

PERU'S EXPERIENCE IN SOVEREIGN DEBT MANAGEMENT AND LITIGATION: SOME LESSONS FOR THE LEGAL APPROACH TO SOVEREIGN INDEBTEDNESS

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I

INTRODUCTION

The world is now facing a global financial crisis that has put the whole international system of payments at serious risk and will probably affect global growth over the coming years. This situation has mobilized international organizations, governments, central banks, and supervisory banking authorities from all over the world, and many commentators have identified commonalities between the current crisis and that of 1929. It is not necessary to go so far back, however, to draw historical parallels: the Latin American debt crisis, initiated in 1982 with Mexico's default, had similar characteristics. At that time, the nine largest U.S. banks had exposures to countries with debt-servicing problems equal to over two hundred percent of their primary capital,¹ and the International Monetary Fund (IMF) described the situation as a crisis of the international system of payments as a whole.² That crisis prompted international organizations like the IMF and the World Bank to grant specific facilities to debtor countries, and national authorities to approve legislative responses like the International Lending Supervision Act³ in the United States. Today the problem also involves commercial banks' assets, but this time the troubled debtors are not governments or foreign agencies, but banks and private

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1. Manuel Monteagudo, *The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective*, 28 INT'L LAW. 59, 61 (1994) [hereinafter Monteagudo, *The Debt Problem*].

2. See INT'L MONETARY FUND, ANNUAL REPORT OF THE EXECUTIVE BOARD FOR THE FINANCIAL YEAR ENDED APRIL 30, 1989, at 23 (1989); see also Manuel Monteagudo, *Reflexiones Sobre la Crisis Financiera Internacional*, 32 DERECHO Y SOCIEDAD 77 (2009); Monteagudo, *The Debt Problem*, *supra* note 1.

3. 12 U.S.C. §§ 3901–3912 (1983).

customers. Domestic authorities are—as during the Latin American debt crisis—taking some actions to reduce systemic spillovers, but with unprecedented measures such as introducing guarantees for bank deposits (unlimited in some cases, as in Ireland),⁴ temporarily nationalizing commercial banks, and increasing deposit-insurance coverage. Central banks have also developed unconventional measures, mainly reducing interest rates to near zero percent and extending new liquidity instruments to banks. For example, the U.S. Federal Reserve Board, in addition to reducing the Federal Funds Rate, authorized the purchase of up to \$100 billion in debt issued by the housing-related, government-sponsored enterprises, and up to \$500 billion in agency-guaranteed, mortgage-backed securities, as well as the creation of the Term-Asset-Backed Securities Loan Facility.⁵

Today, as during the Latin American debt crisis, public powers are taking the initiative to intervene exceptionally in markets in the name of the public interest (that is, to protect the economy from systemic risk). In some countries, like the United Kingdom, the financial packages launched by the government to protect commercial banks from the impact of the international crisis were not free from being suspected as noncompetitive measures that violated European law.⁶ In October 2008, the European Commission issued a clarification to dispel any doubt about the legality of government schemes that proliferated across Europe. According to this communiqué, these actions could be understood as aid “to remedy a serious disturbance in the economy of a Member State” under Article 87(3)(b) of the European Community Treaty.⁷

During the Latin American debt crisis, the international community sought to strike a balance between global and individual interests. Debtor states took the initiative to globally renegotiate the external debt of the whole public sector (that is, central government, agencies, and state-owned companies), including, in some cases, a portion of the external private debt with the support of international organizations and creditor banks’ governments. These operations implicitly replaced a variety of original loan agreements with a new global restructuring agreement. However, a few creditors did not participate in the global scheme and decided to initiate legal actions based on the original terms of the agreements.⁸ Thus, national courts had to decide whether global packages

4. See *infra* note 6.

5. See Ben S. Bernanke, Chairman, Fed. Reserve Bd., Address at the Federal Reserve Bank of Kansas City’s Annual Economic Symposium: Reflections on a Year of Crisis (Aug. 21, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm>.

6. See Tim Congdon, *The Northern Rock Fiasco: How the EU has Damaged Britain’s Ability to Govern Itself*, THE EUR. J., Oct. 1, 2008, available at http://europeanjournal.typepad.com/my_weblog/2008/10/the-northern-ro.html.

7. European Commission, *Communication from the Commission—The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis*, OFFICIAL J. EUR. UNION, Oct. 25, 2008, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:270:0008:0014:EN:PDF>.

