DISTRESSED SOVEREIGN DEBT: A CREDITOR'S PERSPECTIVE

RONALD J. SILVERMAN & MARK W. DEVENO*

INTRODUCTION

The 1980's and 1990's bore witness to a series of financial crises that proliferated throughout Latin America, Asia, Russia, and other emerging markets.[1] In fact, "[s]ome fear [that] such crises may be about to engulf parts of Latin America again,"[2] with Argentina's restructuring efforts, of course, serving as an example. Accordingly, creditors dealing in the sovereign debt arena – whether directly or through the secondary market – must make themselves aware of both the legal and practical principles that govern the resolution of sovereign debt defaults.

Since the early 1980's, creditors of defaulting sovereign governments have had two basic options when addressing the issue of sovereign default: (1) participation in a voluntary restructuring scheme, or (2) litigation. Notably absent from this list is a third option typically available in the case of a defaulting corporate debtor – bankruptcy (whether voluntary or involuntary). For obvious reasons, sovereign governments cannot be forced into proceedings that threaten a liquidation or a wrapping up of affairs. Hence, the lack of a third option.[3]

In recent years, both of the options available to creditors of a defaulting foreign sovereign – voluntary restructuring and litigation – have become more difficult to exercise. Voluntary restructurings have become more difficult as the composition of creditors interested in pursuing restructuring efforts has changed dramatically. In prior decades, the majority of private debt owed by sovereign governments came in the form of syndicated bank loans. The bank lenders providing these syndicated

---

* Ronald J. Silverman is a partner in the New York office of Bingham McCutchen LLP and is a member of the firm's Financial Restructuring practice. Mr. Silverman is a member of the American Bankruptcy Institute and INSOL International, and a significant portion of his practice is comprised of cross-border insolvency matters. Mark W. Deveno is an associate in the New York office of Bingham McCutchen LLP and is also a member of the firm's Financial Restructuring practice.

[1] *See* Anthony Rowley, *What To Do With Emerging Market Bankrupts – The IMF and the Private Sector Seem Poles Apart on How To Deal With the After-effects of Emerging Market Crises*, THE BANKER, Oct. 1, 2002, at para. 3 (discussing financial crises that swept through Latin America, Asia, Russia, and central Europe in 1990's), *available at* 2002 WL 19008163; *see also* Pravin Banker Assocs. v. Banco Popular del Peru, 109 F.3d 850, 852 (2d Cir. 1997) (discussing international sovereign debt crisis of 1980's); Thomas Consol. Indus. v. Koster Group, Inc., No. 00 C 1838, 2002 U.S. Dist. LEXIS 17200, at *8 (N.D. Ill. Sept. 11, 2002) (discussing testimony of expert witness relating to economic crisis that spread throughout Asia in late 1990's).

[2] Rowley, *supra* note 1, at para. 3.

[3] However, both a sovereign entity and its creditors may prefer to restructure all or most of the sovereign's debt in a single efficient proceeding. Thus, in a very real sense, the voluntary restructuring procedures that have developed are something of a cross between (1) an out-of-court workout (resulting in new and binding documentation of the restructured debt) and (2) an in-court bankruptcy (involving multiple creditors and certain debt forgiveness). *See generally* Elliot Assocs. v. Banco de la Nacion, 194 F.3d 363, 366 (2d Cir. 1999) (explaining under "Brady Plan" creditors forgive some debt owed by less developed counties and restructure remaining debt).

loans shared similar concerns and interests when pursuing the terms of a sovereign debt restructuring, which, of course, promoted consensus amongst the group. In recent years, however, the sovereign debt market has become largely comprised of sovereign bonds, which are held by a large number of creditors and are subject to varying concerns and interests amongst the group. These varying concerns and interests cause restructuring efforts to be somewhat more complicated to pursue.

Moreover, litigation, the second option available to creditors in the case of a sovereign debt default, appears to be a less advantageous alternative than it once was. Initially, bank lenders shared a common interest in pursuing voluntary restructurings. As a result, litigation was rare, and defaulting foreign sovereigns had both the means and willingness to satisfy the relatively few judgments and/or settlements with which they were presented. The changing face of the sovereign debt arena, however, has resulted in an increasing number of creditors who are both willing and able to pursue litigation strategies against a defaulting foreign sovereign. Accordingly, the likelihood that a foreign sovereign will have sufficient U.S. (or foreign) assets to satisfy such creditors, either via attachment or settlement, has decreased. Thus, more so than ever, it may be in the best interests of creditors to work toward fostering the development of voluntary restructuring principles in the sovereign debt arena.

The purpose of this Article is to first discuss the modern development of voluntary restructuring principles, the pursuit by some of litigation outside of the voluntary restructuring arena, and the limitations of each such approach. The focus of this Article, however, is the growing need for the development of a more efficient and effective voluntary restructuring process as a preferred vehicle for resolving distressed sovereign debt. Part I hereof explains both the origins of voluntary restructurings, and the current state of such proceedings. Part II offers a brief discussion of the litigation avenues available to those creditors choosing not to restructure. Finally, Part III concludes by presenting possible developments in the voluntary restructuring arena—focusing on the recent consideration of principles and mechanisms for dealing with sovereign debt restructurings as set forth by the Council on Foreign Relations and the International Monetary Fund ("IMF").

