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# SOVEREIGN DEBT DEFAULT: CRY FOR THE UNITED STATES, NOT ARGENTINA

by
Professor Hal S. Scott
Harvard Law School

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## INTRODUCTION

This WORKING PAPER argues that the United States policy of siding with sovereign defaulters against U.S. creditors is fundamentally misguided. The root of the sovereign debt problem is that sovereigns overborrow, borrowing in excess of their institutional capacity to efficiently employ the borrowed capital. Overborrowing results from the fact that sovereigns face few consequences as a result of default. Often they are bailed out by International Monetary Fund (IMF) loans, with the consent of the United States. The default does not impede their access to future credit because creditors have short memories. The only effective remedy against sovereign overborrowing is to allow creditors to enforce their contract rights effectively against sovereigns in default. Any well functioning debt market depends on strong creditor rights.[1]

However, in recent years, the United States has attempted to block the ability of creditors to collect their debts. This was done for foreign policy reasons, to curry favor with debtors in distress. It has not worked, particularly in the case of the biggest defaulter of them all, Argentina. By favoring the Argentine state over private U.S.

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[1] A. Schleifer, "Will the Sovereign Debt Market Survive?," 93 AEA Papers and Proceedings 85 (May 2003).

creditors, the government has fostered Argentina's claim that it can defy the West with impunity, by offering poor restructuring terms, and walking away from $20 billion in debt still in default—with interest now $30 billion. Today Presidents Néstor Kirchner of Argentina and Hugo Chávez of Venezuela have become anti-American economic allies. If Kirchner had been subject to market discipline, his leftist antics would have carried a high price.

The United States must consider reversing its stand and back U.S. creditors against sovereign debtors, at least rogue ones like Argentina. In addition, it should consider strengthening creditor rights by paring back the protections debtors are currently afforded under the Foreign Sovereign Immunities Act.

## I. THE ARGENTINE DEFAULT

The Argentine debt default of December 2001 was the largest sovereign default in history. By the time of the 2005 debt restructuring, the default involved more than $100 billion of privately held debt ($81.8 billion in principal plus $20 billion in past due interest) in the form of 152 different bonds. Bondholders in Italy held $15.6 billion, the U.S. $9.1 billion, and Japan $3.1 billion. A substantial portion of the Argentine debt was retail, by one estimate 44%, held principally by individuals in Italy and Germany.

Between 1997 and 2001, Argentina had been authorized to issue about $44 billion in registered bonds on the U.S. public markets. Argentina reported that about $36 billion in bonds involved in the 2005 restructuring were issued under New York law. This demonstrates that Argentina made very significant use of U.S. public markets, where bonds were available for purchase by U.S. retail investors, and the U.S. legal system

During the years leading up to the crisis, the IMF had itself become a major lender to Argentina, beginning with a stand-by of $7 billion in March 2000 that had increased to $22 billion by September 2001. Of the total $106.2 billion in IMF credit outstanding as of the beginning of 2004, $15.8 billion or 16 percent, was owed by Argentina. Argentina had massively overborrowed. Its debt-to-GDP ratio rose to 53.7 percent by 2001 and then exploded to over 100 percent in the following years, following the devaluation of its currency in 2002.

Before the debt crisis was resolved, Argentina experienced widespread bankruptcies, increased unemployment, runs on banks and huge capital flight (conservatively estimated at $13 billion) and political instability. Several Presidents came and went beginning with Fernando De LaRua, a centrist from the Radical Party, elected in late 1999, followed by Adolfo Rodriguez Saá in December 2001 (who declared the default) and Eduardo Duhalde in January 2002, and ending with the election of Néstor Kirchner, a left wing candidate from the Peronist party. Argentine politics had clearly moved substantially leftward.

In December 2004, Argentina offered to swap its defaulted bonds for new bonds. When new bonds are worth less than old bonds, invariably the case in a restructuring, the market describes this as giving a haircut to the old bonds. Average haircuts (weighted by the face value of the original instruments tendered) were in the range of 71-75 percent. This compares with haircuts averaging just 36 percent on 20 other sovereign debt restructurings since 1990. The terms of the exchange were basically dictated unilaterally by Argentina, without any good faith negotiations with creditors. Many believed that Argentina could have made a more generous offer, given that by the time of the exchange offer it had experienced two years of steady growth (GDP of 8.8% and 9% in 2003 and 2004 respectively) with relatively low inflation (3.7% in 2003 and 6.1% in 2004). By June 2004, Argentina's official reserves minus gold stood at $16.9 billion.

The December 2004 exchange offer was accepted by 76 percent of the old bondholders. This acceptance rate was quite low compared to the 90 percent acceptance rate that would normally be required for the IMF to regard a sovereign restructuring as successful. Recent acceptance rates have been much higher: Ecuador (2000) 97%; Pakistan (1999) 95%; Russia (1998-2000) 98%; Ukraine (1998-2000) 95%; and Uruguay (2003) 93%. The effective rate of acceptance by international creditors was in reality much lower than 76 percent given that domestic Argentine bondholders (including state-controlled entities like banks and pension funds) owned 46.9% of the debt and were subject to strong government pressure to enter the exchange. If one assumes that all the domestic creditors accepted the exchange, the acceptance rate for international creditors, who held 54.1% of the debt, would only have been about 53.4% [76.0 – 46.9 =29.1, 53.4% of 54.1%]. The acceptance rate was substantially below the effective rate of 75% required to trigger the collective action clauses in the new bonds Argentina issued, as that calculation excludes bonds held by state-controlled entities, a major portion of the Argentine domestic debt. The bondholders who accepted the exchange experienced huge losses, about $67 billion. As for the creditors who refused the deal, with close to $20 billion of defaulted debt (now $30 billion with accrued and unpaid interest), they were told their bonds could "remain unpaid indefinitely." So, as matters now stand, creditors as a whole have lost about $97 billion.

## II. THE MARKET DISCIPLINE PROBLEM

### A. The Lack of Future Consequences: For Markets the Past is Past

It does not appear that Argentina paid a substantial economic price for its default. As we have already seen, GDP increased substantially after the default. And, amazingly, there has been no lasting effect on Argentine bond spreads as a result of default. The EMBI global index of JP Morgan Securities is a market-capitalization index that measures the yield on the sovereign debt of 27 emerging market countries including Argentina. Until the months leading up to the default of 2001, Argentine and the EMBI global index spreads over comparable maturities of U.S. treasuries were about the same, somewhat less than 1000 basis points. Just prior to the default in December 2001 the spread between Argentina and EMBI widened considerably, reflecting the significantly lower price the market put on Argentine bonds in anticipation of default. However, the spreads on bonds issued after default were about the same as the EMBI, around a 500 basis point spread from comparable U.S. treasuries. As of July 2006, the spread was only 380 basis points. Standard & Poors has twice upgraded Argentine debt, now at a B rating, based on its current economic performance, and Fitch made similar upgrades recently. Little if any account was taken of its default. Indeed, Argentina's massive reduction in debt may have made its new debt more attractive. Any possible pressure from the IMF was removed when in

January 2006 Argentina repaid its then outstanding debt of $9.6 billion.[2]

In the first seven months of 2006, Argentina has issued $3.9 billion in U.S. dollar-denominated debt in local markets to both domestic and international investors at low yields compared to Brazil. Venezuela has become a major financier of Argentina, purchasing $3.6 billion in Argentine external bonds, so-called BODEN bonds, over the twelve months ending July 2006. According to government announcements, the two countries are contemplating a joint bond issue under foreign law, initially for $2 billion, between late 2006 and early 2007, a so-called "Bond of the South". The participation of Venezuela in Argentine bond issuance indicates further protection for Argentina from possible market consequences of default. Unlike the IMF, Venezuela will not condition its lending on economic policies or fair treatment of other debt.