8. See *infra* Part II.B.

modifying original loan agreements supported by creditor and debtor states (and a substantial majority of commercial banks) should prevail over the individual interests of “free riders.” This was the case when Elliott Associates and Pravin Banker Associates brought Peru before U.S. courts.⁹ Initially, the courts’ decisions appeared to favor global interests, but these were later reversed.¹⁰ In fact, the IMF justified its Sovereign Debt Restructuring Mechanism (SDRM) proposal of 2001 in light of *Elliott Associates v. Banco de la Nacion*, in which the U.S. Court of Appeals for the Second Circuit reversed the original dismissal and granted a \$56 million judgment in favor of Elliott,¹¹ and the Brussels Court of Appeal authorized its execution through an order to block any payment in favor of Brady-bond creditors.¹² Former IMF Deputy Managing Director Anne Krueger described the Elliot case as illustrating “a missing element in the international community’s current approach to the roles of the public and private sectors in debt restructuring.”¹³ It will be interesting to compare the reaction of U.S. courts when they address the balance between global and individual interests in the context of the current systemic financial crisis in the United States.

In fact, Peru’s experience in sovereign debt management and litigation offers a valuable insight for comparing domestic courts’ and creditors’ reactions. Beginning in 1984, Peru was in permanent default for almost thirteen years. But the most significant litigation experience began when Peru initiated restructuring negotiations under the Brady Plan in 1996.¹⁴ Litigation during this period was not promoted by original creditor banks, but by creditors like Elliott and Pravin Banker that had acquired small pieces of Peruvian commercial debt in the secondary market and were aimed at the full collection of the debt.¹⁵

During this period of default, Peru also required U.S. courts’ intervention to clarify the nature and content of immunity for foreign central banks under the U.S. Foreign Sovereign Immunity Act (FSIA),¹⁶ when Riggs National Bank set

9. *Elliott Assocs. v. Republic of Peru*, 948 F. Supp. 1203 (S.D.N.Y. 1996); *Pravin Banker Assocs. v. Banco Popular del Peru and Republic of Peru*, 165 B.R. 379 (S.D.N.Y. 1994).

10. *See infra* Part II.B.

11. *Elliott Assocs. v. Banco de la Nacion*, 194 F.3d 363, 365 (2d Cir. 1999).

12. *Elliott Assocs.*, General Docket No. 2000/QR/92 (Ct. App. Brussels, 8th Chamber, Sept. 26, 2000).

13. Anne Krueger, First Deputy Managing Dir., Int’l Monetary Fund, Address at the National Economists’ Club Annual Members’ Dinner: International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), *available at* <http://www.imf.org/external/np/speeches/2001/112601.htm>.

14. “By offering direct financial support for debt and debt service operations, the IMF and the World Bank could provide new incentives, which would act simultaneously to strengthen prospects for greater creditworthiness and to restore voluntary private financing in the future.” Nicholas F. Brady, U.S. Sec’y of the Treasury, Address Before a Conference on Third World Debt Sponsored by the Brookings Institution and the Bretton Woods Committee: Dealing with the International Debt Crisis 4 (Mar. 10, 1989), *available at* http://findarticles.com/p/articles/mi_m1079/is_n2146_v89/ai_7654675/.

15. Manuel Monteagudo, *Comments About the Experience of Peru in Sovereign Debt Litigation*, 23 BANKING & FIN. L. REV. 293, 296 (2008) [hereinafter Monteagudo, *Comments*].

16. Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, 90 Stat. 2891.

off deposits belonging to the Central Bank of Peru (BCRP) to collect a claim against the Peruvian government. That case, *Banco Central de Reserva del Peru v. Riggs National Bank of D.C.*,¹⁷ raised the issue of whether banks could execute such a self-help remedy against an independent central bank when the law expressly prohibited prejudgment attachments. The parties reached a settlement on appeal,¹⁸ but the conceptual inquiry remains open and deserves a deeper analysis, considering the increase in worldwide central-bank investments and the consolidation of their independence as a common practice.

The end of Peru's debt problem illustrates in some way the accomplishment of Nicholas Brady's dream when the Plan was launched in 1989: the natural return of sovereign debtors to international financial markets.¹⁹ Even though Peru did not follow the calendar of the majority of debtor countries to negotiate its debt (its Brady agreement was executed only in 1997),²⁰ since 2001, it has followed the general pattern with great success. Peru has begun to exchange Brady bonds—Peruvian bonds collateralized by U.S. Treasury bills—for new global bonds based on Peru's own credit risk, and, since 2002, new long-term bond issuances have been placed in international markets.²¹

This article, based on previous research and publications, broadly addresses, from a global perspective, some of the major issues that arose in the course of Peru's litigation—reluctance to sue, balance of interests, *pari passu* claims, and central-bank immunities. It then offers a reflection about the future of sovereign debt management and the role of international law.