I. THE RECENT HISTORY OF VOLUNTARY RESTRUCTURING: THE BAKER AND BRADY ERAS

A. Modern Era of Debt Reschedulings

In August of 1982, for various economic reasons, Mexico announced that it was no longer able to service its debts owed to foreign creditors.[4] Shortly thereafter, a

[4] *See* Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2708 (1996) (discussing beginnings of Latin American financial crisis in early 1980's); Alberto Gonzalo Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction For Latin American Sovereign Debtors*, 66 N.Y.U. L. Rev. 66, 66 (1991) (quoting announcement

number of Latin American countries followed suit.[5] At this point in time, the majority of private debt owed by such nations came in the form of syndicated bank loans, which were primarily issued by U.S. banks. In response to the crisis, the banks initially sought to avoid defaults on these loans "at all costs."[6] In so doing, a two-pronged procedure was developed for "rescheduling" sovereign debt.[7] First, the banks postponed any requirement for the payment of principal, while extending new money to the sovereigns for purposes of facilitating interest payments on their own loans. Second, the banks imposed pressure upon the sovereigns to participate in IMF adjustment programs that were designed to increase the availability of foreign currency and foreign reserves for servicing external debt.[8]

Despite the multitude of bank lenders participating in a given syndicate, the coordination of such a rescheduling effort proved to be a manageable task. Identifying the members of the syndicate was easy, and the very nature of a syndicated loan – with certain banks acting as agents – encouraged the development of "steering committees" that served as advisors for the various lending bodies.[9] Moreover, the lending banks generally shared an important interest: having any debt crisis resolved without a declaration of default.[10] As such, the banks were able to act in a collective and unified manner when negotiating with borrowing sovereigns.[11]

---

of Mexico's Minister of Finance that Mexico "can't pay anymore" (citing Schirano, *A Banker's View*, *in* A DANCE ALONG THE PRECIPICE: THE POLITICAL AND ECONOMIC DIMENSIONS OF THE INTERNATIONAL DEBT PROBLEM 17, 20 (William Eskridge, Jr. ed., Lexington 1985) (comment of Mexican Finance Minister Jesus Silva Herzog))).

[5] *See* Power, *supra* note 4, at 2708 (explaining Brazil, Argentina, Bolivia, and Venezuela followed Mexico's example in announcing inability to pay debts owed to foreign creditors); Santos, *supra* note 4, at 66–68 (discussing development of Latin American debt crisis from 1982 to 1989).

[6] Power, *supra* note 4, at 2709 (discussing bank response to Latin American debt crisis in early 1980's). Such a response was important for the banks (or at least a majority of them). Regulatory rules, at the time, required that the banks declare as "non-performing," any loans from which interest payments had not been received within ninety days of their due date. Moreover, banks were required to maintain adequate loss-reserves for these non-performing loans. Unfortunately, at the time of the debt crisis, had defaults been declared, the largest banks in the syndicates would not have had sufficient capital to maintain such reserves. Thus, avoiding defaults was extremely important. *See id.* at 2710–11 (discussing implications of bank regulatory rules). *See generally* Ross P. Buckley, *Rescheduling as the Groundwork for Secondary Markets in Sovereign Debt*, 26 DENV. J. INT'L L. & POL'Y 299, 303 (1998) (explaining measures to avoid default); Santos, *supra* note 4, at 77 (analyzing international debt crisis).

[7] *See* Rory Macmillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 312 (1995) (explaining two-prong procedure for rescheduling foreign debt).

[8] *Id.* at 312.

[9] *See* Buckley, *supra* note 6, at 300 (explaining role of steering committees in rescheduling process).

[10] *See* discussion *supra* note 6 and accompanying text.

[11] It should be noted that not all banks within a syndicate were always interested in lending new money or rescheduling debt. Banks that held a smaller sovereign debt portfolio were more likely to be able to withstand a default, and thus viewed lending new money as "throwing good money after bad." Power, *supra* note 4, at 2711. The existence of these lenders was often referred to as the "free-rider" problem. That is, if these banks (the free-riders) refused to lend new money to the sovereign, knowing full well that others within the syndicate would so lend, these free-riders would incur no additional risk while benefiting from the increased liquidity of the sovereign as a result of the rescheduling. This free-rider problem, however, was largely avoided as a result of pressure imposed upon the free-riding banks by (1) the other syndicate banks, (2) the IMF, and (3) certain U.S. regulatory agencies (i.e., bank regulators who could not allow the rescheduling to fall through and thus cause the insolvency of the major banks within the syndicate). *See id.*

B. The Baker Plan

Notwithstanding the fact that sovereign debt restructurings continued for several years, as of 1985, the United States government had formed no official policy for resolution of the debt crises. Finally, on October 9, 1985, James. A. Baker, then U.S. Treasury Secretary, announced a plan that eventually became known as "The Baker Plan."[12] The Baker Plan called for commercial banks to lend $20 billion in new money to highly indebted, less-developed countries ("LDCs").[13] At the same time, the plan called for the IMF, World Bank, and other multilateral institutions to make an additional $9 billion in loans to LDCs.[14] The plan contained no provisions for debt forgiveness, and instead simply called on the debtor countries to adopt austerity plans monitored by the IMF.[15]

Not only did Baker's plan fail to fully materialize in the dollar figures proposed, but it also added nothing to the then current state of voluntary reschedulings. Under Baker's plan, as had been the case with the initial reschedulings themselves, sovereign debtors simply continued to grow increasingly more leveraged, while failing to obtain any debt forgiveness.[16] In fact, by the late 1980's, most LDCs had entered into multiple reschedulings. As a result, the LDCs continued to incur increasingly larger amounts of new debt for which they would ultimately be responsible, while at the same time gaining only enough liquidity to make short-term interest payments on their loans.

C. The Brady Era

By early 1989, it became apparent that the Baker era approach of rescheduling debt would no longer be a viable solution. Banks no longer wished to continue advancing funds, and countries had grown weary of their ever-increasing debt.[17] Additionally, the IMF's austerity programs "were no longer politically tenable in Latin America."[18] On March 10, 1989, then U.S. Treasury Secretary, Nicholas

---

(discussing potential threat of insolvency to major banks within syndicates); *see also id*. at 2711–15 for a detailed discussion of the pressures imposed on free-riding banks.

[12] *See* Power, *supra* note 4, at 2714 (discussing origins of Baker Plan).

[13] *See id*.

[14] *See id*.; *see also* Macmillan, *supra* note 7, at 326–27 (explaining Baker approach); Santos, *supra* note 4, at 76–81.

