

Towards a Sovereign Debt Restructuring Framework

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Introduction

Initiatives to improve sovereign debt restructuring (“SDR”) began long before recent Argentine bond decisions but were redoubled in the aftermath of these rulings. At first glance, these cases identify problematic contract language that could be rectified by re-drafting critical boilerplate provisions such as the pari passu and collective action clauses (“CAC”). But given the effects of disorder, costs and delays in restructuring foreign sovereign debt upon debtor countries, creditors, and the bond market itself, it is understandable that some are uncomfortable leaving such matters solely in the hands of private parties to contracts without a framework that assists in minimizing damage to contracting and non-contracting parties alike.

The creation of an agreed upon framework that facilitates the interaction among private and public parties is a good alternative to the status quo if this approach can provide greater stability and efficiency in the restructuring process while allowing for sufficient flexibility and certainty (traditional benefits of the iterative development of contract language) for market participants. There are a broad variety of options to consider and analyses to be performed, particularly relating to political feasibility, before proposing a framework. As discussed herein, given the historic context of SDR, a framework that focuses upon consensual procedures seems to be a logical starting point since it could add value to the restructuring process without treading on the political terrain of sovereigns.

A. The Catalyst for Recent Efforts to Create a Framework for SDR: Argentina

The Argentine litigations feature several attention grabbing aspects. These include the Second Circuit’s one-two punch: its interpretation of pari passu and its granting of unusually broad injunctive relief.

The Court’s ruling regarding the pari passu clause was a complete victory for bondholders who refused to agree to restructuring proposals and a resounding defeat for bondholders who compromised. Though the ruling was limited to the language of the contracts at issue, that wording appears in agreements that will be in the market for many years to come. Accordingly, restructurings are now significantly more difficult to achieve because bondholders have even

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greater incentive to become holdouts (bondholders who refuse to restructure bond payment terms) than before.

Many market participants were upset by this ruling and by the Court's indifference to the broad, dramatic effect of its interpretation of the pari passu clause upon the sovereign bond market. They also felt that the Court failed to apply the well-established meaning of the clause and did so in an inequitably context, namely to the benefit of bondholders who had purchased their interests at deep discounts.

The Court's limited discussion of competing interpretations of pari passu is curious given the centrality of that issue to the post-decision critiques. In the context of foreign debt restructuring, there are principally two competing theories regarding interpretation; one limited to "ranking" (the traditional meaning in bankruptcy contexts which would have disfavoured holdout bondholders) and the other including the concept of "ratable" (which favoured holdouts). The Court's lack of discussion of these competing meanings or of contractual interpretation rules in the case of ambiguity raises questions regarding whether there is indeed a generally accepted meaning of the term in the market or whether and how this issue was presented to the Court. In any event, it is unclear whether the Court considered the argument that market participants (including the buyers of bonds at deep discounts in this specific case) knew that "ranking" was the common meaning of pari passu. Such may have supported arguments based on unjust enrichment and other equitable theories to counter the Court's eventual conclusion that its decision merely held parties to their bargain under state contract law.

As a remedy for breaching the pari passu clause, the Court prohibited Argentina from making payments on its restructured bonds unless it paid the holdouts on a "ratable" basis. The courts defined "ratable" to require that when Argentina pays 100 percent of the amount owed to the restructured bondholders (i.e., the periodic coupon payment), it must also pay 100 percent of any amount owed to the litigating holdout creditors (i.e., all past due principal and interest in an amount aggregating approximately US\$1.6 billion). This does not sound like pari passu as that term commonly is used in the bankruptcy context but this was not a bankruptcy case. Indeed the Court appeared to be saying that subsequent bonds are not in fact pari passu with the bonds at issue. The Court concluded that the deal was that the relevant bonds would be paid come hell or high water prior to any subsequent issuance being serviced. There is of course nothing that would prevent future bonds from containing different language clarifying the meaning of pari passu and even limiting the scope of injunctive relief but the decision does for the time being make sovereign debt restructuring of bonds with similar language problematic due the enhanced leverage of holdouts.

In the context of the Argentine rulings, the United Nations General Assembly overwhelmingly decided on September 9, 2014 to begin work on a multilateral legal framework—effectively a treaty, convention or, as referred to herein, a framework—for sovereign debt restructuring, in order to improve the global financial system. Discussions regarding how to address the Argentine decisions focus upon the following alternatives: (1) creating a new legal/statutory framework as envisioned by the UN, (2) letting the market simply revise problematic contractual terms, or (3) adopting some hybrid of these two alternatives. I will focus upon issues surrounding

a new framework while recognizing that contractual revisions to adjust the problematic CAC language are already well underway in the private market.

