INTEGRATING A THEORY OF THE STATE INTO SOVEREIGN DEBT RESTRUCTURING

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INTRODUCTION

A nation's inability to repay money it has borrowed portends difficult times ahead both for its citizenry and its lenders. Citizens of the defaulting state face the specter of a substantial decline in their standard of living. Defaults on sovereign debt can signal a liquidity crisis that impairs the nation's ability to meet the demands of its citizens as well as those of its lenders. Lenders, many of whom today are themselves citizens of other nations,[1] suffer a shortfall in the income they expected to receive. Sovereign defaults in the last decade have reconfirmed the pain that this type of financial distress can inflict,[2] and the appropriate response by various actors again has come to the forefront of policy debates.[3] The recent spate of sovereign debt restructurings invites consideration of which set of institutions should be in place to minimize the cost of sovereign financial distress.

Most commentators believe that the current system for responding to a country's inability to service its debts can be improved. That system relies on concessions made by debtholders, with much of the negotiations taking place among the embarrassed country, representatives of the bondholders, and the International Monetary Fund (IMF). The standard account of why a default on sovereign debt is often needlessly expensive posits that renegotiation would be in the economic interests of the defaulting nation's creditors, but that renegotiation of previously issued debt faces substantial hurdles. These factors, two present and one absent, are generally thought to make financial

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1 *See* Matt Moffett, *After Huge Default, Argentina Squeezes Small Bondholders*, WALL ST. J., Jan. 14, 2004, at A1 (noting that forty-four percent of Argentina's debt is held by small investors, mainly in Japan and Europe).

2 The most notable recent default is that of Argentina, which, at the time it halted payments, had $88 billion in bonds outstanding. *Id.*

3 For an overview of the current proposals, see William W. Bratton & Mitu Gulati, *Sovereign Debt Restructuring and the Best Interest of Creditors*, 57 VAND. L. REV. (forthcoming 2004).

distress more challenging for a country than it is for other large entities, such as corporations. The first obstacle is a holdout problem created by the structure and distribution of the outstanding debt. A majority of bonds issued by countries with a significant risk of default mandate that any changes in the bonds' payment terms require the consent of the individual bondholder.[4] To be sure, such terms were present in loans that were successfully restructured in the 1980s. Then, however, banks held the lion's share of the debt, but today these bonds are widely dispersed.[5] From the corporate context, we know that companies that only have issued privately held debt have an easier time fashioning a workout when problems arise than do companies with publicly held debt.[6] This is not surprising. When the number of debtholders increases, it costs more to convey the necessary information to all of them. More ominously, the increase in the number of parties increases the "holdout" problem—the tendency of any single creditor not to agree to a restructuring in the hopes that other creditors will take the necessary reduction in their rights to payment, and thus the "holdout" will receive payment according the bonds' original terms.[7]

In addition to a structure that impedes voluntary renegotiations of corporate debts is a feature unique to government-issued bonds—a potential lender of last resort. Frequently in the past, countries that faced the possibility of not being able to service their debt were able to stave off default through a rescue package crafted by the IMF. In light of this history, some bondholders may not agree to a restructuring in the hopes that refusal will increase the pressure on the IMF to engineer a bailout of the embarrassed sovereign. Similarly, a country in distress may overstate the extent of its fiscal woes, hoping to induce an infusion of fresh funds. To be sure, the IMF recognizes the problem that the possibility of a rescue creates and is attempting to alter expectations on this score. Still, any possible infusion of new money will tend to move both bondholders and sovereign debtors away from the negotiating table.

The problem caused by these two factors is exacerbated by a missing element: the inability to repair to a collective forum. There is no legal regime,

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[4] Bonds issued in New York tend to have this feature (though there are a few recent exceptions) and those issued in London tend to have clauses that allow changes based on the votes of a specified amount of the outstanding debt. *See id.*

[5] *See* Barry Eichengreen, *Restructuring Sovereign Debt*, J. ECON. PERSP., Fall 2003, at 75, 81-82.

[6] *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1192-99 (1991); Stuart Gilson et al., *Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990).

[7] *See* Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 235-40 (1987).

no "bankruptcy law," that allows for the individual creditors to work together and avoid holdout problems.[8] In the corporate context, parties are often unable to reach a consensus on how to restructure debt, and the parties invoke bankruptcy law to resolve the matter.[9] Without any mechanism to combat the holdout problem directly,[10] the parties must reach some sort of agreement. The ongoing battle over Argentina's debt restructuring demonstrates the problems that can arise.[11] In response to this state of affairs, commentators and policymakers have searched for alternative ways to handle sovereign distress.

The alternative regimes put forward take aim at the problems endemic in the current structure. One proposal, currently backed by the U.S. Treasury and others, is to move to a system in which all sovereign bonds contain "collective action clauses."[12] These clauses would allow changes in the payment terms of all bonds of the issue provided that a specified number of the bondholders voted in favor of the change. To the extent that a restructuring would be in the interests of bondholders as a group, properly structured collective action clauses could eliminate the threat that opportunistic holdout poses to facilitating a restructuring.[13] Indeed, recent sovereign bond issues in New York, reversing historical practice, contain collective action clauses.[14]

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[8] On Chapter 11 as a collective proceeding, see THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7-19 (1986).

[9] Work in the early 1990s indicated that of financially distressed corporations, about half were able to restructure that debt outside of bankruptcy, and half saw their distress lead them to Chapter 11. *See* Gilson et al., *supra* note 6. Given the dramatic changes in Chapter 11 practice since that time, such as the increased use of prearranged bankruptcies and the use of bankruptcy as a mechanism to sell the firm as a going concern, *see* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003), it is uncertain whether this earlier division between out-of-court restructurings and Chapter 11 continues.

[10] One indirect way to deal with the holdout problem is through the use of exit consents. *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges*, 48 UCLA L. REV. 59 (2000).

[11] As to Argentina's efforts, see *infra* notes 83 and accompanying text.

[12] *See* Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002); Under Secretary of Treasury John B. Taylor, Sovereign Debt Restructuring: A U.S. Perspective, Speech at the Conference Sovereign Debt Workouts: Hopes and Hazards, Institute for International Economics (Apr. 2, 2002), *at* http://www.iie.com/publications/papers/Taylor0402.htm.

[13] Problems in moving to a collective-action-clause regime include devising a mechanism to ensure collective action across bond issues, preventing collusion with a majority of bondholders at the expense of the minority, and transitioning from a world populated with bonds that contain unanimous-consent clauses. *See* INT'L MONETARY FUND, THE RESTRUCTURING OF SOVEREIGN DEBT—ASSESSING THE BENEFITS, RISKS, AND FEASIBILITY OF AGGREGATING CLAIMS 17-25 (2003); Bratton & Gulati, *supra* note 3.

[14] For an analysis of the recent changes in the terms of sovereign bonds, see Stephen Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004).

A second set of reform proposals draws on the lessons found in corporate reorganizations, primarily in the United States.[15] Corporate reorganizations have been a feature of the U.S. legal landscape since the 1800s, and many large businesses each year file under Chapter 11 as a way of addressing their financial difficulties.[16] For those looking for solutions to the growing problem of a nation's inability to repay borrowed funds, it is only natural to turn to Chapter 11 for a template for a sovereign debt restructuring system. While recent efforts to institute such a legal regime have run into political opposition,[17] this approach retains adherents both in the academy and in policy circles.[18] To the extent that what appears to be an ongoing switch to collective action clauses turns out to be insufficient to resolve the problems raised by sovereign financial distress,[19] the case for an international bankruptcy regime for sovereign debtors will remain viable.

