

Lending and Sovereign Insolvency: A Fair and Efficient Criterion to Distribute Losses among Creditors

Juan Pablo Bohoslavsky*

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* European Ph.D., director of the LL.M. in Global Administrative Law, Universidad Nacional de Rio Negro, Patagonia, Argentina. This paper was produced during the postdoctoral fellowship at the New York University School of Law during 2008-2009. The author wishes to extend his gratitude to the Hauser program's academic and administrative staff for their phenomenal support. Special thanks also go to New York University Professors Lee Buchheit, Richard Hulbert, Andreas Lowenfeld, Harvey Miller, and Gerald Rosenfeld for their helpful suggestions and insights, particularly in reshaping early drafts of this paper. I also want to thank all the participants at the 1 April 2009 Hauser forum at NYU where the first version of this paper was presented and discussed. Finally, thanks to Johannes Jüring and the team of editors of GoJIL who made invaluable edits and contributions to this piece. The views and conclusions reflected in this paper are solely mine and are in no way intended to reflect the views of the aforementioned people. A longer version of this paper, developing a comparative analysis of eight private domestic laws on liability for granting abusive loans will be published in the Spanish Yearbook of International Law, 2008 (forthcoming 2008).

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Abstract

This article argues that there are legal and economic justifications for extending the principle of *responsibility for granting abusive loans* from private law to a general principle of international law and, as such, that it can and should be applied to matters of sovereign insolvency. Employing this rationale, the article develops concrete legal and economic reasons and mechanisms by which the financial losses that any sovereign insolvency imposes on creditors should be distributed among them.

In particular, the article takes the position that loans, which are granted to states without following the most elementary prudential guidelines with regard to the analysis of credit risk and which are granted with the intention of taking unfair advantage at the expense of other creditors, should be totally or partially subordinated to those not classified as abusive in the case of sovereign bankruptcy. While the effects of this principle mostly coincide, in practice, with those of the *first-in-time rule*, it is argued that insolvent sovereigns and creditors must respect this criterion when proposing, negotiating and agreeing on a restructuring.

A. Introduction

This paper examines some legal aspects of sovereign insolvency, focusing on the stage at which the financial losses (reduction of the debt) of sovereign bankruptcy have to be distributed among creditors. It argues that a general principle widely accepted in private law – the so-called *responsibility for granting abusive loans* – should have an influence on the credit ranking system of sovereign insolvencies, and thus on the amount of money that each class of creditors collects in these collective procedures.

This paper describes the poor and insufficient legal rules that govern the ranking of credit priorities that apply to creditors when trying to collect their credits from an insolvent state and how this situation leads to inefficiencies and abuses from creditors and debtors. The first section also explains how these legal deficits have negatively impacted on particular creditors, allowing, on the one hand, sovereign debtors to impose excessively painful haircuts and, on the other hand, allowing abusive creditors to take advantage of this at the expense of the *bona fide* ones. The paper introduces a basis of responsibility for granting abusive loans –

emphasizing the way in which the credit risk was assessed and the dishonesty of the lender – as a new principle to promote efficient and fair allocation of financial losses in the sovereign insolvency realm.

The second section applies this general principle to the sovereign insolvency field. Abusive loans are visible as a representation of a collective action problem that comes with the insolvency of the borrower when lenders grant excessive loans to the already insolvent sovereign trying to get unfair benefits at the expense of aggravating the borrower's situation and diluting the other creditors. Departing from the analysis of the practical difficulties inherent to the implementation of this idea, the paper then proposes a feasible way to introduce the new principle into real sovereign insolvency procedures. It also holds the so-called *first-in-time rule* next to the legal principle presented in this paper, in order to articulate the economic rationale of both legal rules in an interactive manner.

B. Distributing the Financial Losses of Sovereign Insolvency Among Creditors

I. Credit Ranking in Sovereign Insolvency: An Insufficient Rule, Difficult to Enforce

In international law there is one general guideline that relates to the distribution of financial losses derived from sovereign insolvencies, and it does not tackle the collective action problem that this article is concerned with. This deficit within the legal framework of sovereign insolvency also produces a notable gap that market forces, sovereign interests, and experts try to fill.

The main rule that governs this field is the principle of *parity of treatment* of creditors in relation to comparable debts.¹ This is a rule that comes from the very basis of most domestic bankruptcy laws.² Because of the practical borrowers' discretion when applying this principle – basically allowing them to decide how to use their assets to pay their debts – creditors

¹ K. Clark, 'Sovereign Debt restructurings: Parity of Treatment between Equivalent Creditors in Relation to Comparable Debts', 20 *The International Lawyer* (1986) 3, 857-865.

² For more on this principle in European law see W. McBryde & A. Flessner, 'Principles of European Insolvency Law and General Commentary', in W. McBryde *et al.* (eds), *Principles of European Insolvency Law* (2003), 9, 81-82.

try to enforce this rule through specific clauses such as the negative pledge, *pari passu* and sharing clauses,³ which minimize (but do not suppress) *ex ante* the impact of the state's power.⁴ Reflecting this idea of parity, we can find some informal rules related to credit ranking if we look at the Paris Club's practice, which works on the ground of equitable burden sharing as follows: each sovereign creditor has to extend debt relief in proportion to its exposure to the debtor country and the debtor is expected to seek comparable relief from the private sector.⁵

The enforcement of this basic legal guideline, which rules the ranking of payments that an insolvent sovereign should follow, is limited mainly by two factual circumstances. First, given that sovereigns cannot be subjected to norms like chapter 7 ("liquidation") of the US bankruptcy code and that they usually do not have assets abroad, they enjoy wide discretion in paying their creditors, often violating informal or customary rules. Second, even these informal criteria applied by insolvent states are neither clear nor unanimously accepted by all the creditors, as they evolve and are constantly challenged.⁶ For example, if the traditionally *excluded* (from restructurings) *creditors* form part of a large portion of the debt stock, it should be expected that these preferred categories will be subject to questioning.⁷

³ L. Buchheit, 'The Search for Intercreditor Parity', 8 *Law and Business Review of the Americas* (2002) 1 & 2, 73, 74-75.

⁴ Under the same rationale, on the old clauses establishing the right of the lender to invoke and utilize in case of need the diplomatic intervention of its own government, see C. C. Hyde, 'The Negotiation of External Loans with Foreign Governments', 16 *American Journal of International Law* (1922) 4, 523, 539-540.

⁵ G. Vitale, 'Multilateral Sovereign Debt Restructuring: The Paris Club and the London Club', in B. Eichengreen & R. Portes (eds), *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors* (1995), 118, 122-123.

