INTERNATIONAL MONETARY FUND

# Proposed Features of a Sovereign Debt Restructuring Mechanism

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## INTRODUCTION

1. This paper follows up on the Executive Board's December 2002 discussion of the design of the Sovereign Debt Restructuring Mechanism (SDRM) and seeks to make further progress on the formulation of a concrete proposal for a statutory sovereign debt restructuring mechanism that could be presented to the IMFC in time for its April 2003 meetings.

2. Section I revisits the objectives and possible design features of the SDRM and discusses a number of outstanding issues, drawing on the views expressed by Directors during the December meeting and the input received during the recent SDRM workshop and conference. Based on this analysis, the Attachment to this paper contains a first draft of the Proposed Features of a Sovereign Debt Restructuring Mechanism. ("Proposed Features") Once finalized, this text could constitute the proposal that would be forwarded by the Executive Board to the IMFC. It is recognized that, depending on the outcome of the Board's discussion, the Proposed Features may need to identify key unresolved issues. Moreover, there are a number of technical issues that, while not identified in the Proposed Features, would need to be resolved before the text of an amendment of the Fund's Articles can be finalized. To that end, an illustrative text of an amendment of the Fund's Articles (based on the draft Proposed Features contained in the Attachment) will be soon be circulated as a supplement to this paper for the information of the Executive Board.

3. Section II includes a preliminary discussion of the potential contribution that could be made by a voluntary code of conduct. Section III sets forth issues for discussion.

## I. THE SDRM: OBJECTIVES, PRINCIPLES AND DESIGN

### A. Objective and Principles

4. At the conclusion of the December 2002 discussion, there was general agreement that the objective of the SDRM should be to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, and thereby reduces the cost of the restructuring process. By creating greater predictability in the restructuring process, the SDRM should also be expected to improve the functioning of capital markets. Most Directors stressed that, in order for the SDRM to achieve these objectives, it must continue to be a part of a general effort to continue to strengthen the framework for crisis prevention and resolution, including the policy on exceptional access to Fund resources. ***(Proposed Features, Section 1)***

5. Most Directors also considered that the general principles set forth in paragraph 14 of the November 27, 2002 paper (the "November paper") to be a sound basis to help guide the mechanism. ***(Proposed Features, Section 2)*** Many Directors noted, however, that as the Fund seeks to garner support for a mechanism that minimizes interference with contractual relations, it needs to ensure an incentive structure that is both effective and balanced. As will

be discussed further below, this is of particular relevance with respect to the design of any stay on enforcement.

### B. Scope of Claims

6. Directors generally supported an approach where the text of the amendment would identify the scope of claims that potentially could be restructured under the SDRM ("eligible claims"), while leaving it to the debtor, in its negotiations with its creditors, to determine which subset of claims would need to be restructured in a particular case. ***(Proposed Features, Section 3)*** Clearly, during the course of negotiations between a debtor and its creditors following activation, creditors whose claims are being restructured may indicate that, for inter-creditor equity reasons, the inclusion of other claims will be a necessary condition for their own support for a restructuring plan. As will be discussed in Section C, this approach assumes that the activation of the SDRM will not trigger a comprehensive cessation of payments.

7. ***Defining eligible claims*** - Defining the scope of eligible claims that could be potentially subject to restructuring provisions raises a number of technical issues that will need to be resolved before the text of the amendment is finalized. However, most Directors generally supported the key elements of a definition of eligible claims that was set out in the November paper. ***(Proposed Features, Section 3)*** Nevertheless, several issues merit further consideration.

8. First, as was indicated in the November paper, eligible claims would include judgment claims arising from the sovereign's default on an eligible claim. ***(Proposed Features, Section 3(b))*** As was noted during the recent workshop and conference, this has important implications on the incentives facing creditors following the activation of the mechanism but prior to a restructuring agreement. Specifically, a creditor considering the enforcement of its claim during this period would need to take into consideration the serious risk that its judgment claim would be restructured with all other claims under the restructuring agreement. This is in contrast to collective action clauses, which cannot bind creditors that have already received a judgment prior to the decision taken by a qualified majority.

9. Second, there is a question as to how the exclusion of multilateral claims would be formulated under the text of the amendment. One possibility would be to provide for a general exclusion for all public international financial institutions and leave it to the Dispute Resolution Forum (DRF) to resolve disputes that may arise in the application of this provision. Alternatively, consideration could be given to including in the text of the amendment a list of international organizations whose claims would be excluded from the amendment but provide that this list could be modified by a decision of 85 percent of the voting power of the Board of Governors. Such an approach would be designed to ensure predictability while, at the same time, retaining flexibility to accommodate the evolution of international organizations and claims on such institutions.

10. Finally, there is the question of the treatment of official bilateral claims under the amendment. At the conclusion of their discussion of the November paper, Directors expressed the views that the preferred course of action would be to proceed, at least initially, on the basis of excluding official bilateral claims from the SDRM, while recognizing that this will require the formulation of principles and procedures, to be developed jointly with private creditors and official creditors, to address coordination and sequencing issues. The staff was asked to continue discussions with the Paris Club Secretariat regarding the possible modalities of coordination between the restructurings of official bilateral debt and private debt, whether outside or within the SDRM as a separate class. Since the discussion of the November paper, staff has met both with the Secretariat and the Club to discuss this issue and, at the request of the Secretariat, prepared a technical note that identified a number of the issues that would need to be addressed in this context (see SM/ 03/51). The Secretariat has indicated that the Club will most likely be in a position to formulate a position on these coordination issues by end-March. Accordingly, it is proposed that further consideration of the treatment of official bilateral claims be deferred until a subsequent discussion, but prior to the Executive Board's report to the IMFC. ***(Proposed Features, Section 3(d)(vi))***

## C. Activation

11. There is general agreement that the proposed mechanism is to assist members whose debt is unsustainable. Most Directors were of the view that the debtor should be allowed to activate the mechanism unilaterally, without third-party confirmation that the activation is justified. ***(Proposed Features, Section 4)*** These Directors noted that several proposed features of the mechanism would discourage abuse of the SDRM. As noted in the November paper, these features included: (i) the right of creditors to vote on a termination of the mechanism once claims are verified and (ii) the absence of an automatic stay (see below). As was noted during the workshop and the conference, if the SDRM is designed in a manner that provides a sanctuary for debtors following a default, it may increase the domestic pressure on governments to activate the SDRM even when the debt is not unsustainable. (As will be discussed below, this issue is relevant to the question of whether there should be an automatic stay on enforcement following activation).

12. One additional disincentive for abuse of the SDRM that was mentioned in the November paper, but which was not discussed by the Board, was the possibility of requiring the debtor to bear all costs arising from an activation of the SDRM (including costs arising from the operation of the DRF, which would normally be borne by the Fund) where the Fund determines that activation was not justified. This feature could also provide an opportunity for the Fund to signal its disapproval of activation.

## D. Consequences of Activation

**Absence of a General Cessation of Payments**

13. It is not envisaged that the activation of the mechanism would trigger a general cessation of payments by the sovereign debtor. To the extent that the debtor is able to exclude certain claims from any of the restructuring lists that it presents following activation, it would be able to continue to service these claims during the process, subject to negotiations with other creditors (who may insist that, for inter-creditor equity purposes, these claims be included). Moreover, as a means of avoiding the economic ramifications of a payment default, the member could also continue servicing claims that it actually intends to restructure.

