
BUILDING A BETTER SEATING CHART FOR SOVEREIGN RESTRUCTURINGS

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INTRODUCTION: THE ODD WORLD OF SOVEREIGN DEBT

While it may cause a shuffle when dinner is served, open seating rewards guest initiative and relieves the host of some delicate advance planning. Seat assignments let the guest concentrate on the menu, albeit at the price of making small talk with the groom's favorite aunt.

In sovereign debt restructuring, open seating might have made sense in the 1980s, when negotiations were dominated by foreign commercial banks and government lenders who could often fit around one table. Today's sovereign creditors could fill a mess hall. Their diverse interests and expectations often trigger a last-minute scramble for advantage that delays resolution and leaves one wishing for a seating chart.

Argentina is a case in point. For over a year, Wall Street analysts have reported with alarm that the country's plans to restructure nearly \$100 billion

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in defaulted external debts would spare roughly \$80 billion in performing domestic and multilateral credits. They predicted that asking private external creditors to subsidize the rest would poison the atmosphere and prolong negotiations.¹ Late last spring further tensions emerged among private external creditors, as European retail investors organized to “balance” the power of U.S. institutions.²

Argentina is only the latest and most elaborate example of a recurring pattern. Reports of intercreditor battles in sovereign debt crises go back to the 1930s and likely beyond.³ Every single sovereign debt crisis of the past decade, in just about every part of the globe—including Ecuador, Nigeria, Pakistan, Russia, Turkey, and Ukraine—has wrestled with the problem of intercreditor equity. In many (arguably most) cases, emerging market governments have discriminated among creditor constituencies in ways that were hard to predict in advance and often were not revealed until after the decision to default or restructure had been made.

In this respect, a sovereign borrower is different from all others. When the borrower is a firm—or, for that matter, an individual or a local government—the problem of intercreditor equity is addressed in part through a system of bankruptcy priorities, which has no equivalent in sovereign debt. A firm’s debts are ranked in order of priority that is established by contract and statute. This ranking is known at borrowing, generally corresponds to the order of repayment in bankruptcy liquidation, and helps define the creditors’ relative bargaining power in reorganization. Combined with a judgment about the debtor’s liquidation value or repayment capacity, the priority ranking can help quantify a creditor’s recovery prospects if negotiations fail. The existence of a bankruptcy backstop also helps shape behavior outside bankruptcy. A priority structure that is beyond borrower discretion, clear *ex ante*, and

¹ See, e.g., EMERGING MARKETS ECON. DAILY (Credit Suisse First Boston), Mar. 7, 2003; EMERGING MARKETS ECON. DAILY (Credit Suisse First Boston), June 24, 2003; Republic of Argentina, Ministry of Economy and Production, Presentation to Consultative Working Groups Meetings 20 (Oct. 2003), available at http://www.infoarg.org/presenta/oct03/road_shoOc03lbw.pdf.

² See, e.g., Felix Salmon, *A United Stand for Retail Bond Investors*, EUROMONEY, June 2003, at 152. Since then, the bondholder groups have come together as the Global Committee of Argentina Bondholders (GCAB). This move may have been in part a response to Argentina’s repeated contentions that none of the bondholder groups was sufficiently representative of all bondholders to warrant its engagement. How the alliance will survive what are sure to be contentious negotiations with the borrower remains to be seen. See Press Release, Global Committee of Argentina Bondholders (Jan. 12, 2004), available at <http://www.tfargentina.it/download/GCAB-press-release120104.pdf>.

³ See Ernst H. Feilchenfeld, *Rights and Remedies of Holders of Foreign Bonds*, in 1 SYLVESTER E. QUINDRY, BONDS & BONDHOLDERS: RIGHTS & REMEDIES § 656 (1934).

enforceable ex post, gives creditors a good sense of where they stand relative to one another.

In the absence of a bankruptcy backstop, most debts of national governments rank as legally equal, or *pari passu*. This is true of debts owed to domestic and foreign private creditors, other governments, and international organizations such as the International Monetary Fund (IMF). Yet in practice, sovereignty uniquely empowers a government to choose the order of repayment among its creditors based on its political imperatives, financing needs, reputational concerns, or any other considerations.

Such power in the hands of the borrower has not led to complete chaos. Over time, patterns of treatment have come and gone, privileging some sovereign creditors while subordinating others; yet these “priority systems” have proven to be obscure and fragile. A creditor that finds itself subordinated involuntarily and contrary to expectations may sue; however, recovery would be uncertain, distant, and costly.

This dynamic has four related sets of implications. First, at the time creditors lend to governments, they do not know how they might fare, relative to the others, should the government default or restructure. One might expect creditors to charge extra for the possibility of being subordinated. Second, especially when lending to countries that have reached the limit of their repayment capacity, some creditors may gamble on diluting or subordinating other creditors. In this case, rather than lending against a country’s growth prospects, a creditor may count on effectively intercepting payments that might have gone to others. Third, instead of charging for the possibility of subordination or gambling on jumping the line, a creditor might literally try to secure its place in line for any eventual restructuring—refusing to lend except backed by collateral it controls.⁴ Fourth, after the government runs into financial trouble, the surprisingly open-ended competition for scarce cash flows among foreign, domestic, private, and official creditors may delay debt restructuring and, with it, economic recovery.

A transparent, enforceable priority system for sovereign debt could mitigate

⁴ I have heard this sentiment from several external creditors of Argentina in the aftermath of their effective subordination. See also Jeromin Zettelmeyer, *The Case for an Explicit Seniority Structure in Sovereign Debt* (Int’l Monetary Fund, Research Dep’t, Working Paper draft, Sept. 29, 2003). Zettelmeyer points to a range of contractual mechanisms to overcome the possibility of subordination. I discuss this line of argument in more detail *infra* pp. 1144-45, where I also discuss why secured lending is qualitatively different from the other mechanisms he lists.

each of these four concerns—reducing at once the risk of involuntary subordination, the attraction of lending to overindebted governments, and the need for collateral, and making restructuring less messy when all else fails. But an effort to imagine such a system shows both the utility and the limits of domestic bankruptcy as a source for policy solutions to sovereign debt crises. This Article suggests that while incremental improvement is possible and desirable, in the sovereign context, the most robust priority structures have disadvantages that often exceed their benefits.

In Parts I, II, and III of this Article, I briefly outline the treatment of priorities in national bankruptcy, highlight the constraints state sovereignty imposes on replicating this treatment for countries, and describe the informal priority systems that have developed in the context of state sovereignty. In Parts IV and V, I summarize the theoretical arguments for pursuing explicit and enforceable sovereign priorities and survey options for improving on the status quo. I conclude that options for making the system more transparent and predictable are limited.

Reducing uncertainty created by the lack of transparent, enforceable priorities in sovereign debt entails two challenges: establishing the content of a priority system and implementing it against the background of sovereign immunity. Options for content range from a comprehensive system that ranks government liabilities in advance and applies uniformly across countries, to one that leaves the ranking entirely up to the borrower, to be determined ad hoc in crisis. I suggest that a comprehensive, uniform system is impractical and potentially counterproductive. Moreover, any substantive hierarchy of claims imposed from the outside is bound to lack political legitimacy in the borrowing country. The most likely, if limited, way to advance transparency is to allow countries to set priorities unilaterally and by contract, but to encourage them to disclose the intended hierarchy at borrowing. This proposal is essentially agnostic as to the countries' substantive choices. It would be a small improvement on the status quo, where all debt ranks equally (but some might expect preferential treatment) and where the debtor retains discretion to change the informal ranking ex post.

Options for implementation run from an international treaty to establish a system of priorities, to an arrangement that is completely voluntary.⁵ Again I

⁵ Amendment of the IMF charter, itself an international treaty, would sit at the former extreme. The status quo would be close to the voluntary end of the spectrum. It has been argued that the preference enjoyed by some international financial institutions is grounded in customary international law. Rutsel Silvestre J.

suggest that the most ambitious option—a treaty—would bring few benefits at high cost. Three other tools remain. First, priorities established by law or contract could be enforced in national courts. This route would be most effective for contractual commitments involving payments outside the borrower's jurisdiction. Second, the IMF as part of its surveillance activities could report on the relative treatment countries have promised their creditors and whether they have lived up to their promises. Periodic reporting could improve transparency and risk assessment and help expose patterns of differential treatment. Finally some commentators have suggested that the reputational consequences of violating priorities in default may be greater than those of selective default on debt that ranks *pari passu*.⁶

In sum, a review of priorities in the sovereign context exposes an underappreciated reason for the complexity of sovereign debt workouts—debt stocks that are highly stratified in ways that often do not become apparent until after default. The relative ease of creating or reordering priorities after issuance complicates risk assessment at borrowing and creates poor debt management incentives. Yet much of the uncertainty and complexity appears to be irreducible—a consequence of state sovereignty.

I. MINING THE BANKRUPTCY ANALOGY

By now, a remarkable number of policymakers and international economists are familiar with elements of Title 11 of the U.S. Code and to a lesser extent with its counterparts in other countries. Even before the IMF's sovereign bankruptcy proposal,⁷ international financial architects and emerging market debt watchers mined bankruptcy law to help address the bank and corporate debt crises in Asia and, by analogy, to respond to the sovereign debt crises in Mexico and Russia.⁸

Martha, *Preferred Creditor Status Under International Law: The Case of the International Monetary Fund*, 39 INT'L & COMP. L.Q. 801 (1990).

⁶ NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS: RESPONDING TO FINANCIAL CRISES IN EMERGING ECONOMIES ch. 7 (forthcoming 2004).

⁷ Anne Krueger, A New Approach to Sovereign Debt Restructuring, Address at the Indian Council for Research on International Economic Relations (Dec. 20, 2001), available at <http://www.imf.org/external/np/speeches/2001/122001.htm>.

⁸ See GROUP OF TEN, THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES: A REPORT TO THE MINISTERS AND GOVERNORS PREPARED UNDER THE AUSPICES OF THE DEPUTIES (1996), available at <http://www.bis.org/publ/gten03.pdf>; INT'L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES: KEY ISSUES (1999), available at <http://www.imf.org/external/pubs/ft/orderly/index.htm>; KENNETH ROGOFF & JEROMIN ZETTELMEYER, BANKRUPTCY PROCEDURES FOR SOVEREIGNS: A HISTORY OF IDEAS, 1976-2001 (IMF,

In sovereign crises, most of the mining has focused on preventing holdout behavior, particularly litigation, among creditors.⁹ Over the past two years, policy and academic attention have shifted to a broader set of intercreditor concerns, highlighting the importance of priorities in domestic bankruptcy and their virtual absence in sovereign debt.¹⁰ Argentina's issuance of over \$20 billion in senior debt while in default has added to the interest.

A system of bankruptcy priorities sets out rules for distributing resources insufficient to pay all in full and on time. Priorities are enforced in liquidation and reorganization alike. If a debtor is liquidated under Chapter 7 of the U.S. Bankruptcy Code, proceeds are distributed in the order prescribed by statute, which lays out a hierarchy of claims to be paid in full before equity gets anything.¹¹ In reorganization, the absolute priority rule precludes approval (cramdown) of a reorganization plan over the objection of a senior creditor class that is not paid in full before those junior to it get anything.¹² In both cases, when funds are insufficient to repay a class in full, members of the class are paid pro rata.

The substantive order of distribution in bankruptcy reflects national policy preferences. To encourage contracting, U.S. bankruptcy law protects contractual ranking such as most grants of security and subordination agreements.¹³ However, it also preempts some contract rights in the name of

Working Paper No. 02/133, 2002), available at <http://www.imf.org/external/pubs/ft/wp/2002/wp02133.pdf>; Robert E. Litan, *A Three-Step Remedy for Asia's Financial Flu*, BROOKINGS POL'Y BRIEF, Feb. 1998; Marcus Miller & Joseph Stiglitz, *Bankruptcy Protection Against Macroeconomic Shocks: The Case for a 'Super Chapter 11'* (Dec. 1999), available at <http://www.warwick.ac.uk/fac/soc/CSGR/glob-fin/milrstig.pdf>; World Bank Insolvency Initiative, at http://www4.worldbank.org/legal/insolvency_ini/overview.htm (last visited June 10, 2004).

⁹ See Nouriel Roubini & Brad Setser, *Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions, and a Roadmap for Reform 2* (Mar. 9, 2003), at <http://www.iie.com/publications/papers/roubini-setser0303.pdf>; discussion *infra* Part III.

¹⁰ See, e.g., ROUBINI & SETSER, *supra* note 7, ch. 7; Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004); Patrick Bolton, Speech at the Sovereign Debt Restructuring Mechanism Conference (Jan. 22, 2003); Kenneth Rogoff, Emerging Market Debt: What Is the Problem?, Speech at the Sovereign Debt Restructuring Mechanism Conference (Jan. 22, 2003), available at <http://www.imf.org/external/np/speeches/2003/012203a.htm>; Jeromin Zettelmeyer, How Can the Cost of Debt Crises Be Reduced? (May 6, 2003) (unpublished manuscript, on file with author).

¹¹ 11 U.S.C. § 726 (2000).

¹² This rule describes the "fair and equitable" standard for treatment of unsecured claims under Section 1129(b) of the Bankruptcy Code, whereby a plan cannot be approved over the objection of a creditor class unless "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." *Id.* § 1129(b)(2)(B)(ii).

