Inter-creditor Equity in Sovereign Debt Restructuring

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2 Question the Unquestionable Beauty of A Collective Proceeding for All Sovereign Debt Claims[1]

2.1 INTRODUCTION

(2.1) Despite the efforts to reform the sovereign debt restructuring process undertaken by the International Monetary Fund ("IMF") in 2003, the restructuring practice is currently facing new challenges. In early 2012, both EU member States and the European Central Bank ("ECB") managed to claim priority status unilaterally in the middle of the current Eurozone crisis. In October 2012, a US court in *NML Capital Ltd. v. Republic of Argentina* granted injunctions in relation to Argentina's breach of the *pari passu* clause, which provides that the payment obligation of the debtor under that particular bond issue shall rank equally with all other existing and future unsubordinated and unsecured external indebtedness. How would the sovereign debt community react to these events? To date, nearly all literature on sovereign debt issues has focused on deterring holdout behavior in foreign bonds restructuring, from a majority voting system to a stay on enforcement.[2] However, these new challenges are likely to shift the attention from holdout behavior to inter-creditor relations,

1 This chapter was prepared for the Annual Meeting of the Academic Forum of INSOL International (18-19 May 2013). It has been published in *International Insolvency Review* Vol. 22: 85–105 (2013) and re-published in *Norton Journal of Bankruptcy Law and Practice* Vol. 22, No. 5: 551- 576 (2013). The author is very grateful to Professor Bob Wessels, Professor Mitu Gulati and Professor Rolef de Weijs for their helpful comments on an earlier draft.

2 L. Buchheit at al., "The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings" (Jan. 2013), available at http://ssrn.com/abstract=2205704 (last viewed 11 Mar. 2013); W. Weidemaier & M. Gulati, "A People's History of Collective Action Clauses" (Nov. 2012), available at http://ssrn.com/abstract=2172302 (last viewed 11 Mar. 2013); S. Hagan, "Designing a Legal Framework to Restructure Sovereign Debt", 36 Geo. J. Int'l L. 299 (2005); J. Eaton, Chapter 15 "Standstills and an International Bankruptcy Court", in: Fixing Financial Crises in the 21st Century (2004); S. Schwarcz, "Idiot's Guide" to Sovereign Debt Restructuring, 53 Emory Law Journal (2004) pp. 1189-1218; IMF, "The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations", prepared by the Legal and Policy Department and Review Departments (Nov. 2002); K. Rogoff & J. Zettelmeyer, "Early Ideas on Sovereign Bankruptcy Reorganization: A Survey", IMF WP02/57 (Mar. 2002); J. Sachs, "Do We Need an International Lender of Last Resort?" Frank D. Graham Lecture at Princeton University, Vol. 8 (Apr. 1995), available at h*ttp://www.earth.columbia.edu/sitefiles/file/about/director/pubs/intllr.pdf* (last viewed 11 Mar. 2013).

which is considered to be one of the key elements of an effective insolvency law.[3]

(2.2) Unfortunately only very few scholars have so far discussed inter-creditors issues in a detailed fashion. Buchheit, Gelpern and Wood provide an excellent overview of contractual provisions in sovereign debt instruments that serve the purpose of ensuring equal treatment within certain groups of creditors (i.e. Paris Club members, commercial banks, bondholders).[4] Wood studies the priority ladder in national bankruptcy law and reveals an existing *de facto* priority ladder in the sovereign debt context, which follows the order of super-priority claims such as set-off, security interests and trusts, priority claims such as IMF loans, and *pari passu* claims.[5] The *status quo*, however, presents an ambiguous picture of inter-creditor relations and leaves a number of issues wide open such as the scope of priority claims, the relationship between multilateral, bilateral and commercial creditors, and the status of new financing. The need to develop substantive legal principles in this context has recently been emphasized by the Dutch government and the Permanent Court of Arbitration ("PCA")[6] in their project on "Sovereign Debt and Arbitration".[7]

3 Key objectives of an effective and efficient insolvency law specified by the United Nations Commission on International Trade Law ("UNCITRAL") Legislative Guide on Insolvency Law include the recognition of existing creditor rights and the establishment of clear rules for ranking of priority claims, and the equitable treatment of similarly situated creditors. See UNCITRAL Legislative Guide on Insolvency Law (2004), available at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (last viewed 11 Mar. 2013), at 11-13.

4 L. Buchheit, "The Search for Intercreditor Parity", 8 L. & Bus. Rev. Am. 73 (2002); A. Gelpern, "Building a Better Seating Chart for Sovereign Restructurings", Emory L. J. 53 (2004); P. Wood, "Sovereign insolvency: the bankruptcy ladder of priorities and the pari passu clause", Tijdschrift voor Financieel Recht (Mar. 2012).

5 P. Wood, "Sovereign insolvency: the bankruptcy ladder of priorities and the pari passu clause", *supra* note 4, at 64.

6 Established by the 1899 and 1907 Conventions for the Pacific Settlement of International Disputes, the PCA is an intergovernmental organization that works to facilitate the resolution of international disputes through arbitration and other processes.

7 Since 2000, several non-governmental organizations ("NGOs") focused on sovereign debt matters have actively advocated for the establishment of an arbitral tribunal for sovereign debt matters, which would function as an international insolvency court. See Jubilee, "Chapter 9/11? Resolving international debt crises – the Jubilee Framework for international insolvency", Jan. 2002, available at http://probeinternational.org/library/wp-content/uploads/2011/02/9-11.pdf (last viewed 7 Jan. 2013); Erlassjahr, "Resolving Sovereign Debt Crises – Towards a Fair and Transparent International Insolvency Framework", Sep. 2010, available at http://www.erlassjahr.de/english/towards-an-international-insolvency-framework.html (last viewed 7 Jan. 2013), and AFRODAD, "Fair and Transparent Arbitration on Debt", 2002, available at http://www.afrodad.org/Publications/FTA/fta%20issues%20paper%202002.pdf (last viewed 7 Jan. 2013). In response to their proposals, the Netherlands government invited the PCA to initiate a project to promote and facilitate the settlement of disputes arising out of international loan agreements. The interim conclusion of this project also refers to the need to develop substantive legal principles in this respect. See

(2.3) Having acknowledged the challenges involved in discussing all open issues about inter-creditor relations at once, the author intends, in this paper, to focus on the relationship between multilateral, bilateral and commercial creditors. The author starts with various proposals touching upon this issue and the different views expressed, ranging from equal treatment to separate treatment to comparable treatment. While studying these different views, the author notices that nearly all proposals envisage a "collective" proceeding that would include "all" sovereign debt claims without explaining any reasons for such a vision, partly because this is the form that all national bankruptcy proceedings take.[8] The main purpose of this paper is to take the unusual route of questioning the unquestionable beauty of a collective proceeding for all sovereign debt claims.

(2.4) This paper is structured as follows: Part II provides an introduction to the context and new developments in sovereign debt restructurings. Part III analyses inter-creditor issues in sovereign debt restructurings with a focus on the concept and *status quo*. In exploring solutions to inter-creditor issues, Part IV starts with a summary of the existing proposals relating to inter-creditor issues and moves on to discuss the appropriateness of a collective proceeding for all claims. First, the author argues that the automatic acceleration principle in national bankruptcy law should not apply to the sovereign debt context because of the "temporary" nature of the sovereign debt crisis, the "alive" feature of the limited pool of sovereign assets and the "non-liquidable" fact of the sovereign debtor. Second, the author argues that a collective proceeding is not the most desirable form of proceeding due to the absence of the common pool problem in the context of sovereign debt and the incomparably different natures of multilateral/bilateral claims that renders the design of a priority order between multilateral/bilateral claims and commercial claims impossible. Part V concludes this paper.

"Arbitration and Sovereign Debt", Paper prepared by the Steering Committee of the Netherlands Government and the Permanent Court of Arbitration, Jul. 11, 2012, at para. 2, available at http://www.slettgjelda.no/filestore/ArbitrationandSovereignDebt.pdf (last viewed 7 Jan. 2013).