⁶ When Ecuador defaulted its debt in 1999, it was logical to assume that the collateralized Brady bonds were going to have priority over uncollateralized bonds. However, Ecuador opened the restructuring negotiations with the Brady bondholders first, apparently because these bonds gave the country a thirty-day grace period for not being in default, see B. Eichengreen & C. Ruehl, 'The Bail-In Problem: Systematic Goals, Ad Hoc Means', *National Bureau of Economic Research Working Paper*, No. W7653 (2000), 15-19.

⁷ L. Buchheit, 'Of Creditors, Preferred and Otherwise', 10 *International Financial Law Review* (1991) 6, 12, 13. This probably can occur with the domestic debt, since countries issue now more of this kind of debt, see A. Gelper, 'Building a Better Seating Chart for Sovereign Restructuring', 53 *Emory Law Journal* (2004) Special Edition, 1115, 1129-1130.

The parity of treatment is altered in practice by the use of preferred treatment, given, for example, to international financial institutions' (IFIs) credits, secured debts, trade debts, new credits, collateralized loans, and inter-bank deposit debts, among others. Each of them is grounded in political and economic reasons that would suggest the recognition of its seniority. Given the nature of these reasons, this ranking evolves continuously and without paying much attention to legal principles, as we will see below.

II. General System of Priorities, Realpolitik and Disorder

Under a general framework lacking an effective sovereign bankruptcy regime,⁸ apart from the weak parity treatment rule we just examined, there are no formal and fixed rules regulating the credit preference ranking in cases of sovereign insolvency. Going back in history, if we observe the debt settlements reached during the thirties, there was no uniformity there either. In most of those cases the agreements were not grounded in legal principles but in practical solutions to meet immediate necessities.⁹ The same phenomenon can be observed in the debt settlements reached in the last two decades.

Insolvent sovereigns do a cost-benefit analysis when deciding which debts to exclude from the restructuring. The main reason why, for example, sovereigns try to care about short-term trade¹⁰ is that they are playing with the country's capacity to participate in the international market. The same reasoning explains why some countries, in particular instances (like Mexico in 1982), decide to exclude capital market instruments from restructuring, because supposedly these markets have very long memories.¹¹

We already saw that the main principle governing the priorities system is the equal treatment of creditors. Thus, the discrimination of creditors would not only be incompatible with international financial tradition and justice, but also with the so-called *pars conditio creditorum* rule distilled

⁸ R. Buckley, 'The Bankruptcy of Nations: An Idea Whose time Has Come', 43 *The International Lawyer* (2009), 1189-1216.

⁹ E. Feilchenfeld *et al.*, 'Priority Problems in Public Debt Settlements', 30 *Columbia Law Review* (1930) 8, 1115.

¹⁰ On the treatment given to the trade debt in the contexts of defaults in Turkey, Romania and Nigeria, see Clarck, 1986, *supra* note 2, 857; K. Clarck, 'Trade Debt in Sovereign Restructurings', 3 *International Financial Law Review* (1984) 10, 33-35.

¹¹ Buchheit, 1991, *supra* note 8, 12.

from most domestic bankruptcy laws, and even from bilateral investment treaties.¹²

In spite of the deficient manner in which this principle has been treated by the IMF in its institutional proposal for a Sovereign Debt Restructuring Mechanism (SDRM), even this institution appears to recognize the importance of this rule. The SDRM has explicitly prohibited *unjustified discrimination* of creditor groups when the insolvent sovereign presents the classification of debts in order to negotiate and approve a restructuring.¹³

The restructuring process involves the allocation of payments over a long period rather than the liquidation and distribution of the present assets of the debtor. This is why prioritization (and discrimination) can emerge in form of at least three different kinds of acts: by paying a certain creditor or creditors first; by reducing their principal and interests less than that of others; and by applying an amortization schedule providing for complete liquidation before others.¹⁴

These kinds of decisions are taken at the early stages of restructuring procedures when the debtor decides, for example, which debts are going to be restructured and which are not.¹⁵ This dynamic is not a fixed practice, since creditors included in restructuring will try to ensure that even those categories of debts that are formally excluded be subjected to informal roll-over agreements.¹⁶ In any case, after deciding which credits are restructured,

¹² For the fair and equitable treatment in foreign investment law see A. F. Lowenfeld, *International Economic Law*, 2nd ed. (2008), 556-558; P. Muchlinski, *Multinational Enterprises & The Law*, 2nd ed. (2007), 635-647. This field of law is nowadays particularly important in sovereign debt restructuring since thousands of financial creditors of Argentina sued the state through the ICSID in order to collect their bonds. The cases are *Giovanni Alemanni and others v. Argentine Republic*, ICSID Case No. ARB/07/08 (claiming 14.3 Euro) and *Giovanna A. Beccara and others v. Argentine Republic*, ICSID Case No. ARB/07/05 (170.000 bondholders claiming US\$ 3.5 billion). Analyzing whether it is legally possible to use the BIT's frame to invoke financial credits, see M. Waibel, 'Opening Pandora's Box: Sovereign Bonds in International Arbitration', 101 *American Journal of International Law* (2007) 4, 711-759.

¹³ IMF, *The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations* (2002), 10, 53, available at <http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf> (last visited 9 December 2009).

¹⁴ Feilchenfeld *et al.*, *supra* note 9, 1144.

¹⁵ W. Bratton, 'Pari passu and a Distressed Sovereign's Rational Choices', 53 *Emory Law Journal* (2004) Special Edition, 823, 843-844; Buchheit, 1991, *supra* note 8, 12.

¹⁶ Buchheit, 1991, *supra* note 8, 12.

the debtor, negotiating¹⁷ with its creditors, determines the terms of the haircut.

Historically, most restructuring procedures have not entailed overly painful haircuts for creditors, while the Brady plan, multilateral bail-outs, and restructuring plans still significantly reduced the extent of the negative effects of the sovereign's defaults. It is thus understandable that the criteria, according to which losses are shared, did not receive much attention among creditors.

This inertia was challenged by the Argentinean case of 2001-2005, when a haircut that exceeded 75% of the face value of the bonds had been accepted by more than 76% of its creditors. Although the Argentinean haircut was the toughest, the most recent defaults (Russia, Ukraine, Pakistan, and Ecuador) led to restructuring agreements that implied haircuts clustered in the range of between 25% and 60%.¹⁸ If the current sovereign insolvency framework allowed a debtor to implement such radical haircuts,¹⁹ then it is possible that other debtors might consider taking similar steps.

