Too Big to Fail? Towards a Sovereign Bankruptcy Regime

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"When people ask me what I mean by stable government, I tell them, 'money at six percent.'"

General Leonard Wood, 1900

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Introduction

On September 13, 2011, Greece had a 98% chance of defaulting on its debt within the next five years.[1] Greece's ten-year bond yield rose to 24.65% and the two-year note yield increased to 76.17%.[2] This is far from General Leonard Wood's definition of a "stable government." In June 2011, the unemployment rate in Greece reached a record 16.2%.[3] In March 2012, Greece exchanged its bonds for new bonds at a lower value, which means that Greece will not repay some of its debt owed to private creditors.[4] Greece is not the only country having trouble repaying its debt.[5]

How can financial markets put such pressure on a sovereign state and its population? The rise of a sovereign debt market in the 1980s multiplied the number of creditors from a few commercial banks to thousands of individual bondholders[6] and therefore intensified the "holdout problem."[7] In the sovereign debt context, the holdout problem materializes when a nation has trouble repaying its debt and seeks a debt-restructuring plan.[8] Some creditors will refuse to agree to the debt-restructuring agreement, attempting to either receive full payment of their claims or to acquire a greater

1. Abigail Moses, *Greece Has 98% Chance of Default on Euro-Region Sovereign Woes*, Bloomberg (Sept. 13, 2011, 9:06 AM), http://www.bloomberg.com/news/2011-09-12/greece-s-risk-of-default-increases-to-98-as-european-debt-crisis-deepens.html.

2. *Id.*

3. *Greece Unemployment Rate Rises to Record 16.2%*, RTT News (June 8, 2011, 6:01 AM), http://www.rttnews.com/Content/AllEconomicNews.aspx?Id=1641603&SM=1.

4. *See* Felix Salmon, *Greece's New-Bonds Era Arrives*, Seeking alpha (Mar. 9, 2012), http://seekingalpha.com/article/423101-greece-s-new-bonds-era-arrives.

5. According to Standard & Poor's sovereigns ratings list, several countries have their bonds considered as "junk bonds," i.e., bonds that have a high default risk: Albania, Angola, Argentina, Azerbaijan, Bangladesh, Belarus, Belize, Benin, Bolivia, Bosnia and Herzegovina, Burkina Faso, Cambodia, Cameroon, Cape Verde, Cook Islands, Costa Rica, Dominican Republic, Ecuador, Egypt, El Salvador, Fiji, Gabon, Georgia, Ghana, Grenada, Guatemala, Honduras, Indonesia, Jamaica, Jordan, Kenya, Latvia, Lebanon, Macedonia, Mongolia, Montenegro, Mozambique, Nigeria, Pakistan, Papua New Guinea, Paraguay, Philippines, Romania, Senegal, Serbia, Sri Lanka, Suriname, Uganda, Ukraine, Uruguay, Venezuela, Vietnam, and Zambia. *Sovereigns Ratings List*, Standard & Poor's, http://www.standardandpoors.com/ratings/sovereigns/ratings-list/en/us?sectorName=Governments&subSectorCode=39 (last visited Mar. 19, 2012).

6. James M. Hays II, Note, *The Sovereign Debt Dilemma*, 75 Brook. L. Rev. 905, 917 (2010).

7. *Id.*

8. Debt-restructuring is a "[m]odification of the terms of a loan to provide relief to a debtor who could otherwise default on payments. The restructuring may involve extending the period of repayment, reducing the total amount owed, or exchanging a portion of the debt for equity in the debtor company." *Debt Restructuring*, Financial Dictionary, http://financial-dictionary.thefreedictionary.com/Debt+Restructuring (last visited Apr. 3, 2012).

share of the debt settlement.[9] Notably, these so-called "holdout" creditors will behave this way because sovereign debtors no longer enjoy foreign immunity protection.[10]

Foreign immunity guarantees that "sovereigns cannot be sued in foreign courts without their consent."[11] Since the second half of the twentieth century, however, creditors have been able to sue sovereigns in courts for certain types of commercial activities, including borrowing money.[12] This change constituted a shift from an "absolute" approach to foreign immunity to a "restrictive" approach to foreign immunity, raising several issues for the sovereign debtors and their creditors.

If a creditor expects that other creditors will succeed in court against the sovereign debtor, she will fear that nothing will be left to recover, and may choose to "run for the exits," which means either suing or selling her debt obligations amidst a crisis.[13] This will ultimately increase the interest rates on subsequent debt, which will further decrease the probability that the sovereign debtor will repay.[14]

This practice is common among creditors. Hedge funds, or so-called "vulture funds," bought sovereign "distressed" bonds at reduced prices and then tried to enforce repayment of the full debt in court.[15] They have been able to negotiate greater settlements with sovereign debtors.[16] A famous example is when the hedge fund Elliott Associates negotiated a settlement of U.S. $56.3 million with the Republic of Peru.[17]

Although some scholars, as well as the heads of these funds,[18] have defended the "vulture fund" practice,[19] most international institutions and

9. Steven L. Schwarcz, *"Idiot's Guide" to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1193 (2004).

10. Jonathan I. Blackman & Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna*, 73 LAW & CONTEMP. PROBS. 47, 48–49 (2010).

11. Ugo Panizza et al., *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LITERATURE 651, 653 (2009).

12. Pablo M. Ros, The Elliott Acropolis?: An Analysis of Individual Creditor Sovereign Debt Enforcement Mechanisms 22 (May 2011) (unpublished J.D. thesis, Harvard Law School), *available at* http://www.law.harvard.edu/programs/about/pifs/llm/select-papers-from-the-seminar-in-international-finance/llm-papers-2010-2011/ros.pdf.

13. Laura Alfaro et al., Gunboats and Vultures: Market Reaction to the "Enforcement" of Sovereign Debt 4 (Apr. 2010) (unpublished manuscript) (on file with Emory University Center for the Study of Law, Politics, and Economics).

14. *Id.*

15. Blackman & Mukhi, *supra* note 10, at 49.

16. Panizza et al., *supra* note 11, at 651, 657–58.

17. *Id.*

18. "Jay Newman, for example, is clear that his fund does not go after countries that truly cannot pay, but corrupt, deadbeat countries that are "'dragging our legal system down by disregarding the rule of law.'" Alfaro et al., *supra* note 13, at 4.

19. For example, Nouriel Roubini argues that "vulture funds" may be "part of the solution rather than a problem" as "[v]ultures are low-risk-aversion speculators who buy low after a default, when debt prices have collapsed, in the hope of getting large mark-to-market gains from a successful deal; this may make them more rather than less likely to accept an exchange offer rather than litigate." Nouriel Roubini, *Do We Need A New International Bankruptcy Regime?*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY 321, 329 (2002).

public figures have denounced this phenomenon. Gordon Brown, the former British Prime Minister, condemned "the perversity where vulture funds purchase debt at a reduced price and make a profit from suing the debtor country to recover the full amount owed" calling the result "a morally outrageous outcome."[20] The International Monetary Fund (IMF) and the World Bank claimed that the vulture funds "interfere with the orderly restructuring of sovereign debt,"[21] and in the words of Anne Krueger, First Deputy Managing Director of the IMF, these practices reveal "a spotlight on what is a missing element of the international community's current approach to the roles of the public and private sectors in debt restructuring."[22]

This Note seeks to provide this missing element. One might think that sovereign debtors benefited from greater protection when creditors could not sue them. On the contrary, this Note argues that foreign immunity for sovereign debtors did not, and never will, provide effective protection. Therefore, the only way to restore an adequate form of legal protection is to create a sovereign bankruptcy regime.

Part I will examine the shift from an absolute theory of foreign immunity to a restrictive theory of foreign immunity and will explain why the holdout problem caused so much difficulty for sovereign debtors. Part II will argue that even "absolute" foreign immunity has not been effective to protect sovereign debtors. First, historical examples show that creditors have circumvented foreign immunity to make sovereign debtors repay their debt. Second, economics literature explains that sovereign debt exists despite immunity because debtor nations have economic incentives to repay their debt. Part III will argue that sovereign immunity should be enforced at the bankruptcy stage. This Note will seek to explain why the current situation is not satisfying and why several features of a bankruptcy regime afford greater protection to sovereign debtors and their creditors, drawing inspiration from several proposals made by scholars and international institutions.