In addition, there is no evidence that foreign direct investment (FDI) was negatively affected by the default. From 1994-2000, Argentina averaged $9.5 billion per year in FDI.[3] According to IMF statistics, FDI in 2000, before default, had fallen to $2 billion, but in the years 2002-2005 was respectively $2.0, $2.8, $1.1, $3.9 and $3.2 billion (estimated).[4] It is clear that the plunge in foreign direct investment occurred before the default and the recovery occurred after the default, a recovery that occurred despite price controls and pesofication. This is not surprising due to Argentina's overall recovering economy and far lower burden of debt. In fact,

[2]35 IMF Survey (Jan. 9, 2006), at 9.

[3]Economist Intelligence Unit, Argentina Risk Briefing (July 27, 2006).

[4]IMF, Country Report No. 05/236 (July 2005), Table 2, at 39.

reduction of debt may generally help improve FDI since the country can afford to offer higher returns to equity. Again, market discipline does not insure debt repayments.

It is not altogether surprising that markets have short memories of sovereign default, even with respect to countries like Argentina that have become serial defaulters—Argentina has defaulted on external debt five times since independence in the 1820s. Just as with corporate and personal bankruptcies in the United States, new lending is usually available if future prospects are good. What this means is that one cannot depend on the prospect of future adverse consequences to deter countries like Argentina from overborrowing and then defaulting.

As a theoretical matter, Bulow and Rogoff[5] proposed that lending to small countries (ones that cannot affect the world interest rate) must be supported by direct sanctions available to creditors (contractual remedies), and cannot be supported by a country's reputation for repayment. This is consistent with findings in the economic literature that defaults do not seem to influence future access of sovereigns to the capital market.[6] While there is some evidence that foreign credit to the *private* sector was affected between 2000-2004 by the Argentine default,[7] it is unlikely that this consequence will deter overborrowing by sovereigns.

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[5]J. Bulow and K. Rogoff, *Sovereign Debt is to Forgive or Forget*, 79 AM. ECON. REVIEW 43 (1989).

[6]B. Eichengreen and P. Lindert, The International Debt Crisis in Historical Perspective, Chapter 1 Overview (1989) and R. Gelos, R. Sahay and G. Sanderlis, "Sovereign Borrowing by Developing Countries: What Determines Market Access?," IMF Working Paper (2004).

[7]C. Areta and G. Hale, "Are Private Borrowers Hurt by Sovereign Debt Rescheduling?," Working Paper (2005).

## B. The Lack of Present Consequences: Weak Creditor Rights

The markets could work to discipline Argentina but the discipline must come from existing not future creditors. If Argentina were required to pay existing creditors 75% of the value of its debt, rather than the 25% it did pay, Argentina would be much less likely to overborrow and then default. Default would not be a way out of pain but would result in the imposition of still more pain. However, under the existing regime, Argentina is free to set unilateral terms for a restructuring without the fear of any real consequences. How could this happen?

Most importantly it is the result of a legal regime that protects sovereign assets from seizure by its creditors, such as the Foreign Sovereign Immunities Act (FSIA) in the United States. Other countries have similar laws. The U.S. FSIA starts with the premise that foreign sovereigns cannot be sued in U.S. courts and then creates some significant exceptions. One exception arises if the action is based on commercial activity engaged in by the sovereign in the U.S. The Supreme Court determined in 1992 in *Republic of Argentina v. Weltover,* 504 U.S. 607, that issuing bonds in the U.S. is a commercial activity in the U.S. This means that creditors can sue sovereigns in the U.S. for defaulting on debt issued here. Another exception is where the sovereign has by contract waived its immunity in the U.S. Thus, because the bonds issued by Argentina contained waivers of immunity from suit, when Argentina defaulted on those bonds in 2001, the federal courts found that Argentina was not immune from suit and that the creditors were entitled to be paid. For example, the Second Circuit decided, in *EM Ltd. v. The Republic of Argentina*, 382 F.2d 291 (2004), that Argentina was required to pay the plaintiff bondholder $740 million on defaulted debt. However, it is one thing to get a judgment, it is another thing to enforce it. This is the heart of the problem—it has become exceedingly difficult for creditors to actually collect on their debts.

The difficulty begins, of course, with the fact that most of Argentina's assets are in Argentina. There was a time in history when this was not an insuperable obstacle, as U.S. gunboats were enlisted in the efforts to collect debt. Today, this is not a realistic alternative. However, there are two important types of assets that are outside the sovereign's territory: foreign currency accounts and interests in the assets of state-owned enterprises. In addition, there are payments and goods flows, as when a country pays dollars to a foreign creditor or receives dollars from a foreign obligor, or exports a state-owned commodity or imports a state-procured commodity. Also, particular assets outside the country may secure debt.

In 2000, it appeared that some creditor discipline might be introduced into the system. The government of Peru had restructured its debt by offering to issue so-called Brady bonds, bonds secured by U.S. Treasury zero-coupons, in exchange for existing government guaranteed syndicated bank debt, with a significant haircut. Elliott Associates, which had acquired some of this bank debt in the secondary market, refused to participate in the exchange and obtained a judgment of $55.7 million, the full face value of the loans. It attempted to satisfy this judgment by obtaining a restraining order with respect to funds Peru was going to transfer to its paying agent Chase Manhattan Bank. This would prevent Chase from paying interest on the new Brady bonds. When Peru evaded this restraint by instead transferring the funds to Euroclear, a major securities settlement system based in Brussels, Elliott Associates obtained an order from the Brussels Court of Appeals that would have imposed a significant fine on financial institutions, clearing through Euroclear, if they accepted the interest payments. Elliott successfully contended that under the *pari passu* clause in the loan agreement, it was entitled to share equally in any payments made to the Brady bondholders. Peru then settled with Elliott to avoid payment disruptions for its new bondholders.

As it turns out, this 2000 decision was the high watermark of creditor rights, albeit in a case decided by a Belgian rather than a U.S. court. But the Brussels decision was effectively reversed when in 2004 the Brussels Court of Appeals held, in a case of unpaid creditors against Nicaragua, that a restraint of incoming funds was an unwarranted interference with Euroclear's operations. And then in 2005 Belgium enacted a statute protecting all settlement systems against third party orders.[8]

Central bank reserves are the most significant assets held outside the territory of the sovereign. As of June 2006, Argentine central bank reserves were about $25 billion. As of March 2006, the Federal Reserve Bank of New York held accounts for 171 central banks and monetary authorities totaling $1.6 trillion. It appears that emerging market countries hold reserves far in excess of what they need for exchange rate or balance of payments purposes. Excess reserves, those over the amount of one year's short-term debt (the so-called Guidotti-Greenspan requirements) are over $2 trillion today and growing. While some like Lawrence Summers have argued that

[8]F. Sturzenegger and J. Zettelmeyer, "Has the Legal Threat to Sovereign Debt Restructuring Become Real," Working Paper (2005) argue, on the basis of *Elliott* that creditors can hinder access of defaulting countries to international capital markets. This vastly overstates the real impact of that case, whose result has yet to be duplicated elsewhere, and has been effectively repealed in Belgium. The fact is that creditors have been on the whole legally impotent with respect to all kinds of actions.

these excess reserves should be invested in longer-term projects rather than in liquid assets like deposit accounts or U.S. Treasury securities,[9] these excess reserves could also be made available to creditors in cases of default.