¹³ *Id.* §§ 506, 510.

overriding policy and political objectives. For example, the law puts administrative expenses of bankruptcy at the head of the line so as to protect a process presumed to benefit all creditors.¹⁴ Contracts that try to subvert the law's purposes can be invalidated.¹⁵ Certain claims are granted priority based on their social or political value: alimony, wages, taxes, employee benefit contributions, and debts to grain producers, fishermen, and others.¹⁶

The treatment of equity and equity-like claims merits special mention because it has no ready counterpart in sovereign debt, and yet it is key to the incentive function of priorities in firm bankruptcy. When a firm is insolvent, common stock is theoretically the very last in line—entitled to no recovery until all other claims are paid in full. Generally, along the spectrum from senior unsecured debt to common stock, the more influence a claim confers over firm management, the lower its ranking. This makes sense because the most junior creditors have the greatest need to maximize total value available for distribution. By definition, if other claimants go unpaid, the juniors get nothing. On the other hand, in strictly financial terms, the most senior creditors care little about the others or the total size of the pie, so long as it is big enough to yield their promised portion.

Recent literature suggests that subordinating equity as a rule in corporate bankruptcy can improve debt management incentives before the firm becomes insolvent.¹⁷ It contributes to better risk assessment by creditors and diminishes potentially harmful biases on the part of borrowers in favor of risky projects and overborrowing. Such biases tend to benefit equity and management decisionmakers at the expense of debt holders.

Although priorities are most commonly discussed when liquidation is the ultimate option, they also exist when liquidation is unavailable. For example, an abbreviated hierarchy of contractual and externally imposed (federal) priorities is enforced in U.S. municipal bankruptcy, even though public entities cannot be liquidated and, as in the case of sovereign countries, most public

¹⁴ *Id.* § 507. Administrative expenses at the head of the line include professional fees and financing that a company obtains while in bankruptcy, whether in the ordinary course of business or by special permission of the judge.

¹⁵ *Id.* §§ 544(b), 547, 548, 727(a)(2).

¹⁶ *Id.* § 507.

¹⁷ *See, e.g.,* LUCIAN ARYE BEBCHUK, EX ANTE COSTS OF VIOLATING ABSOLUTE PRIORITY IN BANKRUPTCY 15 (Nat'l Bureau of Econ. Research, Working Paper No. 8388, July 2001), available at <http://www.nber.org/papers/w8388>.

property is immune from seizure.¹⁸ A reorganization plan under Chapter 9 of the U.S. Bankruptcy Code cannot be approved if it violates the ranking established by law. In turn, a municipal debtor that cannot reorganize in bankruptcy generally would be open to lawsuits demanding tax hikes to pay the debt (the remedy of mandamus).¹⁹

But just because a device is part of bankruptcy law does not mean that it would help resolve sovereign debt problems. Many commentators have written that the firm-state analogy is deeply flawed. Among other features, they have pointed out that firm bankruptcy balances orderly debt adjustment with supervised asset management.²⁰ For insolvent countries, even today's diminished view of sovereignty precludes outside control over debtors' principal assets—national economies and government finances—and economic management. This political nature of the sovereign “bankruptcy estate” also makes it nearly impossible to value for distribution or rehabilitation purposes.²¹ For all the same reasons, establishing a government's capacity to pay has been elusive; unwillingness to pay is routinely blamed for sovereign defaults.²² As a result, some argue that making sovereign debt restructuring less messy would disturb the essential balance between the chaos of restructuring and the remoteness of sovereign assets—tempting countries to default (even more) frivolously and chasing away lenders for good.²³ This goes too far—after all, effecting debt adjustment without ceding control over public policy is central to U.S. municipal bankruptcy, where more targeted measures seem to diminish

¹⁸ 4 COLLIER ON BANKRUPTCY ¶¶ 507.02(6), 510 (15th ed. 1996); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 429-35 (1993).

¹⁹ The fact that U.S. municipal insolvency statutes are sparse and rarely used does not detract from the point. Cf. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 980 (2000); Robert Michael, Chapter 9 Versus Chapter 11 After Orange County: Lessons for the SDRM, Address at the International Bar Association Insolvency and Creditor's Rights Conference (2003). For financial and political reasons states tend to step in with financial support for constituent local governments and assume a degree of control over their affairs. See McConnell & Picker, *supra* note 18, at 460; James E. Spiotto, *Municipal Finance and Chapter 9 Bankruptcy*, 17 MUNICIPAL FIN. J. 1 (1996). This has not precluded local governments from issuing tiered debt or led to rampant violation of priorities.

²⁰ Andrei Shleifer, Will the Sovereign Debt Market Survive? (Jan. 2003) (unpublished manuscript), available at http://post.economics.harvard.edu/faculty/shleifer/papers/debt_NBER.pdf.

²¹ Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, J. INT'L ECON. L. 613, 634-36 (2001).

²² See, e.g., Gabrielle Lipworth & Jens Nystedt, *Crisis Resolution and Adaptation*, 47 IMF STAFF PAPERS 188 (2001), available at <http://www.imf.org/external/pubs/ft/staffp/2000/00-00/ln.pdf>.

²³ Shleifer, *supra* note 20.

the lure of orderly debt composition.²⁴ Although comparisons between U.S. municipal bankruptcy and a sovereign crisis must not be overdrawn,²⁵ both are forms of public financial distress and must be framed in terms of a broader balance among competing claims on public resources. In both cases, the goal is sustainable recovery—including restoration of financing on reasonable terms.

In sum, while automatically transplanting domestic bankruptcy devices into the sovereign context is surely inappropriate, it is also unwise to walk away from the richest available body of theory and practice on economic failure simply because governments do not turn over domestic economies to their creditors or because voters are not the same as stockholders. In particular, none of the distinctions between sovereign and nonsovereign insolvency rules out an explicit priority structure for sovereign debt. Because the core idea of priorities goes to the relative treatment of claims, even if all the debtor's assets are out of reach, as among creditors priorities could be used as a basis to challenge preferential payments.

A comparison between U.S. states and municipalities is instructive. Unlike municipalities, states are not subject to federal bankruptcy law and set repayment priorities unilaterally through the democratic process and by contract. For example, California's Constitution effectively gives absolute payment priority to the support of public education. General obligation debt, specifically authorized by law and backed by the full faith and credit of the state, is next in line for California's General Fund.²⁶ Together, the state's

²⁴ 4 COLLIER, *supra* note 18, ¶ 900.01; Michael, *supra* note 19. Barriers to filing for insolvency and limited judicial review of reorganization plans are among the measures designed to prevent frivolous recourse to Chapter 9. While different balancing measures may be appropriate for countries, the municipal example suggests that maximizing the pain and chaos of sovereign default is hardly the sole, or even the preferable, way to deter it.

²⁵ See Tarullo, *supra* note 21.

²⁶ See, e.g., CAL. GOV'T CODE § 16922 (West 2003) (dealing with state pension finance) ("The committee, at any time or from time to time, upon the request of the Director of Finance, may issue bonds, for and in the name and on behalf of the state, for the purpose of financing or refinancing the program as authorized by this chapter. Bonds for the purpose of financing the program as authorized by this chapter may not be issued after June 30, 2004. However, bonds issued pursuant to this section may be refunded pursuant to Section 16923 whether the date of refunding occurs before, on, or after June 30, 2004. Every issue of bonds, and any ancillary obligation entered into with respect to those bonds, shall be a debt and liability of the state payable from the General Fund of the state or, in the case of bond anticipation notes, payable from the proceeds of bonds to be issued pursuant to this chapter, subject only to the prior application of moneys in the General Fund for (a) support of the public school system and public institutions of higher education, (b) payment of debt service on state general obligation bonds and commercial paper notes, (c) reimbursement of state special funds, to the extent required by law, for internal borrowings, and (d) payment of debt service on

various constitutional, statutory, and contractual arrangements add up to a reasonably well-articulated priority structure. Should California run out of funds on any given day, creditors would be paid in the order prescribed in their documentation. The state controller (California's chief financial officer) could be compelled by a court to follow this order.

These days, it is hard to envy California's state controller, yet his decisionmaking is framed in remarkably clear terms compared to that of the men and women running national treasuries and central banks in emerging market countries.

II. THE DIVINE RIGHT OF KINGS

Long ago, imperial powers stood ready to use gunboats and to impound sovereign debtors' customs receipts on behalf of their creditor-nationals.²⁷ With this approach out of fashion, the baseline for assessing the efficacy of a sovereign priority system is the challenge of suing a foreign government for money damages.

Black's Law Dictionary defines sovereignty in uncharacteristically poetic terms as the "supreme, absolute, and uncontrollable power by which any independent state is governed; . . . [t]he power to do everything in a state without accountability,—to make laws, to execute and to apply them, . . . to make war or peace, . . . and the like."²⁸

Although the doctrine of sovereign immunity has evolved away from absolute protection of the sovereign, it is fair to say that this protection is still considerable.²⁹ Importantly, even when a state may be sued and has waived immunities, collecting on a judgment is difficult. For all practical purposes, state property within its own borders is completely immune.³⁰ Abroad, creditor recourse is limited to property used by the sovereign for commercial activity, exempting diplomatic and military assets, among others.

state revenue anticipation notes or registered reimbursement warrants."); Official Statement, \$900,000,000 State of California General Obligation Bonds, Feb. 1, 2003, at A-4, A-13, A-14.

²⁷ Venezuela and Haiti were among the most prominent cases. See Feilchenfeld, *supra* note 3, § 666.

²⁸ BLACK'S LAW DICTIONARY 1396 (6th ed. 1990).

²⁹ See, e.g., *Republic of Argentina v. Weltover*, 504 U.S. 607 (1992); Georges R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later*, 88 AM. J. INT'L. L. 257 (1994).

³⁰ PHILIP R. WOOD, PROJECT FINANCE, SUBORDINATED DEBT AND STATE LOANS 13-14, 104 (1995).

In the United States and the United Kingdom, central bank assets, including foreign exchange reserves, enjoy even stronger immunities than other state assets. Under U.S. law, they are most likely immune from prejudgment attachment altogether—allowing the debtor plenty of time to shift funds to a safe place while the case is being tried.

To be sure, the U.S. Bankruptcy Code confers a number of advantages on the nonsovereign debtor to encourage reorganization when it is still viable and to discourage eleventh-hour looting and risk-taking.³¹ The even greater advantages accorded municipal debtors have led commentators to conclude that “unlike Chapter 11, Chapter 9 does not attempt to balance the rights of the municipality and its creditors.”³² A typical U.S. locality in Chapter 9 bankruptcy might cede fewer policy prerogatives than a country seeking funds from the IMF.

Yet however skewed the U.S. system might be in favor of the debtor, the creditor has reasonable assurance of enforcing the rights it does have, and hence reasonable certainty in its leverage vis-à-vis the debtor and its creditor comrades. Creditors of a company have a clear alternative to negotiation. If the debtor is liquidated, they know about how much they will get, how much will go to their counterparts, and in what order. For municipal creditors, whose rights might be even more limited, the ability to enforce them is considerable. The opposite is true in the sovereign context—contractual rights may be elaborate, but the ability to enforce them is questionable, and the cost is high absent willingness to send in the gunboats and impound customs revenues.

When the total amount of assets available for enforcement is small relative to the liabilities, and prone to debtor discretion, payments to some creditors may be the sole source of litigation recovery for the others. As a result, an aggrieved creditor may give up on the debtor and focus on intercepting or recapturing a preferential payment to its colleague. Recent high profile cases

³¹ Other features affecting the balance of power among parties to a bankruptcy include: the Chapter 11 presumption that the debtor will operate the insolvent enterprise (“debtor-in-possession”); “automatic stay” protection against enforcement of claims; the debtor’s exclusive right to propose a reorganization plan within a specified time window; the debtor’s leeway to classify claims for voting purposes, but also the creditors’ ability to block a plan and to secure appointment of a trustee or examiner; and the requirement that a judge approve certain actions by the debtor.

³² 4 COLLIER, *supra* note 18, § 900.01[2]. For example, it could not prescribe municipal expenditures. A court’s powers are limited to determining the entity’s inability to meet debts as they mature, whether the proposed plan complies with the provisions of the code, whether it has been accepted by the requisite number of creditors, and similar considerations.

notwithstanding, collecting from other creditors of equal ranking is difficult across diverse instruments and jurisdictions where the sovereign raised money, particularly when large creditors like the IMF and multilateral development agencies enjoy broad immunities of their own.³³ The centrality of intercreditor relationships in sovereign debt might make disclosure and enforcement of priorities in this area even more significant than they are in national bankruptcy regimes. But it also highlights an inherent limitation on sovereign priorities: the debtor retains ultimate control over the total amount subject to distribution.

III. A FOGGY STATUS QUO

In separate conversations, two eminent lawyers who sat across from each other at the sovereign restructuring banquets of the 1980s suggested that there was a relatively clear and widely accepted system of priorities for sovereign debt. “Banks are last in line and the first to restructure. At the top, there is official bridge financing, then the IMF, then the World Bank, then trade and interbank lines, bonds . . .” Counsel to the creditors paused: “Well, at least that is how it used to be.”³⁴

His unease is revealing. As this Part will illustrate, recent history is replete with shattered illusions of seniority, financial arrangements to paper over disputes about ranking, and court rulings that upset old notions of creditor parity.

This upheaval is not new. One observer wrote in 1934 that

[i]n [sovereign debt] resettlements equal treatment of all creditors has been the exception rather than the rule. On the other hand existing resettlements vary considerably among each other as to the classes of creditors who are accorded preferential treatment. There is, thus, no uniform usage. It is possible, however, to list the classes of debts which have repeatedly though not always received preferential treatment, and, therefore, may possibly receive similar treatment on future occasions.³⁵

³³ See *infra* Part IV.