The Argentine case very clearly demonstrates several things: that the impact of the haircut among creditors can be a zero sum game;²⁰ that there is not a stable and predictable priority credit ranking; that creditors do not enjoy an institutional framework within which to have an orderly discussion about how to allocate financial losses among themselves, an issue which delays and complicates the restructuring process;²¹ and, that if the borrower

¹⁷ To read about the aggressive style of the Argentinean government in negotiating the terms of its last default, see A. Porzecanski, 'From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default', 6 *Chicago Journal of International Law* (2005) 1, 311-332.

¹⁸ F. Sturzenegger & J. Zettelmeyer, 'Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998-2005', 27 *Journal of International Money and Finance* (2008) 5, 780, 786-791.

¹⁹ The pending judicial and arbitral claims against Argentina are related to holdout creditors, not to the majority of creditors that in fact accepted the restructuring agreement.

²⁰ Buchheit, 2002, *supra* note 4, 74.

²¹ Recent empirical studies have shown that both creditor coordination problems and political shocks and government behaviour of the borrower provoke messy restructurings, C. Trebesch, *Delays in Sovereign Debt Restructurings. Should we Really Blame the Creditors?* (2008), available at http://www.sfb-governance.de/en/teilprojekte/projektbereich_d/d4/teamd4/Docs_Trebesch/Trebesch_-_Restructuring_Delays1.pdf (last visited 9 December 2009).

feels that it has enough space within which to expand its discretionary (and arbitrary) power, it will do so.²²

Looking at different financial crises that have occurred over the last fifteen years, we can easily confirm that many sovereign borrowers have used their discretion to discriminate against creditors or groups of creditors when dealing with the problem of inter-creditor equity.²³ The last sovereign defaults show that, within the same restructuring the extent of the haircut varied greatly among different classes of creditors, without following any legal guide when doing so.²⁴

In the current legal and institutional framework sovereigns enjoy wide discretionary faculties to negotiate, agree with their creditors, or just decide the terms of the restructuring and how it affects each of them in terms of their place in the credit priority ranking. This prerogative is usually associated with not only the legal disorder in preference terms but also the idea of sovereignty itself.

Even respecting the very core of the notion of sovereignty, it is desirable for every party to develop a minimum set of rules to govern the credit ranking in a sovereign insolvency. There are several negative consequences of not having a clear and enforceable priority system.²⁵ First, some creditors can gamble on subordinating other creditors. Lenders may attempt to obtain *de facto* priorities by issuing debts that involve a very high credit risk through short maturities and dispersed bondholders, provoking higher costs for the borrower, higher risk of default, and higher transaction costs in case of restructuring. Second, because creditors do not know whether they are going to be involuntarily subordinated, they can charge this risk on the price of the loans. Third, the borrower itself, trying to delay the default, may be tempted to take excessive new debts and dilute earlier

²² Since 1987, the coerciveness of the average sovereign borrower has increased, due (primarily) to the change in creditor composition and the international legal environment, *see* H. Enderlein *et al.*, Debt Disputes. Measuring Government Coerciveness in Sovereign Debt Crises (2008), 22, available at http://www.sfb-governance.de/teilprojekte/projektbereich_d/d4/Debt_Disputes.pdf (last visited 9 December 2009).

²³ Gelpern, *supra* note 8, 1116.

²⁴ Sturzenegger & Zettelmeyer, *supra* note 20, 780-805.

²⁵ P. Bolton & D. Skeel, 'Inside the Black Box: How Should a Sovereign Bankruptcy Framework be Restructured?', 53 *Emory Law Journal* (2004) Special Edition, 763, 788-793; Gelpern, *supra* note 8, 1117-1118, 1140-1143; J. Zettelmeyer, 'The Case for an Explicit Seniority Structure in Sovereign Debt', *IMF, Research Department*, Working paper draft (2003).

creditors. Fourth, a creditor may try to lend, but only backed by collateral. Fifth, because the priorities and even the collaterals are difficult to enforce, creditors can try to shelter themselves with faster repayment schedules, provoking a roll-over crisis. Sixth, once the financial distress emerges, creditors will compete to catch the cash flows of the debtor, complicating and delaying the restructuring and, thus, the recovery of the borrower. Finally, it has been pointed out that violating the absolute priority in bankruptcy increases the bias of equity holders and managers in favor of riskier investments, because they know they will receive the benefits while creditors will bear the negative outcomes of this business.²⁶

III. A Sound Guide for Distributing Losses Among Creditors: Looking at the Lender's Behavior and Its Consequences

When we turn to the problem of *how we should* distribute financial losses of insolvency among a sovereign's creditors, we must pay closer attention to domestic bankruptcy laws. Although equal treatment of creditors is the main rule, it is limited from two sides: priority credit ranking and the subordination of certain credits. We will focus on one specific category of this last type of credits.

Most domestic legal systems establish that if creditor A engages in some kind of fraudulent lending practice and grants excessive loans, it does not deserve the same treatment as creditor B which hasn't violated the *pars conditio creditorum*, carefully evaluated its credit risk, and acted according to the economic situation of the debtor. This rule has a clear economic rationality: it provides incentives for creditors to be prudent and diligent in assessing risk, encourages the efficient allocation of financial resources, helps creditors to act in good faith, prevents collective action problems in insolvency contexts, and helps to avoid the aggravation of the debtor's situation and, thus, also of the creditors as a group. This rationale is sensitized in the so-called *responsibility for granting abusive loans*.²⁷

²⁶ L. Bebchuk, 'Ex Ante Costs of Violating Absolute Priority in Bankruptcy', *National Bureau of Economic Research, Working Paper*, No. 8388 (2001), 3.

²⁷ For a comparative analysis of the American, Argentinean, Belgian, English, French, German, Italian and Spanish legal systems specifically in terms of this kind of responsibility, see J. P. Bohoslavsky, *Créditos abusivos. Sobreendeudamiento de Estados, empresas y consumidores* (2009); G.-A. Likillimba, *Le soutien abusif d'une entreprise en difficulté*, 2nd ed. (2001); F. Di Marzio, *Abuso nella concessione del credito* (2004); L. Simont & A. Bruyneel, *La responsabilité extra-contractuelle du donneur de crédit en droit comparé* (1984).

Even when this responsibility is broader in domestic legal systems, from an international perspective – and with the aim of identifying a general principle – reckless conduct alone is not enough to create liability and subsequently lead to being subordinated in a sovereign bankruptcy procedure. This general principle requires the establishment of *fraudulent intent*, which differentiates this rule from the so-called *deepening insolvency* doctrine.