8 C. Paulus, "A Resolvency Proceeding for Defaulting Sovereigns", IILR 2012; A. Dickerson, "A Politically Viable Approach to Sovereign Debt Restructuring", 53 Emory L. J. (2004), pp.997-1041; K. Berensmann & F. Schroeder, "A proposal for a new international debt framework (IDF) for the prevention and resolution of debt crisis in middle-income countries", Discussion Paper 2/2006; Erlassjahr, "Resolving Sovereign Debt Crises – Towards a Fair and Transparent International Insolvency Framework", Sep. 2010, available at http://www.erlassjahr.de/english/towards-an-international-insolvency-framework.html (last viewed 7 Jan. 2013); P. Bolton & D. Skeel, "Inside the Black Box: How should a Sovereign Bankruptcy Framework be Structured?", Emory L. J. 53. 763 (2004); S. Schwarcz, "Idiot's Guide" to Sovereign Debt Restructuring, 53 Emory L. J. (2004) pp. 1189-1218.

2.2 Sovereign Debt Restructurings

2.2.1 The Context

(2.5) The current practice of sovereign lending and borrowing is unprecedented. For two centuries, sovereign debtors borrowed from one or more, but not all, of the following sources: commercial banks, bondholders, governments and multilateral institutions. It was not until the early 1990s that all four types of creditors began to play an active role in the sovereign debt market.[9] While commercial banks and bondholders form the "private sector" creditor group, the "public sector" creditor group is composed of governments ("bilateral creditors") and multilateral institutions such as the IMF, the World Bank and other regional banks (collectively, "multilateral creditors").

(2.6) With debt comes the possibility of default, and sovereigns are no exception to this axiom. At present, there is no international insolvency regime governing sovereign debt defaults, comprised of rules designed to cope with the scenario in which creditors cannot be fully satisfied. Instead, sovereign debt defaults are dealt with using an *ad hoc*, individual case-by-case approach in which most rules are invented along the way. In practice, in order to avoid an eternal default, the sovereign debtor is compelled to seek debt relief from creditors before or shortly after the eve of default, via an extension of maturity, and/or a reduction of the value of the claim. Such relief is obtained by renegotiating the relevant debt instruments with individual creditors. The rationale for renegotiation is that all participants in the sovereign borrowing and lending activities, both debtor and creditors, should share the risk of insolvency.

(2.7) Renegotiations with multilateral creditors are often conducted in this *ad hoc* manner. Renegotiations with bilateral creditors who are members of

9 Following the first issuance of international bonds by Barings in 1817, bonds were the primary means of international long-term lending to States for more than 100 years until the 1930s. Bank lending was often limited to the form of short-term trade financing or interbank credit lines. The Great Depression in the 1930s shut down the bond market. At that time, States began to lend money to one another through loans, grants, and export credits. Since 1944, the IMF, World Bank and many regional development banks have been established to achieve international economic cooperation, and joining the sovereign debt creditor group. Also after the Second World War, long-term borrowing from commercial banks to sovereign States began to grow rapidly, and peaked in the 1970s. A wave of bank loan defaults in the 1980s triggered a new debt crisis, and in the early 1990s, banks agreed to exchange bad loans for Brady bonds. As a result, bond finance, largely dormant for more than sixty years, has again dominated foreign sovereign borrowing. See A. Gelpern and M. Gulati, "Public Symbol in Private Contract: a Case Study", (2006) 84 Wash. U. L. Rev. 1627, at 1632-1633; L. Rieffel, "The Bank Advisory Committee Process", Chapter 6 in Restructuring Sovereign Debt: The Case for Ad Hoc Machinery (2003, Brookings), at 96.

the Paris Club are conducted through the Club's processes. The Paris Club is an informal group of official creditors with 19 permanent members and a small secretariat in Paris.[10] Countries that are not members of the Paris Club renegotiate with the sovereign debtor on an *ad hoc* basis. Renegotiations with commercial banks are either purely *ad hoc* or conducted through the London Club, an informal group of commercial banks with no fixed membership and no secretariat.[11] Renegotiations with bondholders are conducted through exchange offers prepared by the sovereign debtor. Occasionally bondholder committees are formed on an *ad hoc* basis to facilitate the process.[12]

(2.8) From November 2001 through April 2003, the IMF proposed a reform to the contemporary international financial architecture by introducing a treaty-based framework to restructure sovereign debt –the Sovereign Debt Restructuring Mechanism ("SDRM").[13] The key feature of the SDRM is a majority voting system, which binds all creditors to a restructuring agreement that has been accepted by a qualified majority.[14] Whereas this proposal was eventually shelved due to a lack of sufficient support from the IMF member States,[15] the idea of a majority voting system survived. Collective Action Clauses ("CACs"), a contractual approach to implementing a majority voting system, gained broad support from market participants and sovereign debtors.[16]

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10 Paris Club official website, available at http://www.clubdeparis.org/sections/composition/membres-permanents-et/membres-permanents, (last viewed 13 Dec. 2012). See generally E. Cosio-Pascal, "The Emerging of a Multilateral Forum for Debt Restructuring: The Paris Club", UNCTAD/OSG/DP/2008/7, Discussion Papers No. 192, available at http://unctad.org/en/Docs/osgdp20087_en.pdf (last viewed 7 Jan. 2013).

11 L. Rieffel, "The Bank Advisory Committee Process", *supra* note 9, at 103.

12 For a discussion of the use of creditors' committees in the Congo debt restructuring, see M. Richards, "The Republic of Congo's Debt Restructuring: Are Sovereign Creditors Getting Their Voice Back?", (2010) 73 Law & Contemp. Probs 273-299. Creditors' committees were also organized in the Greek debt restructuring, see J. Zettelmeyer, C. Trebesch and M. Gulati, "The Greek Debt Exchange: An Autopsy" (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144932 (last viewed 13 Dec. 2012).

13 S. Hagan, "Designing a Legal Framework to Restructure Sovereign Debt", *supra* note 2, at 300-301.

14 IMF, "The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations", *supra* note 2, at para. 8.

15 An amendment of the IMF's Articles of Agreement needs the approval of three-fifths of member States, holding eighty-five percent of the total voting power. See Articles of Agreement of the International Monetary Fund, as amended, art. XXVIII(a), available *at* http:// www.imf.org/external/pubs/ft/aa/aa28.htm (last viewed 11 Mar. 2013).

16 In fact, CACs in bonds governed by English law began to appear in 1980s. What the SDRM initiative encouraged was the inclusion of such clauses in bonds governed by New York law and others. Countries such as Mexico, Brazil, Belize, Guatemala, Venezuela, Uruguay were among the first group to include CACs in their New York law bonds. More recently, the Treaty Establishing the European Stability Mechanism ("ESM") also forces the inclusion of CACs, as of 1 January 2013, in all euro-area government securities with maturity above one year. In addition, the model CAC prepared includes an aggregation feature – referred to as cross-series modification – that permits changes to bind more than one series of bonds.

2.2.2 New Developments

(2.9) In October 2012, a US federal appellant court in *NML Capital Ltd. v. Republic of Argentina* affirmed the trial court's decision to issue injunctions designed to remedy Argentina's breach of the *pari passu* clause in certain bonds, which arose from the fact that it had issued new debt pursuant to exchange offers in 2005 and 2010 and was making the required payments on this new debt, but had declared that it would make no payments to those still holding the old bonds.[17] In February 2013, a second arbitral tribunal[18] at the Inter-

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See generally Cliffford Chance newsletter, "Euro area member states take collective action to facilitate sovereign debt restructuring", Dec. 2012, available at http://www.cliffordchance.com/publicationviews/publications/2012/12/euro_area_memberstatestakecollectiveactiont.html (last viewed 7 Jan. 2013); M. Bradley & M. Gulati, "Collective Action Clauses for the Eurozone: An Empirical Analysis" (Oct. 2011), available http://ssrn.com/abstract=1948534 (last viewed 11 Mar. 2013); R. Quarles, "Herding cats: collective-action clauses in sovereign debt the genesis of the project to change market practice in 2001 through 2003", Law & Contemp. Probs (Sept. 2010); J. Drage & C. Hovaguimian, "Collective Action Clauses (CACS): an analysis of provisions included in recent sovereign bond issues" (Nov. 2004).

