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Mitu Gulati

Duke University Law School

George G. Triantis

Harvard Law School

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Contracts Without Law:

Sovereign Versus Corporate Debt

**Mitu Gulati
&
George Triantis***

ABSTRACT

Although extralegal enforcement is widely acknowledged, the conventional understanding of written contract provisions, such as the complex and detailed provisions in bond contracts, is that they are drafted to be enforced by law. This framing neglects the value of contracts in shaping extralegal forces, particularly where litigation is unlikely or not possible. Sovereign debt contracts provide an example in which lengthy and detailed contracts play a key role even though the debtor is largely litigation-proof. We examine how contract provisions in sovereign debt contracts improve the efficiency of creditor control outside the realm of legal enforcement.

Introduction

The role of debt in corporate governance has been the subject of much law and economics scholarship over the past twenty years or so. The dominant paradigm is that of principal-agent: the lender is a principal and the borrower is an agent (or perhaps several individual agents) who has the discretion to put the lender's funds at risk. The paradigm is predominantly contractual: although social and market pressures may bear on the agent's decisions, the lender disciplines the borrower's use of its funds by a contract that can be enforced in court. The principal-agent model reflects well the similar tensions present in lending to sovereign countries, but the contractual approach must yield to the distinctive feature of international relations: the absence of a third party arbiter with coercive power. Our

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goal in this article is to outline some of the resulting differences in the design of sovereign and corporate debt contracts.

An important feature of corporate finance is that creditors of a common borrower have both convergent and divergent interests. They converge in seeking to minimize the risk of insolvency, but they diverge because each creditor competes for the borrower's assets if it becomes insolvent. To the extent that creditor interests converge, the borrower can reduce its cost of capital by delegating monitoring and governance responsibilities, thereby avoiding the cost of free riding or duplicative monitoring. Banks often serve the role of delegated monitors. One might think they could play the same role in the sovereign debt context. Banks in fact performed this service until the early 1980s, when they were joined as delegated monitors by the International Monetary Fund ("the IMF"). In this respect, it is interesting that investors would value the monitoring and control of a not-for-profit, public institution, whose mission is to promote economic development and stability rather than investor returns.

This paper elaborates and integrates the foregoing observations – the informal enforcement of sovereign debt and the delegated monitoring of the IMF – in order to explain the different contracting patterns in sovereign and corporate debt instruments. In particular, the combination of informal enforcement and IMF monitoring explains the covenants and events of default that are found in sovereign debt agreements, and those that are not (despite being commonplace in corporate debt contracts). Part I reviews the principal-agent analysis of corporate debt; Part II discusses the difference in the enforcement of sovereign debt; Part III examines the significance in sovereign debt of the delegation of monitoring activity to the IMF and its implication for the design of debt covenants and events of default.

I. A principal-agent analysis of *corporate* debt contracts

Hidden Action and Hidden Information

The design of debt securities addresses primarily the challenge of information asymmetry: the borrower has better information than the lender about the repayment risk. Finance theory divides the information problem into hidden information and hidden action. At the time of contracting, the borrower has better information about the value of its assets than

the lender (hidden information). The borrower has control over the use of these assets and its actions may alter the risk or value of these assets during the term of the loan (hidden action). Lenders are aware of the informational advantage of the borrower and the dangers associated with borrower asset control, and they consequently demand a higher rate of return, or just refuse to lend. Therefore, measures that reduce the severity of hidden information or hidden action are in the joint interests of both parties to the loan.

Our concerns in this article are the problem of hidden action in corporate finance, the contractual means of mitigating it, and the corresponding lessons for the design of sovereign debt. Hidden action lies at the heart of the classic tension in any delegation or agency relationship. A principal uses an agent to carry out a task in order to exploit the agent's expertise or skill in that task. The more discretion the principal delegates, the more he can gain from the agent's expertise. Yet, the agent may use her expertise to serve her own self-interest at the expense of the principal, and to conceal such activity from the principal. On this count, the principal would be inclined to restrict the agent's discretion, even if doing so would limit the ability to exploit her expertise.

A lender invests in a business borrower usually to participate in the exploitation of a somewhat unspecified (in economic jargon, noncontractible) opportunity. The lender relies on the business' expertise in carrying out the project, but is aware of the borrower's incentive to apply the funds in such a way as to maximize the borrower's return rather than ensure repayment to the lender. Risk-alteration is the best known instance of this incentive: the borrower makes decisions that increase the riskiness of the venture, thereby increasing its owners' expected return but compromising the lender's expected recovery.¹ The borrower's managers might also enhance their private returns in other ways, such as by using the venture to gain human capital in the form of training, business connections or reputation that the managers can exploit in other pursuits in which the lender has no interest.

Economists analyze the lender-borrower relationship as one of principal and agent. In the loan agreement, the borrower makes promises called covenants that constrain its discretion

¹ Early work on the risk-altering incentive of borrowers includes EUGENE F. FAMA & MERTON H. MILLER, *THE THEORY OF FINANCE* 178–81 (1972); Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976).

over its assets. A borrower's breach of a covenant is an event of default that permits the lender to accelerate the maturity of the loan's principal and accrued interest, so that they become immediately due. If the borrower does not pay, the lender can recover from the sale of the borrower's assets, by exercising its creditor rights under state law or by enforcing its security interest (if the borrower has granted one).

Although loan covenants vary, they can be divided into four typical categories.² The first set of covenants constrain activities that are usually inefficient, such as the failure to insure key machinery, or the payment of dividends by an insolvent borrower. The second category concerns decisions that have a large impact on the borrower's assets and consequently, the borrower promises to obtain first the consent of the lender: for example, a decision to sell a key asset or set of assets, or the decision to merge or make a large asset acquisition. The third category are ratio tests that, when violated, suggest that the borrower's incentive to misbehave is heightened. In particular, the incentive of a borrower to take inefficient actions increases when its financial condition deteriorates. Therefore, debt contracts commonly include versions of asset-to-liability or revenue-to-cost ratios. The fourth set of default terms condition on public actions of informed third parties. Cross-default clauses are important examples: when one lender calls a default on the borrower, this triggers the default of another agreement with a cross-default clause. Similarly, the issuance of a judgment lien or execution lien against the borrower, or even the filing of an action against the borrower is a default under many loan agreements. Another example is a term that triggers default when rating agencies, such as Moody's or Standard and Poor's, downgrade the borrower's credit.³ Finally, debt contracts often require the borrower to provide periodic reports of compliance with its various covenants. A borrower who has breached, however, faces no additional legal sanction for failing to report the breach. Therefore, the legal incentive to report is trivial. Accordingly, lenders conduct their own monitoring to detect covenant violations.

² For treatment of the basic covenants in corporate loan agreements, see AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES (1971); *see also* Richard S. Simmons, *Drafting of Commercial Bank Loan Agreements*, 28 BUS. LAW. 179 (1972); PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 144 (1980) (discussing covenants in both sovereign and non-sovereign loans); Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

³ See Karan Bhanot & Antonio S. Mello, *Should Corporate Debt Include a Rating Trigger?*, 79 J. FIN. ECON. 69 (2006).

An event of default, whether a default in payment or a breach of a covenant described above, triggers a change in control over the borrower's assets. If the creditor accelerates the maturity of the debt and proceeds to enforce its claim by removing and selling borrower assets, the borrower's loss of control is explicit. An event of default, however, gives the lender an option: the lender has the right to remove the borrower's assets, but it may choose not to do so, without forfeiting its legal rights as creditor. In many cases, in fact, an event of default provides the occasion for the lender and borrower to enter into negotiations that lead to a change in the borrower's business strategy and to a modification of the terms of the loan. The distinction between these two post-default strategies may be framed in the terminology of Albert Hirschmann.⁴ If the lender simply enforces its accelerated claim against the borrower, it *exits*; if the lender chooses instead to induce a change in the borrower, the lender exercises *voice*. The *threat* of default constrains the borrower's decision space *ex ante* and deters borrower misbehavior, while the occurrence of default enables lender control through exit and voice. Together with monitoring, exit and voice provide the essential tools of creditor *governance*.

Delegated Monitoring

A borrower typically has a number of lenders, and these lenders each engage in governance activity to varying degrees, at least partly because of heterogeneous costs of monitoring, exit and voice. To some degree, the interests of creditors in the decision making of the borrower are aligned: most forms of borrower misbehavior affect adversely all creditors so that the monitoring efforts of one will benefit the others. If this delegated monitor also enjoys a comparative advantage in monitoring, its activity enhances the borrower's access to debt financing and lowers its borrowing cost. Banks serve the role of delegated monitor.⁵ Moreover, in the event of default, the bank can exploit its information advantage to address the cause of the distress and provide additional financing, if appropriate, more effectively than a

⁴ ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* (1970).

⁵ Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 *REV. FIN. STUD.* 393 (1984); Christopher James, *Some Evidence on the Uniqueness of Banks*, 19 *J. FIN. ECON.* 217 (1987).

group of dispersed debtholders. The bank's ex post intervention produces benefits for the other debtholders as well.