When a lender tries to obtain extra (unfair) advantages at the expense of other creditors in the context of insolvency, it can do so by attempting to grant loans which assume an excessive risk that can only be understood if we integrate those extra advantages to the cost-benefit analysis conducted by the lender. It is in this way that excessive risk assumed by an abusive lender and unfair advantage can go hand in hand.

Regarding the factual consequences of abusive loans, it is important to mention, firstly, that they can impede the debtor's asymptomatic insolvency from revealing itself, precisely because the new credits keep the debtor afloat and functioning in the market for a longer time, concealing the real (insolvent) situation of the debtor.²⁸

Secondly, during this "extra time" in the borrower's commercial life, its debt usually increases considerably due, on the one hand, to the moral hazard problems that appear in the administrators' and shareholders' behaviour during the final period of the company and, on the other hand, to the gradually worsening conditions in which the company is dealing with other economic players. The assets of the debtor are also dramatically reduced during this period because of the same moral hazard problems and the claims that other creditors are starting to make against the debtor, that erode his wealth.

Finally, the dissimulation of the debtor's situation can inhibit creditors from using their contractual and legal self-protection tools in order to collect their credits and defend the borrower's wealth.

All those patrimonial deteriorations affect the guarantee of the creditors: they will receive less than they could have collected if the debtor had filed a restructuring procedure earlier. Since the debtor's economic situation that leads a loan to be qualified as abusive is characterized by its irreversible distress (no rational financial aid would avoid the collapse), this kind of loan does not eliminate the insolvency, but rather hides it and

²⁸ Di Marzio, *supra* note 27, 39, 170-171, 186-189, 220.

possibly aggravates it, prolonging the interval between the asymptomatic and symptomatic insolvency.

For all the reasons just mentioned, domestic bankruptcy laws have tried to discourage abusive loans by making these creditors collect less money in insolvency procedures than those who did not act abusively. This role is carried out by the responsibility for granting abusive loans.

C. Applying the Principle of *Responsibility for Granting Abusive Loans* to the Realm of Sovereign Insolvency

I. Abusive Loans in Sovereign Finances

A lender may realize the economic situation of a borrower who faces an unavoidable default. The outlook is such that resorting to a moratorium or insolvency procedure is the only way to reduce the debt to a sustainable level. At this point, the lender might speculate about the possibility of gaining an unfair advantage or reducing his losses at the expense of other creditors, violating the *pars conditio creditorum*.

This can occur when a creditor speculates with increasing interest rates, as this will create more liabilities for the common debtor. A creditor can also seek to obtain or improve securities or pledges. In this case, it is clear that these assets are subtracted from the general economic guarantee of the debtor to benefit only this creditor. Granting larger loans or postponing the moratorium can also be an instrument to accelerate terms to collect credit, which implies fewer assets for the other creditors and aggravates the situation.

Another type of advantage or benefit can be identified in the case of multilateral lenders whose credits enjoy a *de facto* preference status,²⁹ which means that they also benefit objectively from more loans without assuming the same major risks. By increasing the volumes of their loans they

²⁹ See broadly J. Boughton, *Silent Revolution: The International Monetary Fund 1979-1989* (2001), 757-846; K. Raffer, *Preferred or Not Preferred: Thoughts on Priority Structures of Creditors*, paper prepared for discussions at the 2nd Meeting of the ILA Sovereign Insolvency Study Group, 16 October 2009 (2009).

strengthen their bureaucratic structures and their political leverage, no matter what the country's economic repayment capacity.³⁰

It is perfectly legal and understandable that a creditor will try to contain and minimize its financial losses. However, when the insolvency is the only possible fate for the common debtor, this creditor cannot protect itself by harming other creditors through the violation of the equal treatment principle. This is precisely one of the collective action problems that bankruptcy laws try, or should try, to prevent. These legal norms seek to protect and maximize the value of the debtor's goods, in the interest of all creditors and the debtor itself.

If we translate the damages from the private abusive credit realm to the sovereign insolvency phenomenon, it should be noted that the loans that only postpone the agony of the country will also aggravate its situation, as experienced by Belize in 2005 to 2006.³¹ In these contexts, debts will increase dramatically, as usually happens in the last stage before a default, because of the high interest rates these lenders usually require. Also, the sovereign tends to ruinously consume its hard currency reserves during this time, while also increasing rates to avoid suspending debt payments.³² The effects – capital flights and the weakening of the banking system – are costs that increase during, after, but also before the default.³³

Moreover, sometimes countries issue excessive amounts of short-term debt while trying to avoid defaulting on their existing debt,³⁴ provoking liquidity problems and forcing higher costs of adjustment which the debtor will have to implement.³⁵ All of these problems are aggravated by one of the main reasons: namely that sovereign governments are reluctant to accept

³⁰ For details about the economic relationship between the IMF and Argentina during the 1990s and its default, see Lowenfeld, *supra* note 12, 719-733.

³¹ L. Buchheit & E. Karpinski, 'Belize's Innovations', 22 *Butterworths Journal of International Banking and Financial Law* (2007) 5, 278-280.

³² B. Eichengreen, 'Restructuring Sovereign Debt', 17 *Journal of Economic Perspective* (2003) 4, 75, 78.

³³ F. Sturzenegger & J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (2007), 49-52.

³⁴ J. Bulow, *First World Governments and The World Debt*, draft version (2002), 16.

³⁵ Inter-American Development Bank (IBD), *Living with Debt. How to Limit the Risks of Sovereign Finance, Economic and Social Progress in Latin America, 2007 Report* (2006), 235.

insolvency and face a restructuring procedure, because, quite simply, they fear the political, financial and economic consequences of the default.³⁶

From the “insolvency game” perspective, when one lends money to an over-indebted sovereign, some creditors can gamble on diluting and subordinating other creditors.³⁷ In that case, when the country has already reached its repayment capacity, the new loans are not aimed at paying the old ones, but rather for paying the new debt: the old creditors are thus diluted in their claims, having to share the debtor’s lower repayment capacity with new creditors.³⁸ This involuntary subordination can also contribute to harming the old creditors since the borrower, desperate for new funds, promises new creditors they will be the first to collect on the loans in times of trouble.

If we look closer, we might say that non-abusive creditors could indeed benefit from abusive loans. If these loans postpone the default and the reduction of the debt during this borrower’s extra life period, the creditors will continue receiving interest payments in a regular way, putting off the application of the fatal restructuring. However, this postponement will also provoke a more painful haircut, precisely because the situation of the country is worse than before this deferring process.

