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TOWARDS A MULTILATERAL FRAMEWORK FOR RECOVERY FROM SOVEREIGN INSOLVENCY

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Towards a Multilateral Framework for Recovery from Sovereign Insolvency

Barry Herman¹

This chapter proposes that the UN General Assembly formulates a set of principles to guide governments and international institution creditors when restructuring sovereign debt and guide the IMF as representative of the international community in assessing restructuring needs. The principles would also guide national courts which would oversee restructuring of sovereign bonds and bank loans issued under national law. An innovative feature is that UNCITRAL would prepare a model law for national governments that would provide common guidance across jurisdictions for court supervision of restructuring of private claims. While sovereigns would continue to negotiate restructurings separately with each class of creditors, the indebted government or creditor groups could appeal the workout to the Permanent Court of Arbitration in The Hague for violating the principles.

Key words: sovereign debt, crisis resolution, debt restructuring, model law, UNCITRAL, international principles

From time to time, sovereign governments find themselves in a situation in which the repayment terms on at least some of their debt must be eased or cancelled. Creditors cannot force repayment, whether from an impoverished sovereign or an irresponsible one. However strong the presumed contractual and moral obligation to fully repay, it cannot or will not be done in some cases. There thus has to be some way to organize restructuring of sovereign debt and it should function independently of judgments by creditors about what the leaders of the defaulting government “deserve”. It should be especially mindful of the heavy harm debt crises usually impose on the people of the indebted country. In short, some internationally agreed principles should govern the process.

Some principles have always been applied, such as “creditor rights”. Once upon a time, governments threatened to send warships on behalf of their bankers and investors to collect debt servicing owed by bankrupt governments. This practice is no longer deemed acceptable; nor is it deemed necessary. Creditors instead mainly rely for repayment on the desire of the indebted government to borrow again, which is generally sufficient incentive. This is similarly assumed to be the operative incentive for a bankrupt sovereign and its creditors to restructure repayment of the debt. However, it is also possible that no restructuring agreement is reached and arrears accumulate, possibly leading to formal repudiation of the debt.

In fact, little sovereign debt, if any, has been repudiated in recent decades, and so

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it may be inferred that the debtors and creditors find the current processes for sovereign debt restructuring to have been a tolerable way out of a debt crisis. Losses are taken by one group or another according to their respective powers and negotiating prowess and the parties move on. That, however, is a very low normative standard and one generally not accepted as sufficient by legislatures when they write national bankruptcy laws. They want to insure that the workout from insolvency is economically efficient (e.g., maintaining operation of some of the physical plant, equipment and employees of bankrupt companies when possible, instead of fully closing them down), timely (i.e., assuring that decisions are not unnecessarily postponed by one party or another), and fair to the relevant stakeholders (i.e., that the burden is appropriately shared among creditors and the debtor). Could we not ask that the debt workout also aims to be effective, timely and fair in the sovereign case?

The usual proposal to reform how sovereign debt is restructured imagines establishment of an international authority that would apply agreed principles in a proceeding that would emulate how national bankruptcy laws and courts bring all parties together to resolve the debt distress of corporations, households or sub-sovereign public entities. This chapter instead proposes a better way to carry out the current decentralized approach. The rest of the chapter first reviews the complex and decentralized organization of sovereign debt workouts, offering a perspective on the political and legal frameworks in which those processes are embedded. This is intended to set the stage for a mental exercise on what an ideal political/legal framework might look like, leading to a reform proposal. The main innovation is not my own but one suggested more than a decade ago by Professor Christoph Paulus of the law faculty of Humboldt University in Berlin.² I think it might be time to look again at that idea, which I try to fit into an international political framework.

The decentralized and complex reality

An insolvent sovereign usually owes money in a variety of currencies, including its own, and it owes it to a variety of lenders, usually including commercial banks, investors in bonds, other sovereign governments and various international financial institutions (IFIs), almost always including the International Monetary Fund (IMF). Most debtor governments will work with IMF on the design of an economic recovery program for the country meant to result in a sustainable fiscal situation. IMF will also help formulate a financing plan for the duration of the adjustment program, including giving an indication of the overall amount of temporary relief needed from debt servicing and whether and how much permanent relief is needed for the country to reach a sustainable debt scenario over the medium-term. The IMF operates under guidance of its Board of Governors and Executive Directors, whose views most heavily reflect the views of the Fund's own main creditors, an approach that is widely and justly criticized (IMF, 2014). The debtor government is then on its own to negotiate how to restructure its debt-servicing obligations or obtain outright debt reduction with each of its creditor classes.