[15] *See* Power, *supra* note 4, at 2714; *see also* Macmillan, *supra* note 7, at 326 n.14 (discussing IMF supervision of free-market policies adopted by debtor-country under Brady Plan). Bankers and IMF officials encouraged governments to impose austerity programs on their citizens as a way for the governments to raise revenue to pay their foreign debts. Buckley, *supra* note 6, at 303–04.

[16] *See* Macmillan, *supra* note 7, at 326–27 (explaining that result of Brady Plan was increase in debtor-country debt while allowing debtor-country to maintain interest payments).

[17] *See* Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT'L L.J. 1802, 1803 (1998) (explaining under Baker Plan "[b]anks had wearied of forever advancing new funds" and "[c]ountries had wearied of their ever-rising level of indebtedness.").

[18] *See id*. at 1803–04.

Brady, announced a broad framework for dealing with such issues. Specifically, Brady proposed, in part, "(1) a series of individual market-based transactions, (2) in which creditors would be invited to participate voluntarily, (3) with debt relief tied into conversion of loans into collateralized bonds, [and] (4) with debtor nations permitted to repurchase their own discounted debt on the secondary market."[19] A key element of the Brady Plan was its recognition, for the first time in this arena, that some form of debt forgiveness would be required as opposed to simple debt reschedulings.

In essence, a Brady Plan restructuring works as follows:

> [B]ank loans owed by a single sovereign debtor are pooled together and repackaged as bonds, which are offered to the public. The proceeds of the bond offering are then used to retire the country's outstanding bank loan indebtedness [at a discount]. After the securitization, therefore, the country's obligations under its various bank loan agreements are extinguished. Instead, the country makes periodic payments to an indenture trustee for distribution to the bondholders. The securitization process thus enables banks to exit completely from the cycle of debt rescheduling and to take troubled sovereign loans off their books forever.[20]

The bonds themselves are generally collateralized by zero-coupon U.S. Treasury bonds of matching maturities, the funding for which often comes, at least in part, from the IMF and World Bank.[21] In addition, it should be noted that, at times, the bonds are not collateralized at all,[22] as there is no uniform Brady scheme.

Since Mexico's Brady restructuring of the early 1990's, a number of LDCs have followed suit. Accordingly, the face of the sovereign debt market has changed dramatically. Gone are the days when the majority of private sovereign debt came in the form of syndicated bank loans. Today, the majority of such debt comes in the form of bonds – often Brady Bonds – which are held by far more bondholders than existed banks in the syndicated loan transaction. Moreover, these bonds are themselves readily tradable instruments. Thus, no longer do LDCs have a creditor base limited to the syndicate banks – many of which share common interests. Instead, LDCs now have a creditor base of potentially thousands of bondholders – each of which may have acquired the bonds at a different price – resulting in very different objectives amongst the group. Moreover, in recent years, sovereigns have

---

[19] *Id*. at 1804.

[20] Power, *supra* note 4, at 2720 (citations omitted).

[21] *See id*. at 2721 (explaining collateralization of Brady bonds); *see also* Buckley, *supra* note 17, at 1810 (explaining collateralization of Mexico's Brady bonds in early 1990's).

[22] *See* Power, *supra* note 4, at 2722. It is important to note that even where the bonds are collateralized, they are not "risk-free." The terms of Brady bonds provide that "bondholders may not access the principal collateral until the maturity date. Thus, depending on when a default occurs, bondholders may have to wait up to thirty years to access their principal collateral." *Id*. at 2721–22.

begun to raise greater amounts of capital through bond rather than bank debt issuances (and both bond debt and bank loans have become readily tradable on an active secondary market, thus multiplying the number of creditors holding sovereign debt).

D. Recent Bondholder Restructurings: The Ecuadorian Example

The recent restructuring by Ecuador of its Brady Bond and Eurobond obligations illustrates the current state of the voluntary restructuring arena. In September of 1999, Ecuador defaulted on interest payments due on both its Euro and Brady Bonds; these bonds had a face value of approximately $6.65 billion.[23] In late July of 2000, Ecuador, with little prior negotiation with its creditors, announced a restructuring plan whereby it proposed a swap of the $6.65 billion defaulted bonds for $3.95 billion in new debt, a swap that would result in a 40% reduction in the principal owed to its private creditors.[24] Only then did Ecuador begin a process of corralling support for its plan by meeting separately with different groups of creditors so as to discuss the merits of its plan.[25] By August 14, 2000, Ecuadorian authorities announced that they had secured more than 85% approval of their plan, and would thus restructure with regard to the approving bondholders.[26] Those who refused to approve the plan could pursue remedies either through the courts or individual settlement negotiations. In fact, analysts noted that Ecuador remained vulnerable to individual lawsuits.[27]

Even amongst the approving bondholders, "[t]here was no rejoicing."[28] Instead, most bondholders expressed that they reluctantly agreed to the proposal in order to avoid the most likely alternative: lengthy court battles.[29] In fact, even prior to approval of the plan, critics intimated that "Ecuador's actions [had] been ad hoc,"[30] and thus "lacking in transparency and equal treatment to all investors."[31] Thus, even current restructurings leave much to be desired. Countries remain vulnerable to

---

[23] Deepak Gopinath, *Putting Ecuador's House in Order*, INSTITUTIONAL INVESTOR (Int'l ed.), Sept. 2000, *available at* 2000 WL 31840647; *see also Ecuador Announces Bond Swap to Slash Foreign Debt*, AGENCE FRANCE-PRESSE, Aug. 15, 2000 [hereinafter *Ecuador Bond Swap*] (discussing same), *available at* 2000 WL 24690150. *See generally* Angela Pruitt, *Ecuador Creditors Expected to Accept Restructuring Plan*, WALL ST. J., August 2, 2000 (discussing Ecuador's $6.65 billion Brady and Eurobond default), *available at* 2000 WL-WSJ 3038643.

[24] *See generally* Pruitt, *supra* note 23 (discussing Ecuador's restructuring plan); *Ecuador Bond Swap*, *supra* note 23 (discussing same).