From a practical perspective, it can be difficult to demonstrate in formal procedural terms that a lender had the intention of damaging or obtaining an unfair advantage, but some indirect evidence can help in approaching the facts. Among the indicators that the lender knew (or must have known) about the situation of the borrower – factors which the loan could only aggravate, causing distress and therefore harming others by trying to take an unfair advantage – are the following: the date on which the transaction was made; the execution date of the contract; the interest rate of the loan; the public availability of the information related to the debtor’s situation; the human and material resources that the lender enjoyed in order to evaluate the risk; the economic volume of the loan; the legal nature of the contract; the request and constitution of strong collaterals; and, the acceleration of payments requested to the borrower, among others.

The rule proposed here suggests that those creditors who behaved with *bona fide* (which implies the fulfillment of minimum due diligence standards when negotiating and signing contracts) regarding the debtor and

36 M. Dickerson, ‘A Politically Viable Approach to Sovereign Debt Restructuring’, 53 *Emory Law Journal* (2004) Special Edition, 997, 1006-1007.

37 Gelpert, *supra* note 8, 1117, 1140-1141.

38 *Id.*, 1140-1141.

the other creditors, should receive different (read *better*) economic and legal treatment during the restructuring process than those creditors who did not follow this standard of conduct and violated the equal treatment principle, as described in the last few paragraphs.³⁹ These *abusive credits* should be totally or partially subordinated to the *constructive ones*.

The peculiarities of each class of creditor and each type of transaction will determine the prerequisites for the definition of responsible lending with regard to each concrete insolvent debtor. Those creditors with the greatest human and material resources to assess the credit risks of the loans, and those which have the largest volume of financing availability, are more likely to be subjected to stricter due diligence duties (and are probably more regulated). The responsibility of lenders has to be proportional to the power and resources that they actually enjoy.⁴⁰

We must employ the same task of individualizing the duties of lenders when looking at the nature and goal of each. Banks and other private financial investors must be presumed to be economically rational: they prioritize their profit, which means that they have to conveniently evaluate the risks of their transactions,⁴¹ and cannot allege extra economic motivations for their decisions. Bondholders are less homogenous than banks, and correlatively their due diligence obligations differ as well. On the one hand, non-institutional investors have more freedom to take risks; on the other hand, institutional ones are more regulated and controlled because of their characteristics, goals, structures and roles in the economy.⁴² The regulation of what they can do (pension funds, insurance companies, sovereign funds, etc.) tends to match with those characteristics.

Regarding bilateral loans⁴³ other factors enter into consideration because of the possibility of political gain. The main problem here is that

³⁹ “In an insolvency procedure respecting existing legal principles, private bona fide creditors would recover more than under present public creditor domination. Disregarding the Rule of Law, official creditors presently cause substantial negative effects for bona fide creditors”, Raffer, *supra* note 31, 17.

⁴⁰ Principle broadly applied in the banking activity, see J. Vézian, *La responsabilité du banquier en droit privé français* (1983), 138.

⁴¹ B. Herman, ‘The Players and the Game of Sovereign Debt’, in C. Barry *et al.*, (eds), *Dealing Fairly with Developing Country Debt* (2007), 15-17.

⁴² For an overview of the different types of institutional investors, see IBD, *supra* note 34, 151-152.

⁴³ BIS *et al.*, *External Debt Statistics. Guide for Compilers and Users* (2003), 42, available at <http://www.imf.org/external/pubs/ft/eds/Eng/Guide/> (last visited 9 December 2009).

these loans do not usually make these political motivations explicit. If the loan does not say anything about these political considerations it is possible to presume that the lender tried to make money with this loan, which means its acceptance of a minimum due diligence when assessing the credit risk.⁴⁴

Finally, although the ultimate institutional goal of IFIs is not to make money from their lending activities, indeed they make profit. Their respective charters require them to ensure that the loans granted to member countries will be repaid, which presumes a proper evaluation of the sovereign state's capacity to repay. In fact, IFIs usually count with sophisticated manuals of risk assessment. Specifically, international development banks must do a serious and reasoned analysis about the viability of their projects.⁴⁵ In any case, IFIs also have a broader room for discretion since they fulfill, at least theoretically, counter cyclical functions.

II. The Application of the Legal Principle and Some Practical Problems

While different countries have different domestic bankruptcy laws, it is clear that all of them postulate that some decisions must be taken by neutral authorities (judges). Creditors can negotiate the restructuring plan with the debtor, but they cannot decide, for example, about the validity of the credits – and neither can the debtor. Nor can they modify certain rules around credit seniority. It is up to a judge rather than the creditors or the debtor to decide when a credit must be subordinated because its holder granted abusive loans.

The *neutral judge* principle is well accepted at the domestic legal level, as well as in international arbitration and the municipality insolvency law of the US (chapter 9, US bankruptcy code). Therefore it is not a surprise that many scholars have also pointed out the importance of a neutral

⁴⁴ This could be drawn from Norway's cancellation of the debt of several countries relating to its Shipping Export Credit Campaign in the late 1970s, based on the recognition that the campaign had been a development policy failure and that Norway shared responsibility in this respect. On this official decision see Royal Norwegian Ministry of Foreign Affairs, Cancellation of Debts Resulting from Norwegian Ship Export Campaign (2006), available at <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2006/Cancellation-of-debts-incurred-as-a-result-of-the-Norwegian-Ship-Export-Campaign-1976-80.html?id=420457> (last visited 9 December 2009).

⁴⁵ A. Rigo Sureda, 'The Law Applicable to the Activities of International Development Banks', 308 *Recueil des Cours* (2004), 87-88, 106.

authority for settling disputes in sovereign insolvency issues.⁴⁶ However, bargaining power and a failure to coordinate the parties involved in the sovereign insolvency problem have evidently not yet permitted the implementation of this basic principle. Even so, it seems that private financial creditors are starting to realize that impartial arbitration could be beneficial for them.⁴⁷ At the same time it is difficult to predict whether or not this tendency will continue and what the position of IFIs and the US will be regarding this trend toward a third-impartial-authority. To make the issue even more complex, due to social movements and NGOs concerned with the debt problem of many developing countries, the idea of a neutral authority settling financial creditor-debtor disputes is slowly gaining acceptance at the international political level.⁴⁸

Regarding collective action clauses, at least in the form in which they have been already implemented, they do not seem to allow the creditors as a group to efficiently and fairly distribute among themselves the burden of a haircut. Why would a creditor vote against its own benefit, accepting that it did not grant a loan in a prudent way? Since there is a capitalist base in the political system to decide what to do with the sovereign debt, and being a *pareto optimum* (the creditors would discuss how to distribute the reduction of the debt previously agreed with the debtor), it is not easy to imagine how creditors themselves could find and implement a sound criterion for sharing the losses. In other words, in the absence of incentives from a legal or contractual framework, this collective action problem could not be solved spontaneously by its protagonists. This collective action limitation is tested, to some extent, when bondholders are asked to subordinate their credits in order to grant priority to the new lending.