³⁴ Interview with anonymous creditor counsel (Dec. 5, 2002).

³⁵ Feilchenfeld, *supra* note 3, § 657. But see Vincent Truglia et al., *Sovereign Risk: Bank Deposits vs. Bonds*, MOODY'S INVESTORS SERVICE SPECIAL COMMENT, Oct. 1995 (surveying recent history of selective sovereign default and implications for different instruments); Azmat Zuberi & David Roberts, *Preferred Creditors and the Sovereign Ceiling*, DUFF & PHELPS CREDIT RATING CO., Mar. 19, 1996.

In the aftermath of the 1980s debt crisis, restructuring agreements between countries and their private creditors covered “specified debt,” which was defined as debt denominated in a foreign currency and/or held by nonresidents. The contracts further excluded specific categories of debt, such as publicly issued bonds, loans made by official multilateral entities such as the World Bank and the IMF (together, the International Financial Institutions, or the IFIs), secured debts, and certain trade and interbank lines. This approach reflected a common understanding among private creditors of the country that “excluded debts” merited either complete exemption from restructuring, or at least separate classification that made special treatment possible.³⁶ IFI financing and publicly traded bonds were in a truly exempt category. IFIs were the most likely sources of new financing for the country’s near-term rehabilitation. Bonds served as an exit vehicle for banks in the Brady Plan.³⁷ Their privileged treatment made them more attractive and was sustainable at the time because bonds took up a small portion of the sovereign’s cash flows, relative to other debt categories. Trade lines were sometimes exempted, sometimes restructured on separate terms; interbank lines were sometimes exempted, rarely restructured, but often rolled over under pressure.³⁸

This view of the sovereign debt hierarchy was supported by the willingness of government-to-government creditors in the Paris Club to exclude IFI financing from restructuring and to refrain from specifically insisting that debtors secure comparable treatment of other excluded debt, notably bonds.³⁹

³⁶ The rationale for this treatment at the time is covered in Lee C. Buchheit, *Of Creditors, Preferred and Otherwise*, INT’L FIN. L. REV., June 1991, at 12, 12-13. See also WOOD, *supra* note 30, at 160-62 (outlining a slightly different version of the sovereign debt hierarchy).

³⁷ See, e.g., John Clark, *Debt Reduction and Market Reentry Under the Brady Plan*, FED. RESERVE BANK N.Y. Q. REV., Winter 1993-94, at 38.

³⁸ See WOOD, *supra* note 30; Keith Clark, *Sovereign Debt Restructurings: Parity of Treatment Between Equivalent Creditors in Relation to Comparable Debts*, 20 INT’L LAW. 857 (1986).

³⁹ This exemption from “comparability” is particularly critical. A sample clause in the Paris Club Agreed Minute reads along the following lines:

In order to secure comparable treatment of its debt due to all its external public or private creditors, [the country] commits itself to seek promptly from all its external creditors debt reorganization arrangements on terms comparable to those set forth in the present Agreed Minute, while trying to avoid discrimination among different categories of creditors.

Agreed Minute on the Consolidation of the Debt of Georgia III(1), at 4 (Mar. 6, 2001). Although historically, the clause did not exclude bonds by name, the Paris Club made no statement and took no action to demand that borrowers restructure bonds to benefit from Paris Club treatment. It has been argued that until Pakistan’s restructuring in 1999, see *infra* notes 43-47 and accompanying text, bonds represented such a small portion of any sovereign’s debt service profile during the restructuring (consolidation) period, that they could be exempted as de minimis—essentially, of little import to other creditors’ financial position. See Paris Club,

The insistence of major government creditors that government debtors seek concessions from other creditors is one of the few policy tools now available to achieve intercreditor equity or at least some balance of concessions. The tool has been remarkably successful considering how imperfect it is. Because the Paris Club has no direct leverage over its debtors' other creditors, to enforce comparability, government creditors must be willing to withhold relief from countries they had already committed to help—a politically challenging proposition. Yet this has never prevented the Paris Club creditors from asking, which suggests that their apparent willingness to tolerate arrears or write down their obligations without demanding similar treatment for “preferred” debt amounted to tacit agreement to subordinate their claims.⁴⁰

A. *Not So Sacred Livestock*

In 1999, an element of the presumed hierarchy came under the weight of what bankruptcy specialists call the “pig to hog” principle.⁴¹ In the case of Pakistan, when the Paris Club determined that the sovereign bond piglet took on hog-like proportions in the country's near-term debt service profile, the hog was led to slaughter—Pakistan was asked to seek “comparable treatment” (restructuring) of its Eurobonds.⁴² Although the bonds were small and narrowly held, broader market reaction was strong and negative. Investor groups warned that “[t]he forced inclusion of sovereign Eurobonds in debt

Rules and Principles—Comparability of Treatment, at <http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B01WP06> (last visited June 10, 2004); Paris Club, Specific Provisions—De Minimis Provisions, at <http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B05WP06> (last visited June 10, 2004).

⁴⁰ It is fair to ask and hard to tell how truly voluntary such subordination could be where the debtor's power to discriminate is considerable.

⁴¹ See *Dolese v. United States*, 605 F.2d 1146, 1154 (10th Cir. 1979) (“There is a principle of too much; phrased colloquially, when a pig becomes a hog it is slaughtered.”); see also *In re Swift*, 3 F.3d 929, 931 (5th Cir. 1993) (“[A]s the finder of fact, the bankruptcy court has the primary duty to distinguish hogs from pigs.”). In domestic bankruptcy, the analysis usually applies to property of the debtor that is exempt from distribution to creditors, often as a result of advance planning by the debtor. It is not used to analyze priorities—a system of dividing assets among creditors. A sovereign debtor has discretion both in determining the total amount available to creditors and in apportioning that amount among them. In lieu of a bankruptcy court, the function of telling pigs from hogs in sovereign debt appears to be decentralized among the creditors. Paris Club members in the case of Pakistan and Brady bondholders in the case of Ecuador have claimed that another category of obligations is so significant to the debtor's payment profile that it must be restructured as a condition of their concessions.

⁴² See Jeffrey Keegan, *Growing Chorus of Regulators Want Sovereign Bondholders to Share the Pain*, INVESTMENT DEALER'S DIG., May 3, 1999; Kristin Lindow et al., *Pakistan's Paris Club Agreement Implies New Official Strategy Regarding Seniority of Sovereign Eurobonds*, MOODY'S INVESTORS SERVICE GLOBAL CREDIT RES., Mar. 1999, at 3. Note that Pakistan's stock of Eurobonds was small relative to other debts, though they all matured in the near term.

reschedulings will substantially raise borrowing costs for all Emerging Markets countries, thus increasing the likelihood that marginal countries will be required to seek increased official sector support and debt rescheduling.⁴³ Others echoed public sector concerns about the legal difficulty of bond rescheduling, forecasting the end of the asset class. Moody's rating agency said it would alter Eurobond ratings to reflect the loss of implied seniority.⁴⁴ Spreads on sovereign Eurobonds that had no connection to Pakistan jumped in response to the restructuring.⁴⁵ Summarizing the state of sovereign priorities, an investment bank analyst with a penchant for Latin wrote:

While bonds typically ranked pari-passu de-jure with other classes of sovereign debt, . . . as per de-facto practice and perception, in the hierarchy of sovereign creditors the multilateral ranked as super-senior, followed by bondholders, with commercial credits (including banks) and bilateral creditors next in line respectively. The Paris Club seeks to reorder this ranking.⁴⁶

Significantly, Pakistan's restructuring covered government-to-government debt and external bonds, but exempted domestic debt. Less than a year earlier, Russia defaulted on a massive stock of domestic debt, while continuing to service Eurobonds and subsequently restructuring government-to-government debt. Several years later, Argentina followed Pakistan's example to the extreme—defaulting on a massive stock of external bonds—where such bonds represented over fifty percent of its debt compared to Pakistan's one percent, and while its domestic debt stood at about twenty-five percent, Pakistan's was over forty percent.

B. Tension at the Top

It would be an exaggeration to suggest that the sovereign priority structure stood firm before the Paris Club presumed on Pakistan's bonds. Even at the very top—the seniority of multilateral lenders—the structure was not immune

⁴³ Brian Caplen, *Sovereign Bonds: Logic Does Not Apply*, EUROMONEY, June 1999, at 17; EMTA, Paris Club Asks Pakistan to Reschedule Eurobonds, at <http://www.emta.org/emarkets/pakistn3.htm> (last visited June 10, 2004).

⁴⁴ Catherine Evans, *Moody's Sees Re-Ratings if Pakistan Defaults*, REUTERS, Apr. 16, 1999; Lindow et al., *supra* note 42.

⁴⁵ Mathew R. McBrady & Mark S. Seasholes, *Bailing-In 20* (Dec. 22, 2000) (unpublished manuscript), available at http://faculty.haas.berkeley.edu/mss/papers/bailing-in_22-dec-2000.pdf.

⁴⁶ Azmat Zuberi, Credit Suisse First Boston, *The Paris Club: Implications of Recent Club Agreements for Sovereign Eurobond Defaults* (Apr. 29, 1999) (unpublished manuscript, on file with author). Wood puts Paris Club ahead of bondholders, as did Feilchenfeld for the equivalents of his day. See *supra* notes 35, 38.

from strain. In particular, while few expressed doubts about the IMF's and the World Bank's entitlement to preferred treatment, some Paris Club creditors had voiced discomfort with financing the preferred status of multilaterals with a narrower creditor base, such as the development lenders of the European Union, the Nordic Investment Bank and Development Fund, the Islamic Development Bank, and the OPEC Fund for International Development. Governments that were not members of such institutions worried that the others would use them as conduits for bilateral lending that would be shielded from restructuring.⁴⁷ The most contentious disputes to date have been settled by agreements to disagree in principle and financial arrangements (such as new credits in lieu of rescheduling) that allow both sides to claim victory.⁴⁸

Although the IMF and the broader-membership multilaterals appear secure in their privilege for now, their preferred creditor status is conferred by convention, not law.⁴⁹ The fact that this convention has faced few challenges during its fifty-year history is testament to the utility of the IFI system *and* its preferred creditor status in the eyes of its official sponsors, the borrowers, and the growing private creditor constituency at home and abroad. The IFIs' willingness to finance where others would not is central to maintaining such broad consensus—though beyond this, different groups may have different reasons for supporting them. Some welcome IFI lending because, at least in theory, it promotes good policies and economic recovery on the model of postpetition (debtor-in-possession, or DIP) financing in domestic bankruptcy. Others contend it lets countries defer reform and helps bail out private creditors. In view of the growing stock of sovereign debt held by the IFIs, it may be harder to maintain this broad base of support; yet it is the IFIs' best protection against the fate of other would-be hogs.⁵⁰

⁴⁷ See Alexis Reiffel, *The Role of the Paris Club in Managing Debt Problems*, in INTERNATIONAL BORROWING: NEGOTIATING AND STRUCTURING DEBT TRANSACTIONS 486 (Daniel D. Bradlow ed., 1994).

⁴⁸ See, e.g., Commission Proposal for a Council Decision Providing Supplementary Macro-Financial Assistance to Ukraine, 2002 O.J. (C 103) 28, available at <http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/ce103/ce10320020430en03660367.pdf>; Report from the Commission to the European Parliament and the Council on the Implementation of Macro-Financial Assistance to Third Countries in 2001, COM(02)352 final, available at http://europa.eu.int/eur-lex/en/com/rpt/2002/com2002_0352en02.pdf; *EU/Ukraine: Commission Tops Up and Restructures Macro-Financial Aid*, EUR. INFO. SERVICE, Jan. 19, 2002; Paris Club, Ukraine Debt Treatment, at http://www.clubdeparis.org/countries/countries.php?CONTINENT_ID=?DETAIL_DETTE_PAGE=1&IDENTIFIANT=346&PAY_ISO_ID=UA (last visited June 10, 2004).

⁴⁹ See, e.g., Martha, *supra* note 5; Reiffel, *supra* note 47; Zuberi & Roberts, *supra* note 35.

⁵⁰ See *The New Man at the Fund*, ECONOMIST, June 3, 2004; Marie Cavanaugh et al., *Preferred Creditor Status Ratings Under the World Bank's Partial Credit Guarantee Program*, STANDARD & POOR'S SOVEREIGN RATINGS SERVICE, Oct. 1998, at 2; see also Buchheit, *supra* note 36; Reiffel, *supra* note 47; discussion *infra* p. 1148-49.

C. *The Pari Passu Snafu*

With these uncertainties at the top and bottom of the sovereign debt hierarchy, it should not come as a surprise that equality among creditors of the same ranking is not as equal as one might expect in the sovereign setting.

The aspiration for equal treatment is usually expressed as a *pari passu* undertaking in a sovereign debt contract. A basic form of the clause comes from corporate contract convention, and without more, is a promise by the debtor not to subordinate the creditor to others that would, as a result, come ahead of it in bankruptcy distribution.⁵¹ For most of its history, the clause has been interpreted as going to the status or ranking of the debt, but not to the manner in which it will be serviced. Outside bankruptcy, a creditor facing discrimination in payment would seek redress under provisions that go specifically to payment, not ranking.⁵²

Contractual parity in payment can be approximated with sharing and early prepayment clauses, as well as, with less certainty, by adding “and will be paid as such” to the standard *pari passu* clause. But for sovereign debt, the effect is largely “*in terrorem*.”⁵³ Where the debtor has insufficient funds to pay all, extracting a mandatory coupon prepayment is hardly worth it. Given the difficulty of suing a sovereign, it makes no sense without accelerating full principal and triggering the collapse of the entire debt structure.