Early signs that creditors would be able to attach at least some of these central bank assets soon dissipated. Section 1611(b)(1) of the FSIA provides that central bank property "held for its own account" shall be immune from attachment unless the bank has waived immunity "in aid of execution." In *Birch Shipping Co. v. Embassy of United Republic of Tanzania,* 507 F. Supp. 311 (D.D.C. 1980), a federal District Court held in 1980 that Tanzania could not shelter commercial assets by commingling them in an immune embassy account, and then in 1993 another federal District Court held in *Weston Cie de Finance et D'Investissement, S.A. v, Ecuador*, 823 F. Supp. 1106 (S.D.N.Y. 1993), that funds in a central bank account used to finance commercial transactions of private parties would not be immune since these were not funds "held for its own account."

But the scope of these decisions was very limited. First, only commercially commingled funds could be attached and secondly, as *Weston* itself and other lower federal courts held, only exposure to post-judgment attachments, those "in aid of execution," can be waived by central banks. While the correctness of this construction of the statute is far from certain, if courts continue to give it this interpretation a central bank will have ample time to remove its funds from the jurisdiction of U.S. courts, between the time a creditor brings suit and the time a judgment is obtained.

[9] "*Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation,*" L.K. Jha Memorial Lecture, Reserve Bank of India, Mumbai, India (Mar. 24, 2006).

Further, in *LNC Investments, Inc. v. Republic of Nicaragua*, 115 F. Supp. 2d 358 (S.D.N.Y. 2000), *aff'd* 228 F.3d 423 (2d Cir. 2000), the District Court held that even if there is an explicit waiver of central bank immunity, the central bank is only responsible for its own debts, not the debts of the sovereign. Thus, creditors may only attach assets held in the name of the central bank that actually belong to the sovereign.

The mere possibility that central bank accounts in the United States and elsewhere might be attachable has led sovereigns, including Argentina, to hold these accounts at the Bank for International Settlements (BIS). Article 10 of the Constituent Charter of the BIS provides: "The Bank, its property and assets and all deposits entrusted to it shall be immune in time of peace and in time of war from any measure such as expropriation, requisition, seizure, confiscation, prohibition or restrictions of gold or currency export or import, and any other similar measures." In addition, there is a so-called "Headquarters Agreement" between the BIS and the Swiss government entered into on February 10, 1987, which provides that BIS deposits are immune from attachment. So the major countries of the world through these agreements have provided a safe haven for central bank liquid assets. Argentina moved over $2 billion of its reserves to the BIS before and after its default. While the rates on BIS deposits tend to be quite low, the London Interbank Bid Rate (LIBID) minus 1/8th of a percent, complete protection is available.

The ability of creditors to attach or garnish flows of payments for goods has also not met with much success. Section 1610(a) of the FSIA provides that the "property in the United States" of a foreign state, "used for a commercial activity in the United States," shall not be immune from attachment if a foreign state has waived sovereign immunity. The difficulties with meeting these criteria have been a focus of extensive litigation by creditors of the Congo, which has generated three decisions of the 5th Circuit, *Connecticut Bank of Commerce v. The Republic of the Congo,* 309 F.3d 240 (2002), *Af-Cap Inc. v. Republic of the Congo*, 383 F.3d 361 (2004) (*Af-Cap*), and *FG Hemisphere Associates v. Republic of the Congo,* Docket Nos. 04-20965 and 05-20042 (July 10, 2006) (*FG Hemisphere*).

All of the creditors in these cases sought to garnish royalty and tax obligations owed to the Congo by oil companies. While *Af-Cap* determined that payments by Texas oil companies were "used for a commercial activity" because they had been used by the Congo to repay commercial debt located in the United States because the garnishee oil companies were located in the United States, the result was different in *FG Hemisphere*. The Court of Appeals reversed the issuance of garnishment writs by the District Court on two somewhat technical grounds—that the federal District Court had failed to determine whether the garnishment orders could be issued under Texas law and because the court had failed to make necessary findings required by the FSIA.

The court went on to determine whether the garnished property was located in the United States. Although the garnishees in *FG Hemisphere* had been located in the United States at the time the creditors brought their lawsuit against the Congo, by the time the creditors sought to garnish the property the garnishees had no presence in the United States, as they had reorganized their operations outside the U.S. in the interim. The court found that the determination of whether property is in the United States should be made at the time when the creditors attempt to garnish, not at the time suit was brought. This approach, of course, invites sovereign defendants to protect their property once suit is brought, much as in the case of central bank reserves, thus offering little effective recourse for creditors.

With respect to attachment of property of state-wholly owned enterprises (SOEs), prospects are similarly bleak. To begin with many sovereigns have shed themselves of SOEs through privatization—indeed Argentina was in the forefront of this effort. But even where a sovereign continues to own enterprises, the sovereign's ownership interest—the shares of stock in the enterprise—is most often located out of the United States and thus not subject to attachment under the FSIA. Indeed, the sovereign will keep the shares outside the U.S. for the principal purpose of avoiding attachment by U.S. creditors. By way of comparison, this limitation on the jurisdiction of a U.S. court does not apply to private debtors, since if a court has jurisdiction over the private debtor, it has the power to compel the debtor to transfer its shares to the court. If the debtor fails to do so, the court can assign claims to the assets of the enterprise, to the extent these assets are in the United States, to the creditor. If other creditors of the enterprise have prior claims, the attaching creditor's claim will be junior (but still potentially valuable). The same rules could be applied to sovereigns.

Creditors have been creative in trying to locate property in the United States, but their creativity has not paid off. On March 21, 2005, in *EM Ltd* v. *The Republic of Argentina*, 131 Fed. Appx. 745 (2d Cir. 2005), creditors who refused to go along with the Argentine bond exchange, and who were owed approximately $1 billion (principal plus interest) on old bonds, obtained an ex-parte attachment of $7 billion of the old bonds that had been tendered to Argentina in the bond exchange. The creditors argued that these tendered bonds, held in what amounted to an escrow account of the Bank of

New York at the Depositary Trust Co., were the property of Argentina in the United States. Although Argentina did not yet have the bonds, they had the right to receive the bonds once the exchange was completed. Argentina's principal argument was that the attachment would frustrate the bond exchange, as they would not go through with the exchange if the tendered old bonds were attached and not able to be cancelled. Argentina also argued that the bonds were not their property, nor did they have any right to the bonds, until they gave the old bondholders new bonds, which they had not yet done. Of course, even if the plaintiffs got these old bonds, they could not compel Argentina to honor them. However, the increase by $7 billion of unsatisfied debt may have put additional pressure on Argentina to come to an accommodation with the holdouts.

After a hearing, the federal District Court dissolved the ex parte attachment order. The court appeared to accept the argument that Argentina had a property right in the bonds. The court believed, however, that part of Argentina's rights to the bonds included its right to cancel the bonds which the attaching creditors would obviously not do, and the failure of Argentina to achieve cancellation would lead them to pull out of the exchange entirely, which they may have had a right to do. The Second Circuit affirmed in a summary order holding that it was within the reasonable discretion of the District Court to deny the attachment, and further stated, quoting the lower court: "If these attachments [and restraints] are still in effect, we throw into doubt, to say the least, the conclusion of the exchange offer." It was left to conjecture as to why the courts should care whether the exchange was or was not completed.

One other attempt to obtain assets from the Argentine bond exchange bears mentioning. In *Capital Ventures International v. Republic of Argentina*, 443 F.3d 214 (2nd Cir. 2006), creditors sought to attach the collateral held for Brady bonds—U.S. Treasury zero coupon bonds and German government bonds held in a collateral account at the New York Federal Reserve Bank—that were part of the debt exchange. The collateral arrangements provided that if the Brady Bonds were redeemed prior to maturity, Argentina would be entitled to the return of the collateral. Argentina offered to pay the old Brady bondholders new bonds plus cash. It intended to obtain at least part of the cash by liquidating the collateral. The plaintiffs claimed that they were entitled to attach that part of the collateral that would not be used to pay bondholders and would, therefore, revert to Argentina. The District Court denied the attachment, on the assumption that no property would revert to Argentina and due to a possible concern that granting the attachment would disrupt the marketplace.