Theoretically, there are other possibilities we can explore before simply accepting that we are in a stalemate where some players are too strong to accept a neutral authority to assure a fair insolvency procedure,

⁴⁶ C. G. Paulus, 'Thoughts on an Insolvency Procedure for Countries', 50 *The American Journal of Comparative Law* (2002) 3, 531, 541-542; K. Raffer, 'Internationalizing U.S. Municipal Insolvency: A Fair, Equitable, and Efficient Way to Overcome a Debt Overhang', 6 *Chicago Journal of International Law* (2005-2006) 1, 361, 362-365.

⁴⁷ In 2007, almost 20% of the claims filed by private creditors challenging the HIPC were in arbitration, IDA & IMF, Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) - Status of Implementation (28 August 2007), 105, available at <http://www.imf.org/external/np/pp/2007/eng/082807.pdf> (last visited 9 December 2009).

⁴⁸ A. Pettifor, 'The Jubilee 2000 Campaign: A Brief Overview', in C. Jochnick & F. A. Preston (eds), *Sovereign Debt at the Crossroads* (2006), 297-317.

and where the US administration is too convinced that the statutory approach is not consistent with its vision about how international financial markets should work.

One option would be to incorporate some basic guidelines into the bonds' collective action clauses. They could come into force once the insolvency erupted. They would establish a gradual system enacting that certain creditors – or categories of creditors – should assume more financial losses than others (subordination of the debt) if they lent money under undue circumstances. They would be defined by the announcement of the most well known credit ranking agencies and IFIs, informing that the country credit risk grade was too high.

One of the problems of this proposal would be its partial approach. Even if bond holders voluntarily accepted instruments with such clauses, IFIs, banks, other sovereigns, and both trade and domestic creditors would not be considered by this seniority ranking scheme. Most importantly, why would creditors buy a bond that already says that it is going to be subordinated? The price of this bond would be very low.

Recently it has been said that the recognition of a broad *ex ante* priority hierarchy would be politically hard to envision, and that for this reason it would be advisable for each sovereign borrower to unilaterally decide its own priority policy. In this scenario, the only requirement would be that the debtor has to disclose the ranking at the time of borrowing.⁴⁹ This proposal falls short in that it does neither explain what guarantees would be in effect in case of financial distress, nor if the sovereign would respect the priority policy announced in tranquil times. In this way, it would likely lack enforceability.

Finally, the *first-in-time-priority rule* has been suggested as a criterion complementing the SDRM.⁵⁰ The priority is based on the time that the loan was extended, with the debt of any given year taking priority over loans granted in subsequent years. This rule would tackle the problem of debt dilution through over-borrowing because, in case of a crisis, the sovereign could not turn to new lenders because they would be junior and their indebtedness would thus be limited. To some extent, this rule is already

⁴⁹ See Gelpert, *supra* note 8, 1143-1150. In 1992, California implemented a system of disclosure like this, *see* details in *id.*, 1152.

⁵⁰ Bolton & Skeel, 2004, *supra* note 25, 799. These authors propose a two-step voting process. In the first one, creditors have to assess the haircut proposal sent by the insolvent borrower. If they accept it, the following step is to discuss the restructuring plan, 796-797.

applied by the Paris Club when agreements work under the *pre-cut-off debt* principle, meaning that the loans granted before an agreed date are incorporated in the restructuring, facilitating a situation in which new lending enjoys priority.

III. The *First-In-Time* Rule, Abusive Loan Liability and Their Economic Rationale

Behind the first-in-time-priority rule there is a presumption that the closer the loan was to the moment of the final default, the less constructive and more speculative it was. Connecting this idea to the abusive loan theory, both must depart from the fact that the situation of the borrower – at the moment the loan is granted – cannot be fixed by adjustments and therefore needs to carry out a debt restructuring to pay off its debts. In this context, any adjustment would either worsen the situation or improve it to an insufficient extent, striving to raise enough hard currency to pay the debts or violating the minimum standard of life that should be assured to any debtor.⁵¹

This criterion allows differentiating the *hero* that trusted the country in tough times and helped it to avoid the crash from those that just speculated and tried to dilute other creditors. If the default was clearly unavoidable and the lender tried to unfairly take advantage of the rest, the conditions required by the abusive loans theory could be encountered. On the other hand, if the country could have reasonably implemented adjustments or changes in order to avoid the disaster and new loans could have helped in this direction – beyond what eventually happened to the borrower's economy – this lender would have behaved constructively. The possibility of recovering presented by the borrower's situation in this case suppresses the idea of fraud on the lender's side.

Some criticism⁵² against the first-in-time rule has been voiced regarding the proposal of Bolton & Skeel, which departs (and modifies) the

⁵¹ *Vital interests of the contractual debtor* according to the terminology used by L. Díez-Picazo y Ponce de Leon, 'Libertad, responsabilidad contractuales e intereses vitales del deudor', in S. Schipani (ed.), *Debito internazionale. Principi generali del Diritto* (1995), 195-201. See also Committee on International Monetary Law, 'Committee Report', in International Law Association, *Report of the sixty-third conference Warsaw* (1988), 418, 428, para. 21.

⁵² Gelpern, *supra* note 8, 1145-1146.

model of SDRM. This criticism also applies to the principle proposed in this paper and this is why it is worth analyzing here.

First, implementing this rule could provoke pro-cyclical effects, accelerating toward the day in which the insolvency is recognized. Lenders would perceive the possibility of default and would likely shorten maturities and raise interest rates in order to compensate for their junior status.

If the over-indebted state does not have more remedy than facing a restructuring procedure, its postponement can only provoke the harms that the abusive loan theory describes.⁵³ Thus, it does not seem particularly wrong to force the sovereign to openly recognize and deal with its problem and implement the bankruptcy remedies necessary for overcoming the difficulties and minimizing the creditors' damages.

However, a country could be traversing liquidity problems and new loans would genuinely help the debtor to avoid the painful consequences that are brought by any default. The first-in-time rule could then discourage refinancing which could have been useful for solving liquidity troubles. This is precisely why the first-in-time priority rule should distinguish between the insolvency and liquidity problems of the debtor – which is not an easy task.

Here, again, we should pay attention to the technical development that bankruptcy law exhibits in this field. When it regulates the goal of promoting prudent credit risk assessment by punishing, in some way, financial recklessness, it opts for adopting a *retrospective-prospective* approach.