I. The Shift from an Absolute Theory to a Restrictive Theory of Foreign Immunity in Sovereign Debt

In recent history, foreign immunity has evolved and its effect has significantly decreased. The shift from "absolute" to "restrictive" immunity has led to a challenge that many sovereign debtors now face: the "holdout" creditors trying to attach sovereign assets wherever they can.

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20. Alfaro et al., *supra* note 13, at 4.

21. *Id.*

22. Anne Krueger, First Deputy Managing Director, Int'l Monetary Fund, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), *available at* http://www.imf.org/external/np/speeches/2001/112601.htm.

A. The Absolute Theory of Foreign Immunity in Practice

Foreign immunity was said to be "absolute" in the nineteenth century and in the first half of the twentieth century.[23] This meant that debtor nations enjoyed complete foreign immunity and that creditors could not sue to enforce repayments.[24] Therefore, in theory, the lack of a bankruptcy regime for sovereign debtors was mitigated by "absolute" foreign immunity. The rationale was that foreign immunity guaranteed equality for sovereign nations in the international community: "legal persons of equal standing cannot have their disputes settled in the courts of one of them."[25]

The Supreme Court of the United States adopted this view in 1812 in *The Schooner Exchange v. McFaddon*.[26] The Court held that "the sovereign power of the nation is alone competent to avenge wrongs committed by a sovereign, that the questions to which such wrongs give birth are rather questions of policy than of law, [and] that they are for diplomatic, rather than legal discussion . . . ."[27] Therefore, creditors used to appeal to the President of the United States to enforce repayments from defaulting sovereign debtors.[28]

In practice, foreign immunity encompassed two principles—immunity from suit, and immunity from execution.[29] Immunity from suit means that creditors cannot sue a debtor nation in court.[30] On the other hand, immunity from execution meant that should a court enter a judgment against a sovereign nation (if the sovereign actually consented to being sued, for example when it agreed to waive its immunity in a contractual clause), the court would not be able to attach the sovereign's assets within its jurisdiction.[31]

Jonathan Blackman, a renowned litigator on behalf of sovereign debtors, distinguishes these two principles by explaining that immunity from suit derived from the notion that a sovereign "should not be made to suffer the indignity of being haled into court against its will," whereas immunity from execution originated from "long-standing concerns about the disruptions and political ramifications that can result from the seizure of a foreign state's property."[32]

Courts have dealt with issues of immunity from execution, especially when foreign immunity eroded to a restrictive approach.

B. Restrictive Immunity: The Birth of the Holdout Problem

After the Second World War, jurisdictions throughout the world

23. Panizza et al., *supra* note 11, at 653.
24. *Id.*
25. *Id.*
26. The Schooner Exch. v. McFaddon, 11 U.S. (7 Cranch) 116 (1812).
27. *Id.* at 146.
28. Hays, *supra* note 6, at 910.
29. Blackman & Mukhi, *supra* note 10, at 48.
30. *Id.*
31. *Id.*
32. *Id.*

started to endorse the "restrictive" theory of foreign immunity.[33] This shift is evidenced by the U.S. State Department's 1952 Tate Letter, the 1972 European Convention on State Immunity, the 1976 U.S. Foreign Sovereign Immunities Act (FSIA), and the United Kingdom's 1978 State Immunities Act.[34]

In the United States, the change was in part the result of the Cold War.[35] In effect, the United States was reluctant to grant foreign immunity to Soviet companies operating in the United States.[36] In the 1952 Tate Letter, named for U.S. State Department's Acting Legal Adviser Jack B. Tate, the U.S. State Department declared that states were not "immune with respect to claims arising out of activities of the kind that may be carried on by private persons."[37] However, because political considerations often guided the U.S. State Department's interpretation of the Tate Letter,[38] the United States "officially" adopted the restrictive approach when Congress enacted the FSIA in 1976, allowing creditors to sue a sovereign debtor in U.S. courts if the complaint was related to a "commercial activity."[39]

In connection with sovereign debt litigation, the Supreme Court later held that issuing bonds in the United States constituted a commercial activity.[40] Justice Scalia, writing for a unanimous court, held that "the foreign sovereign's actions are 'commercial' within the meaning of FSIA" when "a foreign government acts, not as a regulator of a market, but in the manner of a private player within it."[41]

As a result, creditors could attempt to argue for repayment from sovereign debtors, and landmark cases such as *Elliott Associates v. Banco de la Nacion (Peru)* exemplified this new possibility.[42] In *Elliott Associates*, Elliott Associates, a hedge fund, acquired debt guaranteed by the Peruvian government, at a large discount, just prior to Peru's 1996 Brady Deal.[43] Elliott obtained a prejudgment attachment order against Peruvian assets that were used for commercial purposes in the United States as well as a $57 million

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33. Panizza et al., *supra* note 11, at 653.

34. Ros, *supra* note 12, at 24.

35. Panizza et al., *supra* note 11, at 653.

36. *Id.*

37. Alfaro et al., *supra* note 13, at 20.

38. *Id.*

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

40. Republic of Arg. v. Weltover, Inc., 504 U.S. 607, 617 (1992).

41. *Id.* at 614.

42. Panizza et al., *supra* note 11, at 657. *See generally* Elliott Assocs., L.P. v. Banco de la Nacion, 194 F.R.D. 116 (S.D.N.Y. 2000) (giving the background for the series of judgments in the *Elliott Associates* case).

43. In the 1980s, Nicholas Brady, the U.S. Treasury Secretary, announced a plan to "securitize" sovereign debt. Before that plan, banks mainly owned sovereign debt obligations. The so-called "Brady Plan" meant that these loan obligations (largely bank-owned) were converted into bonds to be pooled together and sold in the secondary markets. The idea was to ensure repayment by troubled debtor nations so that banks could exit the market for sovereign loans. Jill. E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1067 (2004).

judgment against Peru.[44] Elliott then convinced a Brussels appellate court to order Euroclear, a payment provider,[45] to suspend payments on Brady bond interest payments.[46] Consequently, Peru decided to settle with Elliott Associates for $56.3 million rather than continue to litigate.[47]

This case created a great deal of controversy, as some commentators feared that holdout creditors (such as Elliott Associates) would ask courts to block payments agreed to as part of a debt restructuring and therefore create a "seemingly formidable obstacle to orderly sovereign debt restructurings."[48] Even though the legal argument that Elliott Associates used to convince the Belgian court has not proved effective in subsequent litigation,[49] the outcome of the *Elliott Associates* case provided great incentives for holdout creditors to sue sovereign debtors. In the case of Greece, should it default, some have also argued that creditors, including "vulture funds,"[50] could bring civil claims against Greece and cause another holdout problem.[51] "A sovereign debt crisis can be a painful experience for both the debtor and its creditors; a mismanaged sovereign debt crisis can be a catastrophically painful experience."[52]

However, the issue of attachment of sovereign assets still remains unresolved for holdout creditors.[53] Although U.S. and European jurisdictions have been able to enforce their decisions by attaching government revenues or other payments that pass through the United States or

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44. Panizza et al., *supra* note 11, at 657.

45. Euroclear is a provider of post-trade services. They help their clients "to settle domestic and cross-border securities transactions and safekeep their investments." *About Euroclear*, EUROCLEAR, http://www.euroclear.com (last visited Apr. 3, 2012).

46. Panizza et al., *supra* note 11, at 657.

47. *Id.*

48. *Id.* at 658.

49. In effect, Elliott convinced the court to adopt a broad interpretation of the "*pari passu* clause" in the debt contract. More conventional interpretations of such clauses have prevailed and now Elliott's interpretation is being challenged in court and by legal scholars. *Id.* A *pari passu* clause "prevents the borrower from incurring obligations to other creditors that rank legally senior to the debt instrument containing the clause." Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 872 (2004) (discussing how *pari passu* clauses evolved and their use in sovereign debt contracts). For example, in *LNC v. Nicaragua*, the Belgian Court of Appeals held that the *pari passu* clause did not give the creditor, LNC, the right to attach payments channelled through Euroclear because Euroclear was not a party to the contract in which the *pari passu* clause arose. Panizza et al., *supra* note 11, at 658.