17 The pari passu clause in dispute provided that securities shall at all times rank *pari passu*, and that the Argentina's payment obligations under the bonds shall at all times rank equally at least equally with all its other present and future unsecured and unsubordinated securities. The appellant court explained that the clause protected against two different forms of discrimination: the issuance of other superior debt and the giving of priority to other payment obligations. It affirmed the injunctions issued by the trial court that requires Argentina to make ratable payments to plaintiffs concurrent with or in advance of its payments to holders of old bonds, and asked the trial court to further clarify how does the payment formula in the injunction intend to operate. The trial court clarified, in a subsequent order issued on 21 November 2012, that the payment formula in the injunction is intended to operate as follows: whenever Argentina pays any amount due under the terms of the exchange bonds, it must concurrently or in advance pay plaintiffs the same *percentage* of the amount due to them. See *NML Capital, Ltd. v. Republic of Argentina,* No. 12-105-(L) (2d Cir. 26 Oct. 2012); *NML Capital, Ltd. v. Republic of Argentina*, 08 Civ. 6978 (TPG), 09 Civ. 1707 (TPG), 09 Civ. 1708 (TPG) (S.D.N.Y., 21 Nov. 2012). For a discussion of this case, see Global Law Intelligence Unit, Allen & Overy LL.P, "The pari passu clause and the Argentine case", 27 Dec. 2012; W. Weidemaier, "Sovereign Debt After NML v. Argentina", Capital Markets Law Journal (forthcoming), available at http://ssrn.com/abstract=2199655 (last viewed 10 Mar. 2013).

18 Between 2006 and 2008, three groups of bondholders initiated arbitration at the ICSID against Argentina under investment treaties that grant foreign investors certain treaty protections with respect to the host country's behavior (i.e. *Abaclat and others v. Argentine Republic*, ICSID Case No. ARB/07/5; *Giovanni Alemanni and others v. Argentine Republic*, ICSID Case No. ARB/07/8; and *Ambiente Ufficio S.p.A. v. Argentine Republic*, ICSID Case No. ARB/08/9). In August 2011, the arbitral tribunal in *Abaclat* upheld its jurisdiction by a majority decision. One of the jurisdictional issues is whether bonds qualify as investment and could enjoy the protection offered by investment treaties. The word "investment" is not defined in the ICSID Convention, but the definition of investment in the applicable treaty in *Abaclat* does include sovereign bonds. Nevertheless, Argentina raised jurisdictional challenge, arguing that ICSID proceedings are not appropriate in the context of sovereign debt restructuring. Views of the members of the Tribunal differed. One member would have declined jurisdiction, explaining that the intervention of ICSID tribunals in sovereign

national Center for Settlement of Investment Disputes ("ICSID"), constituted pursuant to the Argentina-Italy bilateral investment treaty, dismissed jurisdictional challenges raised by Argentina and upheld its jurisdiction in the matter initiated by holdout bondholders.[19] Importantly, the bondholders' remarkable success in these events cannot be underestimated as it introduces a brand new battlefield against sovereign debtors.

(2.10) The term "brand new" is used because the last time sovereign debtors encountered numerous foreign bondholders was before the Great Depression shut down the international bond market in the 1930s, and at that time, sovereign debtors still enjoyed absolute sovereign immunity.[20] From the mid-20th century onwards, the notion of sovereign immunity shifted from the absolute theory to the restrictive theory permitting States to enjoy immunity for their public, but not private, acts.[21] Following the revival of the international bond

debt disputes raises international public policy issues about the workability of future sovereign debt restructurings. However, the majority of the Tribunal, in finding jurisdiction, reasoned that policy concerns are for States, not for the Tribunal, to consider when negotiating investment treaties, and that the appropriateness of ICSID proceedings in this context is irrelevant. See *Abaclat and others v. Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (Aug. 2011), at para. 550; *Abaclat and others v. Argentine Republic*, ICSID Case No. ARB/07/5, Georges Abi-Saab's Dissenting Opinion of October 28, 2011, at para. 271.

19 *Ambiente Ufficio S.p.A. v. Argentine Republic*, (ICSID Case No. ARB/08/9), Decision in Jurisdiction and Admissibility (Feb. 2013). Co-arbitrator Santiago Torres Bernárdez dissented but has yet to issue a separate opinion.

20 Since the doctrine of absolute sovereign immunity did not permit States be sued in foreign courts without their express consent, disappointed private lenders to foreign States had very few options other than to seek the help of their own governments, known as "diplomatic protection". During that period, creditor States have often been debt collectors for money lent by their nationals to other governments through pressuring debtor State into payment or settlement by means of superior bargaining power, the use of power politics (including the use of force) or arbitration and adjudication at international courts and tribunals. A few case examples are *French Company of Venezuelan Railroads Case* (1905); *Canavero Claim* (Italy v. Peru, PCA, 1912); *French Claims Against Peru* (PCA, 1921); *Payment of Various Serbian Loans Issued in France* (PCIJ, 1929); *Payment in Gold of Brazilian Federal Loans Contracted in France* (PCIJ, 1929); *Societe Commerciale De Belgique* (Belgium v. Greece, PCIJ, 1939). See generally M. Waibel, Sovereign Defaults before International Courts and Tribunals (2011, Cambridge); L. Buchheit, "The Role of the Official Sector in Sovereign Debt Workouts", 6 Chi. J. Int'l L. 333 (2005); E. Borchard, State Insolvency and Foreign Bondholders, General Principles Volume I (1951).

21 Quite a few States have passed statutes codifying the restrictive theory of sovereign immunity. Examples include the Sovereign Immunities Acts of the United States. (1976), United Kingdom (1978), Singapore (1979), Pakistan (1981), South Africa (1981), Canada (1982), and Australia (1985). See generally H. Fox, The Law of State Immunity (2008, Oxford). Moreover, Austria, France, Iran, Japan, Kazakhstan, Lebanon, Norway, Portugal, Romania, Saudi Arabia, Spain, Sweden and Switzerland have ratified the United Nations Convention on Jurisdictional Immunities of States and Their Property (not yet in force) signed in December 2004, which recognizes the restrictive theory of sovereign immunity. See the Status of the United Nations Convention on Jurisdictional Immunities of States and Their Property,

market in the early 1990s, when banks agreed to exchange bad loans for Brady bonds, sovereign debtors are again facing numerous foreign bondholders, possibly one-time investors with less incentive to accept the debt restructuring offer. This time it is allowable to sue sovereign debtors in national courts; however, statistics show that foreign bondholders did not run crazily to the courthouse.[22] The reason for this may be associated with certain enforcement problems that bondholders with a favorable court judgment may still encounter: (1) there is currently no international convention dealing with the recognition and enforcement of foreign court judgments; and (2) attaching property both in the sovereign debtor's territory and abroad present problems. Nevertheless, despite great controversy, Argentine bondholders solved both problems in their recent episodes. The ICSID arbitral tribunals' willingness to embrace sovereign debt claims offers bondholders a better enforcement regime, as specified in the ICSID Convention.[23] More alarmingly, the injunction granted by the US court in *NML Capital Ltd.* renders asset searches unnecessary.[24]

(2.11) Despite the significant implications of these episodes for future sovereign debt restructurings, the solution should not exclusively focus on deterring holdouts. First, not all holdout creditors are aggressive vulture funds. The claimants in ICSID sovereign debt arbitrations against Argentina are frustrated bondholder themselves,[25] whose interests need protection. Second, the *NML Capital Ltd.* injunction was granted on the basis of the *pari passu* clause dealing with inter-creditor relations. The court mentioned that the operation of the *pari passu* clause as a constraint on Argentina as payor makes sense in the context of sovereign debt, because when sovereign debtors default they do not enter insolvency proceedings (where the legal rank of debt determines the order in which creditors will get paid).[26] In the view of the author, these

availableathttp://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=III-13&chapter=3&lang=en (last viewed 11 Mar. 2013).