Both sets of alternatives, while arguably improvements over the current state of affairs,[20] are in an important sense incomplete. The existing proposals, self-consciously, borrow heavily from the experience and learning in the corporate reorganization area. Undoubtedly, one can glean useful insights from the lessons learned here, including the often overlooked role that issues of control play in modern reorganization practice and could play in any sovereign restructuring scheme.[21] Still, corporate reorganization law cannot capture all of the relevant dynamics surrounding sovereign debt restructuring. Countries

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[15] *See, e.g.*, PATRICK BOLTON, TOWARD A STATUTORY APPROACH TO SOVEREIGN DEBT RESTRUCTURING: LESSONS FROM CORPORATE BANKRUPTCY PRACTICE AROUND THE WORLD (Int'l Monetary Fund Working Paper No. 03/13, 2003), *available at* http://www.imf.org/external/pubs/ft/wp/2003/wp0313.pdf; ANNE O. KRUEGER, INT'L MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING (2002); Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2004); Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000); David A. Skeel, Jr., *Can Majority Voting Provisions Do It All?*, 52 EMORY L.J. 417, 422-25 (2003).

[16] For a history of corporate reorganizations in America, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA ch. 2 (2001), and Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 925-36 (2001). In the last two decades, the number of publicly held companies filing for Chapter 11 has averaged well over one hundred per year. *See* THE 2003 BANKRUPTCY YEARBOOK & ALMANAC 38 (Christopher M. McHugh ed., 13th ed. 2003) [hereinafter ALMANAC].

[17] *See* INT'L MONETARY FUND, *supra* note 13, at 2 (noting that the IMF "concluded that it was not now feasible to establish the Sovereign Debt Restructuring Mechanism").

[18] *See* Bolton & Skeel, *supra* note 15; Steven L. Schwarcz, *"Idiot's Guide" to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189 (2004).

[19] *See* Skeel, *supra* note 15.

[20] For an argument that these proposals may not be improvements, see Bratton & Gulati, *supra* note 3.

[21] For a discussion of how issues of control may arise in sovereign debt restructuring, see *infra* notes 43-54 and accompanying text.

have a more robust justification for their existence than do corporations. Just as corporate bankruptcy law finds its justification in the theory of the firm,[22] sovereign debt restructuring should be animated by a theory of the state.

Corporations are investment vehicles. The investors that create a corporation seek the most efficient form possible. In terms of financing, they seek to reduce their cost of capital. Corporate reorganization practice is measured against this benchmark. An efficient corporate reorganization law provides appropriate investment incentives and rests control in the hands of those best positioned to make the right decision. Do these things well, and the corporation should pay less for its funds than if these things are done poorly.[23]

Few would seriously contend that a country is simply an investment vehicle for its citizens. This being the case, it is not readily apparent that reducing a sovereign's borrowing costs should be the guiding principle in fashioning a regime to resolve the problems of sovereign fiscal distress. While all acknowledge the fact that nations cannot be liquidated the way that businesses can, the differences between corporations and countries are more profound than this. Only by asking why we have governments and why we support their borrowing funds in the first instance, can we assess what we should be trying to accomplish when a nation encounters financial distress.

Issues of political theory generate much disagreement. At their core, however, most theories of the state turn to the well-being of citizens for their justification.[24] Whether utility, rights, or fairness forms the bedrock of any given political theory, it is utility, rights, or fairness with respect to *citizens* that is important. This focus on the demands that individuals can make of the state points to another strand of bankruptcy law that has yet to find a role in the debate over sovereign financial distress—personal bankruptcy law. Incorporating the insights from individual bankruptcy law expands the possible

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22 *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 756-58 (2002).

23 *See* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 18-23; Alan Schwartz, *A Normative Theory of Business Bankruptcy*, *available at* http://www.law.umich.edu/CentersAndPrograms/olin/papers/Winter%202004/schwartz.pdf (last visited Apr. 11, 2004).

24 By this, I do not mean to restrict myself to "maximizing welfare" in the manner articulated forcefully by Kaplow and Shavell. *See* Louis Kaplow & Steven Shavell, *Any Non-Welfarist Method of Policy Assessment Violates the Pareto Principle*, 109 J. POL. ECON. 281 (2001) [hereinafter Kaplow & Shavell, *Pareto Principle*]; Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001) [hereinafter Kaplow & Shavell, *Fairness*]. Rather, I mean simply that almost all theories of government rest on the well-being of their citizens. Whether one looks to the rights of the citizens, the status of the worse off, or sums up collective welfare is beside the point for this discussion.

choice set of regimes to confront the problem of sovereign financial distress. Most notably, a sovereign debt restructuring system that flows from a theory of the state would contain a right of discharge. States would, under certain circumstances, have the right to have a portion of their debt eliminated. Such a right would not be conditioned on the consent of their creditors. Once a state met the applicable requirements for declaring "bankruptcy," it would be entitled to relief.

One can thus envision four basic regime types for sovereigns: (1) a world in which unanimous action clauses remain the dominant feature of sovereign lending and there is no international bankruptcy procedure, which is basically the world in which we currently live; (2) a world in which collective action clauses are ubiquitous but again no collective forum is available should voluntary restructuring efforts fail, which may be the world that we are moving toward at this moment; (3) a world in which, whatever terms the bonds contain, there is a system in place designed to bring all lenders into a collective forum where they can reach agreement on new payment terms and where this agreement will bind dissenting creditors; and finally, (4) a world in which such a system includes the right on the part of the debtor state to discharge some of its debt.

Selecting an appropriate regime, even putting political constraints to one side, is no easy task. Just as states are not corporations, neither are they individuals. There are strong arguments in favor of allowing corporations to select the insolvency regime that will sort out their affairs should they encounter financial difficulties.[25] The case for allowing freedom of choice for individuals is more problematic, with most agreeing that individuals should not be able to waive their right to file for bankruptcy.[26] States present an intermediate case, with some arguments as to why the state should be permitted unlimited choice in this area—citizens should be bound by the

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[25] *See* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998). Mechele Dickerson argues that such a regime should be implemented in the sovereign debt area. *See* A. Mechele Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, 53 EMORY L.J. 997 (2004). Patrick Bolton and David Skeel similarly suggest that countries be able to contract out of any sovereign restructuring regime. *See* Bolton & Skeel, *supra* note 15, at 818-21.

[26] *See* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985). *But see* Barry E. Adler, *Bankruptcy Primitives*, 12 AM. BANKR. INST. L. REV. (forthcoming 2004) (arguing that individuals should be allowed some degree of freedom in selecting the bankruptcy rules that will apply to them should they become financially distressed); Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL. STUD. 585 (2000).

choices of their leaders—and others as to why it should not be able to select certain regimes—leaders may place their own interests ahead of those of their citizens and thus discount the future too heavily, which would lead them to purchase too little financial distress "insurance."

Part I of this Article canvasses the lessons that we can glean from corporate reorganization practice and scholarship. Part II explores the differences between corporations and states and suggests that we repair to individual bankruptcy law for an additional framework on which to construct a sovereign debt restructuring mechanism. Part III begins this process and raises a new possibility, a sovereign debt regime that allows, in certain circumstances, a country to discharge a portion of its prior debt without agreement by its creditors. Part IV concludes with the observation that we cannot trust states to select the appropriate regime for their citizens, suggesting that reforms, if they are to come, are most likely to come through international cooperation.

I. CORPORATE REORGANIZATIONS IN AMERICA AND SOVEREIGN DEBT RESTRUCTURING

It is understandable that in looking for improvements to the current method of dealing with sovereign distress, commentators would turn to the law of corporate reorganizations in America. A quick glance reveals obvious similarities between large, publicly held corporations and states. Both are large organizations in which governing authority rests in an identifiable set of leaders. These leaders often hold their offices pursuant to an election. The electorate—citizens of a state and shareholders of a corporation—are commonly viewed as the principals whom the elected—heads of state and boards of directors—serve. Both countries and corporations undertake activities the cost of which runs into the tens of millions and hundreds of millions of dollars. To finance these expenditures, both have access to capital markets in which they can amass millions in debt. Such debt may be privately issued or publicly placed. Both also have future cash flows to which investors look for repayment, though in distress situations these cash flows are insufficient to service the outstanding debt.