Until recently, there was consensus among commentators and most market participants about what the basic *pari passu* clause did *not* mean and a fair amount of puzzlement about what it did mean. In 1934, Feilchenfeld observed, “[i]t may safely be stated that discrimination is incompatible with international financial tradition and justice; but those theorists who claim that discrimination forms an international delinquency have, thus far, failed to cite sufficient precedent for their assertion.”⁵⁴ In our conversation last fall, one eminent creditor counsel went so far as to suggest that the clause be dropped as

⁵¹ A typical clause reads: “All the obligations and liabilities of the Borrower hereunder rank, and will rank, either *pari passu* in rank of payment with or senior to all other unsubordinated Indebtedness of the Borrower.” A sovereign debtor could create senior debt by legislative or executive fiat. See LEE C. BUCHHEIT, HOW TO NEGOTIATE EURO CURRENCY LOAN AGREEMENTS 76-79 (1995).

⁵² For a survey of literature and arguments on the meaning of the *pari passu* clause, see Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004); G. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635 (2001).

⁵³ See Lee C. Buchheit, *The Search for Intercreditor Parity*, 8 L. & BUS. REV. AM. 73 (2002).

⁵⁴ Feilchenfeld, *supra* note 3, § 656(B).

meaningless from sovereign debt boilerplate.⁵⁵

Recent developments have introduced an important caveat in this discussion. First, in mid-1999, Ecuador proposed to restructure its Brady Bonds while servicing its Eurobonds. The Bradies contained a basic *pari passu* clause. Illustrating its pragmatic adaptability (and poor sloganeering abilities), the creditor community turned on Ecuador's Eurobonds with "*pari passu*" as its rallying cry. Investors succeeded in forcing Ecuador to include the Eurobonds in its restructuring. Yet Ecuador's assent was testimony less to the persuasiveness of the legal argument than a realization that with tradable debt tarnished as a class post-Pakistan, and most importantly, in the context of Ecuador's own comparability drama,⁵⁶ it had little to gain and a lot to lose by aggravating the Brady bondholders to the point of litigation.

A much more severe jolt to the *pari passu* convention came when a Brussels court, relying on an unconventional reading of the clause, agreed to freeze a payment on Peru's Brady Bonds. The freeze came at the request of Elliott Associates, an investment fund that had become the *bête noire* of the borrower community, the official sector, and some of the creditor establishment, which had invested just over \$11 million in about \$21 million in face value of loans guaranteed by Peru. If Peru had not settled for \$56 million, the court's injunction would have allowed Elliott to be paid pro rata out of the funds going to the bondholders. A noted international law scholar writing for Elliott presented the revisionist reading of *pari passu* in appealingly homey terms:

A borrower from Tom, Dick, and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If there is not enough money to go around, the borrower faced with a

⁵⁵ Interview with anonymous creditor counsel, *supra* note 34.

⁵⁶ *Ecuador: A Case for Comparability?*, EMERGING MARKETS DEBT REP., Mar. 29, 1999, at 13; Felix Salmon, *The Buy Side Starts to Bite Back*, EUROMONEY, Apr. 2001, at 46. Ecuador's stock of Brady Bonds significantly outnumbered its Eurobonds. Holders of the Brady Bonds had a unique argument for being spared in this restructuring: they represented debt already restructured once, *see* Clark, *supra* note 37, with the promise that it would not be restructured again. However, the size of Ecuador's Brady debt stock relative to its other liabilities cut both ways: on the one hand, demands of the Brady constituency could not be ignored, on the other, it was difficult to imagine a debt restructuring that could restore Ecuador's debt to sustainable levels without including the Brady Bonds. *Cf. supra* note 42 and accompanying text (discussing the "pig to hog" principle). At about the same time, Russia was able to avoid restructuring its Eurobonds. The public rationale for this exclusion was the distinction between Soviet and Russian-era debt (commercial bank debt and Eurobonds, respectively), respected by Russia's public and private creditors. However, even with this high level of political commitment, it is hard to believe that Eurobonds could have escaped restructuring if payments on them had dominated Russia's liability profile.

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pari passu provision must pay all three of them on the same basis
.....⁵⁷

In the event, Tom and Dick (the Brady bondholders) were hardly getting paid in full—they had agreed to debt reduction and were awaiting debt service on successor instruments. Elliott stayed out of the restructuring, demanding full payment on the original obligation.

The Brussels decision prompted cries of protest from mainstream practitioners and academics as contrary to the established market understanding of *pari passu*, and as potentially encouraging holdout behavior in sovereign debt negotiations.⁵⁸ Even industry associations went on record to say that rogue courts are a bigger danger to emerging market debt than rogue creditors.⁵⁹ Yet the decision was followed soon by a settlement between the Democratic Republic of Congo and its creditors who had filed suit in California, using similar arguments.⁶⁰ In September 2003, the Brussels Commercial Court followed in the footsteps of the *Elliott* panel, interpreting the *pari passu* clause in Nicaragua's loan agreements to require proportional payment to creditors of equal ranking.⁶¹

In late 2003, Argentina attempted to reverse the tide by getting a U.S. District Court in New York to foreclose the use of the *pari passu* clause by its judgment creditors to enforce their claims.⁶² After some hand-wringing about supporting a defaulting debtor whose efforts at a compromise with its creditors had been dubious at best, the U.S. government, the Federal Reserve Bank of New York, and the New York Clearing House Association submitted amicus briefs arguing that the Brussels court's interpretation of *pari passu* threatened to undermine the payments system and would jeopardize consensual

⁵⁷ *Elliott Assocs., L.P. v. Banco de la Nacion*, 2000 U.S. Dist. LEXIS 368 (S.D.N.Y. Jan. 18, 2000) (executed Aug. 31, 2000); Declaration of Professor Andreas F. Lowenfeld Dated August 31, 2000, at 11-12 (footnote omitted), *Elliott Assocs.*, 2000 WL 1449862 (96 Civ. 7916 (RWS), 96 Civ. 7917 (RWS)).

⁵⁸ See Gulati & Klee, *supra* note 52.

⁵⁹ EMTA Position Regarding the Quest for More Orderly Sovereign Work-Outs (Oct. 17, 2002), available at <http://www.emta.org/ndevelop/keymsg1.pdf>.

⁶⁰ *Red Mountain Fin., Inc. v. Democratic Republic of Congo*, No. CV 00-0164 R (C.D. Cal. May 29, 2001); Buchheit & Pam, *supra* note 52, at 873-74. The creditors included some of the same players as in *Elliott*.

⁶¹ Audience Publique des Référés du Jeudi 11 Septembre 2003, La République Du Nicaragua contre LNC Invs. LLC, Euroclear Bank S.A., R.K. 240/03.

⁶² See Memorandum of Law of the Republic of Argentina in Support of Its Motion Pursuant to CPLR § 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors, *Macrotecnic Int'l Corp. v. Republic of Argentina* (S.D.N.Y. Dec. 13, 2003) (No. 02 CV 5932(TPG)), *EM Ltd. v. Republic of Argentina* (S.D.N.Y. Dec. 13, 2003) (No. 03 CV 2507(TPG)).

restructurings and U.S. participation in IFIs.⁶³ Following arguments on January 17, 2004, the court opted for a cliffhanger—it ruled that the matter was nonjusticiable because the plaintiffs had yet to use the *pari passu* argument to enforce their claim.⁶⁴ Less than two months later, an appellate panel in Brussels appeared to put it all to rest, reversing the initial decision in *LNC v. Nicaragua*. It ruled on narrow grounds, concluding that because Euroclear was not party to the *pari passu* agreement between Nicaragua and LNC, it could not be compelled to enforce the contract term.⁶⁵ One might suspect a strong policy interest behind the ruling: if Euroclear were to become an enforcer for sovereign creditors, its capacity to fulfill its basic mandate to settle financial transactions promptly and efficiently would be fundamentally impaired, and the business would move from Belgium to different jurisdictions.

Even as the matter seems settled for the moment, it is worth noting that the early Brussels decisions were more complex than the critics let on, although they seemed to fly in the face of the prevailing understanding of the *pari passu* clause in sovereign debt and the market practices that had developed around it. The Brussels court had to rule either that the basic *pari passu* clause has no practical meaning in sovereign debt (as our eminent creditor counsel suggested in a moment of admirable intellectual honesty), or that the language in sovereign debt contracts that goes to distribution of payments (as opposed to ranking)⁶⁶ is essentially superfluous—belt and suspenders. After all, to violate the *pari passu* clause as conventionally understood, a sovereign would have to enact a legal measure subordinating its creditors—an act that could have no conceivable purpose given the freedom countries already have to distribute limited resources among claimants, and something that not even Argentina has done in conjunction with publicizing financial projections spelling out the

⁶³ See Statement of Interest of the United States, Memorandum of Amicus Curiae the New York Clearing House Association L.L.C. in Support of Motion Pursuant to CPLR § 5240 to Preclude Plaintiff Judgment Creditors from Interfering with Payments to Other Creditors, *Macrotecnic Int'l Corp. v. Republic of Argentina* (S.D.N.Y. Jan. 12, 2004) (No. 02 CV 5932), *EM Ltd. v. Republic of Argentina* (S.D.N.Y. Jan. 12, 2004) (No. 03 CV 2507); Memorandum of Law of Amicus Curiae Federal Reserve Bank of New York in Support of Defendant's Motion for an Order Pursuant to CPLR § 5240 Denying Plaintiffs the Use of Injunctive Relief to Prevent Payments to Other Creditors, *Macrotecnic Int'l Corp. v. Republic of Argentina* (S.D.N.Y. Jan. 12, 2004) (No. 02 CV 5932), *EM Ltd. v. Republic of Argentina* (S.D.N.Y. Jan. 12, 2004) (No. 03 CV 2506).

⁶⁴ Martin S. Anidjar, *Argentina: The Only News on Debt Is on the Legal Front*, JP MORGAN EMERGING MARKETS RES., Jan. 30, 2004.

⁶⁵ République Du Nicaragua contre LNC Invs. LLC, Euroclear Bank S.A., General Docket No. 2003/KR/334 (Ct. App. of Brussels, 9th Chamber, Mar. 19, 2004); see also Vladimir Werning, *Argentina Commentary*, JP MORGAN EMERGING MARKETS RES., Mar. 23, 2004.

⁶⁶ See Gulati & Klee, *supra* note 52.

subordination of its private external debt.⁶⁷ A court faced with the choice between interpreting contract language as meaningless or redundant might earn some sympathy for picking the latter.

The recent flurry of *pari passu* litigation has inspired a rich and provocative literature.⁶⁸ Lee Buchheit and Jeremiah Pam, and Mitu Gulati and Kenneth Klee before them, build a powerful case against the broad interpretation of *pari passu* as an intercreditor payment sharing device. Their legal and historical readings get support from the policy arguments of Argentina's amici in the New York litigation.⁶⁹ Proponents of the narrow reading tend to focus on risks to international payment flows and settlement systems threatened by creditor injunctions. More controversially, they suggest that the broad reading may give individual creditors too much power to hold up restructurings or "tax" them by extracting a disproportionate settlement from the debtor. William Bratton effectively argues that creditor interests should drive the interpretation. From this perspective, the *pari passu* term is profoundly ambiguous—potentially having one meaning (ratable payment) at the time of contracting and another (legal ranking) at the time of distress. Less wed than others to a particular interpretation of *pari passu*, Bratton uses the clause to show that traditional contract interpretation techniques fail to produce a definitive meaning in crisis. Hence regime change is in order—a sovereign bankruptcy framework to displace contracts that are simply not meant to function in extreme distress.

Their vigorous debate notwithstanding, the *pari passu* partisans on both sides falter in the same place. None offers a robust affirmative rationale for either the broad or the narrow reading. Buchheit and Pam come the closest, suggesting that drafters of early Eurodollar loans deployed the narrow reading to address concerns about revenue earmarking, domestic legal pronouncements and obscure provisions in Spanish and Philippine law that permitted involuntary subordination. But their own arguments suggest the affirmative case is weak—well-crafted modifications to the negative pledge clause took care of earmarking back in the 1970s, U.S. court decisions in the 1980s made domestic legal pronouncements a whole lot less dangerous, and those truly worried about Spanish and Philippine law took the trouble to draft specific

⁶⁷ See, e.g., Republic of Argentina, *supra* note 1.

⁶⁸ See, e.g., William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2004); Buchheit & Pam, *supra* note 52; Gulati & Klee, *supra* note 52.

⁶⁹ See *supra* note 63.

provisions to that effect.⁷⁰ *Pari passu* is left as “belt-and-suspenders” at best, meaningless at worst.

