Fordham Law Review

Volume 64 | Issue 6 | Article 9

1996

Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings

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SOVEREIGN DEBT: THE RISE OF THE SECONDARY MARKET AND ITS IMPLICATIONS FOR FUTURE RESTRUCTURINGS

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Small debts are like small shot; they are rattling on every side, and can scarcely be escaped without a wound; great debts are like cannon; of loud noise, but little danger.[1]

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1. Letter from Samuel Johnson to Joseph Simpson, Esq. (1759), *in* James Boswell, The Life of Samuel Johnson 218 (Everyman's Library ed., Alfred A. Knopf, Inc. 1992) (1791).

INTRODUCTION

By all accounts, the sovereign debt crisis[2] of the 1980s has passed into history.[3] The event, which hobbled the development of Latin America for more than a decade and threatened the stability of the international financial system, is over. In the years after the crisis erupted, U.S. commercial banks averted financial ruin by steadily increasing their loan loss reserves, writing off nonperforming loans, and selling their sovereign loan assets in a growing secondary market for sovereign debt.[4] In addition, since the announcement of the Brady Plan in 1989,[5] banks have converted most of their outstanding sovereign loans to bonds, writing down a large percentage of the loans as part of the conversion process, and spreading the risk of future sovereign defaults among a larger class of creditors. Thus, over the course of more than a decade, banks have taken the bad loans off their books and the sovereign debtors have been afforded a measure of debt relief.

The economic challenges facing the debtor countries have not been eliminated, however. Indeed, Latin America's ratio of aggregate external debt to export earnings remains close to the ratio prevailing at the onset of the debt crisis.[6] Although no one is predicting an imminent Latin American sovereign default,[7] the transformation of the creditor class from a relatively small number of commercial banks to a

2. A sovereign debt crisis occurs when a country's foreign exchange reserves are insufficient to meet its foreign exchange payment obligations over an extended period of time. *See* Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. Ill. L. Rev. 401, 401.

3. *See, e.g.*, Hobart Rowen, *Third World Debt Crisis Has Come to an End*, Wash. Post, May 3, 1992, at H1; Bill Orr, *After a Decade, Bankers Say "Adios" to Latin Debt Crisis*, A.B.A. Banking J., July 1992, at 36 (noting that Argentina, Brazil, Chile, Mexico, and Venezuela, which collectively owed approximately 90% of the $41 billion that Latin American countries owed to U.S. commercial banks in 1992, had all either converted, or were in the process of converting, their bank loans to bonds).

4. *See infra* part I.D.

5. *See infra* part I.E.

6. Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 Stan. J. Int'l L. 305, 307-08 & n.21 (1995).

7. Indeed, recent budget confrontations between Congress and the executive branch briefly shifted concern to the hitherto unthinkable possibility, however remote, of a U.S. sovereign default. *See* Charles Jaffe, *U.S. Credit Rating at Risk of Downgrade, Firm Says*, The Boston Globe, Jan. 25, 1996, at 4; Isabelle Clary, *U.S. Treasury Has Talked About Default With Wall Street*, Reuters, Nov. 10, 1995. If history is of predictive value, however, the possibility of another Latin American debt crisis is too real to ignore. The first debt crisis involving the United States and Latin America occurred in September of 1873 after several Latin American nations declared themselves bankrupt and suspended payments on their debts to foreign creditors, triggering a crash of the New York stock market. *See* Carlos Marichal, A Century of Debt Crises in Latin America 99 (1989). Widespread Latin American sovereign defaults occurred again in the 1890s, *see* Barry Eichengreen & Richard Portes, *Settling Defaults in the Era of Bond Finance*, 3 The World Bank Econ. Rev. 211, 212 (1989), and in the 1930s. *See* Barry Eichengreen & Richard Portes, *Debt and Default in the 1930s: Causes and Consequences*, 30 Eur. Econ. Rev. 599, 621 (1986).

larger group of bondholders suggests that the complexity of sovereign debt restructuring in the event of another debt crisis will cause the last crisis to pale in comparison. That transformation calls for a reappraisal of both the creditor rights established in the wake of the debt crisis and the methods employed during the crisis for restructuring sovereign debt.

Consider the case of Debtor Republic, a hypothetical Latin American country. In the late 1970s, Debtor Republic borrowed $50 billion from U.S. commercial banks to finance infrastructure development projects. In 1982, Debtor Republic experienced a shortage of U.S. dollar reserves and announced that it was unable to repay its debts to the banks. Believing that Debtor Republic was experiencing only a temporary liquidity crisis, the banks agreed to extend by one year the maturity dates of their loans to the country. Moreover, because Debtor Republic was unable to pay interest on the loans, the banks agreed collectively to extend new loans in an amount sufficient to enable Debtor Republic to make its interest payments.

When the rescheduled loans matured in 1983, Debtor Republic again announced it was unable to repay them. Again the banks rescheduled the old loans and made new loans to cover the accrued interest, this time with the reluctant recognition that Debtor Republic would never be able to repay its debts in full. By 1988, the banks had rescheduled their loans to Debtor Republic four times. Collection suits were not an option; Debtor Republic had only $500 million of attachable assets in the United States. Even worse, the banks could not afford to write off their loans to Debtor Republic because they did not have sufficient reserves to cover the loss. By 1989, however, the banks had increased their loan-loss reserves sufficiently to enable them to write off eighty percent of their loans to Debtor Republic. Many of the banks began selling Debtor Republic's loan obligations to intrepid investors at twenty percent of face value and charging the remaining eighty percent against loan-loss reserves.

In 1990, Vulture Venture Fund, Inc., a small investment firm specializing in emerging markets, purchased from a large commercial bank a portfolio of rescheduled loans to Debtor Republic having a face value of $100 million and due to mature in 1994. Vulture Venture paid $20 million for the portfolio. Although Vulture Venture did not expect that Debtor Republic would be able to repay the full $100 million of principal in 1994, Vulture Venture was confident that Debtor Republic would eventually repay at least $20 million of principal. Moreover, the interest payments Debtor Republic was continuing to pay on the loans ensured that Vulture Venture would earn the high rate of return promised to its investors.

When its loans became due in 1994, however, Debtor Republic once again announced that it was unable to repay them. Determined to solve its debt problems once and for all, Debtor Republic requested that all its foreign creditors participate in a bold new debt conversion program, devised in cooperation with the U.S. government and the International Monetary Fund,[8] whereby all of Debtor Republic's outstanding loans would be converted into bonds at a substantial discount in principal amount and bearing fixed interest rates. All of Debtor Republic's creditors agreed to the conversion except Vulture Venture. On the announcement of the conversion plan, the secondary market price of Debtor Republic's loan obligations rose from twenty to twenty-five percent of face value. Instead of taking a $5 million profit by selling its Debtor Republic debt for $25 million in the secondary market, however, Vulture Venture served Debtor Republic with a notice of default and demanded payment of the full $100 million of outstanding principal. Debtor Republic refused to pay and Vulture Venture brought suit in a U.S. court, seeking to attach Debtor Republic's assets in the United States.

Debtor Republic's foreign creditors watched the suit with interest. Because they would not permit Vulture Venture to recover more pro rata than was being offered to them in the debt conversion deal, a face value recovery by Vulture Venture threatened to scuttle the deal. Washington, too, was interested in the suit. Debtor Republic's fragile new democratic government was being challenged by Marxist guerrillas resentful of "a decade of yankee economic imperialism" and calling for revolution. Completion of the conversion deal was crucial to Debtor Republic's economic recovery. Fleeing an already depressed economy, illegal immigrants from Debtor Republic were flowing into the United States, provoking a legislative backlash in California and other states against all immigrants. Should Vulture Venture win its suit?

If traditional contract principles are applied, the answer is surely "yes."[9] Vulture Venture is the assignee of a valid loan agreement and Debtor Republic has clearly breached the terms of the agreement. Standing in the shoes of its commercial bank assignor, Vulture Venture has the same right to collect the full face amount of the loan as did the original lender.[10] As the hypothetical suggests, however, the question is of more than purely legal concern; it has political, foreign policy, and humanitarian dimensions as well. The question must be addressed, therefore, with an understanding of the context in which Vulture Venture's collection rights were established, and of Vulture

8. *See infra* note 31 (discussing the establishment and purposes of the IMF).

9. For a court's answer, see *infra*, part III.B.

10. *See* E. Allan Farnsworth, Contracts § 11.8 (2d ed. 1990); *see also* John D. Calamari & Joseph M. Perillo, The Law of Contracts § 18-6 (2d ed. 1977) ("[T]he obligor may not assert as a defense the fact that the assignee did not provide [adequate] consideration for the assignment. An assignment is an executed transaction and requires no consideration." (footnote omitted)).

Venture's reasonable expectations in purchasing discounted sovereign debt.

The sovereign debt collection rights established in the wake of the debt crisis of the 1980s reflected, in large part, the judicial system's response to an unprecedented international economic calamity. In this respect, the creditor rights that arose out of that crisis are *sui generis*. They were established as an emergency measure designed to reduce the risks of U.S. banks already faced with the risk of ruin. Those risks have abated. Investing in Latin American sovereign debt is indeed still a risky business today;[11] but the threat of an imminent collapse of the world financial system has passed. Today, Latin American sovereign debt is held by investors enticed by the high rates of return available only on risky investments.[12] To the extent such investors have already been compensated for bearing the risks endemic in holding sovereign obligations, they receive a windfall when allowed to assert collection rights which have the effect, *ex post*, of reducing or eliminating the downside that those risks reflect. Moreover, although examples of market speculators using litigation to seek face value collection of sovereign debts purchased at steep discounts are isolated,[13] the trend may present an insurmountable obstacle to the successful resolution of a future debt crisis. The debt crisis of the 1980s was resolved, in large part, through the commercial banks' recognition of the need for shared sacrifice. A panoply of sovereign creditor rights which encourages debt collection by resort to litigation may foreclose opportunities for the collective negotiation and debt restructuring so crucial to resolving the last debt crisis.

This Note comprises four parts. Part I examines the origins of the sovereign debt crisis of the 1980s and describes the various plans instituted by the debtor countries and their creditors in response to the crisis. This part also examines the growth of the secondary market for sovereign debt and explains how secondary market investors acquired sovereign loan obligations at steep discounts from the face values of the original loans. Finally, this part describes how the securitization of sovereign loans has transformed the creditor class from a relatively small number of commercial banks to a comparatively much larger group of bondholders.

Part II examines the most frequently raised sovereign defenses to debt collection actions and evaluates the success of those defenses in litigation arising from the debt crisis of the 1980s. Sovereign defenses based upon Article VIII, section 2(b) of the IMF Articles of Agreement, sovereign immunity, the act of state doctrine, and the doctrine

11. *See* Martin Wolf, *On Sovereign Bankruptcies—Economic Eye*, Fin. Times, May 15, 1995, at 22 (citing the Mexican tesobono crisis of 1994 as an example of the risk).

12. *See* Michael Prowse, *The Rescuers: Why We Saved Mexico*, The New Republic, Feb. 27, 1995, at 11.

13. For two recent examples, see *infra* parts III.A-B.

of international comity are examined in succession. This part also explains why, although these defenses were largely unavailing in collection actions arising from the debt crisis, the commercial banks were nevertheless effectively barred from using litigation to collect on defaulted sovereign loans.

Part III examines in depth two recent collection actions brought against sovereign debtors in which secondary market purchasers of discounted sovereign debt attempted to avail themselves of the collection rights of their commercial bank assignors to recover the full face amount of defaulted sovereign debt. These cases suggest that the new class of sovereign creditors, like the commercial banks before them, remains free of the sovereign defenses described in part II. Unlike their commercial bank predecessors, however, these secondary market purchasers have a strong profit incentive to use litigation, rather than negotiation, to collect on defaulted sovereign loans, and are not subject to the same external pressures to refrain from so doing.

Part IV imagines a future sovereign debt crisis and concludes that, in the event of such a crisis, unrestrained collection actions will have a detrimental impact on attempts by debtor nations to negotiate a successful and orderly restructuring of their debts and return to economic stability. This part proposes appropriate limits on the use of litigation by creditors as a means of enforcing sovereign obligations in the event of a future debt crisis, and argues that courts should, on equitable grounds and in the interest of international comity, afford sovereign debtors certain basic protections of the U.S. Bankruptcy Code.

I. THE LAST SOVEREIGN DEBT CRISIS

The debt crisis of the 1980s has been voluminously chronicled[14] and a full inquiry into its causes and effects is beyond the scope of this Note. Although the precise origins of the crisis, and the question of who, if anyone, is to blame for it, are matters of continuing controversy, the basic facts presented here reflect the consensus of most commentators. Because today's sovereign debt markets developed in response to, and were an integral part of the resolution of, the crisis of the 1980s, an understanding of that crisis must inform any inquiry into a future sovereign debt crisis. Therefore, on the theory that past is prologue, this Note begins with a look at the last debt crisis.

14. *See generally* The International Debt Crisis in Historical Perspective (Barry Eichengreen & Peter H. Lindert eds., 1989) (collecting essays on the crisis in relation to past debt crises); John H. Makin, The Global Debt Crisis: America's Growing Involvement (1984) (discussing the origins of the crisis and the early years of its development); Alfred J. Watkins, Till Debt Do Us Part: Who Wins, Who Loses, and Who Pays for the International Debt Crisis (1986) (discussing U.S. and Latin American perspectives on the crisis).

A. *Origins of the Debt Crisis*

In the 1970s and early 1980s, U.S. commercial banks, with reserves swelled by deposits from wealthy oil producing nations,[15] lent unprecedented sums of money to less developed countries ("LDCs"),[16] particularly in Latin America.[17] World economic conditions made the loans attractive to both lenders and borrowers. From the lenders' standpoint, the economic recessions in many industrialized countries reduced the demand for capital in the developed world, thus forcing lenders to seek out alternative borrowers in the developing world.[18] During the first half of the 1970s, rising prices of Latin American exports made Latin American countries appear to be good credit risks.[19] From the borrowing countries' standpoint, rising U.S. inflation counteracted the high interest rates on the loans.[20]

This mutually favorable lending/borrowing environment came to an abrupt halt by the end of the 1970s. The oil crisis of 1979 forced the

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15. Unable to spend all of their oil revenues on imports, OPEC nations began depositing their "petrodollars" in U.S., European, and Japanese banks as the price of oil increased steadily throughout the 1970s. *See* Jon H. Sylvester, *Impracticability, Mutual Mistake and Related Contractual Bases for Equitably Adjusting the External Debt of Sub-Saharan Africa*, 13 Nw. J. Int'l L. & Bus. 258, 263-64 (1992). Having promised high interest rates as a means of inducing the OPEC nations to deposit their petrodollars, banks then competed with one another to reinvest the OPEC deposits in projects earning high rates of return. *See id.* at 288; Penelope Hartland-Thunberg, *Global Debt: Putting Humpty Dumpty Back Together Again*, Wash. Q., Winter 1986, at 94.

16. By the third quarter of 1982, the total indebtedness of the developing world stood at approximately $700 billion. Hartland-Thunberg, *supra* note 15, at 94. The imprecise and slightly pejorative term "less developed countries" is used in this Note only because it has become the term most widely used to refer collectively to the countries that experienced sovereign debt repayment difficulties in the 1980s crisis, and to the so-called "emerging market" countries that may experience similar difficulties in the future. Other terms, such as "sovereign debtors," "debtor countries," "borrower countries," and simply "countries," are used synonymously in this Note as context requires, always with an appreciation of their shortcomings.

17. *See* Stephen Jukes, *Debt Crisis Refuses to Go Away But May Be at a Turning Point*, Reuters, Dec. 12, 1989, available in LEXIS, NEWS Library, ARCNWS File. "Between 1973 and 1983, Latin American external debt rose from about $48 billion to about $350 billion, amounting to 58% of the gross regional product." MacMillan, *supra* note 6, at 311 n.31 (citing Pedro-Pablo Kuczynski, Latin American Debt 14 (1984)). In the middle of 1982, when the debt crisis erupted, the total debt of Latin America was approximately $295 billion, $90 billion of it owed by Mexico, $75 billion by Brazil, $30 billion by Argentina, $30 billion by Venezuela, and $15 billion by Chile. *Id.* at 312 n.37 (citing Pedro-Pablo Kuczynski, *Latin American Debt*, 61 Foreign Aff. 344, 349 (1983)). By early 1985, Mexico's foreign debt had risen to more than $96 billion, Brazil's to almost $100 billion, and Argentina's to approximately $45 billion. Jody D. Newman, *Exchange Controls and Foreign Loan Defaults:* Force Majeure *as an Alternative Defense*, 71 Iowa L. Rev. 1499, 1499 n.1 (1986). By the end of 1985, the total external debt of the seventeen most indebted LDCs had reached more than $445 billion. Robert K. MacCallum, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks* Inter Sese, 1987 Colum. Bus. L. Rev. 425, 426-27.

18. *See* Alberto G. Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. Rev. 66, 73 (1991).

19. *Id.* at 72.

20. *See id.*

debtor countries to increase borrowing to pay higher oil prices.[21] The worldwide recession of the early 1980s was accompanied by a fall in raw material prices, thus reducing the export revenues on which the debtor countries relied to service their loan obligations.[22] In addition, the U.S. Federal Reserve Board's decision to raise interest rates in 1981 had a doubly detrimental effect on the debtor countries; not only did the rate increase cause them to pay more in interest on their debts to U.S. banks,[23] but the accompanying reduction in the U.S. inflation rate resulted in a sharp increase in real interest rates on the loans.[24] These difficulties were compounded by the investment practices of the debtor countries, many of which allocated loan proceeds to inefficient development projects that failed to generate sufficient earnings to meet debt service obligations.[25]

In August of 1982, Mexico announced that it could no longer service its debts to foreign creditors,[26] primarily U.S. commercial banks. Brazil, Argentina, Bolivia, and Venezuela soon followed Mexico's example.[27] In the ensuing years, many LDCs throughout the world fell into arrears on their debts, and several countries suspended debt ser-

21. Sylvester, *supra* note 15, at 264. Although Angola, Nigeria, and Venezuela are oil exporters, the majority of LDCs buy oil on the international market. *Id.* at 264 n.30.

22. *See* Hartland-Thunberg, *supra* note 15, at 94 (noting that prices of LDC non-oil raw materials fell by an average of 30% in the 18 months after the end of 1980); Watkins, *supra* note 14, at 49; Sylvester, *supra* note 15, at 265.

23. Most of the loans had floating interest rates. Santos, *supra* note 18, at 72; Sylvester, *supra* note 15, at 265.

24. Santos, *supra* note 18, at 72.

25. *Id.* at 69 n.28, 74. Frequently, commercial banks made sovereign loans without the customary profitability analysis of individual investment projects. Believing that sovereign borrowers were immune from bankruptcy risk, lenders based their loan commitments mainly on the expected foreign exchange earnings of the borrower country, leaving the country free to invest the funds as it wished. *Id.* at 74; *see also* Watkins, *supra* note 14, at 22, 30-32.

In addition to the problem of unwise investment practices, a significant portion of the money loaned to Latin America eventually found its way back into the coffers of U.S. commercial banks in the form of "flight capital." One study of eight highly indebted Latin American countries estimated that for every dollar lent to the group, 30 cents was reinvested outside the country by Latin American nationals seeking higher rates of return than could be obtained at home. *See* Sylvester, *supra* note 15, at 289 n.192.

26. *See* Sylvester, *supra* note 15, at 265.

27. *See After the Debt Crisis*, Fin. Times, Aug. 1992; Alexander Nicoll, *Latin America Debt Crisis: Solution Passes the Test of Time*, Fin. Times, July 30, 1992, at 4. This initial series of near defaults rapidly unfolded into a global economic crisis of alarming proportions. The 25 years prior to 1982 had seen only 13 sovereign debt restructurings involving commercial bank creditors. Between the summer of 1982 and the spring of 1983, in contrast, 15 LDCs were involved, many simultaneously, in efforts to renegotiate the terms of about $90 billion of debt owed to commercial banks and other foreign creditors. *See* MacCallum, *supra* note 17, at 426.

vice altogether.[28] The resulting crisis threatened the stability of the international financial system.[29]

B. *The Commercial Banks' Response*

At the outset of the debt crisis in 1982, it was impossible to predict how the commercial bank creditors would respond to the prospect of a widespread default by the debtor countries. There is no regulatory or statutory framework for reorganizing the financial affairs of a foreign sovereign.[30] Moreover, from the beginning of the debt crisis in 1982 to late 1985, the United States did not formulate an official policy in response to the crisis, relying instead on commercial banks and the International Monetary Fund ("IMF")[31] to devise a solution through direct negotiation with the debtor countries.[32]

The banks' initial response to the crisis was to avoid defaults at all cost.[33] To this end, the banks rescheduled[34] the principal components of their sovereign loans as the loans matured, but insisted that interest

28. *See* Santos, *supra* note 18, at 66-67. By 1989, Argentina, Bolivia, Brazil, Costa Rica, Cuba, The Dominican Republic, Ecuador, Guatemala, Honduras, Nicaragua, Panama, Paraguay, Peru, and Venezuela had all fallen into arrears on principal payments for at least several months. *See id.* at 67 n.8.

29. *See* Nicoll, *supra* note 27, at 4. The event was

> an international financial crisis without precedent in modern history.
>
> . . . Along with the social and political impact felt by tens of millions in the developing world and particularly in Latin America, it resulted in a profound change in the business of international banking. It posed fundamental strategic business questions to thousands of banks worldwide, many of which had only recently ventured into international lending in the late 1960's and 1970's, and certainly threatened the survival of many banking institutions, both large and small.

Orr, *supra* note 3, at 36 (quoting former Citicorp chairman William R. Rhodes).

30. *See* Keith A. Palzer, *Relational Contract Theory and Sovereign Debt*, 8 Nw. J. Int'l L. & Bus. 727, 736 n.50 (1988); MacCallum, *supra* note 17, at 427-28.

31. The IMF is an international agency established pursuant to a multinational agreement signed at Bretton Woods, New Hampshire in 1944. In response to the worldwide depression of the 1930's and the world war it partially caused, the nations represented at the Bretton Woods Conference desired to mitigate the hardships caused by future economic recessions. The IMF furthers that goal by extending loans to member nations experiencing temporary balance of payments deficits. Such loans are intended to provide an alternative to the imposition of economic restraints which may adversely affect the economies of both the distressed country and of other nations. Newman, *supra* note 17, at 1509 n.89, 1510 n.92.

32. Santos, *supra* note 18, at 75.

33. *See id.*; *see also* Nicoll, *supra*, note 27, at 4 (noting that the essence of the strategy was "to buy time: stretch out the problem so that debtors could introduce economic changes necessary to restore creditworthiness, and allow creditors to build up their capital sufficiently to absorb the shocks").

34. In a rescheduling of debt, the lender allows payments due or to become due on an existing loan to be made at times later than those specified in the loan agreement. *See* MacCallum, *supra* note 17, at 430; Sylvester, *supra* note 15, at 265-66.

payments be made on schedule.[35] Because the debtor countries lacked sufficient dollar reserves to pay even the interest on their loans, however, the banks extended new loans to enable the countries to make interest payments. These bridge loans were motivated by notions of shared sacrifice. Each bank contributed an amount equal to a specified percentage of the bank's outstanding loans to the debtor country as of a specified base date.[36] In this way, no bank bore a disproportionate share of the cost of preventing a default. Except for these bridge loans, the banks sharply curtailed all new lending to the debtor countries.[37] This policy of "gap financing" prevailed until 1985.[38]

For the banks, the major benefit of the gap financing policy was that it allowed them to list their sovereign loans as "performing loans" on their balance sheets.[39] Regulatory and accounting rules required banks to declare a loan to be "nonperforming" if interest on the loan was not paid within ninety days after its due date. Banks were required to provide against nonperforming loans by setting aside adequate loan-loss reserves. Because the sovereign loan exposures of the largest banks amounted to well over 100% of the banks' capital in the early years of the crisis,[40] it simply was not possible for them to set aside the loan-loss reserves required to withstand a widespread default.[41] By lending new money to enable the debtor countries to make interest payments on schedule, the banks were able to avoid declaring

35. *See* Lee C. Buchheit, *The Evolution of Debt Restructuring Techniques*, Int'l Fin. L. Rev., Aug. 1992, at 10. From mid-1982 through the end of 1983, approximately $100 billion of LDC debt was rescheduled. Hartland-Thunberg, *supra* note 15, at 94.

36. *See* Buchheit, *supra* note 2, at 405; Lee C. Buchheit, *Legal Issues in Trading Sovereign Debt*, Int'l Fin. L. Rev., Feb. 1986, at 19-20.

37. Total bank lending to LDC borrowers decreased from $51 billion in 1982 to $15 billion in 1984. *See* MacMillan, *supra* note 6, at 326 n.110.