[25] *See generally* Pruitt, *supra* note 23 (discussing meetings with Ecuadorian officials and creditors).

[26] Jane Bussey, *Ecuadorean Bondholders Reluctantly Accept Bond Swap After Government Default*, MIAMI HERALD, August 15, 2000, *available at* 2000 WL 25443307; *Ecuador Bond Swap*, *supra* note 23.

[27] *See generally* Pruitt, *supra* note 23 ("Despite getting most investors on board for its debt restructuring plan, Ecuador is still vulnerable to a rash of lawsuits . . . .").

[28] Bussey, *supra* note 26.

[29] *Id*.

[30] Laura D'Andrea Tyson, *The Message in Letting Ecuador Default*, BUS. WK., Oct. 25, 1999, at 2, *available at* 1999 WL 27295659.

[31] *Id*.

litigation and individual attacks while the creditor body is neither treated equally nor fully satisfied.

II. LITIGATION

There were few sovereign debt lawsuits during the Baker era. As noted earlier, for the most part, lending banks at this time shared a common interest in having their debt rescheduled.[32] In the late 1980's and early 1990's, however, a secondary market developed for distressed sovereign debt. As some lending banks sought to remove the seemingly forever rescheduled debt from their books, they often sold the debt at deep discounts on the secondary market. This resulted in the appearance of "vulture" creditors who did not always share the common desire to reschedule or restructure.[33]

The merits of these lawsuits developed into little more than an issue of contract interpretation. That is, despite the assertion by sovereigns of numerous affirmative defenses, the U.S. courts, for the most part, found in favor of plaintiffs with regard to all such defenses. Thus, assuming the occurrence of a default by a sovereign, creditors were likely to obtain judgments through their litigation efforts. Among the unsuccessful defenses asserted by sovereigns during this period were the following: (1) sovereign immunity; (2) the act of state doctrine; and (3) international comity.

A. Sovereign Immunity

1. Immunity from Jurisdiction

Until 1952, the courts of the United States generally deferred to the State Department's request that immunity be granted in *all* actions against friendly foreign sovereigns. In 1952, Jack B. Tate, Acting Legal Advisor for the Department of State, wrote to Acting Attorney General Philip B. Perlman to announce a new State Department approach to sovereign immunity.[34] This letter has become known as the Tate Letter.[35]

In the Tate-Letter, "the State Department announced its adoption of the 'restrictive' theory of foreign sovereign immunity."[36] Under this theory, a foreign

---

[32] *See* discussion *supra* note 6.

[33] These creditors were not subject to the same regulatory constraints as their lending bank predecessors. *See* discussion *supra* notes 6 & 11. Accordingly, these "vulture" creditors were not as easily coerced into voluntary restructuring agreements.

[34] *See* Verlinden B.V. v. Cent. Bank of Nigera, 461 U.S. 480, 487 n.9 (1983) (discussing Tate's letter to Perlman).

[35] 26 Dep't State Bull. 984 (1952); *see also* Kiowa Tribe of Okla. v. Mfg. Techs., Inc., 523 U.S. 751, 759 (1998) (discussing Tate Letter); *Verlinden B.V.*, 461 U.S. at 487 (1983) (discussing same); Dames & Moore v. Regan, 453 U.S. 654, 683–84 (1981) (discussing same).

[36] *Verlinden B.V.*, 461 U.S. at 487; *see also* Altmann v. Republic of Austria, 317 F.3d 954, 964 (9th Cir. 2002) (discussing issuance of Tate Letter as moment when "restrictive theory of sovereign immunity" was

state is immune from suits involving its sovereign or public acts, but acquires no such immunity for cases arising out of strictly commercial acts.[37] In 1976, Congress passed the Foreign Sovereign Immunities Act (the "FSIA"),[38] which, for the most part, codified the restrictive theory of sovereign immunity.[39] Today, the FSIA provides the "sole basis" for obtaining jurisdiction over a foreign state in a United States court.[40] The starting point of the FSIA is, in general, that sovereigns will be immune from jurisdiction.[41]

Unfortunately for foreign sovereigns, the FSIA provides, in relevant part, two broad exceptions to the provisions providing immunity from jurisdiction. First, there will be no immunity where a foreign state, "has waived its immunity either explicitly or by implication."[42] Since the majority of sovereign bond and loan agreements provide explicit waivers of immunity, it is unlikely that a foreign sovereign will be able to avail itself of the protections of the FSIA.[43]

Second, even where there has been no waiver of jurisdictional immunity by a sovereign, the act exempts from immunity certain actions that are based on "commercial activity." Specifically, the act provides that a foreign state will not be immune from jurisdiction in any case in which the action is based:

> [1] upon a commercial activity carried on in the United States by the foreign state . . . [2] upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere . . . or [3] upon an act outside of the territory of the

---

adopted); City of Englewood v. Socialist People's Libyan Arab Jamahiriya, 773 F.2d 31, 34 (3d Cir. 1985) (discussing same).

[37] *Verlinden B.V.*, 461 U.S. at 487; s*ee also Kiowa Tribe of Okla.*, 523 U.S. at 759 (stating Tate Letter announced policy of denying immunity for commercial acts of foreign nation); *City of Englewood*, 773 F.2d at 34 (explaining under Tate Letter "immunity of the sovereign is recognized with regard to sovereign or public acts (jure imperii) of a state, but not with respect to private acts (*juri gestionis*)." (quoting Tate Letter, 26 Dep't State Bull. 984 (1952))).

[38] Foreign Sovereign Immunities Act of 1976, *codified in relevant part at* 28 U.S.C. §§ 1602–1611 (2000).

[39] *Verlinden B.V.,* 461 U.S. at 488; s*ee also* Weltover, Inc. v. Republic of Argentina, 941 F.2d 145, 148 (2d Cir. 1991) (explaining FISA codifies restrictive theory of sovereign immunity); Cruz v. United States, 219 F. Supp. 2d 1027, 1034–35 (N.D. Cal. 2002) (explaining purpose of FSIA was to codify and rationalize policy of restricting sovereign immunity).