50. *See* Philip Aldrick, *Vulture Funds to Profit From a Second Greek Bailout*, TELEGRAPH (June 25, 2011), http://www.telegraph.co.uk/finance/financialcrisis/8598657/Vulture-funds-to-profit-from-a-second-Greek-bailout.html.

51. Ros, *supra* note 12, at 52–53 ("Under current Greek statutory and case law, a creditor of Greece who receives a haircut on his bond based on a restructuring or a default, could bring a lawsuit in Greek courts and, if the creditor were to prevail, he could attach Greek municipal fees and taxes.").

52. Lee C. Buchheit & G. Mitu Gulati, *How to Restructure Greek Debt* 7 (Duke Law Scholarship Repository, Working Paper No. 47, 2010), *available at* http://scholarship.law.duke.edu/faculty_scholarship/2336.

53. Panizza et al., *supra* note 11, at 659.

Europe,[54] holdout creditors usually face difficulties attaching sovereign assets. Legal breakthroughs, such as in *Elliott Associates*, remain the exception rather than the rule. For example, Belgium changed its national law after Elliott Associates succeeded in attaching Peruvian payments that passed through the Euroclear system.[55] Economic research has also found that the "vulture regime" is "very weak" when it comes to enforcing repayment of sovereign debts.[56]

Therefore, we might wonder why creditors lend money to sovereigns when it is so difficult to enforce their claims. Additionally, we might also wonder how it was possible that sovereign debt existed when "absolute" foreign immunity was in place.

II. Lessons from the Past and Economics: Foreign Immunity Cannot Protect Debtor Nations

The evolution from complete sovereign immunity to a restrictive approach no longer protects sovereign debtors from suits. Even given foreign immunity, however, debtor nations would not necessarily enjoy any effective protection for two reasons. First, when foreign immunity was absolute, creditors enforced their claims via different mechanisms that went beyond any foreign immunity protection. Second, economics literature has analyzed the economics of sovereign debt and has argued that other incentives lead debtor nations to repay their debt, meaning that foreign immunity is not a truly critical, nor meaningful, concept in the sovereign debt context.

A. How Creditors Have Historically Circumvented Foreign Immunity

The Gold Standard period, from 1880 to 1914,[57] is particularly interesting because it was an era of "high bond finance."[58] Firms financed their investment projects through debt such as bonds.[59] European countries, as well as Central and South American countries, widely issued sovereign debt.[60] This debt was primarily issued in the London Stock Exchange, and creditor countries came primarily from Western Europe (led by Great Britain).[61] The United States also became a major creditor nation later in the

54. These assets or payments were oil sales, VAT payments, landing fees from U.S.-based airlines, and privatization revenues. Alfaro et al., *supra* note 13, at 3.

55. *Id.* at 26.

56. *Id. See also* Panizza et al., *supra* note 11, at 653; Ros, *supra* note 12, at 25.

57. We call this period the "gold standard" because it was the dominant monetary system at that time, i.e., the standard economic unit of account was a fixed mass of gold. *See* The Concise Encyclopedia Econ., http://www.econlib.org/library/Enc/GoldStandard.html (last visited Apr. 3, 2012).

58. Kris James Mitchener & Marc. D. Weidenmier, *Supersanctions and Sovereign Debt Repayment*, 3 (Nat'l Bureau of Econ. Research, Working Paper No. 11472, 2005), *available at* http://www.nber.org/papers/w11472.

59. *Id.*

60. *Id.*

61. *Id.*

twentieth century and started representing its citizen-creditors on the international scene.[62]

At that time, creditor nations used various coercive mechanisms to regulate sovereign debt and to enforce debt repayment claims. First, these creditor nations used their militaries to enforce repayment of sovereign debt. Second, creditor nations also sought to "administer" the public policy of these sovereign debtors, a practice which some historians and economists have referred to as "house arrest."[63]

1. *Gunboat Diplomacy*

During the Gold Standard period, many Western countries used military might to force sovereign debtors to repay their debt. Perhaps the most salient example of "gunboat diplomacy" is Great Britain and Germany's intervention in Venezuela in 1902. In 1902, British and German warships attacked Venezuela's coastal fortifications until Venezuela repaid its debt to British and German citizens.[64]

Creditor countries viewed this type of action as justified by public international law. One of the canons of public international law was that "a state had a legitimate interest in seeing that its subjects were not mistreated by foreign states."[65] Creditor countries, such as Great Britain, interpreted this principle to find "mistreatment" whenever a sovereign debtor did not repay its debt to a creditor state's citizen.[66]

Similarly, the United States led military interventions in debtor countries such as Cuba, Haiti, Honduras, Nicaragua, the Dominican Republic, and Panama.[67] Debt collection and investment protection were major factors leading to U.S. military intervention in these countries.[68] The famous "Rule of March 3, 1922" stated that the Executive Branch of the U.S. Government should supervise loans made by private investors to foreign governments.[69]

However, these "super-sanctions" were less common in the twentieth century. In 1907, the Drago Doctrine, named for the Argentine jurist Luis Drago, expressed the view that public debt should not give rise to military occupation of debtor countries.[70] This view spread in the international community, as well as in the United States where newly elected President Franklin D. Roosevelt ended the "Rule of March 3, 1922" when he declared

62. Ros, *supra* note 12, at 12.
63. Mitchener & Weidenmier, *supra* note 58, at 6.
64. Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 CHI. J. INT'L L. 333, 336 (2005).
65. *Id.* at 335.
66. For example, in 1848, the British representative to foreign states contended in a circular that the British government was legally entitled to "interfere authoritatively" in support of "the unsatisfied claims of British subjects who are holders of public bonds and money securities" to foreign sovereigns. *Id.* at 335–36.
67. Faisal Z. Ahmed et al., *Lawsuits and Empire: Enforcement of Sovereign Debt in Latin America*, 73 LAW & CONTEMP. PROBS. 39, 41 (2010).
68. *Id.* at 41. *See also* Alfaro et al., *supra* note 13, at 10–12.
69. Buchheit, *supra* note 64, at 337.
70. *Id.*

that the Executive Branch should no longer be involved in settlement negotiations of private loans to foreign governments.[71] At that time, sovereigns were becoming progressively less immune to legal actions.[72]

2. *House Arrest*

The practice of "house arrest," the foreign administration of a debtor country's internal affairs, also shows that foreign immunity has never provided effective protection. This form of "super-sanction" was common during the Gold Standard period.

The United States, under its foreign policy initiative known as "Dollar Diplomacy," directly and indirectly administered governments of debtor countries. The practice of "controlled loans" obligated debtor countries to turn over tariff collection to the United States should the debtor sovereign default on its loan.[73] Other U.S. loans led to, for example, a 3% export tax in Honduras in 1926 to repay the National City Bank of New York and the appointment of a team of U.S. advisors to administer Bolivia's financial affairs.[74]

The United States practice of "house arrest" also took more indirect forms. For example, U.S. State Department representatives lobbied the Colombian government in 1923 to enact tax collection and public administration reforms.[75] This led the Colombian government to enact reforms, and U.S. State Department representatives oversaw their implementation.[76]

Western European countries also engaged in "house arrest" practices, such as when Great Britain and France administered the governments of Egypt, Greece, and Turkey in the early twentieth century. Egypt ceded authority to the British administration to decrease its debt ratio and improve its tax structure.[77] The British administration implemented a new tax collection system and "restored fiscal discipline."[78]

A committee of foreign bondholders administered customs collection and controlled the finances after defaults in Greece and Turkey.[79] In Greece, the financial commission brought fiscal reform to the country, which increased its borrowing power.[80] France and Germany negotiated deals with Turkey to invest in railroad building.[81] However, these improvements had a cost—the government of Egypt was placed under "house arrest" for thirty-two years, Greece for fifteen years, and Turkey for thirty-one years.[82]

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71. *Id.*
72. Ros, *supra* note 12, at 15.
73. Ahmed et al., *supra* note 67, at 40.
74. *Id.* at 41.
75. *Id.* at 40.
76. *Id.*
77. *See* Mitchener & Weidenmier, *supra* note 58, at 19.
78. *Id.*
79. *Id.*
80. *Id.* at 20.
81. *Id.*
82. *Id.*

Therefore, private creditors were able to circumvent the foreign immunity protection thanks to "super-sanctions" levied by their home countries. This practice was quite common. During the Gold Standard period, gunboat diplomacy and house arrests were used in twelve out of forty-three sovereign defaults (or 28% of all defaults during that period).[83] The average length of control by foreign powers was approximately 11.25 years.[84] "For every year a country was in default, there was more than a one in four chance that it would be subjected to military intervention by a creditor nation or the establishment of an international financial council that administered various aspects of the debtor's finances."[85]

It is therefore apparent that sovereign immunity has not been effective to truly protect sovereign debtors. During the recent crisis, it is interesting to note that some form of "house arrest" has reappeared via the significant changes in the governments of Greece and Italy, even if these are not directly controlled by foreign powers.[86] Given the past result of prolonged foreign administration, it does not appear that this is the ideal solution.

