Comments about the Experience of Peru in Sovereign Debt Litigation*

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In 1984, Peru initiated a de facto permanent default with all creditors that lasted until 1997, when it signed an exchange agreement under the Brady plan. This long period of default produced different types of judicial confrontations. However, the most significant litigation experience came up just when Peru began to negotiate a Brady restructuring. Litigation was not promoted by original creditor banks, but by rogue creditors that had acquired small pieces of Peruvian commercial debt in the secondary market and looked for the full collection of the debt before American courts. At the end, creditors succeeded in their judicial battle, but during the process U.S. courts showed some interesting hesitations when trying to balance the interests in conflict. During the pre-Brady period a sovereign creditor set off Peruvian central banks' deposits to collect its claim, raising the question of whether central banks' immunity, under the Foreign Sovereign Immunity Act (FSIA), should also impede setoffs. These experiences show one of the main challenges for future sovereign debt restructurings in the era of globalization: how to conciliate all the interests implied when sovereigns do private business and fail.

En 1984, le Pérou a fait défaut de paiement de dettes à l'égard de tous ses créanciers et ce défaut a duré jusqu'en 1997, à la date de la signature d'un accord d'échange dans le cadre du plan Brady. Cette longue période de défaut a donné lieu à différents types de confrontations judiciaires. Toutefois, le débat judiciaire le plus notable est survenu au moment où le Pérou a commencé à négocier une restructuration de sa dette selon le plan Brady. Le recours au litige n'a pas été encouragé par les banques créancières d'origine, mais par des créanciers malhonnêtes qui avaient fait l'acquisition de petites portions de la dette commerciale péruvienne sur le marché secondaire et ont cherché à recouvrer l'intégralité de la dette devant les tribunaux américains. En bout de piste, les créanciers sont sortis vainqueurs de cette bataille judiciaire, mais dans l'intervalle, les tribunaux américains ont manifesté une curieuse hésitation en tentant de trouver un point d'équilibre entre les intérêt du conflit. Au cours de la période antérieure au plan

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Brady, un pays souverain créditeur s'était remboursé de sommes dues par le Pérou par voie de compensation à même les sommes déposées par des banques centrales péruviennes, soulevant ainsi la question de savoir si les banques centrales, grâce à leur immunité en vertu de la loi intitulée Foreign Sovereign Immunity Act (FSIA), devaient ou non autoriser ces compensations. Ces événements mettent en exergue un des principaux défis de restructuration de la dette d'un pays souverain à l'ère de la mondialisation : comment concilier tous les intérêts inter-reliés lorsque les pays souverains font échec dans les affaires commerciales dans lesquelles ils se sont lancés.

INTRODUCTION

In 1983, as many other Latin American countries, Peru defaulted its external obligations with creditor banks, governments and official agencies. A typical restructuring agreement was reached with the commercial banks led by Citibank for maturities corresponding to the period 1983-1984, as it occurred with governments and official agencies through the subsequent bilateral agreements of the Paris Club. However, 1984 was the beginning of a *de facto* permanent default with all creditors that lasted until 1997 when Peru and commercial banks signed an exchange agreement under the Brady plan, followed by a new Paris Club agreement. Peru arrived to the era of Brady deals rather late in comparison with the major Latin American debtor countries: Mexico (1989), Costa Rica (1989), Venezuela (1989), Uruguay (1991), Argentina (1993), Brazil (1994), Dominican Republic (1994), Equator (1995) and Panama (1996).[1]

In fact, Nicholas F. Brady, the U.S. Secretary of Treasury, proposed in March 1989, the renegotiation of the Less Developed Countries' (LDC) external debt with commercial banks, as a new approach to the debt problem, involving a voluntary debt and debt service reduction.[2] The mechanism implied an exchange of the outstanding debt for collateralized bonds or a buy-back of the debt. Both cases involved a significant discount, thereby financing the operation with IMF and World

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[1] See, P. Kenen, "Refocusing the Fund: A Review of James M. Boughton's Silent Revolution: The International Monetary Fund, 1979-1989" (2003) 50:2 *IMF Staff Papers* – 274, online: <http://www.imf.org/external/pubs/ft/history/2001/ch06.pdf>; See also, Jorge Peschiera, "El Plan Brady Peruano, Operaciones de Reducción de Deuda Externa 1993 – 1997" (Lima: edición Apoyo Comunicaciones, 2002) at 69.