[40] Saudi Arabia v. Nelson, 507 U.S. 349, 355 (1993); *see also* Argentine Republic v. Amerada Hess Shipping Corp., 488 U.S. 428, 443 (1989) (holding district court lacked jurisdiction over Argentine Republic under FSIA); *Altmann*, 317 F.3d at 962 (stating FISA provides sole basis of jurisdiction over foreign state).

[41] *See* 28 U.S.C. § 1604 ("Subject to existing international agreements . . . a foreign state shall be immune from the jurisdiction of the courts of the United States and of the States" except as provided in §§ 1605–1607 of FSIA).

[42] 28 U.S.C. § 1605(a)(1); *see also* General Star Nat'l Ins. Co. v. Administratia Asigurarilor De Stat, 289 F.3d 434, 437 (6th Cir. 2002) ("[A] foreign state is not entitled to sovereign immunity if it either expressly or implicitly waives that immunity."); S & Davis Int'l, Inc. v. Yemen, 218 F.3d 1292, 1301 (11th Cir. 2000) (discussing implied immunity under FISA § 1605(a)(1)).

[43] *See, e.g.*, Proyecfin de Venez., S.A. v. Banco Indus. de Venez., S.A., 760 F.2d 390, 397 (2d Cir. 1985) (concluding sovereign waived immunity in loan agreement); Nat'l Union Fire Ins. Co. v. People's Republic of the Congo, 729 F. Supp. 936, 940 (S.D.N.Y. 1989) (finding sovereign waived immunity pursuant to clause in agreement).

> United States in connection with a commercial activity of the foreign state elsewhere and [where] that act causes a direct effect in the United States.[44]

The United States Supreme Court has broadly interpreted the third "commercial activity" exception in the context of sovereign debt cases. In *Republic of Argentina v. Weltover, Inc.*,[45] the Court essentially held that sovereign debt instruments, regardless of the purpose behind them, are "commercial" in character.[46] Moreover, the Court recognized that a default by a sovereign government where the payments under its debt obligations are required to be made in the U.S., do, in fact, have an "effect in the United States."[47] Therefore, the Court, for all intents and purposes, held that a sovereign's default is an act outside of the United States relating to a commercial activity that has a direct effect in the United States, thus falling squarely within the third of the "commercial activity" exceptions.[48] Accordingly, jurisdictional sovereign immunity is not likely to provide an effective defense for foreign sovereigns.

2. Immunity from Attachment

Even where a U.S. court has jurisdiction over a foreign sovereign, a lawsuit will be of little value if the assets of that sovereign cannot be attached. The FSIA provides rules with regard to attachment that are similar to, but separate from, those on jurisdiction. Like the rules on jurisdiction, the FSIA's provisions on attachment start with a general presumption of immunity from attachment.[49] Also consistent with the rules on jurisdiction, the FSIA allows post-judgment attachment where there has been an explicit or implicit waiver of the immunity.[50] Fortunately for

---

[44] 28 U.S.C. § 1605(a)(2).

[45] 504 U.S. 607 (1992).

[46] *See id.* at 617 (concluding issuance of bonds by Republic of Argentina was "commercial activity" under FSIA).

[47] *See id*. at 617–19 (concluding Argentina's unilateral rescheduling of bond maturity dates had "direct effect" in United States).

[48] It should be noted the *Weltover* decision does not expressly answer the question of whether jurisdiction will exist over a foreign sovereign that is obligated to pay solely outside of the United States. The implication of the decision, however, would be that no U.S. jurisdiction will exist in the case of such a transaction. *See generally* David E. Gohlke, Comment, *Clearing the Air or Muddying the Waters? Defining "A Direct Effect in the United States" Under the Foreign Sovereign Immunities Act After Republic of Argentina v. Weltover*, 18 HOUS. J. INT'L L. 261 (1995) (discussing impact of *Weltover* case); Avi Lew, Comment, *Republic of Argentina v. Weltover, Inc.: Interpreting the Foreign Sovereign Immunity Act's Commercial Activity Exception to Jurisdictional Immunity*, 17 FORDHAM INT'L L.J. 726 (1994) (same).

[49] *See* 28 U.S.C. § 1609 ("Subject to existing international agreements . . . the property in the United States of a foreign state shall be immune from attachment arrest and execution" except as provided in §§ 1610, 1611 of FSIA); *see also* Karaha Bodas Co. v. Pertamina, 313 F.3d 70, 82 (2d Cir. 2002) (recognizing immunity from attachment under FSIA § 1609).

[50] *See* 28 U.S.C. § 1610(a)(1) (excepting immunity where "foreign state has waived its immunity from attachment . . . either explicitly or by implication."); *see also* LNC Inves., Inc. v. Republic of Nicaragua, 115

creditors, sovereign bond and loan agreements generally contain both a waiver of immunity from jurisdiction *and* a waiver of immunity from attachment.[51] Thus, assuming a sovereign has sufficient assets in the U.S. to attach, the FSIA is unlikely to pose a significant problem for a litigating creditor (absent competing litigants chasing the very same assets).

B. The Act of State Doctrine

The act of state doctrine, a judicially created doctrine, precludes judicial inquiry by the courts of the United States into the official acts of an independent sovereign that occur within the sovereign's own borders.[52] More specifically, the doctrine provides that "the Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government."[53] However, judicial inquiry is not precluded with regard to extraterritorial takings.[54]

A defaulting foreign sovereign will, of course, argue that because any decision not to pay its obligations were made within its own territory, any resulting default is, in essence, a taking within the sovereign's borders, and thus, under the act of state doctrine, not subject to judicial review. This interpretation, however, has been largely rejected by the U.S. courts. In *Allied Bank International v. Banco Credito Agricola de Cartago*,[55] the United States Court of Appeals for the Second Circuit determined that in sovereign debt default cases, the taking involved is a taking of the right to receive payment.[56] If that payment is due and owing in the United States (or in some other jurisdiction outside of the foreign sovereign's borders), then the taking has occurred in the United States (or that other jurisdiction), and not within the defaulting foreign sovereign's borders.[57] Thus, at least according to the Second

---

F. Supp. 2d 358, 363 (S.D.N.Y. 2000) (concluding Republic of Nicaragua waived immunity from attachment in loan agreement).

