REFLECTIONS ON SOVEREIGN RESTRUCTURING AFTER THE GLOBAL RESTRUCTURING ORGANIZATION'S CONFERENCE IN MODENA, ITALY OCTOBER 2014

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I. Introduction

As a formal bankruptcy regime for sovereign nations does not currently exist countries have had to rely on a market-based approach to resolve excessive debt problems. Under this approach, a country can offer to exchange old bonds for new bonds with a lower face value, lower interest payments, and longer maturities. If investors accept this offer, the consentual contractual restructuring occurs successfully. On the other hand, investors might decide not to accept the offer and instead sue the country to collect on their debt. So that begs the question, what's the point of restructuring if a creditor can hold out, not participate in the agreement, and get more money through litigation?

So far, the market oriented approaches were not successful. In fact, in 2002 the deputy director of the International Monetay Fund ("IMF") proposed the adoption of a Sovereing Debt Restructuring Mechanism, stating that the absence of a mechanism for majority voting on a

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restructuring terms can complicate the process of working out an equitable debt restructuring that returns the country to sustainability.[4]

In 2013, the IMF issued a paper, which stated that the current contractual, market-based approach to debt restructuring is becoming less potent in overcoming collective action problems, especially in pre-default cases.[5] Recent events have also shown that there is a critical need for a sovereign debt restructuring convention. In particular, Greece showed the high cost Europe is payting for having to bail out the country. The IMF, European Union, and central banks have been forced to underwrite the bailout in order to restore confidence to the financial market. Citizens of Greece have been forced to accept harsh austerity measures as a condition of the bailouts, which led to riots, strikes, and widespread anger. The alternative to the bailout is default, which could trigger a systemic economic collapse.[6] This is prime example that the financial markets cannot handle situations of sovereign financial distress. Debtor-creditor workouts are inefficient solutions if they are not also accompanied with a legal framework. It no longer makes sense for the private financial community to oppose a sovereign bankruptcy law.[7]

The need for an international debt restructuring mechanism has been addressed by the United Nations General Assembly. On September 9, 2014, the General Assembly introduced a draft resolution on sovereign debt restructuring that would establish an intergovernmental

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[4] Anne Krueger, First Deputy Managing Director, International Monetary Fund, Given at the National Economists' Club Annual Members' Dinner, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2001), *available at* https://www.imf.org/external/np/speeches/2001/112601.facilihtm.

[5] *Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework*, (International Monetary Fund, Executive Summary Apr. 26, 2013), *available at* https://www.imf.org/external/np/pp/eng/2013/042613.pdf.

[6] Steven L. Schwarcz, *Toward a "Rule of Law" Approach to Restructuring Sovereign Debt*, THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Oct. 14, 2012, 9:08 am), http://blogs.law.harvard.edu/corpgov/2014/10/14/towards-a-rule-of-law-approach-to-restructuring-sovereign-debt/.

[7] Jeffrey D. Sachs, *The Roadblock to a Sovereign Bankruptcy Law*, 23 CATO JOURNAL 73 (Spring/Summer 2003).

negotiation process aimed at increasing the efficiency, stability and predictability of the international financial system.[8]

In that assembly, there have been two different prespectives. The United States and 10 other countries said that such a mechanism was likely to create economic uncertainty, market-oriented approaches are preferred, and work was ongoing in the IMF and elsewhere.[9] On the other hand, the majority of the United Nations members[10] agreed with the proposed resolution and argued that it was time to establish a legal framework for restructuring that respected creditors while allowing debtors to emerge from debt safely. In particular, they stated that marked based remedies such as collective action clauses, should be complemented by international statutory provisions that are undergirded by the force of law. In the meantime, the IMF published a paper to strengthen the contractual framework and to address collective action problems in sovereign debt restructuring.[11]

In the last 60 years, sovereign "restructuring processes have been widespread both across and within countries, with more than 600 individual cases."[12] Due to the number of sovereign restructurings that have occurred and are likely to continue to occur, there should be an international standard for restructuring sovereign debt that is accepted worldwide and holds up to

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[8] "With 124 votes in favour, 11 votes against and 41 abstentions, the Assembly adopted 'Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes.'" Meetings Coverage, General Assembly, Resolution on Sovereign Debt Restructuring Adopted by General Assembly Established Multilateral Framework for Countries to Emerge from Financial Commitments, U.N. Press Release GA/11542 (Sept. 9, 2014), *available at* http://www.un.org/press/en/2014/ga11542.doc.htm.