In fairness, Bratton’s goal is not to advocate for the broad interpretation of *pari passu*, but to demonstrate the term’s ambiguity and shifting meaning. He debunks some of the disaster scenarios put forward by the narrow reading proponents and shows how a broad reading might be favorable to creditors and acceptable to debtors, using arguments similar to those advanced by sovereign bondholders after the Ecuador eruption.⁷¹ But like others in the broad reading camp, he stops short of showing that at any point before *Elliott*, creditors and debtors had actually bargained for the ratable payment interpretation notwithstanding decades of authoritative commentary to the contrary.⁷²

Most likely, the poorly drafted clause persisted in its many relatively inconsequential meanings, largely ignored until a combination of creative lawyering in *Elliott*, buy-side protest in Ecuador, and the G-7 focus on sovereign debt contracts forced it out of obscurity.⁷³ Overnight, *pari passu* came to express, above all, bondholder frustration with sovereign borrowers’ freedom to discriminate among their creditors. But as recent court cases suggest, the clause is a blunt, unpredictable, and generally inadequate weapon to enforce intercreditor equity. This is hardly surprising when viewed in the context of the broader confusion about sovereign priorities. Where there is no agreement on the basic idea of a distribution sequence or its enforcement, and where, more often than not, the payment ladder is left to sovereign discretion, equality among claimants at one rung of the ladder will be hard to come by.

D. A New Frontier

Borrowers have often tried to limit the *pari passu* undertaking to external debt on the theory that domestic currency or domestic-law debt represents a claim on distinct resources and/or can be managed unilaterally.⁷⁴ This reasoning is losing ground as countries issue more domestic debt and are less

⁷⁰ Buchheit & Pam, *supra* note 52, at 886-89.

⁷¹ See *supra* note 56 and accompanying text.

⁷² See WOOD, *supra* note 30; Buchheit, *supra* note 53, Feilchenfeld, *supra* note 3.

⁷³ See Bratton, *supra* note 68, at 859-60; Anna Gelper, *How Collective Action Is Changing Sovereign Debt*, INT’L FIN. L. REV., May 2003, at 20.

⁷⁴ BUCHHEIT, *supra* note 51, at 79; ANTHONY C. GOOCH & LINDA B. KLEIN, ANNOTATED SAMPLE REVOLVING CREDIT AGREEMENT 39 (1994); INT’L MONETARY FUND, SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 12-19 (Aug. 14, 2002), available at <http://www.imf.org/external/np/pdr/sdrm/2002/081402.htm>.

inclined to inflate or decree it away. Moreover, in the past, the currency of denomination and the governing law and residence of the debt holder used to go together—domestic debt was in local currency, governed by local law and held by local residents; external debt was foreign currency, governed by foreign law, and held by foreign residents. Over the past decade, these categories have become thoroughly jumbled, as domestic residents invest in traditionally external instruments and foreign investors become active in domestic markets. It is no longer reasonable to assume that domestic debt will be treated as a uniform class and in a predictable fashion.⁷⁵

Until recently, discussions of “senior” sovereign debt focused on the multilaterals’ preferred creditor status. Argentina’s proposals to exempt some domestic instruments from restructuring helped shift attention to domestic debt.⁷⁶ This shift is most appropriate. According to World Bank and IMF data, about half of all countries in JP Morgan’s EMBI Global Index owe one-fifth or more of their external debt to the multilaterals (the last “supersenior” creditors standing).⁷⁷ Yet almost eighty percent of Brazil’s public debt is domestic, compared to about one-fifth of its external debt (four percent total) owed to multilaterals.⁷⁸ If Argentina is any guide, the uncertainty about future treatment of domestic debt in a country like Brazil could dwarf concerns over the multilaterals’ seniority.

* * *

These incidents suggest that the current priority structure of sovereign debt is less than transparent and surprisingly fragile. Not only is it vulnerable to subversion by the debtor, as already noted earlier, but it also relies on the acceptance of *and* financing (or more often, forbearance) from major creditor groups. Priority can collapse when one group of creditors refuses to acquiesce in another’s privilege. A further important implication of this history is that analysis of sovereign priorities must consider (as does insolvency analysis

⁷⁵ See Anna Gelpern & Brad Setser, *Domestic Debt and the Doomed Quest for Equal Treatment*, 35 GEO. J. INT’L L. (forthcoming 2004) (citing the examples of Russia, Argentina, and Turkey); Anna Gelpern, *Beyond Balancing the Interests of Creditors and Developing States*, Presentation at the 97th Annual Meeting of the American Society of International Law 221, 223 (Apr. 2-5, 2003)(unpublished manuscript).

⁷⁶ See, e.g., *After Default—Argentina Needs a Very Substantial Reduction in U.S. Debt*, FIN. TIMES, June 30, 2003, at 18; *supra* note 6.

⁷⁷ See Joint BIS-IMF-OECD-World Bank Statistics on World Debt (May 30, 2003), available at <http://www.oecd.org/statistics/jointdebt>.

⁷⁸ See Recent Developments in Republic as of June 10, 2003, at <http://www.sec.gov/Archives/edgar/data/205317/000119312503009626/dex99k.htm> (last visited June 10, 2004); Joint BIS-IMF-OECD-World Bank Statistics on External Debt, at http://www1.oecd.org/dac/debt/htm/jt_bra.htm (last visited June 10, 2004).

under national law) all sources of funds material to the debtor's financial condition and debt service capacity. Unlike recent work on the collective action problem in sovereign debt, a discussion of priorities cannot be limited to private external debt. The case of Argentina is only the latest in which private external creditors mutter about their litigious comrades, but howl about the perceived privileges of official and domestic creditors.

IV. PRIORITY FOR PRIORITIES?

So far, this Article has argued that transparent, enforceable priority systems can shape lending and borrowing incentives and play an important role in domestic insolvency, but not in sovereign financial crises. The sovereign character of the borrower might circumscribe, but would not preclude, such a role, even as it has enabled significant variation in treatment among similarly situated creditors. Yet all this does not add up to a problem in need of legal, academic, or policy intervention.

To date, nearly all such intervention in the field of sovereign debt has focused on deterring holdout behavior in restructuring external bonds governed by New York law. In simplest terms, the problem that has featured in countless G-7 statements, financial press editorials, and academic papers⁷⁹ is this: when a country cannot (or will not) pay all its creditors in full and on time, it serves the collective interest of all creditors to agree on a restructuring where all might lose some value relative to the original promise, provided the debtor's prospects of economic recovery go up and with it the repayment prospects of the restructured debt. However, an individual creditor that refuses to restructure stands to gain disproportionately from the others' concessions. If enough creditors agree to reduce their claims, the debtor may be able to pay the holdout in full. Reluctant to subsidize the holdout, other creditors might refuse to participate in a restructuring.

Sovereign bonds governed by New York law are uniquely prone to this behavior because, until recently, they contained no contractual mechanism to bind the potential holdout. By custom, documentation for such bonds required unanimous approval of the holders to amend financial terms. Although a

⁷⁹ See Anna Gelper, *For Richer, For Poorer: Sovereign Debt Contracts in Crisis*, 1 J. INT'L BANKING REG. 20, 21-22 & nn.4-8 (2000); Gelper, *supra* note 73, at 20; Anthony Richards & Mark Gugiatti, *Do Collective Action Clauses Influence Bond Yields?: New Evidence from Emerging Markets*, 6 INT'L FIN. 415 (2003).

restructuring could be accomplished effectively through a debt exchange (instead of amending the old bond, participating holders exchange it for a new one), creditors refusing to exchange retained the full original claim. In contrast, English-law sovereign bonds could be amended by majority vote. Similar mechanisms in domestic insolvency statutes deter holdouts in corporate reorganization.

Modern-day New York law bonds have featured in three sovereign debt crises to date: Ecuador (1998-99), Uruguay (2002-03), and Argentina (2001-?). Other prominent crises of the past decade have centered on English-law bonds (Pakistan, Ukraine), domestic law bonds (Mexico, Russia), government-to-government credits (Nigeria), or private sector obligations (Thailand, Korea, Indonesia). In Ecuador's and Uruguay's debt exchanges, the presence of holdouts (under ten percent of the debt eligible for exchange) did not appear to deter the bulk of the creditors from participating, even though the holdouts were paid off in full, effectively levying a tax on the restructuring. Argentina's case is the first one to see litigation involving New York law sovereign bonds.⁸⁰ The potential effect of litigation on the eventual restructuring is uncertain. Payments to holdouts in Ecuador and Uruguay, a potential windfall for Argentina's litigants, and recent settlements benefiting holdouts under loan instruments⁸¹ may yet trigger an epidemic of holdout behavior under New York law bonds. However, nearly a decade after it first became the focus of policy and academic attention,⁸² the holdout problem has all but failed to materialize.

In any event, the good news is that a solution is well under way. After years of official and academic exhortation, Mexico led the way in early 2003 in changing its New York law bond documentation to allow a bondholder majority to bind the rest in a restructuring. At least a half-dozen other countries have followed with minimal market reaction, defying dire predictions of Wall Street boycotts and suggesting that New York convention has a decent chance of shifting for good in favor of collective action.⁸³

⁸⁰ See, e.g., Whitney Debevoise & David Orta, *The Class Action Threat to Sovereign Workouts*, INT'L FIN. L. REV., July 2003, at 41; David Skeel, *Why the Class Action Strategy Is Worth a Second Look*, INT'L FIN. L. REV., Sept. 2003, at 23; *supra* notes 62-63.

⁸¹ *Elliott Assocs., L.P. v. Republic of Peru*, 12 F. Supp. 2d 328 (S.D.N.Y. 1998); Felix Salmon, *Elliott Associates' Agression Captures Low-Risk Returns*, EUROMONEY, Feb. 2004; *supra* note 60.

⁸² BARRY EICHENGREEN & RICHARD PORTES, *CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS* (1995); James Hurlock & Troy Alexander, *The Fire Next Time: The Dangers in the Next Debt Crisis*, INT'L FIN. L. REV., Mar. 1996, at 14.

⁸³ See Stephen Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination*

In stark contrast to the holdout-collective action problem, the absence of explicit, enforceable priorities in sovereign debt has received virtually no policy or academic attention until last year, even though ex post discrimination among creditor groups has been a concern in every single one of the sovereign crises listed earlier. In the cases of Ecuador, Russia, and Argentina, small creditor rebellions have erupted in response to perceived discrimination. At a minimum, then, the problem deserves more study.

The status quo, where all debt is legally equal but where the borrower retains effective discretion to discriminate ex post, raises at least four potential concerns. First, when lending to a government, creditors must take into account the possibility of being subordinated if the borrower runs into financial trouble. They would be expected to charge extra for this possibility, raising a solvent country's borrowing costs. This is not necessarily bad—a country effectively pays for an option to subordinate—unless it does not want the option, but falls victim to creditor perceptions of generalized uncertainty. On the other hand, creditors who expected to be treated as senior based on their reading of past sovereign restructurings might charge less than they would have on the expectation of being subordinated against their will.⁸⁴

Second, as Patrick Bolton, David Skeel, and Jeromin Zettelmeyer have argued persuasively, the absence of priorities tempts countries to take on excessive new debt, diluting earlier creditors.⁸⁵ In a variation on the dilution argument, it is not hard to imagine a government, prone to overborrowing, attempting to procure new credits with a promise of outright seniority.⁸⁶

of Sovereign Bonds, 53 EMORY L.J. 929 (2004); Gelpern, *supra* note 73.

⁸⁴ See McBrady & Seasholes, *supra* note 45 (noting that sovereign bond yields jumped across the board after Pakistan restructured its Eurobonds—about one percent of its debt stock).

⁸⁵ See Bolton & Skeel, *supra* note 10; Zettelmeyer, *supra* note 4. The theory is that an insolvent sovereign would keep borrowing new money to repay old creditors, so long as it had access to new financing that is not conditioned on improved policy. Thus, the borrower will delay debt restructuring and policy reform. Moreover, because the borrower had already reached the limit of its repayment capacity before taking on the new debt, repaying the new debt would have to come from funds to which the old creditors had looked for repayment. The old creditors are “diluted” in their claim to the borrower's repayment capacity, which must now be shared with the new creditors.

⁸⁶ Most commentators addressing the dilution problem, including Bolton, Skeel, and Zettelmeyer, ground their analysis in the corporate debt analogy, which assumes that contracts are enforceable and involuntary subordination ex post is not an option. With these assumptions, *pari passu* borrowing and dilution are the expected adverse outcome. Rasmussen makes the same assumption describing a different problem, debt overhang: “This inability to promise all of the potential gain to the funding creditors means that, at the margin, the debtor will be unable to borrow to fund [an otherwise desirable] project.” Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1163, 1172 (2004). Yet as a practical matter, a sovereign borrower is remarkably free to accord preferential treatment to any creditor. IFI

Suppose a country has borrowed up to the limit of its repayment capacity. New borrowing would not spur growth or improve anyone's recovery prospects—it would merely add to the already crushing debt load. The country's leader is running for re-election and faces the choice of defaulting on some debt immediately (risking massive internal dislocation and loss of office) or borrowing more to overcome the near-term payment spike. To induce a new creditor to lend, the leader assures her privately that should trouble strike, she will be repaid before all others—effectively jumping the queue. It is not unreasonable for a creditor hearing such assurances to believe them and proceed to overlend. After all, the leader would owe her his re-election. Both the dilution and the involuntary subordination scenarios imply that new creditors advancing funds to a sovereign facing insolvency are able to charge less than they might have in a world where prior creditors had credible means of constraining the country's subsequent borrowing or treatment of creditors. In sum, the possibility of ex post dilution or subordination makes early borrowing more expensive and late borrowing cheaper than it might have been.⁸⁷

Third, and related to the second point, a creditor lending to a country—whether or not it has reached repayment capacity—may insist on lending backed by collateral to guard against the possibility of subordination. At the moment, very little sovereign debt is secured; most such debt has been issued by state-owned enterprises. Most sovereigns are restricted from pledging assets and selling them forward under negative pledge and related covenants in their private and public debt documentation, with one of the most restrictive formulations found in country agreements with the World Bank.⁸⁸ However, structures designed to go around the negative pledge clause to give creditors greater payment assurances or even something close to security are becoming

financing is the most prominent example of this phenomenon; Argentina's issuance and diligent servicing of new domestic debt is the most recent example. *See supra* note 1; *infra* notes 115-16.