[51] *See* Proyecfin de Venez., S.A. v. Banco Indus. de Venez., S.A., 760 F.2d 390, 397 (2d Cir. 1985) (discussing loan agreement containing waiver of sovereign immunity); Libra Bank Ltd. v. Banco Nacional de Costa Rica, 676 F.2d 47, 49 (2d Cir. 1982) (holding provision in promissory note constituted express waiver of sovereign immunity); Nat'l Union Fire Ins. Co. v. People's Republic of the Congo, 729 F. Supp. 936, 940 (S.D.N.Y. 1989) (finding sovereign waived immunity pursuant to clause in agreement).

[52] *See* W.S. Kirkpatrick & Co. v. Envtl. Tectonics Corp., 493 U.S. 400, 405 (1990) (discussing development and application of act of state doctrine); Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428–29 (1964) (discussing act of state doctrine). *See generally* Frederic L. Kirgis, Jr., *Understanding the Act of State Doctrine's Effect*, 82 AM. J. INT'L L. 58 (1988) (explaining act of state doctrine).

[53] *Sabbatino*, 376 U.S. at 428; *see also* Underhill v. Hernandez, 168 U.S. 250, 252 (articulating "classic" act of state doctrine); Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 520 (2d Cir. 1985) (discussing act of state doctrine under *Sabbatino* and *Underhill*).

[54] *See Allied Bank Int'l*, 757 F.2d at 520 (stating act of state doctrine does not bar inquiry by courts into validity of extraterritorial takings (quoting Banco Nacional de Cuba v. Chemical Bank N.Y. Trust Co., 658 F.2d. 903, 908 (2d Cir. 1965)); Republic of Iraq v. First Nat'l City Bank, 353 F.2d. 47, 51 (2d. Cir. 1965) (explaining act of state doctrine applies only to takings by foreign sovereign of property within own territory).

[55] 757 F.2d 516 (2d Cir. 1985).

[56] *Id*. at 521.

[57] *See id*. at 521 (concluding "situs of the property" was in United States).

Circuit, the act of state doctrine is not likely to provide a viable defense for foreign sovereigns.

C. International Comity

With the commencement of litigation in connection with a sovereign debt default, there may exist a conflict between two national legal systems. This conflict can be resolved if one of the legal systems simply refrains from acting in deference to the other. This deference is known as comity.[58]

The doctrine of comity has broader application than the act of state doctrine. The act of state doctrine applies only to acts of a foreign sovereign which occur within that sovereign's borders.[59] Comity, on the other hand, can apply to acts of an extraterritorial nature as well.[60] Under the doctrine of comity, courts may refrain from deciding litigation where such litigation is in conflict with the laws or actions of a foreign sovereign. However, in the United States, courts will defer to a foreign legal system, in the interest of comity, only where that deference will not result in consequences that are inconsistent with the law and policy of the United States.[61]

For instance, in *Allied Bank International*, the Second Circuit held that certain unilateral acts of the Costa Rican government, in suspending its debt repayments, were contrary to U.S. policy.[62] In the *Allied* case, the executive branch of the United States, through the Justice Department, submitted an amicus brief, which explained that the suspension of payment by Costa Rica was inconsistent with U.S. policy.[63] More specifically, the Justice Department explained that while it supported generally the concept of debt rescheduling by negotiation, it did not support debt rescheduling by unilateral effort.[64] Based upon the Justice Department's brief, the court determined that the Costa Rican suspension was inconsistent with U.S. policy, and thus not properly subject to the comity defense.[65] Accordingly, in the context of sovereign debt defaults, it appears as though the express opinion of the executive branch will weigh heavily in a court's determination of whether a foreign sovereign's action has, in fact, violated U.S. policy, and thus whether comity should be exercised.[66]

---

[58] *See* MARK W. JANIS, AN INTRODUCTION TO INTERNATIONAL LAW 331–34 (2d ed. 1996) (discussing comity).

[59] *See* discussion *supra* Part II.B.

[60] *See, e.g., Allied Bank Int'l*, 757 F.2d at 522 (applying comity in recognizing validity of certain acts of Costa Rican government).

[61] *See, e.g., id*. (stating valid acts of Costa Rican government leading to default of Costa Rican banks were fully consistent with law and policy of United States).

[62] *Id*. at 522.

[63] *Id*. at 519.

[64] *Id*. at 519–20.

[65] *Id*. at 522.

[66] *Id*.; *see also* Pravin Banker Assocs. v. Banco Popular Del Peru, 109 F.3d 850, 854 (2d Cir. 1997) ("[C]ourts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States." (citing *Allied Bank Int'l*, 757 F.2d at 522)).

In more recent years, the United States District Court for the Southern District of New York has recognized that while U.S. policy has potentially changed since the ruling in *Allied Bank International*, the holding in that case continues to be instructive. Specifically, in *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*,[67] the district court recognized that the key to debt restructurings is that they be entered into on a voluntary, as opposed to unilateral, basis.[68] Intertwined with this notion of *voluntary* restructuring is the fact that creditors must be allowed to *choose* to pursue individual remedies rather than being forced to join in renegotiations.[69] Accordingly, U.S. policy does not currently favor a foreign sovereign's efforts to force a restructuring upon its creditors, and thus under *Banco Popular del Peru* the doctrine of comity would not bar individual creditors from pursuing remedies when presented with a forced restructuring.

Importantly, however, it is conceivable that U.S. policy could evolve to require the exercise of comity to a greater degree in the future. The willingness of the Second Circuit to defer to a Justice Department brief on the issue of U.S. policy indicates that the court's interpretation of this issue may be heavily influenced by future Justice Department briefings on the issue. For instance, were the Justice Department to determine and articulate that sovereign debtors engaging in restructuring efforts should be entitled to something of an automatic stay, then comity might, in the future, prove to be a useful defense to creditor litigation.