[9] Joseph Stiglitz, T*he World Needs a Sovereign Debt Restructuring Mechanism*, EMERGING MARKETS: NEWS, ANALYSIS AND OPINION (Dec. 10, 2014), http://www.emergingmarkets.org/Article/3389531/JOSEPH-STIGLITZ-The-world-needs-a-sovereign-debt-restructuring-mechanism.html.

[10] A group of 77 developing countries and China introduced the draft resolution entitled "Towards the establishments of a multilateral legal framework for sovereign debt restructuring processes." *See* Meetings Coverage, *supra* note 8.

[11] *See* Sovereign Debt Restructuring, *supra* note 5.

[12] Christoph Trebesch, Michael G Papaioannou, Udaibir S. Das, Sovereign Debt Restructurings 1950-2010 : Literature Survey, Data, and Stylized Facts , International Monetary Fund Working Paper (Aug. 1, 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf.

challenges.[13] In order to do this, a universally-accepted and applied standard for restructuring sovereign debt should contain:

- a definition for insolvency;
- an automatic injunction or a standstill period;
- creditor participation; a specific time frame for creditors-debtor negotiations; and
- the ability to bind all creditors.

II. The Collective Bargaining Problem and the Argentine Case

Dealing with "holdout creditors" is among one of the biggest issues preventing sovereign countries from being able to successfully restructure debt. The way that sovereign debt contracts are currently written creditors may elect to participate in a restructuring on an issuance-by-issuance basis. Such issuance-by-issuance structured voting makes it possible for creditors to purchase a large share of the bonds in a certain issuance in order to avoid a potential restructuring. These creditors, often referred to as holdout creditors, not only prevent their own class from having to be part of the restructuring but can also sink the entire restructuring.

This is exactly what occurred when Argentina attempted to restructure its debt. In the late 1990s to early 2000s, Argentina's economy took a hit for a number of reasons, including:

- drops in the values of Brazil's currency and the euro, which made Argentina's exports overpriced;

[13] Adam Smith was the precursor of applying bankruptcy processes to insolvent sovereign debtors, arguing that when the situation warranted, bankruptcy is a valid alternative to the chaotic ways that sovereign insolvency is otherwise handled. In Book V, Chapter III of the Wealth of Nations, Smith writes "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both the least dishonourable to the debtor, and least hurtful to the creditor."

– Argentina’s tying its peso to the U.S. dollar, which made it impossible for Argentina to cut interest rates, and
– its attempt to right its economy by cutting wages, which led to more unemployment and less tax revenue.

Without any real alternative choice, Argentina defaulted on its debt in 2001 to the tune of $100 billion dollars—the largest sovereign default at the time. In 2005 and again in 2010, Argentina offered the holders of its defaulted debt exchange bonds of approximately 35cents on the dollar.[14] Ninety-three percent of the bondholders accepted this deal as there was no real alternative to receiving payment. The holdout creditors not only refused to participate in the restructuring, they continued to litigate with the Argentinian government—costing the government, other creditors, and the courts a lot of money. The remaining 7% were mostly made up of hedge funds that bought the defaulted debt at a very low rate and were willing to gamble on winning a law suit that would force Argentina to pay more than what was available through the restructuring. These holdout creditors spent years suing the Argentinian government and attempting to seize Argentine government assets abroad usually without much success.