[2] Nicholas F. Brady, US Secretary of Treasury, Remarks Before a Third World Debt Conference sponsored by the Brookings Institution and the Bretton Woods Committee (10 March 1989), *reprinted in* Dep't of State Bull., May 1989, at 53-56. For some background about the Brady Plan see, Manuel Monteagudo, *"The debt Problem: The Baker Plan and the Brady Initiative: a Latin American Perspective"* (1994) 1 Int'l Law. 28.

Bank resources as well as some industrialized countries' contributions. In legal terms, original loan contracts (or precedent restructuring agreements) should be replaced by a new contractual relationship, based on a bond issued by the country debtor, which was guaranteed by a U.S. Treasury Bill. That is why Brady agreements were called *exchange agreements*, as it is the nature of any restructuring agreement that the original obligation is completely replaced by a new one. In this way, creditor banks replace an original asset (a loan) with a new one (a bond), that even though reflecting some level of discount is enhanced by the addition of collateral (a U.S. Treasury Bill), which was not provided in the previous contract. The interesting evolution of Brady agreements is that LDC's debt migrates from the banking business to securities markets. In recent years, sovereign debt has experienced a new generation of conversions, where new sovereign bonds that do not provide U.S. Treasury bond collateral replace the Brady bonds. In practical terms, this is the final stage of Nicholas F. Brady's proposal, when he envisaged that country debtors should naturally return to international financial markets.

Peru was not part of the general pattern until 1997. After the 1983 restructuring agreement with commercial banks, Peru suspended its payments to all creditors and in 1986 the Executive Board of the IMF declared the country *ineligible*.[3] At the end of 1992, guided by a policy to reinstate the Peruvian economy in international financial markets, Peru initiated a process to repay its arrears with the IMF and obtained a preliminary agreement with the Paris Club. Then, under the auspice of the IMF, the World Bank, the United States, some European countries and Japan, Peru reopened negotiations with commercial banks, reaching a Brady agreement in 1997.[4]

Peru's long period of default (1984-1997) produced different types of judicial confrontations. In March 1990, the terms of many syndicated

[3] On August 15, 1986 the executive Board declared Peru ineligible to use the General Resources of the Fund.

[4] Peru initiated a process of repayment of arrears with the IMF, being entitled in 1997 to access a special financial facility for its debt restructuring with commercial banks. A new minute with the Paris Club members was also signed in 1996 and a general negotiation process with their remaining creditors was already in full execution. See, IMF Press Releases No. 97/10, February 1997 (IMF approves Credits to Support a Reduction of Peru's Commercial Deb) and N. 96/37, July 1, 1996 (IMF approves Three – year Extended Fund Facility Credit for Peru).

loan contracts were about to expire according to New York law. Therefore, creditor banks decided to initiate 34 actions against the Government of Peru and other public entities in different jurisdictions (New York, London, Toronto, Paris and Luxembourg). The suits were suspended in July 1990 by agreement. In these cases, banks were just expecting to avoid the prescription of their claims and not necessarily the full collection of extended credit or even the attachment of Peru's assets. The courts granted this suspension for a limited period of time during which parties were expected to reach a restructuring agreement or a Tolling Declaration. In November 1992, the Peruvian government declared a Tolling Declaration that permitted creditor banks to dismiss their actions.

However, the real and most significant litigation experience came up when Peru began to negotiate a restructuring agreement under the Brady plan. Litigation during this period was not promoted by original creditor banks, but by *rogue creditors* that had acquired small pieces of Peruvian commercial debt in the secondary market and looked for the full collection of the debt before American courts. The expression *rogue creditors* alluded to different meanings. First of all, as these individuals were not original creditor banks, they were reluctant to follow the general pattern of the restructuring agreements. They acted as *free riders*. They also pursued different objectives from those of creditor banks who had seen the reduction of their original assets value as a direct result of the LDC debt crisis. Under restructuring agreements and debt exchanges, banks tried to preserve or diminish this effect. *Rogue creditors* acted as securities investors who tried to maximize the benefit between the acquisition price and the final collection.[5]

At the end, rogue creditors succeeded in their judicial battle, as would any creditor of expired assets demanding the assistance of justice. However, during the process, U.S. courts showed some interesting hes-