22 Schumacher provides an excellent dataset of sovereign debt litigations filed in the UK and U.S. courts between 1976 and 2010. Schumacher et al., "Sovereign Defaults in Court: The Rise of Creditor Litigation 1976-2010", available at http://dx.doi.org/10.2139/ssrn.2189997 (last viewed 11 Mar. 2013), at 8.

23 The ICSID Convention requires its 147 Member States to recognize and enforce an arbitral award rendered pursuant to the Convention as if it were a final judgment of a court in that State. See Art. 54(1), ICSID Convention, available at https://icsid.worldbank.org/ICSID/ICSID/RulesMain.jsp (last viewed 14 Dec. 2012).

24 Schumacher describes the current sovereign debt litigation environment as a hunt for assets. See Schumacher et al., "Sovereign Defaults in Court: The Rise of Creditor Litigation 1976-2010", *supra* note 22, at 8.

25 In *Abaclat*, claimants are over 180,000 bondholders (mostly Italian) at the time of initiation. See *Abaclat and others v. Argentine Republic*, Decision on Jurisdiction and Admissibility, *supra* note 18, at paras. 1, 3. In *Ambiente*, claimants are 119 Italian bondholders at the time of initiation. See *Ambiente Ufficio S.p.A. v. Argentine Republic*, Decision in Jurisdiction and Admissibility, *supra* note 19, at 113.

26 *NML Capital, Ltd. v. Republic of Argentina* (2d Cir. 26 Oct. 2012), *supra* note 17, at 19.

two episodes are likely to shift attention from deterring holdouts to crystalizing inter-creditor issues.

(2.12) Furthermore, the recent Eurozone episode also calls attention to inter-creditor issues. The newly concluded Treaty Establishing the European Stability Mechanism ("ESM") states that ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting the IMF's preferred creditor status over the ESM.[27] On 6 September 2012, the ECB relinquished the preferred creditor status it had previously claimed in the event of a future debt restructuring of bonds acquired in its newly launched Outright Monetary Transactions ("OMT") program.[28] This episode has aptly illustrated the great uncertainty associated with certain creditors' unilateral claims of preferred status.

2.3 Inter-creditor Issues in Sovereign Debt Restructurings

2.3.1 The Concept of Inter-creditor Issues

(2.13) Given that renegotiations necessarily imply a certain degree of debt relief, they are certainly not creditors' favorite activities. When a sovereign debtor is financially sound, renegotiation is only a matter between the debtor and a particular creditor. The creditor does not need to know the identities of other creditors. However, the situation changes when a sovereign debtor encounters serious financial distress and does not have enough money to repay everyone. Under such circumstances, creditors awaken to the reality that sovereign lending activities are not risk-free and that they may have to take a loss. It is often said that, in the time of crisis, creditors should make "contributions" to help the debtor recover. Given that the total amount of contribution needed by the debtor to recover from the crisis is certain, the fact that a particular creditor makes a lesser contribution means that other creditors must make a larger one.

27 Treaty Establishing the European Stability Mechanism, Preamble, at para. 13.

28 The ECB announced that "it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions". Under the OMT program, the ECB buys short-term (one to three year) bonds of Eurozone countries in the secondary market, in unlimited amounts, in order to suppress the yields on those instruments. See ECB Press Release, 6 September 2012 – Technical features of Outright Monetary Transactions. It has been suggested that the uncertainty surrounding these events might have a potentially destabilizing effect on the market. See Global Law Intelligence Unit, Allen & Overy LL.P, "How the Greek debt reorganization of 2012 changed the rules of sovereign insolvency" (Sept. 2012), at 31.

(2.14) Therefore, as soon as the news of the debtor's financial distress spreads, creditors immediately want to find out who the other creditors are, whether they will be willing to make contributions and how large these might be. This change of attitude towards other creditors is referred to as the "conflict of interest issue among creditors" or "inter-creditor issues".

2.3.2 The Status Quo

2.3.2.1 Treatment Within the Same Group

(2.15) As far as the public sector is concerned, multilateral and bilateral creditors enjoy different treatment within their respective groups. Negotiations with multilateral creditors are conducted on an *ad hoc* and individual basis. Each multilateral creditor is responsible for its own negotiation process with the debtor and has no influence over other multilateral creditors' negotiation processes. Bilateral creditors within the Paris Club support the principle of equal treatment within the Club. All Paris Club decisions are taken based on consensus, in the form of so-called "Agreed Minutes". Although the Agreed Minutes are not binding, they guide the future bilateral negotiations that result in changes to the debt contracts.[29] In practice, driven by a mutual interest in avoiding disproportionate repayment of loans, all Paris Club members fully respect the commitments made through the Agreed Minutes.[30] However, such a principle does not apply to bilateral creditors outside the Paris Club, such as China, who are responsible for their own negotiations.

(2.16) In the private sector, commercial banks and bondholders all enjoy equal treatment within their groups but to a different extent. Commercial banks have employed the "mandatory repayment clause", which requires pro rata payments to all lenders in the event of a prepayment to any lender.[31] This clause excludes certain categories of claims, such as IMF debt, trade debt, foreign exchange contract obligations, interest and other agreed categories.[32] In addition, certain bank syndications also contain the "pro rata sharing clause", which provides that any bank receiving a greater proportion of its share must pay the excess to the agent bank who then redistributes to all banks on a pro rata basis.[33] The purpose of this clause is to share individual receipts, such as

29 E. Cosio-Pascal, *supra* note 10, at 12.
30 *Ibid.*, at 13.
31 M. Wright, "The Pari Passu Clause in Sovereign Bond Contracts: Evolution or Intelligent Design?", 1 Hofstra L. Rev. 40 (2011), at 5; L. Buchheit, "The Search for Intercreditor Parity", *supra* note 4, at 76.
32 P. Wood, "Sovereign insolvency: the bankruptcy ladder of priorities and the pari passu clause", *supra* note 4, at 69.
33 *Ibid.*

receipts by set-off, proceeds of litigation, individual guarantees or direct payments by the debtor.[34] Private bondholders have over the years expanded the use of the "*pari passu* clause" in the bond contracts, which provides, in part, that the bonds of that particular issue shall rank equally among themselves.[35]

2.3.2.2 Treatment Among Different Groups

a. Contractual Provisions

(2.17) Two types of contractual provisions in sovereign debt instruments address issues concerning treatment among different creditor groups: the "negative pledge clause" and the "*pari passu* clause". The "negative pledge clause" restricts the sovereign debtor's ability to grant security interests in its property to secure other creditors. The clause provides that if the debtor issues new debt and grants new creditors a security interest in the debtor's assets, the debtor has to grant old creditors an equivalent security interest.[36] While such a clause appears in both bank loan agreements and bond contracts, in the case of bonds the negative pledge generally only applies to security for bonds and other debt that is capable of being listed or traded on a market.[37]

(2.18) Besides ensuring the equal ranking of all bonds of that particular issue, the "*pari passu* clause" in most bond contracts also provides, in its second part, that the debtor's payment obligation under that particular issue shall rank equally with all other existing and future unsubordinated and unsecured external indebtedness.[38] On many occasions, the *pari passu* treatment in bond contracts is further limited to other bonds and tradable debt instruments.[39] Over the past decade, the *pari passu* clause has become a litigation tool for bondholders who refused to accept the exchange offer, and the meaning of

34 *Ibid.*
35 The usage of *pari passu* clauses in unsecured bonds issued from 1960 to 2011 is recorded as follows: 123/144 (1960-1979), 429/464 (1980-1999), and 684/691 (2000-2011). See M. Gulati and R. Scott, The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design (2012, Chicago), Appendix 7.
36 *Ibid.*, at 34. M. Wright, *supra* note 31, at 6.
37 One limitation of the negative pledge clause is that it does not catch various forms of quasi-security or title finance which, although not security in legal form, may be security in substance. P. Wood, "Sovereign insolvency: the bankruptcy ladder of priorities and the pari passu clause", *supra* note 4, at 69-70.
38 Wood lists a few examples of the pari passu clause in sovereign bonds, e.g. Pakistan (15 November 1999), Ecuador (27 July 2000), Ukraine (8 February 2001), Russian (25 February 2004), Argentina (10 January 2005), and Dominican Republic (20 April 2005). *Ibid.*, at 66-67.
39 Global Law Intelligence Unit, Allen & Overy LL.P, "The pari passu clause and the Argentine case" (27 Dec. 2012), at 7.