The borrower's insolvency, however, creates a conflict in the interests of various creditors because the borrower has insufficient value to satisfy all debts. Thus, the temptation to free ride on the governance efforts of others diminishes as the financial condition of the borrower deteriorates, because the latter conflict looms larger and each creditor needs to protect its interest against the self-interested governance activity of other creditors. This concern limits the value of delegated monitoring.

Coordination among creditor monitoring activity (or delegated monitoring) is not difficult to achieve, but is worth unpacking because of its relevance to the central thesis of the article. Suppose a borrower has two lenders, A and B. Both lenders share an interest in preventing the borrower from misbehaving, but A has a comparative advantage in taking such actions (more effective or lower cost). A and B might contract directly with each other in order to delegate governance actions to A (e.g., the lead bank in a syndicate).

At the time of the loan agreements, the debtor also has an interest in efficient allocation of governance responsibilities and may take one of the following strategies to ensure that A monitors while B refrains. First, the debtor may grant priority to B, thereby reducing B's exposure to losses caused by borrower misbehavior and correspondingly raising A's exposure. This shifts monitoring incentives from B to A. Second, A may guaranty the borrower's obligation to B. Borrowers sometimes pay their banks to issue a standby letter of credit to back their commercial paper. Not only does this shift the monitoring responsibility from the paper holders to the bank, but it also ensures the liquidity of the paper market by shifting the screening burden to the bank.

Third, the borrower may agree to a range of covenants in its agreement with A, while including none or very few in its agreement with B. B's contract may have a single non-payment event of default: the termination or modification of the relationship with A. This combination is likely to yield the desirable monitoring delegation. A knows that B has no governance levers and therefore will not monitor, while B can rely on A's monitoring (at least until the borrower's financial condition deteriorates). This strategy may be reflected in the contrast between the events of default contained in bank loan agreements and indentures

covering public debt. Banks charge a higher rate of interest, partly to compensate for greater monitoring responsibility. Public debt contains few covenants because bondholders rely on bank monitoring. This strategy responds to the puzzle raised by commentators concerning the governance passivity of indenture trustees compared to banks.⁶

Interactive governance

The governance benefits of delegated monitoring and of lender voice are straightforward, as are the sometimes indirect contractual means of coordination among diverse creditors. The exit of the delegated monitor (when the borrower repays the loan or grants a valuable security interest) invokes another step in governance. Exit produces information that can be used by other constituencies to address governance needs in the borrower.⁷ As with delegated monitoring, the governance role of exit is not confined to debt relationships. If informed shareholders choose to sell their interests (exit) rather than replace the board of directors (voice), the resulting drop in the market stock price invites acquirers to investigate the firm and assume control if they can correct the governance problem.⁸ The selling shareholder's monitoring efforts and subsequent exit contribute to governance by communicating information to parties who are in a better position to take corrective measures. Similarly, a lender who exits may be replaced by a new lender who specializes in distressed borrowers.⁹ Or, its exit may involve a public act (such as the registration of a substantial new security interest) that indicates to other lenders and shareholders that the borrower may suffer from a problem in governance.

To be sure, this mechanism does not work as smoothly as the preceding paragraph

⁶ See Yakov Amihud, Kenneth Garbade & Marcel Kahan, *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447 (1999). Trustee passivity is explained by delegation to banks in George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995).

⁷ Triantis & Daniels, *supra* note __, at 1085.

⁸ *Id.* See generally ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 229–300 (Roberta Romano ed., Oxford University Press 1993) (discussing a range of external governance mechanisms).

⁹ Triantis & Daniels, *supra* note __. On the phenomenon of vulture investors and their governance techniques, see, for example, *The Return of the Wall Street Vulture*, BUSINESS WEEK, Sept. 10, 2001, at 108; HILARY ROSENBERG, THE VULTURE INVESTORS (2000).

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suggests. Exit might not be sufficiently public, or the reasons for the exit may be too opaque to invite corrective action by others. Exit may also come too late in that there is little opportunity to redress the governance problem. Bankruptcy law, however, encourages both unsecured and secured creditors to exit before the borrower becomes insolvent. For example, the prohibition of preferential payments allows the bankruptcy trustee to recover any payment or property given to an unsecured creditor within ninety days before bankruptcy, provided that the debtor was insolvent at the time of the payment. A creditor receiving payment or a security interest from an insolvent debtor rarely can be confident that bankruptcy will be deferred for 90 days. The debtor cannot contractually commit not to file for bankruptcy and other creditors could file a voluntary petition. The cost to the creditor of propping up the debtor sufficiently to forestall bankruptcy filing involves the investment of new capital with no assurance of success. Although repayment to a fully secured creditor is not a preference, secured creditors have other reasons to exit early and thereby inform other investors. The filing of bankruptcy imposes a stay that prevents the secured creditor from seizing and selling its collateral. Moreover, even if the secured creditor removes its collateral from the debtor before the bankruptcy petition, the trustee can recover the property unless the secured creditor has also foreclosed on the debtor's redemption right, usually by selling the collateral.¹⁰ State law requires the secured creditor to sell the collateral in a commercially reasonable manner, so as to prevent what is in many cases a hasty sale. Therefore, a secured creditor has a significant incentive to call a default and seize collateral before its debtor becomes insolvent, in order to have the time to sell in a commercially reasonable manner before the bankruptcy filing. Thus, bankruptcy law promotes an interactive system of lender control by inducing creditors who seek to exit, to do so at an early stage when another actor can intervene to take corrective action.

II. A principal-agent analysis of *sovereign* debt contracts

As with corporate debt, the principal-agent model captures the basic tensions arising from the risk of sovereign default: the sovereign borrower has better information about its

¹⁰ U.S. v. Whiting Pools, Inc., 462 U.S. 198, 205 (1983).

economic prospects than the lender (hidden information) and the sovereign can alter the risks of the loan after the funds are advanced (hidden action or agency problem).¹¹ For example, corporate scholars often refer to the agency costs raised by managerial perquisites, such as corporate jets. There are many instances of similarly inefficient investments by sovereign borrowers that raise the risk of default. In 2000, Nigeria spent \$330 million on a new football stadium for the FIFA Junior World Cup, even though nine other stadiums in the country had just been newly renovated the prior year (to say nothing of the fact that the cost of that stadium was greater than the education and health budgets for that year).¹² The Ivory Coast constructed the world's largest basilica in the middle of a jungle, at a cost of over \$300 million.¹³ A country may seek to host the Olympic Games without any assurances of private support, or it might choose to buy a dozen F-15 fighter jets instead of fixing its water supply or basic education system. As in the corporate context, other decisions are less obviously inefficient and their effect on default risk depends on the circumstances. For example, the sovereign might sell or nationalize key assets such as natural resources or financial institutions, impose restrictions on imports or currency flows, borrow large additional amounts or reduce its tax rates. In the corporate sphere, debt covenants constrain the freedom of borrowers to engage in activities that are clearly or even possibly inefficient. Yet, similar provisions are absent from sovereign contracts.

We also noted earlier that corporate lenders regularly condition events of default on quantitative measures of the borrower's financial well-being, such as its debt-to-equity ratio. Sovereign debt contracts could use similar measures to reveal financial problems. Indicators such as debt-to-GDP ratio, GDP growth rate, inflation rate, the export-to-import ratio or the

¹¹ Sovereigns borrow billions of dollars and also default on billions in obligations from time to time. The recent debt workouts of Iraq and Argentina, neither of which is complete as of this writing, each involved over \$100 billion. See Anna Gelper, *What Iraq and Argentina Might Learn from Each Other*, 6 CHI. J. INT'L L. 391 (2005).

¹² See Noreena Hertz, *The Debt Threat* 195 (2004). FIFA is the acronym for the Fédération Internationale de Football Association, the international governing body for soccer. See <http://www.fifa.com>.

¹³ See Jason Beaubien, *Ivory Coast Cathedral Is World's Largest Christian Church*, MORNING EDITION, Mar. 24, 2005, available at <http://www.npr.org/templates/story/story.php?storyId=4558634>.

sovereign's bond rating are widely used as indicators of a sovereign's financial stability, as are forecasts published by international economic institutions, such as balance of payments projections. Yet, they are not adopted in sovereign contracts to lower default risks. In this Part, we propose explanations for these differences in covenant patterns between sovereign and corporate debt contracts.