38. Santos, *supra* note 18, at 75.

39. *See* Lee C. Buchheit, *Alternative Techniques in Sovereign Debt Restructuring*, 1988 U. Ill. L. Rev. 371, 382-83. Buchheit notes that "[b]etween the two evils of making an involuntary loan to a less-than-creditworthy borrower, or allowing existing loan assets to slip into the 'non-performing' category, most banks tend to prefer the former." *Id.* at 375.

40. In 1982, the loan exposure of the nine largest U.S. commercial banks to sovereign debtors was over 250% of the banks' capital. MacMillan, *supra* note 6, at 327 n.117; Santos, *supra* note 18, at 82-83. Loan exposure to the five largest LDC debtors as a percentage of bank shareholders' equity was 254.7% for Manufacturers Hanover, 198.3% for Chase Manhattan, 179.6% for Chemical Bank, 178.6% for Citicorp, 166.8% for Bankers' Trust, 145.1% for Bank America, and 134.5% for Morgan Guaranty. MacMillan, *supra* note 6, at 312 n.38 (citing Anatole Keletsky, The Costs of Default 112, tbl. 6.3 (1985)).

41. *See* Macmillan, *supra* note 6, at 321 (noting that, "had interest payments not been made, the banks would have been required to set aside an enormous volume of loan-loss reserves, thereby significantly compromising their capital base").

their sovereign loans to be nonperforming, and thus to buy the time necessary to increase their loan-loss reserves.[42]

Not all banks, however, had the same interest in extending new loans to the debtor countries. For the most heavily exposed banks, new loans were the only alternative to insolvency. Banks having smaller sovereign loan portfolios, however, were better able to withstand a default, and viewed the prospect of extending new credit as throwing good money after bad. Knowing that the more exposed banks had no choice but to make new loans, the less exposed banks had no incentive to participate. By refusing to lend new money to a debtor country, a less exposed bank could maintain its existing exposure to the country with the assurance that the more exposed banks would not permit the country to default on interest payments.[43] This potential free-rider problem was solved by bringing to bear inter-bank peer pressure and various political pressures on banks that refused to participate in sovereign bridge loans.

Inter-bank peer pressure was commonly exerted through the mechanism of the bank advisory committee. Because of the large number of bank creditors,[44] it was impossible for a debtor country to negotiate a rescheduling with all of its creditors simultaneously. Therefore, creditor committees, usually consisting of between ten and fifteen members, were formed to represent the interests of the entire class of commercial bank creditors.[45] The chair of the committee was gener-

42. Thus, by making new loans in amounts sufficient to keep the debtor country current on its interest payments, the banks were able to forestall potentially much greater losses to their balance sheets. As Professor Andreas Lowenfeld explains:

> Assets of a bank basically consist of outstanding loans, and they remain on the [bank's financial s]tatement as assets so long as they are not in default. If a $1,000 loan carries ten percent annual interest, payable quarterly, it brings in $25 every three months; if the interest is not paid, say for two quarters it is considered a non performing loan and must be written down by 50% on the [balance sheet]; if non payment of interest continues further, the loan may have to be written off entirely. Thus, for $25 or $50 in additional funds used to keep interest payments current, a bank saves itself from a write-down of $500 o[r] a write-off of $1,000, a reduction in the asset side of the balance sheet that must be matched (once loan reserves are exhausted) by a corresponding reduction in earnings and (if those are insufficient) in net worth.

Sylvester, *supra* note 15, at 267 (quoting Andreas Lowenfeld, *The International Debt Crisis*, 17 N.Y.U. J. Int'l. L. & Pol. 485, 489 (1985)).

43. *See* MacCallum, *supra* note 17, at 435 (noting that smaller, regional banks, many of whom became holders of sovereign debt through participations in syndicated loans at the invitation of the larger "money-center" banks, generally felt that the larger banks should bear the burden of any required new lending).

44. More than 500 banks were involved in the Mexican debt restructuring of 1982-83, and some 750 banks were involved in Brazil's debt restructuring during the same period. *Id.* at 432.

45. *See id.* at 437. In this way, the commercial bank creditors, acting without the benefit of a body of law governing sovereign insolvencies, organized themselves into bodies strikingly similar to the creditor committees formed in an ordinary Chapter 11 case under the U.S. Bankruptcy Code. *See* 11 U.S.C. §§ 1102, 1103 (1994).

ally filled by the bank holding the largest claim against the debtor country, and other committee members were selected from among the country's major bank creditors based upon the geographic concentration of the loans.[46] The official role of the committee was to serve as a conduit of information between the debtor country and its creditors. Although the advisory committee negotiated restructuring terms directly with the debtor country, the committee could not unilaterally impose those terms on dissenting banks. In practice, however, bank advisory committees were able to exert considerable peer pressure on banks reluctant to commit new funds to a country.[47] Because advisory committees had superior access to information concerning the debtor countries' economies and repayment intentions, the general creditor community had strong incentives to accept an advisory committee's restructuring proposals.[48]

Pressure was also exerted on free-rider banks from official sources. The IMF instituted a practice of conditioning new IMF loans to a debtor country upon the commitment of all of the country's commercial bank creditors to extend bridge loans to the country.[49] The IMF also required debtor countries to implement austerity programs[50] monitored by the IMF as a condition to receiving IMF loans.[51] For their part, the commercial banks viewed the implementation of austerity measures as essential for the debtor countries to regain the financial health necessary to repay their bank loans.[52] All parties were thus dependant upon one another: the banks deemed it essential that the debtor countries implement austerity programs; the debtor countries would not implement austerity programs unless the IMF extended loans; the IMF would not make loans unless the commercial banks extended bridge loans.[53] The result of this triangular depen-

46. *See* MacCallum, *supra* note 17, at 437-38.

47. *See* Santos, *supra* note 18, at 99-100, nn.225-28.

48. In practice, the "information gap" between the advisory committees and the general creditor community forced smaller banks to respond to restructuring proposals without substantial analysis, and led to the perception, among the smaller banks, that restructuring plans were essentially presented for their execution as "a *fait accompli* in which they . . . had little meaningful input." MacCallum, *supra* note 17, at 438.

49. For example, the IMF refused to participate in the 1983 Mexican restructuring until all of Mexico's commercial bank creditors had agreed to increase their existing loan exposure by seven percent. *See* MacMillan, *supra* note 6, at 319 n.76.

50. Such austerity plans typically included efforts to balance current accounts by restricting imports, devaluing local currency in order to move toward "realistic" exchange rates, and balancing domestic budgets. *See* Orr, *supra* note 3, at 36.

51. *See* MacCallum, *supra* note 17, at 430.

52. Avoiding default was also important to the debtor countries, even though it meant incurring new debt to pay interest on old loans. A default in interest payments, the debtor countries believed, would impair their access to capital markets in the future and increase the cost of obtaining credit to finance necessary development projects.

53. *See* MacMillan, *supra* note 6, at 320.

dency was a "quid pro quo system" in which action was taken either collectively or not at all.[54]

Finally, a measure of control over potential free-rider banks was exerted by the federal bank regulatory system.[55] Under the International Lending Supervision Act of 1983,[56] federal bank regulators were given increased powers to require banks to set aside reserves against their loans to sovereign debtors experiencing a "protracted inability . . . to make payment on their external indebtedness."[57] Because regulators had broad discretion to determine whether a bank's exposure to a country required an increase in its loan-loss reserves,[58] regulators were able to cajole reluctant banks into rescheduling their outstanding loans and extending new loans when requested.[59] Recalcitrant free-rider banks might receive "friendly" calls from federal bank regulators, urging the bank to participate in a bridge loan to a country or face a review of its loan-loss reserves.[60]

Notwithstanding the effectiveness of these pressures, bank solidarity strained as the first round of rescheduled loans began to mature and the debtor countries again announced that they were unable to pay principal.[61] After several more rounds of rescheduling,[62] it be-

54. *Id.* at 319.

55. Regulation of U.S. banks falls under the combined jurisdiction of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. Together, these bodies are responsible for promulgating and overseeing compliance with lending and reserve requirements. *See* Palzer, *supra* note 30, at 742 n.82.

56. 12 U.S.C. §§ 3901-3912 (1994).

57. *See id.* § 3904(a)(1)(A); 12 C.F.R. §§ 20.8(b)(2)(ii)(1), 211.43(b)(2)(ii)(1), 351.1(b)(2)(ii)(1) (1995). For more on the International Lending Supervision Act of 1983, see generally, Cynthia C. Lichtenstein, *The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983*, 25 Va. J. Int'l L. 401 (1985).

58. *See* 12 U.S.C. § 3904(a)(1) (1994).

59. *See* MacCallum, *supra* note 17, at 435 n.36 (noting that "the mere intimation of the possibility of enacting legislation or the taking of other action would ordinarily be sufficient to obtain adhesion to national policy").

60. *See* Palzer, *supra* note 30, at 745 n.97 (noting that bank regulators used their authority "to impose a minimum level of reserves on banks which refuse[d] to follow the market"). Moreover because regulators had oversight responsibilities for many of the banks' other operations, "failing to sign onto an important restructuring might result in sanctions applied to [a] bank's other business activities." *Id.* at 746 n.101. Indeed, although there is little direct evidence of their influence on restructuring efforts, anecdotal accounts suggest that federal bank regulators were less than evenhanded in carrying out their oversight responsibilities and exerted considerable pressures on potential free rider banks. *See id.*

61. Mexico's 1983 debt rescheduling, for example, had been praised as a model for other sovereign debt restructurings. Three years later, however, Mexico was unable to meet its obligations on the rescheduled loans and entered negotiations culminating in a $97 billion re-rescheduling. MacCallum, *supra* note 17, at 427.

62. Sixty-eight countries restructured their official or commercial bank debts between 1980 and 1994. Eleven countries, including Argentina and Mexico, restructured their debt 10 or more times. Mexico, for example, underwent 12 restructurings between 1983 and 1990. Wolf, *supra* note 11, at 22.

came apparent to both the banks and the debtor countries that the rescheduling policy was not a long-term solution to the debt crisis. Although the policy had succeeded in staving off a collapse of the banking system, the debtor countries had not "grown out" of the crisis as many banks had predicted would happen.[63] Instead, by borrowing new money to pay interest on old loans, the debtor countries had merely increased their debt burden without improving their economic health.[64] The need for a new approach was apparent.[65]

C. *The Baker Plan*

On October 9, 1985, at the annual meeting of the World Bank and the IMF, U.S. Secretary of the Treasury James A. Baker announced a plan to solve the debt crisis.[66] Baker's proposal called on commercial banks to make $20 billion in new loans to the fifteen most highly indebted LDCs[67] over the course of the three years between 1986 and 1988.[68] Under Baker's plan, the IMF, World Bank, and other multilateral lending institutions would contribute an additional $9 billion in new loans over the same three-year period.[69] In exchange for these loans, Baker called on the debtor countries to implement austerity plans monitored by the IMF.[70]

Although the Baker Plan had the virtue of recognizing that the debt crisis was not merely a temporary disruption, but instead required long-term solutions, the plan met with limited success. Except for its call for $29 billion in new loans, the Baker Plan did not differ substantially from the rescheduling process that had developed between the banks and the debtor countries during the first three years of the crisis. The basic elements of the Baker Plan—rescheduling principal while lending new money to keep interest payments current—re-

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63. As MacMillan notes, "two optimistic assumptions undergirding the original approach to the crisis—that there would be economic recovery leading to a rise in commodity prices, and that there would be renewed voluntary lending—had proven incorrect." MacMillan, *supra* note 6, at 326.

64. The aggregate external debt of the seventeen most indebted LDCs increased from $391 billion in 1982 to approximately $529 billion in 1988. MacMillan, *supra* note 6, at 313 n.41 (citing 1 World Bank, World Debt Tables: External Debt of Developing Countries: 1988-89 Edition at xvii (1988)).

65. *See* Jukes, *supra* note 17 (quoting one IMF official as saying of the debt crisis' early years: "We were all aware that we were preventing a crisis rather than devising a solution.").

66. *See* Statement by the Honorable James A. Baker, III, Secretary of the Treasury of the United States, before the Joint Annual Meeting of the IMF and World Bank, Oct. 8, 1985, Seoul, South Korea, *reprinted in* U.S. Department of Treasury News, Oct. 8, 1985, at 4-5 [hereinafter Baker Statement].

67. The "Baker fifteen" were Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia. Santos, *supra* note 18, at 67-68 n.12.

68. Baker Statement, *supra* note 66, at 9.

69. *Id.*

70. Santos, *supra* note 18, at 76 & n.76; *see* Sylvester, *supra* note 15, at 268-69.

mained the same.[71] Moreover, net lending to the debtor countries under the Baker Plan did not approach the $29 billion target.[72] As the principal amounts of rescheduled loans began to mature, and the debtor countries requested yet another round of reschedulings, the banks became increasingly weary of what they perceived to be an endless cycle of rescheduling and bridge loan requests. The debtor countries also began to tire of the rescheduling process, realizing that by incurring new debt to keep current their interest payments on old loans they were merely increasing their debt burden for the benefit of the banks.[73] The Baker Plan thus failed to redress the problem of the debtor countries' mounting debt burdens—the principal shortcoming of the rescheduling process that had evolved during the early years of the crisis.

D. *The Secondary Market*

Shortly after the first round of debt reschedulings, a small market for sovereign loan assets developed among the commercial banks.[74] At first, trading in sovereign debt took the form of inter-bank swaps. Bank I would consolidate its portfolio of loans to Country A and exchange the portfolio for Bank II's portfolio of loans to Country B, a country in which Bank I placed more confidence.[75] Sovereign loans were typically exchanged in an "as is" condition; neither bank made any representations or warranties to the other as to the ultimate collectibility of the loans.[76] In addition, the assignments by which such

71. *See* Buchheit, *supra* note 35, at 11.

72. Santos, *supra* note 18, at 77. Santos notes that, although new loans to the debtor countries totaled over $20 billion between 1985 and 1988, "the 'Baker Fifteen' paid interest in excess of this amount in 1988 alone." *Id.*; *see also* Sylvester, *supra* note 15, at 269 n.69 (noting that from 1985 to 1987 "the seventeen most highly indebted countries that were to be the primary beneficiaries of the Baker Plan paid $74 billion more than they received from private commercial banks and multinational lending institutions" (citation omitted)).

73. *See* Buchheit, *supra* note 35, at 11.

74. Michael M. Chamberlin & Thomas E. Winslade, *Regulating the LDC Debt Markets*, Int'l Fin. L. Rev., Aug. 1992, at 16, 16.

75. *See id.*; Jonathan Fuerbringer, *A Hot Market Emerges for the Third World's Bad Loans*, N.Y. Times, Dec. 23, 1990, § 3, at 10. There are numerous reasons why a bank might prefer to hold the debt instrument of country A over that of country B. For example, a bank might have a better relationship with country A and might therefore have a better chance of being repaid by that country. In addition, some banks were subject to regulations that required a write-down of loans to borrowers in particular countries. Banks subject to such regulations obviously sought to swap their loans to such countries for loans that did not require a mandatory write-down. Buchheit, *supra* note 36, at 18 (noting that "as long as each side regards the credits it would acquire as marginally less impaired than those it would give up, then an asset trade deal is possible").

76. As one commentator notes:

> [T]o say that a debt obligation is valid and enforceable may suggest that the seller believes that the amount involved is actually recoverable in the sense that if the obligor cannot or will not pay at the appropriate time, adequate

swaps were effected typically contained provisions whereby the assignee bank assumed responsibility for responding to any future requests by the debtor country for bridge loan commitments based upon the exposure level represented by the assigned debt.[77]

As the debt crisis deepened and banks confronted the prospect of repeated reschedulings and bridge loan requests, many banks became willing to sell their sovereign loan assets to third party investors for cash, even if such sales meant offering steep discounts from the face value of the loans.[78] By selling off a portion of a sovereign loan, banks were able to reduce their percentage of the aggregate outstanding loans to the debtor country, and thus to reduce the amount they would be asked to contribute in future bridge loans to the country. Some banks, especially the less exposed banks, decided to sell off their sovereign loan portfolios entirely.[79] Because banks that sold sovereign debt at a discount from its face value were required to record a loss equal to the amount of the discount, the discount tended to reflect the likelihood that the face value of the debt would ever be repaid in full.[80] As it became increasingly evident that the debtor countries were insolvent and would never be able to repay the full amount of their debts, sovereign debt prices in the secondary market fell even further.[81]

Despite the fact that the sovereign debts would never be fully repaid, the secondary market was highly attractive to certain types of investors. Many secondary market debt purchasers were corporations seeking to make equity investments in the debtor country and needed local currency to purchase plants and equipment. For their part, many debtor countries were willing to exchange their dollar-denominated debt obligations for an equivalent amount of local currency.[82] Thus,

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> remedies exist in order to compel repayment of the debt. Because the reason for many [sovereign debt exchanges] is the disposition of assets whose collectibility (or at least timely collectibility) is speculative, sellers tend to see in this representation and warranty a basis on which the purchaser may later seek recourse to the seller should the borrower default.

Buchheit, *supra* note 36, at 19. Purchasers were thus required to represent that they had "formed an independent judgment on matters such as the creditworthiness and financial status of the borrower." *Id.*

77. *See id.* at 20.

78. Sylvester, *supra* note 15, at 272; Buchheit, *supra* note 2, at 402.

79. *See* Fuerbringer, *supra* note 75, at 10; *Third World Debt: At the Discount Store*, The Economist, Mar. 12, 1988, at 74.

80. Alfred J. Puchala, *Securitizing Third World Debt*, 1989 Colum. Bus. L. Rev. 137, 149.

81. *See* MacMillan, *supra* note 6, at 328 n.120 ("In 1986 the average price of the regional debt had already sunk to 65% of its nominal value, and it continued on a constant downward course until it hit 28% in 1989." (quoting Inter-American Development Bank, Economic and Social Progress in Latin America: 1990 Report 18 (1990))).

82. Indeed, from the debtor countries' standpoint, the most attractive feature of such swaps was that they enabled the countries to repay their dollar-denominated debts using their own currencies, rather than using scarce dollar reserves. Of course,

investors could engage in debt-for-equity swaps with a debtor country by purchasing the country's discounted debt with dollars and then selling the debt instrument back to the country for local currency.[83] The investor would then use the local currency to finance its investment in the country.[84] Investors profited from such swaps because they purchased the debt from a commercial bank at a substantial discount.[85] If the debt was subsequently redeemed for its full value in local currency, the swap could be "very advantageous compared to a purchase of local currency on the open market at prevailing exchange rates."[86] The debtor countries also benefitted from such swaps because the reduction of their outstanding debt principal reduced the amount of interest that would otherwise accrue on their debts.[87]

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because many of the debtor countries needed to print more local currency in order to redeem their debt instruments from equity investors, debt-for-equity swaps had a tendency to cause inflationary pressures within the debtor country. *See* Sylvester, *supra* note 15, at 272-73.

83. *See id.* (describing the paradigmatic debt-for-equity swap transaction); Eric N. Berg, *Debt Crisis: Fresh Approaches*, N.Y. Times, May 5, 1987, at D1.

84. In one such swap, Ford Motor Company bought face value $50 million of Mexican debt for only $29 million. Ford then sold the debt to the Mexican government for $43.5 million in local currency and used the proceeds to establish an assembly plant in Mexico. *See* Priya Alagiri, Comment, *Give Us Sovereignty or Give Us Debt: Debtor Countries' Perspective on Debt-For-Nature Swaps*, 41 Am. U. L. Rev. 485, 490-91 (1992).

Another innovative idea for the exchange of sovereign debt for local investment was the debt-for-nature swap. Unlike the purchaser in a debt-for-equity swap, the purchaser of sovereign debt in a debt-for-nature swap, usually an international environmental organization, does not take title to an asset in the debtor country. Instead, the purchaser obtains a commitment from the country to protect an endangered habitat or to commit funds to environmental conservation projects within the country. *See* Rosanne Model, Comment, *Debt-for-Nature Swaps: Environmental Investments Using Taxpayer Funds Without Adequate Remedies for Expropriation*, 45 U. Miami L. Rev. 1195, 1197 (1991). In the first completed debt-for-nature swap, for example, Conservation International, a nonprofit environmental organization, purchased $650,000 of Bolivia's bank debt at an 85% discount on the secondary market. CI then entered into an agreement with Bolivia under which CI exchanged its Bolivian debt instruments in exchange for Bolivia's commitment to pass legislation protecting the country's Yacuma Regional Park, Cordebeni Water Basin, and Beni Biosphere Reserve. Alagiri, *supra*, at 495 & n.56; *see* Sylvester, *supra* note 15, at 274.

85. *See* Richard Lapper, *Conversion Deals Are Back in Fashion*, Fin. Times, Feb. 6, 1995, at 26 (noting a resurgence in the number of debt-for-equity conversion deals following a drop in sovereign debt prices).

86. Buchheit, *supra* note 2, at 411.

87. *Id.* at 390. Buchheit notes that, as a result of a debt-for-equity swap,

> (a) the foreign investor will have obtained the local currency necessary to capitalize the local company at a highly favorable effective exchange rate . . . ; (b) the local company will have received an infusion of new capital without resorting to local borrowing; (c) the commercial bank will have received cash in hand for a loan whose ultimate repayment by the borrower was not expected to take place, if at all, until the indefinite future; and (d) the debtor country will have simultaneously (i) reduced its aggregate stock of external debt, (ii) encouraged foreign investment in a domestic industry and (iii) possibly removed a cantankerous lender from its creditor group.

The steep discounts in the secondary market prices of their debt prompted some debtor countries to repurchase the debt instruments directly from their bank creditors.[88] By eliminating the middleman of the equity investor, the debtor country could benefit directly from the discount.[89] Moreover, in contrast to reschedulings, direct debt buybacks reduced the country's debt burden. Of course, even at a steep discount, the country needed U.S. dollars to repurchase its debt, and many banks felt that any dollar reserves available for debt buy-backs should be applied first to amortizing old loans. Moreover, banks were acutely aware that, in many cases, the debtor country's dollar reserves consisted entirely of the proceeds of the bridge loans the banks had been essentially forced to make.[90] For this reason, debtor countries that attempted to buy back their debt obligations without the knowledge and consent of their bank advisory committees risked arousing the ire of the banking community.[91]

As more banks began to sell their sovereign loan portfolios and offer steeper discounts from the face value of the loans, the secondary market for sovereign debt began to attract investors having no intention of making equity investments in the debtor countries. Investors began to purchase sovereign debt with the sole intention of speculating on short-term appreciation in the value of a country's debt as its

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Id. at 403. According to one source, more than $27 billion of sovereign debt was converted into equity investments between 1984 and 1989. *See* James R. Kraus, *Corporate Finance Fees Rekindle Banks' Interest in Latin America*, Am. Banker, Nov. 15, 1989, at 1.

88. For example, in 1988, Bolivia bought back $240 million of its commercial bank debt for only 11% of its face value and Chile repurchased $300 million of its debt at 56% of face value. Santos, *supra* note 18, at 77-78 n.88 (citing J.P. Morgan & Co., *LDC Debt Reduction: A Critical Appraisal*, World Fin. Mkts., Dec. 30, 1988, at 6).

89. Capturing the benefit of the debt discount for themselves was not the debtor countries' only reason for wanting to eliminate the equity investor. As more debt-for-equity and debt-for-nature swaps were completed, many debtor countries began to view such exchanges as an infringement on their sovereignty. *See* Alagiri, *supra* note 84, at 496-503; *see also* Berg, *supra* note 83, at D1 (noting political scientists' fears that increased foreign ownership of domestic industries might lead to violence).

Moreover, to the extent such swaps took funds that were already committed to a country in the form of debt and recast them as equity investments,

> the country receive[d] no net inflow of fresh funds. If one believes that certain investors would make investments in the country regardless of whether a debt/equity conversion program is in place, then such a program arguably results in the loss of an opportunity for fresh investment by allowing those investors to rechurn funds already committed to the country.

Buchheit, *supra* note 2, at 404-05.

90. *See supra* text accompanying notes 43-60. Bankers were also fearful that permitting countries to repurchase their debt directly on the secondary market would create a moral hazard. Because secondary market prices of sovereign debt inevitably decrease following a default, a country contemplating a buy-back of its debt has an incentive to default in order to benefit from the lower purchase price.

91. Peru, for example, recently accomplished a covert buy-back of its sovereign debt, prompting a predictably angry response from its bank creditors. *See Peru's Cut Rate Debt Buyback Irks Creditors to the Tune of Billions*, Agence France Presse, Sept. 11, 1995, available in LEXIS, NEWS Library, CURNWS File.

economy improved.[92] Although few, if any, of these investors expected that the debtor countries would ever be able to repay the full face amount of the principal, the steep discounts available in the secondary market ensured investors a profit if the countries repaid even a small percentage of the face amount.[93] Moreover, because the interest accruing on the debts was based upon the face value of the outstanding principal, the interest payments on a debt purchased below face value yielded an above-market rate of return.[94]

The secondary market has grown steadily since its inception, enabling banks to exit from the rescheduling process and allowing investors to acquire billions of dollars in face amount of sovereign loan obligations at steep discounts from the face values of the loans. Because there is no formal reporting system for sovereign debt trading, exact figures for the amount of debt traded annually on the secondary market do not exist.[95] In 1986, the World Bank estimated the volume of secondary market sovereign debt sales at $7 billion.[96] By 1993, the figure had reached $273 billion.[97] Most importantly, the development of a large and active secondary market for sovereign debt set the stage for the final solution of the debt crisis—the securitization of sovereign loans under the Brady Plan.

