Northwestern Journal of International Law & Business

Volume 8
Issue 3 *Winter*

Winter 1988

Relational Contract Theory and Sovereign Debt

Keith A. Palzer

Relational Contract Theory and Sovereign Debt†

I. INTRODUCTION

An old adage was given modern relevance by a prominent Brazilian banker at the onset of the developing countries' debt troubles: "If I owe a million dollars, then I am lost. But if I owe fifty billions, the bankers are lost."[1] The treatment of sovereign debt since 1982, however, does not support this thinking. Major banks have broken their patterns of rescheduling,[2] and the developing countries' debts have not been forgiven. Rather than expound further upon the origins of the "debt crisis,"[3] this Comment approaches the problem of sovereign debt in terms of "relational contract theory"[4] and assesses the sovereign loan agree-

† Lowden-Wigmore Award for Outstanding Student Journal Writing, 1988.

1 A. SAMPSON, THE MONEYLENDERS 253 (1982).

2 "Country lending, it is sometimes said, is free of final bankruptcy and definitive loss. All that is needed is occasional rescheduling that gives the lender a breathing space . . . ." H. Wallich, International Lending and the Role of Bank Supervisory Cooperation: Remarks at the International Conference of Banking Supervisors 3 (Sept. 24, 1981), *quoted in* Reisner, *Default by Foreign Sovereign Debtors: An Introductory Perspective*, 1982 U. ILL. L. REV. 1, 5. Simple rescheduling is no longer the only remedy for developing country debtors, as seen in recent restructurings. *See infra* notes 125, 132 and accompanying text. In addition, banks have recognized the possibility that sovereign loans may be uncollectable, as many lenders have begun to establish large loan loss reserves, and even write-off the debt of some nations. *See infra* notes 128-29.

3 *See generally* W. CLINE, INTERNATIONAL DEBT: SYSTEMIC RISK AND POLICY RESPONSE (1984)[hereinafter INTERNATIONAL DEBT]; D. LOMAX, THE DEVELOPING COUNTRY DEBT CRISIS (1986); Barnett, Galvis & Gouriage, *On Third World Debt*, 25 HARV. INT'L L.J. 83 (1984); Eskridge, *Les Jeux Sont Faits: Structural Origins of the International Debt Problem*, 25 VA. J. INT'L L. 281 (1985).

4 Relational theory is a cluster of thinking which emphasizes the interests and behavior of parties in ongoing relationships external to the formal legal institutions of the state. There are two strands of this theory, one general, and one focusing on contract. Relational theory's main developers in the domestic contractual setting are Professor Ian Macneil and Professor Stewart Macaulay. *See, e.g.*, I. MACNEIL, THE NEW SOCIAL CONTRACT (1980); Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465. Relational contract theory emphasizes the behavior of contracting parties outside the formal terms of the contract and contract law, and attempts to enunciate principles and norms of exchange which more accurately describe modern exchange than does conventional contract theory. The more general strand of relational theory does not focus as much on contractual behavior, but rather on a community's operation where no enforcing power of the state is possible or needed. Developing country debt (and international law in general) was earlier explored in this general "relationist" context by Professor Gidon Gottlieb. Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. CHI. L. REV. 567 (1983).

This Comment attempts to apply the more specific strand of relational contract theory to sover-

ment in light of that theory's insights and normative lessons. The overarching thesis of this assessment is that as bankers and economists design new ways to deal with sovereign debt,[5] lawyers should examine their roles as advisers, negotiators, and drafters in restructurings with an eye towards more actively formalizing treatment of sovereign debt.[6] The tools of relational theory will be used to aid the lawyer in this challenge.

Relational contract theory will first be presented using principles gleaned from writings in the field[7] to craft a functional/relational model with which to approach legal practice.[8] This version of relational contract will then be applied to the problem of developing country debt through description of a hypothetical sovereign loan relationship.[9] By exploring the conflicts and trends of this association under a general "taxonomy of relational contract," normative analysis of the restructuring process can be accomplished, contractual trends identified, and suggestions for change offered.[10]

II. RELATIONAL CONTRACT THEORY

The fundamental insight of relational contract theory is that most private exchange occurs within ongoing relationships between parties,[11] rather than the discrete transactional environment[12] assumed in classical

---

eign loan agreements, and is thus an expansion upon Gottlieb's brief and more general treatment of debt. *See id.* at 569-73. The Comment will more fully describe the sovereign loan issue in relational contract terms, and will offer a practical analysis of legal practice in the field based on theory. The reassessment which this Comment undertakes is justified by the many changes which have occurred in the field since 1983, when Gottlieb's article appeared. These factors include continued illiquidity of the borrowers, the failure of a "debtor's cartel" to become a serious actor on the international scene, the growth of a secondary market for sovereign debt, the establishment of reserves and the taking write-offs of developing country debt by banks, and the innovative restructuring terms seen in the Mexican, and other, restructurings.

5 *See generally* Hope & Klein, *Issues in External Debt Management*, in 2 INTERNATIONAL BORROWING: NEGOTIATION AND RENEGOTIATION 4.A (D. Bradlow & W. Jourdin rev. eds. 1984)[hereinafter INTERNATIONAL BORROWING].

6 *See generally* SOVEREIGN BORROWERS: GUIDELINES ON LEGAL NEGOTIATIONS WITH COMMERCIAL LENDERS (L. Kaldereń & Q. Siddiqi eds. 1984)[hereinafter SOVEREIGN BORROWERS].

7 For a survey of relational contract thinking, see Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483 [hereinafter *Relational Contract*].

8 *See infra* notes 11-46 and accompanying text.

9 *See infra* notes 47-101 and accompanying text.

10 *See infra* notes 102-67 and accompanying text. The basic form for this analysis was suggested in Joerges, *Relational Contract Theory in a Comparative Perspective: Tensions Between Contract and Antitrust Law Principles in the Assessment of Contract Relations Between Automobile Manufacturers and Their Dealers in Germany*, 1985 WIS. L. REV. 581, 603.

11 Macneil, *Contracts: Adjustment of Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854, 856-57 (1978)[hereinafter *Adjustment of Relations*].

12 "A *truly* discrete exchange transaction would be entirely separate not only from all other present relations but from all past and future relations as well." *Id.* at 856. "Discreteness is lost even

and neoclassical contractual theory.[13] "[R]elational contracts emerge in

in the simple promise situation, because a basis for trust must exist if the promise is to be of any value." *Id.* at 858. Thus, few if any exchanges are isolated transactions, free from relational principles.

An example of a relatively discrete transaction is buying gas on an interstate highway. *Id.* at 857. An example of a highly relational contract is marriage or a franchise agreement, where the parties are bound by mutual interests created through their long-term association.

[13] Different degrees of discreteness (i.e., levels of interaction of the parties outside the contractual exchange) are assumed in different theories of contract law. These conceptions differ due to the legal and social complexity of a particular society. The rejection of the discretely based contract systems (classical and neoclassical theory) by relational contract theory is a radical departure from the doctrine found in most law schools and treatises. *See* Macaulay, *supra* note 4; Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1985 WIS. L. REV. 565.

The differences in the three distinct contractual doctrines—classical, neoclassical, and relational theories—exist on a continuum best illustrated as they developed in United States law:

> Classical contract law refers (in American terms) to that developed in the 19th century and brought to its pinnacle by Samuel Williston in *The Law of Contracts* and in the *Restatement of Contracts*. Neoclassical contract law refers to a body of contract law founded on that system in overall structure but considerably modified in some, although by no means all, of its detail. The latter is epitomized by the U.C.C. Art. 2 (1972), and RESTATEMENT (SECOND) OF CONTRACTS (1981).

Macneil, *Adjustment of Relations*, *supra* note 11, at 855 n.2 (citations omitted). For a more developed comment on the doctrinal development of contract law, see E. MURPHY & R. SPEIDEL, STUDIES OF CONTRACT LAW 84-91 (3d ed. 1984).

The structure and strict formality of classical contract law encourages discrete transactions in order to preserve the parties' autonomy outside the contract and provide explicit details for planning by the parties. Macneil, *Adjustment of Relations*, *supra* note 11, at 859-61. Flexibility within the contract is sacrificed to the planning aspect of contract through "presentiation" of future contingencies within the formal contract. *Id. See also* Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589 (1974). Law based on classical doctrine does this by ignoring the identity of the parties, limiting interpretation of the agreement to the "four corners" of the contract, and drawing clear and explicit rules of interpretation for those contracts. *See* Macneil, *Adjustment of Relations*, *supra* note 11, at 863-64. Under a classical system, "contract litigation is a primary means of deterring breach and directly and indirectly resolving disputes. Without contract law and the state's monopoly of the legitimate use of force, performance of contracts would be highly uncertain." Macaulay, *supra* note 4, at 467. Flexibility in commercial relations is provided for by the marketplace to which the subjects of classical law have easy access outside the distinct terms of the contract. Macneil, *Adjustment of Relations*, *supra* note 11, at 859-60.

The doctrinal shift from classical to neo-classical contractual theory better accounts for the interests of parties engaged in long-term contractual relations. Those interests include the need to create flexibility and standards in an agreement with explicit terms which may not adequately address future problems. *Id.* at 865. Neoclassical techniques such as third-party standards, cost-of-service clauses, and other gap-filling provisions allow the parties to interpret legal duties during contractual performance through use of objective standards and principled behavior. Another development of neoclassical doctrine is the interpretation of contracts to reflect the fairness which should hold between the parties in the form of mutuality, materiality, and good faith requirements. *Id.* at 880-83.

Though neoclassical systems are more efficient than classical doctrine in addressing the needs of ongoing exchange, parties still suffer from the inherent discreteness which the classical structure forces upon the contracting parties. *Id.* at 866-73. Explicit planning of the parties still governs the transaction unless subsequent agreement allows a different interpretation of the contract. *Id.* at 873-80.

the context of ongoing relationships."[14] In relational contracts, discrete practices, like breach and litigation, have been replaced by adjustment within social and political processes largely separate from the positive legal institutions of the state.[15] The conduct of relational contracts only roughly corresponds to the legal doctrine taught in United States law schools. Instead,

> [t]he source of juridical norms in a relational order is to be found in agreements, arrangements, and other patterns of interaction between the parties. The pronouncements of the courts of the State and the laws of the other branches of governments may purport to govern a relational order formally subject to the State, but they are not sources of law *in* such relationships; they are external to them.[16]

While the foundations of this "internal law" in long-term relations are the contracts drafted between the parties, the internal rules of relational contracts often ignore or modify the technical terms of the formal contract. Despite the potential for irrelevance, written contracts may act "as constitutions establishing legislative and administrative processes for the relation,"[17] with the actual relationship between the parties forming around the rights and purposes expressed in the document. In analyzing such contractual exchanges, the "relational approach focuses on time—on the temporal dimension of relationships. Emphasis on discrete transactions abstracted from the ongoing relationships in which they occur distorts the character of the transactions and of the relationships themselves."[18] Lawyers confronting relational contracts should examine how

---

14 Whitford, *Ian Macneil's Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545, 546.

15 Macneil, *Adjustment of Relations*, *supra* note 11, at 901. Examples of relational contract range from two businesspersons with a long-standing relationship (prone to ignore the forms and contracts which probably comprise the legal substance of their relationship), to commodities and stock exchanges, where bids and buys are probably not legally enforceable in court (since they are largely unwritten, and thus would fall outside the U.C.C.'s statute of frauds, U.C.C. § 2-201), but where few breaches of "contracts" ever occur.