this clause has always remained controversial.[40] A narrow interpretation of this clause holds that all claims legally rank equally; in contrast, a wider interpretation suggests that the debtor must pay all its creditors ratably.[41]

(2.19) Despite Argentine bondholders' success in the recent *NML Capital Ltd.* decision which finds Argentina in breach of the *pari passu* clause, the meaning of this clause is far from being settled. It is not clear whether the US court in *NML Capital Ltd.* chose the narrow or the wider interpretation because it held that a combination of Argentina's actions breached the clause.[42] Furthermore, the court left the issue of whether payments to multilateral creditors would breach the *pari passu* clause entirely open, simply noting that the plaintiffs had not argued that preferential payments to the IMF made by Argentina could similarly entitle the plaintiffs to rateable payments.[43] Nevertheless, what is clear is that the history of the *pari passu* clause indicates that its introduction was intended, at least in part, as a tool for preserving inter-creditor equity and fairness in negotiations.[44]

b. Creditor Policies

(2.20) In the 1980s, commercial banks routinely imposed conditions for the restructuring of their loans, which involved a corresponding restructuring of the Paris Club debt.[45] Paris Club members have actively advocated that a sovereign debtor may not accept less debt relief from its non-Paris Club creditors than the amount agreed with the Paris Club. This is referred to as the comparability of treatment principle.[46] The principle, in essence, forbids

40 For a discussion of relevant case law, see P. Wood, Sovereign insolvency: the bankruptcy ladder of priorities and the pari passu clause, Tijdschrift voor Financieel Recht, March 2012, pp. 60 – 70, at 65-66; M. Gulati and R. Scott, The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design (2012, Chicago), at 20-26.

41 Global Law Intelligence Unit, Allen & Overy LL.P, *supra* note 17, at 8.

42 Those actions included executive-declared moratoriums on payments on the old bonds which had been renewed each year, the fact that Argentina had not made a single payment on the old bonds for six years while timely servicing the new bonds, that Argentina enacted the Lock Law and that Argentina had stated in the prospectuses for the new bonds that it had no intention of making any payments on the old bonds and classified the old bonds as a separate category from the new bonds in its SEC filings. *Ibid.*, at 11.

43 *NML Capital, Ltd. v. Republic of Argentina,* (2d Cir. 26 Oct. 2012), *supra* note 17, at 21; Global Law Intelligence Unit, Allen & Overy LL.P, *supra* note 17, at 12.

44 M. Wright, *supra* note 31, at 4.

45 L. Buchheit, "The Search for Intercreditor Parity", *supra* note 4, at 78.

46 Non-Paris Club creditors include all external creditors except multilateral creditors. The Paris Club explains that non-Paris Club official bilateral creditors grant loans generally similar to those provided by Paris Club creditors. Consequently, non-Paris Club official bilateral creditors often restructure on terms very similar to those agreed with the Paris Club. These creditors may also participate in Paris Club treatments and, under these circum-

other creditors from making a lesser contribution than Paris Club creditors – although the Club considers certain mitigating factors to justify a deviation from the principle.[47] A controversial issue arises with respect to the willingness of Paris Club members to contribute proportionally when other creditor groups make larger contributions.[48] However, it is worth noting that the Paris Club considers on a case-by-case basis whether mitigating factors exist to justify a deviation from the comparability of treatment principle in respect of a particular creditor or debt instrument – although no explanation is provided as to what the "mitigating" factors entail.[49]

2.4 Exploring Solutions to Inter-creditor Issues

2.4.1 Existing Proposals

(2.21) Proposals in favor of a legal framework for sovereign debt workouts advanced by both economists and legal scholars started to emerge in the 1980s.[50] Notably, not all proposals focus on inter-creditor issues in sovereign debt workouts. The IMF's famous SDRM proposal, for instance, identifies the range of claims that could potentially be restructured under the mechanism, but leaves it to the debtor to decide which subset of eligible claims would need to be restructured in a particular case.[51] It nevertheless mentions that debt owed to an international organization could not be restructured under the SDRM;[52] the claims of official bilateral creditors would be excluded from the

stances, apply exactly the same treatment as that applied by Paris Club creditors. See Paris Club official website, *supra* note 10.

47 *Ibid.*

48 L. Buchheit, "The Search for Intercreditor Parity", *supra* note 4, at 76.

49 See Paris Club official website, *supra* note 10; L. Rieffel, "What Is Broken? What Fixes Make Sense?", Chapter 12 in Restructuring Sovereign Debt: The Case for Ad Hoc Machinery (2003, Brookings), at 282.

50 For a summary of proposals, see Das et al., "Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts", IMF WP 12/203, at 87-95; Berensmann & Herzberg, "Sovereign Insolvency Procedures – A Comparative Look at Selected Proposals", Journal of Economic Surveys (2009) Vol. 23, No. 5, pp. 856–881.

51 Examples of eligible claims are listed as follows: (1) repayment of money lent or credit advances; (2) receipt of deferred purchase price of goods or services; (3) payments under bonds, notes or similar instruments; (4) amounts payable under interest rate and current swaps, and other financial derivatives; (5) the right of an issuing bank to be reimbursed for payments made under a letter of credit, bankers acceptance or bond; (6) payments due under leases; (7) guarantees or insurance contracts (direct or indirect) of the indebtedness of another party, and (8) court judgments requiring payment for liability on eligible claims, etc. See IMF, "The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations", *supra* note 2, at 13 &18.

52 *Ibid.*, at 22-23.

SDRM or, alternatively, restructured within the SDRM as a separate class.[53] This section summarizes the discussion of inter-creditor issues in recent proposals.

2.4.1.1 Soft Law Approach

(2.22) According to Gelpern, inter-creditor issues could be addressed by allowing the sovereign debtor to impose priority rules on creditors unilaterally or by contract, to disclose the rankings at the time of borrowing and to comply with its commitments.[54] This proposal gives international financial institutions, like the IMF, a role in monitoring the sovereign debtor's compliance with such obligations. Amongst other things, the IMF could report whether the priorities States disclose in advance are consistent with the "general principles for according priority agreed among the official sector, the borrowers, and the private creditors".[55] In case of any violation, creditors would follow the old path of suing the sovereign debtor in national courts.[56]

(2.23) The Joint Public–Private Sector Committee[57] organized by the Institute of International Finance recently proposed a new version of the Principles for Stable Capital Flows and Fair Debt Restructuring. The principle dealing with inter-creditor issues stipulates that the sovereign debtor should "avoid unfair discrimination among affected creditors", including "seeking rescheduling from all official bilateral creditors."[58] It further provides that in keeping with general practice, short-term trade-related credits and inter-bank advances should be excluded from the restructuring plan and treated separately if

53 *Ibid.*, at 23-25.
54 A. Gelpern, *supra* note 4, Emory L. J. 53: 1119–1160 (2004), at 1153.
55 *Ibid.*, at 1158.
56 *Ibid.* Gelpern argues that this approach would encourage transparency and advance planning by the debtor, improve incentives for risk assessment by the creditors and introduce a multilateral policy check on governments' unilateral decisions in crisis.
57 The Institute of International Finance's *Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution* is a public-private sector initiative launched under the auspices of the Co-Chairs of the Group of Trustees. The Joint Committee is chaired by Jean Lemierre, Senior Advisor to the Chairman, BNP Paribas and Co-Chair of the IIF Special Committee
on Financial Crisis Prevention and Resolution; Thomas Wieser, President, Eurogroup Working Group; David Mulford, Vice-Chairman International, Credit Suisse Group; and Gerardo Rodríguez Regordosa, Undersecretary of Finance and Public Credit, Mexico. It comprised 35 prominent representatives from the public and private sectors with extensive experience in sovereign debt restructuring in the Euro Area and elsewhere. The report was endorsed by the Group of Trustees during their Annual Meeting in Tokyo on October 14, 2012. See Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution (Oct 2012), available at http://www.iif.com/press/press+393.php, last viewed 11 Mar. 2013), at 5-6. Information about the old version of the principles is available at http://www.iif.com/press/press+3.php (last viewed 9 Mar .2013).
58 *Ibid.*, at 22.