Given these similarities, Chapter 11 becomes an attractive pool to troll for solutions to today's sovereign debt crisis. Chapter 11 is often described as a forum in which creditors can come together and overcome the collective action problem that exists under nonbankruptcy law.[27] Moreover, as an empirical matter, hundreds of publicly traded corporations have sought protection under Chapter 11 and emerged with a lighter debt load.[28] If Chapter 11 can reorganize financially distressed corporations worth billions of dollars, why can it not adumbrate a framework for reorganizing financially distressed sovereigns?

Chapter 11, to be sure, has its fair share of detractors. Some argue that it is too expensive, that it too often allows for deviations from contractual priority, and that private ordering could do better.[29] To understand what lessons we should draw from Chapter 11 for the problem of sovereign debt, we should proceed with caution. It is helpful to recall the fundamental task that the law of corporate reorganization performs. U.S. corporate bankruptcy law is best understood as trying to answer the question whether a specific corporation with specific assets should remain intact.[30] As such, the normative justification for bankruptcy law flows from the theory of the firm. Only by articulating why firms have value in the first instance can one begin to assess whether there is any value in a particular corporation and whether Chapter 11 or some alternative provides the right set of procedures to preserve this value. In answering these questions, attention needs to be paid to the decision made in the bankruptcy proceeding itself—whether reorganization practice ensures that assets flow to their highest valued use—and the decisions made prior to bankruptcy—whether managers have the incentives to engage in investments that promise to increase social welfare.[31] The optimal insolvency system would maximize the corporation's investment in worthwhile projects before the proceeding begins and ensure that the assets fetch top dollar once the proceeding commences.[32] Such a procedure would lower the cost of capital

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27 *See* JACKSON, *supra* note 8, at 7-19.

28 Between 1980 and 2002, over 2700 publicly held companies filed for Chapter 11. *See* ALMANAC, *supra* note 16, at 38. Chapter 11 tends to lower outstanding debt to a greater extent than do out-of-court restructurings. *See* Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161, 175-88 (1997).

29 *See, e.g.*, Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213 (1994).

30 *See* Baird & Rasmussen, *supra* note 22, at 757-58.

31 On the need to assess the ex ante effects of reorganization law, see Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992); Rasmussen, *supra* note 23, at 18-23.

32 *See* Rasmussen, *supra* note 23; Schwartz, *supra* note 23.

and allow businesses to pursue more projects that offer the promise of increased social welfare.

The literature on sovereign debt restructuring explains the case for restructuring differently. Most efforts at justifying a regime for resolving sovereign distress focus on the gains that are available once distress has become manifest.[33] When a sovereign defaults, renegotiating its debt to sustainable levels will achieve a greater return to the creditors. These returns come from two sources. One is that a sovereign that is able to pay part of its obligations may balk if it cannot pay the debt in full. Why part with precious cash when default is inevitable? By lowering the amount that the sovereign must pay to discharge its obligations, creditors may see more of the money that the sovereign collects than they otherwise would.

The second way that sovereign debt restructuring can redound to the creditors' benefit is through reduction of the debt overhang problem, a phenomenon well discussed in the corporate setting.[34] In corporate finance, the debt overhang problem refers to a situation in which a business's outstanding debt prevents a corporation from engaging in activities that, on an expected basis, promise to produce a profit. The reason for this is that if the business does not generate sufficient internal cash flows to fund the project itself, it has to turn to outside debt markets for financing. But such markets may be unwilling to provide capital. If all debts, new and old, have the same priority, then any profits from the new undertaking will have to be shared with existing creditors. 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 the project. It cannot promise enough if the project is successful to compensate the creditor for the risk of not being paid in full if the project does not succeed. In the corporate setting, this problem can be overcome either outside bankruptcy through the issuance of secured debt,[35] or within bankruptcy through debtor-in-possession financing.[36]

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[33] *See* Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253 (1988); Jeffrey Sachs, *The Debt Overhang of Developing Countries*, *in* DEBT, STABILIZATION AND DEVELOPMENT 80 (Guillermo Calvo et al. eds., 1989).

[34] The classic paper on this point is Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

[35] *See* René M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. FIN. ECON. 501, 515-18 (1985); George G. Triantis, *Second Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225, 248-49 (1992).

[36] *See* George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 918-27 (1993).

This concern with the effect of debt overhang on potentially profitable projects translates to the sovereign debt context with added force. Here, the concern is that a country could make investments that would, in the long run, increase its tax base. The need to pay current debts and provide a minimal level of social programs for its citizens precludes the country from funding the projects out of its existing revenue stream. Indeed, with little room for secured debt and no extant provision for debtor-in-possession financing, it is difficult in the sovereign context to ensure that a new lender who would fund these improvements receives a priority position. A sovereign debt restructuring regime could overcome this problem either by inducing a reduction of outstanding debt—and hence allowing current revenue to be devoted to these improvements—or by sanctioning priority lending.[37] Indeed, recent empirical evidence suggests that indebted countries do suffer from a debt overhang problem and that this problem can be ameliorated through debt restructuring.[38]

The fight among commentators has not been so much over the existence of the benefits of restructuring, but rather over how to generate them. Proponents have sparred over competing proposals. Some advocate the universal use of collective action clauses. U.S. law prohibits corporations from issuing bonds that would alter the payment terms of a bond issue after a specified majority approved the change, but no such legal impediment exists for sovereign debt. While boilerplate from corporate bonds may have crept into sovereign bonds issued in New York, there is no legal impediment to inserting collective action clauses into new bond issues. Indeed, in the last year an unprecedented number of sovereign bonds issued in New York have contained such terms. Others in the sovereign debt debate, while applauding this progress, fear that such clauses in and of themselves will not be sufficient to induce restructuring, and thus have pressed for a "sovereign debt restructuring mechanism," or, more colloquially, a sovereign bankruptcy law.

Before quickly detailing those Chapter 11 provisions that have seeped into proposals for a sovereign bankruptcy regime, it is worth emphasizing what the sovereign restructuring literature has yet to examine. Just as bankruptcy

[37] As to the potential benefit of priority lending in the sovereign debt context, see Bolton & Skeel, *supra* note 15, at 788-801, and Anna Gelpern, *Building a Better Seating Chart for Sovereign Restructurings*, 53 EMORY L.J. 1115 (2004). For a discussion of recent efforts to increase asset-based financing by sovereigns, see INT'L MONETARY FUND, ASSESSING PUBLIC SECTOR BORROWING COLLATERALIZED ON FUTURE FLOW RECEIVABLES (2003), *available at* http://www.imf.org/external/np/fad/2003/061103.pdf.

[38] For evidence that a debt overhang problem exists and that restructuring can bring gains to both the country and its lenders, see SERKAN ARSLANALP & PETER BLAIR HENRY, IS DEBT RELIEF EFFICIENT? (Nat'l Bureau of Econ. Research, Working Paper No. 10217, 2003).

scholarship in the 1980s focused on the gains that creditors could capture after default through collective action,[39] the current sovereign distress discussion focuses on value-increasing actions after financial distress has occurred. Such efforts are no doubt important to the efficiency of any sovereign debt restructuring system, but a more complete picture would include an ex ante perspective as well.[40] In particular, a complete analysis of any proposed sovereign restructuring regime should also include discussion of how that regime would affect government decisions before distress appears on the horizon.