E. *The Brady Plan*

By gradually setting aside loan-loss reserves,[98] the banks had, by 1989, gained the ability to write off large portions of their sovereign loans, and to withstand pressures to lend new money.[99] In addition,

92. *See* Tracy Corrigan, *Picking Up the Pieces of an Emerging Market*, Fin. Times, Apr. 5, 1994, at 17.

93. MacMillan, *supra* note 6, at 328.

94. *See* Corrigan, *supra* note 92, at 17 (noting that returns on capital as high as 40% began to attract institutional investors, emerging markets investment funds, and so-called "flight capital" held offshore by wealthy Latin American nationals).

95. James R. Kraus, *Trading in Third World Debt Soars as Investors Rush In*, Am. Banker, Sept. 17, 1991, at 10.

96. *See* Eve Burton, *Debt for Development: A New Opportunity for Nonprofits, Commercial Banks, and Developing States*, 31 Harv. Int'l L. J. 233, 236 (1990).

97. Tracy Corrigan, *Emerging Market Debt Trading Volume More Than Doubles*, Fin. Times, Aug. 16, 1994, at 23.

98. The LDC loan-loss reserves of the nine largest U.S. commercial banks increased from an average of 5% of book value in 1982 to approximately 50% of book value by the middle of 1990. Santos, *supra* note 18, at 83. In 1987, Citibank stunned the financial world by setting aside $3 billion in reserves against possible losses on its loans to developing countries. Orr, *supra* note 3, at 36. Other banks soon followed suit. In 1989, J.P. Morgan & Co. became the first bank to reserve 100% against its non-trade related Latin American loans. Paul Craig Roberts, *Development Banks: An Idea Whose Time Has Gone*, Bus. Wk., July 11, 1994, at 28 (noting that the write-off made clear to the financial community "what had been obvious for years: The full value of the debt would never be repaid.").

99. In 1982, when the debt crisis began, the LDC exposure of the nine largest U.S. commercial banks amounted to more than 250% of the banks' capital. By 1990, largely by increasing loan-loss reserves, those nine banks had reduced their exposure

the rapid growth of the secondary market underscored the depth of investor interest in sovereign debt instruments paying high rates of return. Most importantly, it had become clear that the most heavily indebted countries would never regain financial stability without some form of debt and debt service reduction.[100] In March of 1989, then U.S. Secretary of the Treasury Nicholas Brady, recognizing this changed climate, announced a new initiative designed to encourage banks voluntarily to reduce the debt burdens of LDC debtors.[101] The Brady Plan thus went beyond the Baker Plan by urging forgiveness of a portion of the loans.[102]

The primary innovation of the Brady Plan, however, was to "securitize" sovereign loans by converting loan obligations into bonds, now known as Brady bonds. Under a Brady Plan securitization, the bank 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. 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.[103] 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.[104]

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to well below 100% of capital. *See* Santos, *supra* note 18, at 82-83. *See also* MacMillan, *supra* note 6, at 313 (noting that "[c]reditor solidarity lost both its purpose and its strength as the collective threat to world financial stability ended").

100. *See* Pierre Francotte, *The Role of the International Financial Institutions*, Int'l Fin. L. Rev., Aug. 1992, at 13. Bankers increasingly recognized that their previous attempts to solve the debt crisis had failed to deal with the heart of the problem, specifically, "that [the] countries [did] not have—and [were] unlikely for many years to have—enough dollars to make their interest payments, let alone pay back principal." Berg, *supra* note 83, at D1.

101. *See* Nicholas F. Brady, Remarks to the Brookings Institute and Bretton Woods Committee Conference on Third World Debt (Mar. 10, 1989), *in* Brookings Dialogues on Public Policy, Third World Debt: The Next Phase 69-73 (Edward R. Fried & Philip H. Trezise eds., 1989). Secretary Brady urged commercial banks to "work with debtor nations to provide a broader range of alternatives for financial support, including greater efforts to achieve both debt and debt service reduction and to provide new lending." *Id.* at 73.

102. Congress endorsed the principles of the Brady Plan in the International Debt Management Act, 22 U.S.C. §§ 5321-5333 (1994), urging debtors and commercial bank creditors to recognize that current approaches to the debt problem should focus on "a reduction in current debt service obligations." *Id.* § 5322(8).

103. *See* Puchala, *supra* note 80, at 137-38.

104. As in the reschedulings that occurred during the early years of the crisis, political pressures were brought to bear on banks that refused to participate in Brady Plan securitizations. On September 26, 1989, the House Banking Committee approved by voice vote a measure designed to spur banks into cooperating with the Brady Plan. Had it been enacted, the bill would have directed federal bank regulators to require banks to maintain significantly higher reserves for loan losses than were currently required. Regulators would have been given the authority, however, to assign

Securitization also benefits the sovereign debtors because Brady bonds are issued at a discount in either principal or interest from the loans from which they are converted, thus reducing the sovereign's debt service obligations. In a typical Brady Plan securitization, banks may choose from a menu of Brady bond options to receive in exchange for their sovereign loan assets. The most common Brady bond options are par and discount bonds. Par bonds are issued in a principal amount equal to the face value of the loans from which they are converted, but carry a reduced, fixed interest rate.[105] Discount bonds, in contrast, carry a floating interest rate[106] but are issued at a discount in principal from the face value of the loans from which they are converted. In addition, most Brady bonds mature thirty years after their issuance date,[107] considerably longer than the maturities of the bank loans from which they are converted.

Another important feature of Brady bonds is their collateral and protective covenants. The principal components of both par and discount Brady bonds are collateralized by zero-coupon U.S. Treasury bonds of matching maturities purchased by the debtor country.[108] Interest on Brady bonds is collateralized for between twelve and eighteen months.[109] Brady bonds also contain "exit covenants" whereby the sovereign issuer promises not to request a restructuring of its obligations on the bonds. Any such request violates the exit covenant and constitutes an event of default.[110] In spite of their collateral and protective covenants, however, Brady bonds are not risk-free investments.[111] Under the terms of the bonds, bondholders may not access

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favorable risk ratings to loans extended as part of a Brady-style financing package. As a result, banks that balked at participating in the Brady Plan would have had to maintain much higher reserves than those that did not take part. *See* Paul Blustein and Hobart Rowen, *Bush Seeks Banks' Aid On Debt: President Lobbies For Plan to Help Third World Nations*, Wash. Post, Sept. 27, 1989, at A1.

105. *See Sovereign Debt: Take a Closer Look*, The Banker, Mar. 1995, *available in* LEXIS, NEWS Library, CURNWS File.

106. *See id.* Interest on par bonds is generally computed semi-annually at a rate equal to 13/16 of one percent above the prevailing six-month LIBOR rate. Prospectus of HT Insight Funds Inc., Jan. 30, 1996, at 9-10, *available in* LEXIS, STSEC Library, FILING File [hereinafter Insight Prospectus].

107. *See Sovereign Debt: Take a Closer Look*, *supra* note 105.

108. *See* Insight Prospectus, *supra* note 106, at 9-10. Zero-coupon bonds are bonds on which the issuer makes no periodic interest payments. Instead, the bonds are issued at a discount from their face value which represents the issuer's interest cost for the borrowing. At maturity, the issuer pays the full face amount of the bonds. *See* Black's Law Dictionary 181 (6th ed. 1990).

109. *See* MacMillan, *supra* note 6, at 314-15; *S&P Says it Will Rate More Brady Debt*, Reuters, Apr. 27, 1995, *available in* LEXIS, NEWS Library, CURNWS File.

110. *See* Buchheit, *supra* note 35, at 12.

111. *See* Helen Smith, *Latin American Bonds: Are They Replacing Junk?*, Reuters, Aug. 12, 1991, *available in* LEXIS, NEWS Library, ARCNWS File (noting that, "[l]ike junk bonds, [Brady] bonds are rated below investment grade and offer high yields against potential risks"). *See also* Insight Prospectus, *supra* note 106, at 10 (disclosing that, with respect to partially collateralized and uncollateralized Brady Bonds, the fund "will be relying for payment of interest and . . . principal primarily on the

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.[112] Interest collateral would be expended if a default lasted more than eighteen months. Moreover, some Brady bonds are not secured by any collateral.[113] Imaginative bond traders have even created so-called "stripped" Brady bonds by trading separately the interest and principal components of originally secured Brady bonds.[114] As their name suggests, stripped Brady bonds are not secured by any principal or interest collateral.

Since the first Brady Plan securitization, for Mexico in March of 1990, Costa Rica, Venezuela, Uruguay, Argentina, and Brazil have all converted their outstanding bank loans to Brady bonds.[115] Other

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willingness and ability of the foreign government to make payment in accordance with the terms of the Brady Bonds"); Prospectus of Loan Asset Management Trust, Jan. 24, 1996, *available in* LEXIS, STSEC Library, FILING File ("Brady Bonds are often viewed as three or four valuation components: (i) the collateralized repayment of principal at final maturity; (ii) the collateralized interest payments; (iii) the uncollateralized interest payments; and (iv) any uncollateralized repayment of principal at maturity (these uncollateralized amounts constitute residual risk). In light of the residual risk of Brady Bonds and, among other factors, the history of defaults with respect to commercial bank loans by public and private entities of countries issuing Brady Bonds, investments in Brady Bonds are considered speculative."); Prospectus of Warburg Pincus Funds, Dec. 29, 1995, *available in* LEXIS, STSEC Library, FILING File ("Brady Bonds have been issued only recently and therefore do not have a long payment history. However, in light of the history of commercial bank loan defaults by Latin American public and private entities, investment in Brady Bonds may be viewed as speculative.").

For an even stronger, more conservative assessment of Brady Bond default risks, see Prospectus of Strong Conservative Equity Funds Inc., Jan. 15, 1996, at 22-23, *available in* LEXIS, STSEC Library, FILING File ("Holders of sovereign debt, including the Fund, may be requested to participate in the rescheduling of such debt and to extend further loans to sovereign debtors. The interests of holders of sovereign debt could be adversely affected in the course of restructuring arrangements . . . There is no bankruptcy proceeding by which sovereign debt on which a sovereign has defaulted may be collected in whole or in part.").

112. *See* Prospectus of Prudential Distressed Securities Fund, Inc., Jan. 16, 1996, *available in* LEXIS, STSEC Library, FILING File ("In the event of a default with respect to collateralized Brady Bonds as a result of which the payment obligations of the issuer are accelerated, the U.S. Treasury zero coupon obligations held as collateral for the payment of principal will not be distributed to investors, nor will such obligations be sold and the proceeds distributed. The collateral will be held by the collateral agent to the scheduled maturity of the defaulted Brady Bonds, which will continue to be outstanding, at which time the face amount of the collateral will equal the principal payments which would have then been due on the Brady Bonds in the normal course.").

113. *See S&P Says It Will Rate More Brady Debt*, *supra* note 109.

114. When a Brady bond is "stripped," each coupon and each principal payment becomes an individual zero-coupon bond. For example, a bond having twenty annual coupon payments becomes twenty-one separate securities—a single twenty year zero-coupon bond representing only principal, and twenty zero-coupon bonds representing only interest and having maturities of one to twenty years. *See* Rupert Bruce, *Stripteasing European Government Bonds*, Institutional Investor (Int'l ed.), Feb. 1995, at 25.

115. *See* Buchheit, *supra* note 35, at 12.

LDCs, including Bulgaria, Ecuador, Panama, and Peru, are expected to implement Brady Plan securitizations in the future.[116] Approximately $136 billion in principal amount of Brady Bonds had been issued as of the beginning of 1996.[117] As more countries have securitized their bank loans under the Brady Plan, Brady bonds have come to represent the majority of outstanding LDC debt.[118]

II. Suing the Sovereign: The Road Not Taken

From the events of the debt crisis, this part turns to the law that developed in response to those events. At the beginning of the crisis, a number of affirmative defenses were available to sovereign debtors facing collection actions, including, most importantly, defenses based on Article VIII, section 2(b) of the IMF Articles of Agreement, sovereign immunity, the act of state doctrine, and international comity. None of these defenses, however, had been tested in the context of an international debt crisis. Litigation arising from the debt crisis has undermined the viability of each of these affirmative defenses, leaving sovereigns with only contractual defenses based upon the loan agreements under which their debts were incurred. Although the crisis brought many calls for an international framework to govern sovereign insolvencies,[119] U.S. courts did not embrace the idea of offering a "fresh start" to distressed sovereign debtors. Confronted with a crisis that threatened the stability of the world financial system, U.S. courts bolstered the position of U.S. commercial banks by holding sovereign debts to be fully enforceable throughout the crisis. Bank creditors thus established their right to collect on defaulted sovereign debts free of affirmative sovereign defenses. This part examines each of the failed defenses in succession.

A. *Article VIII, Section 2(b) of the IMF Articles of Agreement*

Countries facing a debt crisis may attempt to ration scarce foreign exchange by imposing restrictions on the payment of foreign currency to external creditors. Contract parties, including governments, prevented by such exchange controls from repaying their debts to foreign creditors may argue that the contract under which their debt was in-

116. Prospectus of Schroder Emerging Markets Fund, Jan. 19, 1996, *available in* LEXIS, STSEC Library, FILING File.

117. Prospectus of GT Global Variable Investment Trust, Jan. 5, 1996, *available in* LEXIS, STSEC Library, FILING File.

118. *See* Buraff Publications, International Securities Regulation Report, June 8, 1995 (noting that "Brady Bond trading in 1994 was nearly seven times that of loan trading"). Approximately $1.684 trillion of Brady bonds were traded in 1994. *Id.*

119. *See, e.g.*, Santos, *supra* note 18, at 98 (proposing a Chapter 11-type framework for Latin American sovereign debtors); Christopher G. Oechsli, Note, *Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 Va. J. Int'l L. 305, 309 (1981) (proposing "a renegotiation procedure analogous to the procedure found in Chapter 11").

curred is rendered unenforceable by Article VIII, section 2(b) of the IMF Articles of Agreement[120] (the "IMF Agreement"). The first sentence of Article VIII, section 2(b) provides: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."[121]

This provision, which has been implemented in the domestic laws of all IMF member nations and therefore must be applied by the courts of those nations,[122] was intended to establish a means by which the exchange control regulations of one IMF member state could be enforced against private contract parties in other member states.[123] Parties prevented from performing their contract obligations by the exchange control regulations of an IMF member nation must satisfy four requirements in order to raise a successful Article VIII, section 2(b) defense.[124] First, the contract in dispute must be an "exchange contract."[125] Second, the contract must "involve the currency" of an IMF member nation.[126] Third, the contract must be "contrary to" that nation's exchange control regulations.[127] Finally, the exchange controls must have been maintained or imposed "consistently with [the

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120. Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39, amended by 20 U.S.T. 2775, T.I.A.S. No. 6748, 726 U.N.T.S. 266 (May 31, 1968), amended by 29 U.N.T.S. 2203, T.I.A.S. No. 8937 (Apr. 30, 1978).

121. *Id.*

122. In the United States, the provision has been codified at 22 U.S.C. § 286h (1994) ("[T]he first sentence of Article VIII, section 2(b) . . . shall have full force and effect in the United States.").

123. *See* Gerhard Wegen, *2(b) or Not 2(b): Fifty Years of Questions—The Practical Implications of Article VIII Section 2(b)*, 62 Fordham L. Rev. 1931, 1933-34 (1994). According to the IMF's official interpretation of Article VIII, section 2(b),

> [p]arties entering into exchange contracts involving the currency of any member of the Fund and contrary to exchange control regulations of that member which are maintained or imposed consistently with the Fund Agreement will not receive the assistance of the judicial or administrative authorities of other members in obtaining the performance of such contracts. That is to say, the obligations of such contracts will not be implemented by the judicial or administrative authorities of member countries, for example by decreeing performance of the contracts or by awarding damages for their non-performance.

See Newman, *supra* note 17, at 1512 n.102 (citing Selected Decisions of the Executive Directors and Selected Documents 90-91 (1970)).

124. Newman, *supra* note 17, at 1512; *see also* Pierre Francotte, *Article VIII, Section 2(b) of the IMF's Articles of Agreement*, Int'l Fin. L. Rev., Aug. 1992, at 14 (discussing requirements of an Article VIII, section 2(b) defense).

125. *Id.*

126. *Id.*

127. *Id.*

IMF] Agreement."[128] If these conditions are met, the contract will be unenforceable in the courts of all IMF member countries.[129]

United States courts, however, have almost unanimously rejected Article VIII, section 2(b) defenses, primarily because they have given a narrow construction to the term "exchange contract."[130] United States courts have generally defined exchange contracts as contracts for the exchange of one currency for another.[131] Under this interpretation, contracts to borrow and repay U.S. dollars are clearly not "exchange contracts" within the meaning of Article VIII, section 2(b).[132]

This interpretation was adopted most recently by the court in *Libra Bank Ltd. v. Banco Nacional de Costa Rica*,[133] one of the first collection actions to arise out of the 1980's debt crisis. Prevented by Costa Rican exchange controls from repaying a dollar-denominated debt to a syndicate of foreign banks, Banco Nacional argued that the loan

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128. *Id.*

129. *See* Francotte, *supra* note 124, at 14.

130. *See, e.g.*, Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870, 900 (S.D.N.Y. 1983) (holding that a contract to borrow and repay United States currency is not an exchange contract); Theye y Ajuria v. Pan Am. Life Ins. Co., 161 So. 2d 70, 74 (La.) (holding that an insurance contract is not an exchange contract), *cert. denied*, 377 U.S. 997, *reh'g denied*, 379 U.S. 872 (1964); J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd., 333 N.E.2d 168, 174 (N.Y.) (finding that a letter of credit is not an exchange contract), *cert. denied*, 423 U.S. 866 (1975); Banco do Brasil v. A.C. Israel Commodity Co., 190 N.E.2d 235, 236 (N.Y. 1963) (holding that a contract for the sale of a commodity is not an exchange contract), *cert. denied*, 376 U.S. 906 (1964). *But see* Southwestern Shipping Corp. v. National City Bank, 173 N.Y.S.2d 509, 522-23 (Sup. Ct.) (finding a contract for the exchange of lire for dollars to be an "exchange contract"), *aff'd*, 178 N.Y.S.2d 1019 (App. Div. 1958), *rev'd on other grounds*, 160 N.E.2d 836 (N.Y.), *cert. denied*, 361 U.S. 895 (1959).

131. *See, e.g.*, *Libra Bank Ltd.*, 570 F. Supp. at 897 ("The narrow view of 'exchange contracts' . . . is that they are contracts for the exchange of one currency against another or one means of payment against another" (quoting J. Gold, The Fund Agreement in the Courts: Volume II 425 (1982))).

132. *See, e.g.*, *id.* at 900 ("[A] contract to borrow United States currency, which requires repayment in United States currency, and which designates New York as the situs of repayment, is not an exchange contract within the meaning of Article VIII, section 2(b)."); *Theye y Ajuria*, 161 So. 2d at 74 ("[A] contract payable in the state of Louisiana in United States currency is not a foreign exchange contract."); *Banco do Brasil*, 190 N.E.2d at 236 ("We are inclined to view an interpretation of subdivision (b) of section 2 that sweeps in all contracts affecting any members' exchange resources as doing considerable violence to the text of the section."); Pan Am. Life Ins. Co. v. Raij, 156 So. 2d 785, 786 (Fla. Dist. Ct. App. 1963) ("[A]n American contract, upon which payments [are] to be made . . . by the [obligor] in United States currency, [is] not an [exchange contract]." (footnote omitted)), *cert. denied*, 379 U.S. 920 (1964).

In contrast, German and French courts have defined "exchange contract" as any contract for the exchange of goods or services that has an impact on a country's foreign exchange reserves. Under this interpretation, any contract for the sale of goods or services the performance of which would increase or decrease a country's foreign exchange reserves qualifies as an "exchange contract." Wegen, *supra* note 123, at 1938. This interpretation clearly includes international loan agreements payable in a currency other than that of the borrower's country. *See* Francotte, *supra* note 124, at 14.

133. 570 F. Supp. 870 (S.D.N.Y. 1983).

agreement under which it had borrowed the money was an "exchange contract" within the meaning of Article VIII, section 2(b), and was therefore unenforceable because the agreement was contrary to exchange controls validly imposed by an IMF member country.[134] The court rejected that argument, holding that a definition of "exchange contract" sufficiently expansive to include international loan agreements would "[do] violence to the text of the section."[135]

Even if a U.S. court were inclined to view a loan agreement as an exchange contract within the meaning of Article VIII, section 2(b), a defendant raising an Article VIII, section 2(b) defense to a collection action also bears the burden of proving that the exchange controls which prevent it from repaying its debt were imposed consistently with the IMF Agreement.[136] In *Libra*, for example, Banco Nacional argued that Costa Rica's exchange controls were consistent with the IMF Agreement because they furthered its underlying purposes, "namely, to promote exchange stability and to maintain orderly arrangements among members of Bretton Woods."[137] Without deciding the point,[138] the court expressed doubt that Costa Rica's exchange controls were in fact consistent with the IMF Agreement. The court noted that Article VIII, section 2(a) of the IMF Agreement specifically prohibits IMF member countries from restricting payments and transfers for "current international transactions" without the prior consent of the IMF.[139] The court declined to find whether repayment of Banco Nacional's debt would constitute a "current international

134. *Id.* at 897.

135. *Id.* at 898 (citations omitted).

136. *Id.* at 901 (noting that "[a] defendant who relies on Article VIII, Section 2(b) necessarily asserts that exchange controls are maintained or imposed consistently with the [IMF Agreement], and he should have the burden of proving this fact" (quoting J. Gold, II The Fund Agreement in the Courts 334 (1982))).

137. *Id.* at 901 (citing Defendant's Memorandum in Support of Motion to Reargue, at 11). *See also supra* note 31 (discussing purposes of the IMF).

138. Because the court had already decided that the loan agreement at issue in the case was not an "exchange contract," its discussion of whether the Costa Rican exchange controls were consistent with the IMF Agreement was dictum.

139. *See* Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870, 901-02 (S.D.N.Y. 1983). Costa Rica had not obtained IMF consent prior to imposing the exchange controls at issue in *Libra*. *Id.* at 902.

transaction,"[140] but held that Banco Nacional had failed to sustain its burden of proof on the issue.[141]

Finally, the *Libra* court questioned whether Article VIII, section 2(b) was intended to reach contracts which, although consistent with a country's exchange regulations at the time of their execution, subsequently become "contrary to exchange controls" as a result of intervening currency regulations.[142] Although it declined to decide the issue, the court doubted that Article VIII, section 2(b) was intended to invalidate contracts retroactively whenever an IMF member country imposes valid exchange controls. The court's comprehensive opinion in *Libra* may well be the final word on the viability of an Article VIII, section 2(b) defense to sovereign debt collection actions in the United States. Since the *Libra* decision, the defense has not been raised in an American court and sovereign debtors have turned instead to other defenses.

B. *Sovereign Immunity*

Stripped of its Article VIII, section 2(b) defense, a sovereign debtor defending against a collection action may seek refuge in the Foreign Sovereign Immunities Act of 1976[143] ("FSIA").[144] Enacted to codify

140. *Id.* at 901. Article XXX of the IMF Agreement defines "current transactions" to include, "without limitation (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities; (2) payments due as interest on loans and as net income from other investments; (3) payments of moderate amount for amortization of loans or for depreciation of direct investments." *Id.* Under Article VI, section 3 of the IMF Agreement, however, IMF members are free to impose restrictions without the prior approval of the IMF on capital, as opposed to current, transactions. The court noted, therefore, that a defendant asserting an Article VIII, section 2(b) defense can meet its burden of proving that exchange controls were imposed consistently with the IMF Agreement by showing either that the exchange controls were imposed with the prior approval of the IMF or that such approval was unnecessary because the exchange controls restrict only "capital," as opposed to "current," transactions. *See id.* at 902.

141. *Id.* at 902.

142. *See id.* at 900 ("Art. VIII 2(b) [sic] gives international recognition to the original ineffectiveness of an exchange contract, but does not touch a contract which during its life [becomes] an exchange contract contrary to regulations." (quoting F. Mann, The Legal Aspect of Money 377-78 (4th ed. 1982))).

143. 28 U.S.C. §§ 1330, 1332(a)(2)-(a)(4), 1391(f), 1441(d), 1602-1611 (1994).