[5] In this respect Sean Hagan points out that in some circumstances, a distressed debt purchaser's objective of maximizing value can work to the advantage of the sovereign debtor: a creditor that has purchased a claim on the secondary market at a deep discount may be far more willing to agree to a reduction in the face value of the claim than a creditor who purchased the claim at face value. However, such creditors may also choose not to participate in a restructuring that has been agreed upon by most creditors, with a view towards extracting more favorable terms from the borrower. Indeed, the very possibility that some creditors may hold out for more favorable negotiable terms can make it far more difficult for more cooperative creditors to reach a settlement with the debtor. Sean Hagan, "Designing a legal framework to restructure sovereign debt" (2005) 36 Geo. J. Int'l L. 299 at 310.

itations when trying to balance the interests in conflict. In fact, the majority of creditor banks were in the process of agreeing to exchange original credit into new reduced assets under the Brady plan, so *rogue creditors*' claims opposed a global solution that had the commitment of American foreign policy as well as other countries and international organizations. Even the IMF, when Ms. Anne Krueger proposed the Sovereign debt restructuring Mechanism (SDRM) in 2001, referred to Peru's litigation with Elliot Association as "a missing element in the international community's current approach to the roles of the public and private sectors in debt restructuring. . .."[6]

I will briefly review the U.S. court opinions in *Elliot Association* and *Pravin Banker* as typical rogue creditor litigation against a LDC debtor to highlight some legal implications for future sovereign debt restructurings and inter-creditor problems.

I would also like to make some comments about the *Riggs* case that corresponds to the pre-Brady period.[7] In this conflict, a sovereign creditor set off central banks' deposits to collect its claim, raising the question of whether central banks' immunity, under the *Foreign Sovereign Immunity Act* (FSIA), should also impede setoffs. This case was not generated by a rogue creditor action, but by an original creditor bank that, when confronting a government's default, took the resources invested by an independent central bank. It is interesting to note that FSIA, like similar legislation in England, Switzerland, and Canada to name a few, establishes a special immunity for central banks (vis-à-vis the general immunity accorded to the rest of foreign public entities), in order to make attractive international reserve investments in those countries. So, beyond the factual analysis of the *Riggs* case, it may also reveal the limits of central banks' immunities in stressful times.

If we could summarize the major point of these experiences, we should say that one of the main challenges for future sovereign debt

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[6] Anne Krueger, "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring" online: <http://www.imf.org/external/np/speeches/2001/112601.htm>.

[7] Another pre-Brady lawsuit was the action initiated by Banco Cafetero to recover the principal and Interest owed on a US$5 million Interbank (a State owned bank) deposit made by Banco Cafetero with Banco de la Nación, and guaranteed and assumed by the Republic of Peru. This experience was more typical because – in the absence of a Brady agreement – the Court granted Cafetero's motion for summary judgment on August 18, 1995, and judgment was entered against Peru in the amount of over $8 million.

restructurings in the era of globalization will be how to conciliate all interests involved when sovereigns do private business and fail. Should individual interests prevail over global schemes?

1. WHEN A GLOBAL RESTRUCTURING PROCESS CAN BE AFFECTED BY INDIVIDUAL ACTIONS

(a) Cases

(i) *The Pravin Banker case*

In 1990, Mellon Bank sold US$9 million of its Peruvian defaulted debt to Pravin Banker Associates at a discount. Then, Pravin brought a suit against the Banco Popular (a State owned bank) and the government of Peru, which had guaranteed the debt. The U.S. District Court for the Southern District of New York (SDNY) granted summary judgment in favour of Pravin but it also agreed to subsequent temporary stays based on Peru's efforts to renegotiate its debt with all of its creditors. Finally, judgment was granted by the U.S. District Court and ratified on appeal by the U.S. Circuit Court for the 2nd Circuit.

When granting the stays the judge found that "to allow [Banker] to activate its claim in this case would be like letting the tail wag the proverbial dog," and also that "Peru is actively attempting to conform to mandates of the IMF. . . which may be construed to represent American policy interests." However, just when major international banks had dismissed their lawsuits in exchange for an extension of the prescription period and Peru was committed to negotiating the debt, the judge considered that the judgment should be granted in order to maintain the enforceability of debt instruments,[8] pointing out that "except under the most extraordinary circumstances, [creditors] rights will be determined in accordance with recognized principles of contract law."