16 Gottlieb, *supra* note 4, at 595. Litigation is largely irrelevant in relational contracts:

> The dominant aspect of juridical activities in relational societies is not of a litigious character. It centers instead on the practices of actors and on their usages, customs, and interpretations that mediate between actors' actual patterns of conduct and the formal juridical instruments that are deemed to govern them. It focuses also on the negotiation and renegotiation of juridical instruments accepted as binding.

Id. at 568.

17 Macneil, *Adjustment of Relations*, *supra* note 11, at 894. There are three justifications for exploring the relational aspect of contract:

> First, one might regard relational transactions as giving rise to obligations different from those (promissory) ones that arise in discrete transactions. Second, one might argue that, though the law must promote the same policies in relational and discrete transactions, the actual rules adopted must differ to meet the differing social realities. Third, one could maintain that relational contracts give rise to a different set of policies to be promoted than do discrete transactions.

Kornhauser, *The Resurrection of Contract* (Book Review), 82 COLUM. L. REV. 184, 190 (1982).

18 Gottlieb, *supra* note 4, at 569.

the actual behavior of the parties has deviated from the formal rules of the written contract.

Given the distortion of conventional thinking[19] when applied to relational contracts, adjudication of relational contract disputes is problematic.[20] Moreover, description of relational contracts in conventional terms is inadequate.[21] It is this relational gap—this "discontinuity between doctrine and law-in-action"[22]—which constitutes the major legal challenge relationists pose to conventional contract practice.

Two possible normative insights occur to the lawyer when this relational dilemma is posed: 1) that clients should act with the recognition that ongoing relations cannot fully be governed by conventional contract law (the behavioral norm);[23] and 2) that reform of legal theory is necessary for effective drafting of relational contracts (the legal norm).[24] Thus, both conventional practice and theory should be critically analyzed when approaching relational contracts.

This Comment suggests that this relational dilemma exists in sovereign loan agreements.[25] The resolution of this dilemma requires a combination of behavioral and legal changes which should lead to a revised model for the drafting of sovereign loan agreements in the future. A conceptual framework is provided which explains recent trends in sovereign debt management. While detailed suggestions for change cannot be provided by this Comment, trends and principles will be set forth on which legal approaches to drafting loan contracts can be based.

A. A Functional Model of Relational Contract

A functional model of relational contract must assess the proce-

---

19 Classical and neoclassical contract law systems are labelled "conventional" throughout this Comment.

20 *See* ALCOA v. Essex Group, Inc., 499 F. Supp. 53 (W.D. Pa. 1980)(where a court reformed a 20-year aluminum conversion contract based on mutual mistake of the parties in basing the price of services and aluminum on an index which did not include fuel prices, which skyrocketed in 1973); *see also* Goldberg, *Price Adjustments in Long-Term Contracts*, 1985 WIS. L. REV. 527, 534-40 (criticizing the ALCOA decision because of its failure to consider opportunity costs in determinations and the court's seeming ignorance of the purpose of long-term contracts).

21 The concept of a legal system centered on the State and its officials cannot account for the juridical system of relational societies. The circumstances under which a juridical system can be said to arise in a relational society must be identified in terms other than those of the legal system of the State.

Gottlieb, *supra* note 4, at 569.

22 Gordon, *supra* note 13, at 576.

23 *See* Macneil, *Relational Contract*, *supra* note 7, at 485-90.

24 *See id.* at 491-93.

25 Proof that relational theory applies to the problems of sovereign debt is provided *infra* notes 41-45 and accompanying text. *See also* Gottlieb, *supra* note 4, *passim*.

dures, institutions, and practices which bridge the gap between informal behavior and the formal contract. Since a focus on legal rules and formal contract interpretation is inappropriate in relational contracts,[26] the functional model should suggest behavioral and legal modifications necessary to govern an ongoing relationship between contracting parties effectively.

The invocation of formal terms by parties during the conduct of the relation is the most obvious occasion for conflict between the formal and relational contract. Consequently, the legitimacy of the formal contract is the first step in a functional inquiry into an ongoing relation.[27] Ongoing exchange relations depend primarily on the good will of the parties for their conduct. As a result, the formal contract is often ignored in the parties' practice.[28] The major danger of this tendency to ignore the contract is that principles and terms in the formal contract may intervene in the real conduct of the relation and harm the interests of the parties or others external to the relation (third parties or the state). Formal contract principles "long decayed and made obsolete by less formally established patterns of communications and behavior" may be resurrected to the detriment of the relation.[29]

Delegitimization of the formal contract through the parties' informal behavior may also harm interests embedded in the formal contract. These harms are demonstrated by referring to the internal, external, and relational aspects of rule in a contractual association.[30] Internally, each

---

26 *See supra* notes 11-26 and accompanying text.

27 Legitimacy of a particular contract rests upon the respect given it by the parties and the state: the formal contract (the state's legal recognition of the horizontal commercial relationship) "governs a relationship to the extent that the parties are willing to adopt the law of the state as a rule of conduct or to the extent that the state is able and willing to enforce its law." Gottlieb, *supra* note 4, at 601.

28 "In the words of a businessman, 'You don't read legalistic contract clauses at each other if you ever want to do business again. One doesn't run to lawyers if he wants to stay in business because one must behave decently.' " Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61 (1963).

29 Macneil, *Adjustment of Relations*, *supra* note 11, at 894.

30 Recognition that the positive law of the state is not the only force behind legal rule has long been an accepted tenet of legal theory as well as a cornerstone of relationism. *See* Gottlieb, *supra* note 4, at 602. In addition to this "external" aspect of law attributable to the state or community outside of the contract is the "internal" force arising from an individual's self-interest, morality, and psychology. *See, e.g.*, H.L.A. HART, THE CONCEPT OF LAW 85-86 (1961). In addition, in a relational contract a rule's vitality exists due to neither internal nor external interests, but relational: "there is also an awareness that a breach of certain patterns of behavior may be interpreted by another party as indicating a change in the relationship." Gottlieb, *supra* note 4, at 574. Thus, parties to a relational contract consider not only external and internal rules in performance, but also reactions of the other contracting parties, which will translate into additional obligations based on each person's perceptions of others' actions and interests.

party holds interests in the formal contract regardless of whether litigation is ever foreseen or intended.[31] The major internal interests are those which are protected by the formalized obligations of the contract. This formalization is a choice by the parties to enter into a legally binding agreement, rather than an open-ended or informal one, with the additional assurances which the formal legal system provides to its subjects.[32] Practices which undermine the contract's formal obligations may discount the internal interests protected by these terms, and may also discount the compulsion each party feels towards the relation overall. This may cause "considerable uncertainty and ambiguity" regarding the "extent of the binding obligations of the parties."[33] As a result: 1) the remedies available under the formal contract to protect these interests may seem coercive to one of the parties; 2) the remedies available under the contract may be ineffective; or 3) the interests of the parties themselves will be harmed.

On the relational level, as the formal contract is delegitimized, ad hoc procedures develop which may lead to conflicting interpretations and breakdown of the reciprocity needed for an effective relation.[34] In addition, negotiation or evolution of the informal rules may lead to adversarial stances between the parties which harm the relation through a breakdown of the reciprocity originally formalized in the contract. The informal rules which develop may also be ineffective in promoting the parties' interests, since no recourse to the formal contract will be possible to enforce such rules.

Finally, external interests of third parties or the state in the formal terms of the contract must be considered in the context of formal contract legitimacy. There are two levels of such external interests. The first is society's interest in general formal contract principles, which are undermined to the extent the parties ignore the formal contract during performance. Examples of this interest include principles of mutuality and unconscionability, which are enforced by the courts only after the parties request intervention through litigation.[35]

Specific external interests may also be harmed, however, when

---

31 This interest is promoted only to the extent a party perceives its interest is represented by the contract.

32 *See* Gottlieb, *supra* note 4, at 583-85.

33 *Id.* at 607.

34 "If one party acquiesces to the practice of another's interpretation . . . patterns of expectation develop and the new performance will comprise part of the "price" of the contract for future operation of the relation." Goldberg, *supra* note 20, at 532.

35 It is interesting to note that this interest is primarily an aid to contracting parties, and has only an indirect benefit to society as a whole. For example, the rule against unconscionable contracts will act primarily to protect a particular contracting party, but its enforcement throughout

"[t]he rights and interests of third parties [are] adversely affected by a course of dealing between parties to an ongoing relationship."[36] This would occur where specific legislation exists which restricts or regulates a particular type of contractual relationship.[37] Legislation or similar coercive action[38] may not be effective in enforcing the policy when the formal contract is undermined by informal action. Thus, the government policy will be harmed. Finally, external actors may be able to protect their interests through litigation[39] or social pressure apart from the mechanisms of government.

The dangers of illegitimacy of the formal contract promoted by informal behavior leads to the primary principle of a functional model of relational contract: the formal contract should not be undermined by the parties' practice unnecessarily. Where the legitimacy is undermined, an inquiry into the actual harms must be undertaken to gauge whether formal modification to conform the contract to practice might be more effective in controlling the contract. Even if the danger from erosion of the formal contract's legitimacy is marginal, however, the relation must still be conducted in a "relationally effective" manner[40] in order to be consid-

---

society reflects society's choice to prevent such contracts because they are regarded as harmful to society as a whole.

36 Gottlieb, *supra* note 4, at 607.

37 For instance, state and federal corporate law regulates the corporation's business activity in the United States, which is, after all, only a complex organism constructed of a myriad of contractual exchanges within its corporate structure. When derogations from the basic documents of the corporation occur, more likely than not legislated interests of the state or nation will also be harmed.

38 *See* Gottlieb, *supra* note 4, at 609.

39 As third party beneficiaries or creditors, perhaps, or as plaintiffs under legislation allowing parties to act as "private attorneys general."

40 An ideal relation allows behavior and law to interact in a matter consistent with the twin norms of relational exchange—*preservation* of the relation and *harmonization* of conflicting interests within the association. Macneil, *Adjustment of Relations*, *supra* note 11, at 886. Application of the second functional inquiry asks whether such preservation and harmonization is occurring equitably and efficiently. *See* Whitford, *supra* note 14, at 550-51. This is in contrast to the approach of neoclassical contract, which asks only whether one party is better off and no party is worse off. *Compare* Posner, *Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980)(advancing a wealth-maximizing view of ethics and the law) *with* Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 NW. U.L. REV. 1018 (1981)(critiquing the neoclassical economist's view of contract and proposing more detailed contractual principles)[hereinafter *Rich Classificatory Apparatus*].

The "effectiveness" of relational orders was first referred to by Gottlieb in terms largely concerned with how rules restricted parties' freedom within the relation. Gottlieb, *supra* note 4, at 569-74. His examination of relationism's power to rule, therefore, is really more a study of the efficacy of relational rules than of the effectiveness of the relation itself. Relational effectiveness in this Comment has a more normative character, and primarily questions whether the relational level functions as a fair and cost-beneficial method of exchange between the parties within an exchange relation capable of continuing towards a mutual objective. Should the relation proceed without considering

ered a proper contractual relation. Thus, once the functional inquiry into formal legitimacy has ended, the model should focus upon the effectiveness of the informal behavior in the relation. From a drafting standpoint, a contract with good "relational fit" promotes effective adjustment to change in the relation, yet remains honest to the interests in the formal contract.