Financial agency theory typically assumes that managers agree to contractual constraints on their decisions in order to minimize the cost of capital. Thus, managers would likely agree to constraints on future actions that benefit shareholders at the expense of creditors. However, managers may resist constraints on their self-interested actions, such as the corporate jet, even if doing so would reduce their firm's cost of capital. After all, the higher cost of borrowing comes out of the shareholder's pocket. Only if credit is otherwise unavailable can we be sure that managers will agree to the constraints. The same is true for sovereign borrowers. Their government negotiates on behalf of its citizens and can bind them (and future governments) to the interest obligations. Thus, like managers, the government may be willing to bind its future taxpayers to the obligation of paying higher interest rates in order to enjoy the freedom to engage in self-interested and inefficient actions. In the corporate context, we noted that the interests of shareholder and creditor converge in seeking to minimize managerial agency costs. In the sovereign context, citizens are analogous to shareholders, because they effectively hold a residual claim to the sovereign's assets, after its fixed obligations are paid. Yet, current and future citizens have a conflict of interest that is absent in the case of shareholders. Current citizens might benefit from inefficient investments, such as farm subsidies or import restrictions, and can pass on the cost to future taxpayers. Thus, governments and citizens alike may resist agreeing to even efficient covenants because neither internalizes the benefit from such provisions.

The transaction costs of sovereign debt are also typically higher than the corresponding corporate debt relationship. Debt contracts cannot prevent all forms of inefficient decisions in all future states of the world. In the language of contract theory, a larger number of states of the world would need to be addressed separately in a complete contract. Sovereigns engage in a broader range of actions under more complex decision making structures than do corporations. Contracting parties, however, can respond to these front-end transaction costs by

postponing the assignment of obligations to prospective states of the world until after those states occur: specifically, to the back-end of the contracting process, such as litigation. They may choose a vague term (e.g., prohibiting unreasonable or inefficient decisions), and a court or other adjudicative mechanism complete the contract ex post. Quantitative financial thresholds may still be useful, particularly if they are easily verifiable, because they identify the states in which the borrower's incentives diverge markedly from those of the lender.

A contract is only as good as its enforcement, and contract terms should be tailored to the anticipated mode of enforcement, whether it is litigation, arbitration or informal sanctions.¹⁴ This leads our analysis to the most fundamental distinction that explains the difference between corporate and sovereign debt contracts: their respective enforcement mechanisms.

Corporate creditors sue and use the judicial process to enforce judgments for accelerated obligations against the assets of their debtor. Or, they can threaten to sue, and thereby extract either payment or a change in the governance of the debtor. In contrast, creditors of sovereigns have limited legal recourse. They may sue and attach some types of sovereign assets.¹⁵ Sovereign debt issuers, however, can avoid holding funds in jurisdictions in which they are likely to be sued, so that there are rarely enough assets available to satisfy judgments against them. For example, over \$740 million in judgments have been obtained against Argentina on account of its sovereign debt defaults in 2001. Argentina, however, keeps no funds in the U.S. for commercial purposes and its deposits elsewhere, particularly in Switzerland, are immune from attachment.¹⁶ Indeed, in our sample of sovereign debt offering prospectuses governed by New York law, all sovereign borrowers explicitly disclose that it is

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¹⁴ The effect of different back-end enforcement mechanisms on contract design is explored in Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006).

¹⁵ The U.S., for example, permits suits against sovereigns for actions arising out of their commercial or private activity, including the issuance of sovereign bonds. The plaintiff can attach funds of a sovereign in the U.S. to satisfy its judgment, but it is very easy for a sovereign defendant to keep funds in other jurisdictions where they cannot be reached. For a discussion of the issues involved in a sovereign litigation, see George Weisz, Nancy E. Schwartzkopf & Mimi Panitch, *Selected Issues in Sovereign Debt Litigation*, 12 U. PA. J. INT'L BUS. L. 1 (1991).

¹⁶ For discussions of the difficulties that creditors have faced in attaching Argentine funds, see Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 CHI. J. INT'L L. 311 (2005); Patrick Bolton & David A. Skeel, Jr., *Redesigning the International Lender of Last Resort*, 6 CHI. J. INT'L L. 177 (2005).

extremely difficult to enforce a judgment against a sovereign either in its home jurisdiction or in the U.S.¹⁷

Much has been made of the case of *Elliott Associates v. Peru*, which seemed to introduce a new mechanism for enforcing debt obligations against sovereign borrowers. The borrower, Peru, had sent funds to Euroclear to pay bondholders who had agreed to scale down their claims in a restructuring. The Court of Appeals of Brussels enjoined Euroclear from making the payment because it was in violation of a *pari passu* clause in the borrower's contract with the plaintiff.¹⁸ The significance of that decision, however, may have diminished over time because defaulting debtors take precautions, such as the use of other payment channels, to ensure that their funds do not fall into the hands of third parties who may be subject to such jurisdiction.

Although courts have become more involved in the enforcement of sovereign contracts in recent years, legal enforcement of sovereign debt is much less significant than nonlegal sanctions for default, particularly the threat of damaged reputation and political pressures.¹⁹ Commentators concur that these forces explain why sovereigns repay their debts even in the absence of a credible threat of legal enforcement. Remarkably, for instance, South Africa today is repaying even its apartheid era debt; at least some portion of which was undoubtedly used to subjugate those running the government now. The editorial page of *The Economist* was blunt as to the consequences if South Africa defaulted on its apartheid-era debt: "[South Africa's] credit rating would be wrecked as it came to be lumped with other deadbeats. Foreign investors would be deterred and South Africa would have to pay more for future

¹⁷ See Stephen J. Choi & G. Mitu Gulati, *An Empirical Study of Securities Disclosure Practice*, 80 TUL. L. REV. 1023 (2006).

¹⁸ See William W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, 53 EMORY L.J. 823 (2004).

¹⁹ We should note though that the general trend seems to be one of greater involvement of the domestic courts, particularly those in New York. Marcus Miller & Dania Thomas, *Sovereign Debt Restructuring: The Judge, the Vultures and Creditor Rights* (CEPR Discussion, Paper No. 5710, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923581.

borrowing.”²⁰ In addition to worrying about the costs of future borrowing, sovereigns may also anticipate that their default will damage trade or other international economic relationships.²¹ Lenders may also exert political pressure on their home governments to sanction the defaulting sovereign. Some time ago, rich western creditors could persuade their governments to send in the gunboats to seize assets or at least to threaten mayhem (for example, the British and French colonization of Egypt on account of its unpaid debts).²² Such use of force to enforce sovereign debt obligations has been replaced by softer economic and political pressures.

Although the presence of reputational and political forces is recognized, their impact on contract drafting remains unexplored. While reputation is significant in corporate debt relationships, it is the dominant enforcement mechanism for sovereign debt. In light of this difference in the enforcement mechanism, we expect that sovereign debt contracts would be different from their corporate debt counterparts. To understand the structure of the sovereign debt contract and, specifically, the design of events of default, we must examine how various terms are likely to be enforced by the reputational mechanism. Given that sovereign lenders rely primarily on informal enforcement, what might be the role of covenants and events of default in sovereign debt agreements? Corporate debt contracts threaten acceleration and judicially enforced liquidation rights when a covenant is breached. In considering the drafting of covenants in the sovereign context, we need to focus on how acceleration would operate when the debt contract is enforced by reputation rather than judicial mechanisms.

²⁰ *South Africa's Debt: Unforgivable*, *ECONOMIST*, Apr. 24, 1999, at 1.

²¹ The dominant answer in the literature to the question of why sovereigns ever repay their debts is the reputation cost of default. That is, sovereigns repay because they know that they will need to return to the markets to borrow more, and a reputation for defaulting will raise their borrowing costs. There is, however, a second strain of literature, which contends that it is not so much the fear of reputational penalties that drives sovereign repayment, but fear of other penalties such as trade sanctions (the “enforcement” model). For discussions of the different models, see, for example, Jonathan Eaton & Mark Gersovitz, *Debt With Potential Repudiation: Theoretical and Empirical Analysis*, 48 *REV. ECON. STUD.* 289, 289–90 (1981); Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?*, 79 *AM. ECON. REV.* 43, 46–47 (1989); Harold L. Cole et al., *Default, Settlement, and Signaling: Lending Resumption in a Reputational Model of Sovereign Debt*, 36 *INT’L ECON. REV.* 365 (1995).

²² See, e.g., HERTZ, *supra* note [1](#), at 185; see also Kris James Mitchener & Marc D. Weidenmier, *Supersanctions and Sovereign Debt Repayment* 21 (NBER, Working Paper No. 11472, 2005), available at nber.org/papers/w11472.pdf (describing the use of extra legal sanctions as used in the early 1900s).

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How does a community, such as the global capital market, mete out reputational sanctions to two parties locked in a dispute? Both parties may suffer for failing to resolve their dispute before it becomes public. However, the community also makes some assessment as to blame. Like a court, the community cannot observe all the relevant information and, also analogous to litigation, each party to the dispute publicizes its case to argue that the blame should fall on the other. When a lender accelerates the maturity of a debt obligation, the borrower often argues that (a) no event of default has occurred, (b) the lender's interest in being repaid has not been impaired, © the lender breached its own obligations under their agreement, and/or (d) the lender acted opportunistically in accelerating the indebtedness.