That said, the project of facilitating restructuring ex post merits the considerable attention that it has received. Several important papers have already discussed the major statutory features of Chapter 11, and they have debated the extent to which these features should form part of a sovereign bankruptcy system.[41] These include the automatic stay, the ability to lend money on a priority basis, and the ability of a majority to bind a minority of similarly situated creditors.[42]

Close examination of the statutory framework, however, does not exhaust the insights that Chapter 11 can potentially provide for those exploring sovereign debt restructuring alternatives. Today, issues of control loom large in corporate reorganizations.[43] It is control, not priority or debt restructuring, which has the greatest impact on the fortune of corporations and their various investors. Corporations often become insolvent because they have made operating decisions that have turned out poorly, or because economic conditions have changed and the managers have not been nimble enough to alter their business model to react to these changes. Creditors with control can replace existing policies (and where necessary managers) with new ones.

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[39] This view is best articulated in the Creditors' Bargain Model developed by Douglas Baird and Thomas Jackson. Much of their work is synthesized in JACKSON, *supra* note 8.

[40] For an exception to this tendency to examine the problem only from an ex post perspective, see Bolton & Skeel, *supra* note 15.

[41] *See* KRUEGER, *supra* note 15; Bolton & Skeel, *supra* note 15; Schwarcz, *supra* note 15.

[42] These features are discussed, for example, in BOLTON, *supra* note 15; KRUEGER, *supra* note 15; and Schwarcz, *supra* note 15.

[43] Douglas Baird and I have explored the centrality of control rights in modern reorganization practice in a series of articles. *See* Baird & Rasmussen, *supra* note 9; Baird & Rasmussen, *supra* note 16; Baird & Rasmussen, *supra* note 22; Douglas G. Baird & Robert K. Rasmussen, Corporate Governance, State-Contingent Control Rights, and Financial Distress (Apr. 2004) (unpublished manuscript, on file with author). Jay Westbrook has recently also argued that control is central to modern bankruptcy practice. *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

The causes of sovereign financial distress are not dissimilar. Countries may face more than a liquidity problem caused by events beyond their control; often their financial problems stem from the policies that they have pursued. These policies may have been misguided from the start, or they simply may have turned out poorly due to changing economic conditions. Regardless, a change in policy is often needed.

Senior creditors dominate corporate reorganizations. These lenders control the process from beginning to end.[44] Through devices such as a revolving credit facility, senior creditors can direct many important decisions. They can engineer the installation of a chief restructuring officer, whose loyalties tend to run to the lenders. Using these levers of control, the lenders can put the company on the block and have it sold to a third party, instigate a prearranged bankruptcy that imposes a new capital structure on the corporation that eliminates out-of-the-money creditors and shareholders, thereby solidifying the lender's position, or go through a more elaborate reorganization.[45] In today's Chapter 11 practice, the issue of control is front and center.

The focus on control in the corporate area invites a corresponding focus on issues of control in the sovereign area as well. After all, control has become a central attribute of modern Chapter 11 practice because creditors have realized that by exercising control they can increase their recovery. Whereas two decades ago, when the accepted wisdom was that managers were in control of the process, and creditors bemoaned their treatment at the hands of Chapter 11, now these creditors have devised strategies to ensure control both inside and outside of Chapter 11. Thus, one would expect that, to the extent there is a change in the legal regime governing sovereign debt restructuring, creditors would seek to exercise control in the sovereign context as well.

Admittedly, we will never see such control exercised in the sovereign debt situation as is currently exercised by creditors in Chapter 11. One cannot imagine today a group of lenders flexing their muscle to replace a president of a country the way that they can force out a CEO of a corporation, or insisting that a new economic minister be appointed the way they can trigger the appointment of a chief restructuring officer.

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[44] *See* Baird & Rasmussen, *supra* note 9, at 693-99; David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 930-35 (2003); Matt Miller & Terry Brennan, *Creditors in Possession*, DEAL, Jan. 24, 2004, at 25; Baird & Rasmussen, *supra* note 43.

[45] *See* Baird & Rasmussen, *supra* note 9, at 675-85.

Lenders to sovereign states currently lack the control that they can wield when lending to a corporation for two reasons. The first is political reality. No one objects when a board of directors heeds the desires of its senior lenders.[46] Political leaders who are perceived as being unduly solicitous of the interests of its (mostly foreign) creditors at the expense of its citizens risk being removed from office.[47] The second impediment to control is the current structure of the sovereign debt market. Secured credit is a much less common feature in the sovereign debt context. A corporation can by and large pledge all of its assets to its senior lenders. The creation of a single lender (or consortium of lenders) that is both owed roughly what the business is worth and has priority to all of the business's assets creates a situation in which a single actor has both extensive control rights and the incentive, at least as a first approximation, to maximize the value of the enterprise.

The same is not true for a state. Crucially, a sovereign cannot yield control over its cash flow the way that a corporate debtor can. Such a pledge 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.

Yet issues of control do matter in sovereign restructuring. Lenders in the sovereign arena exercise control more indirectly than they do in the private sector. Most notably, they can prevent future borrowing. Their control is tied to their writing down their debts or putting new money on the table. Indeed, debt restructuring as it is now practiced often seeks to implement new fiscal policies along with a new capital structure, and IMF loans are often conditioned on the adoption of new fiscal measures.[48] For example, the Brady Plan, which saw the restructuring of the debt of sixteen countries, required that

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[46] Well, almost no one. *See* Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's* The End of Bankruptcy, 56 STAN. L. REV. 645, 666-70 (2003) (suggesting that boards in bankruptcy should be attuned to more than creditor interest).

[47] Indeed, in the ongoing situation in Argentina, the current leaders make much of the fact that they are standing up for the citizens of Argentina as against foreign lenders. *See* Michael Casey & Michael Phillips, *IMF, Argentina Go to the Brink in Debt Talks*, WALL ST. J., Mar. 9, 2004, at A14, A15 ("Mr. Kirchner has won popular support at home by characterizing his stance as a refusal to squeeze impoverished Argentines to repay wealthy foreigners.").

[48] Int'l Monetary Fund, IMF Lending: A Factsheet, *at* http://www.imf.org/external/np/exr/facts/howlend.htm (May 2004) ("An IMF loan is usually provided under an 'arrangement,' which stipulates the specific policies and measures a country has agreed to implement in order to resolve its balance of payments problem.").

those countries adopt certain economic reforms as a price of the write-down of the debt.[49]

Under current practice, the IMF exerts a considerable amount of control over a distressed nation's fiscal policies and today is often the lender of last resort.[50] As a condition of its loan, however, it will require that the borrower implement certain economic policies.[51] Indeed, to the extent that part of the cause of sovereign distress is not bad luck but rather the economic policies that the country pursued in the past, from the perspective of social welfare it is more important to alter these policies than to reduce the nation's debt. Reducing the debt may allow the government to service a lower amount out of existing revenues, but increasing the government's tax base will redound to the benefit of the nation's citizens. Just as scholars are turning their attention to the ways that creditors exercise control in the corporate reorganization law context, those seeking a long-term solution to the sovereign distress problem need to focus on those entities that exercise control over the future economic affairs of the debtor state. To the extent that a sovereign restructuring regime will facilitate control, one needs to compare the incentives of the various entities that could gain such power. In particular, the choice is among international organizations such as the IMF, individual states, and institutional lenders. All three have differing interests and may well seek to impose divergent policies.

For example, private creditors—to the extent that a new restructuring regime would increase their ability to work together effectively—would seek the implementation of policies that would maximize their return. They would likely insist on actions that promise them the highest expected payout. How these new measures impact the borrower and its citizens is not their concern. To be sure, the policies that they seek may redound to the benefit of the country's citizens, but this is not necessarily the case. They may well settle for a larger portion of a smaller pie. For example, the current legal regime makes restructuring difficult. This difficulty may well be intentional. Under standard bargaining theory, when there is a surplus to be divided, the gains are allocated—at least in part—based on the respective patience of the parties. The more patient a party is relative to its counterpart, the more of the surplus it

[49] *See* ARSLANALP & HENRY, *supra* note 38, at 4.