The debtor thus may open negotiations with its external creditor banks (usually in

² I apologize if I have distorted Professor Paulus' views to make them fit my framework. Readers can find the original in a number of papers, including, Paulus (2002 and 2003).

an informal arrangement called a London Club), also with the holders of the various series of its foreign currency bonds (who sometimes organize themselves into creditor committees), perhaps as well with its domestic banks and bondholders, and with its foreign government creditors (most of which will come together in the informal Paris Club). Although restructuring of obligations to IFIs is unusual, it has been essential over the past two decades for the debt restructuring of a group of 39 heavily indebted poor countries (HIPC). Such a process could again become necessary for poor and vulnerable countries that owe a large share of their debt to those institutions. This plethora of restructuring bodies is matched by a largely ad hoc and uncoordinated set of procedures and principles governing each set of restructuring negotiations. Not surprisingly, outcomes differ. This is not satisfactory.

Somehow, a workout is arranged with some combination of government spending austerity, tax reform to raise public revenues and restructuring of one or more classes of debt obligations. Citizens may also replace the government that was in charge during the descent into crisis, as also happens in corporate restructuring where the defaulting management may be fired. But sometimes official creditors prefer for geostrategic reasons that governments remain in power despite being responsible for a debt crisis and the key officials may survive – indeed, have survived – many a financial crisis.³ The proportions between economic adjustment and debt relief will differ among country cases, depending on the size of the debt “overhang”, the political importance of the indebted sovereign to the global powers, and the relative skill of the sovereign’s negotiators.

The primarily political framework

One may see that there is a political framework within which the debt workout happens. There is also a legal one, which largely pertains to the contractual relations between the indebted State and its private creditors. Every effort is made to voluntarily resolve unpaid sovereign debt obligations to private creditors. The courts may get involved in difficult cases, but governments also involve when there is a pressing policy concern.

For example, the sovereign debt crises of the early 1980s mainly involved syndicated loans from commercial banks, especially by the “money center banks” which operated the international currency markets. The major governments feared the consequences that recognizing sovereign debtor insolvency would have on the balance sheets of the money center banks and thus pushed them to make “concerted” loans to the otherwise-defaulting sovereigns. The countries met their debt servicing obligations with these forced loans, while the financial regulators applied “forbearance” in their supervision of the banks. The feared collapse of the international currency markets was a good enough reason for the governments to intervene at the time (Devlin, 1993). It took the rest of the decade and considerable policy intervention to arrange the final workout from that crisis (Garay, 2010).

There has been less government intervention in the workouts from excessive

³ Reflect, for example, on the case of Zaire during the career of Mobutu Sese Seko (e.g., Callaghy, 1986).

sovereign obligations to private creditors since the 1990s, when bond issuance became the predominant form of sovereign borrowing from private sources. However, governments – but especially the IFIs – have involved themselves in “important” cases by lending to the over-indebted sovereigns to prevent their default, which would otherwise have triggered the contractual processes for the debt workout. Private creditors have not objected to these bailouts, although voters in creditor countries frowned on the practice. The creditor governments acting through the IMF thus revised their approach by the end of the 1990s to give more emphasis to “private sector participation” or “bail-ins” in workouts from excessive obligations to private creditors (IMF, 2002). As has been clear in the series of Greek restructurings, this sets up a three-way struggle between the debtor government (wanting the least austerity), the private lenders (wanting their money back) and the official international community (wanting the least threat to its bondholding banks, least voter criticism and least threat to its own bailout loans).⁴