On appeal, the Court recognized the principle of international comity and implicitly agreed with the idea that it could be extended to international negotiations with a foreign country, not just to foreign judicial proceedings. But it also argued that "courts will not extend comity to foreign proceedings when doing so would be contrary to the

[8] Mark Cymrot, "What Peru's Brady Deal Means to Rogue Traders" *LatinFinance*, September 1997.

policies or prejudicial to the interests of the United States." To stay the Peruvian debt negotiations would be contrary to the U.S. policy of "ensuring the enforceability of valid debts under principles of contract law." Peru was clearly in default, and the debt negotiations were not sufficient to deny Pravin's rights. Further more, the Court noted that creditor participation in debt negotiations should be on a strictly voluntary basis.[9]

During the lawsuit, Pravin Banker tried to attach Peruvian assets in different ways, but in 1998 it reached an agreement with Peru to settle the claim in similar conditions to those agreed to under the Brady exchange.[10] Pravin's first attachment intent was the proceeds from an international offering of its remaining 29 per cent interest in Telefonica del Peru (1996) that the country would receive in New York. To avoid this Peru had to put in place a new structure for a global stock offering that did not bring Peruvian property into New York's jurisdiction.[11] The second attempt was directed to the quarterly interest that Peru should make before closing the Exchange Agreement under the Brady deal in 1996. The U.S. District Court of the SDNY denied the order saying that "restraining notices on these assets would inappropriately interfere with Peru's efforts to restructure its debts under the Brady Plan, and would unfairly prejudice the rights of those of Peru's creditors who have agreed to settle their claims."[12] In 2001 the Brussels Chamber of appeals did not follow the same criterion when Elliot Associates (see next case) asked for an injunction order against Euroclear to block any payments that would have been received from Peru, avoiding any transfer of the cash proceeds to holders of Brady bonds. So, while in 1996 an American Court considered not affecting the efforts to reach a restructuring agreement, in the context of an execution process in favour of a rogue creditor, in 2000 a Belgian Court did not hesitate to affect the agreement already reached.

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[9] Robert S. Rendell, "In Pravin Banker Associates v. Banco Popular del Peru, the 2nd Circuit held that Pravin's claim should be recognized notwithstanding international comity considerations" 16:6 Int'l Fin. L. Rev. 52.

[10] Peschiera, *supra,* n. 1, at 85-86.

[11] *Ibid.*

[12] District Judge's decision of December 23, 1996 (John S. Martin J.R.).

(ii) *The Elliot Associates case*

As in *Pravin Banker*, Elliot Association acquired US$20 million Peruvian defaulted debt in the secondary market and sued Peru for the full collection of the claim, just when the country was in the process of closing the Brady agreement in 1996. The U.S. District Court for the SDNY dismissed the complaint in 1998, but on appeal the U.S. Court of Appeals for the 2nd Circuit reversed the decision and finally Elliot obtained a judgment in 2000 against Peru for US$56 million that included interests and arrears.

The U.S. District Court held that the purchaser could not sue when it purchased the debt with the intent of rejecting the negotiated Brady settlement available to all holders. In fact, the court found Elliot had acquired Peruvian debt with the sole purpose of suing Peru "by a clear and convincing evidence," something which is expressly prohibited by New York's Judiciary Law S489, which makes unlawful the purchase of debt "with the intent and for the purpose of bringing an action or proceeding thereon." The U.S. District Court accepted the "Champerty defense" raised by the Peruvian government and followed a "strict construction" analysis of the judiciary Law, favoured by the U.S. Supreme Court.[13] In fact, according to American jurisprudence champertous conduct in the acquisition of rights that would then be nullified is based on the intent to sue on that claim as the primary purpose entering the transaction.[14] According to the U.S. District Court opinion, the facts establish that Elliot bought the debt with the intent to sue,

> as the testimony introduced by Elliot's witnesses regarding alternative investment strategies lacked credibility. The facts also establish that on October 25, 1990, Peru signed an agreement with the BAC [Banks Advisory Committee] to stay the lawsuits filed by its commercial lenders, and entered into negotiations to restructure the debt. The facts also establish that in December 1994 the pending lawsuits by all commercial lenders were dismissed, with the exception of Pravin banker, and on October 27, 1995, Peru and the BAC publicly announced an agreement in principle for a debt restructuring plan. Elliot purchased the debt at issue here after the agreement in principle was reached. Thereafter, the debt holders executed the Exchange Agreement and closed the deal.[15]

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[13] *Alan Kolod, Elliot Associates, LP v. Banco de la Nacion* – Claims Trading: Champerty Defense.

[14] *Bluebird Partners, L.P. v. First Fidelity bank, N.A., et al*, NY Court of Appeals (from LII Legal Information Institute).

[15] *Elliot Ass. v. the Republic of Peru*, 12 F. Supp. 2d 328 (SDNY 1998), at 28.