B. Preface to Application of the Model

The overriding fact of sovereign lending in the modern world is that the well-being of international banking is now tied to the domestic economies of developing country debtors through an interdependent world economy.[41] It is this realization which makes the sovereign loan restructuring one of the grandest relational exchanges in the contract universe. Within the current restructuring regime, the adjustments between the sovereign and its creditors affect deep internal interests of the parties (financial interests of the creditors and national interests of the sovereign), as well as external interests of the international political economy.[42] Because "no agreement captures the full texture of [such a] relationship,"[43] serious questions about the effectiveness and legitimacy of the contract arise.

Armed with a basic conception of a functional/relational contract, the model will be applied to a generic sovereign loan agreement to judge whether the written contract properly performs the purposes of contract: 1) fostering reciprocity through exchange; and 2) effectuating planning and performance.[44] Exchange and reciprocity compose the social and economic bases for contract; planning and performance are the mechanical foundations. Application of the functional/relational theory to the contract's substantive and procedural components will demonstrate how the actions of the parties in the "dirty" behavioral world[45] of restructuring recognize the nature of the exchange as "relational" in conduct while many of the legal norms of relational contract are ignored in conven-

---

questions of equity, there is little chance horizontal relations can continue when one party is subject to what it perceives as unfair duties of performance. The interest in efficiency is obvious, considering the nature of commercial exchange as a vehicle of mutual profit.

41 Gottlieb, *supra* note 4, at 570-73.

42 For a sophisticated taxonomy of external interests in contract, see Macneil, *Values in Contract: Internal and External*, 78 NW. U.L. REV. 340, 367-82 (1983)[hereinafter *Values*].

43 Kornhauser, *supra* note 17, at 190.

44 These objectives are distilled from I. MACNEIL, CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS, CASES AND MATERIALS 1-57 (2d ed. 1978)[hereinafter CASEBOOK]; Macneil, *Adjustment of Relations*, *supra* note 11, at 862.

45 Macaulay, *supra* note 4, at 577-80.

tional drafting and adversarial negotiation.[46]

III. A HYPOTHETICAL SOVEREIGN LOAN RELATION

To apply the functional model to sovereign debt instructively, a hypothetical transaction involving a debtor, creditors, and a loan agreement will be presented.[47] The debtor for this example[48] ("Debtor") is a medium-size developing country[49] with substantial debt secured by government guarantee and held by a syndicate of developing country banks.[50] Debtor's loans were previously restructured after default upon its initial set of obligations: interest and principal payments were rescheduled and a package of "new money" extended by creditor banks to quell the temporary illiquidity which threatened default.[51]

Debtor's political situation is a volatile one. The government is dependent upon economic concessions gained from creditors in restructuring and the fortunes of the world economy to meet the social and economic demands of its citizenry.[52] Payment of the external debt is

---

46 For example, while the terms of default within the sovereign loan agreement appear relatively strict and discrete, *see infra* note 66, the reality of restructuring demands that the sovereign and its creditors negotiate with each other through an indeterminate cycle of default and rescheduling.

47 This hypothetical debt relationship strives for a minimum level of description in order to have general applicability to all sovereign loans.

48 Represented by its Ministry of Finance in negotiations and performance. *See* Heckart, *The Process of Rescheduling Sovereign Debt to Bank Creditors*, in 2 INTERNATIONAL BORROWING, *supra* note 5, at 7.1A.1, 7.

49 Debtor has a total of $20 billion in debt to international banks, placing it near the middle of the spectrum of troubled debtors. As of June 1987, Mexico and Brazil each owed around $75 billion to private banks, Argentina $30 billion, Venezuela $26 billion, and the Philippines $14 billion. Wall St. J., July 2, 1987.

50 On the distinction between public (sovereign) and private sector debt, one author has written:

> Restructuring private sector debt has generally been a separate and distinct exercise from restructuring sovereign or public sector debt. One basic is the legal framework. The restructure of private sector debt is ultimately subject to the supervision of a bankruptcy or reorganization court in one or more countries, in the absence of contractual agreement between debtor and creditors. However, there are no bankruptcy or reorganization laws clearly applicable to sovereign or public sector debt, and restructure of public sector debt occurs outside the courtroom and only when debtor and creditors record their mutual agreement by contract. Nevertheless, the basic question is always the same: who pays, lends or defers payment of how much, when and at what price?

Mudge, *Restructuring Private & Public Sector Debt*, 20 INT'L LAW. 847, 848 (1986).

51 The debt crisis has traditionally been thought of in terms of trans-border transfer risk (lack of foreign currency to pay foreign-denominated obligations) as opposed to solvency risk (lack of economic capability to satisfy external obligations). *See, e.g.*, W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 45; *but see* D. LOMAX, *supra* note 3, at 62 (arguing that insolvency of a sovereign might be possible). *See generally* Walter, *Country Risk and International Bank Lending*, 1982 U. ILL. L. REV. 71, 80-83.

52 This is particularly true in Latin America where the most grievous debt exists and where democracy has shown the most growth. *See, e.g., Brazil's Debts Now Carry a Political Price for President*, N. Y. Times, Feb. 22, 1987, § 5 (Week in Review), at 3, col. 4. *See generally* Bloch, *Society and Business after the Great Reschedulings: A Futuristic Essay*, 38 J. INT'L AFF. 91 (1984);

financed by export earnings from Debtor's domestically produced goods, which compete with other nations' wares on the international market. In addition, world interest rates dictate at what rate the loans must be paid back, adding or subtracting millions to the flexible payments when those rates fluctuate.[53] Thus, when Debtor bargains within a restructuring, it is projecting into the future of an unpredictable world economy on which it is dependent, as are its creditors.

The banks holding Debtor's restructured loans are large, medium, and small banks[54] bound together by a variety of contractual, political, and economic bonds.[55] Any action modifying the loan agreement, declaring default, waiving acceleration, or restructuring the debt comes only after "democratic" deliberations by all the creditors through the vehicle of the creditor committee.[56] Also included in the restructuring are secondary holders of debt who have purchased an original creditor's debt at a discounted rate, reflecting the decreased value of restructured loans.[57] In the event of default and acceleration of the loan, recovery by individual banks is pro rata on the basis of exposure in the syndicated

---

Walter, *supra* note 51, at 79. Indeed, as loan restructurings have required fiscal austerity from developing country debtors under International Monetary Fund ("IMF") conditionality, the political climate has often given default a popular appeal. *See Brazilian Debt Crisis Flares Again*, N. Y. Times, Feb. 16, 1987, at 19, col. 3 (nat'l ed.); *Mexico Signals It Wants Debt Concessions*, Wall St. J., Oct. 6, 1986, at 21, col. 1 (nat'l ed.); *Peru Defiant After IMF Acts to Deny New Credit*, Fin. Times, Aug. 18, 1986, at 1, col. 3 (int'l ed.); *see also* Bloch, *supra*, at 93-95 (discussing socio-economic future of debtor nations); *Debt Crisis Is Inflicting a Heavy Human Toll in Dominican Republic*, Wall St. J., Aug. 20, 1987, at 1, col. 6 (describing the poverty and tragedy which comes with large sovereign loans and mismanagement of funds).

53 On Debtor's debt of $25 billion, for example, a rise in the London interbank offered rate ("LIBOR")(a base interest rate for many sovereign loans) of even five basis points will add $200 million to its annual interest payments.

54 For the purposes of this hypothetical, all creditor banks are United States institutions.

55 *See generally* Semkow, *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks*, 18 INT'L LAW. 869 (1984). The political and economic bonds are those implicit in the United States regulatory system and economy. *See infra* notes 82-101 and accompanying text. The contractual bonds take the form of loan syndication, a common practice in modern international banking.

56 This requires a majority of the lenders' vote, calculated on amount of participation in the debt. Wood, *Selected Aspects of International Loan Documentation and Rescheduling*, in SOVEREIGN BORROWERS, *supra* note 6, at 123, 129. Sometimes one bank holds enough debt of a particular country to dominate the loan's restructuring. *See, e.g., Talks on Philippine Debt Collapse*, N.Y. Times, Nov. 8, 1986, at 17, col. 3 (nat'l ed.)("Every time a vote was taken or an issue brought to the table, one institution reserved their [sic] position or objected . . . ." It was rumored that Citibank, holding half of $3.6 billion being renegotiated, was the holdout.).

57 These secondary holders are subject to the same obligations as original lenders. Unfortunately, as a practical matter the secondary holders are difficult to track down. *See Worries Deepen Again on Third World Debt As Brazil Stops Paying*, Wall St. J., Mar. 3, 1987, at 1, col. 6 (banks fruitlessly searched for the secondary holder of Republic Bank's debt after Republic refused to commit new funds, arguing its original exposure was no longer relevant)[hereinafter *Worries Deepen*]. These secondary holders tend to be banks with exposure in other debtor nations seeking to diversify

loan.[58]

The loan agreement is the legal document purporting to rule the debt relation between Debtor and its creditors.[59] After restructuring, the financial terms of the loan are rescheduled, with interest and principal payments spread out over a longer period than in the original loan.[60] Interest is set at a slight premium above the previous rate to reflect the involuntary nature of this new loan.[61]

The agreement's legal terms are the first object of the functional-relational approach to sovereign debt.[62] Such technical terms are left for lawyers to draft after the financial issues—such as interest and duration of the loan—have been settled between Debtor and its creditors.[63] There are two types of legal terms. Operational clauses dictate payment procedure, conditions precedent to drawdown, and other mechanical aspects of the loan.[64] These procedural aspects of the loan contract will affect the nature of the restructuring process when default threatens, as well as how efficiently the loan is managed before illiquidity strikes.[65]

Protective clauses assure the lenders a secure borrower.[66] These

---

or consolidate their international debt portfolios through swap or purchase. *See* INT'L FIN. L. REV., Feb. 1986, at 17.

58 Wood, *supra* note 56, at 134. Despite domination by larger creditors, action by the syndicate during restructuring takes on a highly representative character, including selection of the lead bank and steering committee based on relative levels of exposure and geographical balance. *Id.* at 129-30.

59 For a sample loan agreement between a sovereign and a syndicate of commercial banks, see Cleary, Gottlieb, Steen & Hamilton, *Annotated Sample Loan Agreement* [hereinafter *Sample Loan*], in 2 INTERNATIONAL BORROWING, *supra* note 5, at 5.2C.1. *See generally* Kaldereń, *Negotiating Strategies and the Role of the Lawyer*, in SOVEREIGN BORROWERS, *supra* note 6, at 26.

60 Financial terms are typically rescheduled using the "short-leash" approach. Such a strategy reschedules only a proportion of the payments in arrears plus payments falling due over the six to eighteen months following a cut-off date. Wood, *supra* note 56, at 135.

61 *See* Siddiqi, *Some Critical Issues in Negotiations and Legal Drafting*, in SOVEREIGN BORROWERS, *supra* note 6, at 44, 61. The use of such a penalty is not universal—creditors have begun to concede the penal nature of the interest premium is inappropriate in an extended restructuring relationship. *See Mexico Lenders Agree to Join Rescue Package*, Wall St. J., Oct. 1, 1986, at 31, col. 1 (nat'l ed.).