Judicial adjudication is more formal than reputational judgment. Doctrines that excuse obligations on the occurrence of unforeseen contingencies or impose requirements on a promisee (such as a lender) to act reasonably are often given short shrift in courts of law. The extra-legal community is more receptive to these fact-specific considerations, and this might diminish the value of specifying covenants up front in the contract. Moreover, the facts necessary to assess the appropriateness of excuse or lender misbehavior are often opaque to the community and the publicity created by the parties in attempting to influence the reputational outcomes is likely to be noisy. Political pressures are even more remote from the contract provisions and they often entail considerations completely external to the contractual relationship. For example, Pakistan or Turkey might default on its sovereign debt obligations, but neither is likely to face sanctions from the IMF because of their significance in the U.S.-led fight against terrorism.²³

We mentioned that the external sanction on a defaulting sovereign is affected by ex-post geopolitical forces. Domestic politics in the country of the sovereign borrower also plays an important role. The population of the sovereign might view a default as a sign of mismanagement and jettison the government. Or, the government might convince its citizens that the lender is acting opportunistically and that taxes should not be raised to repay the debt. Indeed, if the government were to succumb to creditor pressure, its citizens may vote or take

²³ See Charlotte Denny, *IMF Sheds No Tears for Argentina*, THE GUARDIAN, Apr. 29, 2002, available at <http://www.guardian.co.uk/argentina/story/0,,706823,00.html>. (describing the "Turkey exception").

other action (in the extreme, by revolution) to replace it. These internal political contingencies are difficult to predict, but they surely affect the decision of a lender to accelerate upon a covenant violation and therefore the design of the covenant in the contract. Argentina's recent default provides a vivid example of the political costs of default: its 2001 default resulted in the demise of five presidents in ten days in December 2001.²⁴

On the flip side, politicians may also try to take advantage of a default or creditor demands when a sovereign is on the brink of default. When creditors of Peru attempted to exert direct control over that sovereign's internal economic policies in 1976, the result was political unrest and rioting.²⁵ More recently, the political platform of Nestor Kirchner in Argentina rested successfully on the pronouncement that Argentina's external creditors had bled the country dry and should not be repaid in full.²⁶ After multiple governments had been toppled, at least partly due to the country's default on its debt, the refusal to pay the debt became an effective political strategy.²⁷

To reiterate, lenders to sovereigns primarily rely on informal rather than legal sanctions. A heavily specified corporate debt contract, laden with explicit covenants and events of default, usually encourages courts to interpret the document literally and exclude extrinsic evidence. Sovereign debt, in contrast, is enforced by reputational judgment that is more susceptible than judicial determinations to exogenous global and domestic political forces that are difficult to anticipate and that are rarely affected by the provisions of the debt

²⁴ Max Seitz, *The Day Argentina Hit Rock Bottom*, BBC NEWS, Dec. 19, 2005, available at <http://news.bbc.co.uk/1/hi/business/4534786.stm>. But creditors have to be wary of the demise of a mismanaging government. The next government may try to be more fiscally responsible and remedy the debt crisis by asking for debt reduction.

²⁵ See Victoria E. Marmorstein, *Responding to the Call for Order in International Finance: Cooperation Between the International Monetary Fund and Commercial Banks*, 18 VA. J. INT'L L. 445, 454 (1978).

²⁶ See Todd Benson, *Argentina Goes on Tour to Sell Debt Restructuring Despite Protests, Outlook for Deal Improving*, INT'L HERALD TRIB., Jan. 13, 2005 (describing how President Kirchner's using hardball tactics in negotiating with creditors had helped his popularity), available at 2005 WLNR 471166; see also *Argentina's Debt Restructuring: A Victory By Default?*, ECONOMIST, Mar. 3, 2005, available at http://www.economist.com/business/displaystory.cfm?story_id=E1_PSTVSSJ (reporting on how Argentina at first demonstrated great reluctance to default on its external debt, then, once it had defaulted, moved very slowly in engaging creditors about a restructuring).

²⁷ See *id.*

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contract. Therefore, the benefits from elaborate written contracts would seem lower in the sovereign than corporate context. Moreover, in light of the exigencies of reputational enforcement described above, the sovereign debt relationship might be fraught with agency problems. The next section, however, reveals a mitigating pattern of delegated monitoring and an explanation for the contract provisions that in fact are found in sovereign bonds.

III. Delegated monitoring in sovereign debt

The delegated monitor

In Part I, we outlined the means by which corporate creditors can coordinate monitoring by resolving free-riding and duplicative monitoring, as well as by exploiting comparative monitoring advantages among creditors. In this section, we consider the delegation of monitoring responsibility in the sovereign debt context in two stages: first, *who* is the delegated monitor and second, *how* does delegation occur? In brief, delegated monitors were often banks until the 1980s and the IMF has assumed the role since then. Accordingly, publicly held sovereign bonds have few covenants, and those covenants serve primarily the objective of delegating monitoring to the IMF and constraining other creditors from acting opportunistically to improve their own position.

As we discussed in Part I, the delegated monitor of corporate borrowers is often a bank.²⁸ Not surprisingly, therefore, primary responsibility for monitoring and control in the 1970s and 1980s was typically delegated to the lead banks of lending syndicates.²⁹ These lead banks were generally large institutions such as Chase Manhattan, Citibank, Chemical, Morgan Guaranty and Manufacturers Hanover, and the smaller syndicate participants were typically happy to leave the monitoring tasks to these lead banks. Through their networks of local offices in the debtor country and their political and financial clout in their home countries, these banks engaged in both monitoring and control using informal pressures. They also

²⁸ See, e.g., Joseph J. Norton, *International Syndicated Lending: The Legal Context for Economic Development in Latin America*, 2 L. & BUS. REV. AM. 21, 22–23 (1996).

²⁹ LEE C. BUCHHEIT, SOVEREIGN DEBTORS AND THEIR BONDHOLDERS 4 (2000), available at <http://www.unitar.org> (type title into search bar; then follow document 1 hyperlink).

intervened ex post, after debtors defaulted, in order to provide emergency financing and to induce domestic economic reforms.

When a number of developing countries (including Mexico, Brazil, Argentina, Peru, and Zaire) fell into financial crisis in the 1970s and 1980s, these banks were overexposed in the emerging market loan sector and forced to write down asset values, merge, sell loans, and shut down branches.³⁰ Thereafter, banks ceased to be the dominant lenders to sovereigns, and bond investors increased their participation, particularly in the emerging market debt arena. Sovereigns now borrow from many types of lenders, including banks, trade creditors, bondholders, other countries, and international financial institutions such as the IMF, the World Bank and other regional development banks. As bank lending lost its dominance, sovereign debt investors looked to quasi-public international institutions such as the IMF and the World Bank to monitor sovereign borrowers.³¹ In particular, the IMF emerged as a delegated monitor when, in the 1980s, dispersed creditors persuaded the IMF to coordinate restructurings and provide scrutiny for their loans.³² To some degree, therefore, the IMF

³⁰ See Robert Kenneth MacCullum, *Sovereign Debt Restructuring: The Rights and Duties of Commercial Banks: Inter SeSe*, 1987 COLUM. BUS. L. REV. 425, 432–33 (1987).

³¹ See Stefan Voigt, *Membership has its Privileges-On the Effects of Delegating Power Internationally* (available at www.isnie.org/ISNIE05/Papers05/voigt.pdf).

³² A 1985 Legal Times article describing the IMF's involvement with the Mexican restructuring explained:

When the IMF granted Mexico the \$2 billion extended fund facility for 1983–85, strings were attached: Continued funding depended on Mexico carrying out an economic “adjustment” program that satisfied the IMF, which monitored Mexico’s economic policies and performance. “This was a particularly sensitive area,” says Walker, noting that the IMF monitoring program has been a source of “tremendous political implications” within Mexico.

The 1984 negotiations between the Mexican government and the bank advisory group stalled over the issue of what role, if any, the IMF should play after the expiration of the extended fund facility. “What [the banks] wanted was a mechanism by which the IMF would continue to be involved in some meaningful way in consulting with Mexico,” as well as communications from the IMF to the banks about Mexico’s economic situation, says Mudge. He adds that with the expiration of the extended fund facility, there was no provision for IMF involvement beyond 1985. Yet the banks were being asked to restructure debt for six years and to reschedule payment of that debt through 1998, he says. Walker portrays the situation a bit differently. “The banks’ position was Mexico ought to, in effect, have a perpetual [IMF] program, “which Mexico considered “absurd,” he recalls. While Walker says, “It was all quite polite,” he charges that “what the banks really wanted was to keep Mexico on a short leash. They wanted to be able to block continued restructuring, but they didn’t want the responsibility of making a decision. They wanted the [IMF] to give a green light or a red light.”

succeeded the lead banks in the syndicated loans of the 1970s as the delegated monitor, both during the term of the loan and in subsequent restructurings.³³ As we note later however, some commentators tend to believe that the IMF's performance of this role has deteriorated since then.