14. Questions have been raised as to the wisdom of this approach. Specifically, there have been suggestions that, at least for a brief period following activation, there should be a comprehensive cessation of payments by the debtor that would be accompanied by an automatic stay on creditor enforcement. It has also been suggested that there should be a cessation of payments on the instruments to be restructured, with a correspondingly targeted stay. It is to the economic considerations of these approaches that the paper now turns.

15. The proposal for an SDRM does not envisage an automatic cessation of payments upon activation of the mechanism. Clearly, in some cases a full or partial cessation may be unavoidable. In other cases, however, it may be possible to reach agreement on a restructuring without such an interruption in payments. Since this approach may offer the best prospects of achieving a sustainable debt burden while limiting damage to the real economy, the financial system, and the economic value of creditors' claims, staff considers it important to preserve this possibility. Moreover, it is likely that establishing a mandatory cessation of payments under the SDRM would strengthen incentives for creditors to rush for the exit in cases in which the activation appeared to be possibility.

16. There is typically at least a brief period between the recognition that a sovereign's debt situation has become unsustainable and the onset of a full-blown crisis. Clearly, such situations are likely to be fragile, as there is the ever-present danger that efforts to address the sovereign's debt difficulties could trigger an abrupt shift in sentiment, and thereby stimulate both a withdrawal of foreign capital and flight by residents. Nevertheless, while recognizing that such operations are fraught with uncertainty, the objective of restructuring debt while limiting the costs of economic ramifications would be best served by securing agreement on a restructuring prior to a default. To this end, the SDRM has been designed with a view to creating incentives for a debtor and its creditors to use the period before the onset of a full-blown crisis to reach agreement on a restructuring that could pave the way toward a restoration of sustainability.

17. It is important to recognize, however, that the limited financial resources available to sovereigns, the pace at which crises unfold, the speed with which authorities recognize the need for decisive action, and the time taken to secure agreement with creditors, have a

bearing on the feasibility of a pre-default restructuring strategy. In some cases, an interruption of sovereign debt service payments may be unavoidable and the SDRM will need to operate against the background of default. Whether such a cessation of payments could or should be either targeted, or comprehensive, would need to be assessed on a case-by-case basis.

18. *What impact would a default have on the restructuring process?* There are a number of factors that could have a bearing on the outcome.[1] On balance it seems likely that while it could facilitate agreement on a restructuring of individual classes of instruments, it could also have broad ramifications for the economy that could have substantial economic costs.

- *A sovereign may determine that default (or even the credible threat of default) on one class of instruments, such as bonds, may help facilitate agreement with creditors holding those instruments, to the extent that it helps forge a consensus concerning the need for a restructuring*. Moreover, interruption of payments on that class of instruments may help achieve adequate inter-creditor equity, by preventing investors holding claims with short residual maturities from being able to exit while those with longer claims are locked in.

- *Default on one class of sovereign instruments could have profound ramifications for other sectors of the economy*.[2] A sovereign default could amplify concerns regarding the soundness and liquidity of the banking system, which may trigger both a cutting of credit lines and a deposit run. (This danger is likely to be particularly acute in cases in which the member maintains an open capital account, and where claims on the sovereign represent a significant portion of domestic banks' assets.)[3] At the same time, fears regarding the imposition of exchange controls may lead corporations to adjust the leads and lags in international transactions, and to capital flight more generally, thereby amplifying the pressure on the balance of payments.

- *As sovereign deposit guarantees are unlikely to be perceived as being fully credible against the background of default, it may be difficult to arrest deposit runs without*

[1] See: Involving the Private Sector in the Resolution of Financial Crises—Standstills—Preliminary Considerations (SM/01/08, 01/09/01).

[2] See: Seminar on Involving the Private Sector in the Resolution of Financial Crises—The Restructuring of International Sovereign Bonds—Further Considerations (EBS/02/15, 1/31/02); A Balance Sheet Approach to Financial Crises (WP/02/210); and Crisis Resolution in the Context of Sovereign Debt Restructuring—A Summary of Considerations (SM/03/40, 1/29/03).

[3] Clearly, in cases in which members maintain very restrictive capital account regimes, the risk that default could trigger unstoppable capital flight is likely to be more manageable.

*resort to draconian measures*. Accordingly, in such—hopefully rare—extreme cases, resort to some combination of deposit freezes and exchange controls may be unavoidable. The impact on the real economy of such measures may be substantial. A credit crunch would be likely because of some combination of banks' natural tendency to preserve capital in periods of acute stress by downsizing their balance sheets, and cost shedding by corporations seeking to ensure their survival in the face of contracting demand and heightened uncertainty. The scale of economic dislocation may be amplified in cases in which the member does not maintain an established exchange control infrastructure—to the extent that controls are effective in restraining capital movements, they are likely to interrupt *bona fide* current transactions and thereby interfere with the essential imports of goods and services.

19. Against this background, sovereigns seeking to impose a payments moratorium would need to balance a number of considerations. On the one hand, it would be desirable to limit a moratorium to payments relating to the immediate source of financial pressure and claims that need to be restructured. On the other hand, it would be desirable—to the extent possible—to continue to service claims that are critical to maintaining economic activity and limiting the scale of the ramifications on the rest of the economy. Obvious examples include servicing trade credit and payment of at least interest to domestic banks. In addition, and as discussed below, it would also be desirable to avoid any interruption in the performance of contractual obligations with respect to claims that do not need to be restructured. In practice, however, the impact on the economy of a sovereign default may be pervasive, and the scope of transactions that exert immediate pressure on the external accounts may expand rapidly, and force the authorities to resort to progressively more draconian measures.

20. The potential spillover effects from a general cessation of payments by a sovereign to other sectors of the economy provide an important limitation to the value of analogies drawn with standstills imposed by corporations in the context of both in- and out-of-court rehabilitations.

- A corporation can typically interrupt payments on all claims (except those essential to the preservation of the business), with only limited concerns as to the impact on its long-run viability (beyond the impact on its reputation).

- An interruption in payments by a sovereign, in contrast, is likely to have important spillover effects to other sector of the economy. On the one hand, there could be powerful feedbacks both onto the sovereign's need to provide financial resources to help restructure the financial system (and possibly corporations), and through an erosion of the capacity of the tax base to generate resources for debt service. On the other hand, an interruption in relations between a sovereign and its creditors may be seen as presaging a broader range of administrative and regulatory actions that could trigger destabilizing behavior.

21. Finally, it needs to be recognized that, while a general cessation of payments may be temporary, its consequences will not be. Any default arising from such a cessation would

likely be followed by an acceleration of all claims; i.e., creditors with long-term claims would probably exercise their right to declare all amounts outstanding due and payable. Accordingly, even if a debtor wished to resume payments on the original terms of certain instruments after the expiration of a temporary standstill period, these terms would no longer be applicable.[4]

**A Stay on Enforcement**

***Further Considerations regarding an Automatic Stay***

22. The November paper did not favor the inclusion of a general stay on enforcement that would be triggered automatically upon activation. During the discussion, however, many Directors saw considerable merit in keeping open, at this stage, the option of imposing an automatic stay on enforcement that would remain in place for a brief period until creditors are sufficiently organized to vote on an extension.