144. The FSIA now provides the sole basis for obtaining jurisdiction in the United States over a foreign sovereign. Republic of Argentina v. Weltover, Inc. 504 U.S. 607, 611 (1992). The FSIA confers on the district courts original subject matter jurisdiction "without regard to amount in controversy of any nonjury civil action against a foreign state as defined in section 1603(a) of this title as to any claim for relief in personam with respect to which the foreign state is not entitled to immunity." 28 U.S.C. § 1330(a) (1994).

In addition, the FSIA provides that "[p]ersonal jurisdiction over a foreign state shall exist as to every claim for relief over which the district courts have jurisdiction under subsection (a) where service has been made under section 1608 of this title." *Id.* § 1330(b). Thus, under the FSIA, "personal jurisdiction equals subject matter juristhe so-called "restrictive theory" of sovereign immunity,[145] the FSIA acts as a jurisdictional bar to certain suits involving the official acts of a foreign country.[146] Although starting from the premise that a foreign state[147] is immune from jurisdiction in U.S. courts,[148] the FSIA provides several exceptions to that immunity.[149] Most importantly, in the context of sovereign loan defaults, the sovereign may relinquish its immunity under the FSIA by express or implied waiver.[150] Most sovereign bonds and loan agreements contain express waivers of sovereign immunity.[151] In addition, the FSIA provides that a foreign state is not immune from jurisdiction in suits arising from acts that the sovereign performs in connection with certain commercial activity. Specifically, three kinds of sovereign acts will implicate the "commercial activity" exception to sovereign immunity: (1) commercial activity carried on in the United States; (2) an act performed in the United States in connection with commercial activity carried on outside the United States; and (3) an act performed outside the United States in connection with commercial activity carried on outside the United States, which act has a direct effect in the United States.[152] A thresh-

diction plus valid service of process." Shapiro v. Republic of Bolivia, 930 F.2d 1013, 1020 (2d Cir. 1991).

145. *See* Verlinden B.V. v. Central Bank of Nigeria, 461 U.S. 480, 488 (1983). *See also* H.R. Rep. No. 1487, 94th Cong., 2d Sess. 1, at 7-8 (1976), *reprinted in* 1976 U.S.C.C.A.N. 6604, 6605-07. Under the restrictive theory, a sovereign's immunity from suit is limited to suits involving the sovereign's public acts (*jure imperii*), and does not extend to suits arising from the sovereign's private acts (*jure gestionis*). *See id.* at 6605.

146. *See* Sylvester, *supra* note 15, at 291.

147. As used in the FSIA, the term "foreign state" includes state agencies and instrumentalities. Thus, a corporate entity whose shares are owned by the state would be entitled to immunity. William W. Park, *When the Borrower and the Banker Are at Odds: The Interaction of Judge and Arbitrator in Trans-Border Finance*, 65 Tul. L. Rev. 1323, 1340 (1991).

148. *See* 28 U.S.C. § 1604 (1988) ("[A] foreign state shall be immune from the jurisdiction of the courts of the United States . . . except as provided in sections 1605 to 1607 of this chapter.").

149. *See id.* §§ 1605-1607.

150. *See id.* § 1605(a)(1):

> (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case—
>
> (1) in which the foreign state has waived its immunity either explicitly or by implication, notwithstanding any withdrawal of the waiver which the foreign state may purport to effect except in accordance with the terms of the waiver.

151. *See* Sylvester, *supra* note 15, at 293; Newman, *supra* note 17, at 1502. In addition, many sovereign loan agreements also stipulate that the sovereign waives any objection to suit on grounds of forum non conveniens, although the enforceability of such provisions has apparently not yet been litigated. Georges R. Delaume, *The Foreign Sovereign Immunities Act and Public Debt Litigation: Some Fifteen Years Later*, 88 Am. J. Int'l. L. 257, 267-77 (1994).

152. 28 U.S.C. § 1605(a)(2) (1994). The relevant statutory language provides:

> A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case—

old question in applying the commercial activity exception to sovereign debt collection actions, therefore, is whether the sovereign borrowing constituted commercial activity within the meaning of the FSIA.[153] If the sovereign borrowing *was* commercial activity but the sovereign did not perform an act in the United States in connection with the borrowing, the court must then confront the additional question whether the sovereign's acts in connection with the borrowing had a direct effect in the United States.

The Supreme Court recently answered both of these questions in the affirmative in *Republic of Argentina v. Weltover, Inc.*,[154] another case arising out of the debt crisis. At issue in *Weltover* were bonds issued by the government of Argentina to refinance the country's existing debt to foreign creditors. The bonds were due to mature in 1986 and provided that payment would be made in U.S. dollars[155] in either New York, London, Frankfurt, or Zurich, at the option of the bondholder.[156] Lacking sufficient funds to repay the bonds as they began to mature in 1986, Argentina's central bank, acting pursuant to a Presidential Decree, notified the bondholders that the country had unilaterally rescheduled the bonds' maturity dates.[157] Several bondholders refused to accept the rescheduling and brought suit in the Southern District of New York to compel Argentina to pay the bonds according to their original terms. Argentina argued that the court lacked jurisdiction under the FSIA.[158]

On appeal, the Supreme Court held that Argentina's issuance of the bonds to its foreign creditors was a commercial activity within the meaning of the FSIA,[159] and that the country's refusal to pay the

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> (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.

Id.

153. The FSIA defines "commercial activity" as "either a regular course of commercial conduct or a particular commercial transaction or act," and further instructs that "[t]he commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose." 28 U.S.C. § 1603(d). As the Supreme Court noted in Republic of Argentina v. Weltover, Inc., 504 U.S. 607 (1992), however, "[t]his definition . . . leaves the critical term 'commercial' largely undefined: The first sentence simply establishes that the commercial nature of an activity does *not* depend upon whether it is a single act or a regular course of conduct; and the second sentence merely specifies what element of the conduct determines commerciality (*i.e.*, nature rather than purpose), but still without saying what 'commercial' means." *Id.* at 612.

154. 504 U.S. 607 (1992).

155. *See id.* at 609-10.

156. *Id.*

157. *Id.* at 610.

158. *Id.*

159. *Id.* at 616-17.

bonds at their stated maturity had a direct effect in the United States.[160] Argentina thus was not entitled to sovereign immunity. According to the Court, the distinction between sovereign activity, which is entitled to immunity, and commercial activity, which is not so entitled, turns on whether the act in question may be performed by any private party, or whether it may only be performed by the sovereign *qua* sovereign.[161] Applying this reasoning, the Court had little difficulty classifying Argentina's borrowing as commercial activity:

> The commercial character of the [Bonds] is confirmed by the fact that they are in almost all respects garden-variety debt instruments: they may be held by private parties; they are negotiable and may be traded on the international market . . . and they promise a future stream of cash income.[162]

Thus, although the Court declined to resolve the question whether all issuance of debt instruments is per se commercial activity,[163] its decision strongly implies that any use of the financial markets by a sovereign as an issuer of bonds or borrower under a loan agreement will constitute commercial activity within the meaning of the FSIA.

The commercial activity finding in *Weltover*, however, was not sufficient by itself to destroy Argentina's sovereign immunity because, by unilaterally rescheduling the terms of its bonds, Argentina had not performed any act within the United States. The Court was thus obliged to address the "direct effect" requirement.[164] The Court had little difficulty concluding that Argentina's unilateral rescheduling of the bonds had a direct effect in the United States.[165] Rejecting any

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160. *Id.* at 617-19.

161. The court held:

> [W]hen a foreign government acts, not as regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are "commercial" within the meaning of the FSIA. . . . [T]he issue is whether the particular actions that the foreign state performs (whatever the motive behind them) are the *type* of actions by which a private party engages in "trade and traffic or commerce." Thus, a foreign government's issuance of regulations limiting foreign currency exchange is a sovereign [i.e., not a "commercial"] activity, because such authoritative control of commerce cannot be exercised by a private party; whereas a contract to buy army boots or even bullets is a "commercial" activity, because private companies can similarly use sales contracts to acquire goods.

Id. at 614-15 (1992) (citations omitted).

162. *Id.* at 615. The Second Circuit had relied on a similar rationale. *See* Weltover, Inc. v. Republic of Argentina, 941 F.2d 145, 151 (2d Cir. 1991) ("Because defendants' issuance of public debt . . . immersed them in the stream of international commerce in foreign currency, the nature of that act was commercial; there was nothing uniquely sovereign about this activity.").

163. *See Weltover*, 504 U.S. at 615-16.

164. The court was obliged to determine whether Argentina's unilateral rescheduling of the bonds had a direct effect in the United States because the parties agreed that the rescheduling was "an act outside the territory of the United States," thus implicating the third clause of 28 U.S.C. § 1605(a)(2). *See id.* at 611-12.

165. *See id.* at 618-19.

requirement of foreseeability or substantiality,[166] the Court held that "an effect is 'direct' if it follows as an immediate consequence of the defendant's activity."[167] Because Argentina had selected New York as a place for payment of the bonds, the failure to pay them at the New York bank designated to receive payment had a direct effect in New York.[168] It seems likely, therefore, that a direct effect will be found in every case in which a sovereign obligor, having designated a U.S. city as the place for performance of its obligations, subsequently fails to perform.[169] Although the sovereign immunity defense was generally unavailing throughout the debt crisis,[170] the Supreme

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166. *Id.* at 618. Argentina had argued that the meaning of "direct effect" was to be determined by reference to section 18 of the Restatement of Foreign Relations Law of the United States (1965), which states that an effect is not "direct" unless it is both "substantial" and "foreseeable." *Id.* at 617-18.

Interestingly, however, the Court did not affirm the Second Circuit's holding that Argentina's rescheduling of the bonds had a direct effect in the United States because it diminished the U.S. "interest in maintaining New York's status as one of the foremost commercial centers in the world." *See Weltover*, 941 F.2d at 153. Although the Supreme Court was "happy to endorse the Second Circuit's recognition of New York's status as a world financial leader," it found "the effect of Argentina's rescheduling in diminishing that status . . . too remote and attenuated to satisfy the 'direct effect' requirement of the FSIA." *Weltover*, 504 U.S. at 618 (internal quotations omitted).

167. *Weltover*, 504 U.S. at 618 (internal quotations and alterations omitted).

168. *See id.* at 619 ("[T]he rescheduling of [the bond] obligations necessarily had a 'direct effect' in the United States: Money that was supposed to have been delivered to a New York bank for deposit was not forthcoming.").

169. Other courts, both before and after *Weltover*, have reached the same conclusion. *See, e.g.*, Commercial Bank of Kuwait v. Rafidain Bank, 15 F.3d 238, 241 (2d Cir. 1994) (holding that failure of Iraqi banks to remit funds in New York, as contractually obligated, had a direct effect in United States); Callejo v. Bancomer, 764 F.2d 1101, 1111-12 (5th Cir. 1985) (holding that nonpayment of a debt payable in the United States to a U.S. company had a direct effect in the United States); Banco Cafetero (Panama) v. The Republic of Peru, 94 Civ. 3569 (JSM), 1995 U.S. Dist. LEXIS 11840, at *10 (S.D.N.Y. Aug. 17, 1995) (holding failure of Peruvian bank to repay interbank deposit had a direct effect in the United States because defendant bank had made interest payments into New York account for six years); L'Européene de Banque v. La Republica de Venezuela, 700 F. Supp. 114, 121-22 (S.D.N.Y. 1988) (holding that default on a syndicated loan had a direct effect in the United States because the loan was payable through the New York account of the syndicate's bank agent).

170. Even before *Weltover* was decided, courts generally held that sovereign borrowing constitutes "commercial activity" and, therefore, that the sovereign borrower is not immune from jurisdiction in actions to collect the debt. *See* Shapiro v. Republic of Bolivia, 930 F.2d 1013, 1018-19 (2d Cir. 1991) (holding that Bolivia's issuance of treasury notes constituted commercial activity); Carl Marks & Co. v. Union of Soviet Socialist Republics, 841 F.2d 26, 27 (2d Cir.), *cert. denied*, 487 U.S. 1219 (1988); (holding that the Russian Imperial Government's issuance of bonds constituted commercial activity); West v. Multibanco Comermex, 807 F.2d 820, 825-26 (9th Cir.) (holding a Mexican Bank's issuance of certificates of deposit to be commercial activity), *cert. denied*, 482 U.S. 906 (1987); Callejo v. Bancomer, 764 F.2d 1101, 1109 (5th Cir. 1985); Wolf v. Banco Nacional de Mexico, 739 F.2d 1458, 1460 (9th Cir. 1984) (holding the issuance of promissory notes and certificates of deposit by government-owned banks to be commercial activity); Schmidt v. Polish People's Republic, 579 F. Supp. 23, 26 (S.D.N.Y. 1984) (holding Poland's issuance of treasury notes to be commercial activity); Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1443

Court's definitive decision in *Weltover* now suggests that the defense will prove unsuccessful in a future debt crisis as well.

C. *The Act of State Doctrine*

A more promising sovereign debt collection defense at the outset of the debt crisis was the act of state doctrine, which prevents U.S. courts from judging the validity of a foreign sovereign's official acts performed within the sovereign's own territory.[171] In contrast to sovereign immunity, which acts as a jurisdictional bar to suits against a sovereign, the act of state doctrine is a judicially created[172] rule of abstention concerning the justiciability of the acts of foreign governments.[173] In further contrast to sovereign immunity, the act of state doctrine defense cannot be waived.[174] Thus, even if it has jurisdiction

(S.D.N.Y. 1983) (holding the issuance of promissory notes by state-owned Costa Rican banks to be commercial activity), *aff'd*, 733 F.2d 23 (2d Cir. 1984), *vacated and rev'd on other grounds*, 757 F.2d 516 (2d Cir.), *cert. dismissed*, 473 U.S. 934 (1985). *But see* Frankel v. Banco Nacional de Mexico, No. 82 Civ. 6457, slip op. (S.D.N.Y. May 31, 1983) (holding that, although issuance of plaintiffs' Mexican certificate of deposit was a commercial activity, imposition of the exchange controls that prevented its repayment was a sovereign activity.).

Commentators had reached the same conclusion. *See* Lawrence V. Ashe, *The Flexible Approach to the Foreign Sovereign Immunities Act in* Weltover, Inc. v. Republic of Argentina, 23 U. Miami Inter-Am. L. Rev. 465, 475 (1991-92) (arguing that "selling securities in the international public market to private parties is patently commercial activity").

Pre-*Weltover* courts had also generally found that a sovereign's default on loan obligations payable in the United States have a "direct effect" in the United States. *See Shapiro*, 930 F.2d at 1019; *L'Européenne de Banque*, 700 F. Supp. at 121; *Schmidt*, 579 F. Supp. at 27.

171. This formulation of the act of state doctrine was first articulated almost one hundred years ago by Chief Justice Fuller in what has become known as the classic American statement of the doctrine:

> Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.

Underhill v. Hernandez, 168 U.S. 250, 252 (1897).

172. The doctrine traces its roots to the English cases Blad v. Bamfield, 36 Eng. Rep. 992 (Ch. 1674) and Duke of Brunswick v. King of Hanover, 9 Eng. Rep. 993 (H.L. 1848) and, in America, to The Schooner Exchange v. M'Faddon, 11 U.S. (7 Cranch) 116 (1812) and Underhill v. Hernandez 168 U.S. 250 (1897). Although Congress has attempted, through legislation, to control the application of the doctrine in certain situations, *see infra* note 176, the doctrine itself remains uncodified in U.S. law.

173. *See* Newman, *supra* note 17, at 1505; Roger M. Zaitzeff & C. Thomas Kunz, *The Act of State Doctrine and the* Allied Bank *Case*, 40 Bus. L. 449, 450 (1985).

174. *See* Michael J. Bazyler, *Abolishing the Act of State Doctrine*, 134 U. Pa. L. Rev. 325, 345 (1986). Moreover, unlike sovereign immunity, which may be invoked only by a foreign government or agency of a foreign government, the act of state doctrine may be invoked even by private parties subject to restrictions imposed by foreign governments. *See* Braka v. Bancomer, 762 F.2d 222, 225 (2d Cir. 1985) (holding that, where Mexican exchange controls prohibited defendant bank from paying plaintiff's certifi-

over a sovereign, a U.S. court must abstain from deciding any case that would require it to sit in judgment on the sovereign's official acts performed within its own borders.[175] The doctrine applies even if the sovereign act violates U.S. or international law.[176] Numerous rationales for the doctrine have been given, including the inability of U.S. courts to grant substantial relief in cases of expropriation by foreign

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cates of deposit in U.S. dollars, a judgment ordering the bank to violate its own national law would be an impermissible inquiry into an official act of the Mexican government).

175. *See* West v. MultiBanco Comermex, 807 F.2d 820, 827-28 (9th Cir. 1987); Empresa Cubana Exportadora de Azucar y Sus Derivados, Inc. v. Lamborn & Co., 652 F.2d 231, 238-39 n.11 (2d Cir. 1981); Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1443 (S.D.N.Y. 1983), *rev'd on other grounds*, 757 F.2d 516 (2d Cir. 1985). *See also* Joseph B. Frumkin, *The Act of State Doctrine and Foreign Sovereign Defaults on United States Bank Loans: A New Focus for a Muddled Doctrine*, 133 U. Pa. L. Rev. 469, 476 (1985) (suggesting that the purpose of the doctrine is "to avoid affront to foreign sovereigns in situations where judicial interference might create foreign policy problems for the executive branch").

176. *See* Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428 (1964). In *Sabbatino*, Justice Harlan, gave the modern formulation of the act of state doctrine:

> [T]he Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government, extant and recognized by this country at the time of suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, *even if the complaint alleges that the taking violates customary international law.*

Id. (emphasis added).

Thus, like Chief Justice Fuller's formulation in *Underhill v. Hernandez*, Justice Harlan's statement of the doctrine limits its application to acts performed by a sovereign government within its own territory. Unlike *Underhill*, however, *Sabbatino* requires that the sovereign government be extant and recognized at the time of the suit, and that courts apply the doctrine even to actions that violate international law.

Eight months after *Sabbatino* was decided, Congress passed the Hickenlooper Amendment to the Foreign Assistance Act of 1961, which requires courts to apply principles of international law to determine expropriation cases on their merits unless the President submits a letter requesting that the act of state doctrine be applied. *See* Foreign Assistance Act of 1964, Pub. L. No. 88-633, § 301(d)(4), 78 Stat. 1009 (codified at 22 U.S.C. § 2370(e)(2)). The Hickenlooper Amendment has been narrowly construed, however. *See, e.g.*, Empresa Cubana Exportagora de Azucar y Sus Derivados v. Lamborn & Co., 652 F.2d 231, 237 (2d Cir. 1981) (holding the doctrine applicable only in cases in which the expropriated property "has found its way back into the United States"). Most importantly, in the context of sovereign loan defaults, the amendment has been held not to apply to contract claims. *See* Menendez v. Saks and Co., 485 F.2d 1355, 1372 (2d Cir. 1973) (limiting application to cases involving claims of title to property nationalized by a foreign government in violation of international law), *rev'd on other grounds sub nom.* Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682 (1976); Libyan Am. Oil Co. v. Socialist People's Libyan Arab Jamahirya, 482 F. Supp. 1175, 1179 (D.D.C. 1980) (holding that repudiation of contractual obligations does not fall within the reach of the amendment). *See also* Braka v. Bancomer, 589 F. Supp. 1465, 1472-73 (S.D.N.Y. 1984), (holding that exchange control regulations do not create "takings" within the meaning of the amendment), *aff'd*, 762 F.2d 222 (2d Cir. 1985). *But see* West v. MultiBanco Comermex, 807 F.2d 820, 829-31 (9th Cir. 1987) (adopting a broad interpretation of the amendment).

For a discussion of the generally narrow interpretation courts have given the amendment, see Joseph W. Dellapenna, *Suing Foreign Governments and Their Corporations: Choice of Law Part V*, 87 Com. L. J. 8, 11-15 (1982).

governments,[177] considerations of international comity,[178] and deference to the primacy of the executive branch in matters affecting foreign policy.[179]

As a defense to sovereign debt collection actions, however, the act of state doctrine is of limited utility. The most important limitation on the doctrine's effectiveness in collection actions is its requirement that the challenged act of state be performed within the sovereign's own territory.[180] Because the doctrine does not apply to suits arising from a sovereign's taking of property located within the United States,[181] U.S. courts adjudicating such suits are free to judge the validity of

177. *See, e.g.*, *Sabbatino*, 376 U.S. at 435 ("When one considers the variety of means possessed by this country to make secure foreign investment, the persuasive or coercive effect of judicial invalidation of acts of expropriation dwindles in comparison."); *see also* The Schooner Exchange v. M'Faddon, 11 U.S. (7 Cranch) 116, 146 (1812) ("The arguments in favor of [the doctrine] . . . have been drawn from the general inability of the judicial power to enforce its decisions in cases of this description, from the consideration, that the sovereign power of the nation is alone competent to avenge wrongs committed by a sovereign."). *But see* Margaret E. Tahyar, *The Act of State Doctrine: Resolving Debt Situs Confusion*, 86 Colum. L. Rev. 594, 598 n.24 (1986) (noting that if the court's inability to grant effective relief were the sole reason for the doctrine, it would be completely subsumed in existing justiciability law).

178. *See* Oetjen v. Central Leather Co., 246 U.S. 297, 303-04 (1918). The court noted:

> The principle that the conduct of one independent government cannot be successfully questioned in the courts of another . . . rests at last upon the highest considerations of international comity and expediency. To permit the validity of the acts of one sovereign State to be reëxamined and perhaps condemned by the courts of another would certainly imperil the amicable relations between governments and vex the peace of nations.

Id. (citation and internal quotations omitted); *see also infra* part II.D.

179. *See* First Nat'l City Bank v. Banco Nacional de Cuba, 406 U.S. 759, 765 (1972) ("[T]he act of state doctrine justifies its existence primarily on the basis that juridical review of acts of state of a foreign power could embarrass the conduct of foreign relations by the political branches of the government."); *see also* Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 432-33 (1964) ("When articulating principles of international law in its relations with other states, the Executive Branch speaks not only as an interpreter of generally accepted and traditional rules, as would the courts, but also as an advocate of standards it believes desirable for the community of nations and protective of national concerns. In short, whatever way the matter is cut, the possibility of conflict between the Judicial and Executive Branches [can] hardly be avoided.").

180. Other exceptions to application of the act of state doctrine include situations in which (1) the foreign state is at war with or not recognized by the United States, (2) the executive branch has asked the court not to apply the doctrine, (3) the challenged act is commercial in nature, (4) the challenged act is in violation of an applicable treaty, (5) the challenged act is in violation of the foreign state's own laws, and (6) the doctrine is invoked as a defense to a counterclaim. A discussion of these and other possible exceptions to application of the act of state doctrine is beyond the scope of this Note. For a comprehensive survey of the doctrine and its many exceptions, see Bazyler, *supra* note 174.

181. *See* Republic of Iraq v. First Nat'l City Bank, 353 F.2d 47, 51-52 (2d Cir. 1965) (act of state doctrine did not bar adjudication of Iraq's confiscation of assets, held in accounts at a New York City bank, of its deposed monarch), *cert. denied*, 382 U.S. 1027 (1966).

such takings according to U.S. law.[182] Therefore, when the property taken is a creditor's right to repayment of a sovereign debt,[183] the situs of the debt effectively determines whether the act of state doctrine will bar an action to collect the debt.

While locating the situs of tangible property for purposes of the doctrine presents little difficulty,[184] courts have experienced some confusion in determining the situs of intangibles, such as the right to repayment of a debt.[185] Courts generally have rejected the argument that simply by defaulting on a debt to foreign creditors, or by issuing exchange controls which prohibit state-owned companies from using foreign currency to repay loans, the sovereign has acted entirely within its own territory for act of state purposes.[186] Because a sovereign's decision to default on a loan or impose exchange controls is always made within the sovereign's own territory, an act of state analysis that considered only the situs of such an act, without also considering the location of its consequences, would clearly be too restrictive. Under such an analysis, the doctrine would apply in every case. Instead, courts have tended to resolve debt situs issues by using one of two methods. Some courts have focused their inquiry on whether the purported taking has come to "complete fruition" by extinguishing the creditor's right to repayment.[187] Other courts, following the debt situs

182. *See* U.S. Const. amend. V ("[P]rivate property [shall not] be taken for public use, without just compensation.").

183. *See* Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 521 n.3 (2d Cir. 1985) ("It seems clear that if the [sovereign's decrees prohibiting payment of debts to foreign creditors] are given effect and Allied's right to receive payment in accordance with the agreements is thereby extinguished, a 'taking' has occurred.").

184. *See, e.g.*, Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 413 & n.14 (1964) (emphasizing Cuba's ability physically to prevent sugar from leaving Cuba); Oetjen v. Central Leather Co., 246 U.S. 297 (1918) (concerning a Mexican general's seizure of hides); Ricaud v. American Metal Co., 246 U.S. 304 (1918) (concerning the seizure of lead bullion).