The creditors appealed to the Second Circuit. While their claims were moot with respect to the collateral used to pay the tendering bondholders, they asserted a right to attach the collateral still held by the New York Federal Reserve Bank to secure the claims of the non-tendering Brady bondholders. The Second Circuit reversed the District Court on the grounds that the plaintiffs had met all the requirements for attachment and that while the likelihood that any of the collateral might actually revert to Argentina was small, that interest was nonetheless attachable. In addition, since the exchange offer had been completed, there was no threat of confusion in the marketplace.

Creditors did get a victory in this case but was it worth anything? If Argentina were to liquidate this collateral to satisfy the claims of non-tendering Brady bondholders, as part of a new offer in the future, and if it did not use all the collateral or its proceeds as part of this new offer, the Capital Ventures creditors would get some value. The likelihood of this happening is exceedingly small. If the default on the non-tendered Brady bonds were to continue to maturity of these bonds, the Brady bondholders would be entitled to all of the collateral, again leaving nothing for Capital Ventures.

The bottom line is that while creditors have been able to obtain judgments that sovereign defaulters must repay their debt, they have been unable—with a few notable exceptions—to attach assets in satisfaction of their judgments. Creditors have been largely rendered impotent by the FSIA and U.S. policies.

## III. THE ROLE OF THE U.S. GOVERNMENT IN UNDERMINING MARKET DISCIPLINE

The United States government has weakened market discipline in three ways: (1) by placing ineffective constraints on IMF lending; (2) by intervening in court cases on the side of defaulting sovereigns; and (3) by promoting weak collective action clauses. In addition, the U.S. has failed to update the FSIA to reflect the realities of how it works in the current world. The last section of the paper suggests some needed FSIA reforms.

### A. Support of, or Acquiescence in, Ineffective Constraints on IMF Lending

As a result of the Asian financial crisis, there was widespread concern that the easy availability of IMF money was inducing moral hazard on the part of both debtors and creditors. Debtors would overborrow from private sources because the IMF would bail them out if the debtors got into difficulty, and creditors would continue to lend to poor credit risk countries since sovereigns would use IMF money to pay the creditors off. This triggered various reform proposals, notably those of the U.S. Congress's 1998 International Financial Institutions Advisory Commission (dubbed the Meltzer Commission for its Chairman) and the 2000 Council of Foreign Relations Report. Both groups recommended constraints on IMF lending.

One justification often offered for IMF lending is that it gives the IMF leverage over a country's economic policies. As the argument goes, the IMF would not be able to achieve reform without providing funds, and debtor governments would not be politically able to implement reforms without the justification of the need for funds. Put another way, if the IMF did not lend, the government would be unable to implement reforms. There are two major weaknesses in this argument. First, there is little evidence that IMF conditions, usually requiring contractionary fiscal and monetary policies, have worked.[10] After all, Latin America has experienced repeated debt crises in the last two decades despite numerous IMF conditionality programs. Furthermore, as Morris Goldstein has argued, IMF conditionality has been extended substantially beyond traditional macro policy to a variety of micro issues, like

[10] J. Stiglitz, GLOBALIZATION AND ITS DISCONTENTS (2002).

bankruptcy law reform and corporate governance, with little proof of success in reducing debt crises.[11] Despite the reform recommendations, in 1999, the IMF had made it even easier to lend to debtors, adopting a policy that permitted it to lend to sovereign debtors "in arrears" (a nice term for default) on a case-by-case basis where prompt Fund support is considered essential for the successful implementation of an adjustment program and where the country was pursuing appropriate policies and making a "good faith" effort to reach a collaborative agreement with its creditors. The good faith criterion was elaborated on in September 2002. The IMF Board stated that a debtor should engage in early and continuous discussion about restructuring with its creditors, should share on a timely basis relevant, non-confidential information, including "the broad outlines of a viable economic program to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims [read, why it can only pay what it proposes]," and provide creditors with an early opportunity to give their input.

These policies on lending into arrears were then supplemented by a February 2003 statement of the IMF with respect to criteria that must be met before the IMF engages in large-scale lending or what it calls "exceptional access," loans in excess of 100 percent of quota on an annual basis, and in excess of 300 percent of quota on a cumulative basis. The criteria for getting exceptional access are: (1) balance of payment pressures on the capital account; (2) high probability of debt sustainability;

[11]M. Goldstein, "IMF Structural Programs," paper prepared for the NBER Conference on "Economic and Financial Crises in Emerging Market Economies," Woodstock, Vermont (2000); IMF, Independent Evaluation Office, Evaluation of Structural Conditionality in IMF-Supported Programs (May 17, 2005).

(3) good prospects for regaining access to the private capital market within the maturity date of the IMF loan; and (4) good economic policies in place.

These requirements sound good but are they really effective? Their real test was Argentina when the IMF decided in September 2003 to extend exceptional access in the form of a three-year stand-by of $12.5 billion (424 percent of quota) and then in March 2004 to rollover a $3.1 billion payment then due from Argentina. The rollover was accomplished by a fiscal dance in which Argentina repaid $3.1 billion owed to the IMF on March 9 in return for the IMF on March 22 disbursing $3.1 billion under the stand-by.

To begin with, the IMF should have denied Argentina any credit under its lending in arrears policy since there were, by any objective standard, no good faith negotiations with private creditors on the defaulted debt. Instead, the IMF gave Argentina mega-exceptional access in September 2003 even though its own staff's analysis indicated that Argentina did not meet the exceptional access criteria. Then, it shut its eyes to Argentina's continued inability to meet the exceptional access requirement when it rolled over the $3.1 billion in March 2004. Then-Undersecretary of the Treasury John Taylor gave a somewhat startling explanation for the disbursement of funds to Argentina in an address on April 16, 2004, at the IMF Conference in honor of Guillermo Calvo: "In both these cases [Argentina and Brazil], however, these countries were already in exceptional access territory and the goal is to exit from this exceptional access over time." Translated, this means once you get exceptional access, rightly or wrongly, the access criteria are no longer applied.

It is clear that these new "limits" on IMF lending, sparked by the Asian crisis and widespread criticism, do not really apply in crunch time–when a large debtor like Argentina gets into trouble. The willingness of the IMF (with the implicit backing of the United States) to bail out countries that have significantly overborrowed, and to engage in phony accounting when doing so, undermines market discipline. More needs to be done to restrain IMF lending.

## B. Court Interventions

There is a well-established tradition of the United States government filing *amicus curiae* (friend of the court) briefs in cases involving sovereign debt, and the courts have usually followed their advice. It is not surprising that the courts follow the advice of the government. As some commentators have remarked, this result is "supported both by considerations of institutional competence and by the distinctive position of the President in the domain of foreign affairs."[12] In their view, the courts should defer to the executive in matters of foreign affairs when it comes to interpreting statutory ambiguities.

Unfortunately, the U.S. has moved from siding with its own creditors to siding with sovereign defaulters. And far from weighing in to clarify ambiguities in the law, the U.S. has lately taken to urging courts to ignore the plain language of contracts in favor of making policy judgments.

[12]E. Posner and C. Sunstein, "Chevronizing Foreign Relations Law," Draft, May 25, 2006, abstract.