23. During the workshop and the conference, there was a recognition that issues relating to the merits of an automatic stay on enforcement were closely linked to the question of whether there should be a general cessation of payments. As noted in the November paper (paragraph 131), from an inter-creditor equity perspective, it is difficult to include the former without the latter. Under most corporate insolvency laws, an automatic stay is accompanied by a requirement that the debtor cease making any payments to *all* creditors. Together, the stay on enforcement and the general cessation of payments put in place a two-way "standstill" that, among other things, ensures inter-creditor equity. A creditor has the assurance that during the period when it is unable to enforce its rights, the debtor will be precluded from dissipating assets by making payments to other creditors; i.e. that all creditors will be treated equally.

24. As described above, however, the proposal does not require—or even presume—that there will be a general cessation of payments. Most importantly, the sovereign may wish to continue to servicing claims that it intends to exclude from the restructuring process. If the SDRM is to give the sovereign this needed flexibility, there are strong reasons why, from an inter-creditor equity perspective, any stay on enforcement should only be put in place through a vote of the creditors affected. Through such a vote, creditors can indicate whether

[4] Of course, where only certain claims are in default, there is still a risk that other claims will also be accelerated through the activation of cross-default provisions or through default clauses that are triggered by the activation of the SDRM itself. As noted in the November paper, however, this risk is reduced when the claims that could be accelerated are being serviced and, as is proposed under the SDRM, the claims could be de-accelerated by the debtor at the time of the approval of the restructuring agreement (see paragraphs 146 and 181 of the November paper).

the exclusion of certain creditors from the restructuring process is acceptable because, for example, such an exclusion is a necessary means of limiting economic dislocation.

25. Moreover, even if a general cessation of payments were considered appropriate from an economic perspective, it is not clear how the sovereign would actually be prevented from making payments upon activation. In the corporate context, creditors have such an assurance. Indeed, in terms of the debtor-creditor relationship, this assurance provides an important balance to an automatic stay. This an important legal feature of every insolvency law and many laws provide for the court to appoint a representative to supervise the management of the corporation during this period to ensure that such payments are not made and, more generally, that assets are not dissipated. It is not clear how creditors could be given such an assurance immediately upon activation without compromising the principle of sovereignty. For this reason, it would appear appropriate that creditors have the opportunity to vote on whether a stay is justified once they have adequate assurances that the debtor is pursuing policies that will protect the value of their claims.

26. Finally, any consideration of an automatic stay must take into consideration whether: (i) there is a serious risk that pre-agreement litigation will severely disrupt the restructuring process and (ii) less intrusive measure could be designed that could adequately address the risks posed.

27. How serious of a risk is pre-agreement litigation? To date, it has not frustrated the restructuring process. However, as noted in the November paper, the SDRM could change that dynamic: faced with the prospect of a process involving a restructuring agreement that can be made binding on all creditors, creditors may consider that they have a limited window of opportunity to enhance their position through litigation and, accordingly, may initiate enforcement immediately upon default.

28. On the other hand, and as was emphasized during the workshop and conference, a creditor pursuing this action would have to take into consideration the considerable risk that a restructuring agreement may have been reached before its claim has been fully enforced; i.e. before it has both receive a judgment and collected on such a judgment. As noted earlier, the fact that the SDRM will be designed in a manner that enables judgment claims to be restructured means that the creditor will only benefit from such litigation if it is confident that it will be able to collect on this judgment (i.e., through the attachment of sovereign assets) prior to the agreement entering into force. Otherwise, it would have incurred considerable legal fees for no benefit since its judgment will be restructured along with the claims of all other creditors.

29. As noted in the November paper, a further disincentive against litigation would be to provide that any privilege received by a creditor after activation that arises from a legal proceeding against the debtor (e.g., a judicial lien) would be included in the SDRM restructuring process (as an exception to the general rule, which excludes privileged claims). Accordingly, the only way that a creditor would be able to avoid the application of the

SDRM would be to actually collect on the judgment prior to a restructuring agreement being reached.

30. Finally, as noted earlier (see Activation), to the extent that the existence of an automatic stay is perceived as tilting the legal leverage in favor of the debtors, it may create domestic pressures on the government to utilize the mechanism even in those cases where the debt is not unsustainable. As was noted during the conference, this risk is of major concern to emerging market members. Accordingly, to the extent that the SDRM provides a legal advantage to the debtor (which an automatic stay would do) that would create an incentive for inappropriate activation, further consideration would need to be given to requiring a third party (e.g., the Fund) to approve activation.

***Alternative Measures***

31. Notwithstanding the above analysis, the staff continues to be of the view that the SDRM should contain features that prevent enforcement actions from disrupting the negotiating process and delaying the conclusion of a restructuring agreement. Although there is insufficient evidence to date to suggest that pre-agreement litigation would disrupt that restructuring process, the SDRM needs to be designed so that it can adapt to the evolution of capital markets. The question is how such features should be designed in a manner that pays due regard to the above considerations.

32. ***Ex Post Measures: The Hotchpot Rule*** - In the November paper, the staff discussed the potential benefits and limitations of a variation of a "hotchpot rule" that would be designed to discourage litigation without imposing a limitation on enforcement rights. As discussed above, the only way in which a creditor would be able to avoid being subject to the SDRM is if it able to collect on a judgment it is has received prior to the restructuring agreement. The "hotchpot" would be designed to offset any advantage received through such a collection: In the event that creditors reached a restructuring agreement, any creditor that had managed to partially satisfy its claim through a collection on a judgment after activation but prior to the agreement would have the value of its claim reduced under the agreement in a manner that ensures that all of the benefits of its enforcement and collection had been neutralized. ***(Proposed Features, Section 7(a))*** In such circumstances, the creditor would have undertaken considerable legal expenses to no avail.

33. A key benefit of the hotchpot rule is that it would approach the problem of litigation from an inter-creditor perspective: creditors would have the some assurance that their forbearance during the negotiating process would not be taken advantage by an aggressive litigant. Although it would apply from the moment of activation, it would only become operational if and when an agreement was reached.

34. As noted in the November paper, there are important limitations to this approach. For example, in the event that the judgment creditor is able to obtain more through litigation than what it had received under the agreement, the above rule would not affect the creditor. Considerations could be given to designing features that could overcome this specific

limitation.[5] However, a more general limitation relates to the fact that the hotchpot rule only applies if—and when—a restructuring agreement is reached. Where a creditor has purchased its claim at a deep discount, the application of the hotchpot rule would not deny that creditor of a significant profit, even if it is only able to partially collect on the judgment. Accordingly, in circumstances where the prospects for a restructuring agreement following activation are particularly uncertain, the creditor may make the determination that it is more advantageous for it to secure this profit through litigation than by waiting for a possible restructuring agreement. This limitation may, however, strengthen incentives for a debtor and its creditors to expedite the agreement.

35. ***Ex Ante Measures: Creditor-Approved Stays*** - As noted in the November paper, one could envisage supplementing the hotchpot rule with a form of creditor-approved stay. As discussed in the November paper, one could envisage two types of such stays: general and targeted. As is discussed below, both have their own advantages and disadvantages.