The IMF is a not-for-profit, political institution disproportionately funded and controlled by the wealthiest countries, that is dedicated to the preservation of stability in international financial markets and the economic development of its member countries.³⁴ The Fund can realize substantial economies by acting as a delegated monitor for sovereign debtholders while pursuing these missions. The IMF monitors its members' economic

The Mexican negotiating team ultimately offered a compromise solution. Mexico would have no formal IMF program, but it would request an "enhancement" of the regular consultations with the IMF that the IMF articles require for member countries. Annual and midyear consultation reports prepared by the IMF would indicate whether Mexico's financial programs were "materially incompatible with sound and sustained economic growth and with a viable external payments position." The reports would be sent to Mexico's bank creditors, who previously were not privy to such reports. The banks then would be able to make their own judgments about whether to take certain actions provided under the restructuring agreements.

Deborah Graham, *Lawyers Reap Benefits in Restructuring*, LEGAL TIMES, June 3, 1985 (describing the roles played by Mark Walker of Cleary Gottlieb (counsel to Mexico) and Alfred Mudge of Shearman & Sterling (counsel to the banks)).

³³ See Charles Lipson, *Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts*, 38 World Politics 200 (1985); see also Barry Eichengreen, Kenneth Kletzer & Ashoka Mody, *The IMF in a World of Private Capital Markets* (NBER, Working Paper No. 11198, 2005) (finding that spreads on bonds are lower when they are issued in conjunction with IMF supported program, suggesting that the programs might convey information).

³⁴ The literature on the IMF is vast. Among the treatments of its operations, origins and functions are JOSEPH GOLD, *THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL LAW: AN INTRODUCTION* (1965); J. MARCUS FLEMING, *THE INTERNATIONAL MONETARY FUND, ITS FORM AND FUNCTION* (1964). For more contemporary treatments of the IMF, including its role in the crises of the 1990s, see PAUL BLUSTEIN, *THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLING THE IMF* (2001); NGAIRE WOODS, *THE GLOBALIZERS: THE IMF, THE WORLD BANK AND THEIR BORROWERS* (2006); Daniel K. Tarullo, *The Role of the IMF in Sovereign Debt Restructuring*, 6 CHI. J. INT'L L. 287 (2005).

For contemporary discussions of the IMF's role by two of its top officials, see Raghuram G. Rajan, *The Role of the International Monetary Fund in a Changing World* (Apr. 10, 2006) (speech available at <http://www.imf.org/external/np/speeches/2006/041006.htm>); Rodrigo de Rato, *Sustaining Global Growth and Stability—the Role of the IMF* (Apr. 6, 2005) (speech available at <http://www.imf.org/external/np/speeches/2005/040605.htm>); Kenneth Rogoff, *The Sisters at Sixty*, ECONOMIST, July 24, 2004.

performance, debt burdens and servicing strategies, and macro economic policies.³⁶ Its staff conducts site visits, prepares country reports, and provides expert assistance to help members address debt servicing or macro economic challenges.³⁷ Arguably, the IMF enjoys monitoring and advisory expertise that exceeds even that of the largest multinational banks. Although IMF scrutiny benefits all sovereign debtholders, they do not pay for these services. Instead, the richer IMF members, such as the U.S., Japan and other G-7 countries, finance the lion's share of the IMF's activities. These countries are also home to the bulk of the creditors in this market. The stake of these countries in the financial stability of other sovereign borrowers extends beyond the interests of their constituent creditors, because of their interest in stable and flourishing global trade and capital markets.

Large restructurings in the 1980s, particularly those of Mexico and Brazil, demonstrated the utility of the IMF as a delegated monitor to the financial community. Each of these restructurings required that geographically dispersed lending syndicates with claims against a common sovereign debtor, coordinate to form a single lending arrangement (a mega syndicate) who would advance fresh funds to the debtor. Yet, the cohesion and coordination that existed within syndicates, as a result of repeat transactions among members and the presence of a single regulator, could not be replicated in the mega syndicate. Banks from different regions were subject to different regulations, as well as other political and economic pressures. As a result, they varied significantly in their ability and willingness to exit or provide new money. A single actor, therefore, was needed to coordinate efforts, and the IMF, as a multilateral organization, emerged to play the leadership role.³⁸

The IMF can serve as a catalyst for the restructuring of sovereign debt. It does not rely on explicit loan covenants to do so, but rather on its international status and political clout, particularly with its principal shareholders such as the U.S. Its assessments influence the reputations of sovereigns in the international debt markets. The IMF actions include advising

³⁶ For discussion of the IMF's functions, see *supra* text accompanying note [v](#).

³⁷ *See id.*

³⁸ The central role of the IMF is exemplified by the events of December 1982 where over 700 banks had to be coordinated and coerced to share the burden of financing Mexico's restructuring. *See The IMF and Latin America*, ECONOMIST, Dec. 23, 1982, at 69; Bagdanowicz-Bindert, *IMF is Emerging as Central Economic Coordinator*, AMERICAN BANKER, Sept. 27, 1983, at 33-34; *see* MacCullum, *supra* note [v](#), at 425-33.

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the sovereign on its choice among restructuring alternatives and setting the threshold of private sector burden sharing (i.e., a creditor “bail-in”) that is necessary before the IMF kicks in funds.³⁹ Most attempts to restructure sovereign debt depend on the IMF’s suggested plan of reform and its subsequent monitoring of compliance with the terms of the plan.⁴⁰ The Fund participates repeatedly in restructurings and its actions are accordingly disciplined by the prospect of repeated dealings with sovereign borrowers.

As a not-for-profit, international institution dedicated to economic development, the IMF can avoid the political obstacles to bank monitoring and control. For example, in 1976 in Peru, bank lenders sought to impose economic performance criteria as a condition of advancing their loans. This strategy failed partly because of the banks’ inability to monitor adequately, but also because Peruvian politicians used the existence of the banks’ controls as a scapegoat for local economic ills. Such attempts by the banks to directly monitor and control the sovereign debtor fell out of favor in subsequent restructurings, and the banks significantly withdrew from their role as delegated monitors.⁴¹ Although the IMF’s reliance on U.S.

³⁹ See REIFFEL, *supra* note 2; see also BLUSTEIN, *supra* note 2.

⁴⁰ When lenders, whether in the Paris Club or the London Club, are engaged in a sovereign workout, they are rarely willing to consent to any restructuring unless the IMF country chief represents that the sovereign in question has agreed to implement the IMF’s suggested plan of reform, which implementation will in turn be subject to regular IMF scrutiny. See LEX REIFFEL, *RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY* Chs. 5, 6 (2003).

⁴¹ For discussions of the Peruvian experience, see Lee C. Buchheit & Mark A. Walker, *Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers*, in *SOVEREIGN LENDING: MANAGING LEGAL RISK* 151 (Michael Gruson & Ralph Reisner eds., 1984); Victoria Marmorstein, *Responding to the Call for Order in International Finance: Cooperation Between the International Monetary Fund and Commercial Banks*, 18 *V.A. J. INT’L L.* 445, 454 (1978); Declan Duff & Ian Peacock, *Refinancing of Sovereign Debt*, *BANKER*, Jan. 1978, at 71. The following excerpt for Ron Chernow’s book, *The House of Morgan*, illustrates what happened vividly:

By the 1970s, gunboat diplomacy was passé. For reasons of foreign policy, Washington was often more eager to appease Latin American governments than bully them about loans. . . . In 1976, when Peru was nearly bankrupt, Citibank, Morgans, and other banks imposed an austerity plan in exchange for a \$400-million loan. Requiring a steep rise in food and gas prices, it provoked riots in Lima and new charges of dollar diplomacy. The banks were appalled by the backlash. “It doesn’t take much to whip up the peasantry with stories about the House of Morgan and U.S. Imperialism to explain why there’s no food,” said a Congressional staffer. Stung by bad publicity, the banks turned to the IMF as a surrogate that could withstand political criticism in debtor countries. It seemed a useful shield behind which to effect painful economic reforms.

RON CHERNOW, *THE HOUSE OF MORGAN* 638–39 (1990) (quoting Institutional Investor, Oct. 10, 1976).

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funding is a blemish on its profile in developing countries, the Fund's interference in their policy making is likely to be viewed by those countries as more benign than if it came from a large, foreign, profit-seeking bank. In past financial crises, the IMF has conditioned its emergency financing of defaulting sovereigns on their compliance with a strict regiment of financial controls. Private lenders though have long been cautious about imposing direct conditions on a sovereign; not only do sovereigns tend to resist what they sometimes see as incursions upon their sovereignty, but there is also the persistent fear that local politicians will point to the lenders' conditions as reason for the sovereign's ills and the end result will be a repudiation of the debt.⁴²

The IMF's not-for-profit status and its commitment to economic development in its members also assure creditors that the Fund is likely to assume the lead role in restructurings. Moreover, the Fund is also concerned about the contagion threat of a sovereign debt default on international financial markets. Therefore, the IMF is less likely to exit in a crisis than a profit-seeking bank. Indeed, the IMF has taken a lead role in developing solutions to restructuring obstacles such as that of hold-out creditors.⁴³ Moreover, commercial banks

⁴² For discussions of this issue, see Lee C. Buchheit, *The Role of the Official Sector in Sovereign Debt Workouts*, 6 CHI. J. INT'L L. 333 (2005); see also Buchheit & Walker, *supra* note __, at 151; GOLD, ORDER IN INTERNATIONAL FINANCE, *infra* note __; Duff & Peacock, *supra* note __, at 71.