While the political intervention in private sovereign debt problems is sporadic and not predictable, the process for restructuring sovereign debts owed to official creditors is completely political. While inter-official loans are formalized in contracts, the decisions to alter the repayment obligations in those cases are in practice taken politically. The bilateral creditors that meet in the Paris Club agree to bind themselves a priori to specific norms for the relief that they offer to different income groups of countries, revising the relief standards from time to time as deemed warranted. However, they actually accord relief on a case-by-case basis, as they have some flexibility in how much relief they give any specific country.⁵ From time to time the Paris Club substantially departs from its standards for politically strategic cases, as for Egypt, Indonesia, Poland and Turkey at one time or another (Cosío-Pascal 2010). Finally, the Club has also offered to unilaterally delay debt repayments to countries harmed by disasters, including the tsunami of December 2004 and the internal conflict that wracked Liberia.⁶

The 1996 initiative to reduce the debt of the HIPC countries was a uniquely comprehensive set of political arrangements for debt restructuring. To begin it, an eligible debtor government had to approach IMF and indicate a willingness to undertake macroeconomic and structural policy reforms, and since 1999 it has had to draft a standardized “Poverty Reduction Strategy Paper”. Typically the government would adopt an austerity and policy liberalization program that would be supported by new loans on concessional terms from IMF, other IFIs and bilateral donors, along with cancellation of 67% of Paris Club debt-servicing falling due during the adjustment period and long-term rescheduling of the rest. After typically three years of staying “on track” with its adjustment commitments, the IMF and World Bank executive boards would jointly

⁴ For a good discussion in an already vast literature on Greek debt, see Xafa (2014).

⁵ Within an agreed framework for relief, the Paris Club can change the amount of relief, i.e., by deciding where to position the “cut-off point” after which date obligations are not restructured. Also, after the Paris Club reaches its decision on these terms of relief, called the Agreed Minute, the debtor needs to renegotiate each specific loan with each member country of the Club, allowing further differences in treatment to creep into the final detailed arrangement.

⁶ The unilateral cases are listed by the Paris Club secretariat at <http://www.clubdeparis.org/sections/types-traitement/recheleonement/traitements/2009-traitements/switchLanguage/en>, last accessed February 18, 2015.

graduate the country to its “decision point”, when additional policy reform commitments would be made by the debtor, including to start implementing its poverty reduction strategy; in addition, a plan for permanent debt relief would be prepared, including reduction of obligations to the IFIs. An “interim phase” then ensued in which the Paris Club would cancel 90% of the debt servicing falling due to its member governments and reschedule the rest, while other official and commercial creditors would be asked to provide comparable relief. The IFIs would start giving annual relief of debt servicing, which would be made permanent at the next stage. When sufficient confidence was earned (originally, after another three years), the IMF and the Bank would graduate the country to the “completion point”, where the Paris Club and multilateral creditors would agree to reduce the stock of debt, and where other official and private creditors would again be asked to grant comparable treatment. The final amount of HIPC relief was intended to put the country on a path to fiscal sustainability, but that was often based on optimistic projections. A further step was thus added to the HIPC Initiative in 2005 when major IFIs adopted the Multilateral Debt Relief Initiative (MDRI) by which they agreed to essentially wipe out all remaining obligations of each completion-point HIPC, on condition that the additional savings in debt servicing would be applied to anti-poverty programs meant to help the country achieve the Millennium Development Goals that had been adopted at the United Nations.⁷

The legal framework

When it comes to private sources of credit, the borrowing country usually issues a bond in a particular financial market and acknowledges in the bond contract that it is to be governed by the laws of the country in which the market is situated. Usually, the government hosting the financial market sets the legal framework in motion and then stands back from the parties involved (except when it doesn't, as in the cases discussed above). The loan contracts themselves specify the possibilities and limitations for changing the repayment terms. Private creditors are relatively confident that, if a repayment problem arises, the contractual terms of the bonds and sympathetic treatment in the courts would prevail.

Bond buyers, banks and other creditors prefer to buy bonds in markets having creditor-friendly legal systems, where standardized and reliable information on the borrower is filed with the market oversight authority, and where the depth of the market makes the purchased bond liquid. Also, economies of scale and competition may hold down the cost of issuing in those centers. Borrowing countries will issue their bonds in such jurisdictions to minimize the interest rate they have to pay, and to be able to issue bonds or obtain bank loans with longer maturities. On the other hand, countries will likely want to diversify their obligations and so might issue in multiple currencies and

⁷ As HIPCs have borrowed after receiving their HIPC and MDRI write downs, their debt servicing obligations have begun to grow again and have become substantial for some of them. IMF announced in February 2015 that it was giving special relief from debt servicing owed to the Fund for the three West African countries hit by the Ebola outbreak. It will not actually reduce the repayments but draw grant monies to cover the debt servicing obligations from a new Catastrophe Containment and Relief Trust at IMF (IMF, 2015).

markets, including the domestic market where there would be no exchange-rate risk but a possible roll-over risk if the market were not very deep.