[50] The IMF uses its ability to provide liquidity as the means of influencing economic policy. This is similar to lenders who provide liquidity through revolving credit facilities and debtor-in-possession financing to gain control over corporations. *See* Baird & Rasmussen, *supra* note 43.

[51] *See* source cited *supra* note 46.

stands to receive. Adopting a structure that makes action difficult is, in effect, committing to be patient. A private creditor that signaled its flexibility in advance would expect to receive less than a creditor who committed to a strategy of intransigence.

The IMF, at least on paper, would seem to be an ideal candidate for exercising some degree of control over a defaulting sovereign's fiscal policies. According to its charter, the IMF is concerned with the economic advancement of member states.[52] Thus, to the extent that it adheres to this mission,[53] it may seek to implement long-term growth policies even if another set of policies would promise a greater return to existing creditors. Indeed, the IMF routinely places conditions on its loans, though the efficacy of this practice is open to dispute.[54]

Finally, individual countries may seek to implement rescue plans because they fear the domestic consequences of other countries' predicaments. For example, in the Mexican monetary crisis in the mid-1990s, the U.S. government crafted its own rescue plan. The United States was moved at least in part by the fact that Mexico lies on its southern border, and fiscal unrest in Mexico could have an immediate impact on its northern neighbor. Foreign governments act largely to pursue their own policies. While their actions may benefit the citizens of the other country, this again is not their prime motivation.

Of course, predicting how issues of control will evolve over time is no easy task. Few of those drafting Chapter 11 in the 1970s would have imagined today's bankruptcy practice. Uncertainty, however, is not an excuse for inattention. As sovereign distress regimes evolve, issues of control may come to have a larger impact than other issues that occupy center stage today.

There are thus valuable lessons to be learned from the law of corporate reorganization. But it is also important to focus on those parts of the sovereign debt crisis that corporate reorganization law cannot illuminate. The next Part

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52 *See* ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND art. I (July 22, 1944), *available at* http://www.imf.org/external/pubs/ft/aa/aa.pdf.

53 The IMF is funded in large part by rich countries, and, as such, needs to maintain the political support of those countries. The extent to which these political dynamics affect the decisions made by the IMF merits inquiry.

54 *See* R. A. Brealey & E. Kaplanis, *The Impact of IMF Programs on Asset Values*, 23 J. INT'L MONEY & FIN. 253 (2004) (finding no increase in asset values associated with IMF support).

suggests crucial ways that the concerns of corporations and corporate law fail to capture defining attributes of governments.

II. THE DISTINCTION BETWEEN CORPORATIONS AND COUNTRIES AND ITS RELEVANCE TO SOVEREIGN FINANCIAL DISTRESS

Many of the innovative proposals for revamping the extant legal regime that governs sovereign debt restructurings find their origins in the law of corporate financial distress. All are careful to note that there are crucial differences between corporations and countries, primarily in that the former can be liquidated and the latter cannot. Yet the differences between the two are deeper and more fundamental than this. In terms of financial distress, countries differ from corporations in two crucial respects. One is that governments have goals that differ from those of businesses, and the second pertains to differences in their respective governance structures.

As to corporations, there is a widespread consensus that they are investment vehicles.[55] We as a society allow activities to be pursued in the corporate form because we believe that it increases economic activity. Corporate law scholarship repeatedly emphasizes that the board of directors should maximize shareholder wealth. To be sure, some suggest that the board should seek to promote the wealth of the various constituents who make investments—broadly defined—in the corporation.[56] This "mediating" theory of the firm seeks more to augment than to replace the shareholder focus that dominates the scholarly literature. Each side claims support in both doctrine and theory.

Regardless of which vision of the corporation one endorses, corporations strive for different ends than do national governments. All agree that corporate law focuses extensively on the interests of shareholders. While states are comprised of citizens, citizens are not shareholders. Perhaps most significantly, shareholders tend to have easy entrance and exit into corporations, but this is not true for citizens of a nation. Most of a state's citizens are citizens from birth to death.

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[55] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) (arguing that asset partitioning is the essential role of organizational law).

[56] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 275-79 (1999).

Painting with a broad brush, states seek (or at least should seek) to promote the well-being of their citizens.[57] To be sure, a fierce debate rages in political theory and the legal academy over how one assesses well-being. Pick your poison: Rawls, Nozick, Sandel, or Waldron. More generally, some argue for looking at general welfare (the modern utilitarians), while others emphasize notions of individual rights, and still others focus on notions of political community.[58] The needs of a state's citizens are actually part of the reason why sovereign borrowing is justified in the first instance. Part of the classical reason for allowing the state to consume future assets today is that it allows nations to buffer their citizens from economic shock. When a country is in a downturn, it can borrow against good times. Such borrowing both lessens the current burden on its citizens and hastens the return of economic health.

Despite this agreement on placing citizens front and center, there is much disagreement over which government policies best further the citizens' well-being. Indeed, even among countries that share a broad range of commitments, we see a difference of opinion on key issues, such as the extent to which taxes should be imposed in order to fund social programs, redistribute wealth, and maintain armed forces. In any event, few, if any, posit that increasing fiscal prosperity is the sole guiding factor.[59] To be sure, all else being equal, a robust economy increases the welfare of citizens. Poverty for the sake of poverty holds little appeal. While there may be disagreement over the precise content of what values a state should embrace, all would reject a vision of the state as a simple wealth maximizer.

A second, though somewhat related, difference between countries and corporations is their governance structure. While one can find discussions of "democracy" in both contexts, an important difference exists, at least as democracy relates to financial distress. In a corporation, we do not hesitate to allocate to the shareholders the responsibility for investment choices made by the board of directors and those they oversee. When the actions of managers do not pan out and the corporation hits financial distress, few dispute the

[57] At least in western political theory. To be sure, one can imagine a theory of the state that does not pivot on the interests of its citizens. Theocracies come to mind, where the goal may be to serve a particular vision of God irrespective of the well-being of the populace. That said, my sense is that a large majority of governments in the world would found their legitimacy on the well-being of the citizens.

[58] In legal scholarship, the debate has entered a fresh iteration with the recent claim by Kaplow and Shavell that law should concern itself only with general welfare and eschew notions of fairness. *See* Kaplow & Shavell, *Fairness*, *supra* note 24, at 1011-21; Kaplow & Shavell, *Pareto Principle*, *supra* note 24.

[59] Even Kaplow and Shavell are careful to use the metric of welfare rather than dollars. Kaplow & Shavell, *Fairness*, *supra* note 24, at 976-99.

notion that the first people to lose their investments are the shareholders.[60] Shareholders are responsible for selecting the board of directors, which in turn selects the managers. Holders of debt claims generally have little influence in selecting managers or guiding investment choices.[61] The allocation of control and loss are congruent. Indeed, as an empirical matter, Chapter 11 today by and large extinguishes shareholder interests.[62]

In part because of this allocation of losses to the shareholders, much of the work of corporate law is designed to align the interests of managers with those of shareholders.[63] Much ink has been spilled over which measures should be left to shareholder decision and which should be the province of the board of directors.[64] For those decisions that rest with the board, the board owes duties of care and loyalty to the shareholders, but not to others. All other participants are left to fend for themselves. To the extent that they want protection against certain actions, they must contract for such restrictions.[65] While creditors thus receive no special advantages, they owe no duties to others. Creditors can maximize their recovery without concern for, indeed even at the expense of, shareholders.[66]

But more than corporate law ties the interest of the board to the shareholders. Corporations compete for investors. Businesses that allow the existence of high agency costs pay more for capital than firms that have reduced agency costs. This creates an incentive for the board of directors to put in place structures that align the managers' interests with those of the shareholders. Debtholders protect themselves through covenants. Firms that offer the best assurances that funds will be spent on value-increasing projects pay less for capital. To be sure, these checks—laws and markets—can fail, or,

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60 The Bankruptcy Code enshrines this result in the so-called "absolute priority rule." *See* 11 U.S.C. § 1129(b) (2000).