Writing in 1922, Charles Cheney Hyde was especially articulate in articulating these same concerns. Hyde wrote the following advising creditors to exercise caution in seeking to impose onerous conditions on sovereign borrowers:

It is merely submitted that some terms exacted of, and unwillingly yet validly accepted by, certain foreign borrowers, might prove to be the sowing of dragons' teeth and beget a popular opposition sufficing in time to jeopardize service and produce default. Involved, therefore, in every external bond transaction is the matter of fiscal statesmanship which is likely to play an increasingly important part in the largest success of foreign loans hereafter to be underwritten in the United States; for the question confronting the American lender is not entirely how rigorously or completely can the borrower be kept under the domination of the lender, but also how can the debtor be made the lasting friend of the American creditor, and inculcated with the desire both to repay obligations as they accrue, and also to seek in the United States rather than elsewhere financial aid wherever needed. It is the effect of such an idea upon the success of American diplomacy in the best sense that gives to every external loan floated in the United States a significance far beyond the horizon of the individual purchaser of a bond. Happily American bankers are not without the larger vision.

Charles Cheney Hyde, *The Negotiation of External Loans With Foreign Governments*, 16 Am. J. Int'l L. 523, 524 (1922).

⁴³ Discussions of the two proposals that have dominated the recent debate about International Financial

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probably lack the massive amount of capital necessary to prevent the collapse of the debt of the largest sovereign borrowers. This is reflected in the experience in the early 1980s, when several of the largest commercial banks were compelled to reduce their exposure in emerging markets by selling portions of their sovereign loans on the secondary market or by merging with other institutions with reduced exposure. In contrast, the IMF played a key role in the restructurings of the early 1980s, not only by providing crisis financing, but also by imposing conditions on sovereigns that promoted financial stability.⁴⁴

Commentators have raised doubts as to whether the IMF has the political will and tools to continue to serve as delegated monitor.⁴⁵ These doubts have become more pronounced because of increasing leniency in IMF policy toward borrowers. For example, until the late 1980s, the IMF had a strict policy not to lend to a distressed sovereign unless the sovereign had come to a restructuring agreement with its other creditors.⁴⁶ In other words, the IMF did not wish to be lending into arrears. The threat of the denial of IMF funds would force the sovereign to find an accommodation with its creditors. In 1989, however, the IMF Board adopted a policy to allow IMF lending despite commercial bank arrears. A decade later, the IMF modified the policy again to allow lending even while there were arrears on bond debt, so

Architecture, the Sovereign Debt Restructuring Mechanism and collective action clauses are available on the IMF's website www.imf.org. For additional discussions of these proposals and the IMF's role, see, for example, Bolton & Skeel, *supra* note [_____](#).

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⁴⁴ See CHERNOW, *supra* note 43, at 639. Lee Buchheit and Mark Walker, two of the lawyers who played key roles in the Mexican restructuring of the early 1980s (and a number of the other major subsequent sovereign restructurings), explained in their 1984 article that the reason why creditors began requiring that their sovereign debtors covenant that they were and would remain members of the IMF was that: "[these] clauses are [favored] by lenders because they regard IMF membership and the ability to use the general resources of the Fund as providing a helpful source of long-term assistance to the country in dealing with its debt problems as well as some assurance that the country has not abandoned its commitment to a realistic adjustment [program]." Buchheit & Walker, *supra* note 43, at 150.

⁴⁵ Prominent among the recent critiques of the IMF are those by the Meltzer Commission and that by Joseph Stiglitz. See Meltzer Commission Report (Mar. 2000), available at <http://www.house.gov/jec/imf/meltzer.htm>; JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (2002).

⁴⁶ See Anna Gelpern, After Argentina, IIE Policy Brief in International Economics, September 2005 (available at www.iie.com). For more details on the IMF's lending into arrears policies, www.iie.com. For more details on the IMF's lending into arrears policies, see IMF, Fund Policy on Lending into Arrears to Private Creditors - Further Considerations of the Good Faith Criterion (2002) (available at www.imf.org)

long as the sovereign was engaged in “good faith” negotiations.⁴⁷ This good faith requirement was diluted further when the IMF continued to fund Argentina after its default in 2001, even though the sovereign offered little more than vague assertions of a willingness to bargain with private creditors.⁴⁸ The IMF’s weakening of its lending policy, some might say, has reduced the value to private creditors of having IMF involvement with the sovereign in question. After all, the IMF is no longer going to use its big stick to force private creditors to enter into an agreement with the government. Indeed, sovereign lenders might even believe that the IMF encourages sovereigns to be aggressive in seeking concessions from their creditors in their restructuring negotiations.

The increasing dissatisfaction with the IMF’s role is manifest in the decision of large borrowers, such as Brazil and Argentina, who have chosen to pay off their IMF obligations and therefore, in effect, cut off the assurance that these programs might have provided to investors that the IMF would be involved.⁴⁹ The decline in the IMF’s stature may also be an explanation for the sovereign debt community’s rejection of the IMF proposal for an international bankruptcy court for sovereigns.⁵⁰

Delegated monitoring and sovereign debt covenants

In preparing this article, we examined the prospectuses for thirty different sovereign issuers having done recent issuances.⁵¹ The only events of default that were common to all issues were the negative pledge clause, the cross-default clause, and the *pari passu* clause. As discussed below, these provisions prevent wasteful jockeying activity among non-monitoring creditors. Other covenants and events of default that are common in corporate debt

⁴⁷ See Gelpern, *supra* note 48.

⁴⁸ *Id.*

⁴⁹ See *Argentina, Brazil and the IMF*, the Economist, December 20th, 2005 (reporting on both Argentina and Brazil deciding to prepay their IMF obligations in December 2005) (available at http://www.economist.com/research/backgrounders/displaystory.cfm?story_id=5327790)

⁵⁰ See Jerome Sgard, *IMF in Theory: Sovereign Debts, Judicialisation and Multilateralism* (CEPII, Working Paper No. 2004-21), available at <http://www.cepii.fr/anglaisgraph/workpap/pdf/2004/wp04-21.pdf>.

⁵¹ A list of these issuers is available from the authors. Given that no more than forty sovereigns regularly seek funds on the international bond markets, the authors believe that they have examined an adequately representative sample.

instruments are notably absent.⁵² We observed earlier that covenants may be omitted to promote delegation of monitoring responsibility. Despite the concerns noted earlier about the effectiveness of the IMF as delegated monitor, the absence of corporate-debt-style covenants may be explained by the delegation of monitoring responsibility to the IMF. Indeed, the delegation is more directly promoted by an event of default that is triggered if the sovereign ceases either to be a member of the IMF or to be eligible for disbursements from the IMF's general resources, including emergency financing (the "IMF clause"). An analogous provision in some corporate debt contracts triggers default if the borrower's line of credit with a bank is terminated or not renewed.

As best we can tell, the IMF clause emerged in the period between 1978 and 1985. As noted earlier, this was a period of multiple major sovereign restructurings and it witnessed the emergence of the IMF as a delegated monitor.⁵³ Under the IMF clause that emerged, the

⁵² The leading treatise writer on the subject, Phillip Wood, explains that sovereign debt contracts are basically bereft of the types of control clauses that are common in corporate debt contracts. Wood explains that:

Policy controls are markedly absent from loans to sovereigns or sovereign-related institutions. It is not difficult to imagine why this should be: . . . Sovereign states are jealous of their sovereignty and are not prepared to countenance policy restrictions imposed by aliens, let alone moneylenders.

WOOD, *supra* note __, at 144. Lee Buchheit, the other leading commentator on contract clauses in sovereign debt instruments, does not explicitly discuss control provisions in his book on clauses in eurodollar loan agreements but the lack of any discussion is further illustration of the point that Wood makes explicitly. LEE C. BUCHHEIT, HOW TO NEGOTIATE EUROCURRENCY LOAN AGREEMENTS (2d. ed. 2000).