necessary.[59] The note to this principle explains that the goal of avoiding unfair discrimination among affected creditors could be achieved through treating all creditors fairly and providing "comparable treatment to all creditors".[60] It stresses that no creditor group should be "excluded ex ante from participating in debt restructuring" and any such arrangement should be "discussed and agreed to among all creditors on the basis of adequate justification".[61]

2.4.1.2 Hard Law Approach

(2.24) Berensmann and Schroeder endorsed the old version of the Principles for Stable Capital Flows and Fair Debt Restructuring proposed by the Institute of International Finance, and suggested a statutory approach to implement such principles. The old version of the principle dealing with inter-creditor issues provides that the sovereign debtor should "guarantee equal treatment of all creditors".[62] In connection with this, Berensmann and Schroeder proposed that all creditors (i.e. private, bilateral, multilateral) should participate in the restructuring negotiations under a newly established International Debt Framework Commission, with a few exceptions made for creditors with new financing and those holding trade credits.[63] The non-governmental organization German Debt Network (Erlassjahr) followed a similar approach. Its proposal states that in principle all creditors need to be treated equally, and preferred creditor status can only be granted by mutual consent.[64] It emphasizes "all claims on a sovereign need to be treated in one single process".[65]

(2.25) Paulus discussed the current "sectoral treatment of creditors" in sovereign debt workouts and emphasized the need for "a comprehensive solution".[66] To that end, Paulus advocated "an all-encompassing resolvency proceeding all claims should be included"[67] and envisaged a single forum.[68] His proposal suggests that different creditor groups could be treated differently and allows small creditors be packed into a separate group receiving full payment while other groups, such as institutionalized creditors, take haircuts.[69]

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59 *Ibid.*
60 *Ibid.*, at 26.
61 *Ibid.*
62 K. Berensmann & F. Schroeder, *supra* note 8, at 11.
63 *Ibid.*, at 14.
64 Erlassjahr, *supra* note 8, at 12.
65 *Ibid.*, at 16.
66 C. Paulus, *supra* note 8, at 6.
67 *Ibid.*, at 16.
68 Paulus mentions that "before it comes to the voting the debtor and its creditors have to sit at the same table and discuss the proposed plan". *Ibid.*, at 13.
69 *Ibid.*

(2.26) Bolton and Skeel addressed issues concerning the ranking for unsecured sovereign debt and proposed a "first-in-time" rule. According to this rule, when a sovereign debtor files for debt restructuring, "all unsecured debt would be classified by date of issue and earlier issues would have higher priority over later issues".[70] In order to avoid the creation of too many classes, they suggested that either each class must be of "a minimum size in value relative to the total value of outstanding debt" or "issues within any given fiscal year" should be put together in a single class.[71]

(2.27) Schwarcz drafted a Model Sovereign Debt Convention dealing with the sovereign debt restructuring process. Art. 6 of the Model Convention states that a debt restructuring plan shall designate classes of claims in accordance with Art. 7(3), specify the proposed treatment of each class and provide the same treatment for the same class.[72] Art. 7(3) provides that each class shall consist of claims against the sovereign debtor that are *pari passu* in priority, "provided that (a) *pari passu* claims need not all be included in the same class, and (b) claims of governmental or multigovernmental entities each shall be classed separately".[73] Art. 4 of the Model Convention requires the sovereign debtor to "notify all of its known creditors of its intention to negotiate a [p]lan under this Convention".[74]

(2.28) Similarly, Dickerson's proposal also requires the sovereign debtor to notify all creditors, disclose all claims, and explain the intended treatment of those claims.[75] It expresses the need to "ensure that all claims will be dealt with in an efficient, predictable, collective proceeding".[76]

2.4.1.3 Observations

(2.29) It appears from the proposals discussed above that inter-creditor issues in sovereign debt workouts are far from being settled. To begin with, not all proposals touch upon issues concerning the ranking of different claims. Among those that discuss the ranking issue, most of them address it in a rather ambiguous way. For instance, the Principles for Stable Capital Flows and Fair Debt Restructuring provide that sovereign issuers should treat all creditors fairly and provide comparable treatment to all creditors. However, the terms "fairly" and "comparable treatment" are not defined. Berensmann and Schroeder and the German Debt Network proposed equal treatment of all

70 P. Bolton & D. Skeel, *supra* note 8, at 799.
71 *Ibid*.
72 S. Schwarcz, *supra* note 8, at 1216.
73 *Ibid*., at 1217.
74 *Ibid*., at 1216.
75 A. Dickerson, *supra* note 8, at 1030.
76 *Ibid*., at 999.

creditors without giving sufficient reasons. Furthermore, a few proposals discussing the ranking issue do not provide a complete picture. Bolton and Skeel advocated a "first-in-time" rule for the ranking of unsecured debt. Schwarcz touched upon the relationship between private claims and bilateral/multilateral claims, suggesting that bilateral/multilateral claims should be classed differently from private claims.

(2.30) Despite the uncertainty of the ranking issue, nearly all proposals envisage a "collective" proceeding that would include "all" sovereign debt claims. Paulus employs the term "an all-encompassing resolvency proceeding all claims should be included". Dickerson mentions that "all claims" should be dealt with in an efficient, predictable, "collective" proceeding. Berensmann and Schroeder propose that "all" creditors should participate in the restructuring negotiations under a newly-established International Debt Framework Commission. German Debt Network emphasizes the need for "all" claims to be treated in a "single" forum. The Principles for Stable Capital Flows and Fair Debt Restructuring provide fair and comparable treatment for "all" creditors. Although Bolton and Skeel do not explicitly mention a collective proceeding for all claims, their detailed discussion concerning national bankruptcy law and claim classification implies a single process for all claims. Schwarcz's extensive discussion of claim classification also calls for a similar conclusion. In this respect, it is observed that the issue of whether a collective proceeding including all claims is the appropriate forum for sovereign debt workouts has never attracted attention in any proposal. These proposals either take a collective proceeding for all claims for granted without explaining any reason for this, or discuss directly issues involved in a collective proceeding including all claims (i.e. claim classification), thereby assuming the appropriateness of such a process. The paragraphs below intend to fill this gap by exploring the reasons behind a collective proceeding for all claims in national bankruptcy law and the rationale for borrowing (or not) such a concept for discussions concerning a legal framework for sovereign debt restructuring.

2.4.2 Treatment of All or Partial Claims

2.4.2.1 Creditors Affected by Inter-creditor Issues

(2.31) As mentioned above, inter-creditor issues are caused by the conflict of interests among creditors. The reason for such a conflict lies with a limited pool of assets that is insufficient for everyone's satisfaction so that creditors have to take a loss and contribute to the debtor's recovery. It is widely accepted that a lesser contribution made by any individual creditor requires that other creditors contribute more. However, this theory only makes sense in the situation of a still pool.

(2.32) By contrast, in the context of sovereign debt, the debtor can always raise revenue through taxation. Therefore, the pool of assets, although limited, is not still but alive. In other words, the pool is dynamic, with money going in and out on a daily basis. In addition, a sovereign State can never be liquidated, thus rendering the crisis merely temporary. Indeed, because the State will ultimately recover, the pool here will never become still. In a still pool, the interests of all creditors are conflicted. By contrast, where the pool of assets is constantly replenished, the ability of individual creditors to make a lesser contribution does not necessarily require other creditors to contribute more.[77] The conflict of interest exists only during the temporary period when there are not enough assets for everyone. During this period, the concerned creditors are those holding claims with maturities before the end of the crisis period. Taking Greece as an example, the financial crisis is severe but will eventually end in X years. Thus, a conflict of interest exists only among creditors holding claims with maturities in the next X years. It follows that inter-creditor issues are only relevant for creditors holding claims that will mature in the next X years. Therefore, any rules designed to address inter-creditor issues should not include all claims.