B. Sovereign Debt in Economic Literature: Why Sovereigns Have Incentives to Repay Their Debt

In addition to "super-sanctions," economists have found other reasons why sovereign debtors would be willing to repay their debt. This section discusses the major factors economists have identified to explain the economic incentives that apply to debtor nations. These factors include access to a debt market, borrowing costs, trade reductions, and domestic costs.

However, some of these findings have been much debated in the economic field and remain unsettled.[87] Also, one factor alone may not be sufficient to explain why a sovereign will not default. Therefore, we should view these principles as complementary. Consequently, the sovereign debt market does not require foreign immunity protection because it provides creditors with influence and power that are more indirect than the "super-sanctions" as discussed earlier in this Note.

Economics literature has found that four factors affect the consequences of a sovereign default and explain why a sovereign debtor has incentives to avoid default: decreased access to the sovereign debt market, increased costs of borrowing, reductions in trade, and domestic costs on the defaulting sovereign debtor.

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83. *Id.* at 7.

84. *Id.*

85. *Id.*

86. *See* Rachel Donadio & Elisabetta Povoledo, *Berlusconi Steps Down, and Italy Pulses With Change*, N.Y. Times (Nov. 12, 2011), http://www.nytimes.com/2011/11/13/world/europe/silvio-berlusconi-resign-italy-austerity-measures.html; Elinda Labropoulou & Andrew Carey, *Greek Prime Minister Set to Resign*, CNN (Nov. 9, 2011, 1:11 PM), http://money.cnn.com/2011/11/09/news/international/Papandreou_to_resign.cnnw/index.htm.

87. *See generally* Panizza et al., *supra* note 11.

1. *Access to the Debt Market*

First, some economists have found that, in general, a capital market exclusion follows a sovereign default.[88] International capital market exclusions have occurred in the past. For example, British creditors formed the Corporation of Foreign Bondholders (CFB) in 1868.[89] The CFB played a role in denying countries with a poor credit reputation access to capital markets.[90] It achieved this goal by publishing economic data on sovereign debt burdens and tax revenues "to discourage investment in countries that did not repay their debt."[91]

If "access" to international capital markets is understood to mean sovereigns issuing bonds or banks borrowing in international markets, defaulting countries in the 1980s were excluded from international capital markets for an average period of four years after their default ended.[92] Some economists have found five-and-a-half year exclusion periods with broader definitions of "access."[93] In the mid-term (i.e., five to ten years), a renewed access to capital markets followed most sovereign defaults.[94] Therefore, capital market exclusions cannot entirely explain the sovereign debtors' economic incentives to repay.[95]

2. *Cost of Borrowing*

When a sovereign debtor defaults on its debt, it will typically face an immediate rise in borrowing costs. In effect, economists have found that spreads[96] of a defaulting country are about 400 basis points[97] higher in the first year after the default occurs.[98]

However, these effects on borrowing costs are not permanent. "Defaults do not seem to affect borrowing costs in a way which is both long-lived and quantitatively important."[99] Rather, the rise of borrowing costs has short-term effects and economists have not found that sovereign defaulters sustain large "output" costs.[100] For example, during the 1997–2004 period, the 400-basis-point increase fell to 250 basis points in

88. *Id.* at 675.
89. Mitchener & Weidenmier, *supra note* 58, at 4.
90. *Id.*
91. *Id.*
92. Panizza et al., *supra* note 11, at 675.
93. Some used the definition of "positive net transfers." *Id.* at 676.
94. "Almost all countries that defaulted in the 1980s regained international capital market access in the 1990s." *Id.*
95. *Id.*
96. Spreads represent the difference between the bid and the ask price of a security or asset. *Spread Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/spread.asp#ixzz1jj9S9rfN (last visited Jan. 21, 2012).
97. A basis point is the equivalent of 0.01%. *Basis Point Definition*, INVESTOPEDIA, http://www.investopedia.com/search/default.aspx?q=basis%20point#axzz1rXsBj3lL (last visited Apr. 9, 2012).
98. Panizza et al., *supra* note 11, at 677.
99. *Id.*
100. *Id.*

the second year and "los[t] statistical significance, and quickly decline[d] further."[101]

Therefore, the rise of borrowing costs partially explain why sovereign debtors would want to repay their debt, but the incentive is only strong in the short-term.

3. *Trade Reductions*

Often times, sovereign defaults have been followed by a decline in trade flows. For the purpose of this discussion, a trade flow is a commercial exchange between sovereign debtors and other countries. Although some economists have found that during the Gold Standard period there was no correlation between bilateral trade flows and sovereign default,[102] other economists have found a correlation. For example, Andrew K. Rose found in 2005 that debt renegotiations under the Paris Club[103] procedures were associated with a decline in bilateral trade of approximately 8% a year.[104]

Although there is much debate among economists about how long these trade reductions last, there is consensus about the fact that defaults are costly for export-oriented industries.[105] Also, there is empirical evidence showing that higher levels of bilateral lending lead to higher levels of bilateral trade flows.[106] As a result, some economists have found indirect support for the thesis that a sovereign default has an impact on bilateral trade flows.[107]

4. *Domestic Costs*

Domestic costs are another strong factor that explain why sovereign debtors prefer to repay their debt. For the purpose of this discussion, domestic costs are the political cost to governments and their officials and the economic impact on domestic growth.[108] Some economists have found, based on empirical evidence, that sovereign defaults can make economic crises worse and cause output losses.[109]

In effect, a sovereign default increases the risk of capital flight and runs on banks.[110] For example, Argentina in 2002 and Brazil in 1999 both faced a currency crisis.[111] Argentina defaulted on its debt whereas Brazil

101. *Id.*
102. In effect, it seems that creditors rather used the "super-sanctions" as described earlier in this Note. *See supra* Part II.A.
103. The Paris Club is "an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries." CLUB DE PARIS, http://www.clubdeparis.org (last visited Jan. 22, 2012).
104. Panizza et al., *supra* note 11, at 678.
105. *Id.* at 679.
106. Bilateral trade flows mean the trade flows between a sovereign debtor and the country in which the creditors reside. *Id.*
107. *Id.*
108. *Id.* at 679–80.
109. *Id.* at 680.
110. *Id.*
111. *Id.* at 680 n.45.

did not.[112] As a result, these two countries faced different economic consequences.[113] In Argentina, Foreign Direct Investment (FDI)[114] collapsed, whereas it remained stable in Brazil; this explains why Argentina experienced much more economic trouble than its neighbor.[115] Some economists associated a fall in FDI with defaults in a debtor country.[116] More particularly, this reduction in FDI flows was "concentrated in flows originating in creditor countries."[117] Economists have designed economic models to explain that defaults reveal information about the institutions and "structural characteristics" of a sovereign debtor, thus having an effect on the confidence of investors.[118]

From a more practical perspective, the recent debt crises in Greece and in other countries from the Eurozone, such as Italy and Spain, show that the risk of default puts great pressure on government officials.[119] This political pressure can be such that government officials can be replaced when their reputation is effectively undermined.[120] Therefore, countries repay their debt partially because of the political costs incurred by government officials, although economists have not yet found a definite link between sovereign defaults and political careers of the government officials in these countries.[121]

These different factors explain why even foreign immunity, when it was absolute, was not enough to protect sovereign debtors and their creditors. Although some of the methods described have been effective in the past to make sovereigns repay their debts,[122] the international community will probably not endorse principles such as military intervention or long-term fiscal control whenever a sovereign debtor defaults on its debt.[123] Economists have tried to explain why sovereigns want to repay their debt, but these incentives do not answer the question of what happens if sovereigns simply cannot pay. Where the money is not available, incentives cannot work. In 2011, Japan's public debt amounted to 208.20% of its Gross Domestic Product (GDP), and France's amounted to 85.50%.[124] The U.S.