D. Future Litigation Efforts

It is important to note, however, that despite the success of these early litigation efforts, the face of the sovereign debt arena is changing in a way that may make litigation less desirable in the future. No longer do commercial banks (many of which possess a common interest in pursuing out-of-court remedies) comprise the majority of a sovereign's creditors. Instead, today, litigation is an option for many sovereign debt bondholders. If each such bondholder pursues a litigation strategy against that sovereign, the sovereign may well have insufficient assets held in the United States (or foreign territories) for purposes of attachment or even for consensual, but individual, settlements. Faced with multiple litigations, a sovereign may be less likely to attempt to enter into multiple individual settlements with litigants. As a result, litigation may very well become more difficult for creditor litigants.

---

[67] 895 F. Supp. 660 (S.D.N.Y. 1995).

[68] *See id*. at 665–66 (discussing voluntary debt restructuring under Brady Plan).

[69] *See id*. (discussing creditor's options under Brady Plan to litigate, negotiate, or to "opt out" of settlements resulting from negotiations); *see also* Nat'l Union Fire Ins. v. People's Republic of Congo, 729 F. Supp. 936, 944 (S.D.N.Y. 1989) (stating foreign government may not force unwilling creditors to accept restructuring agreement). *See generally* Power, *supra* note 4, at 2701, 2758 (1996) (discussing emphasis of Brady Plan on voluntary rather than compelled restructuring).

III. DEVELOPMENTS IN THE VOLUNTARY RESTRUCTURING ARENA

Despite the permissibility of litigation against sovereigns, resorting to adversarial resolution of sovereign debt issues may not prove to be the best course of action for creditors in the future. Prior litigation in this arena came at a time when the majority of creditors were commercial banks. Thus, the majority of these creditors were willing to pursue out-of-court remedies such as debt reschedulings or restructurings. As a result, a defendant sovereign was more likely to have sufficient U.S. assets to cover the random lawsuits brought against it. Today, however, creditors do not share the same common interest in avoiding litigation. As a result, the often described bankruptcy fear of a "rush to the courthouse" is a very real concern. That is, the first creditors to attach a sovereign government's limited U.S. assets will obtain a better recovery than those that follow. Later litigants may find fewer or no assets to satisfy any judgments obtained. Moreover, even the first creditors to file lawsuits may find it difficult to recover as sovereigns expecting a wave of litigation may be less likely to seek settlements than they would have been in the past, and may contest litigation more vigorously.

Accordingly, efforts toward consensual, collective sovereign debt restructurings take on new vitality. However, such voluntary restructuring schemes, in order to have the greatest chance of garnering the agreement of creditors, must be transparent, predictable, and equal in their treatment of all creditors. In this regard, a number of recent commentaries on the issue of sovereign debt restructurings have attempted to address these issues. For instance, some have proposed an international convention that would be based upon the principles of chapter 9 of the United States Bankruptcy Code,[70] but for which there would be no particular international bankruptcy court.[71] Likewise, in 2000, the Council on Foreign Relations, a non-partisan, national membership organization and independent "think tank," [72] issued broad recommendations toward the development of similar international principles. The Council's recommendations suggested something of a voluntary proceeding, which would loosely resemble the workings of an extra-judicial chapter 11 reorganization. Highlights of the principles included: (1)

---

[70] *See* 11 U.S.C. §§ 901–946 (2000) (governing municipal bankruptcies).

[71] *See* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000) (discussing need for and proposing international convention for debt restructuring); *see also* Ann Pettifor, *Resolving International Debt Crises – the Jubilee Framework for International Insolvency* (January 2002), *at* http://www.jubilee2000uk.org/analysis/reports/jubilee_framework.html (proposing similar chapter 9 type of framework to be dealt with by "ad hoc body, appointed to deal with each individual petition for insolvency").

[72] According to the Council on Foreign Relation's Internet Website: "The Council on Foreign Relations was founded in 1921 by businessmen, bankers, and lawyers determined to keep the United States engaged in the world. Today, the Council is composed of men and women from all walks of international life." *Council on Foreign Relations: FAQs*, *at* http://www.cfr.org/about/memberfaq.php (last visited Mar. 21, 2003). Through frequent roundtable meetings of leading thinkers in the international community, the Council aims "to increase America's understanding of the world and contribute ideas to U.S. foreign policy." *Id.*

organization of creditors into an ad hoc steering committee; (2) sharing of financial data by the sovereign to the steering committee (and the creditors at large); (3) retention of professionals by the steering committee to be paid by the sovereign; and (4) imposition of a voluntary stay of legal actions against the sovereign.[73]

Perhaps most notable among the recent commentaries, due both to its timeliness and source, is the IMF's suggestion of developing a Sovereign Debt Restructuring Mechanism ("SDRM"). Specifically, in the latter part of 2001, Anne Krueger, First Managing Director of the IMF outlined a set of principles under which the IMF might govern a sovereign debt restructuring process.[74] By September of 2002, at the annual meeting of the World Bank and IMF, the International Monetary and Financial Committee ("IMFC") requested that the IMF produce, by April 2003, a proposal for a statutory framework addressing the issue of sovereign debt restructurings.[75] As of the time of drafting this article, the IMF had not yet finalized the form of its April 2003 proposal. However, on January 22, 2003, the IMF hosted a Sovereign Debt Restructuring Conference in which a paper (the "SDRM Paper")[76] detailing the mechanics of the potential mechanism was made open to both comment and criticism from several interested constituencies (including representatives of both private creditors and sovereign governments).

Although the SDRM Paper is quite detailed (and deserving of a review in full), certain highlights can be noted as follows:

> (i) a member state with unsustainable debt would determine whether to activate the mechanism (with an open question remaining as to what role private creditors and/or the IMF might play in determining whether such sovereign's debts were truly unsustainable and thus subject to the mechanism's protections);[77]

---

[73] *See* Barbara Samuels**,** *Counsel on Foreign Relations: Key Recommendations from the Roundtable on Country Risk in the Post-Asia Crisis Era*, *at* http://www.cfr.org/publication.php?id=3810 (summarizing proposals from roundtable concerning sovereign debt).