(2.33) Because the task of identifying "X" is extremely complex, if not impossible, the practical solution is to allow the debtor to determine its anticipated date of recovery from the crisis, after considering the debt sustainability analysis provided by international financial institutions. Giving the debtor the freedom to determine X will not be problematic, as it only intends to address the conflict of interests among creditors, but not to make the restructuring process necessarily easier for the debtor.

2.4.2.2 Inappropriateness of the Automatic Acceleration Principle

(2.34) Needless to say, the proposal that inter-creditor issues only exist among creditors holding claims with maturities in the next X years challenges the basic principle of national bankruptcy law that all claims become due upon the filing of bankruptcy ("automatic acceleration principle"). Different national bankruptcy legislations may use different terms for this principle, but it basically refers to the situation that all claims are allowed in a bankruptcy proceeding regardless of the maturity date. The author argues that this principle

77 It is argued that taking assets out of a live pool does not necessarily lead to a situation where fewer assets are available for other creditors, provided that the debtor can coordinate the rate at which assets increase, relative to the rate at which assets are attached by creditors. See S. Block-Lieb, "Fishing in Muddy Waters: Clarifying the Common Pool Analogy As Applied to the Standard for Commencement of a Bankruptcy Case", 42 Am. U. L. Rev. 337 (1993), at 381.

should not be applied to any future legal framework for sovereign debt restructurings for the reasons outlined below.

(2.35) First, the rationale for this basic principle derives from the liquidation scenario, and should not be applied to sovereign States where liquidation is not a possibility. In liquidation, the company will eventually be liquidated and dissolved; thus, all creditors must be able to make their claims immediately instead of years later, according to the maturity date.[78] This principle makes sense under the contract law theory that the debtor's repayment obligations cannot be assigned to a new entity without the creditor's permission unless the original debtor remains responsible.[79] It is argued that, from a contract law perspective, the continuation of a debtor's contractual obligation beyond its liquidation is equivalent to a delegation of that obligation to a new entity.[80] However, because the original debtor does not exist beyond liquidation, such a delegation of the repayment obligation is prohibited, and all claims become due and payable immediately. The principle also applies in reorganization on the basis that a company may still be liquidated if the reorganization plans fail.[81] In the absence of any possibility of liquidation, the principle that all claims are automatically accelerated simply should not apply to sovereign States. However, this rule would not affect creditors' ability to accelerate claims pursuant to the terms of the debt contract.

(2.36) Second, the fact that the US municipal bankruptcy law[82] does not differentiate between the municipal debtor and other types of debtors on this point does not mean that the automatic acceleration principle is appropriate for States. The principle that all claims with different maturity dates are allowed in a domestic bankruptcy proceeding is to be found in the definition of "claim" contained in the general provisions of the US bankruptcy law, which apply to all types of debtors. The US Code defines claim as "right to payment, whether or not such right is […] matured, unmatured […]".[83] This broad definition contemplates that all legal obligations of the debtor, no matter how remote, will be addressed in the bankruptcy proceeding.[84] The US Code explains that the reason for such a broad definition is that it "permits the

78 T. Jackson, "Determining Liabilities and the Basic Role of Nonbankruptcy Law", Chapter 2 in The Logic and Limits of Bankruptcy Law (1986, Harvard), at 38.

79 *Ibid.*

80 *Ibid.*

81 Notably, in reorganization proceedings, Section 1124 (2)(b) of the U.S. Code allows the debtor to "reinstat[e] the maturity of such claim or interest as such maturity existed before such default". *Ibid.*, at 40.

82 11 U.S.C. § 901-946.

83 11 U.S.C. § 101.

84 11 U.S.C.A. § 101.

broadest possible relief in the bankruptcy court".[85] But this presumption does not hold water in the context of sovereign debt restructuring. In the recent successful Greek restructuring, all creditors holding claims with maturities between 0 (20 March 2012) to 45 years (25 July 2057) were offered the same deal, which provides that the latest repayment date is 2042.[86] Accordingly, the bonds with the longest maturity (2057) will actually be paid before they become due (2042); the present value haircut implicit in the restructuring for this bond was -26.5.[87] This negative figure indicates that these bondholders suffered no loss at all; instead, their positions improved through the inclusion of their claims in the restructuring process. This finding contradicts the theory that the inclusion of all creditors in the bankruptcy proceeding necessarily contributes to the broadest possible relief for the debtor.

(2.37) To summarize, the author argues that the "temporary" nature of a sovereign debt crisis and an "alive" pool of sovereign assets put the fundamental principle of automatic acceleration adopted from national bankruptcy law in doubt. An analysis of the underlying reasons for such a principle further demonstrates its inappropriateness for sovereign debtors. Therefore, any future rules for inter-creditor issues should not address all sovereign debt claims, but only those claims which are relevant.

2.4.3 Collective or Non-collective Proceeding

2.4.3.1 Need for a Collective Proceeding in National Bankruptcy Law

(2.38) The need for a collective proceeding in national bankruptcy law is justified by two main theories – the common pool problem and the creditors' bargain theory. Scholars describe the creditors of a debtor with a limited pool of assets not enough for everyone as enmeshed in a common pool problem.[88]

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85 *Ibid.*

86 All creditors were offered (i) One and two year notes issued by the European Financial Stability Facility ("EFSF"), amounting to 15 per cent of the old debt's face value; (ii) 20 new government bonds maturing between 2023 and 2042, amounting to 31.5 per cent of the old debt's face value, with annual coupons between 2 and 4.3 per cent; (iii) A GDP-linked security which could provide an extra payment stream of up to one percentage point of the face value of the outstanding new bonds if GDP exceeds a specified target path (roughly in line with the IMF's medium and long term growth projections for Greece). See J. Zettelmeyer, C. Trebesch and M. Gulati, *supra* note 12, at 6.

87 *Ibid.*, at 17.

88 Susan Block-Lieb, "Congress's Temptation to Defect: A Political and Economic Theory of Legislative Resolutions to Financial Common Pool Problems", 39 Ariz. L. Rev. 801, pp. 802-803 (1997); See also T. Jackson, The Logic and Limits of Bankruptcy Law (1986), pp. 12-13; D. Baird & T. Jackson, Cases, Problems and Materials on Bankruptcy, 20-30 (2d ed.

They compare the debtor's assets to a jointly-owned pool of fish, and the debtor's creditors to self-interested fishermen. They view the creditors' pursuit of their remedies in terms of attachment, garnishment, execution and levy as analogous to the overfishing of a common pool: self- interested creditors have every incentive to collect as many of the debtor's assets as quickly as they can, because the creditors who are first to collect suffer none of the deleterious effects of their collection actions.[89] With this observation they make a powerful case for the need for some form of a collective bankruptcy remedy.[90]

(2.39) Moreover, the creditors' bargain theory holds that it is in the creditors' best interest to agree *ex ante* on binding collective procedural rules. The argument is that unsecured creditors prefer a collective system that treats them alike, because it reduces the costs associated with individual creditors' actions, increases the aggregate pool of assets and avoids a piecemeal dismantling of a debtor's business, as well as enhances administrative efficiencies.[91] However, fully secured creditors are not direct beneficiaries of any of these advantages, because they can easily remove the collateral from the debtor's estate.[92] Thus, unsecured creditors have a strong interest in including secured creditors in the collective proceeding, in order to prevent actions by them that diminish the aggregate estate.[93] Unsecured creditors are therefore willing to give secured creditors at least some benefit in exchange for their agreement to join in the collective proceeding. Secured creditors have no reason to object to inclusion if left as well off as before.[94] The result is a collective system that includes both secured and unsecured creditors, with the rights of secured creditors preserved through a priority position in the order for the distribution of assets.