It is interesting to notice that in 1996 the Judge had already denied Elliot's motion for an order of prejudgment attachment, finding that the attachment would be "oppressive. . . and may work irremediable hardship" because Peru was engaged in "reasonable resistance to settling outside the terms of the Brady Agreement."[16]

In reversing the judgment, the U.S. Court of Appeals referred to the *Pravin Banker* case. Although the United States encourages participation in debt resolution procedures under the Brady plan,

> the United States has a strong interest in ensuring the enforceability of valid debts under the principles of contract law, and in particular, the continuing enforceability of foreign debts owed to United States lenders. This second interest limits the first so that, although the United States advocates negotiations to effect debt reduction and continued lending to defaulting foreign sovereigns, it maintains that creditor participation in such negotiations should be on a strictly voluntary basis.

For the Court of Appeals, the District Court's statutory interpretation was inconsistent with this analysis. Rather than furthering the reconciled goal of voluntary creditor participation and the enforcement of valid debts, the District Court's interpretation of Section 489 effectively forces creditors such as Elliot to participate in an involuntary "cramdown" procedure and makes the debt instruments unenforceable in the courts once a restructuring agreement is reached. Undermining the voluntary nature of Brady Plan participation and rendering otherwise valid debts unenforceable cannot be considered to be in New York's interest, as made plain by this court in *Pravin Banker*.

> While the district court's rule might benefit the debtors in the short run, the long term effect would be to cause significant harm to Peru and other developing nations and their institutions seeking to borrow capital in New York. . . The interpretation posited by the district court would also create "perverse result" because it "would permit defendants to create a Champerty defense by refusing to honor their loan obligations. . ."[17]

Disposing a final judgment against Peru, Elliot sought injunctive relief in different foreign jurisdictions to prevent Peru from making an interest payment to holders of the Brady bonds unless a payment was made to Elliot that was proportionate to the payments being made to the Brady bond holders, based on the *pari-passu* provision contained in the

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[16] Cymrot, *supra,* n. 8.
[17] *Elliot Ass. v. the Republic of Peru*, 194 F. 3d 363; 1999 U.S. App. LEXIS 26370, 96-97.

original syndicated loan contracts.[18] On September 22, 2000 Elliot obtained an enforceable decision from the Brussels Court of Appeals requiring MGT/Euroclear to block any cash payments that would have been received from Peru, in relation to its debt service of Brady Bonds. The Court considered that under the *pari-passu* provision "Peru can not pay Brady bonds' holders to the detriment of other creditors who should rank equally and therefore share pro-rata in the Brady bonds proceeds."[19] In practical terms the final American Court decision on the *Elliot* case, even recognizing the U.S. support to Brady negotiations, provoked a potential default of Peru under their Brady bonds obligations. Finally, Peru and Elliot reached a settlement in which Elliot received US$58.45 million covering the amount of the original debt and accumulated interests.

(b) Comments

(i) *Why Elliot and Pravin's lawsuits were exceptional*

The vast majority of Peru's creditors did not use lawsuits – since the beginning of the default – to recover their claims. As a conflict resolution mechanism, creditor banks preferred negotiation rather than litigation. In fact, both Pravin Banker and Elliot Association were not original creditor banks, but investors of LDC debts in the secondary market that had acquired debt documents at a discount. On the contrary, original creditors, such as banks subjected to capital adequacy requirements and highly exposed to LDC debts, were reluctant to classify their LDC credits as non-performing loans once legal actions were initiated. As a general tendency from 1982 to 1987, banks tried to keep their LDC loans as current as possible in order to record them in the original value, to gain time for increasing general reserves and capital.[20] But as Peru's long default was exceptional vis-à-vis the rest of Latin American debtors who had agreed on continuing restructuring agreements, its creditors

[18] See Hagan, *supra*, n. 5 at 313.

[19] See the records of the Elliot case in the Peruvian Minister of Finance web portal in <http://www.mef.gob.pe/DNEP/otros_temas/Caso_E/frame_pdf.htm>. Consider also Diego Devos, "*Illustration of creditor disputes: The Belgian judicial cases against Peru and Nicaragua in relation to cash payments channelled through Euroclear*" presented before the Committee on International Monetary Law of the International Law Association (MOCOMILA), during its 82nd session at Pretoria, South Africa (23 & 24 February 2007).

[20] Monteagudo, *supra,* n. 2 at 62.

could have acted exceptionally with Peru, litigating to recover their claims. However, that did not occur. The negotiated solution with Peru, when banks had already consolidated their capital position in 1996 (the year of Peru's Brady exchange offer), could have been inspired by the banks' phobia to litigate on LDC debt.