185. For a discussion of the situs problem and the varying methods courts have employed in locating a debt's situs for act of state purposes, see Tahyar, *supra* note 177.

186. *See, e.g.*, *Allied*, 757 F.2d at 521-22; Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870, 878 (S.D.N.Y. 1983) (finding that Costa Rican decrees prohibiting defendants from repaying loans negotiated in the United States and payable in New York had consequences in the United States, and holding act of state doctrine not applicable); *see also* Maltina Corp. v. Cawy Bottling Co., 462 F.2d 1021, 1025 n.3 (5th Cir.) (The act of state "refers to full exercise by the foreign state of dominion over the property in question, not to the documentary execution of whatever legal action the foreign state takes toward the property. . . . [I]t looks not to execution of a nationalization decree, but rather to exercise of dominion over . . . property located in the United States."), *cert. denied*, 409 U.S. 1060 (1972).

187. *See, e.g.*, *Allied*, 757 F.2d at 521 (holding that because Costa Rica, by imposing exchange controls, could not "wholly extinguish" the defendant banks' obligation to repay a debt payable in New York, the situs of the debt was New York, not Costa Rica); Menendez v. Saks & Co., 485 F.2d 1355, 1364 (2d Cir. 1973) (holding that "a debt is not 'located' within a foreign state unless that state has the power to enforce or collect it"), *rev'd on other grounds sub nom.* Alfred Dunhill of London, Inc. v. Republic of Cuba, 425 U.S. 682 (1976); Tabacalera Severiano Jorge v. Standard Cigar Co.,

analysis of *Harris v. Balk*,[188] have held that a debt has its situs anywhere jurisdiction over the debtor can be obtained.[189]

392 F.2d 706, 714-16 (5th Cir.) (holding that expropriation of accounts receivable did not come to "complete fruition" because sovereign was not "physically in a position to perform a *fait accompli*"), *cert. denied*, 393 U.S. 924 (1968); Weston Banking Corp. v. Turkiye Garanti Bankasi, 442 N.E.2d 1195, 1199 (N.Y. 1982); (holding act of state doctrine not applicable because "[a] debt is not located within a foreign State unless [that State] has the power . . . to enforce or collect it").

As commentators have noted, the "complete fruition" analysis is somewhat conclusory. *See* Tahyar, *supra* note 177, at 597 n.19 (noting that because a debt's situs is a legal conclusion, a default being challenged in a United States court does not wholly extinguish the creditor's right to repayment until the court declares the right to be extinguished).

188. 198 U.S. 215 (1905). The *Harris* court held that "[t]he obligation of the debtor to pay his debt clings to and accompanies him wherever he goes. . . . [T]he judgment against Harris in Maryland, condemning the $180 which he owed to Balk, was a valid judgment, because the [Maryland] court had jurisdiction over [Harris]." *Id.* at 222, 226. Although *Harris* has been overruled insofar as it pertains to issues of personal jurisdiction, *see* Shaffer v. Heitner, 433 U.S. 186, 212 n.39 (1977), its holding with respect to debt situs remains valid law and was explicitly endorsed in Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870, 880 (S.D.N.Y. 1983) ("This court believes that *Harris* is still valid to the extent that when a debtor is sued in a court which has jurisdiction over the debtor, the debt has its situs in that jurisdiction assuming that personal jurisdiction over the debtor comports with the due process requirements of minimum contacts.").

189. In Vishipco Line v. Chase Manhattan Bank, 660 F.2d 854 (2d Cir. 1981), for example, the court stated:

> [F]or purposes of the act of state doctrine, a debt is not "located" within a foreign state unless that state has the power to enforce or collect it. The rule announced in Harris v. Balk . . . continues to be valid on this point: the power to enforce payment of a debt depends on jurisdiction over the debtor.

Id. at 862 (citation omitted); *see also* United Bank Ltd. v. Cosmic Int'l, Inc., 542 F.2d 868, 873-74 (2d Cir. 1976) (applying situs analysis of Harris v. Balk to determine debt situs for act of state doctrine purposes).

Because the FSIA provides the sole basis for obtaining jurisdiction over a foreign sovereign, and because most sovereign loan agreements contain waivers of sovereign immunity, this test has the effect of making the exercise of jurisdiction dispositive of whether the act of state doctrine will apply to cases involving sovereign defaults.

Another obvious problem with this analysis arises in any case over which the foreign sovereign has concurrent jurisdiction with a U.S. court. Applying the holding of *Harris v. Balk* to such cases would lead logically to the conclusion that the debt has more than one situs. Courts have attempted to evade this problem by applying a kind of balancing of contacts analysis to determine which country has the greater interest in being the situs of the debt. *Compare* Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 521-22 (2d Cir.) (holding that where promissory notes are payable in New York in U.S. dollars, creditor is located in New York, and negotiations between the parties took place in New York, New York is the situs of the debt), *cert dismissed*, 473 U.S. 934 (1985) *and Libra*, 570 F. Supp. at 881 ("[A]lthough a debtor may in theory be sued at the creditor's choice in either of two jurisdictions, the legal incidents of the debt may nevertheless place it, for the purposes of the act of state doctrine, in this nation rather than in the foreign nation.") *and* Weston Banking Corp. v. Turkiye Garanti Bankasi, 442 N.E.2d 1195, 1199 (N.Y. 1982) (holding that where promissory note is payable in New York and specifies New York law as controlling, the mere fact that suit could have been brought on the note in Turkey does not render Turkey the situs of the debt) *with* Braka v. Bancomer, 762 F.2d 222, 224-25 (2d Cir. 1985) (holding that where certificates of deposit issued by a Mexican bank designated

The Second Circuit combined both situs approaches in the landmark case *Allied Bank International v. Banco Credito Agricola de Cartago*.[190] *Allied* was a collection action brought by a syndicate of creditor banks against three state-owned Costa Rican banks.[191] Early in the debt crisis, the defendant banks had defaulted on a debt to the syndicate after Costa Rica imposed exchange controls prohibiting payment of foreign currency to external creditors.[192] The debt had been partially negotiated in New York and was payable in New York in U.S. dollars.[193] The court rejected the defendants' act of state doctrine defense, holding that the situs of the debt was New York.[194] In rather conclusory fashion, the court held that, because the Costa Rican exchange controls had not "wholly extinguish[ed]" the defendants' obligation to repay the debt in New York, the purported "taking" had not come to complete fruition within Costa Rica's borders.[195] In addition, although the loan agreement at issue called for concurrent jurisdiction in New York and Costa Rica,[196] the court found that New York had the greater interest in being the debt situs for act of state purposes. The court emphasized that

> [t]he United States has an interest in maintaining New York's status as one of the foremost commercial centers in the world. . . . United States banks lend billions of dollars to foreign debtors each year. The United States has an interest in ensuring that creditors entitled to payment in the United States in United States dollars under contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law.[197]

The court's situs analysis in *Allied* essentially foreclosed the act of state doctrine as a defense to sovereign debt collection actions. Because loan agreements between U.S. lenders and foreign borrowers typically provide for repayment in U.S. dollars and jurisdiction in U.S. courts, the policy interests articulated by the Second Circuit in *Allied*

Mexico City as the place of deposit and of payment, the situs of the debt represented by the certificates was in Mexico).

190. 757 F.2d 516 (2d Cir.), *cert dismissed*, 473 U.S. 934 (1985).

191. *Id.* at 518.

192. *Id.* at 519. In July of 1981, in response to a national economic crisis, the Board of Directors of Costa Rica's central bank passed a resolution prohibiting all state-owned entities from paying any interest or principal owing on debts to foreign creditors and denominated in foreign currency. *See* Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1442 (S.D.N.Y. 1983).

193. *Allied*, 757 F.2d at 521.

194. *Id.*

195. *Id.*

196. Ruben Sklar, *Renegotiation of External Debt: The* Allied Bank *Case and the Chapter 11 Analogy*, 17 U. Miami Inter-Am. L. Rev. 59, 62 (1985).

197. *Allied*, 757 F.2d at 521-22.

will be implicated in almost every action to collect the debts incurred under such agreements.

D. *International Comity*

The Supreme Court has defined comity as "the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation."[198] Although similar in its effect to the act of state doctrine, comity

> is not a rule of law, but one of practice, convenience, and expediency. Although more than mere courtesy and accommodation, comity does not achieve the force of an imperative or obligation. Rather, it is a nation's expression of understanding which demonstrates due regard both to international duty and convenience and to the rights of persons protected by its own laws.[199]

The doctrine of comity differs from the act of state doctrine in two principal ways. First, unlike the act of state doctrine, the doctrine of comity does not include a territorial limitation. Thus, a court may extend comity even to a foreign sovereign's acts performed, or having repercussions in, the United States. Second, because of the lack of a territorial limitation, a court will extend comity only to sovereign acts that are consistent with the law and policy of the United States.[200]

In practice, sovereign debtors have invoked the doctrine of comity as a fallback defense from the act of state doctrine.[201] If the court finds the situs of the sovereign's debt to be within the United States, then the act of state doctrine will not bar adjudication of a suit arising from the sovereign's default on the debt.[202] Under the doctrine of comity, however, a sovereign default may still be unreviewable if the sovereign demonstrates that the default was consistent with U.S. law

198. Hilton v. Guyot, 159 U.S. 113, 164 (1895).

199. Somportex Ltd. v. Philadelphia Chewing Gum Corp., 453 F.2d 435, 440 (3d Cir. 1971), *cert denied*, 405 U.S. 1017 (1972); *see also* Ehrlich-Bober & Co. v. University of Houston, 404 N.E.2d 726, 730 (N.Y. 1980) ("The doctrine of comity . . . does not of its own force compel a particular course of action. Rather, it is an expression of one State's entirely voluntary decision to defer to the policy of another." (citations omitted)); Zaitzeff & Kunz, *supra* note 173, at 450 ("[T]he principle of comity is essentially a voluntary recognition of foreign acts based on policy considerations.").

200. *See Allied* 757 F.2d at 522; Banco Nacional de Cuba v. Chemical Bank New York Trust Co., 658 F.2d 903, 908-09 (2d Cir. 1981); United Bank Ltd. v. Cosmic Int'l Inc. 542 F.2d 868, 871-72 (2d Cir. 1976); *see also* Zaitzeff & Kunz, *supra* note 173, at 451 ("Because the act of state doctrine has constitutional underpinnings, it mandates the result in appropriate cases. In contrast, application of the more general principle of comity is voluntary.").

201. *See, e.g.*, Pravin Banker Assocs. Ltd. v. Banco Popular del Peru, 895 F. Supp. 660, 664 & n.4 (S.D.N.Y. 1995) (noting that, although the act of state doctrine was inapplicable because the situs of the debt at issue was in the United States, the sovereign debtor could still raise a successful comity defense by proving that its default was consistent with U.S. policy).

202. *See supra* text accompanying notes 181-82.

or policy.[203] In determining whether to extend comity to sovereign loan defaults, therefore, courts have found themselves in the somewhat awkward position of attempting to interpret U.S. policy on such defaults—sometimes even before the political branches have formulated a policy at all.

The Second Circuit found itself in that position in *Allied*.[204] The defendant banks had argued in the district court that the suit was barred by the act of state doctrine. The district court agreed and denied the plaintiff bank syndicate's motion for summary judgment.[205] While the case was pending before the district court, the parties entered into negotiations to restructure the debt.[206] Eventually, the parties came to terms and the bank syndicate agreed to dismiss the action voluntarily.[207] One member of the syndicate, however, Fidelity Union Trust Company of New Jersey, refused to accept the restructuring terms, and Allied Bank, as agent for Fidelity Union, appealed the district court's decision.[208]

On appeal, the Second Circuit affirmed the district court, but on grounds of comity. The court saw no need to determine the situs of the debt for act of state purposes because it found Costa Rica's exchange controls fully consistent with the law and policy of the United States, and thus entitled to deference in the interest of comity.[209] As support for this conclusion, the court took notice of expressions by the U.S. executive and legislative branches of support for Costa Rica's efforts to restructure its debts to foreign creditors.[210] More surprisingly, the court reasoned that

> Costa Rica's prohibition of payment of its external debts is analogous to the reorganization of a business pursuant to Chapter 11 of our Bankruptcy Code. Under Chapter 11, all collection actions against a business filing an application for reorganization are automatically stayed to allow the business to prepare an acceptable plan for the reorganization of its debts. Costa Rica's prohibition of pay-

203. *See* Newman, *supra* note 17, at 1505; *see also Pravin* 895 F. Supp. at 664.

204. For the facts of *Allied*, see *supra* text accompanying notes 190-93.

205. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440, 1444 (S.D.N.Y. 1983). The district court noted:

> A judgment in favor of Allied in this case would constitute a judicial determination that defendants must make payments contrary to the directives of their government. This puts the judicial branch of the United States at odds with policies laid down by a foreign government on an issue deemed by that government to be of central importance. Such an act by this court risks embarrassment to the relations between the executive branch of the United States and the government of Costa Rica.

Id.

206. *Allied*, 757 F.2d at 519.

207. *Id.*

208. *Id.*

209. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 733 F.2d 23, 27 (2d Cir. 1984), *vacated on reh'g*, 757 F.2d 516, *cert. dismissed*, 473 U.S. 934 (1985).

210. *Id.*

> ment of debt was not a repudiation of the debt but rather was merely a deferral of payments while it attempted in good faith to renegotiate its obligations.[211]

The court thus implied, in effect, that Costa Rica had treated its bank creditors as well as the banks could expect to be treated by a U.S. corporate debtor in domestic reorganization proceedings, and dismissed the action.[212]

The Second Circuit's dismissal of *Allied* caused considerable consternation in the financial community.[213] Allied Bank subsequently petitioned for rehearing, at which time the United States filed an *amicus curiae* brief explaining its policy on sovereign debt restructuring and stating that Costa Rica's unilateral imposition of exchange controls was in fact inconsistent with that policy.[214] Deferring to the executive branch's elucidation of U.S. policy,[215] the court then vacated its original opinion, reversed the district court, and remanded the case

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211. *Id.* (citations omitted).

212. *Id.*

213. *See* Sklar, *supra* note 196, at 65; *see also* Zaitzeff & Kunz, *supra* note 173, at 474. Zaitzeff & Kunz argued that *Allied's* holding should be strictly limited to its facts, viz.:

> (1) a state suffering from a genuine fiscal crisis, (2) a good faith effort on the part of the state to reschedule, rather than repudiate, the state's debts, (3) the concurrence of a substantial majority of the state's creditors in such rescheduling, and (4) expressions and demonstrations of support for the state from the U.S. government.

Id. Recognizing, however, that *Allied's* fact pattern was fairly typical of the great majority of sovereign debt collection actions that might arise from the debt crisis, *see e.g.*, Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870, 874-76 (S.D.N.Y. 1983), Zaitzeff & Kunz argued that the *Allied* court should reverse itself, or be reversed by the Supreme Court. *See* Zaitzeff & Kunz, *supra* note 173, at 483.

214. In its brief, the United States explained:

> The United States supports the cooperative and negotiated resolution of international debt problems within a context in which legal principles require enforcement of international loan agreements. Substantial alteration of these legal principles changes expectations in a way that renders contractual relations less certain, thereby discouraging needed further lending. . . .
>
> [B]y denying lenders enforcement of their loan contracts according to their terms, the Court introduces uncertainty in future international contractual relations and makes the adversarial context more attractive to the debtor than cooperation with all creditors and the IMF. Thus, the Court's decision undermines the established cooperative framework essential to continued success in dealing with international financial problems in the months and years ahead. The effect is therefore not to further United States interests, including interests in the international financial system, but to jeopardize those interests and important policy objectives.

Brief for the United States as Amicus Curiae, July 1984, at 6-7, 18, Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985) (No. 83-7714).

215. The court stated that, in its original opinion, its

> interpretation of United States policy . . . arose primarily from our belief that the legislative and executive branches of our government fully supported Costa Rica's actions and all of the economic ramifications. On rehearing, the Executive Branch of the United States joined this litigation as *amicus curiae* and respectfully disputed our reasoning. . . .

for entry of summary judgment in favor of Allied Bank.[216] The court noted that U.S. policy on sovereign debt restructuring

> is grounded in the understanding that, while parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable. Costa Rica's attempted unilateral restructuring of private obligations . . . was inconsistent with this system of international cooperation and negotiation and thus inconsistent with United States policy.[217]

Although the *Allied* court, properly instructed by the executive branch, confidently declared a sovereign's unilateral attempt to reschedule its debts to be inconsistent with U.S. policy, the court's abrupt reversal exposed a limitation of the comity doctrine as a defense to sovereign debt collection actions: the defense's likelihood of success is subject to reassessment with each shift in U.S. policy on sovereign debt restructuring. The announcement of the Brady Plan four years after *Allied* was decided, with its emphasis on debt reduction and its implicit acceptance of the reality that LDC debts would never be repaid in full, therefore begged the immediate question whether a comity defense might be successful in light of that change in U.S. policy. Post-Brady Plan cases have answered that question in the negative, interpreting the Brady Plan as essentially a call for *voluntary* debt forgiveness while emphasizing that the sovereign's obligations remain fully enforceable.[218] Thus, courts have not extended comity to the unilateral imposition of exchange controls or to outright defaults by sovereign debtors in response to domestic economic crises, even when persuaded that denying comity will impact adversely on a country's economy.[219]

> In light of the government's elucidation of its position, we believe that our earlier interpretation of United States policy was wrong.

Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 519-20 (2d Cir.), *cert. dismissed*, 473 U.S. 934 (1985).

216. *Allied*, 757 F.2d at 523. After concluding that Costa Rica's actions in suspending debt payments were not entitled to deference in the interests of comity, the court proceeded to consider whether adjudication of the suit was barred by the act of state doctrine. The court found the situs of the debt to be New York and therefore concluded that the act of state doctrine did not apply. *Id.* at 520-22; *see supra* text accompanying notes 194-97.

217. *Id.* at 519.

218. *See infra* text accompanying note 330; *see also* National Union Fire Ins. Co. v. People's Rep. of the Congo 729 F. Supp. 936, 944 & n.5 (S.D.N.Y. 1989) ("If this Court were to refuse to enforce this default judgment . . . it would have the effect of depriving a creditor of its right to choose whether to reschedule a debt or to enforce the underlying obligation to pay.").

219. *See, e.g.*, Banco Cafetero (Panama) S.A. v. The Republic of Peru, 94 Civ. 3569 (JSM), 1995 U.S. Dist. LEXIS 11840, at *13 (S.D.N.Y. Aug. 17, 1995) ("While the Court is not unsympathetic to Peru's efforts . . . to restructure its debt, as the Second Circuit noted in *Allied* . . . , a country's 'inability to pay United States dollars relates only to the potential enforceability of the judgment; it does not determine whether judgment should enter.' " (quoting *Allied* 757 F.2d at 522)). Similarly, in *National Union*, 729 F. Supp. at 936, the court stated:

E. *Averting the Nightmare Scenario*

The Second Circuit's decision in *Allied* was a landmark in the legal history of the debt crisis. Decided in the crisis' darkest days, the case set a reassuring precedent for bank creditors fearful that a judicial declaration that their sovereign loans were less than fully enforceable would undercut their position in debt restructuring negotiations or, worse, prompt regulators to require them to write off a percentage of their LDC loans. In a single stroke, the decision eliminated the banks' concerns about the viability of an act of state or comity defense, the two most likely prospects in a sovereign debtor's arsenal of affirmative defenses. More fundamentally, however, *Allied* foreclosed further judicial inquiry into the application of bankruptcy principles to collection actions arising from the debt crisis. The Second Circuit's first *Allied* decision[220] deferred on comity grounds to Costa Rica's unilateral attempt to reschedule its debts, finding the country's situation analogous to a Chapter 11 reorganization.[221] Had the decision not been vacated on rehearing, it might have become precedent for subsequent judicial attempts to apply bankruptcy principles to sovereign debt restructurings. Creditor banks, understandably, viewed that prospect with horror at the time, and it is impossible to say now whether that course would have brought disaster or merely an earlier acceptance of reality. Four years later, however, when the Brady Plan was announced, the banks had already accepted the need for a measure of debt forgiveness. In any event, the Second Circuit's self-reversal in *Allied* renders the question purely academic. *Allied* thus permitted the banks to come to the negotiating table in a position of strength: new loans and debt service reduction could be arranged if the sovereign debtors agreed to institute necessary economic reforms. If not, there was always the courts. The banks' nightmare scenario was averted.

> The Court is mindful of the fact that enforcement of this default judgment is likely to cause financial difficulties for the Congo. . . .
>
> [But t]his Court is not the appropriate government institution to weigh the harm to the Congo of paying a valid judgment, against the harm to [plaintiff] that would flow from its being denied its legal right to enforcement of the judgment.

Id. at 945. In A.I. Credit Corp. v. Government of Jamaica, 666 F. Supp. 629 (S.D.N.Y. 1987) the court stated:

> We have been advised by defendant that our holding could have a devastating financial impact on the Government of Jamaica. . . . But it is not the function of a federal district court in an action such as this to evaluate the consequences to the debtor of its inability to pay nor the foreign policy or other repercussions of Jamaica's default.

Id. at 633.

220. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 733 F.2d 23 (2d Cir. 1984), *vacated on reh'g*, 757 F.2d 516, *cert. dismissed*, 473 U.S. 934 (1985).

221. *See supra* text accompanying notes 211-12.

There was, of course, the *other* nightmare scenario: by reversing its first decision in *Allied*, the Second Circuit implicitly upheld the right of the "rogue bank" to opt out of a sovereign debt restructuring plan accepted by a majority of creditors and to seek full payment of a debt that other banks were willing to compromise.[222] A wave of such collection actions might have damaged restructuring efforts irreparably, perhaps prompting the debtor countries to suspend debt service altogether. Indeed, it is remarkable, in light of the debtor countries' vulnerability to collection actions throughout the debt crisis, that so few creditors chose to use litigation to assert the rights which the courts had so dutifully declared themselves willing to enforce.[223]

One reason for the banks' restraint can be found in the provisions of the loan agreements themselves. Many of the loans were held pursuant to syndicated loan agreements,[224] which required a majority or supermajority vote of the syndicate banks to declare an event of default.[225] Most of the loan agreements, moreover, contained provisions designed to insure that all bank creditors would be treated equally after a default was declared. Cross-default clauses, for example, provided that a default under certain of the borrower's other loan agreements would constitute a default under the loan agreement in which the clause was contained.[226] Thus, if one bank or bank syndicate declared a default under its loan agreement, the agreement's cross default clause would give other banks an equal and immediate right to pursue default remedies under their loan agreements. The ensuing race to attach limited sovereign assets in the United States promised to be one with few winners and a great number of losers.[227]

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222. *See supra* text accompanying notes 206-08.

223. *See* Cleary Gottlieb Steen & Hamilton, New York & Clifford Chance, London, *Avoiding the Nightmare Scenario*, Int'l Fin. L. Rev., Aug. 1992, at 19 ("When one considers that the debt crisis has offered more than US$500bn of provocation to potential plaintiffs, the number of lawsuits actually filed . . . over the last decade has been astonishingly small.").

224. In a syndicated loan, a group of banks makes loans to a debtor under an agreement that binds all of the banks to the basic payment terms. These terms, which cannot be altered by individual syndicate members, typically include ratable sharing of payments among the syndicate members. MacMillan, *supra* note 6, at 324 n.95; Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, 1988 U. Ill. L. Rev. 493, 500-01.

225. A bank syndicate member thus could not sue the borrower for unmatured principal unless a majority of its fellow syndicate members declared a default and accelerated the debt. *See* Buchheit & Reisner, *supra* note 224, at 496.

226. *See id.* at 496; Sklar, *supra* note 196, at 75 n.92.

227. Buchheit aptly describes the banks' predicament during the crisis as

> a kind of balance of terror; each ha[d] its full panoply of legal rights in the face of a massive default, but any attempt to enforce those rights w[ould] jeopardize the position of all creditors. The clear message [was] that a move toward the courthouse by a *few* lenders would risk a stampede by *many* lenders, thus damaging—perhaps irretrievably—the interests of *all* lenders.

Buchheit & Reisner, *supra* note 224, at 504-05 (footnote omitted).