62 While the sheer volume and long maturity of the loan initially make relational contract theory applicable to sovereign debt due to the ongoing nature of the relation, the legal aspect determines how relationally functional the loan contract is. *See supra* notes 26-46 and accompanying text.

63 *See* Siddiqi, *supra* note 61, at 45-46.

64 *See id.* at 48, 52.

65 *See infra* notes 135-50 and accompanying text.

66 *See* Sample Loan, *supra* note 59, §§ 8-11 (examples of typical protective clauses). *See generally* Siddiqi, *supra* note 61, at 55-66. Protective clauses include: the borrower's representations and warranties; covenants or undertakings; events of default; and terms governing changed circumstances. A period to cure a violation of these terms is included in the contract.

Representations and warranties of the borrower assure the lender that: documentation conveyed is accurate, the proper governmental and private authority has approved the loan, no legal encumbrances exist which subordinate claims of the lender to other persons (the *pari passu* clause); and

legal clauses get their strength from the remedies for default, allowing acceleration of the loan and set-off of debts against certain assets in the event that a "material" provision in the loan agreement is violated.[67] In principle, interest rates decrease as loan terms become stricter. This lowering of the interest rate reflects the increased security which restrictions on freedom of the sovereign represents, and the decreased risk to the creditor that an unforeseen default will occur.[68]

A. The Restructuring Process

The original loans to various public and private entities in Debtor were extended during a glut of petro-dollar deposits and inflated interest rates which encouraged bank lending in hopes of large profits and pres-

---

other facts which existed at the time of agreement have not materially changed to prejudice the loan's execution. *See Sample Loan, supra* note 59, § 9; *see also* Venkatachari, *The Eurocurrency Loan: Role and Content of the Contract*, in SOVEREIGN BORROWERS, *supra* note 6, at 73, 86-91.

The sovereign's covenants to the lender bind it to: keep the loan consistent with governmental regulations of the borrower's jurisdiction; update documentation of the loan throughout performance; allow inspection; give prompt notice of default; allow no prior claims to that of the lender upon security (the negative pledge); and fulfill other pledges which formally maintain the lender's interest in a secure loan and borrower. *Sample Loan, supra* note 59, § 10. *See also* Venkatachari, *supra*, at 91-94.

Events of default under the loan are conditions which will allow acceleration by the borrower of the remaining payments at will. These include: failure to make a payment; failure to perform a covenant; default on a substantial obligation to another borrower (cross-default); a materially adverse court action; and various others. Sample Loan, *supra* note 59, § 11. *See also* Venkatachari, *supra*, at 95-99.

Changed circumstances enumerate who bears the risk when legal or financial facts surrounding the loan add costs to or otherwise affect successful performance. *See* Venkatachari, *supra* at 99-100.

[67] *See generally* Youard, *Events of Default*, in SOVEREIGN BORROWER, *supra* note 6, at 176. The representations, covenants, and events of default in the loan contract are examples of presentiation. "Presentiation is a way of looking at things in which a person perceives the effect of the future on the present. . . . [T]he presentiation of a transaction involves restricting its expected future effects to those defined in the present, i.e., at the inception of the transaction." Macneil, *Adjustment of Relations, supra* note 11, at 863 [footnotes omitted]. Looked at this way, the protective clauses of the loan agreement are presentiated versions of what might go wrong in the loan relation and thus serve a planning and communication role, aside from their obvious purpose as protectors. Unfortunately, the discrete mindset of drafters makes presentiation little more than a worst-case scenario, with little real effect.

[68] Siddiqi, *supra* note 61, at 61. One additional class of clauses are litigation clauses: the choice of law, choice of forum, and waiver of sovereign immunity which are standard terms in sovereign loan contracts. *E.g., Sample Loan, supra* note 59, § 15. *See generally* Venkatachari, *supra* note 66, at 101-05.

Almost all sovereign loan agreements have stipulated adjudication in New York or London, with New York or English law controlling. This is due to the growing sophistication and specialization of those financial centers as well as the unacceptability of a developing country forum to creditor banks lending to developing country sovereigns. *See* Semkow, *supra* note 55, at 903-911. United States law is used for this hypothetical.

tige.[69] The process of restructuring on a country-by-country basis (ad hoc restructuring[70]) strengthened mutual interests between Debtor and its lenders over time as various private and public loans were consolidated[71] into a huge "involuntary" loan guaranteed by the sovereign.[72] This original consolidated loan has been rescheduled at least once by Debtor and its creditors.

Restructuring begins when large-scale defaults are threatened throughout Debtor, and loans are consolidated through documentation and exchange among the creditors in preparation for negotiation.[73] Both public and private external debts are unified under the guarantees and assumptions of the sovereign during this stage.[74] Flexibility lost to the sovereign by consolidating debt does not outweigh the advantages of having one body of negotiators responsive to the problems of the sovereign.[75]

---

69 *See generally* A. SAMPSON, *supra* note 1, ch. 2. *Compare* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 13-31 *with* Eskridge, *supra* note 3, at 287-306.

70 Ad hoc restructuring remains the most prevalent procedure for the workout of problem sovereign loans. Any attempt at relational analysis must work through this vehicle. *See* Sargen, *Managed Lending: An Assessment of the Current Strategy Toward LDC Debt*, 17 N.Y.U.J. INT'L L. & POL. 533 (1985). Unfortunately such individual treatment promotes "crisis myopia," which directs the banks' and sovereign's attention to solving the short-term liquidity problem, rather than its long-term structural causes. *See* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 73-78. There are other advantages of ad hoc restructuring which make it the preferred vehicle for long-term debt management: the ad hoc approach prevented (and prevents) the formation of a "debtors' cartel" by isolating developing countries in their own financial problems and allowing separate but unequal treatment by lenders. "[B]y the end of 1984 . . . there was no longer a global debt crisis but a series of different debt situations." D. LOMAX, *supra* note 3, at 150. This differentiation has widened with the rise of secondary markets for sovereign debt. *See supra* note 57.

Ad hoc adjustment (rather than an international or regional approach) also instills greater confidence in the world capital markets, since failure of a particular restructuring or reform can be isolated to that particular country's debt. This is a luxury international proposals do not have by nature of their scope. *Cf.* F. BERGSTEN, W. CLINE & J. WILLIAMSON, BANK LENDING TO DEVELOPING COUNTRIES: THE POLICY ALTERNATIVES 93-199 (1985)(summarizing proposals for international debt relief).

71 *See infra* notes 74-77 and accompanying text. *See generally* Mudge, *supra* note 50.

72 *See* Semkow, *supra* note 55, at 875-84. The loan is involuntary because the lender has no choice but to refinance the credit in hopes funds will be available in the future to pay off the debt. Without ample cash reserves to absorb the blow of non-performing status, *see infra* notes 85-86 and accompanying text, no lender can afford *not* to provide a loan to help pay the huge interest payments.

73 *See* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 73-78.

74 "[L]inkage between private sector debt and public sector debt is [one way of] combining both for the purpose of the new money request by the country, frequently with the endorsement of the International Monetary Fund and bank regulators." Mudge, *supra* note 50, at 851. Another technique is assumption or guaranty of old private debt by the sovereign through a governmental arm or subsidiary corporation. *Id.* A third method is "onlending" of funds, where a loan is extended to a public sector entity with the contractual understanding that a third-party private sector borrower will receive the proceeds of the loan in domestic currency. *Id.* at 854.

75 Consolidation assures the creditors that their loans will be treated on an equal footing and allows them to focus on the problem of satisfying all debt, thus avoiding a "race" among the credi-

Unifying debt also allows peer pressure among banks to keep smaller creditors in a renegotiating posture when default by individual obligees in Debtor threatens; costly litigation and attachment of sovereign assets in an unsure legal environment are thus avoided.[76] There are disadvantages to consolidation, however, since it allows the terms of a new loan to be tied to overall performance of the national economy,[77] and makes Debtor directly answerable for all citizens and subjects whose debt has been consolidated.

The most painful aspect of restructuring for the creditors is the "new money" obligation of each bank proportional to its original exposure in Debtor.[78] Force for this obligation comes internally (from other creditors), relationally (through the threat of default from Debtor), and externally (through the United States regulatory system). The new money is used to preserve bank profits through refinancing of interest payments in arrears,[79] and to spark economic growth in the debtor nation.[80] After the terms of the restructuring are settled, it is then offered

---

tors for attachment which would occur in absence of consolidation. *See generally* Clark, *Sovereign Debt Restructurings: Parity of Treatment Between Equivalent Creditors in Relation to Comparable Debts*, 20 INT'L LAW. 857 (1986). The advisory committee can then conveniently negotiate a restructuring agreement with the sovereign, which guarantees all or most of the country's external debt. This policy flexibility is crucial considering the national and international problems which brought on the liquidity crisis.

76 Another aspect of this debt consolidation is coercion of the sovereign short of accelerating the whole debt. The presence of smaller creditors preserves the potential threat of "renegade" legal actions upon smaller pieces of external debt which are held by the relatively less exposed creditor banks. *Cf.* Brown, *How to be Paid on a Defaulting Loan*, INT'L FIN. L. REV., Apr. 1983, at 10. Suit by any creditor triggers the cross-default clause and allows set-off of assets of the sovereign to facilitate judgment.

77 With IMF conditionality being incorporated into the contract, the sovereign is often faced with austerity imposed at the hands of its commercial creditors. This severely limits the sovereign's freedom-of-action and autonomy, and suggests a legal argument based upon the public international law doctrine of odious debt. *Compare* Frankenberg & Knieper, *Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, 12 INT'L J. SOC. L. 415 (1984) *with* Hoeflich, *Through a Glass Darkly: Reflections Upon the History of the International Law of Public Debt in Connection with State Succession*, 1982 U. ILL. L. REV. 39. *Cf. Sudan's Leader Says Nation Won't Pay All Foreign Debt*, N.Y. Times, Oct. 8, 1986, at A10, col. 3 (blaming foreign debt on predecessor's "unconstitutional regime"). *See generally supra* note 65.

78 Semkow, *supra* note 55, at 893-94. In recent restructurings, the new money obligations have led many banks to refuse to join negotiated packages. *See* W. CLINE, MOBILIZING BANK LENDING TO DEBTOR COUNTRIES 5-6 (1987)(stating that, according to the Mexican government, 139 banks out of a possible 494 failed to sign on to Mexico's September 1986 restructuring package)[hereinafter MOBILIZING].

79 *See* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 74-78.

80 This aspect of new money is doubly important in the wake of the Baker Plan, a policy initiated by Secretary of the Treasury James Baker to deal with developing country debt. *See Baker Debt Plan Is Alive, but Is It Well?*, Wall St. J., Sept. 26, 1986, at 22, col. 1 (nat'l ed.). The Baker Plan's focus is on coordinated economic development, aided by injections of new capital from international sources to power the developing country out of the debt crisis. The establishment of large-scale

to and accepted by creditor banks.[81] Significant resources and coercion within and without the relation are wielded before the restructuring agreement is agreed to, however. It is clear that recent write-offs and reserve additions by creditor banks in the United States have increased the possibility that restructurings may not be as widely subscribed to as in the past.

