt of the entire creditor body to be restructured by an affirmative vote of a qualified majority of the creditors.

If one were to add all of the above features to a temporary stay, the mechanism would begin to bear an increasing resemblance to a corporate insolvency framework. If there were adequate will within the international community to establish such a framework, the role of the Fund in administering the procedure would also raise a number of difficult issues. Since the IMF is also a creditor, there may be concerns regarding a potential conflict of interests.

V. Conclusions

Over the last ten years, the globalization of capital markets has enabled emerging market economies to obtain unprecedented access to foreign credit. As has been demonstrated over the past five years, however, this access has also made these countries more vulnerable to financial crises. To assist in the resolution of these crises, the IMF has provided financing in support of strong economic adjustment programs. However, the amount of financing that can be provided by the IMF, and the degree of adjustment that can be undertaken by the member, is not unlimited. In some cases, therefore, balance of payments viability requires financing from private creditors, either in the form of new money or in the form of rescheduling. This is becoming increasingly relevant, given the magnitude of the financing needs of these countries. Where at all possible, this contribution should be voluntary and spontaneous, based on the creditors' confidence in the benefits of the readjustment program. Where necessary, however, this contribution may need to be coercive, particularly in circumstances where the country has demonstrated a willingness and capacity to implement a strong adjustment program. During the 1980s, such a coercive approach was facilitated by a number of institutional and legal factors. As a result of the disintermediation of credit and growing number and diversity of creditor interests, many of these factors no longer exist. Although to date, there have been several successful restructurings of sovereign debt, it is still not clear whether there are sufficient tools to ensure that there will be adequate participation by the private sector in the resolution of future crises.