36. *A general stay on enforcement* would be approved by a qualified majority of creditors with verified claims and would stay all enforcement actions of creditors whose claims are on the SDRM Restructuring List. The benefit of such a stay is that its design is aligned with that of the decision to be taken with respect to the restructuring terms; i.e., it empowers a qualified majority of creditors to take decisions that are binding on all creditors whose claims are on the SDRM Restructuring List. Its disadvantages are twofold. First, it could not be applied immediately after activation since creditors would not be in a position to vote until the registration and verification process had been completed. Second, it could be an excessively blunt instrument. For example, where a debtor has broken off dialogue with its creditors, there may be cases where creditor litigation may be a necessary inducement for a debtor to re-engage with its creditors. In these circumstances, the existence of a general stay that had been approved when the debtor was more cooperative could actually be counterproductive. Of course, this risk could be mitigated by enabling creditors to approve a general stay for very brief periods (e.g., 60 days), subject to renewal.

37. *A targeted stay on enforcement* would only prevent specific enforcement actions that are determined to seriously undermine the restructuring process. While the DRF would be responsible for making this determination, it could not do so on its own motion. Rather, such

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[5] For example, one could envisage designing the rule where, in these circumstances, the litigant would actually be liable to the debtor for an amount equivalent to the value of the creditor's enforcement recovery that exceeds the amount it would have received under the agreement. For example, in the event a creditor holding a claim with a face value of $10 million seizes assets worth $6 million through judicial enforcement, it would receive nothing under a restructuring agreement that provided for a 50 percent reduction in the original face value of the claim. Moreover, it would be liable to the debtor for $1 million, the amount by which the litigation recovery exceeds the amount that the creditor would have received under the agreement.

an action would also require a request of the debtor and approval of the creditors. One of the advantages of this approach is that it would only stay enforcement actions that are perceived by the debtor and creditors as being disruptive to the restructuring process. In addition—and unlike the general stay—it could become operational very soon after activation. As noted in the November paper, one could rely on a representative creditors committee to approve such a measure between the time of activation and the time when a vote by creditors is feasible, i.e., after the registration and verification process had run its course.[6] From that point on, approval would require an affirmative vote of 75 percent of outstanding verified claims.

38. A number of Directors took the view that the disadvantage of this approach is that it would envisage a role for the DRF beyond that which was originally envisaged. To the extent that a stay is targeted against specific enforcement actions, its activation would need to be conditioned upon the satisfaction of a substantive condition. (As noted above, the proposed condition would be a determination that there is a serious risk that the action in question could disrupt the restructuring process.) Such a determination would need to be made an independent party, such as the DRF. Otherwise, there would be a risk that the stay could be used in a discriminatory manner by a qualified majority against minority creditors. However, it should be emphasized that the authority of the DRF would still be limited since it could not take this action without the approval of creditors. Accordingly, while the DRF would have the discretion to *reject* a proposed stay (on the grounds that the substantive condition had not been met), it could not impose such a stay unless it had received a request from the debtor and approval of creditors.

39. *One could also envisage a combination of the two types of stays described above in a manner that minimizes their drawbacks.* For example, upon activation, a creditors' committee could approve a targeted stay that the DRF found had satisfied the substantive criteria noted above. However, once claims had been registered and verified, creditors could only approve general stays (albeit for limited periods). This would mean that the potential role of the DRF in this area would be limited to the beginning of the process. Alternatively, one could give the creditors the choice of being able to rely on either type of stay after the expiration of the registration and verification process. ***(Proposed Features, Section 7(b)(c))***

40. Whichever type of stay is chosen, it should be recognized that its application will be limited to circumstances where the sovereign debtor has a number of private creditors and litigation is opposed by most of them. Neither of these stays would apply, for example, where the only private creditor is the one that is enforcing its claim and this enforcement action is complicating the debtor's ability to normalize its relations with international financial institutions or official bilateral creditors (if the claims of official bilateral creditors are

[6] This feature may not become operational *immediately* upon activation since it may take some time for a representative committee to form. However, such delays could be reduced if the debtor successfully encourages creditors organize into a committee prior to activation.

outside the SDRM). Since such claims would be outside the mechanism, these creditors would have no standing to approve a stay.

**Information, Registration and Verification**

41. Directors saw the general features of the information, registration and verification procedures set forth in the November paper as a useful basis for further work. Directors encouraged the staff to continue discussions with the private sector on the appropriate design of the registration and verification procedures, including on approaches that will ensure the transparency and accountability of the process. Based on further consultations with restructuring professionals, there is a recognition that it would be counterproductive to specify all features of these procedures in the text of the amendment since the procedures may need to be modified in light of experience and the evolution of the capital markets.

42. For the above reason, it is proposed that the amendment authorize the DRF to promulgate rules in this area, provided that such rules are consistent with the general objectives of these procedures, as set forth in the amendment. These objectives would be to establish procedures that strike an adequate balance between, on the one hand, the need to safeguard the overall integrity and transparency of the process and, on the other hand, the need to preserve asset values through a rapid decision-making process. ***(Proposed Features, Section 6)*** As is discussed below, the Board of Governors, by a decision taken by 85 percent of the voting power, could be given the authority to overrule rules and regulations by the DRF (see paragraph 55).

## E. Creditor Participation: Organization, Voting and Decisions

43. ***Creditors' Committees*** - During the discussion of the November paper, Directors considered that a representative creditors committee could play an important role under the SDRM to address both debtor-creditor and inter-creditor issues, although it was noted that decisions in this regard should best be left to market participants. Consistent with best practices in this area, some Directors considered it appropriate that the debtor bears the reasonable cost associated with the operation of these committees. Some other Directors, however, favored a cost-sharing formula. ***(Proposed Features, Section 8)***

44. ***General Voting Rules*** - There was general support for a voting threshold that would require support of 75 percent of outstanding verified claims to approve the terms of any restructuring agreement, subject to the classification rules discussed below. As discussed in the November paper, it is proposed that claims held by creditors that are under the control of the sovereign would be excluded from the restructuring process. To the extent that the SDRM contains voting rules for either priority financing or a creditor-approved stay on enforcement, these general rules would also apply. ***(Proposed Features, Section 9)***

45. ***Priority Financing*** - During the discussion of the November paper, most Directors favored the establishment of a framework that would create incentives for private creditors to provide financing during the restructuring period and, to that end, encouraged further

exploration of the proposal that a specified amount of financing would be excluded from the restructuring if such exclusion is supported by 75 percent of outstanding verified claims.

46. During the Workshop, it was argued that such a feature may not provide a sufficient incentive for creditors to provide such financing. On the one hand, there was a concern that against the background of the limited control that bondholders could exercise over the conduct of economic policies and the use of priority financing, they would be reluctant to agree to the establishment of a new senior class of financing, which would likely be extended only at high spreads. On the other hand, there was a concern that commercial banks—which are likely to be the primary source of priority financing—would not consider priority financing to be a commercially sound proposition. The specific concern related to the prospects for repayment of the priority financing in the event that the restructuring proposal were to fail, and the need for banks to set aside capital to provision such financing. A contrast was drawn with debtor-in-possession (DIP) financing in the corporate context, where such financing is typically secured through the liquidation provisions of the insolvency law, which guarantee the creditor priority in distribution in the event that the restructuring plan fails and the entity is liquidated.