The bankruptcy approach on banks' mind could also have played an important role in avoiding litigation. The Brady agreement could have been perceived as the closest way to organize a bankruptcy process on sovereign debt. As Bartholomew, Liuzzi and Stern point out, bankruptcy is designed to avoid a costly "free-for-all" where efforts by individual creditors to enforce their claims destroy value and reduce the total amount available to creditors as a group. In addition to this, the mere existence of a bankruptcy process enables a debtor and its creditors to come to agreement on a debt restructuring.[21]

(ii) *American courts supported negotiations of the Brady agreement between Peru and creditor banks only at the outset*

We have seen how since the Tolling Declaration, courts supported Brady negotiations as they did to justify the stay of *Pravin Banker's* judgment and the lower court's decision in *Elliot*. In fact, in both cases courts' decisions were totally or partially founded on the global restructuring efforts between creditor banks and Peru. In the end, however, when courts were compelled to balance between respecting original terms of contracts (even in the hands of successful rogue creditors) and validating a global solution that could limit original rights, they acted in a *conservative* way. As long as the Brady agreement (well supported by the U.S. government) was not a real bankruptcy mechanism imposed by law, not respecting original contracts would be contrary to the *interests* of the United States.

Actually, this conservative approach is somehow similar to the exceptional admission, at the international law level, to excuse non-performance of loan agreement by the States. In old cases, a force majeure or state of emergency justification does not include economic problems that might be anticipated in any credit risk assessment. In the

[21] E. Bartholomew, A. Liuzzi & E. Stern, "Two step sovereign debt restructuring: a market-based approach in a world without international bankruptcy law" (2004) 35:4 Geo. J. Int'l L. 859 at 862.

case of the Serbian and Brazilian loans, debtors claimed that economic difficulties caused by World War I prevented them from repaying their debt obligations. But the Permanent Court of International Justice determined that a mere increase in the debtor's burden, although unanticipated when entering into the agreement, would not excuse its non-performance.[22] However, in the Elliot and Pravin Banker cases national courts confronted the balance between a global solution (the Brady bond agreement) that resolved a transnational problem implicating national and foreign governments and international organizations, and individual and original claims in the hands of successor creditors. U.S. courts opted for individual rights.

(iii) *Collective action clauses as a market limited solution*

Collective action clauses (CAC) have emerged as an effective contractual mechanism to avoid new *Elliot* and *Pravin Banker* cases. The basic idea of these clauses is to authorize a qualified majority (75 per cent) of bondholders to modify original financial terms of the contract under a restructuring agreement and to preclude minority bondholders from challenging the restructuring process under their original rights.[23] In September 2002, the working group of the Group of 10,[24] created to promote the development of suitable contractual provisions in sovereign debt restructurings, proposed the inclusion of a majority amendment clause "permitting amendments of payments terms with the approval of a supermajority of bondholders." By this mechanism the majority of creditor banks could have imposed the Brady terms to all of Peruvian debt holders.

As mentioned above, in 2001 when the IMF proposed the SDRM it precisely referred to the *Elliot* case as an example of how individual actions could disrupt global efforts under a restructuring debt process, necessitating the intervention of an international organization to support a temporary standstill in a country's debt repayments, as long as it is

[22] August Reinisch, "Debt restructuring and State Responsibility" in D. Carreau & M. Shaw eds., *La Dette Extérieure/The External Debt* (The Hague: Hague Academy of International Law, 1995) 537 at 568.

[23] See S. J. Galvis & A. L. Saad, "Collective Action Clauses: Recent Progress and Challenges Ahead" (2004) 35:4 Geo. J. Int'l L. 713 at 715.

[24] Represented by the US Treasury, the French Ministry of Finance, the European central Bank and the central Banks of Japan, Germany, Italy, Switzerland and Sweden (the IMF acted as observer).

implementing a sensible economic adjustment package and is ready to negotiate with its creditors in good faith.[25] The SDRM proposal implies the establishment of an official restructuring process for sovereign debtors under a multilateral treaty sponsored by the IMF that would "prevent creditors from disrupting negotiations leading to a restructuring agreement by seeking repayment through national courts."[26]