II

RELEVANT ISSUES FROM PERU'S EXPERIENCE IN SOVEREIGN DEBT LITIGATION

A. Reluctance to Sue

Most syndicated-loan agreements signed by Peru's central government, agencies, and state-owned companies with commercial banks were governed by foreign laws and submitted to Peruvian courts and to foreign jurisdictions such as New York and London as is the usual practice in the international banking industry. Peru's default, as in most cases, was based on specific domestic legislation mandating that national debtors not pay the external debt and instead place the corresponding amount of capital and interest in special

17. *See generally* Banco Central de Reserva del Peru v. Riggs Nat'l Bank of D.C., 919 F. Supp. 13 (D.D.C. 1994).

18. JORGE PESCHIERA CASSINELLI, EL PLAN BRADY PERUANO: OPERACIONES DE REDUCCIÓN DE DEUDA EXTERNA 1993–1997, at 86 (2002).

19. *See supra* note 14.

20. PESCHIERA, *supra* note 18, at 58.

21. *See Emisiones Internacionales* [International Emissions] 2002–2009, MINISTERIO DE ECONOMÍA Y FINANZAS [MEF], http://www.mef.gob.pe/DNEP/tabla_bonos_globales.php (last visited July 10, 2010).

accounts of public banking entities.²² This domestic legalization of defaults was the reverse of the principle that the creation of public debt should be authorized by law (that is, through the congressional power to authorize taxes and public debt).²³ A mandate to not pay the public debt must be authorized by law because, as opposed to a simple commercial failure, the act of defaulting has been characterized as a public power's intervention to prevent the execution of a commercial obligation. In the United States, the Act of State Doctrine authorizes U.S. courts to abstain in circumstances in which they would have to assess the validity of sovereign acts performed in their own territory.²⁴ Conversely, this judicial doctrine does not apply to obligations that should be executed in the United States, as in the case of syndicated loans payable in the United States. That is, the situs requirement of the Act of State Doctrine renders it inapplicable to sovereign debt defaults,²⁵ something that was not definitively clarified until the debt crisis of the mid-1980s.²⁶

In any case, Peru's commercial-bank creditors had sufficient support to pursue legal actions in the United States during the long period in which Peru remained in default (1984 through 1997). Yet creditor banks did not follow this option. In March 1990, when the terms of many syndicated-loan contracts were about to expire under New York law, creditor banks initiated thirty-four actions in five different jurisdictions (New York, London, Toronto, Paris, and Luxembourg).²⁷ However, the suits were suspended by agreement four months later because the banks were expecting to avoid only the prescription of their claims, and not necessarily the full collection of extended credit or even the attachment of Peru's assets. In November, the Peruvian government issued a Tolling Declaration that permitted creditor banks to dismiss their actions.²⁸ The

22. In the case of Peru, legislation began with the Decreto Supremo No. 079-83-EFC and was amplified by subsequent legislation: Decreto Supremo Nos. 100 and 198-83-EFC and Decreto Legislativo 368. See Roberto Mac Lean, *Legal Aspects of the External Debt*, in 214 RECUEIL DES COUR: COLLECTED COURSES OF THE HAGUE ACADEMY OF INTERNATIONAL LAW 31, 91 (1989).

23. Like many national constitutions, the Peruvian Constitution accords to Congress the power to create taxes and public debt. The default decrees were initially approved by the executive using exceptional constitutional powers. CONSTITUTION OF THE REPUBLIC OF PERU.

24. *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 416 (1964) (explaining that under the Act of State Doctrine, U.S. courts will not question the validity of the public acts of foreign sovereigns within their own territory).

25. It has been recognized that:

In cases involving the 'location' of debts, most courts, like *Bancomer* [*Braka v. Bancomer*, 762 F.2d 222 (2d Cir. 1985)], have concluded that the debt is located at the situs for its repayment.

Under this analysis, the act of state doctrine is applicable to the repudiation of debts that must be repaid within the foreign state, but not to debts payable only at other locations.

GARY BORN & DAVID WESTIN, *INTERNATIONAL CIVIL LITIGATION IN THE UNITED STATES COURTS* 545-46 (1989) (citing *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 757 F.2d 516 (2d Cir.), *cert. denied*, 473 U.S. 934 (1985)).

26. Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 913-14 (2004). "[F]or a drafter of a Eurodollar loan agreement in 1970, these judicial decisions were fourteen years in the future." *Id.* at 914.

27. PESCHIERA, *supra* note 18, at 23-24.

28. Monteagudo, *Comments*, *supra* note 15, at 296.

major litigation Peru confronted came, rather, from assignee creditors (not original creditor banks), just when it had begun to negotiate a restructuring agreement with a large majority of commercial banks.