That is until one of these holdout creditors, a hedge fund named NML Capital Ltd. (“NML”), brought 11 actions against Argentina in the U.S. District Court for the Southern District of New York to collect on its debt of approximately $2.5 billion.[15] Essentially, NML argued that under the “*pari passu*” clause,[16] a boiler plate clause found in nearly all sovereign

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[14] Matt O’Brien, *Everything You Need to Know about Argentina’s Weird Default*, THE WASHINGTON POST WONKBLOG (Aug. 3, 2014), http://www.washingtonpost.com/blogs/wonkblog/wp/2014/08/03/everything-you-need-to-know-about-argentinas-weird-default/.
[15] Republic of Argentina v. NML Capital, Ltd., 134 S.Ct. 2250, 2251 (2014).
[16] “The Securities [i.e., the bonds] will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness (as defined in this Agreement).” Kathy

debt agreements that requires the borrower to treat all its creditors equally,[17] Argentina could either pay all its bondholders or none, but could not pay only those who cooperated with the 2005 and 2010 restructuring and ignore the rest.

In 2012, U.S. Judge Thomas P. Griesa interpreted the *pari passu* clause in the bond contract to mean that Argentina could not make payments to the owners of restructured bonds unless it also made payments to the holdout creditors. Not paying holdouts, he said, would be a violation of the pari passu clause. If this had been the totality of the ruling, Argentina could have simply ignored the decision and paid the restructured bonds without recourse. Judge Griesa's ruling went one step further. He stated that any financial institution that helped Argentina make payments to the restructured bondholders could be held in contempt of his order.[18] This was affirmed by the U.S. Court of Appeals for the Second Circuit.[19] And ultimately, certiori was denied by the U.S. Supreme Court.[20] In the summer of 2014, Argentina had to decide whether to pay the holdouts or default on its restructured bonds. Despite having the capital to make the restructured payments, it chose default.

Judge Griesa's ruling makes abundantly clear that the current framework for sovereign debt restructurings is no longer viable and must be reformed. This ruling may encourage more creditors to "hold out" in future sovereign bond debt restructurings. Thus, bond contract clauses that led to this ruling need to be addressed in order to incentivize all creditors to participate in a restructuring—and give the sovereign state a chance at a successful financial reorganization.

Gilsinan, *65 Words Just Caused Argentina's $29 Billion Default: A Tale of Debt and Difficult English*, THE ATLANTIC (July 31, 2014 11:59 am), http://www.theatlantic.com/international/archive/2014/07/65-words-just-caused-argentinas-29-billion-default/375368/.

[17] *Id.*

[18] Nicole Hong, *Argentine Bond Standoff Puts U.S. Judge in Focus: Judge Thomas Griesa Gains Notoriety after Ruling in Nation's Dispute with Holdout Creditors*, THE WALL ST. J. MARKETS, (July 30, 2014 12:47 am), http://www.wsj.com/articles/argentine-debt-crunch-puts-u-s-judge-in-focus-1406660549.

[19] NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2nd Cir. 2012).

[20] Stewart Bishop, *Argentina Euro Bondholders Seek Exemption from US Courts*, LAW 360 (June 30, 2014 8:33 pm), http://www.law360.com/articles/553135/argentina-euro-bondholders-seek-exemption-from-us-courts.

The International Monetary Fund has proposed two solutions to this problem.[21] The first is to change the language of collective action clauses in sovereign bond contracts so that a decision by the majority of creditors binds all creditors.[22] Currently, most sovereign debt contracts require an issuance-by-issuance vote to approve a restructuring, which makes it easier for holdout creditors to buy shares of a single issuance and sway that issuance's vote. Changing the voting structure to allow the majority of creditors in a single vote to control outcome prevents holdout creditors from being able to purchase a sufficiently large share of bonds to influence a vote.