Thus, the world has and will have multiple financial markets trading bonds of different sovereigns, each market governed by its own national laws. The desirability of issuing in a particular financial market can change with changes in its laws or in how they are interpreted by their courts. A case in point is the United States where the attraction of being able to issue there has led governments to waive their sovereign immunity from being sued in US courts when they issue their bonds. However, the attractiveness of the New York market may have fallen recently owing to the strange treatment of Argentina in the US courts. The courts privileged the claims of a small group of uncooperative bondholders (aptly named “vulture funds”) against those of the overwhelming majority of Argentina’s other private creditors. Moreover, the US court claimed authority over bonds issued under the laws of other countries, namely, the United Kingdom, Japan and Argentina herself.

The evolution of the legal treatment of sovereign bonds in the US market is also interesting because it highlights how the courts in interpreting the law can show independence from the foreign policy priorities of the government. In the Argentinean case, the US Government offered a number of *amicus* briefs in support of Argentina’s position against the vulture funds as the case percolated up from the District Court to the Supreme Court.⁸ This was to no avail. In other words, there seems to be a measure of separation between the legal regime governing the sovereign debtor’s relationship with its private creditors and the political regime governing other aspects of the debt restructuring regime. It may generally be thought that the legal regime is more stable and predictable than changing priorities of foreign policy and politics. Perhaps that is true in general, although as the Argentine experience shows it is not always so. Still, the government can change the law that the court applies in its decisions, and thus the political framework can trump the legal one in the end.

All in all, one may see that the system works in a fashion in that it produces debt workouts. However, this is hardly a satisfying criterion. In fact, if the debt restructuring produced by this system worked well, then Greece would not be seeking another restructuring in 2015 after having restructured its privately held bond debt in 2012. Jamaica would not have had to restructure its debt again in 2013 after having restructured it in 2010. Also, Russia would not have had five trips to the Paris Club in less than a quarter of a century.

An ideal framework

Let us now try to imagine an ideal system. To begin, one might want to see a system in which some respected neutral authority – a philosopher king, as Plato would have it – was responsible for oversight and coordination of the overall restructuring of the

⁸ For example, see Supreme Court of the United States, “Brief[s] for the United States as Amicus Curiae in Support of Petitioner,” Republic of Argentina, Petitioner v. NML Capital, Ltd (Case No. 12-842), December 4, 2013 and March 3, 2014; United States Court of Appeals for the Second Circuit, Brief for the United States of America as *Amicus Curiae* in Support of Reversal,” NML Capital, Ltd. [et al.] v. The Republic of Argentina (10-1487), December 28, 2012, April 4, 2012 and November 3, 2010.

obligations to private and public creditors of the indebted sovereign. It would ensure that the end-point of the debt restructuring was a “fresh start”, which is to say a situation in which no further debt restructuring would be expected for many years (natural or economic catastrophes aside). It is also necessary that essential social services are maintained during the crisis period. In particular, the philosopher king would make sure that the “social protection floor” was maintained. The king would also entertain complaints from insolvent states or the creditors that believed they were not being treated according to the king’s principles of effective, timely and fair restructuring.

However, the king would not need to intervene directly with each of the public and private classes of creditors in most instances. A principle of subsidiarity could apply. The philosopher king in considering the overall amount of needed relief could set the target for the degree of restructuring of the official and private claims. Official creditors could then offer the specific terms of relief under the watchful eye of the king. Moreover, a judge from a national bankruptcy court could oversee the workout with the private creditors, guided by the king’s principles and rules. As the king appreciates that there will be multiple financial markets in which sovereign bonds would be issued, he could mandate that essentially the same law governs the relations with the private creditors in each state, including that of the borrowing government. In this way, domestic investors and banks purchasing domestic currency issues of the government’s securities would face the same legal protections as purchasers of its bonds issued in foreign markets. Similarly, foreign investors in the bonds issued under domestic law would also settle any claims in the domestic court.⁹

Still at the level of the ideal, we can imagine that the foreign and domestic creditors would find the resulting sovereign insolvency regime attractive. Creditors would feel that their property rights were protected fairly, i.e., that they would recover the maximum possible of their investments, including interest, and that there was a reasonable way to reach decisions that were enforceable on all creditors in their class (e.g., no more “vultures” to destabilize an otherwise agreed restructuring). Nevertheless, unhappy creditor groups could appeal to the king for review.