Whoever judges such a case has to *isolate* the actual possibilities for recovery that the debtor presented when the loan was granted.⁵⁴ This analysis requires a distinction between *liquidity* problems (which allows one to think that with new loans there are hopes of solving the situation) from *solvency* ones (which need, because they lack a way out, a haircut and/or debt restructuring). The key is to determine whether, when the loan was granted, real possibilities for recuperation existed. If so, they were probably

53 “In the absence of enforceable priorities, when a debtor country approaches financial distress any new debt it issues is partly at the expense of existing creditors who face a greater risk of default and will have to accept a greater ‘haircut’ (or debt reduction) in the event of default, since the total resources the debtor can muster towards repayment of its stock of debt will have to be divided pro rata among its creditors, old and new”, P. Bolton & D. Skeel, ‘Redesigning the International Lender of Last Resort’, 6 *Chicago Journal of International Law* (2005-2006) 1, 177, 185.

54 V. C. A. Lyon, *Revue de la Banque* (1983), 1198.

encouraged by the new set of loans,⁵⁵ which is why whoever analyzes the situation has to perform an economic evaluation that is at the same time retrospective and prospective.⁵⁶ This analyst must ponder whether, at a certain moment in the past, it was easy to forecast that the debtor was not going to be capable of avoiding the default.

Beyond the important nuances and limitations that the first-in-time rule can engender, it is necessary to remember again that it was proposed in the context of an improved version of the SDRM. This means that it required an amendment in the IMF's statutes, which implies an enormous political energy⁵⁷ towards enforcing this system. Suggestions of using section VIII (2b)⁵⁸ of the IMF's agreement in order to implement some of the new institutional ideas seem to strain the text and spirit of this section too much, which could provoke political troubles among the member states.

IV. The Legal Principle Already Exists: Now It Must Be Applied

The principle proposed in this paper must be added to the priority ranking system, which does not require any statutory change as it is a *lege lata* rule. This idea – that the treatment of abusive and non-abusive lenders must be different in terms of bearing the financial consequences of the haircut – already exists and is strongly evident in the similarities among domestic laws of different countries which embody this general legal principle.⁵⁹ This principle applies to a problem which is not directly tackled by any other legal source.

⁵⁵ A. Buthurieux, *Responsabilité du banquier. Entreprises en difficulté. Crédit fautif. Expertise* (1999), 78; P. Van Ommeslaghe, 'La responsabilité du banquier dispensateur de crédit en droit belge', 49 *Société Anonyme Suisse* (1977), 109, 128-129.

⁵⁶ Likillimba, *supra* note 27, 134.

⁵⁷ A. Beattie, 'US Set to Block 'Sovereign Chapter 11 Proposal' ', *Financial Times*, 31 March 2003.

⁵⁸ R. Euliss, 'The Feasibility of the IMF's Sovereign Debt Restructuring Mechanism: An Alternative Statutory Approach to Mollify American Reservations', 19 *American University International Law Review* (2003-2004), 107, 128-142; P. Power, 'Sovereign Debt: The rise of the Secondary Market and its Implications for future restructurings', 64 *Fordham Law Review* (1995-1996) 6, 2701, 2723-2727.

⁵⁹ See J. P. Bohoslavsky, 'Legal and Economic Consequences of Abusive Credits (With Special Reference to Sovereign Debt)', 14 *Law and Business Review of the Americas* (2008) 3, 495, esp. 501-506 and 496-497, note 2.

Regarding the practical features of this proposal, since the state's goods are mostly in its territory, it cannot be ignored that sovereign power is at the very core of the sovereign insolvency priority system. The state will try to do what is the best for its interests (even trespassing contractual and legal limits); therefore, trying to force the sovereign to renounce *ex ante* the use of its discretion, especially in tough times, seems an infertile effort that, in any case, would require costly statutory changes. Hence, the control should be *ex post*, which once applied would exemplarily work *ex ante* as well.

When a creditor challenges the restructuring agreement that an insolvent sovereign reached with the majority of its creditors, it can argue different reasons. For example, if it is a rogue creditor, having done a very high risk bet buying the instruments at their lowest price and then claiming to collect the full face value, it could attempt merely to argue that the majority cannot modify the monetary terms of its contract. Depending on the political climate and the global effects that the threat of the frustration of sovereign debt restructuring can reach, a court will decide whether this holds out credit or if the agreement is legally superior. Sometimes the sanctity of contracts is really sacred,⁶⁰ sometimes it is not.⁶¹

This points to a different, specific problem, which is conceptually subsequent to the haircut: when the distribution of the financial losses (reduction of the debt) among creditors is legally unfair. Of course, arbitrary discrimination implies the violation of the *pars conditio creditorum*. However, sometimes it is also unfair to treat all creditors in the same way. For example, it is legally and economically difficult to argue in favor of forcing those creditors that bought ten-year-instruments nine years before the default to bear the same financial losses as those that bought them only a few months before the moratorium with a huge interest rate, at a very low price, and reaching some collateral.

There is a viable manner for applying this *responsibility for granting an abusive loan* rule to the current institutional and legal sovereign

⁶⁰ See *Allied Bank International v. Banco Credito Agricola de Cartago*, U.S. Court of Appeals, 2d Cir., 18 March 1985 (757 F.2d 516); *Pravin Banker Associates v. Banco Popular del Peru*, U.S. Court of Appeals 2d Cir., 25 March 1997 (109 F. 3d 850, 854); *Elliot Associates v. Banco de la Nacion and the Republic of Peru*, S.D.N.Y., 1998 (12 F. Supp. 2d 328).

⁶¹ *CIBC Bank and Trust Co. (Cayman) Ltd. v. Banco Central do Brasil*, S.D.N.Y., 1995 (886 F. Supp. 1105); *EM Ltd. V. Republic of Argentina*, S.D.N.Y., 12 January 2004 (No. 03 CV 2507).

insolvency framework. When a creditor challenges the legal effects, which it had on it by a sovereign debt restructuring, the court has to analyze whether the agreement fulfills basic legal rules, such as the principle that nurtures the responsibility for granting abusive loans. This is a concrete way to enforce seniority, bringing into play the possible effects that this implies in terms of efficiency when negotiating haircuts.⁶²

The court does not have the authority to decide how much money the agreement has to assign to each creditor, but deciding in a particular case that the sovereign – even when ratified by a majority of creditors – engaged in arbitrary discrimination of some creditors and/or in violation of the rationale underlying the rule proposed here, the borrower (and the creditors who could have ratified it) would absorb this judicial decision and consequently react. If both sovereigns and creditors want to legally shield restructurings, they should fulfill the principle studied in this paper.