B. Context For Evaluating a Sovereign Debt Restructuring Framework

Any framework to address SDR will be a piece in the mosaic of international law and will be evaluated based on its perceived fairness. Fairness, like beauty, is of course in the eye of the beholder but the desire for fairness is universal and the perceived lack of it can lead to conflict. Russia's President Putin, for example, is in the midst of an international campaign to underscore his perception of deep-rooted unfairness in economic and political relations and institutions. In Valdai, he continued his efforts to form coalitions to alter the rules of the game and/or establish competing international organizations and economic levers. Simultaneously, he sends the same message by taking various types of military action.

Putting aside the irony of Putin lecturing on fairness, the sentiment strikes a chord of truth in many parts of the world. Several nations have established competitors to major international financial institutions. China, for example, after long complaining that the IMF, World Bank and Asian Development Bank were dominated by the interests of the US, Europe and Japan, established the Asian Infrastructure Investment Bank ("AIIB") with the support of many nations. The IMF and England announced their desire to cooperate with the AIIB, but the US has voiced strong opposition and pressured others not to provide support. The New Development Bank very recently formed by the BRICS (Brazil, Russia, India, China and South Africa) also was expressly designed to counter the unfairness perceived by these nations in the governance of the IMF and World Bank.

Whether or not merited, there is certainly some degree of skepticism regarding the fairness of western institutions outside of the western world. If the framework to address SDR is to be perceived broadly as fair, proponents must take this into account by, for example, making extraordinary efforts to gather the perspectives of market participants including those of debtor nations and potential debtor nations. On the other hand, for a SDR framework to move from conceptual to actual, proponents must understand and address the political and market-based objections of the US and other established powers whose support is vital to the adoption and implementation of a framework. In short, crafting a SDR framework evokes the long history of weaker nations seeking to gain power over their fates and of more powerful nations resisting ceding power. The last major effort to adopt a framework was led by the IMF. The IMF's proposed Sovereign Debt Restructuring Mechanism ("SDRM") was voted down, however, in 2003. Countries including the U.S. did not wish to cede the power necessary to the IMF or other multilateral bodies to allow the SDRM to function. It is helpful to keep this context in mind as we discuss possible frameworks for SDR.

C. Strategy and Tactics for Adopting an Initial Framework for Sovereign Debt Restructuring

Given the inability to garner support for SDRM in the past, what is the best shot at adopting a useful framework now? Clearly we must address the objections of those who opposed SDRM while at the same time considering carefully fairness issues if we want a framework to be viewed

as a legitimate dispute resolution tool even by critics of western institutions who have begun setting up competing institutions. We need to (1) identify clearly which problems we are trying to solve through a framework (and which we are not) (2) make the case for its need (meticulously explaining why the current contract based system is insufficient) and (3) demonstrate how a framework can better address the problems identified in point 1 through narrow drafted provisions. Each element is addressed briefly below.

i) Problems to Be Solved by a Framework for SDR

It is difficult to find consensus on precisely which problems a framework should be designed to address and which problems should not be within its purview. This is due in part to the different approaches taken by public versus private institutions. The public sector measures the success of restructuring largely by the effect on the debtor economy (focusing on the timing of initiation of restructurings and various economic results) while the private sector focuses upon the negotiation elements and effects on bondholders. Moreover, there is little consensus on the breadth of the powers a framework should possess.

Nonetheless, here is my list of problem areas relating to the initiation as well as negotiation of restructurings that a framework should address in its initial procedurally oriented incarnation:

- The coordination of restructurings;
- The speed of restructurings;
- The efficiency of restructurings: and
- The process and predictability of restructurings.

It is also important to identify problems outside the purview of a framework for SDR. These include in my view:

Moral hazard: an SDR framework will be unlikely to stop debtor's from borrowing aggressively and counting the leverage of contagion/systemic risk and political harm to obtain bailouts and possibly gain leverage over existing bondholders to accept haircuts. (As discussed below, this may be better addressed through up-front regulatory issues.)