47. Nevertheless, staff consider that in the event that, in an individual case, it is possible to secure the necessary support of both existing investors and potential financiers, the availability of a mechanism that could provide priority financing would be helpful. Conversely, in cases in which such support is not forthcoming, its presence within the mechanism would do no harm. On balance, therefore, it is proposed to retain this feature within the mechanism. ***(Proposed Features, Section 10)***

48. ***Restructuring Agreement*** - Directors generally supported the broad thrust of the features of the decision making process described in the November paper relating to the final restructuring agreement. ***(Proposed Features, Section 11)*** Clearly, the design of the rules that would apply to official bilateral creditors will need to await the outcome of discussions with the Paris Club creditors as to whether such claims would fall within the SDRM and, if so, how they should be treated. If they were to be included, it is generally recognized that the text of the amendment would provide that they would participate as a separate class. As discussed in the November paper, and as was noted by a number of Directors during the discussion of that paper, safeguards will need to be in place to ensure that the creation of optional classes—which may in principle, facilitate a restructuring agreement—will not result in unjustified discrimination of creditor groups. With respect to the restructuring of the claims of multiple debtors, it is recognized that while, as a legal matter, the completion of one restructuring would not be dependent on the completion of others, effective coordination among these restructurings would be necessary.

### F. Sanctions

49. With respect to sanctions, the discussion of the November paper revealed lack of Board support for the proposal that the provision of false information by the sovereign during the restructuring process would constitute a breach of a member's obligations under the

Articles of Agreement. With respect to sanctions for noncooperation and inappropriate use of the mechanism by the member, there was general support for reliance on the Fund's existing financial policies, including its lending into arrears policy. ***(Proposed Features, Section 13).*** As noted above, sanctions could also be imposed on the member for the unjustified activation of the mechanism (see paragraph 12).[7]

## G. Termination

50. While there was general support for most of the staff's recommendations regarding the termination of the SDRM, Directors were generally reluctant to give the DRF the power to terminate the mechanism on the basis of its assessment that continuation did not serve a constructive purpose because of compelling evidence of a breakdown in relations between the sovereign debtor and its creditors. Although there was general support for a provision that would enable creditors to vote on an early termination of the mechanism at the expiration of the verification period, the question of the relevant voting threshold was left open. On the one hand, one could envisage establishing a very low threshold of 26 percent: to the extent that this percentage of creditors is against a restructuring under the SDRM, the necessary percentage needed for the approval of an agreement (75 percent) would not be reached anyway. On the other hand, there may be a benefit in requiring a higher majority to terminate during this initial period on the grounds that it will facilitate a "cool down" period to enable more supportive creditors to persuade others of the merits of a restructuring process. For this reason, the staff would propose a voting threshold of 40 percent of outstanding verified claims. ***(Proposed Features, Section 12)***

## H. The Sovereign Debt Dispute Resolution Forum

51. During the discussion of the November paper, most Directors supported the general considerations for the establishment, through an amendment to the Articles of Agreement, of a DRF and also agreed with the proposed procedure set forth in the November paper regarding the selection and appointment of members of the DRF. ***(Proposed Features, Section 15)*** During the workshop and conference, panelists generally observed that the consultative manner in which the selection panel is to be formed, the open nomination process for DRF candidates, and the consultative budget process would lead to the independence of the DRF and its members.

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[7] During the workshop and the conference, some panelists also suggested that, by analogy with national judicial systems, the DRF could be given limited powers to impose non-monetary sanctions for a creditor's actions, such as bad faith or abuse of the judicial process. This could include, for example, exclusion from the voting process. The purpose of such sanctions would be to ensure expeditious and cost-effective proceedings. The limited sanction powers of the DRF could be supplemented in the amendment by authorizing domestic courts to impose civil or criminal sanctions for fraud (e.g., forgery).

52. During the workshop and the conference, the Secretary of UNCITRAL provided a preliminary indication that UNCITRAL would be willing to play a role in the designation of the selection panel. He noted that, consistent with UNCITRAL's existing practices, it would be in a position to consult broadly with leading professional associations in the insolvency area when performing this role. Consideration could be given for UNCITRAL to delegate this task to the Secretariat of UNCITRAL.

53. During the discussion of the November paper, most Directors generally supported the staff's proposals regarding the organization and operations of the DRF and the legal effects of its decision. ***(Proposed Features, Section 14(b))*** However, there was also a recognition of the need to limit the DRF's powers to the administration of claims and the resolution of disputes. On the question of powers, the role of the DRF in the approval of a targeted stay or in the termination of the DRF was discussed above. With respect to the administration of claims and the resolution of disputes, the discussions that took place during both the workshop and the conference demonstrated that these tasks will be complicated and that it would not be possible to specify a detailed set of rules in the amendment that would cover all foreseeable situations. Moreover, even if it were possible to include these rules in the amendment, they may become outdated with the evolution of capital markets.

54. For this reason, it is proposed that the amendment give the DRF important rule-making authority with respect to claims administration and dispute resolution procedures. As discussed in an earlier section of the paper, these rules would include those that would govern the verification of a registration process, issues relating to the choice of law and the procedures that would govern the public hearings that would arise during the dispute resolution process. Such rules could also address a number of substantive—but highly technical—issues that would be difficult to specify in the amendment without the risk of inflexibility and circumvention (e.g., defining when a holder of a claim is "under the control" of the member). ***(Proposed Features, Section 14(c))***

55. If the DRF is to be given this authority, the question arises as to whether some limited check should be placed on the exercise of this authority. For example, the amendment could provide that any rules proposed by the DRF would become effective unless overruled by the Board of Governors, perhaps pursuant to a decision taken by a qualified majority of the Fund's voting power. While this feature would place some limit on the DRF's authority in the rule-making area, it would not compromise in any way its independence when resolving specific disputes. It is important to note that the existing practice of other international organizations varies. For example, the International Court of Justice has the power to adopt its own rules of procedure and these rules are not subject to review by any other organ of the United Nations. In contrast, the rules of procedure adopted by the European Court of Justice must be approved by the Council.[8]

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[8] It is instructive to note the manner in which the bankruptcy rule-making process under U.S. law strikes a balance between the authority of the judicial organ to prescribe procedural rules

(continued)

## I. Legal Basis of the SDRM

56. During the discussion of the November paper, most Directors agreed that an amendment of the Fund's Articles would provide the most appropriate vehicle for the establishment of the SDRM. ***(Proposed Features, Section 15)*** As noted in the Introduction, the staff will be circulating an illustrative text of such an amendment for the information of the Board. With respect to the impact that such an amendment will have on domestic legal systems, the staff will be circulating a technical note on this subject once the text of the Proposed Features has been finalized. This note could be used by members as a basis for internal discussions as to what legal steps would need to be taken under their own domestic legal systems to enable them to accept and implement the amendment.

## II. Code of Conduct and the SDRM

57. Over the past several months, there has been considerable discussion within both the private and official sectors regarding the potential benefits of a voluntary Code of Good Conduct (a "Code"). This is a constructive development that could be helpful in establishing expectations regarding the behavior of the various parties under both current and future legal frameworks.