As empirical studies have recently shown,⁶³ the correlation between creditor losses and government coerciveness is rather weak. That is why it is also necessary to pay attention to the cases in which creditors' majorities voluntarily accompany large haircuts (like the Russian case⁶⁴), which can also implement a discriminatory distribution of losses. The will of the majority cannot punish non-abusive creditors by making them bear more loss than what the credit ranking system establishes for them – including the criterion emanating from the new rule proposed here. It bears repeating here the logic previously argued in explaining why the rationale of “\$1=1 vote” behind the Collective Actions Clauses cannot be the exclusive rule to decide how to distribute the financial losses among creditors: as a group they do not efficiently and fairly distribute among themselves the burden of a haircut.

In fact, creditors that feel they were victims of abusive treatment from the debtor or other creditors – and who are not receiving the financial consideration they deserve in the restructuring – will simply not accept this agreement. This is precisely how some small creditors reacted in Argentina, when they felt that the IMF and the big investment banks should have borne heavier losses according to their behavior toward the common debtor.

⁶² On these effects and role of policy intervention in sovereign lending, see P. Bolton & O. Jeanne, ‘Structuring and Restructuring Sovereign Debt: The Role of a Bankruptcy Regime’, 115 *Journal of Political Economy* (2007) 6, 901-924.

⁶³ Enderlein *et al.*, *supra* note 22.

⁶⁴ The international promissory notes (Prins/Ians) presented a moderate degree of coerciveness but a haircut of over 50%.

The logical effect would be that sovereigns financially treat creditors respecting the equal treatment principle not in an automatic or egalitarian way, but by focusing on the creditor's behavior itself. And by the same token, creditors would be constrained to respect this rule when agreeing the terms of the restructuring.

When implementing the right credit ranking system in a concrete case, different treatments must be given to different categories of credits which are previously proposed by the sovereign under objective and well-founded criteria that must reflect the rationale of the abusive loan theory according to the parameters sketched out in this paper. In this case, the restructuring must partially or totally subordinate, specifically, the abusive credits and, correlatively, benefit other creditor categories. And beyond the freedom that they have to decide concerning the extent of the haircut by freely negotiating with the debtor, creditors have to take lawful decisions when allocating the financial losses amongst themselves.

Finally, regarding the IFIs' credits: their immutable preference disconnects the quality of these loans from the losses caused by the borrower's insolvency. While the anti-cyclical functions of these institutions deserve to some extent a different (read *better*) treatment than that which private creditors receive, IFIs should be incorporated into the general scheme of sharing some losses and promoting efficient and prudent loans. This idea could be translated in practice into a partial preference, which would recognize the public interest element of the functions of these institutions and, at the same time, force them to act diligently, demonstrating that even development banks have to assess the viability of their projects⁶⁵ and some losses with the private sector.

D. Final Considerations

The theory of abusive credit, in both private and sovereign spheres, is based on a failure of the market. Abusive credit is a manifestation of imperfect and asymmetrical information, generating a negative externality for other market participants. This phenomenon exacerbates the collective action problems that usually come into play when insolvency is approaching. Assigning legal responsibility for the abusive granting of credit, and thus protecting confidence as an ethical and legal principle, is a corrective remedy for this market failure. This is the point where the

⁶⁵ Rigo Sureda, *supra* note 43, 87-88, 106.

persuasive and reparatory mechanism of responsibility for abusive credit intercedes, promoting a constructive attitude amongst all creditors.

In the context of the unavoidable bankruptcy of a sovereign, some lenders try to unfairly benefit at the expense of other creditors, facilitating the aggravation of the debtor's situation and diluting other creditors. This explains why they grant loans under circumstances where the financial deontology would usually suggest otherwise. This conduct must have some financial impact at the moment of conceiving, agreeing on, and implementing the credit ranking in the sovereign restructuring. Applying the general principle on abusive loans, this rationale is translated into a subordination mechanism, which gives total or partial priority to the good faith creditors while correlatively subordinating those that are abusive. This principle is complementary to the main pillar of bankruptcy law – the equal treatment of creditors – since it applies except for when a fair and justified differentiation must be made among creditors.

This system not only protects *bona fide* creditors from abusive creditors, but also from the arbitrariness of the sovereign debtor. The sovereign debtor can be tempted to treat different groups of creditors only according to its own convenience, unfairly discriminating against them and/or rewarding abusive behaviors. This can happen even when some creditors ratify this illegal discrimination by approving restructuring agreements that confirm this treatment to some of them.

Since the proposed principle demands greater rigorousness from market agents in obtaining, processing, and transmitting information, and discourages non-cooperative behavior among creditors, it would presumably impose higher standards of good practice on the participating parties – both public and private – in international finance, and would therefore enhance a more efficient functioning of market economies.

The responsibility for granting abusive loans is not a revolutionary act; it is about applying sound rules of risk management that presume the need to be informed about the client and its situation.⁶⁶ Critics of this responsibility principle warn that this theory could dampen, and maybe preclude, efforts to restructure distressed entities, precipitating potentially premature bankruptcy cases. Beyond this warning, however, there is no empirical data that confirms this premonition.⁶⁷ Because this responsibility

⁶⁶ Likillimba, *supra* note 27, 144.

⁶⁷ In 2005, when the French National Assembly was discussing the reform of article L. 650 *code de commerce* – reducing significantly the scope of this type of bank responsibility – representative Arnaud said (without being contradicted) that the new

only applies when all other financial efforts are in vain, and the loans can only deepen the insolvency and facilitate the dissipation of assets, the extent of the responsibility proposed here only discourages *abusive* loans, not those that can be dramatically helpful in situations of distress.

It is in this manner that constructive risk and diligence are promoted among lenders⁶⁸ and the distressed entities are forced to turn to formal relief before there is a dissipation of assets and the ability to reorganize. It is true that a form of *flexible borrowing* can be a way to face cataclysmic events and economic crisis and to avoid the intrinsic costs that any default implies. In that case, the criteria for assessing whether a loan was abusive must be adjusted to this environment of extreme and overall financial need. Regardless, bad faith of lenders is not justifiable – or to be rewarded – in any context.

act would protect the banking industry from a ghost, since in 2004 the damnatory sentences for abusive loans had only reach the sum of 14 million Euro.

⁶⁸ 'Mémoire de Barys', *Revue de la Banque* (1977), 331-352; A. Bruyneel, 'Le Memoire de Barys sur la responsabilité du donneur de crédit', *Revue de la Banque* (1977), 313, 314-317.