Politics: an SDR framework will be unlikely to infringe upon political territory. The political process does and will have a tremendous impact on the course of significant potential defaults so politicians are highly unlikely to support any framework that limits their options or powers. Taking Greece as an example, the resolution of that country's crisis affects the viability of Eurozone, the prospects for success of EU itself, as well as Europe's ability to remain united in responding to the Ukraine crisis. For these reasons, SDR and related bailouts are often colored by politics and hence unsuitable for resolution by a judicial decision-maker.

ii) Deficiencies of Current Private Contract System

The arguments against maintaining only the current private contract system include:

- a. It fails to address voting among different bond issuances (absent universal aggregation provisions) thereby complicating restructuring. This implies a short-term need to deal with language in existing bonds that rewards holdouts under the Argentine rulings.
- b. It fails to allow for new funding resulting in default or bailouts by IMF or regional institutions.
- c. It fails to provide a common forum for all parties to address restructuring.
- d. Most importantly, it is concerned only with the interests of contracting parties, not systemic threats (“too big to fail” issues, contagion) that affect non-contracting parties.

iii) How a Framework Can Address the Identified Problems?

A framework granting substantive powers to decision-makers could, like a bankruptcy court, adjudicate disputes that could not be negotiated successfully. While an international bankruptcy court for SDR may be the ultimate goal of the international community, it not likely achievable at the outset for the political reasons mentioned above that doomed the SDRM and for the additional reasons discussed below. If limited in power, consensual and consistent with contract rights of bondholders, however, the first iteration of a framework might be feasible politically and practical. If all goes well, it could foster trust sufficient to enable it to take on additional responsibilities.

Accordingly, here are suggested features of a SDR framework that is designed to be broadly acceptable:

- a. Consensual.
- b. Invites all relevant parties to one forum including the IMF.
- c. Provides rules and procedures for restructuring.
- d. Utilizes substantive law only to the extent contracting parties adopt it.
- e. Provides impartial, expert SDR decision-makers who adjudicate only with consent of relevant parties. Otherwise, they play the role of expert SDR facilitators.
- f. Facilitates discussion regarding contagion risk, sustainability of debtor economy and balance of payments.
- g. Provides prospect of establishing creditors’ committees.
- h. Focuses upon procedure, not enforcement.
- i. Pursues the support of leading participants in the market by showing that the framework would speed up restructuring, create greater predictability and ultimately increase liquidity.

D. Maturing Into A Substantive Framework:

Several scholars have proposed draft frameworks that seek to do more than establish the procedural framework outlined above. These can generally be described as setting up an international bankruptcy tribunal (“Tribunal”) specializing in SDR with various powers including deciding matters of substantive law and enforcing its decisions. Though it may not be feasible to implement such a framework initially, it is important to be working to develop it now for several reasons including the need to think through a multitude of complex issues (some of which are referenced below) and the desirability of laying out next stages in the maturity of a

framework.

The starting point is to identify which problems a substantive rather than procedural framework would seek to address. Which principles would then guide a Tribunal? Would these include promoting liquidity in the bond market, helping existing bondholders get paid, safeguarding the economies of debtor nations, and/or promoting IMF goals of systemic stability and of structural reforms by debtors. A decision-maker needs to have in hand binding laws that set out the principles to be applied, how to balance competing principles as well as the extent of a Tribunal's jurisdiction and powers. To agree upon such fundamental matters will be very challenging particularly since fairness issues become more pronounced as a framework moves from consensual procedures to substantive rulings.

The mechanics of bankruptcy also present myriad practical issues that will take time to address. To establish an international bankruptcy law, which we arguably have been inching towards in the US with the replacement of Section 304 with Chapter 15 of the US Bankruptcy Code (the "Code"), would be an extraordinarily complex undertaking. If based on US concepts embodied in Chapters 9 and 11 of the Code, this would imply that the key features of those Chapters would be applied to SDRs such as the ability of bankruptcy courts to alter contractual terms in order to promote the greater good of restructuring. On what basis would bond terms be altered without creditor consent, a typical feature of unsecured claims in bankruptcy? Balancing the interests of all parties in this process requires massive societal buy in even in the comparatively simple context of domestic US bankruptcies. Such consensus and support will be all the more difficult to achieve on an international scale. Moreover, who will adjudicate and enforce international bankruptcy law? Just as all politics is local, so is bankruptcy law in the sense that bankruptcy rulings have real effects upon employment and wealth in specific jurisdictions. As we consider the concept of international bankruptcy, we must keep in mind the practical reality of how rulings would be enforced and how home court advantages will play out.