112. *Id.*

113. *Id.*

114. Foreign Direct Investment refers to an "investment made by a company or entity based in one country, into a company or entity based in another country." *Foreign Direct Investment Definition*, Investopedia, http://www.investopedia.com/terms/f/fdi.asp#axzz1r0KkAxaS (last visited Apr. 3, 2012).

115. Panizza et al., *supra* note 11, at 680 n.45.

116. *Id.* at 680.

117. *Id.*

118. *Id.* at 681.

119. *See* Donadio & Povoledo, *supra* note 86; Labropoulou & Carey, *supra* note 86.

120. *See* Donadio & Povoledo, *supra* note 86; Labropoulou & Carey, *supra* note 86.

121. *See* Panizza et al., *supra* note 11, at 682.

122. *See id. See generally* Alfaro et al., *supra* note 13.

123. Alfaro et al., *supra* note 13, at 6; *see, e.g.*, UN Charter art. 1, ("The Purposes of the United Nations are [t]o maintain international peace and security . . . ."), *available at* http://www.un.org/en/documents/charter/chapter1.shtml.

124. *Country Comparison: Public Debt*, Cia Factbook, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2186rank.html (last visited Nov. 12, 2012).

public debt was 100.31% of the GDP in September 2011.[125] These figures, and corresponding figures for other nations, raise concerns about the risk that sovereigns will not repay all or some of their debt.

The "super-sanctions" guaranteed repayment of sovereign debt, but appear to be politically unacceptable at the present time. In addition, the current legal framework is not satisfying because it fosters the holdout problem caused by potential litigators.

Countries that are unable to repay their debt cannot wait for a miracle, because the situation may well deteriorate further. Defaulting countries may suffer from foreign administration of their economies for years, if not decades. They will pay higher interest rates on their public debt, and the austerity plans they will be forced to adopt may further stunt economic growth.[126] At worst, major conflicts can arise from future sovereign defaults; we have seen that creditors' home countries have used military force to assure repayment from sovereign debtors.

III. The Sovereign Bankruptcy Regime as the Best Equivalent of Foreign Immunity

Because the current legal framework does not sufficiently protect sovereign debtors and creditors, as argued above, this Part will highlight the main principles of a sovereign bankruptcy regime that should be designed and implemented at the international level, borrowing examples from recent proposals made by scholars and international organizations.

A. The Current Framework Is Not Sufficient

The current framework for debt restructuring is insufficient to protect sovereign debtors and their creditors. The contractual approach currently in force and the international institutions that once renegotiated debt agreements for sovereigns have both proved incapable of resolving the current international debt crisis.

1. *The Inefficiency of the Current International Institutions*

In the past, the Paris and London Clubs resolved international sovereign debt crises. The Paris Club met with sovereign debtors and their sovereign lenders to find a solution, while the London Club brought together defaulting sovereign debtors and their international bankers.[127] However, these "non-institutions"[128] would not solve the situation today because

125. YCHARTS, http://ycharts.com/indicators/us_public_debt_gdp (last visited Jan. 21, 2012).

126. *EU Forecasts 4.4% Slide in 2012 Greek GDP*, EUBUSINESS (Feb. 23, 2012), http://www.eubusiness.com/news-eu/eurozone-growth.fd6.

127. FRANÇOIS GIANVITI ET AL., A EUROPEAN MECHANISM FOR SOVEREIGN DEBT RESTRUCTURING CRISIS RESOLUTION: A PROPOSAL, BRUEGEL 7 (Nov. 9, 2010), *available at* http://www.bruegel.org/publications/publication-detail/publication/446-a-european-mechanism-for-sovereign-debt-crisis-resolution-a-proposal/.

128. A former Secretary of the Paris Club, Mr. De Fontaine Vive, has referred to such entities as "non-institutions." Ann Pettifor, *Just as in Kosovo*, HENCICLOPEDIA, http://

most of the public debt is in the form of government bonds, especially in the Eurozone.[129] It will be much more costly to reach a consensus by utilizing these institutions because there are many more investors.[130]

Moreover, the Paris Club's debt-revision procedures created informal priority rules among creditors of sovereign debt:[131] "The priority traditionally granted to creditors like the IMF, the World Bank, and other multilateral development banks . . . is almost always respected . . . ."[132] Informal rules of this type have been much criticized because they increase the risk of disorder when debtors seek to restructure a debt agreement due to the lack of transparency and enforceability of such rules.[133] Also, creditor-investors cannot easily anticipate what will happen to their debt holdings in the event of a default,[134] meaning that they will be more reluctant to invest and lend money to sovereigns.[135] Therefore, the international institutions already in place have failed to respond to the current debt crisis.

2. *The Drawbacks of the Current Contractual Approach*

The current system that the international community endorses is essentially contractual and relies on Collective Action Clauses (CACs). CACs are clauses in debt contracts that permit a "supermajority" of creditors (as opposed to unanimity) to amend terms of sovereign bonds in a debt-restructuring process.[136] For example, English law bonds typically have a two-thirds voting requirement.[137]

The main purpose of CACs is to avoid the holdout problem discussed earlier, as a majority of creditors can force a minority of creditors (presumably the "holdout" creditors) to accept a debt restructuring.[138] Creditors thus have greater leverage to negotiate debt-restructuring agreements.[139] Therefore, CACs are now quite common in debt agreements.[140]

However, CACs have been ineffective in protecting sovereign debtors and their creditors for several reasons. First, CACs constitute what some scholars call a "private market solution,"[141] meaning these clauses work

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www.henciclopedia.org.uy/autores/AnnPettifor/JustKososvo.htm (last visited Jan. 21, 2012).

129. Gianviti et al., *supra* note 127, at 7.

130. *Id.*

131. Jurgita Grigienë & Akvilë Mockienë, *Can a Sovereign State Declare Bankruptcy?*, 3 Baltic J. L. & Pol. 125, 131 (2010).

132. Nouriel Roubini & Brad Setser, Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies 250 (2004).

133. *See* Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 Emory L.J. 1119, 1121–22 (2004).

134. *See id.*

135. *See id.*

136. *See* Ros, *supra* note 12, at 17.

137. *Id.* at 18.

138. *Id.* at 17.

139. *Id.* at 19.

140. *Id.*

141. *See* Steven L. Schwarcz, *Sovereign Debt Restructuring Options: An Analytical Comparison*, 2 Harv. Bus. L. Rev. (forthcoming 2012) (manuscript at 7), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1872552.

only on an agreement-by-agreement basis.[142] To explain this argument, Professor Schwarcz uses the example of Argentina's default during the 2001 debt restructuring.[143] In 2001, Argentina had 152 types of bonds, issued in seven different currencies and governed by the laws of eight different countries.[144] The result was that failure to approve the debt-restructuring plan in one agreement made disagreeing parties holdout creditors.[145] This is precisely what happened to Argentina in 2001, when several individual investors and hedge funds refused the restructuring proposal and chose to litigate despite the fact that 70% of bondholders had already agreed to the proposal.[146]

According to Professor Scott, "[t]he insertion of collective action clauses in sovereign bonds is an exercise in futility . . . ."[147] This problem is linked to the potential conflicts of interest among creditors, because holders of different financial instruments have different interests.[148] For example, holders of longer-maturity debt want immediate acceleration of their debt, while holders of short-term debt do not.[149]

A second argument against CACs comes from economics literature. Some economists have found that leaving sovereign debtors free to include clauses similar to CACs in their debt is inefficient.[150] These economists call for public intervention that will encourage debt-restructurings through tax incentives or subsidies.[151] Other economists have studied bond yields[152] to show that it is difficult in practice to distinguish between bonds that have CACs and bonds that do not.[153] As a result, CACs tend to make the legal framework more obscure for creditors, making it more costly for debtors and creditors to negotiate debt-restructuring agreements.[154]

A final argument against CACs is more practical. Sovereign financing agreements do not always include CACs.[155] For example, during Greece's

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142. *Id.* at 17.