⁸⁷ Because the pool of emerging market investors is relatively small and specialized, "new" creditors are often old creditors refinancing old debts that cannot be paid. Argentina's funding strategy in 1999-2001 is an unusual example of a financially sophisticated sovereign tapping distinct pools of capital. After its institutional investors had lost confidence, Argentina proceeded to raise more money from retail investors, then pressured domestic banks and pension funds to buy yet more government paper, and finally drew on additional IMF resources in an effort to avoid default—which came anyway at the end of 2001. Even though few of these investors were truly "new" and all were deluding themselves to some extent, each group might have hoped that Argentina would treat it better than the rest in an eventual restructuring. *See* Brad Setser & Anna Gelpert, *Pathways Through Financial Crisis: Argentina* (Apr. 27, 2004) (unpublished manuscript, on file with author).

⁸⁸ LEE C. BUCHHEIT, *HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS* 86 (2000).

increasingly common. Most of these involve placing dedicated payment streams under creditor or third-party control.⁸⁹ Moreover, negative pledge waivers do happen and may become more attractive to lenders facing the choice between certain default and some hope of a coupon payment combined with a chance of riding out the crisis. To the extent an unsecured creditor's access to the sovereign's assets is already remote, the availability of new secured credit to overcome a liquidity crunch may make a negative pledge waiver look like a cheap giveaway.

Secured sovereign debt presents a special problem of political accountability. Pledging collateral in this context would likely involve locking up foreign currency resources in advance. Whereas unsecured debt competes with a government's other spending priorities on more or less an equal footing at the time payment is due, secured debt effectively puts payments to creditors ahead of domestic policy and other government spending in a financial crisis. A grant of security combined with yielding control of the collateral deprives future governments and voters of a chance to decide on spending priorities at what would surely be an extremely sensitive political moment.⁹⁰ In this respect, secured borrowing by political and commercial entities is fundamentally distinct. In the political context, leaders with limited time horizons may have strong incentives to profit (financially or otherwise) by encumbering their successors and future voters. This argues in favor of eliminating to the maximum extent possible any incentives for secured borrowing by governments, or subjecting such borrowing to a higher standard of political accountability.⁹¹

⁸⁹ See, e.g., discussion *infra* note 90. When the United States advanced money to Mexico in the middle of the 1995 financial crisis, it ensured that Mexico's oil revenue streams would pass through a special account at the Federal Reserve Bank of New York. The United States did not get a formal security interest in the payment streams, and therefore did not seek negative pledge waivers.

⁹⁰ See ROUBINI & SETSER, *supra* note 6, ch. 7. For purposes of this Article, it is critical to distinguish between priorities and security interest in property collateral, including payment streams. In the priorities context, the paramount question about secured debt is whether contractual grants of security should be respected in distress. The broad affirmative answer to this question for sovereign debt is supported by the work of IMF staff in designing the SDRM. INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 139-40 (Nov. 27, 2002), available at <http://www.imf.org/external/np/pdr/sdrm/2002/112702.htm>. Once that presumption is established, most questions focus on the creditor's claim to the particular property. In contrast, the broader treatment of priorities in this Article is concerned primarily with claims on the debtor's general resources, not specific property. Mindful of an age-old warning against conflating security and priority in sovereign debt, I leave further discussion of security and related negative pledge issues to a separate paper. See Feilchenfeld, *supra* note 3, § 656.

⁹¹ IMF staff make a somewhat more tempered case to this effect in a recent paper, suggesting that cash flow pledges complicate fiscal management and risk undermining financial transparency and governance.

Fourth and last, once a country has hit financial trouble, fights over allocating its inadequate repayment capacity tend to be longer and messier in the absence of an enforceable priority structure, potentially delaying economic recovery. This is a version of the collective action problem, distinct from the litigious holdout variety discussed earlier. Because different creditor groups expect to be treated differently, no group would agree to take losses before knowing how the other groups may be treated. And because there is no agreed point in time that constitutes sovereign insolvency, nor a generalized process for restructuring all of a government's debts (including domestic, external, public, and private), fights would ensue over the sequence of restructuring among groups—as in fact they have, between the Paris Club of government-to-government creditors and the private creditors of Russia and Ecuador, among others.⁹²

V. ELUSIVE SOLUTIONS

One could conclude here with the thought that the opaque and unstable priority structure of sovereign debt, prone as it is to debtor discretion, distorts lending and borrowing incentives and contributes to the messiness of sovereign debt restructurings. Unlike the collective action problem, which has received much policy attention, the priority problem has received little and deserves more.

Going beyond this insight—making priorities more transparent and predictable—involves complex challenges. First, any attempt to formalize the current informal system would bring political controversy. For example, the IFIs and their sponsors surely would want to keep their place at the top of any formal hierarchy. They would probably succeed in the end, judging by the fact that the IFIs' preferred creditor status has been widely acknowledged and rarely challenged notwithstanding its customary provenance. It is also certain

INT'L MONETARY FUND, ASSESSING PUBLIC SECTOR BORROWING COLLATERALIZED ON FUTURE FLOW RECEIVABLES (June 11, 2003), *available at* <http://www.imf.org/external/np/fad/2003/061103.pdf>; *see also* Zettelmeyer, *supra* note 4, at 21. Rasmussen points out that giving creditors control over corporate cash flows “effectively gives the creditor the power to shut down the corporation. A state cannot, even if it were willing to do so, enter into an agreement that would give a creditor the power to, in effect, shut down the government.” Rasmussen, *supra* note 86, at 1176.

⁹² Normally, the Paris Club restructures first and demands that the borrower seek “comparable treatment.” In Russia and Ecuador, private creditors went first and pressed the country to demand “reverse comparability” from the Paris Club. Although comparability is notoriously hard to establish, the Club essentially ignored this argument and proceeded to restructure under its conventional formulas. *See, e.g.,* Jorge Gallardo, *Cracks in the New Financial Architecture*, EUROMONEY, Apr. 2001, at 50.

that an effort to formalize the IFIs' seniority would draw objections from creditors who question the institutions' added value, particularly when they provide no net new financing. The wisdom of fortifying the status quo at such high political cost is questionable.⁹³

Beyond formalizing the status quo, the most promising proposals would rank credits based on the time they were extended. Depending on the proponents' particular view of the sovereign debt problem, either the oldest or the most recent credits would receive priority treatment. The most common of these time-based proposals takes its cue from the privileged treatment of certain postpetition (DIP) financing in U.S. bankruptcy. This tends to be lending into a high-risk environment under court supervision to preserve the debtor as a going concern and to facilitate rehabilitation. The DIP financing rationale is already part of the basis for exempting IFI and post-cut-off Paris Club debt from restructuring.⁹⁴ The need to attract priority *private* financing in crisis has been discussed by the IMF and Bolton and Skeel in the context of statutory sovereign bankruptcy regimes, as well as by Buchheit and Gulati in their comprehensive contractual framework.⁹⁵ Giving repayment priority to private credit extended in crisis makes sense either if the official sector does not have enough funds to cover the financing need or if it is undesirable to have the official sector do so. On the other hand, in the ideal, official lending is explicitly tied to policy reform that helps lead the country out of crisis. Delegating some of this lending to the private sector could dilute the official sector's policy leverage. While some might see this as a positive, a broader debate on the utility of IFI lending is beyond the scope of this Article.⁹⁶

⁹³ The exorbitant political costs of formalizing any sovereign restructuring arrangements, especially in ways that would reopen international treaties and require approval of national legislatures, had long been understood and were publicly acknowledged by U.S. officials just before the death of the IMF's SDRM proposal. See Alan Beattie, *U.S. Set to Block 'Sovereign Chapter 11 Proposals'*, FIN. TIMES, Mar. 31, 2003.

⁹⁴ Paris Club agreements operate only on so-called "pre-cut-off debt"—financing commitments by creditors contracted before an agreed-upon date. The goal is to exempt new debt from restructuring "to help the recovery of the debtor country"—essentially identical to the rationale for privileging DIP financing in U.S. bankruptcy. See Paris Club, Cutoff Date, at <http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B01WP05> (last visited June 10, 2004).

⁹⁵ INT'L MONETARY FUND, PROPOSED FEATURES OF A SOVEREIGN DEBT RESTRUCTURING MECHANISM 26 (Feb. 12, 2003), available at <http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>; Bolton & Skeel, *supra* note 10, at 788-93; Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 53 EMORY L.J. 1317 (2003).

⁹⁶ See Edwin M. Truman, *Perspectives on External Financial Crises*, Address to the Money Marketeters of New York University 8 (Dec. 10, 2001) (on file with author). The analogy to firm reorganization is instructive. Under Chapter 11 of the U.S. Bankruptcy Code, reorganization proceeds with court supervision. A court has no financial interest in the outcome of the debt restructuring it oversees. In sovereign insolvency today, the IMF effectively combines the roles of plan supervisor, plan proponent (with the borrowing

Bolton and Skeel also propose a “first-in-time” priority rule to address their principal concern—overborrowing by the sovereign.⁹⁷ They observe that every subsequent *pari passu* borrowing by a country that is at the limit of its repayment capacity dilutes prior creditors. A country that is able to borrow new money by diluting old creditors would keep taking on new debt to delay reform and restructuring. However, if every subsequent credit were junior to the ones that came before, the recovery prospects for new credit would diminish or even disappear once a country has reached its repayment capacity. Where creditors know the country’s debt stock and can assess its repayment capacity, this would discourage new lending.

Although this approach may indeed stem overborrowing, it has disadvantages. First, its effect would be procyclical. That is, unless a government had the foresight to issue large amounts of contractually subordinated debt in good times (unlikely with short political horizons), the rule would tend to raise borrowing costs and shrink maturities as sovereign finances deteriorate, to compensate for progressively more junior ranking. Thus, a rule that would help speed the day of reckoning in solvency cases may also make liquidity crises harder to manage.⁹⁸ Second, a first-in-time rule would discourage refinancing, even on favorable terms, potentially constraining a common and sensible debt management practice.⁹⁹ Third, the rule would yield a multitude

government), and provider of priority financing. IMF critics point out that this gives rise to profound conflicts of interest. The response—that the IMF’s public policy mission trumps any financial interest it might have as a creditor—is unsatisfactory if only because it suggests that the rich country taxpayers funding the IMF are willing to take losses on their investment. See pp. 1153-54 for a related discussion of control and the IMF’s proper place in the hierarchy of priorities.

⁹⁷ Bolton & Skeel, *supra* note 10, at 786; *see also supra* note 77 and accompanying text.

⁹⁸ An insolvent sovereign borrower generally has more debt than it can service over the foreseeable future, even with major policy adjustments. A sovereign’s main assets are intangible—its capacity to generate primary budget surpluses and use domestic tax revenues to buy foreign exchange. But some sovereigns accumulate liabilities in excess of any realistic assessment of their ability and willingness to pay. An illiquid borrower merely lacks readily available funds to make payments coming due in the near term. It may not be carrying too much debt relative to its medium- or long-term repayment capacity. Forcing such a borrower to default or restructure may cause needless market panic and economic dislocation, and may impair its long-term economic prospects. It may well make sense for such a borrower to take on new debt to refinance the old, perhaps reprofiling its overall debt stock in the process without reducing the face value of its old debt. However, in sovereign debt, the distinction between liquidity and solvency is a matter of art and opinion rather than science. Very few countries staring into the abyss have so little debt that new borrowing is the obvious choice. In most cases (including, incredibly, Argentina at the end of 2001, *see* Truman, *supra* note 96, at 4), the country’s leaders and creditors prefer to hope they can ride out the immediate financing crunch with a bit of new money, which would bring renewed market confidence, yet more money, new investment, and economic growth. Sadly, in many cases they are just gambling for resurrection.

⁹⁹ *See, e.g.*, Celebration of Mexico’s Early Repurchase of its Brady Bonds, Presentation by the Minister of Finance and Public Credit (June 12, 2003) (on file with author). A country may avoid some effects of the

of classes and would require an ambitious monitoring and enforcement apparatus across jurisdictions. Faced with this implementation challenge, policymakers and market participants may prefer a straightforward (if less nuanced) debt ceiling already common in high-yield debt and some IFI programs. Finally, it is inconceivable that any of the G-7 would agree to constrain their own debt management with a first-in-time rule, raising further obstacles to implementation.¹⁰⁰

Beyond these time-based categories, consensus would be even more elusive. Giving priority to debts held by particular creditors—be it domestic financial institutions, individuals, or any other groups of creditors based on their likely importance to crisis resolution—would be hard to justify across the board, and even harder to administer. For example, even though protecting the banking and payments systems may be all-important in crisis, *ex ante* promise of priority treatment may mean rewarding corrupt bank owners or, at the very least, may add up to a distorted deposit insurance scheme. Moreover, as different types of holders increasingly hold the same tradable instruments, tracking beneficial owners for privileged treatment would be a tall order.¹⁰¹

Trade credits are frequently singled out for special treatment in

automatic subordination of new debt by issuing contractually subordinated debt in advance. This would complicate the already complicated system. It may also attempt to “grandfather” the new debt by contract to the issue date of the debt being retired. California has done this with some registered warrants that inherit the priority ranking of the debt they are used to pay. *See supra* note 26. This would require vigilant monitoring of the use of proceeds at the risk of undermining the whole system.

