Hal S. Scott *How Would a New Bankruptcy Regime Help?*

A KEY ISSUE IN THE debate over reform of the international financial system is whether to adopt a new international bankruptcy regime for sovereign debt, and an important aspect of that debate is the lack of consensus about the problems that such a regime would be designed to solve and whether it would solve them. My remarks are focused on a new bankruptcy regime rather than a new court, because the former does not necessarily entail the latter. The authors of the three papers in this symposium all have quite different conceptions of the problems, as do other important protagonists.

Bulow's paper, like his past articles on this subject, is focused on the need to reduce bailouts of developing-country debt by international financial institutions (IFIs) and governments in the industrial countries, so as to achieve more optimal flows of private capital to emerging markets. Sachs' paper sees two different roles for the bankruptcy process: avoiding a creditor grab race for the sovereign debtor's assets, and giving the sovereign debtor a new start by substantially reducing its debt. White's paper mainly addresses two objectives that differ from both Bulow's and Sachs': preventing rogue creditors from upsetting private debt reorderings and making sure defaulting countries have adequate sources of funds, through granting seniority to creditors who lend in the wake of a default. The U.S. Treasury, in the form of John Taylor's statement during the same week as this conference,[1] has yet a different objective. He wants to reduce the uncertainty of the current process by providing a more orderly structure for resolving crises when they occur. Finally, the purpose of the IMF proposal offered by Anne Krueger is more encompassing. In her proposal last November she said the IMF's aim is "to create a catalyst that will encourage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner."[2]

Krueger's latest proposal for a sovereign debt restructuring mechanism (SDRM) contains the following elements: a stay for some fixed duration

1. Taylor (2002).
2. Krueger (2001).

on creditors' seizure of a troubled debtor's assets, reform of the debtor's economic policies as part of the bankruptcy plan, seniority for creditors who lend after the petition for a stay, and a mechanism enabling a supermajority of creditors to bind other creditors to a plan. How does this proposal relate to the objectives identified by Krueger herself, Taylor, and the others?

The relationship between Krueger's SDRM and reducing bailouts is not clear. One could argue that this objective could be achieved more directly than through adoption of an SDRM, by placing restraints on crisis lending by the IFIs. This could be done in a variety of ways. Under the proposal by Adam Lerrick and Allan Meltzer,[3] IMF support would be limited to a commitment to buy the debt of defaulting sovereigns at some discount from the price being offered by the sovereign. Under a proposal offered jointly by the Bank of Canada and the Bank of England,[4] there would be procedures like those adopted in the United States in 1991 under the Federal Deposit Insurance Corporation Improvement Act for official lending to failed banks. Lending would be permitted only when there is a threat to the stability of the international monetary system and only after approval by a supermajority of the IMF's executive board.

Krueger's proposal for an SDRM addresses the bailout problem more indirectly. The idea is that pressure for IMF lending would be lessened if the SDRM offered a mechanism by which a troubled sovereign debtor and its creditors could reach an agreement to reduce the sovereign's debt. One reason that IMF lending has been so prevalent is that there is no workable mechanism for reducing debt. Indeed, the argument would be that the IMF could not risk the chaos, economic and political, that might ensue in the absence of its lending unless an alternative debt reduction process were in place. Of course, in the short term, this is proving wrong in Argentina. One can just say no, without an SDRM. One wonders how long such a policy would be sustainable, however.

Even if an SDRM existed, nothing would ensure its use, at least under the current versions of the proposal. A country would *choose* to use the procedure, and then would be permitted to do so only if it met some threshold test of insolvency, in the sense that it was unable to service its debt. A country could well choose not to use the procedure even though to

3. Lerrick and Meltzer (2001).
4. Haldane and Kruger (2001).

do so offered the prospect of cutting its debt burden. It might fear being cut off from market access in the future and prefer to solve the problem through a bailout. And, as the Argentine case currently illustrates, as do the examples of Ecuador and Russia in the 1990s as well as the Latin American crises in the early 1980s, a country does not need an SDRM to default and restructure its debt. Thus the proposed SDRM will lead to increased debt reduction and fewer bailouts only if sovereigns prefer that outcome. Most heavily indebted poor countries will, but what about countries like Brazil, Korea, or Turkey?

Is a bankruptcy procedure necessary to avoid the rush to seize a sovereign's assets when the sovereign defaults, as Sachs has contended? This depends at the outset on how exposed the sovereign's assets are to such seizure. There is little empirical evidence that this is a serious problem. Sovereign default should not put at risk the assets of state enterprises, such as state-owned airlines, because these are separate entities from the sovereign. It is unlikely that these assets would be collapsible into those of the sovereign as a matter of course. Certain assets, like those of the central bank, enjoy absolute immunity, that is, immunity that cannot be waived. Nonetheless, the creditor grab race remains a concern. A stay, if binding on all countries, would prevent the seizure of sovereign assets once a default occurred.

Is a bankruptcy procedure necessary to bind rogue creditors? White does not think so. She, like Taylor, thinks this could be done through the use of U.K.-style collective action clauses in which a supermajority of creditors could bind all others. The problem is that such clauses have not been adopted, probably because of the increased cost of issuing bonds that have them.[5] As Taylor has suggested, this problem could be overcome by requiring such clauses as a condition for IMF programs or by subsidizing such clauses through lower IMF charges for borrowing. But this would not solve the problem of outstanding bonds without such clauses.