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⁵³ Senior sovereign debt lawyers told us that IMF clauses first appeared in this period. They were, however, unable to explain the timing. Consistent with the theory that the banks were looking for a way to actively involve the IMF in their lending to emerging markets, the literature from that period contains numerous calls for the IMF to collaborate more with private lenders. See Hauge, *How the Banks Should Work With the Fund*, EUROMONEY, Oct. 1977, at 57; Cary Reich, *Why the IMF Shuns a "Super" Role*, INSTITUTIONAL INVESTOR, Sept. 1977, at 35; Marmorstein, *supra* note __. See also U.S. Participation in the Supplementary Financing of the International Monetary Fund: Hearing Before the Subcomm. on International Trade, Investment and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess. 185, 196 (1977) (statement of Anthony Solomon, Under Sec. of the Treas. For Monetary Affairs); *The 1977 Economic Report of the President: Hearing Before the Joint Economic Comm. of Congress*, 95th Cong., 1st Sess. 185, 196 (1977) (statement of Irving S. Friedman, Senior Vice President and Senior Advisor for International Operations, Citibank).

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Discussions of the need for the IMF to play the role of a delegated monitor can be found in the contemporary academic literature as well. As best we can tell though, these discussions do not consider the implications of the IMF clause in contemporary standard sovereign bond contracts. See Tarullo, *supra* note __, at 305–309; see also JEAN TIROLE, FINANCIAL CRISES, LIQUIDITY, AND THE INTERNATIONAL MONETARY SYSTEM (Princeton 2002); Prasanna Gai & Nicholas Vause, *Sovereign Debt Workouts with the IMF as Delegated Monitor—A Common Agency Approach* (Bank of England, Working Paper No. 187, 2003), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=425792.

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borrower promised to “maintain its membership in and eligibility to use the general resources of the International Monetary Fund.”⁵⁴ If not cured within a specified grace period, the loss of membership or eligibility constitutes an event of default that gives debtholders the right to accelerate the maturity of principal and accrued interest.⁵⁵

IMF clauses are not needed where the sovereign is either one of the developed nations in a stable financial condition or an established issuer that would be considered too big to be abandoned, such as Brazil, Mexico, or China. The IMF’s continued interest in these countries is assured because of their importance to the stability of international financial markets. Rather, IMF clauses have an effect with respect to countries rated below investment grade. In this larger group of borrowers, there is considerable variation in their relationship with the IMF and, consequently, the impact of the IMF clause. Some countries engage in small-scale borrowing from the IMF so as to subject themselves to heightened IMF scrutiny,⁵⁷ while other countries, like Kazakhstan, covenant to maintain membership in not only the IMF but also its sister organization, the World Bank.⁵⁸ The IMF clause raises the stakes if the IMF should withdraw membership or eligibility: by doing so, it would trigger the acceleration of the sovereign’s debt. The IMF is a political body and it does not wish to be blamed for such a financial calamity, either to individual sovereigns or to the global economy. In this sense, the parties to sovereign debt contracts use IMF clauses to co-opt the IMF, by exploiting its responsibility to preserve international financial stability. The clause cements the IMF’s

⁵⁴ See, e.g., Offering Circular for the Republic of Costa Rica, Jan. 25, 2002. In some cases, default is also triggered by loss of membership to the World Bank. See Agarwal, *infra* note _____.

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⁵⁵ In the U.S. context, acceleration typically requires an affirmative vote of the holders of at least 25% of the principal amount. See WILLIAM TUDOR JOHN, SOVEREIGN RISK AND IMMUNITY UNDER ENGLISH LAW AND PRACTICE, in 1 INTERNATIONAL FINANCIAL LAW: LENDING, CAPITAL TRANSFERS AND INSTITUTIONS (Robert S. Rendell ed., 1983); Mark A. WALKER & LEE C. BUCHHEIT, LEGAL ISSUES IN THE RESTRUCTURING OF COMMERCIAL BANK LOANS TO SOVEREIGN BORROWERS, in SOVEREIGN LENDING: MANAGING LEGAL RISK 139 (Michael Gruson & Ralph Reisner eds., 1984); READE H. RYAN, JR., DEFAULTS AND REMEDIES, in SOVEREIGN LENDING: MANAGING LEGAL RISK 157 (Michael Gruson & Ralph Reisner eds., 1984); James R. Silkenat et al., *Eurodollar Borrowings by Developing States: Terms and Negotiating Problems*, 20 HARV. INT’L L. J. 89, 98 (1979).

⁵⁷ Argentina, for example, did small scale borrowing from the IMF even in 1997 when it was not in need of IMF funds. The goal was to assure creditors that the IMF was continuing to scrutinize Argentina. See BLUSTEIN, *infra* note _____, at 43. That said, in hindsight, it does not look like the IMF’s scrutiny and advice did much good for Argentina’s creditors.

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⁵⁸ See offering circular for the Republic of Kazakhstan, dated 16th December 1996, U.S. \$200,000,000 (9.25% notes due 1999), Page 8 (copy of circular on file with author).

commitment to monitor the borrower, and to be a leading force in any debt restructuring, by providing emergency financing and intervening in the economic management of the sovereign.

This explanation for the IMF clause was missed by many commentators, including those in the 1978-85 period who were puzzled by the emergence of the clause at that time.⁵⁹ Some commentators thought that the clause served no valuable purpose for either debtor or borrower.⁶⁰ Indeed, the UNITAR Training Manual on Events of Default advises sovereigns to refuse to agree to the IMF clause.⁶¹ Other writers suggested that the clause was a “seal of approval” that provided assurances to the international debt market that the borrower was creditor-worthy.⁶² This seems to be part of the explanation. An alternative theory was that the IMF clause acted effectively as a cross-default, because the lender could exit whenever the IMF had information that the borrower was in grave financial difficulty. However, IMF membership communicates little, if any, information about the financial condition of a country. The IMF does not reject members in serious financial defaults nor do members withdraw in advance of default. During the sovereign crises since 1995 (including Argentina, Uruguay, Pakistan, Ukraine, Ecuador, Dominican Republic, Mexico, and Russia), no memberships were

⁵⁹ For example, Joseph Gold, the general counsel to the IMF at that time was the most prominent of these commentators. See JOSEPH GOLD, IMF PAMPHLET SERIES, No. 39, ORDER IN INTERNATIONAL FINANCE, THE PROMOTION OF IMF STAND-BY ARRANGEMENTS, AND THE DRAFTING OF PRIVATE LOAN AGREEMENTS (1982); Joseph Gold, *Relations Between Banks' Loan Agreements and IMF Stand-by Arrangements*, 3 INT'L FIN. L. REV. 32, 33 (1983).

⁶⁰ PADAZIS KARAMANOLIS, THE LEGAL IMPLICATIONS OF SOVEREIGN SYNDICATED LENDING 78 (1992); Vinod K. Agarwal, *Negotiating and Drafting Clauses in Loan Agreements: Events of Default*, UNITAR, Mar. 2001, http://www.unitar.org/dfm/Resource_Center/Document_Series/Document15/Agarwal/1Intro.htm. Agarwal also refers to the standard IMF clause as being violated not just when a sovereign ceases to be a “member” of the IMF, but when a sovereign ceases to be a “member in good standing.” See also Gold, *supra* note ____ (describing the membership provision as being triggered by a loss of “good standing”). Agarwal points out though that it is not clear to anyone what constitutes a “member in good standing.” Agarwal, *supra* note ____ at 16. We do not make much of this point though because our brief survey suggests that the “member in good standing” language has been replaced by the simpler “member” language in sovereign bond contracts.

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⁶¹ Agarwal, *supra* note 60, at _____. UNITAR is the United Nations Institute for Training and Research.

⁶² See DANIEL D. BRADLOW, INTERNATIONAL BORROWING: NEGOTIATING AND STRUCTURING INTERNATIONAL DEBT TRANSACTIONS 407 (2d. ed. 1986); see also RYAN, *supra* note 54, at 162: (“Lenders get some comfort in the creditworthiness of a foreign sovereign borrower if the country of the borrower is a member of the IMF and can use its resources. Consequently, many agreements provide that it is an event if the country is not an IMF member or cannot use its resources.”).

terminated by either the IMF or any sovereign borrower.⁶³ Indeed, the countries who lost their membership withdrew long before any financial emergency had triggered the IMF clause: Poland (1950), Czechoslovakia (1954), Cuba (1958), and Indonesia (1965).⁶⁴ Similarly, none of the sovereigns in significant financial crisis (that is, with a large external debt profile) has lost its eligibility to use IMF resources. The IMF itself has a fairly technical definition of eligibility, involving satisfaction of a number of IMF criteria that are unlikely to be of relevance to lenders.⁶⁵ Even Argentina did not come close to a declaration of ineligibility, despite its showing a singular disinterest in complying with any of the IMF's requests to implement internal reforms and engage its creditors following default.⁶⁶

To reiterate, we suggest that the IMF enjoys monitoring and control capabilities that private creditors lack, as well as political advantages in restructuring that stem from its multinational, not-for-profit stature. Private creditors might use the IMF clause to compel the IMF to participate in the creditors' private lending relationship with the sovereign. This particular event of default (loss of membership or loss of eligibility vis-a-vis the IMF) is not meant to provide an early warning signal of the borrower's financial distress when triggered. As noted, by the time a loss of membership or

⁶³ See NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? 117–119 (2004) (describing the various sovereign financial crises in the 1995–2004 period).