61 This often changes when the business becomes distressed. *See* Baird & Rasmussen, *supra* note 43.

62 *See* Baird & Rasmussen, *supra* note 9, at 692 & n.65.

63 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001).

64 For a summary and bibliography, see George Bittlingmayer, *The Market for Corporate Control (Including Takeovers), in* 3 ENCYCLOPEDIA OF LAW & ECONOMICS 725 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000).

65 The one exception is that a board's fiduciary duties may shift to the corporation's creditors when the enterprise is insolvent. For a discussion of this issue, see Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993).

66 As a general matter, creditors do not have fiduciary duties that run to either other creditors or shareholders. For a summary of the law on this point, see Bratton & Gulati, *supra* note 3.

more likely, work imperfectly.[67] That said, when they do not adequately constrain managers, we have no doubt as to who bears the brunt of the failure: the shareholders.

The governance structure of countries differs from corporate governance in at least two respects. Most obviously, in some nations, citizens have little or no input in the selection of their leaders. They have no mechanism by which to ensure that monies borrowed are spent on projects that benefit the citizens as a whole. These funds could well be used to allow the leaders to consume private benefits. Once a new regime is in place, a regime more responsive to the governed, it is not obvious why citizens should be charged with all of the debts of those they did not elect. To be sure, citizens may have benefited (or have reasonably expected to benefit) from the monies that were borrowed in the past. For such debts, debts that may well have been incurred even if a responsive regime been in place, there is a strong case for the obligation to be carried forward. While we do not embrace dictators, we should have compassion for those who live under dictatorial rule. A blanket rule that all debts incurred by certain types of regimes are discharged when the regime is ousted would close the lending window, thereby worsening the plight of those in the country. However, to the extent that the monies received were spent on the follies and fancies of the erstwhile leaders, it is far from obvious that the citizens should remain burdened by the debt. In this situation, lenders may be better positioned to reduce the agency costs that arise between citizens and their rulers than are the citizens themselves. These are precisely the issues on which the "odious debt" debate centers.[68]

Even in a democracy, however, it is by no means uncontroversial that citizens should bear complete responsibility for the actions of their leaders. In some democracies, the leaders do not face a serious threat of being voted out of office even should they become corrupt. Voting itself is no panacea. A country needs other institutions such as a free press to ensure that citizens have the information necessary to monitor government actions. Also, in some countries that hold elections, the military is the 800-pound gorilla in the room.

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[67] To the extent that norms also guide corporate action, *see* Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619 (2001), these too can fail.

[68] *See* MICHAEL KREMER & SEEMA JAYACHANDRAN, INT'L MONETARY FUND, ODIOUS DEBT (Apr. 2002), *available at* http://www.imf.org/external/np/res/seminars/2002/poverty/mksj.pdf.

Moreover, even in well-functioning democracies, agency problems may still exist. A current set of leaders whose continuation in power turns on future electoral success may have an incentive to borrow against the future simply to ensure that they stay in power. In other words, the time horizon of the leaders may be much shorter than the time horizon of the citizens.[69]

To make these differences between a corporation and a country a bit more concrete, consider the following scenario. There is a "project" that will cost $100. If the project succeeds, it will generate a return of $210. If it fails, which is equally likely, it will be worthless. Thus, the project has an expected positive net present value. Assume that the project at issue is a new product that a corporation could invest in and bring to market. The corporation in recent years has been struggling to break even. If the project succeeds, it portends years of success. If it fails, the business will have insufficient capital to continue and its assets will be sold in bankruptcy. In such a situation, we want the business to undertake the project. The project increases overall social welfare. Even if failure means that the shareholders' investment will be wiped out, we do not hesitate in allowing, even encouraging, the business to pursue this strategy.

Such a conclusion is less clear, however, in the case of a country. Here, assume that the project is development of a new manufacturing area. To the extent that failure, while costly, would not imperil the ability of the government to service its debt, the project should be undertaken. If, however, this is a large-scale operation, failure may impair the state's ability to fund social programs deemed vital by its citizens. This failure, however, will become obvious only after the next set of elections. In such a situation, it may be in the best interest of the citizens to not proceed unless they receive some protection from the consequences of failure.[70] At a minimum, the citizens may be willing to pay to its creditors part of the potential gain if the new strategy succeeds in order to not suffer devastation should failure strike. They may be willing to pay a higher rate of interest for capital to fund this project in exchange for assurances that, if failure occurs, they will not have to pay back the borrowed funds in full. In short, citizens of a country may be risk averse in a way that participants in a business are not. While diversified shareholders are best served by a corporate restructuring regime that reduces the cost of

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[69] *See* Bolton & Skeel, *supra* note 15, at 771.

[70] *Cf.* Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991) (analyzing how the threat of insolvency and job loss affects managers' choice of investment projects).

capital, citizens care about their treatment when a country's debts cannot be repaid in full. Simply put, shareholders can diversify their portfolios, citizens cannot.

These two differences—the focus on the welfare of citizens and the problem with agency costs—suggest that we should look to scholarship on individual bankruptcy law to round out possible sovereign debt regimes.

III. INDIVIDUAL BANKRUPTCY AND ITS IMPLICATIONS FOR SOVEREIGN DEBT RESTRUCTURING

Citizens are individuals who have few, if any, ways to protect themselves against the financial distress of their government. Moreover, the effects of sovereign financial distress could be as severe as their own financial distress. As to individual financial distress, U.S. bankruptcy law provides mandatory protection. Regardless of whether one's distress is the result of bad luck—usually medical expenses not covered by insurance—or poor judgment—credit card debts that the individual could not possibly pay back in full—bankruptcy law provides a vehicle for alleviating distress without having to procure the consent of the debtor's creditors.

The fundamental feature of individual bankruptcy law is the right to a discharge of past debts. Jump through the right hoops, and debts of the past are gone. The erstwhile debtor receives a "fresh start" in life. U.S. bankruptcy law offers two alternatives for the individual debtor. Under Chapter 7, she may surrender the bulk of her assets, keeping a small portion for herself, and enjoy all of her future income.[71] Alternatively, if a debtor files for Chapter 13, she may pledge her future income for a short time—three to five years—and retain the bulk of her assets. In both situations, she is discharged from her debt.[72]

Of course, debt relief is not free. The ability to discharge a debt absent creditor consent is a cost to those extending credit. It increases the risk that they will not be repaid the money that they have lent. To compensate for this risk, they will either increase the rate of interest that they charge or not lend at all, preferring to put their money into other investments. This is, in effect,

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[71] *See* 11 U.S.C. §§ 701-728 (2000).

[72] *See id.* §§ 1301-1330.

insurance.[73] To the extent that citizens would want to have less pain in the bad state of the world, they will have to pay for it. The cost of this insurance depends on the risk imposed on the creditors. The easier it is to discharge debt, the more interest a creditor will demand.

There is currently a serious debate in this country over the availability of discharge.[74] No one seriously argues for eliminating the right to discharge, or for bringing back debtors' prisons. Rather, the main issue is whether those debtors who could pay off some of their debt should be forced into Chapter 13 rather than Chapter 7. To be sure, currently there are limits on a person's ability to use Chapter 7. The bankruptcy court can dismiss a petition filed under Chapter 7 if it determines that the proceeding represents a "substantial abuse" of Chapter 7.[75] Moreover, certain mischievous acts by the debtor can result in the debtor forfeiting all or part of its relief. Those who view these safeguards as too limited suggest that, regardless of the debtor's actions before bankruptcy, if she can pay back a portion of her debts out of her future income, she should.

It would make little sense to pursue such a bifurcated approach in the sovereign sector.[76] Countries in distress, by and large, have few current assets that they can transfer to their creditors. Rather, the bulk of any payments to creditors will come from the country's future income stream. The crucial questions for any sovereign restructuring system are the extent to which the system can guard against imprudent borrowing, maximize future revenues after default, and decide what portion of these future revenues should be available to creditors.