58. For example, a Code would complement the SDRM in a number of respects. First, while the SDRM provides a framework for the resolution of financial crises, a Code could be made applicable to a broader set of circumstances ranging from periods of relative tranquility to periods of acute stress, and in particular could become an established set of best practices. Second, even if agreement were reached quickly on the text of a statutory framework, it will necessarily take some time before an SDRM enters into force. Accordingly, there is merit in discussing the extent to which a Code could increase the predictability of the restructuring process in the absence, at lease initially, of a statutory framework. Finally, even when the SDRM is in force, a Code may provide some guidance as to how the new legal framework would be used. For example, it could provide some assurance to the private sector that the SDRM would be intended to be used in a manner would enhance—not supercede—the negotiation process.

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and the oversight of the legislative body. Under U.S. law, the Supreme Court has the power to prescribe general rules on bankruptcy practice and procedure. The Supreme Court must transmit such procedural rules to Congress by May 1 of the year in which the rules are to become effective. Congress, in turn, has a statutory period of at least 7 months to act. If Congress does not enact legislation to reject, modify or defer the procedural rules, they take effect on December 1 of the year in which they were transmitted to Congress. (*The Rules Enabling Act, Title 28 U.S.C. § 2075*.)

59. *It is helpful to place any analysis of the possible role of a Code within the broader context of a discussion of the key impediments to a predictable and rapid agreements on restructurings.* Three impediments stand out as being of particular importance:

- *First,* delays in the elaboration and implementation of comprehensive adjustment program, with concomitant uncertainties regarding payment capacity that provide incentives for creditors and debtors alike to delay agreement.

- *Second,* uncertainties regarding the process of reaching agreement, relating to, for example, the lack of predictability to the framework for dialogue and sharing of information, which impedes creditors' ability to conduct their due diligence analysis while complicating the task of achieving adequate inter-creditor equity.

- *Third,* collective action difficulties among creditors.

60. The Fund, through existing channels for policy advice and financing for appropriate policies, seeks to address the first impediment. The SDRM, complemented by the Fund's lending into arrears policy, seeks to address the second impediment by providing a framework for, and expectation of, the process of restructurings, including through the establishment of transparency obligations. Finally, the complementary approaches of CACs and the SDRM are intended to address the third point.

61. *Which of the above impediments could be most effectively addressed by a Code?*

62. *Issues relating to the process of restructuring would seem to be most amenable to a Code.* Establishing expectations in a Code concerning the nature and extent of dialogue between a debtor and its creditors, and transparency, could both guide behavior, and would provide a useful yardstick against which all parties could assess performance. To the extent that greater predictability could be established with respect to the debtor's behavior, this may encourage more cooperative behavior by the majority of creditors. In contrast, market failures associated with collective action cannot, by definition, be addressed through a voluntary codes of conduct. The fact that a Code will have no legal basis—in contrast to collective action clauses and the SDRM—represents its major limitation.

63. *Moreover, the relationship between the resolution of collective action problems through a legal framework and the creation of a predictable dialogue through a Code is a close one.* Specifically, it is likely that the incentives to follow behavior described in a Code—particularly in periods of acute stress—would generally be strengthened to the extent that it operates in the shadow of a legal framework, particularly one which catalyzes creditor organization through the aggregation of claims across instruments. This has proven to be the case in the nonsovereign context, where voluntary out-of-court frameworks operates most effectively in the "shadow" of the insolvency law.

64. *As noted above, while a Code would, in a number of key respects, be more limited than a statutory framework, in others it could be significantly broader.* The SDRM is

intended to be invoked only in circumstances in which a member's debt burden has become unsustainable, and provides a statutory mechanism for resolving collective action difficulties and resolving disputes. A Code, in contrast, could cover a broad spectrum of circumstances ranging from periods of relative tranquility through to periods of acute stress, but could neither resolve collective action problems nor provide a statutory dispute resolution mechanism.

65. *Clearly, a Code could only be effective to the extent to which it is able to attract broad support among debtors and their creditors.* Accordingly, the most promising approach to developing a code that could form the basis of a consensus would be for it to be developed jointly by debtors, their creditors, and other interested parties (including the Fund). Conversely, it appears unlikely that a Code suggested by the Fund or other bodies would attract broad support.

66. *In light of the above, a starting point for defining the objectives of a Code would be the following:*

- The promotion of an effective dialogue between a debtor and its creditors, as well as the provision of timely and transparent information, with a view to promoting efficient decision taking by debtors and creditors alike. By establishing a framework within which debtors, creditors, and the official community could operate, a Code could serve to promote the common objective of avoiding instability and periods of acute stress. More generally, it would be intended to strengthen the framework for emerging market finances.

- In a world of integrated capital markets, the responsibilities of sovereigns stretch well beyond issues relating narrowly to relations between a sovereign and its creditors, and encompass a broad spectrum of institutional and policy issues that have a bearing on private to private capital flows (covering both the extension of credit and direct investment). Indeed, the legal and regulatory infrastructure that underpins the efficient operation of capital markets are key responsibilities of the sovereign.

- In periods of mounting pressures, a Code could help facilitate the resolution of crises in a manner that minimizes economic dislocation and loss of the economic value of assets, to the extent that it helps to establish procedural clarity and expectations of the actions expected by the various players.

- The benefits of avoiding unwarranted intrusion into the rights of domestic and international investors.

67. *A threshold question relates to the parties that would be covered under a Code. It is suggested that the primary focus of the Code would be debtors and their private creditors.* These are the parties most directly involved in creditor-debtor relations, and whose behavior will determine the scale and allocation of private capital, the extent to which vulnerabilities

are held under appropriate restraint, and the way in which building tensions—including hopefully rare cases of full blown crises—will be resolved.

68. *In practice, however, the actions (and even expectations regarding such actions) of the official community will have a bearing on the incentives faced by a debtor and its creditors, and will thereby influence the outcome.* Accordingly, and in order to help frame and provide clarity to the discussion in the Code of the behaviors expected of debtors and their creditors, it may be considered appropriate for the Code to include a general summary of the role and policies of the IMF, the Paris Club, and the official community more generally. It would not be appropriate, however, for the Code to include commitments regarding the scale and conditions attached to financing from the official community. (By the same token, the Code would not seek to establish the parameters for the private sector's extension of, and secondary market trading of, credit.) Consistent with the Fund's Articles of Agreement, the design and implementation of Fund policies would remain the exclusive prerogative of the Executive Board.

69. *To what extent could the design and implementation of a Code be facilitated by the creation of some form of institutional infrastructure?* Several years ago, the Fund discussed the potential merits of the establishing a private and independent body—whose membership would be sought from both the public and private sectors—that would be responsible for designing and implementing best practices in the area of sovereign debt restructuring (see Creditors' Committees—Preliminary Considerations" (SM/99/206)) ("Voluntary Forum")

70. Possible ways in which a Voluntary Forum could support the design and implementation of the Code include the provision of mediation services that would facilitate both the resolution of inter-creditor and debtor-creditor. Moreover, in the context of the SDRM, the Voluntary Forum could establish a voluntary registration system which would enable creditors to vote on certain decisions at an early stage following activation. Finally, during periods of relative tranquility, a Voluntary Forum could continue to assess the implementation of the Code and, if necessary, revise it to take into consideration relevant experience.

71. *Consistent with the overall approach of the Code, however, any decisions taken by the Voluntary Forum would have no binding effect unless the debtor and its creditors had entered into agreements to confer the Voluntary Forum with such authority (e.g., through the inclusion of arbitration clauses in their original debt contracts that confer).* In this respect, it would differ considerably from decisions rendered by the DRF, whose jurisdiction would be mandatory.