¹⁰⁰ This argument parallels the debate surrounding introduction of majority amendment and other so-called collective action clauses in sovereign debt. *See supra* note 82 and accompanying text. After some years of exhorting emerging markets governments to use such clauses, the United Kingdom and Canada led by example. However, the U.S. Treasury—one of the oldest and strongest supporters of contractual modernization—flatly refused to consider including such clauses in U.S. Treasuries. Ironically, the Treasury’s rationale was the same as that of its emerging markets counterparts—that including procedures for debt restructuring in debt contracts would in fact signal the possibility of restructuring, which every government professes to be zero at issuance. A mandatory first-in-time rule would be even more controversial because it would operate as an automatic constraint on debt management—if the priority ranking were meaningful, every subsequent debt issue would be more expensive. As in the case of collective action clauses, some would argue that the incremental rise in borrowing costs *should* be zero for rich countries, because the market would never expect them to default or restructure, or for the priority system to be deployed. The difference between “should” (sufficient for economists) and “would” (necessary for debt managers) is key. One need not believe the most dire assessments of U.S. debt sustainability, *see Don’t Look Down*, N.Y. TIMES, Oct. 14, 2003; Paul Krugman, *Rubin Gets Shriek*, N.Y. TIMES, Jan. 6, 2004, to suppose that the United States would not risk upsetting its multitrillion dollar public debt market on the distant hope of a moderate benefit for a few developing countries that issue a few billion dollars in debt combined. Note that this approach would substantially alter sovereign yield curves in such a way that debt with the same residual maturities would have different yields based on the time of issue. ROUBINI & SETSER, *supra* note 6, at 72.

¹⁰¹ *See supra* note 75.

restructuring. However, to the extent most trade debt is owed by private entities rather than governments, giving it formal ex ante priority in the *sovereign* debt hierarchy could increase pressure for government guarantees when more limited measures (such as facilitating access to foreign exchange) might be appropriate in a given crisis. Many observers have also noted that trade credits are often hard to distinguish from other types of financing. Formal priority might lead to more financing structured to look like trade credit.¹⁰²

It has been suggested that from the perspective of orderly restructuring (as distinct from ex ante financing incentives) the optimal priority structure is general equality—across-the-board *pari passu* treatment—where the insolvent borrower's available assets are divided equally among claimants.¹⁰³ The concern is that in any hierarchy, senior creditors—who only care about their own recovery—will quickly agree to deep debt reduction and abscond with most of the value available for distribution, leaving the rest empty-handed or fighting more bitterly for the leftovers.¹⁰⁴

The power of senior creditors to negotiate debt restructuring on behalf of the rest is an issue distinct from the priority structure itself, and is generally beyond the scope of this Article. However, the IMF's comprehensive survey of national insolvency procedures reveals that many countries exclude senior and secured creditors from voting altogether when the reorganization plan does not impair the value of their claims; alternatively, senior creditors may vote in separate classes. They may block a reorganization plan only if it gives them less value than they would have received in liquidation, or if their value is impaired while creditors junior to them are allowed to recover.¹⁰⁵ Thus the hypothetical where senior creditors reach a deal with the borrower that deprives junior creditors of all value is inconsistent with bankruptcy practice. Recognizing that liquidation is not an option in sovereign distress, the voting regime may need to establish proxies for liquidation value. However, the key

¹⁰² Bolton and Skeel propose a creative solution for this problem in their statutory sovereign bankruptcy regime. Bolton & Skeel, *supra* note 10, at 793-95.

¹⁰³ I am indebted to Jeromin Zettelmeyer for this argument. See Zettelmeyer, *supra* note 4; Eduardo R. Borensztein & Paolo Mauro, *Sovereign Debt Structure for Crisis Prevention*, IMF STAFF REP. (forthcoming 2004).

¹⁰⁴ See *supra* p. 1125.

¹⁰⁵ INT'L MONETARY FUND, *supra* note 8; INT'L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES ch. 4 (1999), at <http://www.imf.org/external/pubs/ft/orderly/index.htm#rehab>; see also Bolton & Skeel, *supra* note 10, at 793; David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

point is that a priority hierarchy does not inherently imply voting rules that disenfranchise junior creditors; to the contrary, voting rules may be used to balance the power of senior creditors.

Another version of the argument focuses on substantive distribution rules—if senior creditors are allowed to skim off the top, less is left for the rest, who may find it harder to agree on a restructuring. It is difficult to predict the extent to which fights among equally ranked creditors get more bitter as the asset pool shrinks. What is certain is that with every layer of clear, enforceable priorities, a group of creditors steps out of the fight in the prescribed order. Even in a simple two-tier system with one senior creditor, once that creditor recovers in full, it steps out of the picture. A hierarchy with more levels—and an enforceable distribution “waterfall”—would take yet more creditors out of contention in a predictable order. Using the firm bankruptcy analogy, the remaining junior creditors that rank *pari passu* among themselves would split the smaller asset pool pro rata.

In sum, from the perspective of orderly restructuring, it appears that the content of priority rules matters less than their existence and strict enforcement. However, from the perspective of maximizing the aggregate value of the sovereign “estate,” the content of a priority system and the place of each creditor in a hierarchy matter a great deal.

Based on the history of sovereign debt markets,¹⁰⁶ it is safe to assume that governments will continue to discriminate among creditors on political, economic, and any number of other grounds. In any hierarchy, junior creditors want to maximize the size of the total pie, because otherwise they risk getting nothing. Senior creditors are content to let go after they have collected what is owed to them alone. With countries as with firms, different creditor groups differ in the amount of leverage they have over government policy. It stands to reason that those with more leverage should have a higher stake in promoting policy that would maximize repayment capacity.¹⁰⁷ Candidates for subordination on these grounds include domestic residents who are voters and the IFIs. On the other hand, these same creditors are less like firm shareholders and more like postpetition (DIP) creditors in bankruptcy—which argues in favor of making them senior. Voters (to the extent they hold government debt, keep money in the banks, pay taxes or work) and the IFIs are often the only sources of financing for a government in crisis and its only hope

¹⁰⁶ Feilchenfeld, *supra* note 3.

¹⁰⁷ See *supra* pp. 1125-26.

of financial and economic rehabilitation. But what if the primary motivations of these creditors were nonfinancial? By this logic, which focuses on the difference between countries and firms, there is no downside in granting seniority to voters and the IFIs, because they would not cut and run after getting their money—they have an interest in the country’s recovery that is independent of debt repayment, and would pursue it vigorously beyond their own recovery.¹⁰⁸ The upshot seems to be that a hierarchy is inevitable, but yet again it is hard to tell who should be on top.

Finally, there is no authority in the international realm that enjoys the legitimacy necessary to legislate the appropriate distribution of substantive priorities.¹⁰⁹ For example, the IFIs are increasingly faulted for conflict of interest—they establish the policy framework that sets a country’s repayment capacity, but as senior creditors, they also “skim off the top.”¹¹⁰ Similarly, governments of major financial centers are under suspicion that they are trying to enrich their reckless investor nationals at the expense of poor countries.

In sum, it is hard to envision a broadly applicable, substantive hierarchy of priorities that would have political and financial viability. Most of the proposals to date have serious flaws that would make them poor candidates for ex ante, across-the-board implementation, even if they might work in individual cases.

What remains is the option of allowing each country to set priorities unilaterally or by contract, but encouraging it to disclose the rankings at the time of borrowing and helping it enforce this commitment when funds are short. Under this system a country could, for example, disclose its intention to

¹⁰⁸ Among recent commentary on sovereign restructuring, Rasmussen’s is unique in explicitly focusing on issues of control. See Rasmussen, *supra* note 86, at 1174-78. U.S. corporate bankruptcy scholars have documented a shift in control of the restructuring process from management or equity to senior creditors. See, e.g., Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003). As noted earlier, the sovereign control picture has been more complex from the start, because creditors that have often enjoyed senior status also have equity characteristics. For example, local elites (more often than average voters) tend to exercise considerable control over policymaking both before and after the crisis, but also tend to do relatively well in debt workouts. The most prominent senior creditors—the IMF and the World Bank—are membership organizations in which the borrowing country holds stakes, as well as public policy institutions ostensibly looking out for the welfare of their members. The position of most private external creditors in sovereign restructurings is perhaps farthest from the corporate analogy. Ever since gunboat diplomacy has taken a backseat to more civilized methods of debt collection, the difficulty of private enforcement against sovereign borrowers has diminished private creditors’ policy leverage. The political challenge of giving more policy control to private creditors would make it improbable.

¹⁰⁹ See Tarullo, *supra* note 21.

¹¹⁰ See *supra* note 83.

privilege the IFIs, certain domestic expenditures, and any other categories of debt currently presumed to enjoy priority.¹¹¹ It could also subordinate certain domestic expenditures and issue contractually subordinated debt, which, when disclosed, would enhance the standing of the country's other obligations.¹¹²

One concern with this approach is that a country may want to discriminate in ways that are undesirable from a policy standpoint—for example, by distinguishing among different nationals holding the same instrument. Such discrimination can be ruled out of bounds by national courts to the extent it is against national law, under bilateral or multilateral treaties (e.g., in national

¹¹¹ This could be documented contractually much the same way as California's priority structure. For example, documentation for the state's subordinated debt states specifically that it is

payable and will be paid from Unapplied Money in the General Fund on any date after all Priority Payments have been made on that date. "Priority Payments" are defined as payments to (i) support the public school system and public institutions of higher learning (as provided in . . . the Constitution of the State), (ii) pay principal of . . . and interest on general obligation bonds of the State, (iii) provide required reimbursement from the General Fund to any special fund . . . pursuant to California Government Code . . . ; and (iv) pay State employees' wages and benefits, State payments to pension and other State employee benefit trust funds, State MediCal claims, rental payments to support lease revenue bonds, and any amounts . . . required by . . . law . . . to be paid with State warrants that can be cashed immediately.

Forward Warrant Purchase Agreement Dated as of June 18, 2003 by and Between the State of California and Goldman, Sachs & Co., at 4-5, 9 (on file with author).

¹¹² For example, the credit rating of the City of Naples was boosted by its explicit subordination of municipal expenditures to debt service. In 1996, Naples sought a credit rating to access the international capital markets. The city's economy was in shambles and its governance left so much to be desired that local and national authorities had agreed to put Naples in bankruptcy to stop city officials from siphoning off cash. It was not going to get the rating it had hoped for—until the visiting analyst was shown an Italian law requiring Naples to funnel most receipts through a fund that was under irrevocable instructions (*delegazione di pagamento*) to make interest and principal payments to the city's creditors before applying funds to other municipal purposes—even pressing social needs. *Delegazione* is mandatory for bond issues, and optional for loans—though Naples chose to apply it across the board. Impressed, the analyst gave Naples the highest possible subsovereign credit rating—investment grade, on par with the Republic of Italy.

Delegazione is more than a mere promise to repay some claimants ahead of others. But the mechanism is also less than a security interest and remains vulnerable to changes in local and national law and political sentiment. Yet Naples has had a perfect debt servicing record since World War II, and at the time Naples received its rating, four hundred other local governments were in bankruptcy—yet not one had missed a payment under *delegazione*. The rating agency's willingness to put stock in the *delegazione* mechanism—dramatically reducing the cost of borrowing for Naples—suggests that sovereign borrowers and their creditors both may have something to gain from a transparent, credible commitment to a payment sequence.

But the viability of state and municipal debt tiering may depend critically on the existence of a national government. For example, because the *delegazione* mechanism is a matter of Italian law and because most of Naples's revenues came from central government transfers, creditors were effectively looking to national law and the national treasury for repayment—not the city's say-so. See Annual Report of the City of Naples (*Comune di Napoli*) on Form 18-K, for Fiscal Year Ending Dec. 31, 2001, at 16-19, available at <http://www.sec.gov/Archives/edgar/data/1016472/000095011703005352/0000950117-03-005352.txt>.

treatment provisions), or by international institutions where their policy tools are used to support enforcement of priorities, as discussed below. Substantive limits on discrimination must be sparse to be credible, and could be articulated in a coordinated fashion as part of a code of conduct endorsed by the IFIs, the G-7, and major market participants (sovereign borrowers and creditors).¹¹³

Even if the content of priorities is left largely to the country and its creditors, the challenge of implementation remains. When only a tiny fraction of sovereign assets is available to creditors at any given time, and the debtor effectively cannot be compelled to pay anyone against its will, can a system of priorities be meaningful?

When liquidation is impossible, as in the cases of countries, states, and municipalities, insolvency is framed in cash flow terms.¹¹⁴ Thus when market participants refer to “senior” Argentine debt (including multilateral obligations and compensation bonds issued to local institutions), they mean obligations presumed to have first claim on the country’s primary budget surplus when it is insufficient to pay all.¹¹⁵ “Junior” debt (including private external obligations) would get the residual flows, if any. It is further assumed that senior obligations either would not be restructured at all, or would be restructured on terms different from the junior claims and beyond the control of junior creditors.¹¹⁶ These market expectations are based on prior experience of sovereign restructurings and signals from Argentina; legally, the instruments in question presumptively rank *pari passu*. In the alternative, a transparent and predictable system of sovereign priorities would explicitly commit Argentina to a debt hierarchy of its choice at issuance and compel it to distribute its primary surplus in the expected order when it runs short of funds.