143. *Id.* at 18 n.85.

144. *Id.*

145. *Id.* at 18.

146. *Id.* at 17 n.84. *See* Gianviti et al., *supra* note 127, at 14.

147. Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 Int'l L. 103, 129 (2003).

148. Gianviti et al., *supra* note 127, at 15.

149. Int'l Monetary Fund, *Proposed Features of a Sovereign Debt Restructuring Mechanism* 12 (Feb. 12, 2003) (Working Paper, 2012), *available at* http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf.

150. *See, e.g.*, Patrick Bolton & Olivier Jeanne, *Structuring and Restructuring Sovereign Debt: The Role of a Bankruptcy Regime* 6 (Int'l Monetary Fund Working Paper No. 07/192, 2007).

151. *Id.*

152. Bond yields constitute "the return an investor will receive by holding a bond to maturity." *Advanced Bond Concepts: Yield and Bond Price*, Investopedia, http://www.investopedia.com/university/advancedbond/advancedbond3.asp#axzz1jj9HRW91 (last visited Jan. 21, 2012).

153. Gianviti et al., *supra* note 127, at 27–28.

154. *See generally* Bolton & Jeanne, *supra* note 150; Gelpern, *supra* note 133.

155. *See* Stephen J. Choi et al., *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism* 2, 14 (John M. Olin

debt crisis, only Greek bonds issued under English law contained CACs,[156] whereas local law governed 90% of Greece's total debt stock.[157] Therefore, it is difficult to imagine a global solution since CACs do not apply in all situations, especially urgent ones such as the Greek debt crisis. The fact that the Greek government enacted new legislation to retroactively include CACs in Greek law bonds during the March 2012 restructuring offer[158] does not solve the problem because it raises issues of predictability as to whether the interest on these bonds will be paid and their principal reimbursed.[159]

Other types of clauses have been utilized to try to resolve the holdout problem, such as the *pari passu* clauses. *Pari passu* clauses guarantee that "all creditors can be regarded equally, and will be repaid at the same time and at the same fractional amount as all other creditors."[160] In practice, the sovereign debtor promises in the debt agreement that it will not subordinate the creditor to others.[161] However, recent litigation has called into question the scope of these clauses, which encourages holdout behavior.[162] For example, in Brussels, a court authorized the hedge fund Elliott Associates to recover funds from Peru based on an unconventional interpretation of a *pari passu* clause.[163]

Scholars disagree on the real meaning of *pari passu* clauses in the sovereign debt context.[164] In Professor Gelpern's words, "the clause is a blunt, unpredictable, and generally inadequate weapon to enforce intercreditor equity."[165]

In sum, the current legal framework is not satisfying as it does not sufficiently protect debtors and creditors. Current international institutions are not adequate to deal with the increasing number of creditors, and CACs may increase the holdout problem. *Pari passu* clauses have failed to address the problem and provide for equality among creditors because courts and scholars have been unable to come to a stable and consistent interpretation of such clauses.

Law & Econ. Working Paper No. 541, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1713914.

156. *Id.* at 14.

157. *Id.* at 13.

158. Ben Rooney, *Greece: Historic Restructuring Paves Way for Bailout,* CNN MONEY (Mar. 9, 2012), http://money.cnn.com/2012/03/09/markets/greece-creditors-default/index.htm.

159. *See infra* text accompanying notes 227–32.

160. *Pari Passu Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/p/pari-passu.asp#ixzz1jq1yn22w (last visited Jan. 21, 2012).

161. Gelpern, *supra* note 133, at 1135.

162. *Id.* at 1139.

163. *Id.* at 1136; *see also supra* text accompanying notes 43–47.

164. *See* Gelpern, *supra* note 133, at 1139.

165. *Id.* at 1140.

B. Why the Bankruptcy Regime is the Best Response to the Current Debt Crisis

Implementing a bankruptcy regime is the best response to the debt crisis that many sovereign debtors face. For a number of years, economists and legal scholars found justifications for a bankruptcy regime. Principles that are found in U.S. bankruptcy law are essential to protect both creditors and debtors, such as an automatic stay, a system of priorities among creditors, and the ability of a debtor to access priority financing.

1. *General Views on a Bankruptcy Regime*

Many scholars in the economics and legal literature have advanced strong arguments in favor of a bankruptcy regime for sovereign debtors. Among the advocates for a bankruptcy regime in the economics field, Patrick Bolton and Olivier Jeanne have claimed that enforcing a bankruptcy regime will lead to a more efficient and less costly debt-restructuring process.[166] The authors reasoned that individual lenders are able to make their debt harder to restructure, and therefore it will be more likely that sovereigns will repay this "hard debt" rather than debt which is easier to restructure ("good debt").[167] Therefore, a "hard debt" is de facto a senior debt (i.e., it has higher priority for the debtor).[168] Lenders can achieve this result in several ways, such as lifting sovereign immunity, insisting on a unanimity requirement for restructuring the debt, lowering the maturity of the debt, or inserting acceleration clauses.[169]

As a result, individual lenders will compete to avoid a selective default,[170] and this will make sovereign debt "excessively hard" to restructure from an ex ante perspective.[171] For that reason, a bankruptcy regime will be able to facilitate debt restructuring in a sovereign debt crisis.[172] "Selective default" is one of the main reasons economists have found the current framework unsatisfying because "sovereigns do not default in the same way on different classes of debt instruments and this selectivity generates an implicit seniority between debt classes."[173] Bolton and Jeanne support a bankruptcy regime that will put this implicit seniority to an end.[174]

166. Bolton & Jeanne, *supra* note 150, at 5.
167. *Id.*
168. *Id.*
169. *Id.* An acceleration clause is a "provision that allows a lender to demand payment of the total outstanding balance or demand additional collateral under certain circumstances, such as failure to make payments, bankruptcy, nonpayment of taxes on mortgaged property, or the breaking of loan covenants." *Acceleration Clause*, INVESTORWORDS, http://www.investorwords.com/36/acceleration_clause.html (last visited Jan. 21, 2012).
170. A selective default occurs when the sovereign debtor chooses to default on some debt classes whereas it will not default on some other debt classes. *See* Bolton & Jeanne, *supra* note 150, at 5.
171. *Id.*
172. *Id.*
173. *Id.* at 10.
174. *See id.* at 7–10.

In the legal literature, several scholars have criticized the absence of a sovereign bankruptcy regime at the international level. "The extraordinary aspect of state insolvency is that it operates in a legal vacuum without a bankruptcy law."[175] Therefore, many argue that a bankruptcy regime should be created to fill the current judicial gap,[176] and others suggest that implementing features of the U.S. bankruptcy framework would bring more certainty and order to the current debt restructuring structure.[177] Professor Schwarcz also argues that a statutory approach, similar to domestic bankruptcy statutes, will help to solve the holdout problem and the funding problem.[178]

Proponents of a bankruptcy regime have argued for some type of judicial forum that will have authority to decide issues during the debt-restructuring process.[179] For example, the IMF argued for a Dispute Resolution Forum (DRF) that will have "important rule-making authority with respect to claims administration and dispute resolution procedures."[180] An independent judicial body will be beneficial for both debtors and creditors. In effect, a court that has exclusive jurisdiction over all matters related to sovereign bankruptcy will provide enforceable restructuring agreements in all jurisdictions and act as a single entity that will interpret sovereign bankruptcy law.[181] Of course, this new judicial entity will require an independent body of judges.[182] This Note will not discuss the specifics of the independent forum, but other international tribunals, such as the International Court of Justice (ICJ) and the International Criminal Court (ICC), implement independence of their judges in their internal rules and could serve as guides.[183]

A bankruptcy regime will also require that countries adopt an international treaty that applies to as many jurisdictions as possible. Although it will probably take time for sovereign states to adopt this treaty, proponents from the IMF have argued that countries could amend the IMF's Articles to

175. Philip Wood, *State Insolvency: Bankruptcy Without a Bankruptcy Law*, ALLEN & OVERY (Jan. 19, 2009), http://www.allenovery.com/publications/en-gb/Pages/State-insolvency—bankruptcy-without-a-bankruptcy-law.aspxhttp://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=49910&prefLangID=410.