Even the winners of the race to the courthouse would find their victory pyrrhic. Pari-passu clauses in the loan agreements provided that no creditors under subsequent loan agreements would be given senior secured status.[228] All banks thus had an equal right to the sovereign's limited attachable assets. Most syndicated loan agreements, moreover, contained sharing clauses by which each bank in the syndicate promised that, if it received any payment from the borrower, including payments in respect of litigation settlements or judgments, which exceeded its proportionate share in the syndicated loan, it would share the payment ratably with the other syndicate members.[229] Thus, a bank that elected to sue the borrower might find that it had to share most of its recovery with other banks.[230]

The most important reason for the banks' restraint, however, was the sheer size of the loans.[231] During the early years of the crisis, the most heavily exposed banks did not have sufficient reserves to cover their sovereign loans.[232] The banks were desperate, therefore, to avoid doing anything that would require them to write off the loans, and they could not pursue litigation without first declaring the loans to be in default. Although in theory the banks could accelerate the loans and sue for the entire unpaid balances, the chances of actually recovering such amounts from the attachment and sale of limited sovereign assets in the United States were close to nil.[233] The effect of these pressures was a de facto replication of the U.S. Bankruptcy Code's automatic stay of collection actions against a debtor.[234] The banks were effectively unable to pursue their collection rights even though those rights were fully enforceable.[235]

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228. *Id.* at 497 & n.9.

229. *Id.* at 510.

230. *Id.*

231. A Brazilian banker aptly characterized the situation by updating an old adage: "If I owe a million dollars, then I am lost. But if I owe fifty billion dollars, the bankers are lost." Palzer, *supra* note 30, at 727 (footnote omitted).

232. *See supra* note 40.

233. *See* James B. Hurlock, *The Way Ahead For Sovereign Debt*, Int'l Fin. L. Rev., July 1995, at 10-11 (noting that "it [was] much more difficult than often supposed to seize sovereign assets of any significance. Usually, only limited assets exist outside the debtor country and much of that is legally immune from attachment."); *see also* Palzer, *supra* note 30, at 748. Palzer notes:

> [A]cceleration, despite the fact of technical default, [was] rarely if ever employed. Such action would wreak havoc on the accelerating banks, the domestic economy of the sovereign, and the international capital markets. . . . [D]ue to the large amounts of debt loaned by the banks, relational and external forces affect[ed] the formal legitimacy of the contract almost immediately. . . . These forces impose[d] a categorical rule upon the loan relation- never litigate, never accelerate, and never exercise the substantive legal rights of the formal contract.

Id. (footnotes omitted).

234. *See* 11 U.S.C. § 362 (1994).

235. As one commentator noted:

III. Suing the Sovereign: The Way of the Future?

The effective freeze on collection actions has thawed as banks have reduced their exposure to LDC debtors and unloaded their LDC loan assets in the secondary market. The growth of the secondary market has created a new class of sovereign creditors, having incentives and expectations entirely different from those of their commercial bank predecessors. Because their debt holdings are comparatively smaller, individual secondary market purchasers of sovereign debt are more likely than were their commercial bank assignors to obtain full satisfaction of their claims by attaching the sovereign's limited U.S. assets following a default. In addition, secondary market purchasers are not subject to the same peer and political pressures to participate in debt restructurings, and may have a strong profit incentive to use litigation to collect on their sovereign loan assets. Indeed, the substantial discount in secondary market prices may cause LDC debt to become more valuable in default than as a performing loan asset. While the debt is performing, the investor holds an asset valued at pennies on the dollar; the chance that the sovereign will be able to repay the face value at maturity is slim. After a default, however, the investor acquires the right to accelerate the debt and proceed against available sovereign assets in the United States. The effect of these different incentives on the ongoing sovereign debt restructuring process is illustrated by the two recent cases discussed in this part.

A. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil

Like Mexico, Brazil became unable to pay its debts to foreign creditors in 1982.[236] In September of 1988, after a series of reschedulings,[237] Brazil and its creditors entered into a Multi-Year Deposit

> [I]t is astonishing how the fundamental bankruptcy freeze on piecemeal creditor actions to protect the debtor and to preserve the *pari passu* principle has been aped by state debt moratoriums—but without a bankruptcy statute, without a court sanction. The observance of the freeze is the more remarkable in that it happened at a time when the sovereign's protective immunity had been recently stripped away . . . by case law and legislation so as to leave the sovereign debtor bare of his armour.

Philip R. Wood, *The Lessons of State Bankruptcy*, Int'l Fin. L. Rev., Aug. 1992, at 9, 9; *see also* Buchheit, *supra* note 35, at 10 (noting that "[f]rom the beginning, sovereign debt restructuring took as one of its fundamental tenets the principle of 'equal treatment of creditors' ").

236. *See* Nicoll, *supra* note 27, at 4.

237. Brazil had previously negotiated restructurings with various of its commercial bank creditors in 1983, 1984, and 1986. Statement of Interest of the United States of America in Opposition to the First Amended Complaint at 2-3, CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995) (No. 94 Civ. 4733) [hereinafter Statement of Interest]. In February of 1987, Brazil declared a general moratorium on the repayment of interest on its commercial bank loans. Santos, *supra* note 18, at 88 n.170. After the appointment of a new finance minister in December of 1987, however, Brazil adopted a new policy of cooperation

Facility Agreement ("MYDFA"), which restructured over $60 billion (the great majority) of Brazil's debt to commercial bank creditors. Banco Central do Brasil, the Brazilian central bank (the "Central Bank"), was the obligor under the MYDFA.[238] Only a year after the MYDFA was executed, however, Brazil again found itself unable to meet its obligations, and initiated negotiations to restructure the MYDFA debt.[239]

In July of 1992, Brazil and its creditors reached an initial agreement-in-principle on a Brady Plan securitization of the MYDFA debt (the "1992 Accord").[240] Under the 1992 Accord, Brazil's creditors were offered a menu of options for converting their MYDFA debt into Brady bonds. Most creditors opted for par bonds, which would give them the full face value of their MYDFA principal, but bear a lower, fixed interest rate.[241] The par bonds would be collateralized by U.S. Treasury bonds to be purchased by Brazil with the proceeds of IMF loans.[242] A second option offered under the 1992 Accord was uncollateralized bonds, to be converted from the MYDFA debt at full principal value, but bearing an initial interest rate of four percent, rising to eight percent over six years.[243] After receiving commitments to the 1992 Accord, however, Brazil sought to alter its terms, and asked its creditors to convert at least thirty-five percent of their MYDFA debt to yet another option—collateralized bonds to be converted at a deep discount from the face value of the MYDFA principal, but bearing a floating interest rate.[244] All of the MYDFA creditors ultimately agreed to this proposal except one, the Dart family of Sarasota, Florida.[245]

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with its creditors and resumed payments of interest arrears. Statement of Interest, *supra*, at 2-3.

238. *Id.* at 4.

239. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1107 (S.D.N.Y. 1995).

240. *See* Statement of Interest, *supra* note 237, at 4-5. The 1992 accord was not finalized until early 1994. The Brady Plan conversion, which restructured more than $47 billion of Brazil's debt to commercial bank creditors, closed in New York on April 15, 1994. *Id.*

241. Kenneth N. Gilpin, *Darts Clash With Brazil Over Loans*, N.Y. Times, Oct. 23, 1993, § 1, at 37, 46.

242. *Id.* at 46.

243. *Id.*

244. *Id.*

245. *See* Adrian Dickson, *Brazil Sees Smooth Debt Bond Exchange Friday*, Reuters, Apr. 14, 1994, *available in* LEXIS, NEWS Library, CURNWS File (noting that the "only flaw" in Brazil's debt restructuring deal, in which more than 700 creditors converted their MYDFA debt to bonds, was the Dart's refusal to participate). The Darts, one of America's richest families, own the Dart Container Corporation, a manufacturer of styrofoam cups. Kenneth N. Gilpin, *Dart Family Files Lawsuit to Nudge Brazilian Bank*, N.Y. Times, June 30, 1994, at D5.

Since 1991, the Darts had been quietly purchasing Brazilian debt at a sixty-five percent discount[246] in the secondary market. By 1993, the Darts had acquired obligations having a face value $1.4 billion,[247] making them Brazil's fourth largest creditor.[248] The family did not reveal the extent of its holdings, however, until Brazil attempted to alter the terms of the 1992 Accord.[249] The Darts' potential profit from the Brady deal, had they accepted the deep discount bond option, was estimated at $270 million.[250] Instead, the Darts insisted on converting all of their MYDFA debt to the uncollateralized bonds originally offered under the 1992 Accord.[251] Under the uncollateralized bond option, the Darts stood to reap a profit of $360 million from the conversion.[252] Holding out for the greater profit, the Darts refused to convert their MYDFA debt at the April 15, 1994 closing of Brazil's Brady deal.[253]

Faced with the Darts' intransigence, Brazil took defensive measures. Under the terms of the MYDFA, an acceleration of the MYDFA debt could be declared only with the consent or at the request of holders of more than fifty percent of the principal outstanding under the MYDFA.[254] Therefore, if, as contemplated by the 1992 Accord, all of Brazil's creditors (except the Darts) converted their MYDFA debt to bonds, the Darts would have an immediate right after the conversion to declare an acceleration of their $1.4 billion of

246. *See* Mark A. Cymrot, *LDC Debt Market Mavericks Are Taking Big Risks*, Am. Banker-Bond Buyer, Nov. 1, 1993, at 7.

247. *See* Gilpin, *supra* note 241, at 37; *see also* Peter Krijgsman, *Escape to El Dorado: Why Are Investors Venturing Again to the Third World Where They Got Burnt in the 1980s?*, The Independent, Dec. 12, 1993, at 9.

248. Gilpin, *supra* note 245, at D5; Michael Kepp, *Brazil's Make or Break Week*, Am. Banker-Bond Buyer, Mar. 14, 1994, at 1.

249. *See* Gilpin, *supra* note 241, at 46.

250. *See* Krijgsman, *supra* note 247, at 9.

251. *See* Gilpin, *supra* note 241, at 46.

252. *See* Krijgsman, *supra* note 247, at 9. Moreover, the Darts apparently still had the option of selling their debt on the secondary market at a profit. The Darts purchased the debt in 1991 and 1992 for approximately $375 million. After Brazil closed its Brady deal in 1994, the Darts' stake was valued at $980 million, a three year gain of 161%. *See* Elizabeth Lesly, *The Darts: Fear, Loathing, and Foam Cups*, Bus. Wk., July 10, 1995, at 58; *see also* Cymrot, *supra* note 246, at 7 (describing the Darts' position as a "no lose situation: either gain concessions from Brazil or sell its appreciated debt at a profit").

253. *See Brazil Nears Brady Despite Last-Minute Action by the Darts*, Reuter Textline, Euroweek, Apr. 15, 1994. Because of the size of the Dart's holdings, Brazil did not attempt to repurchase its debt directly from the family. *See* Gilpin, *supra* note 241, at 37. In addition, any special deal giving the Darts better terms than those offered to Brazil's other creditors might have caused the Brady deal to come unhinged, since the 1992 Accord was built on notions of shared sacrifice. *See id.* at 46 (quoting one of Brazil's other creditors as saying "Nobody will permit the Darts to get a better deal than they [sic] get. . . . [The Darts] are being offered what everybody else is getting, so it's hard to see how they are being treated unfairly").

254. *See* CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1113 (S.D.N.Y. 1995) (quoting section 10.01 of the MYDFA).

MYDFA debt.[255] To prevent that occurrence, the Brazilian government instructed Banco do Brasil, a state owned commercial bank,[256] to retain an amount of MYDFA debt sufficient to ensure that the Darts would not hold more than forty-nine percent of the MYDFA debt outstanding after the conversion.[257] At the April 15, 1994 closing, therefore, Banco do Brasil converted all of its MYDFA debt except approximately $1.6 billion, which it continued to hold under the MYDFA.[258]

Foiled in their attempt to obtain better terms than Brazil's other creditors, the Darts filed suit[259] in the Southern District of New York, naming as defendants the Central Bank, Banco do Brasil, and Citibank, as agent under the MYDFA. Alleging that Banco do Brasil had retained its $1.6 billion of MYDFA debt in a bad faith attempt to prevent them from becoming a majority creditor under the MYDFA, the Darts sought a declaration of their right to accelerate the MYDFA principal without the consent of Banco do Brasil.[260] In addition, the Darts sought repayment of the full $1.4 billion face amount of their debt, together with some $60 million in accrued interest.[261] The defendants all moved to dismiss the Darts' complaint.[262] Perhaps appreciating their probable futility, the defendants did not raise any of the affirmative defenses discussed in part II. Instead, the defendants relied solely on the terms of the MYDFA. Banco do Brasil was the majority creditor under the MYDFA. Therefore, the defendants argued, the Darts could not accelerate the MYDFA principal without the consent of Banco do Brasil.

255. After all of Brazil's other creditors converted their MYDFA debt at the 1994 restructuring, the Darts would be the largest holder of MYDFA debt. *See* Stephen Fidler, *Washington Opposes Suit Over Brazil Debt*, Fin. Times, Sept. 20, 1994, at 5.

256. Banco do Brasil is 51% owned by the Brazilian Treasury. Although an obligor under the MYDFA, Banco do Brasil is also an original creditor under that agreement. *CIBC*, 886 F. Supp. at 1107.

257. *See* Fidler, *supra* note 255, at 5; *Banco do Brasil Ready to Swap Debt for Brady Bonds*, Latin America Regional Reports: Brazil, Sept. 22, 1994, at 4. Anticipating a lawsuit and a possible attempt by the Darts to attach Brazilian assets, Banco Central also ordered Brazilian commercial banks involved in foreign exchange operations to deposit long positions in excess of $10 million in the Banco do Brasil's Grand Cayman subsidiary, outside the reach of United States law. *See Brazil Moves to Stop Darts From Foiling Debt Deal*, Reuters, Apr. 14, 1994, *available in* LEXIS, NEWS Library, CURNWS File; *Brazil Nears Brady Despite Last-Minute Action by the Darts*, Reuters, Apr. 15, 1994, *available in* LEXIS, NEWS Library, CURNWS File; Mary D'Ambrosio, *As Brazil Deal Closes: Reform Delay Miffs Investors; Focus Shifts to Elections*, LDC Debt Report/Latin American Markets, Apr. 18, 1994, at 1.

258. *CIBC*, 886 F. Supp. at 1107.

259. The plaintiff in the suit was CIBC Bank and Trust Company (Cayman) Ltd., the designated holder-of-record of the Darts' MYDFA debt.

260. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1108 (S.D.N.Y. 1995).

261. *See id.*; Gilpin, *supra* note 245, at D5.

262. *CIBC*, 886 F. Supp. at 1108.

Conceding that they were not the majority creditor under the MYDFA, the Darts argued that Banco do Brasil's share of the MYDFA debt should be disregarded in determining whether the Darts had the authority unilaterally to declare an acceleration under the MYDFA.[263] In support of their argument, the Darts reasoned by analogy to four areas of law. First, they cited the New York common law regarding compositions,[264] under which a court, in determining whether a composition should be approved, will disregard the votes of creditors who are controlled by the debtor.[265] The Darts also cited section 1129 of the U.S. Bankruptcy Code, under which insiders[266] are prevented from voting on whether a reorganization plan will be accepted by a class of impaired creditors.[267] As a third source of authority, the Darts cited the Trust Indenture Act of 1939,[268] under which, unless otherwise specified in an indenture, bondholders controlled by the issuer are excluded from voting on whether to consent to any default by the issuer.[269] Finally, the Darts cited section 612(b) of the New York Business Corporation Law, which prevents a subsidiary corporation from voting shares held in its parent.[270]

Although acknowledging the Darts' creativity, the court found no support for their argument in any of the four sources of law they cited.[271] The court noted that the Trust Indenture Act of 1939 explicitly does not apply to foreign sovereign debt,[272] and found the New York Business Corporation Law "as distant in terms of reasoning as New York is from Brazil in terms of geography."[273] Although it found the common law of compositions and the U.S. Bankruptcy Code more nearly on point, the court noted that both sources of law merely prevent entities controlled by the debtor from voting whether to accept a composition or reorganization plan in the first instance.[274] Such entities are not prevented from voting on the interpretation of a composi-

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263. *Id.* at 1113-14.

264. The court defined a composition as

> [a]n agreement, made upon sufficient consideration, between an insolvent or embarrassed debtor and his creditors, whereby the latter, for the sake of immediate or sooner payment, agree to accept a payment less than the whole amount of their claims, to be distributed *pro rata*, in discharge and satisfaction of the whole.

Id. at 1114 (quoting Black's Law Dictionary 286 (6th ed. 1990)).

265. *See id.* at 1114 (citing *In re* Henry, 11 F.Cas. 1148, 1150 (S.D.N.Y. 1878)).

266. "Insiders" are defined by the Bankruptcy Code as entities controlled by, or under common control with, the debtor. *See* 11 U.S.C. § 101(31) (1994).

267. *See id.* § 1129(a)(10) (1994).

268. 15 U.S.C. § 77aaa-bbbb (1994).

269. *See* 15 U.S.C. § 77ppp(a) (1994).

270. N.Y. Bus. Corp. Law § 612(b) (McKinney 1986).

271. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1115 (S.D.N.Y. 1995).

272. *See* 15 U.S.C. § 77ddd(a)(6) (1994).

273. *CIBC*, 886 F. Supp. at 1115.

274. *Id.* at 1114.

tion or reorganization plan after it has been executed or confirmed.[275] The Court found it

> unremarkable that an entity controlled by the debtor should not be allowed to vote on whether the composition or reorganization plan—instruments that *define* the debtor-creditor relationship—should be adopted. To allow such voting would alter the relative bargaining strengths of the debtor and his or her creditors in such reorganization negotiations. In the instant case, on the other hand, the issue revolves around whether [Banco do Brasil] should be able to exercise rights that are already set out in the provisions of the existing "composition," *i.e.*, the MYDFA.[276]

Although the court's conclusion is entirely correct from a legal standpoint, an implicit assumption of its reasoning is that the dispute over whether the Darts had the right unilaterally to declare an acceleration under the MYDFA was merely a question of interpreting an "existing 'composition,' *i.e.*, the MYDFA." If, instead, the court viewed the terms of the MYDFA as the original source of Brazil's obligations to the Darts,[277] then it would seem equally plausible to view the 1992 Accord, not the MYDFA, as the composition or reorganization plan, and to view Banco do Brasil's eleventh hour decision not to convert $1.6 billion of its MYDFA debt as an attempt to "alter the relative bargaining strengths of the debtor and [its] creditors in [the] reorganization negotiations."[278] A debtor in Chapter 11 must propose a reorganization plan in good faith,[279] and a plan generally must be accepted by all impaired classes of creditors before it may be confirmed.[280] A court bent on drawing the analogy to the bankruptcy code might indeed have viewed Brazil's Brady Plan conversion, including Banco do Brasil's calculated retention of $1.6 billion of MYDFA debt, as a bad faith attempt to retaliate against the Darts for refusing to accept the plan as offered, and to "cram down" an inequitable reorganization plan over the dissent of its fourth-largest creditor.

In any event, the court dismissed the Darts' claim for a declaration of their right unilaterally to accelerate the principal of their MYDFA debt,[281] but did not dismiss their breach of contract claim for $60 million in overdue interest.[282] The case was recently settled for a $25

275. *See id.*

276. *Id.* at 1115.

277. After all, the Darts were not creditors of Brazil in 1988 when the MYDFA was executed; they purchased their debt on the secondary market in 1990 and 1991.

278. *See supra* text accompanying note 276.

279. 11 U.S.C. § 1129(a)(3) (1994).

280. *Id.* § 1129(a)(8) (1994). Alternatively, a plan can be "crammed down" under 11 U.S.C. § 1129(b)(1) if all the other requirements of § 1129(a) are satisfied and the plan does not discriminate unfairly and is fair and equitable with respect to each class of impaired claims that has not accepted the plan.

281. CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1117 (S.D.N.Y. 1995).

282. *Id.* at 1111.

million cash payment and $52.3 million in bonds, representing interest accrued to April of 1994.[283] A number of important questions were left unanswered by the court's decision, however, including whether the Darts may recover the full $1.4 billion of outstanding principal of their MYDFA debt at maturity. That question was presumably answered affirmatively by the Second Circuit's decision in *Allied* ten years earlier.[284] A "Statement of Interest" submitted by the United States in *CIBC*, however, cast doubt on the continuing validity of *Allied* as applied to secondary market purchasers of sovereign debt.

In its Statement of Interest in *CIBC*, the United States urged the court to deny the Darts' request to accelerate their MYDFA debt. The United States noted that the rapid growth of the secondary market for sovereign debt since *Allied* was decided has dramatically altered the relationship between LDC debtors and their creditors. The Statement of Interest observes that

> [i]n 1984, the United States identified in its *Allied* brief a number of factors extant at that time that helped assure good faith efforts on the part of debtors and creditors to resolve sovereign debt problems. These included: creditors' realization that orderly resolution of such problems is the best assurance of full repayment; a dearth of debtor assets to satisfy judgments; and peer pressure from like-minded fellow creditors that helped constrain impulsive or short-sighted behavior. The United States also observed at that time that there were only a limited number of banks unwilling to participate in sovereign debt restructurings, preferring instead to litigate to enforce their contractual rights (so-called "rogue banks").
>
> As a result of these factors, until now there have been relatively few lawsuits stemming from the sovereign debt crisis. These factors, however, are not present in 1994 to the same extent they were ten years ago. Most significantly, there has been a dramatic increase in the number of secondary market purchasers of sovereign debt.[285]

The growth of the secondary market is significant, the Statement of Interest observes, because

> purchasers of debt on the secondary market do not necessarily have the same long-term interests as the commercial bank creditors who were the original lenders. Entities that purchase sovereign debt on the secondary market often do not intend to undertake a direct credit relationship with the sovereign borrower. Rather, some are investors who intend either to use the debt in debt-for-equity transactions or for other debt exchanges, or to resell it at a later date at a profit.[286]

As a result of these divergent interests of secondary market sovereign debt purchasers,

283. *See Brazil Settles a Suit With Dart Family*, N.Y. Times, Mar. 20, 1996, at D5.
284. *See supra* text accompanying note 197.
285. Statement of Interest, *supra* note 237, at 12-13.
286. *Id.* at 14.

> the sovereign debtor can no longer count on creditors being like-minded, similarly situated commercial financial institutions susceptible to peer pressure.
>
> This is a significant development in light of the absence of a neutral decisionmaking body, such as a bankruptcy court, with authority to restructure sovereign debt.[287]

In light of the changes wrought by the growth of the secondary market, the United States observed that its concern in *CIBC* was a "mirror image" of its concern in *Allied* ten years earlier.[288] In *Allied*, the United States had been concerned that a judgment for Costa Rica would encourage sovereign debtors to use the courts to extract better terms from creditors than they could obtain through negotiation.[289] In *CIBC*, conversely, the United States was concerned that a judgment in favor of the Darts would encourage *creditors* to use the courts to gain unfair concessions from sovereign debtors.[290]

More surprisingly, the United States also suggested that the availability of discounted sovereign debt in the secondary market has lowered creditors' reasonable expectations of full repayment. The Statement of Interest notes that

> [w]hile in 1984 banks rescheduled debt with the expectation of eventual full repayment, the widespread acceptance of the Brady Plan, which calls for commercial debt service and debt reduction, has generally changed this expectation.[291]

Without stating explicitly what amount of sovereign debt recovery by secondary market purchasers the United States would consider reasonable, the Statement of Interest notes that

> [sovereign] debt obligations effectively have two values. One is their original legal contract value, *i.e.*, the values stated in the obligations themselves, expressed in terms of outstanding principal and interest due over a particular period of time. The other is their generally recognized market value, *i.e.*, the amount outside investors are willing to pay for the debt instruments at a particular point in time.[292]

Although the United States stopped short of urging the court to limit the amount of any MYDFA principal the Darts might ultimately recover to their debt's "second" value, i.e. its "generally recognized market value," the Statement of Interest notes that

> [g]iven the Brady Plan's insistence that the contractual terms of debt instruments be honored, certain creditors—like Dart—who have purchased debt on the secondary market and are not suscepti-

287. *Id.* at 13.
288. *Id.* at 17.
289. *See supra* note 214.
290. Statement of Interest, *supra* note 237, at 17.
291. *Id.* at 14.
292. *Id.* at 14-15.

> ble to the same influences as the original commercial bank creditors may be motivated to seek compensation based upon the values stated in the original debt obligations, *rather than upon their lower, present market values.* These creditors may seek through litigation to benefit from voluntary debt reduction previously agreed to by the commercial banks . . . rather than negotiate a restructuring with the debtor in the orderly manner that the United States described in its *Allied* brief and has supported consistently since 1982 through the Baker and Brady Plans.[293]

The Statement of Interest thus betrays a studied ambiguity on the question of the proper value of the Darts' MYDFA debt for purposes of calculating any future recovery of the principal.[294] Interpreted most broadly, the Statement of Interest seems to suggest that secondary market purchasers of discounted sovereign debt may use litigation to recover only the present market values of their debt instruments in the event of a default. Any greater recovery is presumably not objectionable, provided it is achieved through "orderly" negotiation, rather than litigation. If that is in fact the current official U.S. policy on the enforceability of foreign sovereign debt by secondary market purchasers, it has not been widely disseminated, and no doubt would be of considerable interest to the thousands of U.S. investors who collectively have purchased more than $136 billion of Brady bonds to date.