⁶⁴ JOSEPH GOLD, MEMBERSHIP AND NONMEMBERSHIP IN THE IMF (1947). Venezuela is an interesting example of a sovereign borrower who is very critical of the IMF and yet whose bond covenants include the IMF clause. Loss of membership or eligibility is a possibility in this case, but even here it is remote.

⁶⁵ As Joseph Gold explained in his 1985 article on the subject, that “would almost certainly disappoint the expectations of the lenders.” Gold, *supra* note __ at 19-20. Gold explains that since “ineligibility does not impede transactions financed directly with the resources held in the Special Disbursement Account,” a sovereign in serious financial distress from the point of view of its private lenders might still not be totally ineligible, allowing it to claim that the IMF Event of Default had not been triggered. Along those same lines, the country remains “eligible” during the period when the IMF issues a Report of Concern and the time for the sovereign to respond to it. *Id.* at 19–22. The point of the foregoing is, once again, to emphasize how this clause does not operate as an early warning mechanism.

⁶⁶ For an extensive discussion of the Argentine default and the IMF's involvement see PAUL BLUSTEIN, AND THE MONEY KEPT ROLLING IN (AND OUT) (2006). The one country that has gotten into serious trouble with the IMF in recent years was Zimbabwe in 2001. Not only was Zimbabwe denied the ability to access further IMF funding, but also, in subsequent years, was considered for compulsory withdrawal on two occasions. Zimbabwe: 2005 Article IV Consultation-Staff Report (IMF Country Report No. 05/360), available at <http://www.imf.org>; see also *Zimbabwe: D-day Looms at IMF Board Meets*, IRINNEWS.ORG, Sept. 8, 2005, <http://www.irinnews.org/report.asp?ReportID=48966>. Zimbabwe, however, is not a significant borrower on the sovereign bond market.

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eligibility comes around, the sovereign will likely have long since defaulted on its external debt. Instead, the default clause compels the IMF to participate in the relationship between the private creditors and the sovereign borrower. Indeed, in the 1970s, banks failed in its ex post efforts to pull the IMF into a formal collaborative role in the restructuring of emerging market debt.⁶⁷ The private lenders were anxious to secure the IMF's involvement because they were finding it remarkably hard to directly control sovereign debtors in the same way that they might control corporate debtors. The IMF clause, we contend, emerged as an ex ante mechanism to draw the IMF into the relationship and, indeed, to give it notice of this fact.

The IMF does not fit the description of the delegated monitor in private debt contracting. As noted earlier, creditors must be reassured that the delegated monitor will not use its informational advantage to improve the conditions of its exit, particularly by exiting before the less informed creditors. Bankruptcy law helps to address this concern in the corporate setting if, the delegated monitor can accelerate on demand or if it enjoys priority. The public mission of the IMF is the corresponding assurance to creditors of sovereign borrowers that the IMF will fulfill its role as delegated monitor. In co-opting the IMF, private lenders exploit the IMF's public mission to preserve international economic stability and to intervene when such stability is threatened by the distress of a sovereign debtor. Large private lenders can often apply ex post pressure on their own national governments to induce the IMF to respond, but the IMF clause sends a signal that the parties rely on the IMF as delegated monitor during the term of the debt as well as during any necessary restructuring. The debt contracts reinforce the co-opting of the IMF by including cross-default clauses that spread default across debt claims and thereby compound the severity of a single default. These clauses raise the IMF's stake in preventing default, and pressure the IMF into contributing its share of new money along with the other lenders.⁶⁸

The foregoing explanation then also helps us understand two otherwise puzzling

⁶⁷ See *supra* note 57 (citing materials).

⁶⁸ See Buchheit & Walker, *supra* note 43, at 153.

aspects of the choice of the IMF as delegated monitor: (a) that the IMF typically enjoys de facto priority in repayment and (b) that it is typically a short-term lender that provides emergency financing.⁶⁹ Ordinarily, creditors would be unlikely to delegate monitoring responsibility to a lender that, because of the maturity or priority of its loans, is likely to exit the lending relationship. Other things being equal, the group would rather choose the creditor with the lowest priority and debt of the longest durations because that creditor has the best incentive to ensure repayment for all the other creditors as well. Yet, the foregoing discussion emphasizes that the public mission of the IMF assures private lenders that the IMF will not abandon sovereign debtors.

In the previous section, we noted the skepticism among commentators concerning the IMF's role as delegated monitor, particularly in light of recent policy trends. The contemporary story seems to be the sovereign borrowers and lenders no longer view that IMF as a valued delegated monitor. We noted earlier that major borrowers, such as Argentina, are increasingly choosing to pay off their IMF obligations and therefore, in effect, cut off the assurance that these programs might have provided to investors that the IMF would be involved.⁷⁰ Yet, the IMF clause persists in sovereign debt instruments, and this may indicate either that the reports of the IMF's diminished importance to private creditors have been overstated or that contract clauses change a lot slower than economic realities. At this stage of our research, we cannot tell.

Before concluding, we move briefly to explain how the three other standard creditor covenants - the negative pledge clause, cross default clause and the *pari passu* clause - operate in the absence of the possibility of meaningful formal enforcement against the sovereign debtor. Although ceding priority to the IMF is not an obstacle to the delegate monitoring arrangement, priority among the other creditors is a serious matter for two reasons. First, there is no system of disclosure for contractual priority as there is under the domestic law of most countries. To preclude the danger of hidden liens, sovereign debt contracts might include negative pledge clauses that prevent the

⁶⁹ The de facto priority that the IMF and other official sector entities such as the World Bank enjoy has no official legal basis, as best we can tell. For a discussion, see Bolton & Skeel, *supra* note [\[redacted\]](#), at n.4.

⁷⁰ *Supra* note 48.

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sovereign from pledging assets to any other creditor.

Second, there is rarely a third party who can be relied on to enforce creditor priorities against the assets of a sovereign. The order of actual payment determines the de facto priority in these cases. Debt maturity, in turn, is likely to be a factor in the order of payment: the sovereign pays the debt that matures (perhaps because of reputational sanctions) before the obligation that has yet to mature. Thus, a debt instrument that matures earlier is likely to have de facto priority over an instrument with a later maturity. Not surprisingly, therefore, cross-default clauses are common in sovereign debt agreements to ensure that no other creditor will enjoy significant de facto priority in payment.

Third, if no creditor enjoys enforceable legal priority and competing obligations mature at the same time, then de facto priority will be determined by creditor racing ex-post rather than by contract ex-ante. To take the pure, stylized example we have been using, suppose that all creditors of a sovereign borrower abstain from monitoring and rely on the IMF. If an IMF country report observes a deterioration in the financial condition of a sovereign borrower, each creditor would struggle for priority by pressuring the borrower to pay its claim before that of the others. This race is a waste of resources because it produces no information and simply determines the allocation of the sovereign's funds. The *pari passu* clause of sovereign debt contracts provides that all creditors must be treated equally and no priority - such as a decree by the sovereign that the claims of one creditor will be subordinated to those of another - may be granted to one creditor over another. The extension by the Brussels court in the infamous *Elliott Associates v. Peru* case may be justified as preventing creditor racing, in much the same way as the preference avoidance provision of the U.S. Bankruptcy Code.⁷¹

Conclusion

⁷¹3 11 U.S.C. § 547 (2006). For a detailed discussion and critique of the *Elliott* case, see Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869 (2004). The operation of that *pari passu* clause as per the *Elliott* decision would more conventionally have occurred under a provision known as the sharing clause that required the sharing of payments among creditors (thereby deterring any particular creditor from seeking a preferential payment). See Lee C. Buchheit, *Changing Bond Documentation: The Sharing Clause*, 17 INT'L FIN.L.REV. 9 (1998).

Contracts typically create legal obligations that are enforceable by a court, and they are drafted in anticipation of possible litigation.⁷² Yet, this legal framing of the role of contracts is unduly narrow because it ignores the fact that written contracts are important even when there is little possibility of litigation. Sovereign debt contracts provide an excellent example: the debtor is largely litigation proof, but lengthy and detailed contracts among sophisticated parties still play a key role. The question is, what is that role? One function is to communicate with a third party. For example, we suggested that the IMF clause in sovereign bond instruments effectively coopts the IMF to act as a delegated monitor of the sovereign debtor. Most contracts anticipate both formal and informal enforcement (such as reputational sanctions), in varying degrees of importance. Thus, even “legal” contracts such as corporate debt instruments may well do more than simply anticipate the possibility of litigation.

⁷²It is from this perspective that the basic law school's classes in transactional subjects such as contracts and business associations are taught. Students read a series of cases that involve disputes over contracts and from those cases, develop insights about how they might better structure their clients' contracts so as to prevent such disputes.