Some have argued that majority action clauses are really not necessary given the alternative possibility of using exit consents.[6] Under this technique, as used in conjunction with an exchange offer as in Ecuador, those

5. Eichengreen and Mody (2000).
6. Buchheit and Gulati (2000).

tendering the old bonds vote to poison them by changing all of their nonpayment terms (payment terms themselves on bonds issued under New York law cannot be changed without unanimous consent). For example, the tendering creditors could vote to retract any waivers of sovereign immunity or to prohibit the bonds from being listed, thus making them much less attractive to hold. But although this might increase the tender rate, the vulture creditor looking to realize the face value of the old bond would still hold the bond and sue. And the prospect of finding sovereign assets to attach to satisfy such judgments is significant. This is the lesson of the case involving Elliott Associates and Peru, where vulture creditors refused to tender old bonds for new Brady bonds, and then, in an action in a Brussels court, attached interest payments that were to be made on the Brady bonds through the Euroclear system. Peru's decision to settle this claim makes future actions of this kind more likely.

Bulow thinks the problem could be addressed by the United States repealing the Foreign Sovereign Immunities Act of 1976 (FSIA), and that other countries should similarly repeal their foreign sovereign immunity acts. The idea is that the FSIA is bad because it permits creditors to seize sovereign assets in the United States in satisfaction of their claims. This is far from clear. The FSIA does permit creditors to seize nonexempt assets in connection with commercial activity of the sovereign, and the Supreme Court has held, in *Republic of Argentina* v. *Weltover, Inc.,*[7] that issuance of a bond constitutes a commercial activity. But it does not follow that creditors would have no remedies in the absence of the FSIA. In its absence, the jurisdiction of U.S. courts would be determined by international law, which generally itself provides a commercial activity exception to sovereign immunity. This exception could be eliminated only by international agreement. So neither exit consents nor repeals of sovereign immunity provisions are likely to solve the problem of rogue creditors.

We are therefore back to majority action clauses, but the problem remains that today's outstanding bonds do not have these clauses. Furthermore, as Krueger points out, even if these clauses existed in all *bonds*, "a country with an unsustainable debt burden will require a comprehensive restructuring across a broad range of indebtedness, potentially including different bonds issued under different jurisdictions, bank loans,

7. 504 U.S. 607 (1992).

trade credits, and some official claims."[8] This is a fundamental point. The very existence of corporate bankruptcy laws responds to the collective action problem in trying to provide such a process through private contract. Although Alan Schwartz has argued that the state should permit parties to contract for the corporate bankruptcy system they prefer,[9] such contracting would take place against a default system of law, in the shadow of the law. Such a default is missing in Taylor's exclusive reliance on private contract.

Is a bankruptcy procedure necessary to ensure the continued flow of funds to defaulting debtors, as White contends? Not if the lender providing new financing enjoys seniority, as the IMF clearly does, and as do all official creditors to a degree. But if we are seeking to minimize assistance from governmental institutions, it is necessary to ensure seniority for private postdefault creditors. This would be impossible to achieve through subordination agreements, because preexisting creditors are unlikely to agree to subordination without substantial compensation, and the transactions costs of subordination negotiations would be high. Thus seniority for new money could be ensured only through some international agreement, which could be part of a new SDRM.

To conclude, I believe it is relatively clear that private contracting alone will not be able to achieve the various objectives I have examined, although it can play an important role, particularly in the shadow of a default rule. I think we should focus in the future on issues of implementation of an SDRM, such as who will administer this procedure, what types of debt should be covered, whether any creditors should enjoy seniority, and how the "plan" of reorganization with respect to the sovereign's future economic policies should be handled. Whatever procedure is adopted must, however, be flexible and responsive to the political and foreign policy concerns of creditor governments. In a pinch, and perhaps more often, one must be able to override the SDRM. This counsels against entrusting authority to any independent court, as Krueger's latest proposal suggests, at least if the jurisdiction of the court cannot be restrained where necessary.

The black hole in the SDRM proposal is, What happens to the debt if, even with majority voting rules, the sovereign and its creditors cannot

8. Krueger (2002).
9. Schwartz (1998).

agree on a plan? Liquidation is not a practical alternative. Corporate cramdown, as White points out, is judged against a liquidation benchmark—all classes of creditors must get what they would have received in liquidation. Like liquidation itself, this benchmark is unavailable for sovereign bankruptcies.

One solution might be to require that bankruptcy creditors get no less in bankruptcy than the debt would be worth absent bankruptcy. The market would be able to value newly issued debt. One could probably not rely on the actual market value of the old debt to make a determination of what creditors would receive absent bankruptcy (assuming there was a market in the instrument), because that value might be heavily influenced by expectations of what would happen in bankruptcy. One might look, however, to valuation models to determine what the debt was worth.

Finally, it is unlikely that politics would permit private creditors to impose an economic plan on the debtor, as in a corporate bankruptcy. This suggests that the debtor's interlocutor about future economic plans be the IMF, with input, as at present, from the private creditors.

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