Militating against a broad interpretation of the Statement of Interest, however, is the fact that it was addressed to the narrow question whether the Darts should be allowed to declare an acceleration under the MYDFA. The question of the proper measure of MYDFA principal recovery after any such acceleration was not technically before the court. The United States was particularly concerned by what it viewed as an attempt by the Darts effectively to amend the terms of the MYDFA to prevent Banco do Brasil from asserting its contractual right to vote on any acceleration under the MYDFA.[295] The Statement of Interest is more ambiguous, however, on the question of the extent to which the Darts may enforce their own contractual right to recover the full face amount of their MYDFA principal at maturity, notwithstanding that (1) the Darts purchased their debt at thirty-five percent of face value and (2) all of Brazil's other creditors agreed to

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293. *Id.* at 15-16 (emphasis added).

294. The Statement of Interest does emphasize the

> critical role of the contract in resolving the debt crisis. Specifically, the Brady Plan does not condone a debtor's unilateral repudiation of the stipulated value of a contract or any of the terms of a contract. Rather, the Brady Plan contemplates the sharing of financial sacrifices between sovereign debtors and their commercial creditors in the context of negotiated and mutually agreed-upon arrangements.

Id. at 15.

295. *See id.* at 17-18.

write off a portion of their MYDFA debt by accepting discounted Brady bonds in exchange for their debt instruments.

B. Pravin Banker Assocs. Ltd. v. Banco Popular del Peru

The proper measure of recovery was even more hotly contested in a recent collection action against Peru, decided shortly after *CIBC*. In 1990, Pravin Banker Associates, Ltd., the plaintiff in the case, purchased from Mellon Bank a $9 million debt owed by Banco Popular del Peru, a commercial bank owned by the Peruvian government.[296] The debt had been guaranteed by Peru and was payable in the United States in U.S. dollars. As a result of Peruvian exchange control regulations, Banco Popular had not made a payment of the debt principal since 1984, instead limiting payment to interest amounts as they fell due.[297] The debt was thus in technical default at the time Pravin purchased it. Pravin purchased the debt for twenty-seven cents on the dollar[298] and within two days resold all but $1.4 million of the debt to other investors for an undisclosed price.[299] Notified of the assignment, Banco Popular made interest payments on the $1.4 million directly to Pravin until February of 1992,[300] when Pravin served Banco Popular with a notice of default and demanded payment of the full principal amount.[301] In December of 1992, the Peruvian Superintendent of Banks instituted liquidation procedures against Banco Popular. Instead of filing a claim in the liquidation, however, Pravin filed suit against Banco Popular and Peru in the U.S. District Court for the Southern District of New York.

The timing of the suit was not coincidental. At the time the suit was filed, Peru's debt was trading on the secondary market at approximately thirty-four cents on the dollar.[302] Had Pravin sold the debt at that price, therefore, it would have turned a profit, in addition to the interest payments it had received, of seven cents for each dollar of debt sold.[303] By seeking a judgment for the full face amount of the

296. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 165 B.R. 379, 380, 382 (S.D.N.Y. 1994).

297. *See id.* at 381.

298. *Id.* at 382.

299. *Id.*

300. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, No. 93 Civ. 0094, 1995 U.S. Dist. LEXIS 12377, at *24-25 (S.D.N.Y. Aug. 24, 1995).

301. *Pravin*, 165 B.R. at 383.

302. *Id.* at 382.

303. Whether Pravin in fact could have sold the debt on the secondary market was a contested question in the case. The defendants maintained that the option of selling the debt at a profit on the secondary market had always been available to Pravin. *See* Defendants' Reply Memorandum in Support of Their Motion to Dismiss or Stay and in Opposition to Plaintiff's Motion for Summary Judgment, Sept. 16, 1993, at 17, Pravin Banker Assocs. Ltd. v. Banco Popular del Peru, 895 F. Supp. 660 (S.D.N.Y. 1995) (93 Civ. 0094) [hereinafter Defendants' Reply Memorandum] ("[Pravin] purchased its debt at 27 cents. As a result of Peru's compliance with its IMF Economic Program, Peru's non-performing debt is quoted by Citibank at 44 cents. By

debt, however, Pravin stood to reap a profit of seventy-three cents on each dollar of debt it held. Moreover, Pravin knew that Peru would have a strong incentive to settle the suit quietly. At the time the suit was filed, Peru was negotiating an $8 billion Brady Plan restructuring with its commercial bank creditors.[304] As a prelude to the negotiations, Peru's creditors had entered into a tolling agreement whereby they agreed to stay their pending lawsuits as long as no other collection actions against Peru went forward.[305] A judgment in Pravin's favor would entitle Peru's other creditors to reactivate the lawsuits they had stayed pursuant to the tolling agreement.[306]

Instead of settling, however, Banco Popular and Peru moved to dismiss or stay the action, and Pravin cross-moved for summary judgment. The defendants raised two primary arguments. First, they argued that, if allowed to go forward, Pravin's suit would completely disrupt Peru's efforts to negotiate a restructuring of its debts to commercial bank creditors.[307] The success of that restructuring was vital to U.S. policy concerns, the defendants contended, because it was undertaken in conjunction with an IMF-monitored economic revitalization plan, and "U.S. public policy . . . encourages [debt restructuring]

selling its debt, [Pravin] could make a windfall recovery brought about by the sacrifices of the Peruvian people.").

Pravin, on the other hand, insisted that it had been unable to sell the debt at any price and had brought suit on the debt only as a last resort. *See* Plaintiff's Memorandum in Support of its Renewed and Supplemented Motion for Summary Judgment and in Opposition to Defendants' Motion to Dismiss or Stay, Oct. 21, 1994, at 8, Pravin Banker Assocs. Ltd. v. Banco Popular del Peru, 895 F. Supp. 660 (S.D.N.Y. 1995) (93 Civ. 0094) ("Peru's suggestion that [Pravin] has a 'menu' of options, including the immediate resale of its debt at a profit, is simply wrong. . . . There is no market for the interbank working capital debt of Banco Popular, even though such debt has been guaranteed by Peru.").

304. Mary D'Ambrosio, *Successful Suit Against Peru: Nuisance and Opportunity*, LDC Debt Reports/Latin American Markets, Sept. 11, 1995, at 3.

305. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 165 B.R. 379, 382 (S.D.N.Y. 1994).

306. *See Peru Wins Delay in Pravin Banker Suit*, LDC Debt Report/Latin American Markets, Feb. 28, 1994, at 5 (noting that "[s]everal dozen of Peru's largest commercial bank creditors are watching the case with interest, and some are said to have threatened to press their own long pending lawsuits over non-repayment if Pravin Banker won its case").

307. *See* Defendants' Memorandum in Support of Their Motion to Dismiss or Stay and in Opposition to Plaintiff's Motion for Summary Judgment, July 19, 1993, at 22-24, Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp. 660 (S.D.N.Y. 1995) (93 Civ. 0094) [hereinafter Defendants' Memorandum]. The defendants argued that

> [t]his lawsuit should not be viewed as a claim by a[ ] creditor merely seeking the court's assistance to collect a debt. Pravin is misusing the Court's process to create disruption in an internationally sanctioned procedure for resolving Peru's sovereign debt problems. Pravin appears to be trying to use the threat of this case to extract concessions which Peru can not provide to other similarly situated creditors.

Id. at 26.

negotiation under the auspices of the IMF."[308] Peru argued therefore that Pravin's suit should be dismissed in the interest of international comity.[309] In addition, the defendants argued that allowing Pravin to recover the full face amount of the debt, when Pravin had paid only twenty-seven percent of the face amount, would constitute unjust enrichment.[310]

In response to the defendants' comity argument, Pravin argued that its collection rights were established by the Second Circuit's decision in *Allied*. Confronted with a similar unilateral suspension of debt repayment by Costa Rica, the *Allied* court had concluded that Costa Rica's action was inconsistent with U.S. policy, and therefore not entitled to deference in the interest of comity.[311] In response to the defendants' unjust enrichment argument, Pravin maintained that the argument, if accepted, would "create massive disruption of the financial markets, in which instruments payable at par are regularly purchased at a discount."[312]

In February of 1994, the court adjourned both motions for six months.[313] The court noted that Pravin had offered no explanation for its refusal to participate in the liquidation of Banco Popular then pending in Peru.[314] That liquidation process included a method for identifying creditors, allowance of claims, evaluating claim priorities, and appellate review in the Peruvian court system.[315] The court noted that

> [t]he Peruvian bankruptcy procedures appear to share the central premise of the United States Bankruptcy Code[ ], which is to seek equality of distribution of assets among creditors . . . and correllatively avoid[ ] preference to some.[316]

Allowing Pravin to opt-out of Peru's liquidation of Banco Popular and seek full recovery of its debt in the United States, the court held, "would be like letting the tail wag the proverbial dog."[317]

308. Defendants' Reply Memorandum *supra* note 303, at 9.

309. *See id.* at 8-10.

310. Defendants' Memorandum, *supra* note 307, at 30-32.

311. *See supra* text accompanying notes 204-17.

312. Plaintiff's Memorandum in Opposition to Defendant's [sic] Motion to Dismiss or Stay and in Further Support of its Motion for Summary Judgment, Aug. 6, 1993, at 26, Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp 660 (S.D.N.Y. 1995) (93 Civ. 0094) [hereinafter Plaintiff's Memorandum]. Pravin argued that a "purchaser [of sovereign debt] acquires the right to enforce the obligations in accordance with their terms, not watered down rights as measured by its subjective expectations at the time of purchase." *Id.*

313. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 165 B.R. 379, 389 (S.D.N.Y. 1994).

314. *Id.* at 386.

315. *Id.* at 383, 385-86.

316. *Id.* at 386 (internal quotations omitted).

317. *Id.* at 387. In granting the stay, however, the court couched its holding in rather tepid language. The court held:

At the end of the six-month adjournment, the parties renewed and supplemented their respective motions. Pravin stressed that, in addition to its claim against Banco Popular, it was also seeking to recover directly from Peru on Peru's guaranty of Banco Popular's debt.[318] The availability of a Peruvian procedure for the liquidation of Banco Popular, Pravin argued, should not prevent it from suing on Peru's guaranty in the United States.[319] In response, Peru reiterated its argument that it was negotiating in good faith with its bank advisory committee to restructure the country's external debt, and that Pravin's claims should be stayed pending the outcome of those negotiations.[320] The court granted an additional stay of sixty days and ordered the parties to submit responses to several questions regarding the status of Peru's debt restructuring negotiations.[321] In their responses, the parties offered starkly different interpretations of Peru's progress and good faith in carrying on the negotiations. In addition, Pravin submitted a letter to the court detailing press reports that Peru had quietly used the proceeds of recent privitizations to buy back, on the secondary market and without the consent of its commercial bank creditors, approximately $2 billion of its $3.8 billion of external debt at a discount of forty-five cents on the dollar.[322]

> Peru is actively attempting to conform to the mandates of the IMF. The policies of the IMF . . . may be construed to represent American policy interests. Therefore, as there is a paucity of strong policy grounds against the temporary delay in this action, a grant of a six month delay in this case appears to be appropriate.

Id. at 389. The court also noted that "a stay [of the action] in no way abrogates Pravin's ability to enforce its contract rights in the future, especially as Pravin has made no showing of urgency." *Id.* at 387.

318. *See* Plaintiff's Memorandum, *supra* note 312, at 23 (arguing that "[a] guarantor's liability attaches immediately upon default by the primary obligor when the obligations undertaken by the guarantor are unconditional. . . . Regardless of any purported defenses that Banco Popular may assert, Peru may not assert these defenses on its own behalf" (citations omitted)).

319. *Id.* at 1-2, 23-24.

320. Defendants' Memorandum, *supra* note 307, at 22-24.

321. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, No. 93 Civ. 0094, 1995 U.S. Dist. LEXIS 2730, at *3-4 (S.D.N.Y. Mar. 7, 1995).

322. *See* Letter from Pravin to Court, at 2-4 (July 21, 1995) (*on file with* the U.S. District Court for the Southern District of New York, 93 Civ. 0094). Pravin quoted several reports in both the Peruvian and U.S. press indicating that a buy-back had been accomplished through the use of privatization proceeds maintained in Swiss accounts. *Id.* (citing *Did Peru Buy It All Back?*, LDC Debt Report/Latin American Markets, July 3, 1995, at 5; Soma Biswas, *Peru Little Changed Ahead of Debt Talks*, Dow Jones Emerging Market Rep., July 7, 1995).

Pravin, pointing out the implications of a buy-back, noted that "if it is buying back its own debt, [Peru] is circumventing the debt restructuring negotiations by using its dollar reserves to secretly cash out certain holders of its debt while keeping the balance of its creditors at bay in the debt restructuring negotiations." *Id.* at 3; *see also* Sally Bowen & Lisa Bransten, *Peru Saves $1bn in Daring Debt Buy-Back of Foreign Debt*, Fin. Times, Aug. 1, 1995, at 4 (noting that the buy-back "has angered some banks because Peru has used money which, they believe, could have been used to repay debt and, instead, has bought back its obligations at discounted prices").

The court granted Pravin's motion for summary judgment.[323] Although noting factual differences from the *Allied* case, the court accepted as a premise *Allied's* holding that a sovereign debtor's unilateral suspension of external debt repayment is not entitled to deference in the interest of comity unless the suspension is consistent with U.S. policy.[324] The court then attempted to determine the extent to which U.S. policy on sovereign debt restructuring has changed in the ten years since *Allied* was decided.[325] As evidence of such a policy change, the defendants observed that *Allied* was decided before the Brady Plan signalled a U.S. endorsement of debt forgiveness for distressed sovereign debtors.[326] In addition, the defendants referred the court to the Statement of Interest in *CIBC*,[327] in which the United States argued that the growth of the secondary market for sovereign debt has dangerously altered the balance of power in sovereign debt restructurings[328] and lowered the legitimate repayment expectations of secondary market purchasers.[329]

The court was not persuaded by either argument. Although acknowledging that the Brady Plan represented a shift from the U.S. policy on sovereign debt restructuring prevailing when *Allied* was decided, the court held that

> the Brady Plan is essentially a call for *voluntary* participation by creditor banks in negotiations with foreign debtor nations to restructure their debt. The Brady Plan does not abrogate the contractual rights of creditor banks, nor does it *compel* creditors to forbear from enforcing those rights while debt restructuring negotiations are ongoing, or prohibit them from "opting out" of settlements resulting from such negotiations.[330]

The court thus affirmed for secondary market purchasers of sovereign debt the right that the *Allied* court had implicitly affirmed for commercial bank creditors ten years earlier—the right to reject a restructuring proposal that a majority of a country's other creditors are prepared to accept.[331] The *Pravin* court found support for that right in the Statement of Interest in *CIBC* and suggested that the right to opt-out might be even more important to secondary market purchasers than to commercial bank creditors.[332] The court observed that

323. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp. 660, 662 (S.D.N.Y. 1995).
324. *Id.* at 665.
325. *Id.* at 665-67.
326. *Id.* at 665.
327. *Id.* at 666.
328. *See supra* text accompanying notes 285-90.
329. *See supra* text accompanying note 291.
330. Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp. 660, 666 (S.D.N.Y. 1995).
331. *See supra* text accompanying note 222.
332. *Pravin*, 895 F. Supp. at 616.

> Pravin has never signed a general debt restructuring agreement, has not participated in any restructuring negotiations and is not represented on [Peru's] Bank Advisory Committee. In light of this fact, the CIBC Statement of Interest's observation that secondary market sovereign debt purchasers often have divergent interests from original lender creditors[333] cuts in favor of Pravin. Because Pravin's interests may well diverge from those of the creditor banks [on] the Bank Advisory Committee, the Committee does not provide Pravin with a forum in which to exert influence on the negotiations affecting the restructuring of [its] debt.[334]

The outcome in *CIBC*, the court reasoned, did not signal a retreat from *Allied's* affirmation that creditors have a unilateral right to hold the sovereign to its loan agreement because, in *CIBC*, the Darts had attempted to use litigation effectively to *amend* the terms of their loan agreement.[335] Pravin, in contrast, sought merely to enforce the terms of its agreement as written.[336]

In light of the fact that the court had twice stayed the action on comity grounds, it is striking that the court did not find the comity rationale sufficient to deny Pravin's summary judgment motion, or to stave it off indefinitely.[337] A clue to the court's apparent reversal may perhaps be found in the opinion's mention of press reports of Peru's secondary market buy-back of $2 billion of its debt at a discount of forty-five cents on the dollar.[338] Together with the court's statement that the effect of its two prior stays had been to delay resolution of the action for almost eighteen months,[339] the observation suggests the court may have been concerned that Peru was using dilatory tactics to keep Pravin and the rest of its creditors at bay, while using funds otherwise available to pay creditors to repurchase its debt instead. Indeed, the court's decision may amount simply to a recognition that comity is a two-way street. By repurchasing its debt, Peru was willing to jeopardize its ongoing debt restructuring negotiations,[340] the suc-

333. *See supra* text accompanying note 286.

334. *Pravin*, 895 F. Supp. at 666-67.

335. *Id.* at 666.

336. *Id.*

337. Commentators have remarked that "one reasonable interpretation of Pravin . . . is that, in the absence of a statement from the Executive Branch supporting the debt repudiation policy of the foreign sovereign, principles of international comity will not be applied." Lawrence W. Newman & Michael Burrows, *Defenses to Payment of Sovereign Debt*, N.Y. L.J., Oct. 31, 1995, at 3.

338. *Pravin*, 895 F. Supp. at 663.

339. *Id.* at 662.

340. Press reports speculated that the buy-back would have a detrimental impact on Peru's debt restructuring negotiations. One report, noting an "increasingly acerbic negotiating climate," observed that "the more debt the country has bought back, the less inclined banks will be to furnish relief. Peru will look too rich for sympathy." *Peruvians, Bankers to Face Off Sept. 11*, LDC Debt Report/Latin American Markets, Sept. 4, 1995, at 2; *see also Peru's Cut-Rate Debt Buyback Irks Creditors to the Tune of Billions*, Agence France Presse, Sept. 11, 1995, *available in* LEXIS, NEWS Library,

cess of which, Peru had argued to the court, was vital to U.S. policy interests. A litigant invoking a court's equitable powers must generally come to the court with clean hands.

On the other hand, by repurchasing its own debt, Peru was merely attempting to capture for itself the benefits of the steep discount in the secondary market price of the debt. Pravin, after all, was attempting to profit from the very same discount by suing Peru for the face amount of the debt. That the court was untroubled by the apparent double standard is evidenced by the fact that it devoted relatively little attention to the defendants' unjust enrichment argument. Indeed, the court's failure to state expressly that Pravin was entitled to the full face amount of its debt presented an opportunity for Peru to force the issue. The defendants moved to vacate the judgment on the ground that it was not for a sum certain. A reargument was held, at which the defendants reiterated their contention that, because Pravin had purchased Peru's debt at a substantial discount, face value recovery upon default was not contemplated by either party, would constitute unjust enrichment, and would permit Pravin to reap a windfall profit from Peru's economic misfortune.[341]

CURNWS File, (reporting that the buy-back violated contracts with Peru's commercial bank creditors).

341. *See* Defendants' Memorandum *supra* note 307, at 30-32. The defendants argued:

> Pravin was not an original lender to Banco Popular; it has never conferred any benefit upon Banco Popular or Peru. Pravin is not in the same position as the many lenders who lent funds to Peru and have waited many years for repayment. Pravin is merely a speculator in secondary market debt who is attempting to use the tactics of disruption to obtain a windfall which it could not obtain through the marketplace.
>
> Pravin has this leverage because the Peruvian Government has diligently and responsibly sought to satisfy its creditors, and the Peruvian people have suffered through a three-year austerity program that has required many sacrifices, lost jobs, high prices, and a dwindling value for their currency. These sacrifices have conferred upon Pravin a higher secondary market price for Peru's foreign debt. Pravin purchased its debt at 27 cents. Due to the success of Peru's economic program, Peruvian non-performing debt is now quoted by Citibank at 34 cents.
>
> This benefit is exactly the benefit Pravin expect[ed] to receive when it purchased the Banco Popular debt. When Pravin purchased its debt in December of 1990, Banco Popular had not paid principal on the debt since 1984. Peru had not made any payments on its guarantee, and it was general knowledge in the international financial community that the [sic] Peru did not have the capacity to pay its foreign debt. . . . Pravin, which is a sophisticated investor, was well aware that it could not recover the principle [sic] of the Banco Popular debt in the near future.

Id. at 31-32 (citation omitted).

In response, Pravin argued that if secondary market purchasers of distressed sovereign debt were not entitled to recover the face amount of their debt instruments, "no investor would ever purchase distressed debt instruments at a discount—in essence paying $.50 for the privilege of *possibly* getting $.50 back in the future." Sur-reply Memorandum of Pravin Banker Associates, Ltd. in Support of Judgment and in Response to Defendants' Reply Memorandum in Opposition to Notice to Settle Judg-

Unpersuaded, the court entered judgment for the full face value of the outstanding principal and overdue interest, noting that

> [Pravin's assignment agreement] does not say that the term "principal amount" has a different meaning once a default occurs than it would [have] if the debt were paid on schedule. Nor does it say that once there is a default, the difference between what a lender or holder "paid" for the debt and the face amount must be calculated, with the result that a "new" principal amount comes into being.
>
> . . . The incentive for acquiring [this] type of debt, at whatever cost, is the possibility of eventual full payment of principal as due under the contract, whether through on-time payments or in the event of default.[342]

The court was correct that the substantial discount in the secondary market price of Peruvian debt was irrelevant to determining the amount owed upon default. The fact that the market valued Peru's debt at twenty-seven cents on the dollar at the time of Pravin's purchase does not indicate that Pravin agreed to accept only twenty-seven cents on the dollar in the event of default. Rather, it indicates that Pravin expected to be paid 100 cents on the dollar, but discounted that expectation by a seventy-three percent probability that it would receive nothing in the event of a default, or by some lesser probability that it would receive something more than zero in that event.

This observation, however, does not undercut Peru's argument that full face value recovery by Pravin, in light of Pravin's diminished expectations when it purchased the debt and Peru's continuing economic difficulties, would constitute unjust enrichment. Pravin certainly believed it had purchased the *right* to receive 100 cents on the dollar; whether it actually *expected* to receive that amount is another matter entirely. The court was probably incorrect, therefore, in its assertion that Pravin's incentive for acquiring Peru's debt, "at whatever cost, [was] the possibility of eventual *full* payment of principal."[343] The seventy-three percent discount in the purchase price of the debt indicated that Pravin would earn a substantial profit if Peru repaid even a small percent of the principal.[344] It is even possible, in light of the fact that the debt was in technical default at the time Pravin purchased it, that Pravin's "incentive for acquiring [that] type of debt" was the hope of recovering more than twenty-seven cents on the dollar in a collection action.

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ment, Oct. 23, 1995, at 2, Pravin Banker Assocs., Ltd. v. Banco Popular del Peru, 895 F. Supp. 660 (S.D.N.Y. 1995) (No. 93 Civ. 0094)

342. Pravin Banker Assocs. v. Banco Popular del Peru, No. 93 Civ. 0094, 1996 U.S. Dist. LEXIS 492, at *8-9. (S.D.N.Y. Jan. 19, 1996).

343. *Id.* at *9 (emphasis added).

344. Because Peru was maintaining interest payments based on the face amount of the debt, secondary market purchasers would be more than compensated for the time value of their money.

As the foregoing analysis suggests, both *CIBC* and *Pravin* were close cases; perhaps closer than the courts let on. Legal justification might convincingly have been found for each case to go the other way. Although the *Pravin* court took pains to distinguish *CIBC* on purely legal grounds,[345] the different results obtained by the similarly situated plaintiffs in the two cases may perhaps be better explained by a single factual difference between them: Pravin held $1.4 million of Peruvian debt; the Darts held $1.4 *billion* of Brazilian debt. The three extra zeros on the end of the Darts' claim gave them the power, if they won their suit, effectively to ruin Brazil's Brady restructuring, thus wreaking economic havoc in a foreign land. Pravin's smaller claim against Peru, although irksome to both the country and its other creditors, was not about to bankrupt the Peruvian treasury or scuttle the country's contemplated Brady deal.[346] In light of that reality, and the fact that Brazil had given equal treatment to all creditors in its Brady deal whereas Peru, by its debt buy-back, had preferred some of its creditors over others, a stronger case could be made for setting aside the Darts' contract rights than for setting aside those of Pravin.

Even so, contract law does not typically consider the adverse economic consequences to the obligor in determining whether to hold him to his contract. That such considerations may have swayed the courts in *CIBC* and *Pravin* suggests that those cases were about something more than plain contract interpretation, both courts' assurances to the contrary notwithstanding. With the success of two countries' debt restructurings hanging in the balance, the outcome in each case likely resulted from a pragmatic balancing of the creditors' rights to receive payment against the debtors' asserted inability to pay, a process more familiar in bankruptcy proceedings than in ordinary contract disputes. To the extent such balancing in fact occurred in the two cases, it was not illegitimate. Both outcomes were within the courts' inherent equitable powers. The next section argues that a similar pragmatism should inform courts' decisions in collection actions arising from any future debt crisis.