## III. ISSUES FOR DISCUSSION

72. As a general matter, Directors may wish to indicate whether they agree with the proposed features of the SDRM as set forth in the Attachment. In addition, guidance is sought on a number of specific issues that have not yet been discussed in detail by the Executive Board or where there has been considerable divergence of views. Specifically:

(a) With respect to how the exclusion of multilateral claims would be formulated under the amendment, the paper considers various approaches, including one where the amendment would contain a list of institutions but would give the Board of Governors the power to amend this list by a decision of 85 percent of the voting power of the Board of Governors. Directors may wish to comment.

(b) As a means of creating a disincentive for inappropriate activation by the debtor, the paper discusses the possibility of requiring the debtor to bear all costs arising from an unjustified activation, including costs arising from the operation of the DRF. Directors may wish to express their views as to the desirability of such a feature.

(c) The paper explains why, from an economic perspective, the SDRM does not envisage an automatic general cessation of payments upon activation. Moreover, it explains why an automatic—albeit temporary—stay on enforcement would not be appropriate. Directors may wish to comment.

(d) Directors may wish to express their views as to the effectiveness and desirability of alternative measures that could be relied upon to discourage pre-agreement litigation. For example, one additional feature being proposed would be to restructure privileged claims under the SDRM, to the extent that such privileges are obtained after activation and arise from legal proceedings against the member.

(e) As means of ensuring that the SDRM is sufficiently flexible and able to adapt to the evolution of capital markets, the paper proposes that the DRF be given rule-making authority with respect to the administration of claims and the establishment of dispute resolution procedures. In that context, the paper considers the possibility of enabling the Board of Governors, perhaps by a decision of a qualified majority of the total voting power, to overrule rules and regulations adopted by the DRF. Directors may wish to comment.

(f) The paper contains a very preliminary discussion of the possible contribution that could be made by a voluntary code of conduct, and how this framework could interact with existing and future legal frameworks. Comments by Directors would be welcome.

**Proposed Features of a Sovereign Debt Restructuring Mechanism**

After an initial set of discussions, the Executive Board has identified a number of the key features of a statutory sovereign debt restructuring framework that could greatly enhance the operation of the overall crisis resolution framework. Although the features described below are supported by most Executive Directors (unless otherwise indicated), it is recognized that the views expressed by the Executive Board are preliminary and that modifications will likely be needed as discussions continue. Moreover, the finalization of the text of the amendment to the Fund's Articles will require the resolution of a number of technical issues that have yet to be addressed.

## 1. Objectives

The objective of the Sovereign Debt Restructuring Mechanism (SDRM) is to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, thereby reducing the cost of the restructuring process. In order for the SDRM to achieve these objectives, it must continue to be a part of a general effort to continue to strengthen the framework for crisis prevention and resolution, including the policy on exceptional access to Fund resources.

## 2. Principles

The design of the SDRM would be guided by the following principles:

- The mechanism should only be used to restructure debt that is judged to be unsustainable. It should neither increase the likelihood of restructuring nor encourage defaults.

- In circumstances where a member's debt is unsustainable, the mechanism should be designed to catalyze a rapid restructuring, both in terms of when it is initiated and, once initiated, when it is completed.

- Any interference with contractual relations should be limited to those measures that are needed to resolve the most important collective action problems.

- The framework should be designed in a manner that promotes greater transparency in the restructuring process.

- The mechanism should encourage early and active creditor participation during the restructuring process.

- The mechanism should not interfere with the sovereignty of debtors.

- The framework should establish incentives for negotiation—not a detailed blue print for restructuring.
- The framework needs to be sufficiently flexible—and simple—to accommodate the operation and evolution of capital markets.
- Since the framework is intended to fill a gap within the existing financial architecture, it should not displace existing statutory frameworks.
- The integrity of the decision making process under the mechanism should be safeguarded by an efficient and impartial dispute resolution process.
- The formal role of the Fund under the SDRM should be limited.

**3. Scope of Claims**

(a) While the mechanism would identify the scope of claims that could potentially be subject to a restructuring (“eligible claims”), whether all or some these claims would be restructured in a particular case would depend on the negotiations between the debtor and its creditors.

(b) For purposes of the mechanism, and subject to (c) below, eligible claims would be limited to rights to receive payments from the specified debtor (as defined in the mechanism): (i) that arise from a contract relating to commercial activities of the specified debtor and (ii) that are neither governed by the laws of the member activating the SDRM, nor subject to the exclusive jurisdiction of a tribunal located within the territory of that member. Eligible claims would also include claims for payment of judgments resulting from a right to receive payments under a contract that meets criterion (i) above, if the enforcement of such judgment is sought or obtained outside of the territory of the member activating the SDRM.

(c) For purposes of the mechanism, a sovereign debtor would constitute the central government of the member activating the mechanism and, subject to consent of the debtor in question, could also include (i) the central bank or similar monetary authority of the member and (ii) any subnational governments or public entities within the territory of the activating member that is not subject to a domestic statutory debt restructuring framework.

(d) Notwithstanding the above, eligible claims would exclude:

(i) Claims that benefit from a statutory, judicial or contractual privilege, to the extent of the value of such a privilege [unless such a privilege: (i) was created after activation and (ii) arises from legal enforcement proceedings against a specified debtor];

(ii) Guarantees or sureties, unless the underlying claim benefiting from such a guarantee or surety is in default;

(iii) Wages, salaries and pensions;

(iv) Contingent claims that are not due and payable, unless such contingent claim possesses a market value;

(v) [Claims held by international organizations that are specified in the amendment. The amendment would authorize the Board of Governors, by an eighty-give percent majority of the total voting power, to amend the initial list of such organizations and claims; and]

[(vi) Claims held by foreign governments or qualified governmental agencies][9]

## 4. Activation

Consistent with the principle of sovereignty, the mechanism could only be activated at the initiative of a member. When activating the mechanism, the member would represent that the debt to be restructured was unsustainable. For purposes of the legal effectiveness of activation, this representation would not be subject to challenge.

## 5. Provision of information

Upon activation, a procedure would unfold that would require the debtor to provide all information regarding its indebtedness and the indebtedness of other included entities (including debt that will not be restructured under the SDRM) to its creditors. A debtor would be expected to present the following:

(i) a list of claims for which the SDRM restructuring is sought ("SDRM Restructuring List");

(ii) a list of claims for which restructuring is sought outside of the SDRM ("Non-SDRM Restructuring List"); and

(iii) a list of claims for which no restructuring is sought.

Such information shall be published by the Dispute Resolution Forum (DRF). Upon notification to the DRF, a debtor may also modify these lists during the restructuring process.

## 6. Registration and Verification of Claims

Once the debtor provides the above-mentioned information, a registration and verification process would take place that would enable creditors to be in a position to vote on an

[9] Pending outcome on discussions regarding the treatment of official bilateral claims under the SDRM.

aggregated basis. Only those creditors whose claims are included in the SDRM Restructuring List and who wish to participate in the voting would have to register. Creditors whose claims are on the SDRM Restructuring List, but who fail to register within the specified period would not be entitled to vote, but their claims would be restructured on the terms approved by the required majority of holders of registered and verified claims ('verified claims"). The Dispute Resolution Forum (DRF) would have the responsibility for adopting rules regarding the registration and verification process with the objectives of safeguarding the overall integrity and transparency of the process on the one hand, and preserving asset values through a timely process, on the other hand.