176. *See, e.g.*, Grigienë & Mockienë, *supra* note 131, at 131.

177. *See, e.g.*, Gelpern, *supra* note 133, at 1159 (arguing that a more transparent priority structure will facilitate debt restructuring).

178. The funding problem is about "enabling a sovereign debtor to obtain funding to pay critical expenses during the debt-restructuring process." Schwarcz, *supra* note 141, at 25.

179. *See id.* at 31.

180. Int'l Monetary Fund, *supra* note 149, at 16.

181. *See* ANNE O. KRUEGER, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 34 (2002).

182. *See* Int'l Monetary Fund, *supra* note 149, at 20.

183. *See generally Rules of Court*, Int'l Criminal Court, *Code of Judicial Ethics*, ICC-BD/02-01-05 (Mar. 9, 2005), *available at* http://www.icc-cpi.int/NR/rdonlyres/A62EBC0F-D534-438F-A128-D3AC4CFDD644/140141/ICCBD020105_En.pdf (setting guidelines for judges); INT'L CT. JUST., http://www.icj-cij.org/documents/index.php?p1=4&p2=3&p3=0 (last visited June 17, 2012).

achieve "universality in the absence of unanimity."[184] In theory, it would be effective upon all members of the IMF, which already constitute a majority of countries in the world. In the alternative, adopting an international treaty will facilitate enforcement of sovereign bankruptcy law because states signing a convention will be directly bound.[185]

Many commentators say that achieving an international system of bankruptcy is unrealistic given the extent of such an endeavor. The problem with this skeptical perspective is that it disregards reality. As we have seen earlier in this Note, an informal bankruptcy system is already in place.[186] Both sovereign debtors and creditors are suffering from this system, because it does not promote an orderly system of priorities and, therefore, encourages the "holdout problem."[187] Furthermore, this would not be the first time that an international framework of legal rules and a judicial forum with power to enforce those rules was created. The ICJ was established in 1945 by the United Nations (UN) Charter and has jurisdiction over all UN Members, 193 states in total.[188] More recently, the ICC was created in July 2002 when the Rome Statute came into force.[189] 121 states are parties to the ICC,[190] which can prosecute individuals for various crimes and has jurisdiction over individuals coming from all states parties.[191] Ratifying a treaty could lead to the creation of a sovereign bankruptcy court. The court may have jurisdiction over states parties, such as the ICJ, and over private parties, similar to the jurisdiction of the ICC.

To understand exactly what a bankruptcy regime would consist of, it is necessary to highlight the underlying principles of bankruptcy law that should be implemented at the international level to protect both sovereign debtors and their creditors.

2. *The Specifics of a Bankruptcy Regime: Principles that Should Protect Both Creditors and Sovereign Debtors*

Previous sections having explained why a bankruptcy regime is needed, this section will list several fundamentals of bankruptcy law implemented in jurisdictions such as the United States. These features would prove beneficial for debtors and creditors and improve the current situation. This section will also discuss proposals that legal scholars and international organizations such as the IMF make.

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184. KRUEGER, *supra* note 181, at 34.

185. *See generally* Schwarcz, *supra* note 141.

186. *See supra* Part III.A.2.

187. *See id.*

188. *History*, INT'L CT. JUST., http://www.icj-cij.org/court/index.php?p1=1&p2=1 (last visited Apr. 3, 2012).

189. *About the Court*, INT'L CRIM. CT., http://www.icc-cpi.int/Menus/ICC/aAbout+the+Court/ (last visited Apr. 3, 2012).

190. *The States Parties to the Rome Statute*, INT'L CRIM. CT., http://www.icc-cpi.int/Menus/ASP/states+parties/ (last visited Apr. 3, 2012). *Id.*

191. *Jurisdiction and Admissibility*, INT'L CRIM. CT., http://www.icc-cpi.int/Menus/ICC/About+the+Court/ICC+at+a+glance/Jurisdiction+and+Admissibility.htm (last visited Apr. 3, 2012).

a. An Automatic Stay on Enforcement

Automatic stays on a sovereign's debt would protect the sovereign and its creditors. An automatic stay is "[a]n injunction that automatically stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed."[192]

The debate over the implementation of a stay in the context of state insolvency is not recent. In 1944, John Maynard Keynes and Harry Dexter White, considered the founders of the Bretton Woods Institution, attempted to draft a stay provision for sovereign states in the IMF agreement, which was quite similar to the Chapter 11 stay in U.S. Bankruptcy law.[193] More recently, the IMF made a proposal named the Sovereign Debt Restructuring Mechanism (SDRM) that includes some form of an automatic stay.[194]

The main benefit of an automatic stay is that it promotes collective action by preventing creditors from bringing suit.[195] During debt restructuring negotiations, there is often a great risk that creditors will race to the courthouse because, individually, each creditor has an incentive to sue, anticipating that all other creditors will do the same.[196] This is known as the collective action problem. Imposing a stay on creditor litigation eliminates the race to the courthouse and remedies the collective action problem.

However, some in the IMF have proposed alternatives to the automatic stay on enforcement because, usually, a stay on enforcement includes a general cessation of payment to all creditors.[197] On that point, some proponents from the IMF have argued that a sovereign debtor should be able to exclude some claims from the restructuring agreement so that the debtor can address these claims separately.[198] Since a sovereign default always has an impact on financial and banking systems, as has been evident during the recent crisis,[199] a limitation on a stay on enforcement is desirable to the extent possible.

A stay on enforcement should apply only to those claims that are in the restructuring list of a sovereign debtor. Further, it is possible to supplement this feature by an ex post rule that would also protect creditors during negotiations. Some have proposed adopting a so-called "hotchpot rule."[200] According to this rule, "any creditor that had managed to partially satisfy its claim through a collection on a judgment after activation

192. *Glossary*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Glossary.aspx (last visited Mar. 19, 2012).
193. Wood, *supra* note 175.
194. *See* Int'l Monetary Fund, *supra* note 149, at 25.
195. *See* KRUEGER, *supra* note 181, at 37.
196. *Id.*
197. Int'l Monetary Fund, *supra* note 149, at 8.
198. *Id.*
199. *See Merkel: 50 Pct Haircut to Cut Greek Debt by 100 Bln Euros*, REUTERS (Oct. 26, 2011, 10:50 PM), http://www.reuters.com/article/2011/10/27/eu-greece-programme-idUSL5E7LR02120111027 [hereinafter Greek Haircut].
200. Int'l Monetary Fund, *supra* note 149, at 10.

but prior to the agreement would have the value of its claim reduced under the agreement in a manner that ensures that all of the benefits of its enforcement and collection had been neutralized."[201] Such a rule would make sure that an "aggressive litigant" would not harm creditors willing to negotiate.[202]

With the automatic stay, the debtor will enjoy absolute protection from its creditors. In turn, the creditors should be able to require the sovereign debtor to assure that the value of its assets will remain the same. In other words, the creditors should be able to ask for some form of "adequate protection," which is a fundamental principle of U.S. bankruptcy law.[203] For example, the sovereign may be required to assure that it will conduct "policies in a fashion that preserves asset values."[204]

b. An Order of Priorities Among Creditors

As suggested earlier, an informal priority system has developed in the context of sovereign debt.[205] For example, it is generally recognized under the Paris Club debt-revision procedures that sovereign debtors will pay the IMF first.[206] Furthermore, "[m]ost sovereigns do respect a number of informal rules, avoiding total chaos. The priority traditionally granted to creditors like the IMF, the World Bank, and other multilateral development banks (MDBs) is almost always respected . . . ."[207]

The IMF's SRDM proposal also included a formal system of priority among creditors by requiring the sovereign debtor "not to make payments to nonpriority creditors."[208] The only justification the IMF proponents found for this policy was that it would avoid "dissipation of resources that could be used to service the claims of relevant creditors in general."[209] However, there are many other reasons for imposing a formal system of priorities among creditors in sovereign bankruptcy.