In fact, creditor banks were subject to capital-adequacy requirements, and being highly exposed to less-developed countries' (LDC) debts, they were reluctant to initiate legal actions that would have forced them to classify their LDC credits as nonperforming loans. As a general trend from 1982 to 1987, banks tried to keep their LDC loans as current as possible in order to record them at their original value, thus gaining time for increasing general reserves and capital.²⁹ For creditors that had purchased sovereign debt in the secondary market, the approach would be completely different:

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.³⁰

In the case of Peru, assignee creditors (Elliott Associates or Pravin Banker) rejected any possibility to participate in a restructuring agreement.

But a question that remains for history is why in the case of a debtor country like Peru, which had remained in default for more than thirteen years (an exceptional case among LDC debtors), original creditor banks did not opt to sue when they had probably written off the loans from their balance sheets and consolidated their capital position. One way to address this question is to recall the general attitude of commercial banks during the debt crisis, which was oriented mainly toward a negotiated solution for the reasons mentioned above, and the proposals from governments—like the Baker³¹ and Brady Plans—and international organizations. At least up to the end of the past century, the debt problem was resolved out of court, and it is possible that the case of Peru reflected banks' inertial reluctance to sue.

B. The Global Versus the Individual Approach of U.S. Courts

The negotiated solution of Peru's debt problem, both through multi-year restructuring agreements signed by LDC debtors and commercial banks since

29. *Id.* at 302; see also A.F. Lowenfeld, *Foreword*, 17 N.Y.U. J. INT'L L. & POL. 485, 489 (1985); Monteagudo, *The Debt Problem*, *supra* note 1, at 62.

30. Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 319 (2005).

31. The Baker Plan proposed approaching the international debt problem by promoting sustained growth in less developed countries (LDCs) through the application of sound economic policies, the central participation of the International Monetary Fund and multilateral development banks, and the increase of commercial bank financing to LDCs. See James Baker III, U.S. Sec'y of the Treasury, Address Before the Joint Annual Meeting of the IMF and the World Bank (Oct. 8, 1985), *reprinted in* FOREIGN DEBTS IN THE PRESENT AND A NEW INTERNATIONAL ECONOMIC ORDER 291-301 (Detlev Dicke ed., 1986); see also Monteagudo, *The Debt Problem*, *supra* note 1, at 59.

the beginning of the crisis and through the Brady exchange arrangements since 1989, consisted of *global* procedures intended to affect all creditors. In the absence of international or multilateral mechanisms, such as the IMF's SDRM, those packages became, in practice, the only way to organize a process of sovereign debt "bankruptcy." Individual legal actions forced U.S. courts to confront the dilemma of recognizing original rights of insignificant creditors (under original terms of contracts) against the global renegotiating package supported by the U.S. government.

Initial U.S. courts' decisions in *Elliott* and *Pravin* favored global interest and negotiation. They accorded temporary stays of summary judgments against Peru³² and denied requests to seize Peru's assets in the United States,³³ when the Brady agreement was still being negotiated and Peru was reinserting itself into the international financial system with the support of foreign governments and international organizations. For example, in justifying the stay of a summary judgment in favor of *Pravin*, a U.S. district court reasoned, "To allow *Pravin* to activate its claim in this case would be like letting the tail wag the proverbial dog. . . . Peru is actively attempting to conform to mandates of the IMF[.] . . . [which] may be construed to represent American policy interests."³⁴ In denying an order to attach Peru's quarterly interest payment to close the Exchange Agreement under the Brady agreement, the court in *Pravin* also pointed out 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."³⁵ In *Elliott*, the court refused to order prejudgment attachment of Peru's assets, reasoning that the attachment would likely be "oppressive . . . and . . . work irremediable hardship" upon Peru,³⁶ and that *Elliott* may have purchased the debt with the intent to sue, knowing of Peru's "reasonable resistance to settling outside the terms of the Brady [a]greement."³⁷

Yet the appellate courts' final decisions took the opposite tack when the global Brady agreement had concluded, preferring the protection of original terms of loan agreements in the hands of insignificant creditors. When the Second Circuit affirmed summary judgment in favor of *Pravin*, it established that preferring Peruvian debt negotiations would be contrary to the U.S. policy of "ensuring the enforceability of valid debts under the principles of contract

32. *Pravin Banker Assocs. v. Banco Popular del Peru and Republic of Peru*, 165 B.R. 379, 389 (S.D.N.Y. 1994).

33. *Elliott Assocs. v. Republic of Peru*, 948 F. Supp. 1203, 1214 (S.D.N.Y. 1996).

34. *Pravin*, 165 B.R. at 387, 389.

35. Order Denying Plaintiff's Application for Attachment, *Pravin Banker Assocs. v. Banco Popular del Peru and Republic of Peru* (S.D.N.Y. Dec. 23, 1996).