B. The Regulatory System

The primary external force in the sovereign loan relation is the federal regulatory system,[82] which undercuts formal contract law[83] and intervenes in the informal system of sovereign debt restructuring in two ways. The more apparent manner is through the accounting, reporting, and reserve requirements of the banking laws in general and the International Lending Supervision Act of 1983[84] ("ILSA" or "Act") in particu-

---

reserves by major creditor banks has been interpreted by some to ring the death knell for the Baker Plan. *See Death of 'Baker Plan' on Debt Seen*, N.Y. Times, May 26, 1987, at D1, col. 3 ($3 billion reserve established by Citicorp is the "coup de grace" for the floundering Baker Plan). *But see Citicorp's Reed Outlines Path on Third World Loans*, Wall St. J., May 28, 1987, at 6, col. 1, col. 4 (asserting that the Baker initiative is not dead because the three basic prongs of its strategy—growth-oriented adjustment, structural adjustment, and new bank money—are still valid and necessary)[hereinafter *Citicorp's Reed*].

81 Semkow, *supra* note 55, at 899.

82 The United States banking system is regulated by the overlapping jurisdictions of the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("Comptroller" or "OCC"), and the Federal Deposit Insurance Corporation ("FDIC"). *See* Friesen, *The Regulation of International Lending: Part I*, 19 INT'L LAW. 1059, 1068-70 (1985). This structure oversees reserve and lending guidelines of the federal banking law which affects member banks of the Federal Reserve System, nationally-chartered banks, and federally insured state banks.

The complex United States regulatory system is interesting because despite the detail of its rules, the discretion of the regulators has left much flexibility in the system.

> A number of commentators have referred to the "formal and legalistic character" of banking regulation and supervision in the United States. . . . It is commonly acknowledged that a complex regulatory structure has helped to insulate the banking system from "executive interference and discretion." . . . But a corollary has been the development of equally elaborate means of circumventing rules and regulations not desired by commercial banks.

Id. at 1068 n.42 [citations omitted]. This circumvention, whatever the cause, is quite important in the sovereign debt context. *See infra* notes 87-95 and accompanying text.

The existence of banks falling outside the OCC's, the FRB's, and the FDIC's regulatory gaze will not be addressed in this Comment. "Only a handful of state-chartered nonmember noninsured banks are in existence, and they are not significant lenders." Friesen, *supra*, at 1069 (citing Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 3 (1977)).

83 Reference to contract law here refers not only to the legal system which would come into play during litigation, but the assumption of the freedom to contract and terminate contracts implicit in discrete conceptions of commercial association which the loan agreement implicates by its harsh and discrete wording. *See supra* notes 11-25 and accompanying text.

84 The International Lending Supervision Act of 1983 ("ILSA"), 12 U.S.C. § 3901 *et seq.* (Supp. IV 1986). The regulations implementing ILSA are found at 12 C.F.R. §§ 20.6-.10 (1987)(OCC regulations governing nationally-chartered banks); 12 C.F.R. §§ 211.41-.45 (1987)(governing Federal Reserve System banks under the supervision of the FRB); 12 C.F.R. §§ 351.1-.3 (1987)(FDIC regu-

lar. The second, more active form (though rarely documented) is through the brokering, encouragement, and management of particular restructurings through the regulator's informal, discretionary oversight role. Therefore, both formal and informal regulation act as an external force in the sovereign debt relation.

From the accounting standpoint, clarifications of ambiguities in the accounting rules since the beginning of the debt crisis now require that interest due cannot be accounted as paid on if more than ninety days overdue.[85] Banks must confront missed loan payments under the formal loan agreement sooner because of the requirement that they place such overdue loans on "nonaccrual" status.[86] This tightening of accounting procedures is only part of the accounting process, as the valuation of the loans themselves remains largely intact under regulation of the federal agencies and private auditors, despite a true market value below the original amount of the loan.

Under ILSA, federal regulators were given additional oversight mandates and power to require special reserves when long-term problems in a debtor country were present.[87] Despite the purpose of the Act to compel banks to acknowledge past lending practices,[88] however, the myopic practice of preserving interest profits through reschedulings remained intact under administration of the law.

Bank regulators, through the Interagency Country Exposure Review Committee ("ICERC"),[89] periodically evaluate the debt situations

---

lations governing federally insured state banks). *See generally* Lichenstein, *The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983*, 25 VA. J. INT'L L. 401 (1985); Friesen, *supra* note 82, at 1068-85.

85 Under previous practice, the 90-day limit for accounting of interest on loans was "bent" by banks so that overdue interest could often be accounted as earnings. *See* Friesen, *supra* note 82, at 1071 n.53. After clarification, the accounting status of the interest was tightened, and the need to cover outstanding interest on loans in the non-accrual status before a bank's accounting quarter lapsed was made more immediate. *See* Link, *The Value of Bank Assets Subject to Transfer Risk*, 23 COLUM. J. TRANSNAT'L L. 75, 77-78 (1984).

86 "The date on which a loan reaches nonaccrual status is determined by the contractual terms of the loan." *Comptroller and FRB, Joint Policy Statement on Nonaccrual Status of Loans*, Fed. Banking L. Rep. (CCH) ¶ 86,017 (June 11, 1984).

87 12 U.S.C. § 3904.

88 The legislation was passed after congressional complaints against the support of banks which had become overexposed in their cascade of lending during the 1970s and 1980s. As Senator Garn stated: "the price of an $8.4 billion increase in the IMF authorization in Congress is going to be legislation so that lawmakers can go home and report that 'we did not bail out the banks.'" *Rejection of Supervision Plan Clouds Convention*, Fin. Times, Apr. 18, 1983, *quoted in* Freisen, *supra* note 82, at 1070.

89 This committee was created in 1978 and is composed of members of the Comptroller, the FRB, and the FDIC. Friesen, *supra* note 82, at 1079. Information on the operation of this body is difficult to locate. For a rare account of the committee's operations, see *Mystery Surrounds Agenda, Decisions of Foreign Loan Review Committee*, Nat'l J., Sept. 21. 1985, at 2136.

of about twenty countries, in terms of United States lenders. The ICERC country risk examination system consists of:

> (a) identifying countries with actual, imminent and potential debt servicing problems, (b) citing loans to countries with actual or imminent debt problems for the attention of bank management in examination reports, (c) including "special comments" in bank examination reports when loans to countries with potential debt problems exceed certain levels in relation to bank capital, and (d) evaluating the internal systems used by banks to manage country exposures.[90]

The major sanction arising from this review under statute is the requirement of an allocated transfer risk reserve ("ATRR") for "protracted inability" of foreign debtors "to make payment on their external indebtedness"[91] where prospects for an "orderly restoration of debt service" are remote.[92] This regulation has great potential for channeling banks' behavior, depending on how aggressively the regulators implement their appraisal process.[93] Establishing the reserve improves the financial security of the bank by allocating a cushion for the initial damage default would have upon the banks' assets.[94] A bank may also skirt the ATRR requirement by writing off the value of the loan from its books.[95] Either way, the formal contract terms grow increasingly important as

---

90 Friesen, *supra* note 82, at 1079-80.

91 12 C.F.R. §§ 20.8(b)(2)(ii)(1), 211.43(b)(2)(ii)(1), 351.1(b)(2)(ii)(1) (1987). Factors which go into the determination of "protracted inability" include, inter alia, interest payments, compliance with the terms of a restructuring, and failure to comply with an IMF or similar adjustment program.

92 12 C.F.R. §§ 20.8(b)(2)(ii)(2), 211.43(b)(2)(ii)(2), 351.1(b)(2)(ii)(2) (1987).

93 To date, only Zaire, the Sudan, Nicaragua, Poland, Bolivia, and Peru have been placed in the ATRR category. *See Regulator Lists Countries Whose Loans Require Special Reserves at U.S. Banks*, Wall St. J., July 24, 1985; *U.S. Tells Banks with Peru Loans to Set Aside Reserves on Exposure*, Wall St. J., Oct. 29, 1985 (Midwest ed.). Neither Brazil nor Ecuador has been placed in this category yet, despite those countries' moratoriums on external debt payments since 1987. Had the language in the law been drafted more stringently, the regulators would not have the discretion to ignore such protracted inability and unwillingness to pay. One wonders whether such flexibility is necessary. *See infra* note 94. While more informal regulatory methods by the ICERC are said to exist, *see* Friesen, *supra* note 82, at 1080 n.92 (quoting R. DALE, BANK SUPERVISION AROUND THE WORLD 65 (Group of Thirty 1982)), it does not appear that these methods have been any more effective in modifying banks' behavior than the formal statutory powers. *See Citicorp Accepts a Big Loss Linked to Foreign Loans*, N.Y. Times, May 20, 1987, at A1, col. 1 (federal regulators stressing that "Citicorp's decision was strictly on its own.")[hereinafter *Citicorp Accepts Loss*].

94 The relational practice of crisis myopia persisted primarily because Congress gave great discretion to the regulators in their finding of protracted inability. *See* 12 U.S.C. § 3904(a)(1). Since a similar amount of discretion exists in the level of ATRR allocations once the authorities make the necessary findings ("The initial year's provision of the ATRR shall be ten percent of the principal . . . or such greater or lesser percentage determined by the Federal banking agencies." 12 C.F.R. §§ 20.8(b)(2)(ii)(B); 211.43(b)(2)(ii)(B); 351.1(b)(2)(ii)(B) (1987)), perhaps too much discretion was given to the regulators in light of the legislation's intent. The fact that the banking authorities use discretion to skirt a finding of protracted inability rather than reducing the levels of ATRR required of troubled debtors, undercuts the formal contract by leaving the banks to their own regulation.

95 12 C.F.R. §§ 20.8(c)(4), 211.43(c)(4), 351.1(b)(3)(iv) (1987).

banks are forced to recognize the low value of sovereign loans on their books through market pressure and the oversight of private auditors.[96] By requiring a small amount of reserves for only the most indebted of countries, however, and leaving the very finding of necessity for the ATRR completely to the regulators' discretion, ILSA has failed to work many substantive changes in banks' restructuring policies. Instead, the banks reinvigorated the formal obligations of the loan agreement by establishing loan loss reserves themselves.[97]

The reason ad hoc restructuring has been preserved under ILSA may be the great value to the regulators of this flexible process.[98] The post-ILSA regulatory structure maintains the flexibility of the system to react to particular country shocks, rather than demanding that developing country debts be approached in a comprehensive manner. In addition, banks have been given the opportunity to develop innovative financial devices to arrive at restructured loans, without requiring that reserves be applied automatically wherever they might be legally justified.

The second way in which the regulatory system intervenes in restructuring is through informal brokering of a restructuring negotiated by the lead creditor banks. This can be done in several ways, an obvious one being the provision of government funds or guarantees as part of the restructuring package, as in the most recent Mexican restructuring.[99] A less obvious way is through political coaxing of the banks to subscribe to a restructuring package where the incentive for them to participate is low.[100] To overcome this reluctance, the regulatory authorities often use

---

96 *See Auditors Press Banks to Bite Bullet on Foreign Loans*, Wall. St. J., June 8, 1987, at 6, col. 1 (Midwest ed.).

97 *See infra* note 128. The ATRR has thus become a way to impose a minimum level of reserves on banks which refuse to follow the market, rather than the protective device it was originally designed to act as. With the failure of the ICERC to classify Ecuador and Brazil as value-impaired loans, it is obvious the federal regulators are content to leave the banks in the ad hoc restructuring mode.

98 *See* Friesen, *supra* note 82, at 1068 (quoting FRB Chairman Volcker as saying "we already have a process that seems to work").