### 1. *Allied: The Reagan Administration Supports the Creditors*

In the 1980s, during the Reagan Administration, the U.S. sided with creditors. In 1984, in *Allied Bank International v. Banco Credito Agricola deCartago*, 757 F.2d 516 (2d Cir.), *cert. denied*, 473 U.S. 934 (1985), the federal District Court ruled that the action of Costa Rica in blocking payment on promissory notes issued by Costa Rica to thirty-nine creditor banks was protected by the act of state doctrine because the action of Costa Rica did not involve commercial activity but rather the exercise of a governmental function. The Court of Appeals for the Second Circuit initially affirmed on the understanding that Costa Rica's actions were fully supported by the U.S. government. On a petition for rehearing, the United States joined the litigation as *amicus curiae* opposing the action of Costa Rica because it had "attempted [a] unilateral restructuring" outside the IMF framework which "encourages the cooperative adjustment of international debt problems."

The technical issue was whether under the act of state doctrine, which insulates from court review the validity of the taking of property by a sovereign within its own territory, the situs of the debts was in Costa Rica. Based largely on the intervention of the U.S., on policy grounds, the court decided, as a technical matter, that the debt was located in the U.S. and thus not protected by the act of state doctrine. This case demonstrated that the views of the U.S. government would be highly influential in sovereign debt cases.

*2. CIBC Bank and Pravin: The Clinton Administration on Both Sides*

In 1995, under the Clinton Administration, the United States filed an *amicus* brief supporting the position of Brazil in a case involving its default on a 1988 agreement restructuring its debt, *CIBC Bank and Trust Co. v. Banco Central do Brasil*, 886 F. Supp. 105 (S.D.N.Y 1995). A key issue in the case was whether one of the creditors, CIBC Bank, which held debt on behalf of the Dart family, could accelerate the entire debt owed based on the default. This depended on an interpretation of the acceleration clause that required consent of 50% of the creditors for exercise. Whether CIBC met this requirement depended on whether one counted the debt held by a Brazilian commercial bank, a majority of which was owned by Brazil.

The United States intervened as an *amicus curiae* opposing acceleration on the ground that this would upset the new restructuring. The government stated: "because the United States has a strong interest in encouraging the voluntary restructuring of sovereign debt. . . .[it] does not wish to see a creditor use United States courts as a means of amending the terms of sovereign debt contracts [on the grounds that such action] would harm the process that has evolved to deal with sovereign debt problems." The government was concerned that creditors, like the Darts, who had bought their debt in the secondary market, would not have the same interests as the bank lenders in achieving a restructuring. The government went on to state that its concern was the mirror image of its concern in the *Allied* case. Whereas in *Allied* it was concerned with the ability of sovereign debtors to extract better terms in courts than they could through negotiations, in *CIBC* it was concerned that a judgment in favor of the Darts would encourage creditors to use the courts to gain unfair concessions from sovereign debtors.

The District Court sided with the creditors on all issues other than acceleration, basing its decision on that issue on technical grounds without mentioning the position of the United States—nonetheless, it could hardly have failed to take account of it. The U.S. continued to intervene in sovereign debt litigation but had now changed sides.

Two years after *CIBC*, the Second Circuit, in *Pravin Banker Associates v. Bancopopular del Peru*, 109 F.3d 850 (1997), was called on to decide whether Pravin, which had bought bank debt in the secondary market, could enforce its debt despite Peru's restrictions on repayment. The District Court had enjoined enforcement for six months on the basis of a claim of comity, to allow Peru to complete its efforts to restructure its foreign debt, but had refused to do so indefinitely. The United States did not intervene in the case, and the *Pravin* court affirmed the District Court, siding with the creditor. Indeed, the Second Circuit relied on the government's briefs in both *Allied and CIBC Bank* in concluding the result was consistent with U.S. policy, which it characterized as follows: "although the United States advocates negotiations to effect debt reduction and continued lending to defaulting sovereigns, it maintains that creditor participation in such negotiations should be on a strictly voluntary basis. It also requires that debts remain enforceable throughout the negotiations."

The United States did not, as in *Allied*, join in a petition for rehearing, thus accepting de facto the legitimacy of the Second Circuit's characterization of its position. The *Pravin* outcome underscores the continuing deference of the courts to the views of the United States. It also indicates that the U.S. can influence courts by remaining silent.

### 3. *The Argentine Cases: The Bush Administration and the New York Federal Reserve Bank Support Argentina*

The United States has most recently filed *amicus* briefs on the side of Argentina against the position of U.S. creditors in cases involving the 2001 debt default, and the Federal Reserve Bank of New York (NY Fed) has done so as well. In *Macrotecnic International v. Republic of Argentina*, No. 02 CV 5932 (TPG) (Jan. 15, 2004), the District Court denied Argentina's motion to preclude the plaintiff creditors from using the *pari passu* clause to attach payments to other creditors, much as Elliott Associates had done with Peru, holding that the motion was premature since the creditors had not, in fact, moved for attachment. Although the issue was not resolved, it is notable that the United States and the New York Federal Reserve bank sided with Argentina's position on the merits—arguing that the *pari passu* clause could not be used by creditors to attach payments to other creditors.

The United States contended that allowing holdout creditors to seize payments to other creditors, including creditors receiving payments on restructured debt, would undermine "consensual orderly sovereign debt restructuring." The brief contended that if creditors knew that payments on their restructured debt could be attached, they would be less likely to agree to a restructuring. The United States failed to state that all creditors in 2004 were in the process of being forced to accept the worst deal in recent memory in what was far from a consensual process. The plaintiffs were not holding out on any deal—no deal had yet been reached in 2004. And as we have seen, substantially more than 25 percent of international creditors eventually rejected the deal. The idea that creditors generally would reject certain payment at a *reasonable* level for highly uncertain payment at par (one would have to find property to attach), with high legal fees, is very unlikely. More fundamentally, the United States should have been opposing the extortionate settlement offered by Argentina, not supporting it.

The second major reason advanced by the United States for supporting Argentina was that the interpretation of the *pari passu* clause advanced by the plaintiffs would unsettle "market understanding" of the *pari passu* clause. The authority for this understanding was papers written by Lee Buchheit of Cleary, Gottlieb, *the attorneys for Argentina*. In fact, neither the United States nor Mr. Buchheit could point to any cases siding with their view of the clause—and the Belgian decision in the earlier *Elliott* case had come out the other way. Under the Argentine view of *pari passu* the clause could only be used to protect a creditor's priority in a bankruptcy proceeding—the problem is that sovereign debtors never have such proceedings, so the clause would be rendered meaningless. One would think market understandings would be far more unsettled by a judgment debtor using specious arguments to avoid paying its debts.

The NY Fed's main argument was that use of the *pari passu* clause to intercept payments due to other creditors would disrupt the payment system. Why would this be so?

> ...[I]f an injunction of the type issue[d] in the *Elliott* case were served on a Reserve Bank, Fedwire operations staff would be required to search each individual Fedwire transfer received

> within some specified period of time. If the period of time were merely a single day, over 400,000 wire transfers would have to be searched for the data referenced in the injunction papers. It is impossible to know with certainty where the data will appear in the wire instruction or how it will be presented. Therefore, the search would require the operations staff to review the entire message not only for the originator's name but also for possible variations and abbreviations of the name.
>
> While it might appear that, given the state of technology, such a search could be conducted electronically, in fact electronic searches raise significant problems affecting both the speed and certainty of the Fedwire process. The New York Fed has searched the records of completed funds transfers in response to law enforcement initiatives related to counter-terrorism...Each of these searches, which are conducted electronically, inevitably yields a substantial number of false positives. Of course these searches were conducted after the funds transfers were completed and, as a result, there was no impact on the parties to the transaction that were identified in error. A real-time Fedwire search would have a wholly unacceptable impact both on the speed of the system and the certainty it handles.