A path to reform

We have no philosopher king, but we have an international political process in the United Nations where its member states have agreed in its General Assembly to various guidelines for international political and economic behavior that are widely accepted (admittedly with sometimes distressingly common violations), as on human rights, gender equality, peaceful settlement of disputes, or sustainability of development. They have also agreed that debt crisis countries should obtain relief that treats their citizens fairly and that equitably shares the burden of relief with and among its creditors.¹⁰ The General Assembly could similarly draw up guidelines on how sovereign debt crises should be addressed. For example, it could agree that in a sovereign restructuring the social protection floor should be protected; that attaining a “fresh start” was the goal of

⁹ In this ideal world, the courts perform competently, independently and honestly in each jurisdiction.

¹⁰ See the Monterrey Consensus on Financing for Development (United Nations, *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (A/CONF.198/11, chapter 1, resolution 1, annex), paragraph 51.

the workout; that comparable creditors should be treated comparably; that creditors and the debtor should deal transparently with each other and so on.

The Assembly could convoke a preparatory intergovernmental deliberation and invite all classes of stakeholder to contribute their views on principles for sovereign debt workouts, after which the Assembly could draft a set of principles for consideration by governments, financial interests and civil society. The draft principles, perhaps amended after such consultations, should then be adopted by the Assembly, becoming a part of what legal scholars call “soft law”.

The key point is that the formal step of adoption would reflect an actual political consensus that had grown during the deliberative discussion stages. Governments and international institutions would then agree, *ipso facto*, to apply the principles when they undertake workouts from sovereign insolvencies. In other words, adoption of the principles would reflect actual political commitments to employ them. The IMF, as designated intermediary for the international community, would agree to be guided by them.¹¹ Henceforth, there would be an international standard against which to assess sovereign debt workouts and opportunities through public or peer pressure (as there is no philosopher king) to draw back relevant actors that depart from the guidelines. The essence of the proposal is that because workouts from sovereign debt crises are political in nature, involving relations between states and with IFIs, the guidance for appropriate functioning needs to be governed politically.

The world’s governments should want their agreed principles to also govern the relations of the sovereign debtor with its private creditors. One such principle could specify the priority for repayment of obligations. The principle might be stated as repayment of IFI obligations first (as is current practice), then repayment to government creditors and finally repayment to private creditors. This would subordinate the standing of private claims and might raise the risk premium embedded in the interest rates of these instruments. But that seems a fair deal, as taxpayers must cover losses on official loans. Moreover, as governments increasingly draw the largest portion of their borrowings from the private sector, the priority of payments to other governments will have less and less influence on the risk of repayment to private creditors.

Recognition of these principles could be placed into the standard “boilerplate” (fine print) of bond contracts. But they should also be reflected in how the relations of private creditors and the sovereign borrower are governed should creditors bring cases to court. This may entail reform of national insolvency laws so as to be harmonized with the guidelines. One way to bring this about would be to ask an internationally respected expert legal body to address this question, namely, the United Nations Commission on International Trade Law (UNCITRAL). The General Assembly could ask it to take the

¹¹ It is usual at this point in such discussions to say that the IMF needs to better reflect the views of developing countries in its decision making (e.g., as promised in the Monterrey Consensus, *op. cit.*, para. 63). Yes, that is correct. But even the existing governance structures should be guided by the agreed principles. This would not be an instruction from the UN to the IMF, but rather reflect an actual consensus among all UN and thus IMF member governments. The IMF Executive Board might formally adopt this interpretation for the sake of clarity.

principles as a base and draft a model law that would implement the principles as they relate to the claims of private creditors. UNCITRAL is the appropriate body to undertake this task owing to its balanced membership and deep expertise, including on insolvency issues.¹² The UNCITRAL draft model law should then be endorsed by the General Assembly, signaling its global political acceptance, on the basis of which each UN Member State would then be expected to adapt the model law to fit its constitution and institutions and then adopt it into its national law.