This approach seems to have some credibility in California—although it was tested only in very limited circumstances during the state’s fiscal crisis in 1992. Neither Argentina nor California is subject to bankruptcy. Neither can be liquidated nor have its principal assets attached for the benefit of its

¹¹³ See, e.g., Press Release, Sec. Indus. Ass’n, Leading Financial Industry Associations Propose Market-Based Approach to Sovereign Debt Restructuring and Note Inherent Flaws with IMF’s Proposal (Dec. 17, 2002), available at http://www.sia.com/press/2002_press_releases/html/pr_joint_release.html.

¹¹⁴ See 4 COLLIER, *supra* note 18, ¶ 900.02[2][c]; McConnell & Picker, *supra* note 18. Note that in insolvency practice, including municipalities and sovereign bankruptcy proposals, the focus is on voting rules. See Bolton & Skeel, *supra* note 10. This Article presumes no new comprehensive debt restructuring mechanism, and therefore does not address voting rules across instruments.

¹¹⁵ Martin Anidjar, *Argentina: Persisting Economic and Political Uncertainty Does Not Justify Current Debt Prices*, EMERGING MARKETS RES. STRATEGY REP., Dec. 19, 2002, at 10.

¹¹⁶ *Id.*

creditors. Yet unlike Argentina, California has explicitly defined a priority hierarchy to which it expects to be held. It has disclosed the hierarchy to its creditors before selling the debt and has paid for it in up-front fees and high interest rates associated with issuing junior public debt. By buying the debt at prices that vary with its priority, creditors appear to accept California's promise to pay in the order disclosed.¹¹⁷ This results in more options and more order in crisis management.

Argentina could adopt a similar approach relatively easily with respect to debt governed by domestic law (the closest analogy to California), where priority or subordination could be accomplished by statute or even decree, as well as contract. For debt governed by foreign law, subordination must be contractual—the junior creditors must agree.

Without a bankruptcy backstop, basic agreement to a payment “waterfall” between the debtor and its junior creditors may not give senior creditors enough comfort should the debtor choose to pay the juniors in violation of its contract. When the senior creditor is not party to the subordination agreement, assuming the documentation is otherwise drafted to protect its interests, the senior creditor could have some recourse against a junior on a third-party beneficiary theory.¹¹⁸ In practice, the most likely enforcement scenario may continue to be one where a creditor seizes a debtor's attempted payment to another before the transfer is complete, on the *Elliott* model.¹¹⁹ Presumably, a national court's attachment order would be on stronger legal footing if done on behalf of a senior creditor with respect to a preferential payment on junior debt, particularly given a clear contractual commitment. Roubini, Setser, and Zettelmeyer have argued that, to the extent junior debt is issued to enhance the standing of senior debt, deliberate reversal of priorities could have even greater reputational consequences for the borrower than outright default.¹²⁰ Today, without a clear payment hierarchy, sovereigns have little trouble cherry-picking among *pari passu* creditors when they run out of funds.¹²¹ The same

¹¹⁷ See, e.g., Robert Reinhold, *Cash-Poor but Wily Californians Live by Their Chits*, N.Y. TIMES, Aug. 30, 1992, at E2.

¹¹⁸ See WOOD, *supra* note 30, at 79-80.

¹¹⁹ See *supra* note 73. But see *supra* note 61 and accompanying text. If payments and settlement systems become off limits to enforcement following the recent reversal of the *LNC v. Nicaragua* decision, the scope for seizing payments “in process” would be drastically constrained even when such payments manifestly violate explicit sovereign promises on the priority of payments.

¹²⁰ See Roubini & Setser, *supra* note 10; Zettelmeyer, *supra* note 4.

¹²¹ Debtors have frequently continued to service private external and IFI debt while in protracted arrears to the Paris Club (e.g., Nigeria); more recently, different treatment of domestic and external debt has sparked

behavior might be harder to defend when the distribution order is specified.

Finally, it is possible for the IFIs, as a matter of policy, to discourage countries from reversing unilaterally the agreed order of distribution. This mechanism could also be used to discourage a country's attempts to contract for forms of intercreditor discrimination that are undesirable from a policy perspective. Nevertheless, practical options for using the IFIs in this way are limited.

First, it is unlikely that the IFIs could credibly agree to withhold disbursements when countries violate priorities. Recent history supports the view that when countries meet core macroeconomic and structural conditions and secure financing for their restructuring program, political pressure on the IFIs is enormous to waive or interpret away conditions relatively less central to near-term recovery.¹²² Burdening the programs with such conditions merely strains institutional credibility.¹²³

controversy. While Russia defaulted on the GKO and continued to service its Eurobonds, Argentina has made clear that Boden would enjoy privileged treatment over its external and other domestic debt. *See, e.g., Zettelmeyer, supra* note 4, at 17-20.

¹²² The IMF's core mandate is to provide timely balance of payments assistance to members that are implementing sound adjustment policies. Over time, the range of policies required to secure IMF assistance has expanded beyond basic macroeconomic adjustment. In particular, specific policy conditionality relating to sovereign borrowing from private creditors has become more elaborate as they became an important source of finance. The evolution of Fund policy on lending into arrears to private creditors illustrates the sensitive balancing required to make such conditionality work. Before 1989, the IMF did not lend to countries that were in arrears to private creditors. This increased the leverage private creditors had in negotiations with sovereign borrowers: by refusing to agree to debt restructuring, private creditors would hold up their own as well as the IMF's financing. The policy was changed in the context of the bank debt restructuring initiatives of the late 1980s and early 1990s, to allow lending into arrears by the IMF so long as the country was implementing sound economic policies. In the late 1990s, the policy was changed again to include arrears on bonds (in addition to bank loans), but also to add the requirement that the borrower make "good faith efforts" to reach "a collaborative agreement" with its creditors. INT'L MONETARY FUND, FUND POLICY ON LENDING INTO ARREARS TO PRIVATE CREDITORS—FURTHER CONSIDERATIONS OF THE GOOD FAITH CRITERION 3-9 (July 30, 2002), available at <http://www.imf.org/external/pubs/ft/privcred/073002.pdf>.

Lending to Argentina in 2003-04 was the first serious test of the "good faith" iteration of this policy. Having defaulted on its debt, Argentina did little to reach out to its creditors for most of 2003. However, its fiscal and monetary policies were essentially sound, and its economy was growing rapidly, rebounding from the recent deep fall. Moreover, the IMF program funding was just enough to cover repayments to the IMF itself—with little or no new money forthcoming to increase the IMF's leverage with the Argentine authorities. As a result, the IMF kept disbursing funds throughout 2003—and even approved a new medium-term program for Argentina—even as no one could seriously suggest that Argentina was engaging in good faith with its creditors. *See* Randal K. Quarles, Assistant Secretary of Treasury for International Affairs, Testimony Before the Senate Banking Committee: U.S. Economic and Financial Policy Toward Argentina (Mar. 10, 2004), available at <http://www.treas.gov/press/releases/js1228.htm>.

¹²³ Roubini & Setser, *supra* note 9.

Second, in some cases, withholding IFI funding to enforce priorities may run against the interests of both debtors and creditors. In corporate workouts, senior creditors frequently “buy off” junior creditors to speed an agreement.¹²⁴ Similarly, the history of customary sovereign priorities shows that creditors have been surprisingly tolerant of countries privileging some creditors at the expense of others. While complaints have been loud, effective protests—when creditors threatened to sue or block a deal on discrimination grounds—have been rare. As suggested earlier, at least some creditors must see a benefit in allowing themselves to be subordinated.¹²⁵ In this context, a bright-line cut-off may disrupt a sovereign workout. Yet more nuanced alternatives to a bright-line test bring their own baggage. For example, cutting off funds based on “bad faith” discrimination would involve the IFIs in assessments that are both inchoate and politically charged.¹²⁶ Soliciting creditor approval before sanctioning discrimination would require a voting procedure across different categories of debt that would come close to the statutory mechanism effectively rejected by the IMF’s sponsors last spring.

This argues in favor of a softer approach that sends a clear signal but does not test IFI credibility at each disbursement. For example, the IMF may consider a country’s use of and compliance with priorities in reviewing its debt management practices as part of annual monitoring under Article IV of its charter.¹²⁷ It could report whether the country has articulated its priorities in advance, whether these priorities are consistent with the general principles for according priority agreed among the official sector, the borrowers, and the private creditors, and whether the country has unilaterally departed from its established priorities.¹²⁸

This would leave much of the enforcement task to private actions in national courts, with the attendant difficulties already discussed. And yet such a system would be an improvement over the status quo in three ways: first, it

¹²⁴ See, e.g., Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984).

¹²⁵ See *supra* note 40 and accompanying text.

¹²⁶ The application of the IMF’s new lending-into-arrears policy to Argentina, see *supra* note 126, illustrates the challenge of getting the Fund into the business of assessing a member’s good faith.

¹²⁷ ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND art. IV(3) (1945), available at <http://www.imf.org/external/pubs/ft/aa/index.htm>; see, e.g., Int’l Monetary Fund, 2003 Article IV Consultation with the United States of America, Statement of the Fund Mission (June 16, 2003), available at <http://www.imf.org/external/np/ms/2003/061603.htm>.

¹²⁸ Although an IFI policy can be effected without a charter amendment, it would still require the approval of the relevant institution’s executive board, which can take years of work and enormous amounts of political capital.

would encourage transparency and advance planning by the sovereign; second, it would improve incentives for risk assessment by the creditors; and third, it would introduce a multilateral policy check, however soft, on what are now unilateral decisions by governments in crisis.

CONCLUSIONS

I have argued that the lack of a transparent, enforceable priority structure of sovereign debt makes debt restructuring and crisis management more painful and costly than it could be, complicates risk assessment, and encourages overborrowing and secured lending in the absence of higher political accountability. However, much of the uncertainty and disorder in the current priority structure stems from state sovereignty—particularly the fact that most assets of sovereign borrowers are immune and beyond creditors' reach. This gives governments unique and largely irreducible discretion to establish priorities unilaterally and *ex post*. The occasional emergence of a customary priority structure has relied in part on the willingness of some creditors to tolerate arrears or to restructure while others are getting paid. Refraining from effectively conditioning their own concessions on those of others has made for tacit subsidies that are the foundation of the existing system (for example, as in the case of Paris Club and Eurobonds before Pakistan).

If the international community could agree on a substantive priority structure that should apply *ex ante* to all countries, it might be possible to secure advance commitments from major creditor groups to forbear or provide financing to ensure that debts at the top of that structure are repaid. However, I argue that it is virtually impossible to devise a sensible, generally applicable structure because of the difference in country circumstances, policy priorities, and crisis paths.

On the other hand, to the extent countries will continue to establish priorities unilaterally, there is value in encouraging them to do so up front, and to disclose the expected order of distribution in their debt contracts and other instruments. This could help facilitate restructuring, improve risk assessment, and provide a financing cushion in crisis. When debt pricing reflects relative priority, creditors face greater incentives to monitor debt issuance.¹²⁹ This

¹²⁹ In the late 1990s, the World Bank and other multilateral development banks experimented with guarantee instruments that would “share” the institutions' customary preferred creditor status with sovereign borrowers to facilitate countries' access to the capital markets. Under one such instrument issued by the

might limit the debtor's capacity to place senior debt, enhancing its credibility. Holders of junior debt would be compensated for the higher risk they assume with higher fees and interest rates, or with equity-like features that allow them to reap higher benefits of the borrower's success. In addition to standard private contract enforcement mechanisms, IFI surveillance could be used to encourage countries to observe the priorities to which they commit. IFI policies and a code of conduct endorsed by the IFIs, the G-7, and major market participants (borrowers and creditors) could articulate outside limits on the international community's willingness to back a country's priorities—for example, by specifying unenforceable forms of intercreditor discrimination.

Despite the apparent benefits, introducing a system of priorities in sovereign debt carries risks. It is worth noting that although firms, municipalities, and states in the U.S. system issue tiered debt, the U.S. government itself does not. U.S. Treasuries rank *pari passu* among themselves. And even though California is sovereign, it does not print its own currency. A commitment by a country's government to respect pre-announced priorities across its entire stock of obligations openly admits to the possibility of default and could amount to a massive policy undertaking difficult to honor in crisis. Yet to the extent customary rankings already govern expectations of repayment on emerging market sovereign debt, and to the extent these expectations are often frustrated, improving its transparency and predictability would be good for the system.

Electricity Generating Authority of Thailand, the World Bank offered a "rolling" guarantee for interest payments—if the borrower made the interest payment itself or reimbursed the World Bank for the payment the Bank had made on the guarantee, the guarantee would "roll" to the next interest payment. If the Bank had to pay out on the guarantee and the borrower failed to reimburse it, the guarantee no longer applied. Investors in the instrument bet on borrowers' reluctance to default to preferred creditors such as the World Bank. However, rating agencies reviewing the arrangements warned that borrowers' reluctance to default on senior debt depended on the total amount of such debt they had outstanding—as discussed in Part III.A, when there is too much senior debt, it becomes vulnerable to default or restructuring. This creates an incentive for monitoring the aggregate debt structure, and particularly the ratio of senior debt to all other. Rating agencies promised to monitor the ratios in the context of rating the new instruments. See, e.g., Cavanaugh et al., *supra* note 50; Zuberi & Roberts, *supra* note 35.

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