This parade of horribles argument is not persuasive. First, the only "data" that the Fed would be asked to search for would be wire transfers sent by Argentina—variations on "Argentina" could be easily specified, and this data could be entirely searched electronically. This is quite different than monitoring terrorist payments that could involve large numbers of potential originators and beneficiaries. Second, there would be no (or extremely rare) false positives since the plaintiffs' theory of the *pari passu* clause is that they are entitled to share in *any* payment made by Argentina. We are certainly not dealing with the scale of false positives involved in trying to identify terrorist payments. These are purely lawyer's arguments, not backed up by facts about real consequences. The real question is why the NY Fed felt compelled to side with Argentina. Were they pushed into the cause by Treasury and State?

The second set of Argentine cases in which the United States and the Federal Reserve Bank of New York intervened, *NML Capital, Ltd. v. The Republic of Argentina*, 06-0405 and 6-cv and *EM Ltd. v. Argentina*, 06-0403-cv (Central Bank cases), arose out of the efforts of creditors (EM already had obtained a judgment against Argentina, while NML had pending legal claims) to attach $105 million that the Central Bank of Argentina had on account with the Federal Reserve Bank of New York. The Republic of Argentina had required that the Central Bank use these funds as part of a repayment of more than $9 billion of the Republic's debt to the International Monetary Fund.

The District Court vacated the attachment orders issued earlier by another federal judge, by a written order of January 24, 2006, but stayed the effect of its decision pending an appeal to the Second Circuit that is currently underway. The court held that the funds in the Central Bank account were the property of the Central Bank and that the Central Bank had not explicitly waived sovereign immunity as required by Section 1611 of the FSIA. If the funds were not being held for central bank purposes—if the Central Bank was just sheltering funds of the sovereign used for a commercial purpose—the funds could be attached under Section 1611 even without a waiver. The court appears to have ruled that the funds were being used for central bank purposes. The court further held that even if these were the funds of Argentina, they were not being used for a commercial activity, as required by FSIA section 1610(d), since repayment of an IMF loan was a "governmental financial activity and not a commercial activity."

The *amicus* brief of the United States is focused on two policy concerns: "protecting the catalytic role of the International Monetary Fund...in the world financial system, and in protecting the preeminence of the dollar as a reserve currency." The brief states that the IMF has provided funding repeatedly in debt crises, and for the IMF to play this role it must be able to get timely and complete repayment. It goes on to state that "[o]nly if the IMF can expect that it will be paid first and in full, ahead of other creditors, can it afford to lend in crisis situations, when no commercial lender is available."

The government also contends that if central bank accounts were exposed to attachment orders, foreign central banks might be led to withdraw their funds from the United States, resulting in a substantial deterioration of the United States' balance of payments, and possible heightening of U.S. interest rates and an unsettling effect on foreign exchange markets.

The NY Fed's brief focuses on operational concerns, as had its brief in *Macrotecnic*. It contends that the funds in the Central Bank account at the NY Fed are the funds of the Central Bank because that was the name on the account. Its brief states that central banks "look to the [NY Fed] for assurance that their accounts at the [NY Fed] are protected under U.S. law." "The [NY Fed] also has an interest in protecting its reserves abroad by promoting international principles of sovereign immunity." In addition, the NY Fed's argument echoes the government's concern about the strength of the dollar. In a supplemental brief, it focuses on the operational concern that attachment orders of this type would interfere in the timely completion of payments. It is hard to see how the future of the payment system hangs on the disposition of one wire transfer from Argentina to the IMF.

The Bush Administration should, as already discussed, be trying to limit the role of IMF lending, not promoting its "catalytic" role. In its early years, this was the Bush Administration's clear objective, but it now seems to have gotten off track. The IMF has no official status as a preferred creditor—there is no provision to this effect in any legislation or regulation. Indeed, one means of limiting IMF credit would be to subordinate their loans to those of private creditors, or at best make them of equal rank. Further, the fact that creditors are able to attach $105 million of the $9 billion of reserves Argentina appropriated so it could pay its debt to the IMF would not mean all sovereign payments to the IMF were so exposed. In most cases of IMF repayments, there are no holdout creditors pursuing court remedies. Finally, most debtors facing holdouts can rearrange their payment methods to avoid this result. In this case, Argentina was able to repay the rest of the $9 billion debt to the IMF without using funds that were the subject of attachment. Fundamentally, the U.S. was siding with Argentina as much as it was protecting the IMF.

The argument that the value of the dollar would be threatened if creditors were able to attach $105 million in funds earmarked for payment to the IMF borders on the laughable. The attachment was not aimed at central bank reserves generally, just funds that were to be used for debt repayment. These funds were not being used to invest in U.S. Treasury bills or to support the Argentine currency. They were in the process of being withdrawn—the question was who should have them, the IMF or private creditors.

It is interesting that the U.S. government did not intervene in the cases involving the Argentine bond exchanges. Unlike the case of *Pravin*, however, the courts did not interpret silence as indicating the government was siding with the creditors. The Second Circuit was concerned that if it allowed the attachments, the restructuring would fail. It had already become clear, through the position of the Bush Administration in *Macrotecnic*, that the government wanted to promote Argentine restructuring, and generally opposed creditors that attacked it. The Second Circuit knew this without having to be told.

### C. Promoting Weak Collective Action Clauses

The United States, through the G7, has promoted the use of collective action clauses (CACs) in sovereign bonds; this was a central objective of John Taylor during his service as Under Secretary of the Treasury for International Affairs. These clauses provide that 75% of creditors can accept a restructuring plan with binding effect on all creditors, precluding holdout creditors from mounting subsequent court challenges. In addition, these bonds make use of an indenture trustee, thus eliminating the right of individual bondholders to bring suit. Suit can only be brought if a certain percentage of bondholders, usually 25%, instruct and indemnify the trustee. Trustees are very careful about the terms of their indemnification and don't make it easy. Until 2003, when Mexico first issued bonds under U.S. law with CACs, these kind of CACs were only used in sovereign bonds issued under U.K. law; bonds issued under U.S. law provided that 100% of the creditors had to approve changes in bond payment terms.

Treasury got behind the CAC idea after the IMF had proposed a quasibankruptcy procedure, called the Sovereign Debt Restructuring Mechanism (SDRM), that was widely opposed by influential international creditor groups, such as the Institute of International Finance, who did not want the IMF or a new bankruptcy court to control the process or terms of a restructuring. These international creditors preferred to work things out on their own with the sovereign debtors, in a "market" solution under which bonds would be restructured according to the covenants of the bonds themselves.

In reality, CACs were a way to kill off the more offensive SDRM. Creditors originally wanted a 90% agreement but eventually settled for 75%, as favored by the Treasury. However, the effective percentage required under the CACs was much higher than 75% because entities controlled by the sovereign were excluded from voting. Given that sovereigns can also control the votes of domestic private creditors—not only actually controlled entities—these domestic private creditors should also be excluded from voting in calculating whether the CAC percentage requirement is met. Indeed, it is conceivable that the voting results could be challenged in a U.S. court if the sovereign brought pressure on such private creditors to support its restructuring terms.