36. *Elliott*, 948 F. Supp. at 1214.

37. *Id.* at 1209.

law.”³⁸ The same reasoning was followed in *Elliott* to reverse the earlier decision to deny recovery to Elliott:

[T]he 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.³⁹

C. *Pari Passu* Provisions

Once Elliott obtained a final decision against Peru, it sought injunctive relief in several foreign jurisdictions to prevent Peru from making an interest payment to holders of the Brady bonds unless a proportionate payment was made to Elliott based on the *pari passu* provision contained in the original syndicated-loan contracts.

The guaranty extended in May 1983 by the Republic of Peru through a letter agreement in favor of Banco de la Nacion and Banco Popular del Peru (as original public-sector debtors) provided that “the obligations of the Guarantor hereunder do rank and will rank at least *pari passu* in priority of payment with all other External Indebtedness of the Guarantor, and interest thereon.”⁴⁰ Elliott filed an ex parte motion before the Commercial Court of Brussels, Belgium, to enjoin Morgan, the operator of Euroclear, for reasons of absolute necessity, to instruct its cash correspondents not to have any amounts credited to their accounts that originate from the Republic of Peru or Banco de la Nacion, including amounts designed to pay interest under the Brady bonds. And in case such funds had already been received, Morgan was to instruct the cash correspondents to block those funds and to take no action that would result in the funds being distributed in any manner within the Euroclear system.⁴¹

Initially, Elliott’s motion was denied because the court considered that the tests of “absolute necessity” and “extreme urgency” had not been fully met.⁴² But in September 2000, Elliott obtained an enforceable decision from the Brussels Court of Appeal requiring Euroclear to block any cash payments from

38. *Pravin Banker Assocs. v. Banco Popular del Peru*, 109 F.3d 850, 855 (2d Cir. 1997); see also Robert S. Rendell, *Collection of Sovereign Debt*, INT’L FIN. L. REV., June 1997, at 52, 52 (“[T]he Second Circuit affirmed the District Court’s ruling that Pravin’s claim should be recognized notwithstanding international comity considerations.”).

39. *Elliott Assocs. v. Banco de la Nacion*, 194 F.3d 363, 379–80 (2d Cir. 1999) (quoting *Pravin*, 109 F.3d at 855) (emphasis added).

40. See Declaration of Professor Andreas F. Lowenfeld at 8 (Aug. 31, 2000), filed in *Elliott Assocs., L.P. v. Banco de la Nacion*, No. 96 Civ. 7916 (RWS), 2000 U.S. Dist. LEXIS 14169 (S.D.N.Y. Sept. 29, 2000) (on file with author).

41. *Elliott Assocs.*, General Docket No. 2000/QR/92 (Ct. App. Brussels, 8th Chamber, Sept. 26, 2000).

42. *Id.*

Peru associated with its Brady arrangement.⁴³ Under the *pari passu* provision, the court wrote that Peru could 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.⁴⁴

The Brussels Court of Appeal's decision and its implications for the *pari passu* clause have been widely examined within the academic community. Lopez Sandoval suggests that, in *formal* terms, we should not overreact to the consequences of that decision at the level of jurisprudence or doctrinal development. According to Belgian law, any decision made pursuant to an *ex parte* petition "is not related to the legal validity of any right alleged by the petitioner, but only to the formal admissibility of the petition."⁴⁵ Peru's experience with the court's reading of the *pari passu* clause, however, has produced an interesting discussion about its interpretation. For Professor Lowenfeld, the clause entitles each lender to share equally and ratably with any other holder of external debt,⁴⁶ so if Peru pays interest to holders of the Brady bonds, it is obligated to pay a proportionate amount to any other holder of Peruvian debt covered by a *pari passu* clause (like Elliott). On the other hand, Professors Mitu Gulati and Kenneth Klee propose that, in the context of corporate debt, the clause implies that "no other lender will enjoy a priority in a liquidation distribution of the borrower's assets."⁴⁷ Lee Buchheit and Jeremiah Pam think that, if brought to extreme situations, Elliott's ratable-payment theory would make it impossible to make a full payment to anybody once a *pari passu* debt ("this bond shall rank *pari passu* in priority of payment with all of the borrower's other debts") is in default:

[E]qually-ranking debts must be paid equally—that's the theory. By the debtor[s] openly announcing its agreement (in a registration statement filed with the U.S. Securities and Exchange Commission, for example) to maintain the equal ranking of this bond with other debts, have those other creditors been given the power to enjoin a payment under this bond, regardless of whether the instruments evidencing those other debts contain their own *pari passu* covenants? And if there is even the remotest possibility of this outcome, why would the purchasers of such a bond agree up front to decline to accept payments under their instrument unless every other equally-ranking lender to that borrower was also being paid in full? Analyzed in this way, a *pari passu* covenant is a positively dangerous clause to include in any debt instrument.⁴⁸

For Professor Roberto Mac Lean, the purpose of this clause is to ensure that the borrower treats all creditors holding the same category of debt equally and to prevent earmarking of government revenues for the benefit of only some

43. *Id.*

44. *Id.*

45. Eduardo Luis Lopez Sandoval, *Sovereign Debt Restructuring: Should We Be Worried About Elliott?* 16 (May 2002), available at <http://www.law.harvard.edu/programs/about/pifs/education/sp44.pdf>.