2.4.3.2 Absence of the Need for a Collective Proceeding in the Sovereign Debt Context

(2.40) To begin with, the so-called common pool problem does not exist in the sovereign debt context. Litigation against a sovereign debtor in national courts is not an easy undertaking. Sovereign debt creditors holding a favorable judgment may still encounter problems with enforcement. Whereas attempts to attach property in the sovereign debtor's territory may face objections based

1990); T. Jackson & R. Scott, "On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain", 75 Va. L. Rev. 155, 178 (1989).

89 Thomas Jackson, The Logic and Limits of Bankruptcy Law (1986), p. 13.

90 Susan Block-Lieb, "Fishing in Muddy Waters: Clarifying the Common Pool Analogy As Applied to the Standard for Commencement of a Bankruptcy Case", *supra* note 77.

91 T. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and The Creditors' Bargain" (1982) 91 Yale L. J. 857, at 864, 866.

92 *Ibid.*, at 868.

93 *Ibid.*, at 869.

94 *Ibid.*, p. 870.

on public policy, efforts to enforce the judgment abroad may fail due to the sovereign's lack of attachable assets in foreign countries and the principle that certain assets located abroad cannot be attached due to their special characteristics (i.e. diplomatic missions, central bank reserves, military assets etc.).[95] Due to these difficulties and uncertainties, the number of court litigation against sovereign debtors is relatively small.

(2.41) Schumacher recently conducted empirical research concerning sovereign debt litigation filed against debtor governments in the US and UK courts between 1976 and 2010.[96] This research shows that only 108 cases were filed in the US and the UK by foreign banks, bondholders and other commercial creditors during this period, and that these cases only relate to 29 of the 180 sovereign debt restructurings with private creditors (16%).[97] It further reveals that only 27 out of 69 debtor governments have been sued.[98] It is worth noting that the number of creditors who manage both to obtain a favorable judgment and to enforce that judgment is even smaller. The author argues that such a small number of individual actions which may diminish the debtor's pool of assets cannot be compared with the overfishing situation in a common pool. Although the recent *NML Capital Ltd.* decision is likely to encourage future litigation against sovereign debtors, it is still too early to gauge that effect. Any decision to implement a collective proceeding should be balanced against the actual need and costs involved.

(2.42) Turning to the creditors' bargain theory, as discussed above a collective proceeding is only desirable when it is in the best interests of both unsecured and secured creditors, and secured creditors would only agree to be included in the same proceeding as unsecured creditor if their rights are well preserved through priority rules. In the sovereign debt world, however, whether creditors are secured or not is not a major difference between them as a result of the negative pledge clause which restricts the debtor's ability to grant security interests in its property to secure other creditors. One unique feature of the sovereign debt context is the involvement of multilateral and bilateral creditors. While commercial creditors lend for profit, multilateral and bilateral creditor lend for a wide variety of purposes, except making a profit. The rationale for multilateral lending relates to information provision in terms of monitoring government policies in recipient countries and the exercise of conditionality

95 R. Olivares-Caminal, Legal Aspects of Sovereign Debt Restructuring (2009, Sweet & Maxwell), at. paras. 2-001, 2-002, 2-004.
96 Schumacher et al., *supra* note 22.
97 *Ibid.*, at 3.
98 *Ibid.*

aimed at changing governmental policies.[99] Similarly, bilateral creditors often extended to advance political and social objectives, such as ensuring that domestic exporters are not disadvantaged by financial support offered by other governments, or sharing the costs of building infrastructure projects that can help the debtor achieve higher rates of economic growth.[100]

(2.43) Given the non-comparable differences between multilateral/bilateral creditors and commercial creditors, it seems extremely difficult, if not impossible, to weigh political and financial considerations and to devise a priority order between them. Such difficulty is acknowledged in the sovereign debt framework proposals put forward by the IMF and Schwarcz, in which the term "separate" is used to describe the treatment for multilateral and/or bilateral creditors.[101] Importantly, separate treatment does not necessarily violate the equitable treatment principle in national bankruptcy law, which basically ensures the fair treatment of creditors with similar legal rights so that assets are distributed according to the creditors' ranking.[102] That is, all creditors do not need to be treated equally, but "in a manner that reflects the different bargains they have struck with the debtor".[103]

(2.44) In light of the foregoing, the author argues that a collective proceeding is not the most desirable form of proceeding due to the absence of the common pool problem in the context of sovereign debt and the incomparably different nature of multilateral/bilateral claims that renders the design of a priority order between multilateral/bilateral claims and commercial claims impossible. In the view of the author, the inapplicability of a collective proceeding offers two possibilities: several separate collective proceedings or a non-collective proceeding. Whereas collectivity is considered to be the easiest way to ensure equal treatment, a similar result can arguably be achieved through the implementation of mandatory rules to the same effect and legal sanctions against violation of these rules. The ultimate choice largely depends on an analysis

99 D. Rodrik, "Why is There Multilateral Lending?", NBER Working Paper No. 5160 (June 1995), at 2. Crippa discusses the human right issues involved in projects financed by multilateral development banks. See L. Crippa, "Multilateral Development Banks and the Human Right Responsibility", 3 Am. U. Int'l L. Rev. 25 (2010): 531-577.

100 L. Rieffel, "What Is Broken? What Fixes Make Sense?", *supra* note 49. It is worth noting that China as a major bilateral lender to developing countries has a different approach towards bilateral lending. For example, Chinese loans generally do not require any change of national economic policies. See M. Mattlin & M. Nojonen, "Conditionality in Chinese bilateral lending", BOFIT Discussion Papers (14/2011); E. Downs, "INSIDE CHINA INC.: China Development Banks' Cross-border Energy Deals", The John L. Thornton China Center at Brookings (2011).

101 IMF, "The Design of the Sovereign Debt Restructuring Mechanism-Further Considerations", *supra* note 2, at 23-25. S. Schwarcz, *supra* note 2, at 1217.

102 UNCITRAL, *supra* note 3, at 11.

103 *Ibid.*

evaluating the benefits and costs involved for collective proceedings within a smaller circle.

2.4 CONCLUSION

(2.45) In light of recent creditor episodes, the *NML Capital Ltd.* decision in particular, the time for academic attention to shift from holdout concerns to inter-creditor issues has become ripe. This paper details the concept and *status quo* of inter-creditor issues in sovereign debt restructurings and explores possible solutions to inter-creditor issues. Notably, it questions the unquestionable beauty of a "collective" proceeding for "all" sovereign debt claims.

(2.46) With respect to "all" claims, this paper identifies the scope of creditors affected by inter-creditor issues by discussing the "temporary" nature of the sovereign debt crisis and the "alive" feature of the limited pool of sovereign assets. It maintains that where the pool of assets is constantly replenished, inter-creditor issues do not concern all creditors because the ability of individual creditors to make a lesser contribution does not necessarily require other creditors to contribute more. To further support this argument, the paper discusses the reasons for non-applicability of the automatic acceleration principle in national bankruptcy law in the sovereign debt context through its analysis of the non-liquidable nature of sovereign debtors and the legislative motivation for the adoption of the automatic acceleration principle for municipal debtors in US chapter 9 bankruptcy.

(2.47) Turning to a "collective" proceeding, this paper explains the theories in favor of such a proceeding in national bankruptcy law, namely, the common pool problem and the creditor's bargain theory. It uses empirical data concerning the number of litigation against sovereign debtors in the US and UK courts between 1976 and 2010 to argue that the common pool problem does not exist in the sovereign debt context. Moreover, it explains that, according to the creditor's bargain theory, a collective proceeding is only desirable when it is in the best interests of both unsecured and secured creditors, and that secured creditors would only agree to be included in the same proceeding as unsecured creditors if their rights are well preserved through priority rules. It analyses the incomparably different nature of multilateral/bilateral claims and argues that it is almost impossible to weigh political and financial considerations and to devise a priority order between multilateral/bilateral claims and commercial claims. Therefore, multilateral/bilateral claims and commercial claims should receive separate treatment and should not be included in a collective proceeding.