A sovereign debt restructuring system based on individual bankruptcy law must specify when a country could avail itself of the right of discharge and the level of debt relief the country would be entitled to receive. Even though there are currently few impediments in U.S. law for those seeking bankruptcy relief,

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[73] On personal bankruptcy law as a form of mandatory insurance, see Adler et al., *supra* note 26, and Jackson, *supra* note 26.

[74] *See* A. Mechele Dickerson, *Bankruptcy Reform: Does the End Justify the Means?*, 75 AM. BANKR. L.J. 243 (2001); Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. REV. 177; Hung-Jen Wang & Michelle J. White, *An Optimal Personal Bankruptcy Procedure and Proposed Reforms*, 29 J. LEGAL STUD. 255 (2000); Elizabeth Warren, *Philosophy and Design of Modern Fresh Start Policies and Consumer Proposals*, 27 OSGOODE HALL L.J. 189 (1999).

[75] *See* 11 U.S.C. § 707(b).

[76] Indeed, personal bankruptcy law itself may be better served by a single provision. *See* Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at the Incentives Under U.S. Personal Bankruptcy Law and a Proposal for Change*, 65 U. CHI. L. REV. 685, 710-16 (1998).

granting a nation unlimited access to debt relief may skew future borrowing decisions in undesirable ways. In short, it may induce either too much borrowing or too little. As to the potential for too much borrowing, leaders of a country that will not bear all of the consequences of failure may be tempted to borrow more than they otherwise would.[77] Yet this problem may not loom large. After all, a borrower needs a willing lender, but lenders may well be hesitant to lend to a country when such a loan may become distressed and the country has a right to discharge part of the loan. Lenders in competitive markets need to receive a market rate of return. To the extent that a country's right to discharge debt would lessen the amount that a lender could expect to receive when things turn out poorly, the lender is less likely to lend in the first instance. Indeed, the less a lender recovers in financial distress, the more likely it will be to ensure that borrowed funds go to productive projects rather than to the follies of the current rulers.

To be sure, lenders routinely lend to consumers who are poor credit risks. Given the size of the loans involved, lenders have little incentive to thoroughly investigate each individual consumer. Sovereign borrowings, in contrast, tend to be large events. Thus, potential lenders are much more likely to explore the borrower's ability to repay the loan. While Citibank may rationally decide not to spend resources to ascertain whether an individual's credit card borrowing creates a high risk of a bankruptcy filing, it would most likely investigate the financial health and future prospects of a borrower seeking to float a multimillion dollar bond issue. Citibank may not ask a consumer where borrowed money is to be spent; it is likely, however, to investigate a nation's plans for funds that it is attempting to procure.

While an unfettered right to discharge may not result in too much borrowing, it may create too little. Few may be willing to lend if they fear that a country could, perhaps opportunistically, invoke its right to discharge shortly thereafter. The fear of a near-term discharge could well turn a temporary liquidity problem that could have been solved by short-term lending into a crisis if a country sees the lending window shut precisely when it needs it the most. A sovereign debt restructuring mechanism could respond to this concern in one of at least three ways. One would be to exempt from discharge loans made recently—say, in the past year. Indeed, current practice is that the IMF

[77] The potential for such overborrowing would be similar to the potential overborrowing caused by the existence of the IMF as a lender of last resort.

and the World Bank often lend in distress situations, and repayment in full is normally required.[78]

The second way to ensure that a unilateral right of debt forgiveness does not unduly limit a sovereign's access to credit is to restrict the country's ability to invoke its right of discharge a second time. For example, a country seeking a second discharge within ten years of a first may have to agree to a set of stringent fiscal controls. This constraint would have the effect of increasing the cost of using the discharge. Cast in the parlance of real options, the cost of debt relief is the option value of the discharge.

Perhaps the most obvious way to protect against an opportunistic use of a sovereign debt restructuring mechanism would be to impose a good faith requirement on the nation seeking relief. In particular, a good faith requirement could guard against the prospect of a country opportunistically seeking to achieve debt relief by conditioning discharge on a demonstration of financial hardship. To the extent that lenders could be assured that a country will only reduce its debt when it is facing a certain level of economic distress, this will assuage the doubts of those who may be otherwise reluctant to lend.

In addition to preventing opportunistic invocation of the sovereign debt restructuring mechanism, a good faith requirement could also require that the country seeking discharge adopt certain economic policies.[79] Such a situation would in effect make the ability to discharge some debt a "bribe" to induce national leaders to adopt reforms. The need for such a bribe is based on the observation that many countries do not adopt certain financial reforms on their own. If such reforms would increase the economic well-being of a nation's citizens, there must be some countervailing domestic political force that impedes their adoption. Offering debt relief in exchange for adoption of these policies increases the likelihood that these policies in fact would be adopted.[80]

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[78] *See* Gelpern, *supra* note 37, at 1126. Of course, as Bolton and Skeel point out, the ability to borrow on a priority basis creates concerns of excess borrowing. The debtor can be borrowing for a project that does not expect to produce positive return, but the lender is willing to fund the project because the risk of failure is borne by the earlier creditors who are lower in priority. *See* Bolton & Skeel, *supra* note 15, at 788-93. To combat this problem, they suggest limiting priority borrowing to the IMF and, to insure that the IMF itself does not lend excessively, allowing the IMF to fund only trade debt. *Id.* at 807-08.

[79] This differs from the IMF proposal that requires a country to implement certain policies before it avails itself of the sovereign debt restructuring mechanism. Here, in contrast, the policies could be adopted contemporaneously with debt relief.

[80] One issue that I do not address in this Article is which forum should oversee the implementation of debt relief. For a summary account of possible fora, see Bolton & Skeel, *supra* note 15, at 809-18.

The crucial element of a regime along the lines sketched here is the extent of the discharge it would provide. U.S. bankruptcy law by and large discharges all prepetition unsecured debt. There is no reason that a country's fresh start should be so generous.[81] The relevant question is how much debt a country should carry. A country should leave bankruptcy with some capacity to borrow new funds. One possible scheme would have a country's debt scaled down to a certain level of GDP. Moreover, this could be a sliding scale, with relatively richer countries carrying a higher proportion of debt than poorer ones.

Setting this level is no ministerial task.[82] As discussed above, countries differ in the scope of social programs to which they are committed. To the extent that a discharge is set so that it leaves the debtor with a relatively high level of debt, the sovereign would be forced to curtail these programs. This suggests that a set level of discharge may not be optimal for all countries. Citizens in countries with relatively more generous social programs may desire a greater level of insurance than those with fewer such programs. The difference among nations could be taken into account by tying debt relief to a formula that includes spending on established programs.

In any event, questions of sustainability are endemic to any debt restructuring regime. Both current law and other proposed reforms require that this issue be addressed only after a country becomes financially distressed. In such an environment, factors other than sustainability of debt payments may well dominate the negotiations. Creditors, obviously, want to be paid as much as possible and countries, just as obviously, want to pay as little as possible. To the extent that the parties are bargaining over the available future revenues the nation will generate, bargaining theory suggests that the division reached will be a function of two factors—the relative patience of the parties (the more patient party captures a bigger share of the available surplus) and the parties' options to reaching an agreement (a party begins its negotiations from what it would receive in the absence of an agreement). Thus, both parties have an incentive to convince the other side that they are in no hurry to reach agreement and that they could do just as fine without one.

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[81] Indeed, the more generous the discharge, the greater the possibility that a country will seek to use it opportunistically. One of the current debates in U.S. consumer bankruptcy law is the extent to which some who file are doing so opportunistically. *See* sources cited *supra* note 74.