46. Declaration of Professor Andreas F. Lowenfeld, *supra* note 40, at 7.

47. Mitu Gulati & Kenneth N. Klee, *Sovereign Piracy*, 56 BUS. LAW. 635, 639 (2001).

48. Buchheit & Pam, *supra* note 26, at 886.

creditors. Moreover, he believes the *pari passu* clause is not related to the timing of repayments because different loans can be repaid at different times.⁴⁹

In the context of sovereign debt management and the debt crises, experience shows that even with *pari passu* clauses in force, many creditors enjoyed preferred status as part of a common practice in both domestic and international law without any particular reaction from remaining creditors. In studying the emergence of a transnational law on external debt, Professor Dominique Carreau identified as privileged creditors (those who will keep the original terms of their loans) the obligatory creditors, the short-term commercial creditors, and the international public creditors (the IMF, the World Bank, and regional banks such as the Inter-American Development Bank).⁵⁰ Elliott's interpretation of the *pari passu* clause would make impossible the continuity of financial operations of a debtor breaching a contract (with a universal effect like the cross-default effects of ISDA (International Swaps and Derivatives Association) transactions), and would render unnecessary the mere existence of bankruptcy-law principles. According to those principles, under a debtor's petition, the State prohibits any individual creditor's recovery outside of an orderly and proportional payment to all creditors.⁵¹

Nicaragua was confronted with a situation similar to *Elliott* before Brussels courts, but with different results. There, the Brussels Court of Appeal rejected an injunction to prevent Euroclear from processing payments to certain bonds, reasoning that measures were all directed at Euroclear as operator of a securities system, which led to accord loan-contract stipulations (the *pari passu* clause) with binding effects on a third party (Euroclear)—all contrary to the basic principles of Belgian civil law.⁵² As a result, a new law was passed in November 2004 to include incoming cash transfers that are to be credited ultimately to cash-settlement accounts via a Belgian or a foreign bank as formally protected against blocking measures.⁵³

49. Mac Lean, *supra* note 22, at 58–59. In the same perspective as Mac Lean, Buchheit and Pam ask, “As the lawgiving authority in its own country, what would stop a sovereign from passing a law that, for example, purported legally to subordinate all of its existing foreign lenders in favor of some new set of creditors . . . ?” Buchheit & Pam, *supra* note 26, at 913.

50. DOMINIQUE CARREAU, *LA DETTE EXTERIEURE [THE EXTERNAL DEBT]* 18 (Dominique Carreau & Malcolm Shaw eds., 1995).

51. Ed Bartholomew, Angela Liuzzi & Ernest Stern, *Two-Step Sovereign Debt Restructuring: A Market-Based Approach in a World Without International Bankruptcy Law*, 35 GEO. J. INT'L L. 859, 862 (2004).

52. Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A., General Docket No. 2003/KR1334 (Ct. App. Brussels, 9th Chamber, Mar. 19, 2004); *see also* Buchheit & Pam, *supra* note 26, at 882.

53. *See* Loi modifiant la loi du . . . 28 avril 1999 visant à transposer la Directive 98/26/CE du 19 mai 1998 concernant le caractère définitive du règlement dans les systèmes de paiement et de règlement des opérations sur titres [Law Amending the Law of April 28, 1999 to Transpose the Directive 98/26/EC of May 19, 1998 on Settlement Finality in Payment Systems and Settlement of Securities Transactions] of Nov. 19, 2004, MONITEUR BELGE [M.B.] [Official Gazette of Belgium], Dec. 28, 2004, 85854, 85855 (amending Loi visant à transposer la Directive 98/26/CE du 19 mai 1998 concernant le caractère définitive du règlement dans les systèmes de paiement et de règlement des opérations sur titres [Act to