Each country would then have a comparable process to treat creditor claims against a troubled sovereign, including claims against its own government. Creditors could still seek a voluntary restructuring agreement, but it would now be explicitly in the shadow of the court. The adoption of the model law would thus give greater confidence to sovereign bondholders and other private creditors as to the extent and limitations of their rights to repayment (assuming that the courts of each country fairly apply the law in individual cases, a question made salient by the aforementioned treatment of vulture fund claims against Argentina in the US courts). Not only would this discourage the practice of “forum shopping” to find the most creditor-friendly courts in which to press an unhappy bondholder’s claims, but it would simplify restructuring bonds issued in different markets that would be subject to otherwise different local laws.

This innovation could be valuable in itself. There is already a strong growth in issuance of government and private securities in domestic markets in domestic currencies and under domestic laws. There is also a strong international investor interest in holding such securities (Akyüz, 2015).

Finally, the proposal needs a real-world counterpart to the right of appeal to the philosopher king from the official and/or private participants in the workout. In fact, a relevant forum exists in the Permanent Court of Arbitration (PCA). It was created in 1899 at the Hague Peace Conference to assist States in peacefully settling disputes. The Conference reconvened in 1907 and adopted several additional treaties, including one on using arbitration to settle sovereign debt disputes, with a view to ending “gunboat diplomacy”. In this regard, the PCA has a very old mandate to address sovereign debt workouts, which might be revived.¹³

And now a first step

Perhaps we are not so far from being able to take the first step in the reform proposal, i.e., agreeing on the principles. There are various candidates that could serve as

¹² Created in 1966, UNCITRAL has 60 members selected by the General Assembly to reflect the various geographical regions and principal economic and legal systems of the world. The Commission operates through working groups, including one on insolvency law, which currently focuses on cross-border issues in corporate insolvency (UNCITRAL, 2013).

¹³ In fact, the PCA is not a court but an international organization with 116 member states that helps parties to a dispute set up arbitral panels for cases encompassing territorial, treaty, and human rights disputes between states, as well as commercial and investment disputes, including disputes arising under bilateral and multilateral investment treaties; it administers arbitration, conciliation and fact finding in disputes involving various combinations of states, private parties, state entities, and intergovernmental organizations (as per its website at www.pca-cpa.org).

the starting point for consultations. Perhaps the expert group of the United Nations Conference on Trade and Development (UNCTAD), which formulated a set of principles on responsible sovereign borrowing and lending to sovereigns (UNCTAD, 2012) and its successor group that is preparing a report trying to define desirable characteristics of a sovereign debt workout mechanism could fruitfully start off the conversation.¹⁴ In addition, the Human Rights Council adopted “Guiding principles on foreign debt and human rights” in 2011 which might be considered.¹⁵ Although the guiding principles were adopted by vote in the Human Rights Council, this seemed to reflect less on the content of the proposals, which seem quite good, and more on the decision to undertake such an exercise in that forum. There could also be a contribution to the principles discussion from the Institute of International Finance (IIF), an organization of major private financial institutions, which formulated a set of Principles for Stable Capital Flows and Fair Debt Restructuring (IIF, 2012).

The principles could be guided as well by the imperatives of the post-2015 development agenda that will be adopted in September 2015 at the United Nations. More precisely, it could accord high priority to poverty eradication, to the creation and maintenance of decent work and rising incomes, and to progress in protecting the global and domestic environment.

To take the first step, the world’s governments need to agree that the current global system for addressing sovereign insolvency is unacceptable. The preference for staying with the status quo seems weak, a preference for the system we know with all its faults, rather than taking the risk of trying to reform it. That view could change. Nothing in politics is immutable.

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¹⁴ The ongoing work on a debt workout mechanism is available at <http://www.unctad.info/en/Debt-Portal/Project-Promoting-Responsible-Sovereign-Lending-and-Borrowing/About-the-Project/Debt-Workout-Mechanism/>, last accessed on February 25, 2015.

¹⁵ See Human Rights Council, 2011 (adopted by Human Rights Council resolution 20/10).

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