[82] Much of the rhetoric in the sovereign debt area focuses on reducing debt to a "sustainable" level. *See, e.g.*, KRUEGER, *supra* note 15, at 2. What constitutes sustainability, however, is rarely defined.

The ongoing negotiations over Argentina's debt illustrate this dynamic. Argentina's economy entered a recession in 1998. In December 2000, the IMF negotiated a support package in an attempt to stave off default. These efforts, however, did not succeed, and in early January 2002, Argentina defaulted on its sovereign debt. Argentina, however, was in no hurry to strike a deal. Its economy had recovered, and it did not need immediate access to the capital markets. It offered its bondholders new bonds that, in effect, would pay ten cents on the dollar. Such a writedown far exceeds other recent sovereign debt restructurings. Argentina's creditors were incensed at what they viewed as a paltry offer, and the standoff between Argentina and its creditors continues.[83]

The point is that Argentina can afford to wait. As such, unless conditions change, we would expect Argentina to eventually reach a deal on relatively favorable terms.

This general dynamic creates an ironic situation. From a perspective of social welfare, the country most in need of debt reduction is in the worst position to insist on a substantial writedown. The bondholders know both that the country needs a quick fix and that it does not have an attractive exit option.

Faced with this state of affairs, it may be that the less a country needs immediate relief, the greater the relief it can extract. Attempting to specify in advance a sustainable level of debt would be a more desirable system than relying on postdefault negotiation. While such an attempt may face informational problems—precisely what will constitute sustainability for this country in the future?—these problems may cause less serious difficulties than does the ex post bargaining endemic in other restructuring efforts.[84]

The existence of a right of discharge would also affect consensual restructuring. After all, just because a bankruptcy system exists for debt relief does not mean that it will be employed in every instance. Many businesses reach agreement with their creditors without resort to formal bankruptcy proceedings. Sovereigns and their creditors may find it in their interests to eschew the mechanism and strike their own deal. The possibility of invoking a right of discharge, however, will change the negotiations. It will alter the

[83] For a discussion of Argentina's default and the ongoing negotiations, see *The Insouciant Debtor*, ECONOMIST, June 5, 2004, at 8.

[84] The problems that arise when the parties attempt to bargain after a default has occurred do not appear when the terms of debt relief are set before the sovereign issues debt. Here, competitive pressures limit the lenders to the market rate of return, and the price of credit will reflect the treatment that bondholders can expect should distress arise in the future.

country's threat point. This being the case, bargaining theory suggests that, to the extent that a restructuring creates a surplus, countries that invoke a right of discharge would be able to capture more of that surplus than they do under the current legal regime.

IV. CHOOSING THE OPTIMAL DEBT RESTRUCTURING SYSTEM

There are thus a number of plausible regimes to deal with the question of sovereign distress—individual action bonds, collective action bonds, sovereign debt restructuring modeled on corporate reorganization, and sovereign debt restructuring modeled on individual bankruptcy law. Which institution or set of institutions should select the regime?

In the case of corporate reorganizations, corporations themselves are well placed to select the optimal regime.[85] The intuition here is that, at the time a corporate charter is adopted, those in charge of a corporation will pay for the price of any bankruptcy regime in the form of interest payments to debtholders. They thus have the incentive to make sure that they pay for the most cost-effective regime.

That argument does not carry over to the sovereign context.[86] The problem with allowing countries to choose any of the possible regimes is one of agency costs, as alluded to earlier. A country may have leaders who would find it in their interest to keep their current borrowing costs as low as possible. They would be willing to opt out of a right to discharge debt even though such a right would be in the best interests of their citizens. They would proceed in this fashion because they get the present benefit of the choice—a lower interest rate on the funds they borrow—whereas future governments are left with the costs—financial distress without a right of discharge. Thus, one would think that, on a systematic basis, national leaders would be too quick to contract away a country's right to discharge.

More broadly, to the extent that one concludes that a sovereign debt restructuring mechanism containing a right to discharge would increase social welfare, would it ever be in the interests of citizens to seek a waiver of discharge? When markets can distinguish those countries that may be at risk of distress from those that are not, high-quality countries—by which I mean

[85] *See* Rasmussen, *supra* note 25.

[86] *But see* Dickerson, *supra* note 25 (arguing that each country be allowed to customize the debt restructuring rules that will govern any future financial distress).

countries with low levels of default risk—should pay a lower rate of interest than countries with more substantial risks. Yet the higher the risk of future distress, the less likely it is that it would be in the best interest of the citizens to forgo the discharge insurance. In the end, just as we force citizens to purchase distress insurance by not allowing them to contract out of Chapter 7, it may be that countries should be forced to purchase financial distress insurance on behalf of their citizens.

The difficulty is getting there. Little reflection is needed to conclude that a regime crafted along the lines suggested in this Article would have to be championed by the international community, primarily the wealthier nations. Instituting a right of discharge will likely raise the interest rate that many countries will be forced to pay. To the extent that the current leaders of these countries privilege their short-term cost of capital over the long-term insurance effect of discharge, they are unlikely to press for such a regime.

Creditors gain no advantage from a sovereign debt restructuring mechanism containing a right of discharge, and hence are unlikely to lobby for it. Indeed, they could well oppose it, if they thought that it would apply to bonds that have been issued in the past. Forcing a right of discharge onto existing holders of sovereign bonds would, in effect, be a transfer of wealth from these bondholders to the indebted countries. While current bondholders may agree to debt relief in situations where they conclude that such relief will, in the end, maximize their return on their investment, there is little appeal in forcing them to absorb the cost of a switch to a sovereign debt restructuring mechanism. Even if such bondholders are protected, say, either by having their bonds remain outside any new procedure or by arranging a transfer payment to ensure that they are made whole, they cannot be counted on to advocate a system that includes a right of discharge.

This leaves the international finance institutions—the IMF and the World Bank—and wealthy countries as the potential instigators of a debt restructuring system that includes an automatic discharge. Both should see some attraction to such a system. Sovereign distress is a destabilizing event. Its effects extend beyond the country and its lenders. It can disrupt the world economy. At a minimum, an embarrassed state contributes less to worldwide economic development than does a state not in arrears. To the extent that the international finance institutions exist in part to guard against such shocks and that wealthy countries gain from vibrant trading partners, they seem to be the players best positioned to press for a new debt restructuring system.[87]

Yet wealthy countries may face domestic pressures that lobby against a system designed to safeguard the interests of citizens of poorer countries. Private lenders often are citizens of wealthier countries. As such, they may lobby their government to oppose any change in sovereign debt restructuring that they view as counter to their interests. We are thus left with a somewhat gloomy conclusion: A new sovereign debt restructuring system containing a right of discharge could increase social welfare, but the teachings of public choice theory suggest that no effective group will press for its adoption.

V. CONCLUSION

Any procedure for addressing sovereign financial distress should be premised on a theory of the state. States are neither wealth-maximizing firms nor autonomous individuals. Rather, they are institutions that should seek to better the lot of their citizens, but often suffer from agency costs in implementing this goal. A sovereign debt restructuring mechanism built upon the unique attributes of a sovereign nation would, from an ex ante perspective, encourage investments that benefit the citizens, allocate control of the process to actors whose incentives best mirrored those of the distressed country's citizens, and provide a right of discharge that would ensure that any restructuring offers sufficient relief to the nation's citizens.

We do not allow individuals to place themselves in a situation where their only hope lies in the calculus of their creditors. Similarly, the fate of a country's citizens should not be left to the concessions that its government can wring out of lenders after problems have arisen. The political obstacles to implementing a new system are formidable. These obstacles, however, should not obscure the goals that sovereign debt restructuring should seek to advance.

[87] Of course, this does not mean that they will necessarily do so, as the current U.S. opposition to the IMF's proposed sovereign debt restructuring mechanism indicates. Rather, the point is that if change along the lines sketched in this Article is to come, it will come from them or not at all.