D. Setoff and Central Bank Immunities

The risk of attachment of a debtor country's assets in the context of a general default with creditor banks constitutes one of its major concerns. This concern is even more dramatic for debtor countries' central banks when they have to keep and invest their last international reserves within the borders of the international financial system. Special immunity should be accorded to the central bank to avoid confusion by U.S. courts between sovereign obligations and central-bank assets. The FSIA is silent, though, about the confusion that could be activated by a commercial bank that plays the dual role of creditor bank of the government and recipient of a deposit made by an independent central bank.⁵⁴ This was the issue discussed in the context of the action initiated by the BCRP (the Central Bank of Peru) against Riggs National Bank of Washington, D.C.⁵⁵

The BCRP claimed that, because it was not an obligor of Riggs's credit, Riggs was unable to compensate its assets: there was an absence of mutuality as the minimum premise to compensate.⁵⁶ Additionally, the FSIA's immunity from attachment and execution should imply the interdiction to setoff in some cases, as suggested by a 1993 U.S. district court case pointing out that prejudgment attachment is a "disruptive" provisional remedy obtained through ex parte application.⁵⁷ In fact, these characteristics are even more evident in a setoff, which is an extrajudicial, self-help remedy executed without any notice or procedural safeguards.

The U.S. District Court for the District of Columbia in *Riggs* denied the motion for summary judgment, reasoning that the central bank (as supposed the guarantor) could not disassociate itself from the Republic of Peru: "[T]his would work injustice on Riggs."⁵⁸ 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."⁵⁹ After the appeal (with the support of an amicus curiae of some central banks), the parties settled the case. The question remains open, though, as to whether banks can do by themselves what is prohibited to courts by permitting the extension of governments' responsibilities to independent central banks.⁶⁰

Implement Directive 98/26/EC of May 19, 1998 on Settlement Finality in Payment Systems and Settlement of Securities Transactions] of Apr. 28, 1999, MONITEUR BELGE [M.B.] [Official Gazette of Belgium], Jan. 6, 1999, 19563, 19567).

54. Monteagudo, *Comments*, *supra* note 15, at 306.

55. Banco Central de Reserva del Peru v. Riggs Nat'l Bank of D.C., 919 F. Supp. 13 (D.D.C. 1994).

56. *See id.* at 16.

57. Weston Compagnie de Finance et D'Investissement, S.A. v. La Republica del Ecuador, 823 F. Supp. 1106, 1111 (S.D.N.Y. 1993).

58. *Riggs*, 919 F. Supp. at 16.

59. *Id.* at 17.

60. Monteagudo, *Comments*, *supra* note 15, at 309.

III

PROSPECTS FOR SOVEREIGN DEBT ISSUES

History shows that public powers have always demanded financial resources from private markets. Italian banks have financed many sovereigns since the fifteenth century for different projects.⁶¹ The debt of Charles V's empire with private bankers increased from one million ducats in 1539 to more than six million ducats, despite the revenues from the colonies.⁶² Wars were another reason for government indebtedness or the assumption of financial obligations. In the nineteenth century, most of the new Latin American republics initiated a long restructuring of their external debt.⁶³ European nations have not been exempted from defaults and unilateral moratoria. France defaulted eight times between 1500 and 1800, while Spain defaulted thirteen times between 1500 and 1900.⁶⁴ Today, we see both developing and industrialized countries placing sovereign bonds in domestic and international financial markets. Additionally, modern central banks execute monetary policy through "repo" transactions with Treasury bonds, and in the European Monetary Union, national central banks are authorized to accept public securities from any EU member.⁶⁵ In the United States, treasury bills were instrumental in creating the largest public debt in U.S. history.

During the current global financial crisis, many governments have assumed a significant proportion of banks' liabilities. In this context, it is correct to conclude that the state's role as debtor of private markets is still alive and that new episodes of sovereign debt default cannot be ruled out. With a larger public debt in the hands of more creditors across the world, some of the legal issues addressed during the debt crises of the 1980s could reappear, this time in a much more complex scenario. How to we deal with all the interests involved? Should sovereign debt problems be resolved by private markets through negotiated solutions or through soft-law enforcement and harmonization? Is it realistic to envisage a role for international law?

61. See Henri Hauser, *Réflexions Sur L'Histoire des Banques à L' Époque Moderne*, 1 ANNALES D'HISTOIRE ÉCONOMIQUE ET SOCIALE, 335, 338 (1929).

62. PIERRE VILAR, *HISTOIRE DE L'ESPAGNE* 32 (2001).

63. Roberto Mac Lean describes this history thus:

Even since Latin American countries became independent from Spain or Portugal in the 19th century, many of them had to pay for their wars of independence by borrowing from foreign lenders. In 1822, one year after it took office, the first Government of Peru had to borrow £1.2 million sterling to pay for munitions, salaries and bonuses for the troops . . . In 1848, during the era of guano prosperity, new loans were received for the construction of railroads, irrigation projects and restructuring of the previous debt.