Private foreign creditors were concerned that too low a percentage would make it generally easier for the sovereign to make a deal. Requiring a higher percentage gives creditors more leverage to get better terms. Here is an example of a creditor negotiation line: 65% of us are willing to agree to a 35% discount but you are never going to get the other 25% to agree to this—they would rather take you to court. We can only get a deal with less of a discount, say 20%.[13]

Higher CAC thresholds may also be in the interest of some sovereigns. A 2004 analysis by Haldane et al. of the Bank of England suggests that risk-neutral debtors may prefer high CAC thresholds because the ex-post default benefit of getting away with a lower offer (facilitated by a low threshold) is more than outweighed by the ex-ante benefit of lower interest rates when the debt is issued. Risk-averse debtors, more concerned with default (particularly when more risky) may prefer higher thresholds.[14]

When Mexico issued its CAC bonds in February 2003, in a $1 billion offering, an analysis of two Australian Reserve Bank economists indicated that the yield on the new bonds was consistent with previously issued bonds with similar maturities that did not contain CACs.[15] This seemingly contradicted the Haldane analysis. Perhaps the reason there was no additional cost to issuing bonds with the CACs was because the market believed the CACs would never be used, or because the effective voting percentage, while not 100%, was so close as to make no practical difference (Brazil used an 85% CAC in 2003 with the same controlled entity exclusions). If these clauses would actually affect future restructurings, they should have some price effect. If restructurings would be more expensive for creditors the bonds should have increased in price; if they would make future restructurings less expensive for creditors, they

[13] J. Fisch and C. Gentile, *Vultures or Vanguards? The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L. J. 1043 (2004) argue that holdout creditors serve as a check on opportunistic defaults and unreasonable restructuring terms.

[14] A. Haldane, A. Penalver, V. Saporta, and H. Shin, "Optimal Collective Action Clause Thresholds," Bank of England Working Paper 248 (2004).

[15] *See* M. Gugiatti and A. Richards, "Do Collective Action Clauses Influence Bond Yield? New Evidence From Emerging Markets," Reserve Bank of Australia Research Discussion Paper 2003–02 (Mar. 2003).

should decrease in price. The one thing that should not happen is no change in price. Of course, another possibility is that buyers of the bonds paid no attention to the covenants at all, regardless of their possible effect.

There are, in fact, several reasons to expect CACs will not have an appreciable effect on future restructurings, apart from the high effective percentage requirement. First, there will be a substantial transition issue since non-CAC bonds may not be fully replaced until 2013. Second, the CAC clauses have not been tested in court. It is possible that courts would intervene to prevent a majority of bondholders from abusing a minority—the avoidance of this possibility is one of the reasons bonds under U.S. law traditionally required a 100% consent for change in payment terms. Third, as Anne Kreuger, the former First Deputy Managing Director of the IMF, who proposed the SDRM, repeatedly observed, the CAC solution will not work across different credit instruments. Even if the same CAC were inserted in all sovereign bonds, other major debt that would be simultaneously subject to restructuring negotiations, like syndicated bank debt or trade credit, would not have such clauses. Nor is it clear that bonds issued by the same sovereign would all have the same collective action requirements.

In May 2003, Uruguay announced completion of the swap of $5.1 billion of old bonds for new ones with longer maturities. Uruguay provided a method for facilitating majority action across different bonds. The new bonds provide that the payment terms of multiple bonds in a "series" (ones issued under the same indenture) can be changed with a vote of 85% of the aggregate principal amount of all outstanding bonds (again subject to the exclusions of state controlled entities), and 66.6% of each issue. If an issue falls short of 66.6%, it is not included in the aggregate deal. The same type of provision is in the new Argentine bonds issued as part of the 2005 exchange.[16] But current sovereign issuers cannot control the future. This kind of "series control" can simply be avoided by starting a new series. Nor can bond aggregation rules solve the problem of the need to coordinate with other forms of debt.

On the other hand, if these CACs are actually used in future crises, they will help defaulting sovereigns achieve better terms than they were previously able to achieve. As already observed, individual lawsuits will be curtailed, even before any restructuring agreement is reached—thus removing even the small threat creditors now have to pressure sovereigns for better terms. Further, given the aggregation feature, potential holdout creditors would have to muster a sufficient majority across all bonds subject to aggregation, not merely their own bonds, to block a deal. This will be a tall order for countries like Argentina and Brazil, with large debt stock outstanding.

CACs were not, despite the advertising, a market solution. The market had been free to choose between CACs under U.K. law or non-CACs under U.S. law. In fact, what happened is that the U.S. Treasury and the G7 imposed these new CACs on the marketplace to facilitate sovereign restructuring. Once again the U.S. government was siding with Argentina and undermining market discipline.

If the United States and the G7 are to mandate some form of CACs, in the author's view a mistake, the CACs should be stronger so as to insure that creditors have more leverage in the restructuring negotiations. As originally proposed by

[16]G. Gomez-Giglio, *A New Chapter in the Argentine Saga: The Restructuring of the Argentine Sovereign Debt*, J. OF INT'L BANKING L. R. 345 (2005).

creditors, the threshold should be 90%, and this threshold should apply to aggregated as well as individual debt issues. Private domestic creditors subject to sovereign pressure, as well as controlled entities, should be excluded from voting. The sovereign should be required to disclose all information relevant to its ability to repay during the restructuring negotiations.[17] Unless high CAC thresholds with required disclosures are required, future sovereigns will use the CACs to cram down what may now be called Argentine terms.

There is also the issue of the threshold required to bring suit. One could argue that any creditor, before 90% of the creditors have accepted a restructuring, should be able to sue, just as they were able to do before the newly mandated CACs. Indeed, if creditor rights remain weak, as they currently are, this should continue to be the case—otherwise there will be no pressure on the sovereign to reach a deal (recognizing that current creditor suits put little pressure on the sovereign anyway).

However, if creditor rights were to be strengthened along the lines advocated in this paper, there could be a need for some collective action mechanism to avoid a race to the courthouse. Perhaps, bonds could incorporate an automatic stay on creditor actions after a default that would dissolve after the default had been outstanding for a fixed period of time, perhaps two months. After that, the stay would continue only with consent of 90% of the creditors, using the same voting rules as for the CACs.

[17]Transparency and the timely flow of information is the first principle enunciated in the Institute of International Finance's Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, Mar. 31, 2005.

## IV. THE MISTAKE OF SIDING WITH ARGENTINA

The interest of the United States in Latin America is to promote democracy, strong economic growth and friendly relations with the United States. The U.S. does not want Argentina or other Latin American countries to drift leftward toward Castro in Cuba or Chávez in Venezuela. Although never articulated, it is this author's opinion that the Bush Administration sided with Argentina during the debt crisis, by refusing to support creditors attacking the restructuring, because it thought it would achieve these foreign policy objectives. The court interventions were not about the meaning of *pari passu* clauses or the payments system—they were about currying favor with Argentina. The United States was seeking to achieve headlines like this one in *Ambito Financiero* on July 17: "Good News: Support from the United States in the Vulture Fund Lawsuit," referring to the U.S. brief submitted in the *Central Bank* cases. The thinking was that if the United States supports the efforts of Argentina to restructure its debt, even on harsh terms for creditors, Argentina would be friendlier. This has obviously not worked. Indeed, it has backfired.

Néstor Kirchner in Argentina has increasingly made common cause with Hugo Chávez—as already discussed, Venezuela is now buying substantial portions of Argentine debt. The two countries plan to jointly issue debt and have announced plans to establish a regional IMF. The U.S. has certainly not stopped Argentina from moving leftward. And China is now in the mix as well, romancing Argentina as part of its "south-south" strategy, to build a coalition of cooperating countries across Latin America and Africa.

Kirchner is wildly popular, with approval ratings over 80%. Much of his populist appeal is based on denunciation of the IMF, the U.S. and foreign creditors. Indeed, by backing Kirchner's draconian debt restructuring, the U.S. allowed him to demonstrate his power and ability to resist Western pressure. If the United States had opposed the restructuring and supported efforts of creditors to seize Argentine assets, Kirchner would not be able to claim the ability to snub the West without cost.