99 In the Mexico restructuring, government zero-coupon bonds were provided by the United States government to guarantee a portion of the rescheduled debt. *See New Way Offered to Relieve Crisis in 3d World Debt*, N.Y. Times, Dec. 30, 1987, at A1, col. 6 [hereinafter *New Way*].

100 Typically banks are asked to contribute new money proportionate to their "base rate" of debt existing at a set date before the major debt troubles began. The base rate is calculated on the bank's exposure as of a particular date before the original problems with the developing country began. *See* W. CLINE, MOBILIZING, *supra* note 78, at 13. Some banks, however, particularly smaller ones, may have reduced their exposure prior to restructuring by writing off the losing loan from their books, and are thus being asked to contribute new money based on a loan exposure which no longer exists. *Id.* at 6. Even if the bank did not write off the loan, it may feel that its exposure is small enough, or that its reserves are great enough, so that placing the loan in the non-accrual category or writing it

political pressure to coerce the lenders into signing on with the syndicate's restructuring, in addition to the methods used by banks among themselves.[101]

In short, the United States regulators have done little to disrupt the parties' informal behavior under the sovereign debt relation. If anything, the ad hoc restructuring process has been strengthened while the governmental goal of bank stability, seemingly embedded in the ILSA, has been achieved outside the legal mechanisms of the Act.

IV. APPLICATION OF THE FUNCTIONAL MODEL

Since the vast portion of the sovereign debt relationship takes place outside the technical terms of the contract over an indefinite time, relational contract theory seems ideally suited to explain and analyze the process. The inextricable nature of the relation, the incremental process of agreement,[102] and the complex interaction of external, relational, and internal legal interests combine[103] to render discrete conceptions and descriptions of contract problematic, if not obsolete.[104] The principles of relational exchange outlined earlier exist in the sovereign debt relation, but are not easily identified or explained by discrete legal terms. Rather, functional/relational analysis must be used in order to gauge the effec-

off completely would not threaten its security. Since the decrease in exposure fostered by write off does not affect the base rate on which each bank's contribution is calculated, the incentive for refusing to make the new money contribution is greater with each restructuring. *See also* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 78-81.

101 *See Worries Deepen*, *supra* note 57 (one of the few news reports mentioning the political force necessary to push through some restructurings). The coercion and persuasion necessary to gain the new money contributions will be greater as restructured loans increase their concessionary financial terms—i.e. lower interest and new money on a non-discretionary basis. Such concessions appear to be the trend, at least for the larger debtors. *See I.M.F.-Style Pact Seen for Brazil*, N.Y. Times, Feb. 25, 1987, at 25, col. 6 (nat'l ed.); *Mexico's IMF Loan Approved as Banks Commit to Package*, Wall St. J., Nov. 20, 1986, at 30, col. 4 (nat'l ed.). Because the regulatory authorities maintain a great deal of discretion over such things as mergers and scrutiny of inspections, failing to sign onto an important restructuring might result in sanctions applied to the bank's other business activities. T. Link, Guest Lecturer, International Financial Markets Class (Northwestern University School of Law, Nov. 20-21, 1986). *See also* D. LOMAX, *supra* note 3, at 135.

102 A major behavioral trait of relational contracts is that they are formed over time during "an incremental process in which parties gather increasing information and gradually agree to more and more as they proceed. Indeed, the very process of exercising choice in such circumstances . . . may entail major parts of the total costs of the whole project as finally agreed." Macneil, *Rich Classificatory Apparatus*, *supra* note 40, at 1041. To any who have followed a sovereign restructuring through the media, this fact is evident. *See Mexico Given Debt Aid by 'Paris Club' Nations*, N.Y. Times, Sept. 18, 1986, at 2, col. 5; *Spotlight on Loans for Mexico*, N.Y. Times, Sept. 25, 1986, at 34, col. 1 (nat'l ed.); *Volcker Acts to End Mexican Loan Impasse*, Fin. Times, Sept. 30, 1986, at 1, col. 3 (int'l ed.); *Mexico Lenders Agree to Join Rescue Package*, Wall St. J., Oct. 1, 1986, at 31, col. 1 (nat'l ed.).

103 *See generally* Macneil, *Values*, *supra* note 42.

104 *See supra* notes 11-25 and accompanying text.

tiveness of the loan relation.[105]

In approaching each of the roles of contract in the sovereign debt context, the legitimacy test first demonstrates how informal behavior compromises formal functions in the document. To the extent formal aspects of the relation are undermined, the institutions which usurp the functions of contract will be assessed for relational effectiveness to judge if improvements can be made. The basic principles of relational contract—reciprocity through exchange and planning of performance (the substance and procedure of exchange, respectively)—have been an active part in the development of the sovereign loan relation and will provide drafting principles for the lawyer considering the loan agreement from a normative perspective.

A. Fostering Reciprocity Through Exchange

Exchange is the cornerstone of modern economic relations in both the international and domestic arena.[106] In order to foster exchange in contractual relations, reciprocity between the actors must be promoted. Reciprocity is fulfillment of goals to the mutual benefit of each party through procedures spelled out or based on the contract.[107] The contractual goals are either explicit or implicit in the terms of the document. In relational exchanges, goals are spread throughout the formal and informal legal systems.

The sovereign loan agreement has an obvious objective on its face: exchange of money for present use by the sovereign for repayment of the principal and interest to the creditor over time.[108] This literal reciprocity, however, is a legal fiction when compared to the restructuring cycle of which each contract is merely a documentary by-product. The fact that loan agreements are usually nothing more than worst case scenarios and precedent documents leads one to question their effectiveness compared to the parties' actual relation. The remedies and rights of the contract assure reciprocity only in the discrete ideal of the lawyer's mind.[109]

In the real world, relational and external interests undermine each

---

105 *See supra* notes 26-46 and accompanying text.

106 *See* A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (E. Cannan ed. 1937)(1st ed. 1775).

107 Macneil, *Values*, *supra* note 42, at 375.

108 Factors other than profit included a necessity to funnel off the petro-dollar deposits of the 1970s as well as maintain prestige in international banking. *See generally* A. SAMPSON, *supra* note 1, ch. 2.

109 *See supra* notes 11-25 and accompanying text. Should the sovereign default, the government's assets may be set-off against the loan upon acceleration by the creditors; breach of any of the material provisions of the loan to which the borrower has agreed, also bestows the right of acceleration. *See supra* notes 59-68 and accompanying text.

party's freedom to exercise its rights under the contract and terminate the relation.[110] The reciprocal freedom which allows "efficient breach" by either party under conventional thinking is hijacked by costs in the relation far greater than in traditional contract.[111] The sheer magnitude of the sovereign loan makes such economically rational thinking completely irrational.

Acceleration, despite the fact of technical default, is rarely if ever employed. Such action would wreak havoc on the accelerating banks, the domestic economy of the sovereign, and the international capital markets.[112] In fact, due to the large amounts of debt loaned by the banks, relational and external forces affect the formal legitimacy of the contract almost immediately.[113] On the borrower's side, the existence of short-term trade credits, inter-governmental relations, and public welfare considerations demand that the sovereign's cost horizons include international and social calculations, as well as simply economic ones.[114] From the creditor's point of view, any acceleration is impossible except for the most paltry sums.[115] In both instances, external, internal, and relational factors overpower the discrete terms of the contract.[116] These forces impose a categorical rule upon the loan relation—never litigate, never accelerate, and never exercise the substantive legal rights of the formal contract.

The enormous profits and prestige of the loan which prompted banks to lend to developing countries in the 1970s were quickly forgotten once a pattern of increasing levels of rescheduling developed.[117] This

110 Recall that the freedom to contract and breach accounts for the necessary flexibility of contract in classical and neoclassical legal systems. *See supra* note 13.

111 *See* Ohlin, *Economic Risks in Sovereign Loan Agreements*, in SOVEREIGN BORROWERS, *supra* note 6, at 10, 19. The contract law of the state guards this right through imposing a duty to cover (which curbs the power of one party to damage the other by inefficient use of the right) and principles of contract mutuality (which protect this right of contractual autonomy from being coercively denied one party by another).

112 "[T]here is an astonishing paucity of litigation involving claims by U.S. banks on foreign sovereign debtors." Reisner, *supra* note 2, at 6.

113 This is reflected in the ignorance of the usual forms of risk calculation when lending to sovereign borrowers and the belief that sovereigns can never go bankrupt. *Id.* at 5.

114 *See* W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 87-93.

115 Sovereign governments are unlikely to have more than a couple of billion dollars in attachable funds within a given jurisdiction named in the contract as the situs of debt. Set-off will be severely limited by this fact, and a repudiating sovereign is likely to withdraw its funds from banks before acceleration is declared. Finally, any acceleration of debt by creditors will be likely to translate into censure of the bank or banks by the sovereign in future relations. *See* Gottlieb, *supra* note 4, at 570-73.

116 *See id.*

117 Professor Macneil considers patterns of constant increase a status quo within a relational contract. *See Macneil, Adjustment of Relations*, *supra* note 11, at 888.

glaring formal illegitimacy leads one to search the informal relation for the reciprocal goals which relational contract theory proves must be promoted for the relationship to continue. If such a reciprocity is absent in the relation, then exchange is not being accomplished and the parties have no reason to continue the relation.

Within the informal system of the relation, the sovereign's long-term goal in restructuring is a return to voluntary lending markets. This would restore political and economic sovereignty sacrificed by the restructuring's requirements of austerity[118] while allowing access to voluntary loans with which the country can spur economic growth. Simultaneously, the banks' goal is to reduce and diversify international exposure *and* meet accounting regulations so that bank capital and earnings are safe from the losses which problem loans impose. The shortsighted goal of meeting interest payments, which is reinforced by the regulatory system, demands that the long-range goals remain unfulfilled. The vigor with which this more substantial mutual interest can be pursued is diluted by external forces, and relational effectiveness is therefore sacrificed from the substantive reciprocity standpoint. There is no real exchange; moreover, the underlying transaction is not performing a function which will allow it to continue into the future, as the interdependent nature of the parties demands.

Under the United States regulatory system, banks must ensure that interest is paid so that loans are not classified as non-performing assets.[119] Such an action would plunge large creditors into trouble, as the adequacy of their earnings and capital was questioned by the public,[120] the interbank market,[121] and the regulators themselves.

From the relational point of view, the ad hoc restructuring process

---

118 Some debtors have spurned the assistance of the IMF because of austerity required as a condition for the help, which in turn is used as a benchmark for negotiations with commercial banks. Peru, for example, has defied the IMF's policies since 1985. *Peru Defiant After IMF Acts to Deny New Credit*, Fin. Times, Aug. 8, 1986, at 1, col. 3 (int'l ed.). Brazil has been the largest country to spurn IMF austerity and avoid it in negotiations with developed nations. *Brazil Gets Flexible Debt Aid*, N.Y. Times, Jan. 22, 1987, at 29, col. 6 (nat'l ed.). Even without austerity, the drain debt service has on a country's economy is substantial.

119 *See supra* notes 85-86 and accompanying text; *see also* Wall St. J., Oct. 6, 1987 (Midwest ed.)(The United States regulatory framework discouraged an "enlightened approach" in recent Mexican restructuring).