345. *See supra* text accompanying notes 335-36.

346. Indeed, in spite of Peru's dire predictions of the effect of Pravin's lawsuit on its efforts to conclude a restructuring agreement with its other creditors, two months after the court granted Pravin's motion for summary judgment, Peru and its commercial bank creditors signed an agreement-in-principle to proceed with the country's Brady deal. *See Peru Reaches Debt Accord*, N.Y. Times, Oct. 30, 1995, at D8; *Peru Reaches Brady Plan Accord With Commercial Banks*, BNA Banking Rep., Nov. 6, 1995, at 770. The terms of the accord are considered to be highly favorable to Peru. *See Gold or Guano?*, The Economist, Nov. 4, 1995, at 75 (noting that "[a]fter 12 years of paying almost nothing to its creditors, Peru . . . has secured a 40% discount on $10 billion of debt and interest; last year neighboring Ecuador got only 23%").

IV. The Next Sovereign Debt Crisis

Karl Marx observed that all great world-historical facts occur twice—"the first time as tragedy, the second as farce."[347] His theory was that protagonists in world events stage an unwitting parody of history by borrowing the language and costumes of actors in genuine upheavals of the past to lend grandeur and legitimacy to their campaigns in the present.[348] Holders of sovereign debt such as Pravin and the Darts enact a similar parody by invoking the creditor rights of their commercial bank predecessors in the crisis of the 1980s, and the trend bodes ill for the resolution of a future debt crisis. If the commercial banks of the last debt crisis confronted a genuine financial tragedy, the stampede of secondary market speculators suing to enforce their legal right to the full face amount of their sovereign debt during the next debt crisis will indeed look a lot more like farce. The growth of the secondary market and the securitization of sovereign debt was hailed as the solution to the last debt crisis. It may also present the greatest obstacle to solving the next debt crisis. Before fashioning the law that will apply to the next crisis, therefore, courts must appreciate the important differences between today's class of sovereign debt holders and the creditor class of the last debt crisis. This part proposes that, for the protection of both sovereign debtors and the majority of their creditors, courts should apply certain basic principles of the U.S. Bankruptcy Code in the event of another debt crisis.

A. *The Effect of the New Creditor Class*

The sovereign debt securitization process implemented under the Brady Plan[349] has transformed the relatively small and homogenous class of commercial bank creditors into a comparatively much larger and more diverse class of bondholders.[350] The implications of this transformation for a future sovereign debt crisis are manifold. Most importantly, the free rider problem,[351] so narrowly averted during the

347. Karl Marx, *The Eighteenth Brumaire of Louis Bonaparte, reprinted in* The Marx-Engels Reader 594 (Robert C. Tucker ed., 2d ed. 1978) (1852).

348. Marx's subject was Louis Bonaparte's *coup d'état* of 1851, in which the French dictator evoked the spirit of his more illustrious uncle to install himself in the Tuileries. *See id.* at 603-17. As Marx noted, however, the phenomenon is of long standing throughout history: "Luther donned the mask of the Apostle Paul, the Revolution of 1789 to 1814 draped itself alternately as the Roman Republic and the Roman Empire, and the Revolution of 1848 knew nothing better to do than to parody, in turn, 1789 and the revolutionary tradition of 1793 to 1795." *Id.* at 595.

349. *See supra* part I.E.

350. *See* Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 Rutgers L. Rev. 1211, 1253 (1994) (noting that "[t]he net effect of securitization . . . is that the pool of creditors has been enlarged, stratified into classes of claimants with degrees of priority with respect to one another that may be difficult to sort out, and distanced from the debtor in terms of the availability of information").

351. *See supra* text accompanying notes 43-60.

last debt crisis, will return with a vengeance to plague both debtors and creditors alike in the next crisis. The new creditor class consists largely of pension and mutual funds, insurance companies, investment firms, and sophisticated individual investors. In the event of another crisis, these creditors will not be subject to the same external pressures to participate in sovereign debt restructurings as were the commercial banks during the last crisis. In addition, many, if not most, of these creditors are simply not in the business of lending money, and therefore will be unable to respond to a sovereign's requests for the new loans it will need to grow its way out of a debt crisis.[352] The absence of sharing clauses in Brady bonds[353] and the comparatively small claims (in relation to attachable sovereign assets) of individual creditors will make litigation a more attractive option for the new creditor class than it was for their commercial bank predecessors in the last debt crisis. Indeed, if the secondary market price of a country's debt is substantially discounted to reflect default risk,[354] at least some creditors may be able to obtain greater profits from a face value collection action than could be realized on a pre-default resale of their debt at the prevailing market price. Collection actions, whether brought by Brady bond holders or other secondary market purchasers of sovereign debt, may foreclose opportunities to resolve a future crisis through collective negotiation and voluntary debt forgiveness. Such litigation, most likely in multiple fora and leading to the seizure of important sovereign assets, would impose substantial costs on the sovereign, further compromise its ability to meet its obligations and, ultimately, harm the interests of the majority of its creditors.[355] In addition, the inability to bind dissenting creditors to a restructuring plan may induce otherwise willing creditors to reject a viable proposal for restructuring a sovereign's debt. The next section discusses ways to avert these problems.

B. *Averting the (New) Nightmare Scenario*

By definition, a future sovereign debt crisis will mean that not all creditors can be paid the face amount of their claims.[356] Whether through direct debtor-creditor negotiation, arbitration, or judicial administration, some means must be established by which to allocate losses equitably among creditors. Courts were spared that task during the last debt crisis because the creditor class was effectively unable to

352. *See* MacMillan, *supra* note 6, at 331.
353. *See id.* at 332.
354. *See* Prospectus of Morgan Stanley Fund Inc., Jan. 9, 1996, *available in* LEXIS, STSEC Library, FILING File (noting that "[t]he price and yield of Brady Bonds purchased in the secondary market will reflect the market conditions at the time of purchase, regardless of the stated face amount and the stated interest rate").
355. *See* Mendales, *supra* note 350, at 1233.
356. *See supra* note 2.

enforce its collection rights.[357] Because today's creditor class will not be subject to the same constraints in the event of another debt crisis, U.S. courts will not be able to avoid the difficult tasks of determining claim priorities, evaluating the fairness of restructuring proposals, and adjudicating claims brought by dissenting creditors.

1. An International Bankruptcy Court?

Since the last debt crisis, commentators have sought the establishment of an international bankruptcy court in which a sovereign's obligations could be modified or discharged in the event of a debt crisis.[358] Recent proposals have suggested that such a tribunal be formed under the auspices of the World Bank or the IMF. Those institutions, however, are ill-suited for the role of disinterested arbiter of disputes between a sovereign and its foreign creditors. U.S. bankruptcy proceedings are premised on the equal standing of debtors and creditors before an impartial bankruptcy court. The IMF and World Bank, in contrast, are effectively controlled by their most powerful member states, whose citizens and lending institutions are creditors of the countries most likely to seek the protection of an international bankruptcy court.[359] It is unlikely, therefore, that the debtor countries will submit to proceedings that will inevitably be biased in favor of their creditors.

Nor is it likely that an effective world bankruptcy court could be formed even under a more neutral administrative body. A U.S. bankruptcy court, although it plays only a limited role in the formulation of a reorganization plan under Chapter 11, has authority to enforce compliance with the plan after its confirmation.[360] Debtor countries would likely view the exercise of such authority by an international bankruptcy court as an intolerable infringement on their sovereignty, and a world bankruptcy court which lacked such authority would be largely ineffectual.[361] For their part, U.S. holders of foreign sovereign

357. *See supra* text accompanying notes 223-35.

358. *See* Hurlock, *supra* note 233, at 10-12 (arguing that the protections afforded by the bankruptcy code to domestic debtors, such as the automatic stay, claim priority for post-bankruptcy creditors, and binding majority voting on reorganization plans, should be adapted for sovereign debtors); Wolf, *supra* note 11, at 22 (arguing that the three chief benefits of proceedings under the federal bankruptcy code, "protection from creditors; provision of fresh working capital . . . and procedures for forcing recalcitrant creditors to accept a proposed restructuring" should be translated into an international bankruptcy mechanism).

359. *See* Hurlock, *supra* note 233, at 11; Winston E. Langley, *Third World Debt is Everybody's Problem*, N.Y. Times, Sept. 22, 1987, at A34.

360. *See* 11 U.S.C. § 1142 (1994).

361. Consider the reaction of Peru's creditors to the country's covert buyback of its debt on the secondary market. *See Peru's Cut-Rate Debt Buyback Irks Creditors to the Tune of Billions*, Agence France Presse, Sept. 11, 1995, available in LEXIS, NEWS Library, CURNWS File; *Peruvians, Bankers to Face Off Sept. 11*, Am. Banker-Bond Buyer, Sept. 4, 1995, at 2; Bowen & Bransten, *supra* note 322, at 4; *Did Peru Buy it All Back?*, LDC Debt Report/Latin Am. Markets, July 3, 1995, at 5. Any international

debt are also unlikely to press for the creation of an international bankruptcy court. As discussed in part II, the U.S. legal system currently provides holders of sovereign debt with an effective forum in which to assert their collection rights. An international bankruptcy court would be viewed by such creditors as a risky alternative to the comparative certainties of current U.S. law. The creation of an international bankruptcy court is therefore politically infeasible.[362] Even if it were feasible, however, a world bankruptcy court is undesirable. One of the most important lessons to emerge from the last debt crisis is the importance of debt restructuring techniques tailored to the unique economy of each debtor country.[363] The effect of creating an international bankruptcy court subject to a single set of rules or body of law would inevitably be to impose a measure of uniformity on sovereign debt restructurings.

A more flexible approach to the next debt crisis would be to continue the goals of the Brady plan—cooperative negotiation between sovereign debtors and their creditors, and voluntary forgiveness of loans than can never be repaid. Because the creditor class will have a greater diversity of interests, and be more litigious, than the creditor class existing when the Brady plan was formulated, however, courts must adapt by responding to collection actions in a manner which preserves the climate in which the Brady plan was conceived—the understanding on the part of creditors that collective action and good faith negotiation provide the best available means of recovering their sovereign debts. Courts can perform that function by applying to sovereign debt restructurings certain basic protections of the U.S. Bankruptcy Code. Although foreign sovereigns may not file for bankruptcy under the Code,[364] certain of the Code's basic protective fea-

bankruptcy act, to be acceptable to creditors, must provide a means of preventing such conduct. See 11 U.S.C. § 547 for the U.S. Bankruptcy Code's solution to an analogous problem. It is unlikely, however, that any sovereign would consent to a scheme which prevented it from taking advantage of the discounted prices of its bonds; it is equally unlikely that the sovereign's bondholders would agree to be bound by a scheme that would, in effect, allow the sovereign to cash out some bondholders but not others.

362. For fuller discussion of the obstacles to the creation of a world bankruptcy court, see John H. Chun, *"Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 Fordham L. Rev. 2647 (1996).

363. Former Citibank chairman William Rhodes observes:

> One of the principles that came to the fore in the early days is still very applicable: the need for a case-by-case approach. While that is today taken for granted, some bankers and academics at the time were pressing for "global solutions"—a kind of "one-size-fits-all" answer to the debt problem. A look at the distinctive varieties of the Brady plan employed over the past three years in Mexico, Venezuela, Argentina, Brazil, the Philippines and Uruguay shows how ill-suited a generic response would have been.

William R. Rhodes, *Third-World Debt: The Disaster That Didn't Happen*, The Economist (U.K. edition), Sept. 12, 1992, at 23.

364. 11 U.S.C. § 109(a) (1994).

tures may be applied to sovereign debtors in the event of a debt crisis, both on equitable grounds and in the interests of international comity. In the event of another debt crisis, courts should aim to replicate two of the most important features of the bankruptcy code: the automatic stay of collection actions and the ability of the debtor to bind dissenting creditors to a restructuring plan that has been accepted by an overwhelming majority of creditors. Of course, sovereign debtors should not be granted these protections in every case. Courts must first determine that the sovereign is genuinely unable, and not merely unwilling, to repay its debts.[365] At a minimum, courts should require certification of the sovereign's insolvency by an institution such as the IMF or the World Bank.

2. An Automatic Stay

Under section 362 of the U.S. Bankruptcy Code, the filing of a bankruptcy petition acts as an automatic stay of the commencement or continuation of actions against the debtor.[366] In practice, the automatic stay protects both the debtor and its creditors. The debtor is protected by receiving a "breathing spell" during which it may organize its affairs.[367] Creditors are also protected because the stay "permit[s] the debtor's property to be assembled in an orderly fashion instead of being dismembered and consumed by litigation."[368] For the same reasons, collection actions against a sovereign debtor should be stayed, at least temporarily, during a debt crisis. A stay of collection actions would encourage both the sovereign debtor and its creditors to negotiate in good faith to restructure the sovereign's debts. A stay could be lifted if it were to appear at any time that the sovereign is not bona fide insolvent, or has preferred certain of its creditors over others.

A de facto stay of collection actions could be achieved by strengthening any one of the four sovereign defenses discussed in part II. Any such change to Article VIII, section 2(b) of the IMF Agreement[369] or to the FSIA,[370] however, would require congressional action, and there is no principled way of relaxing the act of state doctrine's[371] territorial limitation[372] solely for sovereign defaults during a debt crisis.

365. To be a debtor under the Bankruptcy Code, a U.S. municipality must show that it is "insolvent." *See* 11 U.S.C. § 109(c)(3) (1994). This means that the municipality is either "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute" or "unable to pay its debts as they become due." *Id.* § 101(32)(C).

366. 11 U.S.C. § 362(a).

367. Mendales, *supra* note 350, at 1242 n.117 (quoting Maritime Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1203-04 (3d Cir. 1991)).

368. *Id.*

369. *See supra* part II.A.

370. *See supra* part II.B.

371. *See supra* part II.C.

372. *See supra* text accompanying notes 180-82.

Moreover, each of these three defenses, if amended to bar collection actions in the event of a debt crisis, would sweep too broadly. A successful defense under Article VIII, section 2(b), the FSIA, or the act of state doctrine would require the court to dismiss or stay a collection action without reaching the merits of the case. A de facto bar of all collection actions would leave creditors with essentially no choice but to accept the sovereign's restructuring terms, and would preclude courts from hearing a case even when, like Peru in the *Pravin* case for example, the debtor country has preferred certain of its creditors over others.[373]

Alternatively, an effective stay of collection actions could be maintained with greater flexibility under the doctrine of comity.[374] Unlike the other sovereign defenses, the comity doctrine requires courts to reach the merits of a case to determine the extent to which a sovereign's actions are consistent with U.S. policy. Another debt crisis would again place courts in the position of having to divine U.S. policy on sovereign defaults during a debt crisis,[375] and the United States, in its Statement of Interest in *CIBC*, may already have signalled a retreat from its policy, articulated ten years earlier in its brief in *Allied*,[376] that sovereign debt remains fully enforceable during a restructuring.[377] If a court finds a sovereign's efforts to restructure its debts to be consistent with U.S. policy, the court may dismiss or indefinitely stay a collection action.

3. Binding Dissenters

In a corporate reorganization under Chapter 11 of the Bankrtupcy Code, each class of creditors must generally accept a reorganization plan before the court may confirm the plan.[378] A class is automatically deemed to have accepted a reorganization plan, however, if the plan has been accepted by the holders of at least two-thirds in amount and more than one-half in number of the creditor claims within the class.[379] In addition, the so-called "cram down" provision of the Bankruptcy Code permits a court to confirm a plan over the objection of a dissenting class of creditors if the plan "does not discriminate unfairly, and is fair and equitable."[380] "Fair and equitable" is a term of art under the Bankruptcy Code; it means that either the dissenting class will be paid in full under the plan or, if the dissenting class is paid less than in full, no class junior in priority to the dissenting class will

373. *See supra* text accompanying notes 338-39.
374. *See supra* part II.D.
375. *See supra* text accompanying notes 203-04.
376. *See supra* note 214.
377. *See supra* text accompanying notes 285-91.
378. 11 U.S.C § 1129(a)(8) (1994).
379. *Id.* § 1126(c).
380. *Id.* § 1129(b)(1).

receive anything under the plan.[381] In addition, each class of creditors must receive at least as much under a Chapter 11 reorganization plan as it would receive if the debtor were liquidated under Chapter 7 of the Bankruptcy Code.[382]

The absolute priority rule cannot be replicated precisely in the context of a sovereign debt restructuring. For obvious reasons, it would be neither feasible nor desirable to "liquidate" a sovereign debtor, and thus impossible to calculate the "liquidation value" of a creditor's claim. Nevertheless, courts are qualified to evaluate the basic fairness of a restructuring proposal that has been accepted by an overwhelming majority of the sovereign's creditors. In *CIBC*, for example, to permit the Darts to accelerate their Brazilian debt after the completion of the country's Brady deal would not have been "fair and equitable" to either Brazil or its other creditors.[383] Courts should "confirm" a fair and equitable sovereign debt restructuring plan by declining, in the interests of comity, to hear suits brought by creditors in dissent from such a plan.

Interestingly, precedent for such judicial abstention on comity grounds may be found in a Supreme Court decision from the nineteenth century, *Canada Southern Railway v. Gebhard*.[384] At issue in *Gebhard* were bonds issued by the Canada Southern Railway Company and payable in New York. Two years after issuing the bonds, Canada Southern realized it would be unable to make upcoming interest payments and asked bondholders to exchange their existing bonds for new bonds having later maturities.[385] One year after the exchange, Canada Southern was essentially nationalized by act of the Canadian Parliament.[386] Two years later, the company again became unable to make payment on the bonds and proposed another exchange offer. After more than three-fourths of Canada Southern's bondholders consented to the exchange, the Canadian Parliament enacted a law which purported to make the terms of the exchange offer binding on all the bondholders.[387] Several of the dissenting bondholders brought a collection action in the United States.

The Supreme Court, in an opinion by Chief Justice Waite, held that the act authorizing the exchange offer was binding on foreign bondholders because it had been validly enacted by the Canadian Parliament.[388] The Court reasoned that

381. *Id.* § 1129(b)(2)(B).
382. *Id.* § 1129(a)(7)(A).
383. *See supra* text accompanying notes 246-61.
384. 109 U.S. 527 (1883).
385. *Id.* at 529.
386. *Id.*
387. *Id.* at 530-31.
388. *Id.* at 537-38.

> [E]very person who deals with a foreign corporation impliedly subjects himself to [the] laws of the foreign government... It follows, therefore, that anything done at the legal home of the corporation, under the authority of such laws, which discharges it from liability there, discharges it everywhere.[389]

Although this categorical rule would clearly sweep too broadly in a sovereign debt crisis, it may perhaps be doubted whether the Court fully meant what it said. The Court was particularly concerned by what it perceived as an attempt by a small minority of Canada Southern's American bondholders to hold out for the full value of their bonds, thereby threatening the success of an exchange offer which had been accepted by the overwhelming majority of the company's bondholders and approved by the Canadian parliament.[390] Under such circumstances, the Court concluded, considerations of international comity required that dissenting bondholders be bound by the terms of the exchange:

> Unless all parties in interest, wherever they reside, can be bound by the [exchange offer,] the scheme may fail. All home creditors can be bound. What is needed is to bind those who are abroad. Under these circumstances the true spirit of international comity requires that schemes of this character, legalized at home, should be recognized in other countries. The fact that the bonds made in Canada were payable in New York is unimportant, except in determining by what law the parties intended their contract should be governed; and every citizen of a country, other than that in which the corporation is located, may protect himself against all unjust legislation of the foreign government by refusing to deal with its corporations.[391]

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389. *Id.*

390. The Court noted:

> This corporation was created in Canada to build and work a railway in that Dominion.... That business affected the public interests, and the keeping of the railway open for traffic was of the utmost importance to the people of the Dominion. The corporation had become financially embarrassed, and was, and had been for a long time, unable to meet its engagements in the ordinary way as they matured. There was an urgent necessity that something be done for the settlement of its affairs. In this the public, the creditors and shareholders were all interested. A large majority of the creditors and shareholders had agreed on a plan of adjustment which would enable the company to go on with its business, and thus accommodate the public . . . The Dominion parliament had the legislative power to legalize the plan of adjustment... [This power] is in entire harmony with the spirit of bankrupt laws, the binding force of which . . . is recognized by all civilized nations.

Id. at 538-39.

391. *Id.* at 539. Justice Harlan, characteristically ahead of his time, dissented from this conclusion in an opinion which anticipated, by a hundred years, the reasoning behind the decisions of the Supreme Court in Republic of Argentina v. Weltover, Inc., 504 U.S. 607 (1992) and of the Second Circuit in Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985). Justice Harlan noted that

> [T]he laws of Canada, by the judgment now rendered, are given effect here, to the injury of our own citizens, notwithstanding [that] those laws arbitrarily deprive them of their contract rights. This railroad company, under express

The sovereign debt market may indeed protect itself from the possibility of "unjust" restructuring plans by refusing to deal with the corporations or governments of LDCs. At the very least, the market will demand a premium, in the form of higher interest coupons on the sovereign's bonds, as compensation for the risk that a U.S. court may decline on comity grounds to hear a collection action in the event of a debt crisis. Although wholesale abandonment of the LDC debt market by investors would be catastrophic for LDCs, marginally higher costs of credit would not necessarily be objectionable if exchanged for increased debtor protection in the event of a default.[392] The critical questions are "how much higher costs?" and "how much more protection?"

CONCLUSION

In January of 1995, Mexico's Minister of Finance informed U.S. officials that his country lacked sufficient foreign exchange reserves to meet external obligations and, without an immediate cash infusion, would be forced to default on its foreign bonds.[393] For a period of several days, it appeared history was about to repeat itself once more. Suddenly, it was 1982 all over again. The Clinton administration urged Congress to take immediate action by passing a $40 billion loan guaranty for Mexico. When passage of the guaranty appeared doubtful, the administration instead arranged a $50 billion rescue package, including an unprecedented $17.8 billion IMF loan, the largest loan ever made by the IMF to a single country, and $20 billion from a U.S. Treasury fund reserved for the stabilization of the dollar in an exchange crisis.[394] Mexico's crisis was one of short-term illiquidity, not

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> authority conferred by its charter, executed bonds payable . . . in New York, and secured them by mortgage executed to citizens of the United States. It sent them to this country for sale and our people invested their money in them. Intrenched behind the arbitrary edict of a foreign government, it now says to American holders of its bonds, that it will not comply with its contract—that if they do not surrender those securities and take others of less value, they shall not receive anything.= Canada Southern Ry. v. Gebhard, 109 U.S. 527, 543 (1883).

392. After all, the cost to a U.S. borrower of obtaining credit would undoubtedly be lower if the U.S. Bankruptcy Code did not afford debtors a discharge or modification of their debts. The cost of credit might be lower still if bankruptcy laws permitted creditors to carve up the physical person of the debtor into pro rata portions. *See* Vern Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 Cath. U. L. Rev. 809, 810 (1983) ("Where a party is delivered up to several persons, on account of a debt, after he has been exposed in the forum on three market days, they shall be permitted to divide up their debtor into different parts, if they desire to do so." (citing the Roman Twelve Tables)). Sometime between 450 B.C. and the present day, however, the law has recognized the right of the borrower to trade higher credit costs in exchange for greater protection in the event of his bankruptcy.

393. For a discussion of the peso crisis, see Chun, *supra* note 362.

394. *See* MacMillan, *supra* note 6, at 306.

long-term insolvency. Nevertheless, the crisis depressed the LDC debt market[395] and renewed fears of another widespread LDC debt crisis. For the sovereign debt market, the Mexican peso crisis was a timely reminder of the risks inherent in holding LDC debt.

When the next sovereign debt crisis comes, courts must be prepared for the inevitable rush of creditors to collect their sovereign debts. The Brady plan, with its call for good faith negotiation between sovereign debtors and their creditors, and for voluntary debt forgiveness, is widely and deservedly credited with solving the last debt crisis. To further the goals of the Brady Plan, U.S. courts sent a message to sovereign debtors that their obligations remained fully enforceable, even by so-called rogue creditors, throughout the 1980's debt crisis. To further the Brady Plan's goals of collective negotiation and voluntary debt forgiveness in the event of another debt crisis, courts will have to send a different message—a creditor may not enforce the full value of its sovereign debt if the result will be to undermine a fair and equitable restructuring plan approved by a majority of the sovereign's creditors.

395. Within three weeks of Mexico's devaluation of the peso on December 20, 1994, one index of the weighted average prices of LDC debt representing 47 bonds and loans from 14 countries dropped 25%. *See Sovereign Debt: Take a Closer Look*, The Banker, Mar. 1995.