Two articles in *Foreign Affairs* in the last six months document the leftward movement in Latin America.[18] Castenada says of Kirchner: No one really knows "what Kirchner intends to do when his economic recovery runs out of steam. But it seems certain that the Peronist chromosomes in the country's DNA will remain dominant: Kirchner will hand out money, expropriate whatever is needed and available, and lash out at the United States and the IMF on every possible occasion. At the same time, he will worry little about the number of Argentines living under the poverty line and be as chummy with Chávez as he can." This is not someone the U.S. will get "brownie points" from for opposing the efforts of his U.S. creditors. He is probably laughing at us all the way to the bank.

Argentina was a rogue debtor, acting considerably outside the norms for debt restructuring. U.S. and foreign creditors lost billions of dollars that Argentina could have repaid. The way to deal with outrageous behavior of this kind is not to encourage or facilitate it but to oppose it. The U.S. will not win back Argentina or show its strength in Latin America by allowing Chávez and Kirchner to punish its creditors. In addition, the U.S. has a strong interest in discouraging overborrowing since this is

[18] Peter Hakim, *Is Washington Losing Latin America*, (Jan./Feb. 2006) and Jorge Castenada, *Latin America's Left Turn*, (May/June 2006).

what eventually produces fiscal and political instability, impoverishing people of the region and leading to the rise of anti-American populist leaders. To prevent overborrowing, we must strengthen not weaken the hands of our creditors.

## V. WHAT SHOULD THE UNITED STATES DO?

The United States must consider taking the following actions:

1. **Start intervening in court cases on the side of U.S. creditors, not on the side of defaulting sovereigns**. Interventions supporting the debtors are particularly unjustified in the case of Argentina, which acted outside the boundaries of international norms in the restructuring, repudiated its debt contracts, evaded the effect of U.S. court judgments, and pursued openly hostile policies toward the United States by allying itself with the Latin American left. Appeasement does not work and has not worked in the case of Argentina. At the very least, the United States should stop intervening at all and let the courts decide the issues.

2. **Put more teeth in anti-bailout policies by creating more political barriers to sizeable IMF bailouts**. Exceptional lending should require the explicit approval of the G7 and IMF loans should be junior, not senior, to private credit. Without effective restraints on IMF lending, sovereigns will continue to overborrow and look to the IMF honeypot when they get into trouble. In addition, any IMF or official lending should be prohibited to a country, like Argentina, when a default lasts longer than a year until such time as a restructuring. The restructuring plan should require a 90% acceptance rate by foreign creditors.

3. **Stop pressuring countries to adopt CACs. Let the market freely decide what kind of CACs it wants for a particular borrowing, as was the case before the Argentine default**. If the United States and the G7 continue to insist on CACs, they should require a 90% threshold for creditor acceptance with respect to both individual bonds and overall debt, and that all domestic creditors, not just controlled entities, be excluded when determining whether the CAC threshold has been met. Threshold requirements, e.g. 25% for bringing suits, should be abolished. Consideration of a bond provision calling for an automatic stay for a limited period of two months should only occur after creditor rights have been considerably strengthened.

4. **Take the lead internationally in removing safe havens for sovereign assets in cases of debt defaults, such as under the BIS rules**. There should be complete disclosure of the assets held by the central banks of sovereigns in default on court judgments in a G7 jurisdiction. In addition, protection of central bank foreign currency assets at BIS should not exceed assets reasonably required to conduct monetary and foreign exchange policy. A method should be devised, however imperfect, to set this cap.

5. **Exclude sovereigns in default on court judgments in G7 countries from selling their bonds in the United States**. Satisfying U.S. judgments should be required for U.S. market access. The SEC can currently exclude private issuers who have violated disclosure laws from using our securities markets. The same result should follow if sovereigns fail to honor orders of U.S. courts. The U.S. should attempt to get other G7 countries to follow the same policy.

6. **Change the FSIA to strengthen creditor rights**. If creditors have stronger rights to seize sovereign debtor assets in cases of default, sovereigns will be much less likely to overborrow.[19] Generally, the U.S. should endeavor to give creditors the same rights against sovereign borrowers that they have against private borrowers. The United States should advocate that other countries take a similar approach, in order to avoid international regulatory arbitrage. The following reforms should be considered:

- Allow sovereigns and central banks to waive all FSIA protections, against pre- or post-judgment attachment, with respect to all property, whether commercial or not, and whether inside or outside the United States. Also, make clear that if a central bank waives sovereign immunity its assets are available to be attached in satisfaction of debts owed by the sovereign. This would allow the rules of the marketplace to govern. Sovereigns are strong enough to protect themselves. There is no reason to interfere in consensual activity. For existing debt instruments, follow the BIS approach outlined above, by providing that central bank immunity only exists with respect to assets reasonably required to conduct monetary and foreign exchange policy.

- Broaden the key definitions of property and commercial activity. Property should include all trade and payment flows, including the right to receive something of value. Commercial activity should include any activity, including those of a business or financial nature, other than an activity in which only a sovereign can engage. Thus, any payments or goods flows involving a sovereign would be covered since private parties could also engage in such activities. This would include any payment to the IMF. While only a sovereign could actually make a payment to the IMF, the kind of activity involved, debt repayment, can also be engaged in by private parties. An example of the kind of activity that only a sovereign can engage in is the collection of a tax.

[19]Interestingly, Jeremy Bulow, the Stanford economist, has advocated reducing overborrowing by cutting back on creditor rights, specifically by making debts only enforceable in the courts of borrowers, *First World Governments and Third World Debt*, I Brookings Papers on Economic Activity 229, 245 (2002), on the theory that this will cure creditor moral hazard, lending too much because of the expectation of being bailed out. This ignores the fact that creditors have had no effective rights for some time and overborrowing has grown and persisted.

- Authorize creditors to attach stock of state wholly-owned enterprises, wherever the stock may be actually located. The sovereign would be ordered to deliver the stock to the court. Failing compliance, a lien would be granted to creditors on the U.S. assets of the state-owned enterprise. The priority of the lien would be determined according to normal rules for private debtors.

- Provide by statute that, unless otherwise provided by the parties, that a creditor of a defaulting sovereign has a remedy under state law to attach all payments and good flows of the sovereign. This includes goods shipped or being received, and payments made or being received. This would clarify the current scope of attachment law. It would also have the benefit of eliminating litigation over the *pari passu* clause, as the right to attach payment flows would be part of the remedies the state gives creditors against defaulting debtors, unless the contract provides otherwise. The statute should further provide that no payment system or other operational objections, of the kind put forth in *Macrotecnic*, may be raised by parties subject to such attachments.

- Authorize courts to require a sovereign to bring assets into the U.S., to post security for costs and to incur monetary sanctions for discovery or other litigation abuses, again treating sovereigns the same as private borrowers.

- In the case of default, clarify that under the Federal Rules of Civil Procedure sovereigns must disclose details of all assets, wherever located, and expand these rules to permit creditors to depose sovereign officials.

## CONCLUSION

*Cry for the United States*. It has pursued a failed foreign policy that has resulted in huge losses for U.S. creditors and allowed Argentina to thumb its nose at the United States, further strengthening the left in Latin America. *Don't cry for Argentina*. It was able to restructure $80 billion of debt with a massive haircut and ignore the $30 billion still owed to non-tendering bondholders—with impunity. Argentina returned to the bond markets, continued to attract foreign investment, and avoided creditor sanctions. Under this scenario, why would any country repay its debt?

It is time for the United States to pursue a new policy of toughness with respect to sovereign defaulters. It should start backing its creditors in court, credibly restrain IMF lending, abandon the pursuit of weak collective action clauses, oppose the use of international safe havens, like the BIS, to shelter sovereign assets, deny market access to sovereign debtors that are in default on G7 judgments and enact wholesale reforms of the FSIA to strengthen creditor rights, encouraging other G7 countries to do so as well.