[74] *See* Anne Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring* (November 26, 2001), *at* http://www.imf.org/external/np/speeches/2001/112601.htm; *see also* Mark A. Cymrot, *Barricades at the IMF: Creating a Municipal Bankruptcy Model for Foreign States*, 36 INT'L LAW. 1103 (2002) (discussing problem of foreign debt and IMF proposal).

[75] *See Battling Over the Bankrupt – Battles Over Sovereign Default*, THE ECONOMIST, October 5, 2002, *available at* 2002 WL 7247711 (discussing Sovereign Debt Restructuring Conference and international reaction); *see also* Anne Krueger, *Sovereign Debt Restructuring Mechanism – One Year Later* (Dec. 10, 2002), *at* http://www.imf.org/external/np/speeches/2002/121002.htm (updating IMF position on collective action clauses and debt restructuring statutory framework).

[76] International Monetary Fund, *The Design of the Sovereign Debt Restructuring Mechanism–Further Considerations* (November 27, 2002), *available at* http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf. (Nov. 27, 2002) [hereinafter International Monetary Fund].

[77] *Id*. at 9.

(ii) activation of the mechanism would not result in an automatic stay on individual litigation efforts;[78]

(iii) early in any proceeding, creditors committees would be established, with the debtor sovereign to bear the reasonable costs associated with operation of such committees;[79]

(iv) as a means of inducing financing for the debtor, certain new financings would be allowed to be excluded from the SDRM (i.e., not required to take the hair cut ultimately imposed upon other creditors by the mechanism) but only if supported by 75% in principal amount of registered claims;[80]

(v) generally speaking, most types of claims against the debtor sovereign would be "eligible" for restructuring, with the debtor sovereign to determine whether certain claims might be excluded (i.e. likely allowed to remain at par);[81]

(vi) certain claims would be deemed automatically ineligible for the restructuring, including claims held by international organizations (such as the IMF);[82]

(vii) secured creditor claims would be included within the restructuring only to the extent of their deficiency amount;[83]

(viii) upon activation of the mechanism, the sovereign debtor would be required to provide all creditors with information regarding its indebtedness;[84]

(ix) ultimately, the sovereign would be required to propose a restructuring plan (and, at that time, disclose to all creditors the nature of any claims that will be excluded from the restructuring);[85]

(x) subject to certain classification rules, creditors would approve the proposal by super majority vote of 75% per class, in which case

---

[78] *Id*.
[79] *Id*. at 10.
[80] *Id.*
[81] International Monetary Fund, *supra* note 76, at 8.
[82] *Id*. at 9.
[83] *Id*.
[84] *Id.*
[85] *Id.* at 10.

> the proposal would become binding on all creditors who had been notified that their claims were to be restructured;[86] and
>
> (xi) finally, certain disputes within the restructuring would be addressed by an IMF body, the Sovereign Debt Dispute Resolution Forum ("SDDRF").[87]

It should be noted that the SDRM is not the only proposal being considered by the IMF on the sovereign debt issue. Among other proposals the organization is considering is the institution of collective action clauses within all future sovereign bond documents.[88] Such collective action clauses would (1) allow a super majority of bondholders to bind individual bondholders to the terms of a restructuring (even those affecting payment rights) and (2) require a minimum percentage of bondholders to act collectively in any enforcement proceeding, thus limiting individual litigation. Such clauses would contractually require bondholders and sovereigns to work collectively toward restructuring efforts in the future. However, critics note that (1) such provisions will not affect restructurings in the near term, where older documents still remain in effect, and (2) will not serve to bring all creditors together when a sovereign has more than one bond issuance.

It, of course, remains to be seen how the IMF's SDRM proposal will develop and to what extent other efforts to promote sovereign debt restructuring will flourish. Given the evolving nature of the sovereign debt arena and the pace of sovereign debt restructuring efforts, it will behoove sovereign debt creditors to familiarize themselves with such efforts, so as to allow such creditors both to understand and to participate in the evolution of sovereign debt restructurings going forward.

CONCLUSION

As noted throughout this paper, the efficiency of mass-litigation efforts against defaulting foreign sovereigns may be decreasing. Moreover, the current state of voluntary restructuring practice is still relatively undeveloped and may lack in predictability, transparency, and equal treatment for creditors. Accordingly, the

---

[86] International Monetary Fund, *supra* note 76, at 10. Initially, the SDRM proposals called for an automatic stay upon activation. The most recent paper, after receiving creditor input, has done away with this concept. Importantly, according to the SDRM Paper, any creditor receiving a recovery through litigation efforts shall have its discounted SDRM claim reduced further by such amount. This, combined with the fact that the restructuring will ultimately bind all creditors, causes the SDRM Paper to conclude that a stay will not be necessary (as creditors should be discouraged from litigating due to the fact that, in order to receive an increased recovery, litigating creditors would need to both (i) complete their litigation/collection efforts prior to completion of the debtor's restructuring and (ii) receive more through such efforts than the restructuring ultimately provides similarly situated creditors). *See id.* at 34.

[87] *Id*. at 56.

[88] Horst Kohler, *Opening Remarks for the Sovereign Debt Restructuring Mechanism Conference* (Jan. 22, 2003), *available at* http://www.imf.org/external/np/speeches/2003/012203.htm.

time is now for parties involved in the sovereign debt arena to work toward establishing a more effective format for future restructurings. Given the increased focus on sovereign debt restructurings by financial institutions, industry groups, and international non-governmental institutions, as most recently illustrated by the IMF's SDRM proposal, parties affected by sovereign debtors would be well advised to familiarize themselves with such current developments and proposals so as to prepare for and have a voice in the development of forthcoming sovereign debt restructuring mechanics.