The second proposal involves changing the *pari passu* clause to make clear that there is no obligation to pay all creditors *pro rata*. Without this change, holdout creditors could multiply as they stand to receive a much better return on their investments on the secondary market outside of a debt exchange. There is also a significant risk that bondholders will choose not to participate in a debt exchange out of fear that the sovereign state will default on the exchanged debt. Thus, those creditors who would have been inclined to participate in a consensual restructuring may now be less likely to do so. In other words, by offering holdouts a mechanism to extract recovery outside a voluntary debt exchange, the decisions would increase the risk that holdouts will multiply and creditors who are otherwise inclined to agree to restructuring may be less likely to do so due to inter-creditor equity concerns. The International Capital Markets Association, ("ICMA"), is a trade association representing debt capital markets participants that has traditionally taken a leading role in the development of model contractual clauses for

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[21] Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, International Monetary Fund Policy Paper (Sept. 2, 2014), *available at* http://www.imf.org/external/np/pp/eng/2014/090214.pdf.

[22] *IMF Supports Reforms for More Orderly Sovereign Debt Restructurings*, IMF SURVEY MAGAZINE: IN THE NEWS (Oct. 6, 2014) , http://www.imf.org/external/pubs/ft/survey/so/2014/new100614a.htm.

international sovereign bonds. ICMA has recently published the following new model contractual clause:

> The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank pari passu, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.[23]

This clause makes explicit that, while the *pari passu* clause requires equal ranking of all unsubordinated external indebtedness, it does not require that such indebtedness be paid on an equal or ratable basis.[24]

While these changes are good first steps to creating a functioning sovereign restructuring mechanism, more needs to be done in order to provide uniformity, consistency, and prediciability to the sovereign debt marker.

III. What more should be done?

Each country seeking to restructure its debt should have to meet the same definition of "insolvent" as any other country that wishes to restructure. To be considered insolvent, the country should have to show:

- that its annual income is insufficient to pay debts as they come due;
- increasing its income through new or higher taxes would lead to worsening economic problems for its citizens; and
- that it has acted in good faith prior to seeking a declaration of insolvency.

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[23]International Capital Market Association, Standard Pari Passu Provision for the Terms and Conditions of Sovereign Notes, *available at* http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-Pari-Passu-Provision-August-2014.pdf.

[24] Strengthening the Contractual Framework, *supra* note 21, at 15.

Once insolvency is met, the country should be permitted a certain time period in order to get its restructuring plan in place. Thus, the sovereign should be afforded a break from creditors in a way that is similar to the "automatic stay" in American bankruptcy law. This injunction should temporarily prevent creditors from being able to collect on their debts.

The injunction also ensures that one creditor does not receive payment while other creditors are left without pay. It also helps motivate creditors to participate in the reorganization process.

To be successful, any debt restructuring process must have a way for creditors to participate in the restructuring. The restructuring should ensure that all creditors feel they are being "heard" and treated fairly. The basics of this include a process through which creditors can formally assert the amount due to them.

Similarly situated creditors should garner similar treatment under the restructuring, though, creditors with more debt should have more influence than creditors who are owed less.

Creditors should be required to participate in the restructuring in "good faith." For failing to act in good faith, a creditor could be penalized by the neutral adjudicator assigned to the case. The penalty could be a reasonable reduction in debt, such as lower interest payments, extended payback period, or a reduction in principal).

Another mechanism for protection of creditors may consist of setting forth the maximum period for restructuring negotiations. In that case creditors will be more secured that the process will last no longer than a certain period.

Both creditors and countries will benefit from establishing a single collective forum to work toward a restructuring plan and to provide a neutral third-party who oversees the process and who should have the authority to bind the debtor-country and creditors to the restructuring

plan. The neutral could be one person—such as a judge—or a panel of individuals, so long as the neutral has the authority to enforce its own orders. The neutral could take testimony and resolve disputes over the amount of debts owed and would have the final word on how much a particular creditor or class of creditors will be paid. The neutral would also make a determination as to whether or not the sovereign will be able to maintain future payments.

The Argentine insolvency, as well as the likelihood of future restructurings of sovereign debt of other countries, underscores the need for a standardized sovereign restructuring regulations.