Markets participants reacted with skepticism to the SDRM proposal and insisted on the market solutions rather than enforcing institutional alternatives,[27] which is clearly demonstrated by the Group of 10 document. Thus, the CAC represents the *leitmotiv* of the private sector approach to the new restructuring process. Sean Hagan has pointed out that "one of the tangible benefits of the SDRM initiative is that market participants and emerging-market sovereigns have finally agreed to include collective action clauses in their debt instruments. It would appear that a credible threat of official intervention prompted this degree of self-regulation."[28] However, the CAC solution implies that these clauses already exist in all existing loan or securities contracts accorded by sovereign debtors.[29] If they did not, a global restructuring agreement would always confront free riders' claims. So, as long as all sovereign debt contracts do not provide collective action clauses, a Bankruptcy process for sovereign debtors, such as SDRM IMF's proposal, is still another effective mechanism to avoid individual actions. Perhaps, international efforts (through *Soft Law*) could be directed, by legislative harmonization, to impose collective action clauses to all sovereign debt contracts.

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[25] See Krueger, *supra,* n. 6. See also in particular the article of S. Hagan, *supra,* n. 5, in which as the IMF General Counsel offers a deep analysis of the SDRM proposal and its implications.

[26] *Ibid.* "There is a need to replace a process that can richly reward a few holdouts with one that is fair to all parties. It would avoid lengthy negotiation with debtors and lengthier litigation with the hold-outs," remarked Thomas C. Dawson of the IMF, in "Collective action International Finance," Letter to the Editor, *Financial Times* (28 January 2002).

[27] See, "To Make Sovereign Debt Restructuring Smoother, Not to Dictate The Terms" in *Le Monde Economie*, (18 February 2002).

[28] Hagan, *supra*, n. 5 at 304.

[29] Even if collective action clauses became standard in new issuance, as they indeed have become, it would take some time for the entire stock of outstanding sovereign debt to be converted. In addition, with the exception of Uruguay, CACs as implemented do not contain aggregation provisions across instruments, so coordination across many bonds could still pose a significant challenge. E. Bartholomew, A. Liuzzi & E. Stern, *supra*, n. 21 at 861.

2. CENTRAL BANK'S IMMUNITY AND SETOFFS: THE RIGGS CASE

Immunity for central banks in foreign jurisdictions constitutes a very special chapter in the general treatment of foreign sovereign immunities. In the United States s. 1611(b) of the *Foreign Sovereign Immunity Act* (FSIA) provides that the property of a foreign central bank or monetary authority held "for its own account" is immune from execution and attachment in aid of execution, absent an explicit waiver. U.S. courts have established absolute immunity from prejudgment attachment, with the exception that only postjudgment attachment can be waived. "The enactment of this provision reflected congressional concern that the attachment of or execution against central bank assets 'could cause significant foreign relation problems' and, if attachments or execution were allowed, 'deposit of foreign funds in the United States might be discouraged.' "[30] In fact, immunity for central banks in times of debt crisis plays a dramatic role when LDC governments default their foreign debts with creditor banks and their central banks must invest their last international reserves in the international financial system. Special immunity accorded to the central bank should be the mechanism to avoid the confusion by U.S. courts between sovereign obligations and central banks' assets. However, the FSIA is silent about the confusion that could be activated by a commercial bank that plays the double role of creditor bank of the government and recipient of a central bank's deposit.

The Riggs National Bank of Washington made loans for US$6 million to Banco de la Nación, Corporación Financiera de Desarrollo S.A. and Banco Popular del Peru (all of them wholly owned by the Peruvian government). In 1983, Riggs renewed the loans pursuant to the global restructuring agreement that provided Peru's unconditional guarantee for the repayment of the loans upon demand. The President of Peru's External Debt Committee promised in a letter to maintain a US$2 million deposit in the name of Banco de la Nación with Riggs until the debt had been repaid. One month after this declaration, Riggs received US$2 million deposits from the Central Bank of Peru, accompanied by a telex stating that the operation was part of the agreement

[30] Federal Reserve Bank of New York, "Immunities of Central Banks Assets, Country Report: United States of America" BIS Central Bank Legal Experts' Meeting (18-19 January 2007). The NYFed Report refers to Congressional debate as H.R. Rep. No. 94-1487, at 31 (1976), reprinted in 1976 U.S.C.C.A.N. 6604, at 6630.

with Peru's External Debt Committee. However, in subsequent communications, Riggs demanded that existing deposits be converted in the name of Banco de la Nación (as agreed). This conversion never happened and in the middle of Peru's general default in 1985, the Central Bank of Peru instructed Riggs to cancel its deposit. Riggs did not follow the instruction and setoff the Central Bank's deposits against its defaulted credit to Peru.