Anna Gelpern, a scholar specializing in the field of sovereign bankruptcy and debt restructuring, has found four reasons explaining why a formal system of priorities will be more efficient than informal priorities. First, a formal system of priorities will bring more certainty to the current framework because, as discussed earlier,[210] creditors currently ignore the priority that will be assigned to their debt.[211] Second, a formal priority

201. *Id.*
202. *Id.*
203. In Chapter 11 of U.S. bankruptcy law, creditors are able to ask the debtor-in-possession to make periodic or lump sum cash payments, or provide an additional or replacement lien to protect the value of the creditor's interest. *See* 11 U.S.C. § 361 (2006).
204. KRUEGER, *supra* note 181, at 16.
205. *See* Gelpern, *supra* note 133, at 1122.
206. Grigienë & Mockienë, *supra* note 131, at 131.
207. ROUBINI & SETSER, *supra* note 132, at 250.
208. KRUEGER, *supra* note 181, at 16.
209. *Id.*
210. *See supra* Part III.A.2.
211. Gelpern, *supra* note 133, at 1130.

system will not be subject to each private creditor's approval.[212] Under the current system, a group of creditors will refuse to acquiesce to the priority of other creditors.[213] In that case, the holdout problem reappears and this can lead to the failure of any debt-restructuring agreement. In contrast, a formal system would impose priorities on private creditors to be enforced in court. Third, if a court enforces a formal system of priorities, a sovereign debtor will be bound to respect these priorities among creditors.[214] Otherwise, the sovereign debtor could persuade a creditor to lend extra money by assuring this creditor that it will have seniority on the repayment of its debt. The sovereign debtor could then lie to the new creditor, or the older creditors could be impaired because their claims will be "diluted" in the new debt, and they will therefore have a smaller chance of being repaid.[215] By binding debtors to a formal system of priorities, a sovereign bankruptcy court would prevent any misbehavior from debtors as well as any panic from creditors. Fourth, if a country encounters financial trouble an enforceable priority structure can quicken economic recovery—in the absence of such a structure, there is a risk that new creditors will ask for a harsh form of adequate protection, for example, by requesting a lien[216] to secure their claims.[217] Secured claims in sovereign bankruptcy is unsound because it results in seizing government assets.[218] This can impair the country's entire economy. Therefore, a court enforcing formal priorities will be able to limit grants of liens to creditors.

Concededly, political controversy will ensue with respect to the assignment of priorities. Some have even argued that a bankruptcy system will not be effective to achieve compliance with a formal order of priority.[219] However, we can advance some main principles that will govern the rules of the system of priorities. For example, we have seen that the recent Greek debt reduction imposed a debt-restructuring on the private sector (mainly banks) but not on the sovereign creditors.[220] Countries should have priority over private creditors as a matter of international comity and because of the potential impact of default on national economies. Further, domestic creditors should be given priority over foreign creditors, because defaulting on debt that the creditors' own citizens hold could lead to greater economic turmoil.[221]

Another counterargument is that, since they will now be aware of the risk of default, creditors will have fewer incentives to lend money to sover-

212. *Id.* at 1141.
213. *See id.*
214. *Id.* at 1145.
215. *Id.* at 1144 n.85.
216. "A lien is "[a]n interest in real or personal property which secures a debt; the lien may be voluntary, such as a mortgage in real property, or involuntary, such as a judgment lien or tax lien." *Glossary*, MORAN L., http://www.moranlaw.net/glossary.htm#Lien (last visited Jan. 21, 2012).
217. *See* Gelpern, *supra* note 133, at 1145–47.
218. *See id.* at 1147.
219. *See id.* at 1150.
220. *See* Greek Haircut, *supra* note 199.
221. Gelpern, *supra* note 133, at 1152.

eigns. This argument is, however, weak. Creditors still lend to corporations in spite of a corporate bankruptcy system,[222] and there is no evidence to suggest the same would not be true for sovereign nations. In the long run, by acknowledging the risk of default, a sovereign bankruptcy court will provide more incentive to creditors and sovereign debtors to be more reasonable in extending credit and borrowing money.[223]

Therefore, we can establish basic priority rules that are beneficial for a sovereign debtor and its economy. More complex priority rules will give rise to extended debate, but this discourse is the price to pay given the possibility that sovereign states may not repay some of their public debt. The 2011 and 2012 credit ratings downgrades that agencies such as Standard & Poor's publish unfortunately confirm this new phenomenon.[224]

c. Priority Financing

A bankruptcy regime should implement priority-financing procedures because they are essential for the sovereign debtor's economic recovery, especially considering the fact that a debt crisis and an economic crisis tend to occur at the same time. Priority financing is "new money from . . . creditors during the period of the stay."[225] In exchange, the new creditors will receive some form of priority on the new debt they extended to the sovereign debtor. Absent any kind of priority financing, "a sovereign debt crisis coupled with an exchange rate and banking crisis can result in substantially higher costs than a situation of financial distress for a corporation."[226]

In corporate bankruptcy law, priority financing (also called "DIP financing") helps preserve the "going-concern value of the firm."[227] Professor Schwarcz argues that only the statutory approach, and not the "free-market option" (i.e., the private contract clauses such as the CACs), can solve the "funding problem."[228] In a forthcoming article, he shows that private market solutions are not sufficient to encourage new-money lending[229] because of risks of change in national law on which the parties would rely.[230]

According to Patrick Bolton, a statutory approach will permit the connection of priority financing to a debt-restructuring agreement.[231] New creditors will have incentives to lend because their debt will have priority

222. *See generally* Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, 50 IMF ECON. REV. 41, 58 (2003).
223. *See id.* at 64.
224. Gerrit Wiesmann et al., *S&P downgrades France and Austria*, FT.COM (Jan. 14, 2012, 9:34 AM), http://www.ft.com/intl/cms/s/0/78bf6fb4-3df6-11e1-91f3-00144feabdc0.html.
225. KRUEGER, *supra* note 181, at 17.
226. Bolton, *supra* note 222, at 58.
227. *Id.* at 63.
228. *See* Schwarcz, *supra* note 141, at 25.
229. *See id.*
230. *Id.* at 26.
231. Bolton, *supra* note 222, at 64.

over older debt. This system could be similar to a Chapter 11 U.S. bankruptcy procedure, where "[m]ajor decisions such as new investment or asset sales and new debt issues are subject to court approval."[232]

Similarly, the IMF proposed that the SDRM would provide "assurance that any financing in support of the member's program [in the IMF] extended after the introduction of the stay would be senior to all preexisting private indebtedness."[233] However, the IMF focused solely on financing from the IMF in its proposal. Other financial institutions, such as the World Bank, should be involved in the priority financing procedure.

Conclusion

In conclusion, this Note argues that foreign immunity in sovereign debt has evolved into a restrictive approach that enables creditors to sue sovereign debtors. At the same time, sovereign creditors stopped using "super-sanctions" against debtors, such as "house arrest" and "gunboat diplomacy."

This Note argues that the absence of foreign immunity leads to a judicial gap, leaving sovereign debtors and their creditors unprotected. The holdout problem is such that sovereign debtors are unable to restructure their debt. Furthermore, the holdout problem can aggravate the current economic crisis, especially in the Eurozone. However, going back to the so-called "super-sanctions" is not a solution given the prolonged harshness of such methods.

For these reasons, the best solution is the creation of a bankruptcy regime. A similar form of "foreign immunity" could be enforced because it will protect sovereign debtors against suits from creditors via the automatic stay. Priority financing that an independent judicial forum approves and enforces will help solve the funding problem that many sovereign debtors have to deal with. The international community should view the current crisis as a unique opportunity to reform the sovereign debt system and, using ideas that have emerged in the past, provide a general framework that may be sustained in the future.

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232. *Id.* at 46.
233. KRUEGER, *supra* note 181, at 17.