Mac Lean, *supra* note 22, at 45.

64. Carmen Reinhart, Kenneth Rogoff & Miguel Savastano, *Debt Intolerance* 12 tbl.2 (Nat'l Bureau of Econ. Research, Working Paper No. 9908, 2003).

65. See Press Release, European Central Bank, The Single Monetary Policy in Stage Three: General Documentation on ECSB Monetary Policy Instruments and Procedures 48–49 (Sept. 16, 1998), available at <http://www.ecb.int/pub/pdf/other/gendoc98en.pdf>.

The answers to these questions cannot be conclusive and could be affected by the wishful thinking of international-law practitioners. Just before World War II, the League of Nations proposed an International Tribunal for Debts that never materialized, even though this type of mechanism was subsequently used in specific cases like the German Reparations Treaty of 1953.⁶⁶ Almost fifty years later, in 2003, more than seventy percent of member states supported the IMF's SDRM proposal.⁶⁷ But some industrial countries and financial markets strongly opposed it.⁶⁸ For the United States, the SDRM's provisions

would still interfere with the contractual claims of U.S. investors. Moreover, the jurisdiction of the [Dispute Resolution Forum], although limited, would supersede that of the U.S. courts during the restructuring process. . . . Opposition to the SDRM proposal by financial industry associations was, of course, also an important reason why a number of emerging-market countries also opposed the SDRM proposal. The private sector consistently warned that the SDRM, if adopted, would adversely affect the volume and price of capital to these countries.⁶⁹

Still, the SDRM proposal did create a positive reaction from the markets, which responded with the acceptance of collective-action clauses (CACs) in new contracts to facilitate future restructurings in the era of bonds and avoid the emergence of free riders like Elliott and Pravin Banker.⁷⁰

If we look for international-law principles that address sovereign debt issues, the answer will not be conclusive, either. In old cases, a force majeure or state-of-emergency justification does not cover economic problems that might be anticipated in any credit risk assessment. The Permanent Court of International Justice has stated that a mere increase in the debtor's burden, although unanticipated at the agreement's inception, would not excuse the debtor's nonperformance.⁷¹ But if we do not find international-law principles in the classical sense, at least some practice could become a sort of *lex mercatoria* in future customary international law. This is not mere wishful thinking, considering the rapid evolution of foreign-investment international law. Whereas fifty years ago, Latin American countries claimed exclusive domestic jurisdiction for the treatment of foreign investment,⁷² today most of these

66. CARREAU, *supra* note 50, at 23.

67. Bartholomew, Liuzzi & Stern, *supra* note 51, at 859–60.

68. Hagan, *supra* note 30, at 391.

69. *Id.* at 391–92.

70. “During 2002, investors began to view CACs more favorably, in preference to the SDRM alternative. And in February 2003, just a few weeks before the IMFC meeting, Mexico came to the market with a new bond that included CACs.” Bartholomew, Liuzzi & Stern, *supra* note 51, at 860.

71. “The economic dislocation caused by the Great War has not, in legal principle, released the Brazilian Government from its obligations.” Payment in Gold of Brazilian Federal Loans Contracted in France, 1929 P.C.I.J. (Ser. A) No. 21, at 120 (July 12, 1929); *see also* August Reinisch, *Debt Restructuring and State Responsibility Issues*, in LA DETTE EXTÉRIEURE, *supra* note 50, at 537, 568–69 (1995).

72. Under the Carlos Calvo doctrine, many Latin Americans demanded during a large part of the twentieth century that foreign investors be subject to national courts and domestic legislation. *See* DOMINIQUE CARREAU, DROIT INTERNATIONAL [INTERNATIONAL LAW] 428–30 (Pedone ed., 9th ed. 2007).

countries have accepted the application of international law and the international-arbitration jurisdiction under the ICSID (International Centre for Settlement of Investment Disputes) Treaty, bilateral-investment treaties, and free-trade agreements.⁷³

IV

CONCLUSION

Although international-law principles that address sovereign debt issues may as yet be too inconclusive to guide the international system of payments through the current global financial crisis, prior experiences such as the Latin American debt crisis of the 1980s may provide guidance in terms of what to expect or even of how domestic courts, governments, international organizations, and banks may face some unresolved issues that derive from the era of financial globalization. Peru's sovereign debt litigation is an example of this, showing some isolated hesitations by domestic courts to balance collective and individual interest when deciding whether an individual's claim, based on the original terms of a loan agreement, should prevail over a global negotiation.

73. See Reinisch, *supra* note 71, at 582–84 (noting that internationalization clauses in contracts between private investors and sovereign states provide an international-law standard in case of an expropriation, a standard that may apply as a matter of customary international law).