120 *See* Berg, *Banks' Reserves and Latin Loans*, N.Y. Times, Dec. 16, 1987, at 38, col. 3 (nat'l ed.)(examining the effect of the write-offs of one large bank holding company on large creditors of the Latin American countries); *Dow Drops 18.70; Bank Issues Hurt*, N.Y. Times, Feb. 24, 1987, at 29, col. 6 (nat'l ed.)(report of stock market reaction to news that Brazil had suspended its interest payments).

121 *E.g.*, D. LOMAX, *supra* note 3, at 172-175 (describing the collapse of the Continental Illinois Bank in 1984).

resembles an institution half-way between bankruptcy and loan, without the safeguards and purposiveness of the statutory outlet, or the flexibility of discrete contract doctrine.[122] Terms are spread out and relief for creditors is allowed, but there is never any hope that the debts can be forgiven. Thus, the creditors have very little satisfaction of their original loans, and the debtor gets very little relief from interest payments. Though reciprocity may be present in the give and take of renegotiation and the letter of the loan agreement, it is distinctly absent in the substance of the restructuring regime. Purposive exchange is absent.

The sovereign loan agreement in a restructuring cycle becomes the formal component of a relation crafted with the sole hope that the world economy will eventually carry the developing nation "into the black" through export earnings from the international economy.[123] Such an informal purpose amounts to a relational paradox: the sovereign and syndicate strive to *preserve* the relation in hopes that circumstances in the international economy will *terminate* the restructuring regime.[124] The reality of relational contract theory, with its emphasis on real exchange, cannot allow such a substantive lack of reciprocity to occur. Quite simply, the parties will be unable to continue the relation under the pure ad hoc restructuring regime. A contractual relation built upon such a fatalistic premise cannot survive while ignoring the formal contractual freedom of the loan agreement. Either substantive financial reform of restructuring must take place to promote greater reciprocity in the relation, or the contractual freedom existing in the document must be restored. Either way, the sovereign loan relation cannot remain at the status quo of rescheduling.

In fact, the lessons of this paradox in relational contract are borne out by the innovative financial terms of the 1986 Mexican restructuring and others which have followed. These restructurings have moved away from traditional rescheduling and towards more pointed exchange.[125]

---

122 *Cf.* Oechsli, *Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the U.S. Bankruptcy Reform Act*, 21 VA. J. INT'L L. 305 (1981).

123 This resolution would entail gradual retirement of debt on or close to previously renegotiated schedules. *See* Gurria-Trevino, *Negotiations With Transnational Banks: A Sovereign Borrower's Perspective*, in 2 INTERNATIONAL BORROWING, *supra* note 5, at 5.3A.1. For an empirical model which suggested this was possible before the Mexican restructuring, see W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 44-72.

124 To do this the liquidity crises which are the cause of periodic default scares must be lessened in degree and frequency so that exports can carry the country on its rescheduled payback. W. CLINE, INTERNATIONAL DEBT, *supra* note 3, at 71-73.

125 *See Mexico Debt Link Seen as Precedent*, N.Y. Times, Oct. 2, 1986, at 25, col. 3 (nat'l ed.)[hereinafter *Mexico Debt Link*]. Commercial banks agreed to automatic new money loans over the next few years if certain targets in economic growth were not reached. In addition, the largest debt-for-equity exchange was accomplished as part of the restructuring, where creditor banks re-

Such reform may reinvigorate the reciprocity lost in sovereign loans if the internal goals of the parties are more effectively promoted. Viewed in this way, the Mexican restructuring is not only a strong precedent for developing countries weary of rescheduling, but also an indication of the direction all sovereign loan relations must take if they are to remain viable relational exchanges in the interdependent world economy. Real exchange must be injected into sovereign loan relations.[126] Only if this occurs can relational effectiveness be restored.

From the perspective of formal contract, it is also clear that lenders are placing themselves in positions where contract autonomy can be more easily exercised through declaration of default and litigation.[127] The recent international trend of setting aside reserves against developing country debt[128] thus not only ensures stability in international banking, but also reduces the need for restructuring through a greater ability of banks to declare default or refuse to restructure.[129] This point may be less significant in marking a trend towards greater respect for the formal contract, however, than a trend towards admitting that substance must be injected into future restructurings. The establishment of greater reserves clears the way for restructurings utilizing the discount of loans as required for conversion to equity or some other innovation.[130]

Under either interpretation, it is clear that the basic principles of relational exchange are being recognized in sovereign loan relations. Of

---

ceived a majority in the largest private conglomerate in Mexico in return for the forgiveness of the entity's foreign debt. *Banks to Get Stake in Mexico Concern*, N.Y. Times, Dec. 11, 1986, at 37, col. 6 (nat'l ed.).

126 *See Mexico Debt Link*, *supra* note 125, at 25, col. 3; *see also* Siddiqi, *supra* note 61, at 46.

127 An example (more illustrative than probative) is found in the declaration of default by creditors of North Korea in August 1987. *Western Creditors Declare N. Korea in Formal Default*, Fin. Times, Aug. 25, 1987, at 1, col. 3 (int'l ed.). Simply put, the creditors were unwilling to reschedule the loans further and front the new money which North Korea requested. The fact that North Korea is not a very big borrower (only around $2.57 billion in total debt) probably accounts for the choice to declare default. United States banks are barred by legislation from lending to North Korea.

128 Between Citibank's original $3 billion charge to earnings, *see Citicorp Accepts Loss*, *supra* note 93, and the end of summer 1987, many international lenders had boosted loan loss reserves significantly. *See Regional Banks Taking a Double Dose of Medicine on Foreign and U.S. Loans*, Wall St. J., June 16, 1987, at 2, col. 3; *Canadian Banks Bite Debt Bullet*, Fin. Times, Aug. 25, 1987, at 15, col. 4 (int'l ed.); *An Even More Bitter Pill*, Financial Times, June 17, 1987, at 22, col. 3 (int'l ed.)(recounting U.K. banks' reserve positions). At the end of 1987, an even starker assessment of Latin American loans came from the bank holding company Bank of Boston, which wrote off (charged completely off capital) 20% of its Latin American loans and boosted reserves to over 50% for the remainder. *See Banks' Reserves and Latin Loans*, N.Y. Times, Dec. 16, 1987, at 38, col. 3 (nat'l ed.).

129 Interestingly, John Reed, chairman of Citicorp, denies that the reserves change the banks' bargaining positions. *See Citicorp's Reed*, *supra* note 80, col. 1 (Midwest ed.).

130 *Id.*

the myriad international reforms proposed for the debt crisis, each one aims at greater reciprocal exchange within the debt relation than that which exists in traditional loan rescheduling to cure short-term liquidity shortfalls.[131] The structure of the restructuring regime and the need for substantive exchange necessarily demands that parties both internal and external to the relation contribute towards this substantive exchange. Since the traditional rescheduling represented a political and economic equilibrium between the various actors, innovation comes at the expense of internal or external interests to the relation, or more likely demands a sacrifice from both.[132]

Given the need for greater exchange in the substance of debt restructuring, and thus greater relational effectiveness, a question arises as to the role of contracts in moving towards restored reciprocity in debt relations. By applying the functional analysis to the more procedural aspects of contract—planning and performance—possibilities for a renaissance of contract are seen, and the basics of a drafting model emerge. While the increase in substantive exchange has occurred without the active participation of lawyers, it is possible that now that the trend has begun, a more active role for lawyers exists and can occur through the vehicle of the sovereign loan agreement.

B. Planning and Performance

The sovereign loan relation leaves much of the progress towards its goals to the informal system arising under the formal contract. The reason for this abdication is the great flexibility which a strict formal contract grants parties operating in an unsure economic environment.[133] Unfortunately, while granting the parties tremendous flexibility, the formal contract system cannot substantively promote the real goals of the sovereign loan—ultimate retirement of the sovereign's external debt.[134]

---

131 *See generally* F. BERGSTEN, W. CLINE & J. WILLIAMSON, *supra* note 70, at 93-199; W. CLINE, MOBILIZING, *supra* note 78; D. LOMAX, *supra* note 3, at 264-80. This does not include refinancing methods which amount to revised rescheduling schemes. *See* F. BERGSTEN, W. CLINE & J. WILLIAMSON, *supra* note 70, at 1-92.

132 Supporting this hypothesis is the recent posturing of the Brazilian government in bypassing commercial banks after its initial payment stop in early 1987. *Brazil Talking to Nations, Not Banks, on Debt*, N.Y. Times, Feb. 27, 1987, at 37, col. 3 [hereinafter *Brazil Talking to Nations*]. The newest Mexican package is a stronger indication of this projection, where greater substantive exchange is promoted in the restructuring, and the United States government's aid was directly involved in the change.

133 *See* Ryan, *Defaults and Remedies Under International Bank Loan Agreements with Foreign Sovereign Borrowers—A New York Lawyer's Perspective*, 1982 U. ILL. L. REV. 89, 90. Such flexibility through strict drafting is certainly a fact of legal life in the United States commercial law system.

134 Or at least reducing the debt to the level where interest payments can be easily made without further debt. Certainly, if the sovereign successfully fulfilled the terms of the loan agreement, the

This substantive failing of the loan agreement as a functional tool might lead one to expect a failure in the contract's planning role as well. Functionally though, the terms which fulfill planning functions have much relational value in the life of a restructured loan. Despite this value, lawyers have limited their roles to drafting agreements which articulate when and how restructurings commence, but not how the substance of the relation occurs. The greater value of the lawyer in the sovereign loan relation—as it drifts towards greater institutionalization and substantive exchange—is the formality the attorney can lend to the proceedings.

Under relational contract, different kinds of planning exist between the parties throughout their performance: "Two fundamental characteristics of contract planning are a constant interplay between planning and nonplanning and a distinction between performance planning and risk planning."[135] Nonplanning "consists at most of an anticipation, vague, or otherwise, of future cooperation or lack of it in taking the actions necessary to make the contract work out satisfactorily . . . ."[136] Performance planning within the contract specifies what must be done if the contract is to be successful.[137] Risk planning spells out contingencies for events which might arise during performance, but are not necessary for completion of the contract.[138] While conceptually distinct when written into a contract, as the contractual relation unfolds nonplanning melds into planning,[139] and risk planning mirrors performance planning.[140] At the informal level, the clauses which perform a planning role also act as vehicles for communication between the parties, by virtue of their formal power.

A ready example of the dual roles of contract planning within the formal sovereign loan is the business terms of the contract. Since payments and drawdowns are clearly specified, both creditors and the debtor can plan finances to meet the obligations of the loan. If payments are not made on time, remedies will lie against the breaching party. A further example of the melding of performance and risk planning is the documentation which accompanies a sovereign loan. By warranting that its

---

mutual goal would be reached. The loan document, however, cannot actually aid in the promotion of that goal; it is only by coincidence that the aim is fulfilled through export earnings from the world economy.

135 I. MACNEIL, CASEBOOK, *supra* note 44, at 20.

136 *Id.* at 21.

137 *Id.* at 25.

138 *Id.* at 26.

139 The more precisely anticipation of the unplanned events is accounted for by terms of a contract which might accommodate them, the more closely such vague anticipation resembles planning. *Id.* at 21.