**7. Limits on Creditor Enforcement**

(a) When, after the date of activation but prior to the certification of a restructuring agreement, a holder of a claim that appears on the SDRM restructuring list has recovered amounts due on the claim through legal proceedings (enforcing creditor), the claim of the enforcing creditor shall be restructured as follows: (i) First, the percentage of reduction offered to all other claims in the same class will be calculated with respect to the claim of the enforcing creditors on the basis of the value of the claim at the time of activation (the notional restructured amount) and (ii) Second, the amount recovered through post-activation legal proceedings shall be deducted from the notional restructured amount.

(b) Upon the request of an activating member and the approval by 75 percent of verified creditors, a temporary suspension (stay) would become effective for all enforcement proceedings or other legal actions brought by creditors holding claims on the SDRM restructuring list involving the sovereign debtor or its assets. The period of the suspension would be as specified in the request made by the debtor.

(c) Upon the request of an activating member and the approval by a representative creditors' committee, the DRF will issue an order to suspend a particular legal action against the sovereign debtor brought by creditors holding claims on the SDRM restructuring list if, in the assessment of the SEDRO, the proceeding or action has the potential to undermine the SDRM restructuring; provided that, once the registration and verification process has been completed, such action may only be taken upon the approval of 75 percent of verified creditors

**8. Creditor Committees**

As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee, if formed, would be given a role under the SDRM to address both debtor-creditor and inter-creditor issues. Consistent with best practices in this area, the debtor would bear the reasonable costs associated with the operation of these committees. The DRF would have the authority to review these fees and reduce them where they appear to be excessive.

## 9. General Voting Rules

Subject to the classification rules set forth in Section 9 below[10], creditor approval of proposals made by the debtor regarding: (i) a stay on enforcement; (ii) priority financing; and (iii) the terms of a restructuring agreement would be made by 75 percent of the outstanding principal of verified claims. Holders of verified claims who are under the control of a debtor shall not be entitle to vote.

## 10. Priority Financing

As a means of inducing new financing, the SDRM would provide that a specified financing transaction) could be excluded from the restructuring if the extension of such financing is approved 75 percent of outstanding principal of verified claims. Where such a decision has been taken, the DRF would be precluded from certifying an agreement that restructured such excluded financing absent the consent of the creditor that had extended the financing in question.

## 11. Restructuring Agreement

(a) When a sovereign debtor proposes a restructuring agreement, it would also be required to provide information to the DRF as to how it intends to treat claims that are not to be restructured under the SDRM, thereby enabling holders of verified claims to make a decision regarding the sovereign's proposal with the full knowledge of how other claims are to be treated.

(b) Holders of verified claims would be requested to vote on the proposed restructuring agreement, except for holders of unimpaired claims. For purposes of the mechanism, a creditor would be considered unimpaired if the restructuring of the creditor's claim was limited to a reversal of an acceleration of the claims in question, payment of all outstanding interest and no other default is continuing. Once certified by the DRF, the agreement would become binding on all holders of verified claims and all creditors that appeared on the SDRM Restructuring List but who failed to register. Subject to the classification rules below, all holders of eligible claims would have to be offered the same restructuring terms or the same menu of terms.

[(c) Mandatory classification of official bilateral claims, if such claims are included under the SDRM]

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[10] If official bilateral claims are included under the SDRM, they would also vote as a separate class for purposes of a stay on enforcement and priority financing.

(d) As a means of facilitating a restructuring agreement amongst creditors with different preferences, a debtor would have the option—but not the obligation—of creating different classes of registered claims. In such cases, holders of claims in different classes could be offered different terms. Classification could note be used in a manner that would result in the discriminatory treatment of similarly situated creditors.

**12. Termination**

The SDRM procedure would terminate:

(i) automatically upon the certification of all restructuring agreements by the DRF;

(ii) by notice of termination given by the central government of the member that had activated the mechanism; or

(iii) upon completion of the registration and verification process, by an affirmative vote of 40 percent of verified claims.

**13. Sanctions**

With respect to sanctions against a debtor for noncooperation or inappropriate use of the mechanism, the Fund would rely on its existing financial policies, including its lending into arrears policy. [ In circumstances where the Fund determines that debtor has activated the mechanism without adequate justification, the debtor shall bear the costs of the operation of the mechanism, including the costs of the DRF].

**14. Dispute Resolution Forum**

(a) The DRF would be established and organized in a manner that ensures independence, competence, diversity and impartiality. The DRF would be established and organized as follows:

(i) First, upon the advice of international organizations (such as UNCITRAL) and professional associations with expertise in this area, the Managing Director would designate a selection panel of 7-11 highly qualified judges or private practitioners.

(ii) Second, the selection panel would be charged with identifying 12-16 candidates that would constitute the pool from which judges would be impaneled when a crisis arises. Although the amendment would specify the qualification criteria (e.g., judicial experience in debt restructuring matters), the nomination process would be an open one. Once selected, this pool would be approved by the Board of Governors by an “up or down” vote. Except for the President of the DRF, all of members of the pool would continue to work in their own countries and in their other capacities until impaneled.

(iii) Third, when the SDRM is activated, four judges from the pool would be impaneled by the President of the DRF. One of these judges would be responsible for making initial determinations. The remaining three judges would constitute an appeals panel.

(b) The responsibilities of the DRF would be limited. It would have no authority to challenge decisions of the Executive Board or make determinations on issues relating to the sustainability of a member's debt. Its primary functions may be summarized as follows:

(i) Administrative Functions – this would include notification to creditors, registration of claims and the administration of the verification and voting process. It would also include the certification of decisions taken by the requisite majority of creditors.

(ii) Dispute Resolution – the DRF would be charged with resolving disputes that will arise during the restructuring process and would have exclusive jurisdiction over such disputes during this period. These disputes will arise during the claims verification procedure (challenges will be made with respect to the validity and value of claims), the voting process (where disputes may arise as to whether certain creditors should be disqualified because they are controlled by the sovereign), and the classification process. Disputes may also arise in the context of the formation and operation of creditors' committees. In performing this function, the DRF will be reactive: it will not initiate investigations regarding potential issues, but will merely adjudicate deputes brought by a party. While it could request the parties to provide evidence, it would have no subpoena power.

(iii) Suspending enforcement – Upon the request of the debtor and upon the approval by creditors, the DRF may issue an order that will enjoin specific enforcement actions during the restructuring process when it determines that such enforcement actions could seriously undermine the restructuring process.

(c) In order to discharge the above responsibilities, the DRF would have the power to issue rules and regulations,[ which would enter into force unless overruled by a decision of the Board of Governors taken by a qualified majority of the total voting power within a specified period.]

**15. Legal Basis of the SDRM and its Consistency with Domestic Laws**

The SDRM and the DRF could be established through an amendment of the Fund's Articles, which requires acceptance by three-fifths of the members, having 85 percent of the voting power. Since the amendment will involve the establishment of new treaty obligations that will affect the rights of private parties under domestic legal systems, most countries will need to adopt legislation for acceptance of an amendment and for making the new provisions

effective under their internal law. It is for each member to determine the extent to which the adoption of the SDRM would require changes in its domestic laws.