The Central Bank of Peru sued Riggs before the U.S. District Court for the District of Columbia, requesting recovery of its deposits alleging that the setoff was improper because of the absence of mutuality and the violation of the FSIA. The Central Bank claimed that, not being an obligor of Riggs' credit, this bank was unable to compensate its assets. Additionally, the FSIA's immunity from attachment and execution extends to immunity from setoff as it is implied by the *Weston,*[31] the decision where the court observed that prejudgment attachment is a "disruptive" provisional remedy obtained through *ex parte* application. In this case, the court concluded that Congress intended to prohibit any prejudgment attachment of central bank funds because such exposure would (1) discourage deposit of those funds in the United States and (2) cause significant foreign relations problems. In fact, the concerns of discouraging central bank deposits and causing disruptions in foreign relations apply with even greater force in the case of setoff than in the case of prejudgment attachment, as the former is an extra judicial, self-help remedy executed without notice or any procedural safeguards.

The District Court did not accept the Central Bank's arguments and denied Peru's motion for summary judgment. For the court, the central bank could not disassociate itself from the Republic of Peru, circumventing the entire purpose of the deposit and guaranty. *This would work injustice on Riggs*. Regarding the FSIA argumentation, the court considered that attachment and execution are fundamentally different from setoff. "*The* former are legal remedies to legal wrongs, whereas the latter is a remedy that rests in equity."[32]

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[31] *Weston Compagnie de Finance et D'Investissement*, *S.A. v. La Republica de Ecuador*, 823 F. Supp. 1106 (SDNY 1993).

[32] See *Banco Central de Reserva del Peru v. The Riggs National Bank of Washington*, D.C., Memorando Opinión, December 12, 1994. 919 F. Supp. 13 (D.D. C. 1994).

On appeal, the Central Bank of Peru was accompanied by an amicus curie intervention of the Central Banks of Argentina, Colombia, Chile, Ecuador, Bolivia and the Dominican Republic and Professor Geoffrey Miller from the University of Chicago law school. The U.S. Court of Appeals did not have to resolve the case because both parties achieved a settlement agreement in the context of the Brady plan in 1996. However, the question is still on the table: could banks do by themselves what is prohibited to courts?

Beyond the discussion about real facts in the *Riggs* case, the issue of extending FSIA's preclusions to setoffs is a major one for Central Banks' investments in the United States. In fact, the discretionary power of a creditor bank to set off a central bank's deposits might be challenged by the lack of mutuality between both parties' assets, and also by the well recognized doctrine of the *central bank's independence*. As it has been the case in Europe, Latin America and Asia, following the experience of the U.S. Federal Reserve Bank system and the Bundesbank of Germany, since the eighties most of central banks' legislation has been amended at the legislative and constitutional level, to assure independence of the monetary policy from government action.[33] The basic rationality, founded on some level of consensus in monetary theory, is to separate fiscal activity of government from monetary creation by the Central bank in order to preserve monetary stability and avoid inflation. That is why in many national constitutions[34] and in treaties the European Union[35] the prohibition of central banks to lend money to governments has been established. So one of the evident consequences of a central

[33] See among others: Capie F. & Wood G., *Central Banks and inflation: an historical perspective*, Part I, in Balino T. & Cottarelli C., "Frameworks for Monetary Stability: policy issues and Country Experiences", *Central Banking*, (1991) 2:2, at 27; Bain K., Arestis P. & Howells P., "Central Banks, Governments and Markets: An Examination of Central Bank Independence and Power", Economies et Sociétés, Série monnaie et production, n° 10, 2-3/1996; Smith C., Lingren C.J. & Dueñas D. E., *Strengthening central bank independence in Latin America* in *Frameworks for monetary stability*, Washington D.C., IMF, 1994, at 93-94; Lastra R. M., *Central banking and banking regulation*, London: Financial Market Group, 1996; Lastra R. M. & Wood G., "Constitutional approach to central bank independence" *Central Banking* (Feb. 2000). The author has also written his doctoral thesis on central bank's independence, Manuel Monteagudo, *l'indépendance de la Banque centrale – aspects juridiques* (these doctorale à l'Université de Paris I, Panthéon Sorbonne 2004).

[34] In Latin America we find this constitutional interdiction in the case of Brazil (article 164), Chile (article 98), Peru (article 84), Colombia (article 373).

[35] Article 108 of the European Community Treaty.

bank's independence should be that central banks' do not respond for governmental obligations at the national or international level. This should also be promoted as a consensus in financial centers, following the path initiated by foreign sovereign immunity legislation.