It is worth keeping in mind Alex Rosenberg's work in exploring how the human mind developed cooperative behavior. His theory is that cooperation reflects a tit for tat process; I will trust you next time if you acted honorably this time and will not trust you this time if you burned me last time. How does this potentially apply to creating a framework, such as international bankruptcy laws, to address SDR? As we broaden the community interacting in applying a set of laws (moving from national to international in the case of SDRs), we will be relying at some level upon enforcement of rulings in the domestic courts of various nations and must therefore consider how tit for tat will function in order for an SDR framework to be perceived as fair. Similarly, the procedures, laws and decision-making procedures under an SDR framework must also be perceived as fair if we expect parties to participate.

Then there are "rubber meet the road" problems to take into account such as the willingness of attorneys to advise their clients to include in their documents dispute resolution for SDR in an untested, complex new forum. At least initially, an international bankruptcy court would likely need to apply some existing substantive law since creating a new body of substantive law will deprive market participants of the comfort of precedent (seeing how that law has been applied in the past.) It is, accordingly, worthwhile to begin focusing on the substantive laws that could be utilized as well as to consider a pilot SDR framework to test out substantive provisions. This

may be feasible in the Eurozone where the partial surrender of sovereignty that has already occurred may make substantive statutory rules less controversial.

For these reason, it appears to make more sense to create a procedural framework as the first step, rather than a more ambitious substantive framework, and see whether trust and confidence emerging from that allow for certain matters to eventually be decided by some authority. Much of the Code in the U.S. is procedural so effectuating this first step should not be viewed as a small accomplishment. Such a framework could be under UN auspices while remaining consensual, much like the International Court of Justice.

This can all be viewed as leading towards a standing international bankruptcy court tasked with addressing SDR and recognized by domestic courts through treaties or otherwise. How far can this go before becoming politically impractical to adopt? Nations have shown some recognition that it serves narrow national interests to have international disputes addressed through widely respected consensual dispute resolution mechanisms but there is a long way to go before this perspective becomes politically popular in domestic settings. The desire to be heard in an independent forum by a fair decision-maker will always be present so a well-conceived SDR framework has a role to play in the expansion of civilized international dispute resolution. But it will take the development of precedent, enforcement mechanisms, and trust that arises from positive tit for tat experiences for a new framework to grow and function effectively.

E. Concluding Comments

A final thought – our task today was to explore a framework for the improvement of sovereign debt restructuring. But the very term sovereign debt restructuring may be too narrow to effectively address important problems such as contagion and systemic risk because SDR focuses upon post-contractual difficulties. If were instead to consider the broader question of how to avoid, limit or minimize the impact of potential sovereign defaults (rather than just how to restructure), then regulation before debt is incurred would become fair game. Just as countries regulate “too big to fail” financial institutions, so the international community could seek consensus on proper regulation of sovereign debt offerings to limit systemic risk. For example, consensus might be reached that bonds must contain CACs and aggregation clauses to avoid hold out problems such as that faced by Argentina. Another example is a standstill clause to provide contractually authorized breathing space under certain conditions. More creative concepts would doubtless also emerge. In short, it seems logical to focus not just upon SDR but also upon front-end regulation to address the public policy concerns of contagion and systemic risk that result from private contractual arrangements.

Such provisions would raise questions of sovereignty, such as the freedom of nations to seek to borrow on whatever terms they wish. But if a global solution to sovereign debt crises is the goal, some elements of sovereignty must be on the table. Moreover, while financial networks are interrelated and hence difficult to tinker with, the advantage of setting specific contractual requirements is that they focus only upon the content of private agreements. Though private parties may not desire any regulation, at least they would be able to take the requirements into account as they negotiate their deals. The content of required contractual terms would be limited to those few provisions around which consensus could be built. If such regulation were approved

by the UN, it would constitute a positive precedent that may allow for the gradual adoption of additional regulatory provisions and add legitimacy to the proposition that competition among sovereigns for debt should not be based on whether or not systemic risk prevention clauses appear in debt instruments.

The stakes are high in establishing a new framework for SDR not just because of the relationship of this undertaking to sensitive international themes but also because sovereign debt restructurings are so commonplace and lending to developing countries so important. The opportunity is at hand to build stronger international relationships by exploring together and implementing a framework that can add value immediately to sovereign debt restructurings and offer the prospect of even greater effectiveness as the framework's role expands over time.