140 *Id.* at 26.

financial information is correct, the sovereign is required to gather and disseminate vast amounts of documentation to its creditors. This process aids performance of the loan through facilitating management of liquidity by the sovereign. The creditors can utilize documentation to monitor the sovereign's financial health.[141]

The negative pledge[142] has a similar dual planning and performance function. By periodically representing that no prior claim has been placed over that of the debtors, the sovereign assures the lenders that their security is intact, thus fulfilling a risk planning function for the lender.[143] If the sovereign manages its finances well, the necessity of giving such a prior claim will be avoided. This clause thus promotes planning to avoid granting security superior to that of the restructuring creditors.[144]

This duality is the functional "meat" of the sovereign loan agreement. The true power of the protective contract clause lies in its role as a trigger of the restructuring process, not in the technical consequences of default. Acceleration[145] is "primarily important to bank lenders for getting the attention of and negotiating with a financially or otherwise troubled debtor, or with other creditors of the borrower, in order to effect other measures like restructuring the credit . . . ."[146] The extreme consequences of a default promote communication between the illiquid sovereign and the profit-conscious creditors.[147] Of course, the more strict and detailed the covenants and events of default are, the less flexibility the borrower will have in attempting to stave off the financial crisis which will require restructuring.[148]

Once restructuring has begun, the contract continues to assert itself

---

141 Walter, *supra* note 51, at 71, 86-88. *See generally* Kaldereń, *supra* note 59, at 38.

142 *See supra* note 66.

143 Breach of the negative pledge signals to the lender that nonpayment of the loan is likely since the sovereign felt compelled to bestow prior interest; action can be taken to stave off the crisis. *See* Youard, *supra* note 67, at 176, 178.

144 *See* Siddiqi, *supra* note 61, at 58.

145 Should an event of default remain uncured after a stipulated period in the contract, the lenders have the right to accelerate the loan: "the right to terminate the lending commitment and to declare due and payable any outstanding loans." Venkatachari, *supra* note 66, at 92-93.

146 *Id.* "An event of default may portent economic losses to international banks, and the legal sanctions that accompany such an event may significantly influence borrower behavior." Walter, *supra* note 51, at 71.

147 The structure of the sovereign's loans is such that default on even one loan would cause cross-default on many others before renegotiation would be commenced. Only by clear communication with all debtors can the transaction costs which are necessitated by restructuring—bookkeeping, negotiation, maintenance of credit lines—be kept at a minimum.

148 *See* Cone, *The Treatment of Default*, in DEFAULT AND RESCHEDULING: CORPORATE AND SOVEREIGN BORROWERS 25, 26-27 (D. Suratgar ed. 1984)[hereinafter DEFAULT AND RESCHEDULING].

in the planning and form of the restructuring. Documentation from the predecessor loan and rights previously agreed to give the parties a basis for renegotiation and bargaining.[149] Yet the contract will only have effectiveness within the limited scope of its writing. The contract will have little or no effect on the negotiation or substance of the restructuring. The transient nature of the loan agreement, even in the context of more substantive exchange in restructurings, is disturbing. Given the resurrection of substance in the sovereign loan agreement, why is there not a resurrection of process? Why is the restructuring process itself not set out in the contract?

The failure of the contract to specify a procedure between default and normal performance of the loan has not been considered a real problem in sovereign loan contracts.[150] Lenders are unwilling to accept specific renegotiation procedures without acceleration because negotiations absent this right may leave creditors with little bargaining power.[151] In addition, "the situation at the time of renegotiation cannot be foreseen accurately enough to enable the lenders to know what they are committing themselves to."[152] By leaving the de facto remedy of restructuring out of the contract, crucial flexibility in approaching liquidity shortfalls is maintained.

The formal performance and planning clauses of the sovereign loan agreement appear to maintain legitimacy in the informal system up to the moment restructuring commences. The substantive reforms now being seen in certain countries' restructurings,[153] however, may require a change in the unwritten status of restructuring in loan agreements. Now that substantive terms of the loan relation are promoting more purposeful exchange between the parties, it is possible that the procedural aspects of the loan agreement might extend past the life of the agreement's payment obligation.

One example lies in the power of precedent in the sovereign debt field. Before the recognition that substantive exchange was needed in the sovereign loan relation, the loan contract was an effective instrument in traditional reschedulings of sovereign debt. With the treatment of debtors varying even more in recent episodes due to increased innovation, failure to monitor debtors' economic situations effectively[154] may give

149 Gottlieb, *supra* note 4, at 572-74 (citing Ryan, *supra* note 133, at 90).

150 *See* Youard, *supra* note 67, at 178-79.

151 *Id.* at 178.

152 *Id.*

153 *See supra* notes 125-32.

154 Traditionally, the IMF has performed the monitoring function by focusing on targets of austerity imposed when renegotiating IMF financings. *See generally* Nowzad, *The Role of the IMF in*

smaller debtors[155] incentive to halt payments prematurely in order to force creditors' hands. This may occur even where traditional rescheduling is viable.[156] In order to police such "bad faith" invocation of restructuring, arbitration on the issue of financial necessity might be required[157] before restructuring is undertaken.[158] Such a contractual practice—or variations upon it—may be the quid pro quo for grander and more innovative restructurings. The advantage such formalism would have is that ad hoc restructuring would be gradually formalized out of existence, while still maintaining the individualism which has stabilized the world economy up to this point. In short, the restructuring parties would set up their own formal law, subject to objective dispute resolution procedures, in recognition that more substantive restructurings would have to be monitored carefully in order to obtain the support of the international financial system.

V. Conclusion: Resurrection of Contract in an Institutionalized Debt Regime

"To have even a glimmer of hope of understanding relational contract we must overcome the impact hundreds of years of history have had on our minds."[159] Indeed, at the end this work appears to be nothing more than a theoretically based echo of the call heard earlier in the 1980s, at the onset of the debt crisis: that "lenders as well as borrowers . . . in the event of actual or threatened default . . . put to one side all

Rescheduling International Debt, in DEFAULT AND RESCHEDULING, *supra* note 148, at 131; Robichek, *The International Monetary Fund: An Arbiter in the Debt Restructuring Process*, 23 COLUM. J. TRANSNAT'L L. 11 (1984). Several countries have refused resort to the IMF as a matter of principle, however, leaving a void to be filled by the informal planning procedures of the loan agreement which may not be enough in many cases. *See supra* note 118.

155 Without the leverage of a Mexico or Brazil.

156 *See, e.g., Ecuador Failed to Make January Debt Payment*, N.Y. Times, Feb. 19, 1987, at 30, col. 1 (nat'l ed.)(Former manager of central bank says decision not to pay was a tactic to gain more favorable terms. Ecuador was viewed by bankers as a "bright spot" in international debt).

157 Despite some misgivings by bank counsel early on in the debt troubles, *see* Ryan, *supra* note 133, at 128-31, arbitration is now accepted in contracts between sovereigns and syndicates. *See* Delaume, *Special Risk and Remedies of International Sovereign Loans*, in DEFAULT AND RESCHEDULING, *supra* note 148, at 91, 100-03 (1984).

158 Although provisions barring bad faith halts in interest payment could certainly be written into loan agreements enforceable by developed country courts, *e.g.*, Ryan, *supra* note 133, at 101-02, the point of arbitration before restructuring is to provide alternate procedures before litigation is threatened, thereby avoiding the extreme consequences of acceleration which trap parties into restructuring in the first place. In addition, by stipulating intermediary procedures before restructuring, greater cooperation between the parties, reduced costs through specialization, *e.g.*, Ohlin, *supra* note 111, at 28, and a change in the prevalent spirit of "fault" during debt restructuring might be accomplished. *See, e.g.*, Cone, *supra* note 148, at 25.

159 Macneil, *Adjustment of Relations*, *supra* note 11, at 885.

notions of wrongdoing and focus[ ] exclusively on the objective content of their common problem."[160] The trend now, however, is not just a shift from adversarial restructuring, but towards greater institutionalization of sovereign debt refinancing in the international economy.

Due to chinks in the traditional rescheduling armor of creditor banks brought on by the realities of relational exchange, precedent is eroding the legitimacy of ad hoc restructuring for smaller as well as larger debtors. The lack of substantive reciprocity and exchange in traditional restructuring has led to wider acceptance of innovative approaches.[161] In addition, the sovereign debt landscape has begun to resemble that of a normal financial market, with the rise of a secondary market in debt,[162] a growing debt-for-equity swap practice in many nations' loans,[163] and for the first time, the possibility of converting sovereign debt into internationally backed bonds.[164] If this trend continues, it is possible that the liquidity crisis of the future may be no more than another problem for investment bankers to resolve with some innovative finance offering, akin to those now flourishing on the Euro-market.

The lawyer has an active role to play in this process. For years, detailed sovereign loan contracts have granted flexibility to the relational actors while the governmental regulators were content to see the outcome of the rescheduling cycle. Important interests in contractual formality were sacrificed in this ad hoc restructuring regime. Trading flexibility for formality may be a way to protect such interests in the future.[165]

Relational theory may not act as a perfect predictor of the economic future for sovereign debt. The outcome of the debt crisis depends ultimately on the world economy. Given that the nature of sovereign debt is

---

160 Cone, *supra* note 148, at 25. *Cf.* Hoeflich, *supra* note 77.

161 *See supra* notes 125-32 and accompanying text. For one of the most frank views by bankers, government officials, and economists on trends in sovereign debt, see Official Transcript of the U.S. Congressional Summit on Debt and Trade, New York City (Dec. 3-5, 1986)(available from Smick-Medley & Associates, Washington, D.C.); *see also* Buq, *Debt Crisis: Fresh Approaches*, N.Y. Times, May 5, 1987, at 1, col. 1 (nat'l ed.)(describing several innovations in debt restructuring).

162 *See supra* note 57.

163 *E.g., U.S. Banks Swap Latin Debt*, N.Y. Times, Sept. 11, 1986, at 29, col. 3 (nat'l ed.).

164 *See Brazil Talking to Nations*, *supra* note 132 (Brazil may push for bond conversion of its external debt in the upcoming restructuring); *New Way*, *supra* note 99 (most recent Mexican restructuring, where the United States government backed zero-coupon bonds); *see also* Alpern & Emerson, *Making Life Easier for Debtor Nations*, N.Y. Times, at 15, col. 1 (nat'l ed). *See generally* F. BERGSTEN, W. CLINE & J. WILLIAMSON, *supra* note 70, at 93-199; W. CLINE, MOBILIZING, *supra* note 78.

165 John Reed of Citibank has called for "a more textured and somewhat more market-related set of agreements" in sovereign loan restructurings. *Citicorp's Reed*, *supra* note 80, col. 1. Contractual formality may be the lawyers' procedural contribution to this substantive need.

changing, however, relational theory can serve as a drafting model for the lawyer asked to craft the contract needed to govern a successful restructuring.[166] Relational theory can also point to principles which must be respected in all relational exchanges. By isolating the various legal aspects of the sovereign debt relation and applying a functional analysis similar to that presented here, practitioners can "develop a new normative structure to accommodate and regulate"[167] the restructuring regime as it evolves into the 1990s. The existence of institutionalism and the growing attraction of formalism may indicate a resurrection of contract in the sovereign debt field. Lawyers should take the initiative and suggest to their clients the use of formal contract as a functional part of debt restructuring. While such tools may not solve the debt crisis, they may serve to better justify attorneys' fees.

Keith A. Palzer

166 One would expect the same specialization of legal documentation to develop in the future sovereign debt regime which arose in Euro-market offerings. *See* Wood, *supra* note 56, at 131-32.

167 Macneil, *Rich Classificatory Apparatus*, *supra* note 40, at 1039.