The International Financial Architecture and Sovereign Debt Crisis Resolution

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I. Introduction

This chapter reviews the international financial architecture and its role in sovereign debt crisis resolution. All debts are creatures of contract and sovereign debt is no different in this regard: Sovereign debtors enter into loan agreements with banks, sell securities to investors in capital markets, and conclude debt contracts with other governments or multilateral organizations. What makes these debts special is that the legal value of their promise to repay the borrowed amounts is often compromised by the doctrine of sovereign immunity and the lack of a central court for adjudicating contract-related disputes. A rule of customary international law, sovereign immunity entails that a sovereign state cannot be sued before the courts of another state without its consent. Resolution of disputes emerging in the sovereign debt context is thus largely an ad-hoc exercise with shifting contours shaped by politics, international law, and the domestic norms of key financial jurisdictions, notably New York and England.

These features have proven to be malleable and shifting over the past centuries. Simply taking stock of their status quo at any given point in time risks conveying a quickly outdated picture. Instead, this chapter will highlight the flexibility and moving aspects of this 'architecture' and thereby argue that when it comes to sovereign debt crisis resolution, the oft-quoted international financial architecture could be better described as furniture or dynamic ecosystem. Its building blocks can be moved and re-arranged to suit the mood of the times. More importantly, the ways in

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which sovereign debt crises are solved have changed (from gunboat diplomacy and sovereign income stream encumbrances to IMF intermediation, court adjudications, and collective action clauses), but the outcomes have remained remarkably similar. As of this writing, the New York state legislature, which has jurisdiction over more than 50% of outstanding international sovereign bonds,[1] has been working on legislative options to improve restructuring processes over the past four years.[2] Whether these shifts actually take place is yet to be seen, but initiatives such as the one put forward in New York are not new.

For example, in 2001, driven by concerns over holdout creditors and the lack of an efficient process to coordinate dispersed private holders of sovereign bonds, Anne O. Krueger, then the Deputy Managing Director of the International Monetary Fund (IMF), published what is to date the most ambitious proposal to create a sovereign debt resolution architecture.[3] It sought to create a bankruptcy-analog regime with the IMF at its center. Yet, political economy constraints and concepts of sovereignty have stood, and continue to stand, in the way of the statutory approach to sovereign debt restructuring.[4] Instead, the IMF membership has since promoted the contractual approach, which relies on negotiations between creditors and the use of contractual coordination mechanisms.[5]

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[1] International Monetary Fund (IMF), 'The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options' (IMF Policy Paper, 2020) 22 (noting that '[a]s a share of the nominal principal amount, about 45 percent of the total stock outstanding of international sovereign bonds are governed by English law and about 52 percent by New York law.').

[2] For an overview of the different Bills related to sovereign debt restructuring that have been under legislative consideration in the past few years, see Clifford Chance, 'Sovereign Debt Restructuring: Active New York Assembly Bill Providing for a New Comprehensive Sovereign Debt Restructuring Mechanism and a Limit on Recoveries on Sovereign Debt' (11 March 2024) https://www.cliffordchance.com/briefings/2024/03/sovereign-debt-restructuring--active-new-york-assembly-bill-prov.html accessed 18 September 2024.

[3] Anne Krueger, 'A New Approach to Sovereign Debt Restructuring' (IMF, 2002) https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf accessed 18 September 2024.

[4] Brad Setser, '12 The Political Economy of the SDRM' in Barry Herman, José Antonio Ocampo, and Shari Spiegel (eds), *Overcoming Developing Country Debt Crises* (OUP, 2010).

[5] IMF, 'Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring', IMF Policy Paper (2014) https://www.imf.org/external/np/pp/eng/2014/090214.pdf accessed 3 September 2024.

Many experts pinpoint disincentivizing private creditors' holdout behavior as the key rationale for their support of a revamp in sovereign debt resolution mechanisms.[6] Restructurings are often delayed until they are inevitable and once a process starts, they take too long.[7] This is the root problem: sovereign debt resolution tends to be a protracted affair, involving a variety of different cooks that could spoil the broth.[8]

Moreover, recent research finds that the costs of default are regressive (i.e. the poorest suffer the most upon a default).[9] Poverty rates increase shortly after default, over the following decade life expectancy declines, infant mortality increases by 1.5%, and, of course, GDP plunges and does not recover.[10] More importantly, these costs are time variant; with slower resolutions leading to increasing costs.[11] While there may be interim restructurings, the decisive restructuring which cures the default and keeps the country from re-defaulting for at least 24 months takes on average 7.9 years to arrive.[12]

Importantly, the landscape of sovereign financing markets has changed significantly over the past decade or so. Bilateral creditors are now the most important financial counterparties to many developing economies and their lending practices are not governed by the same legal framework as bonds or other commercial debt instruments.[13] In fact, delays on the recently completed Zambian restructuring have been largely attributed to coordination challenges among

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[6] See, eg, Lee Buchheit and Indermit Gill, 'A Better Way to Induce Creditor Cooperation in Sovereign-debt Workouts', *World Bank Blog*, 16 May 2024, https://blogs.worldbank.org/en/voices/a-better-way-to-induce-creditor-cooperation-in-sovereign-debt-workouts accessed 18 September 2024.

[7] Whether or not this would improve by replacing the contractual, negotiation-based approach with a top-down statutory regime remains controversial and a discussion of the trade-offs would go beyond the scope of this chapter.

[8] Sebastian Grund, *Sovereign Debt Restructuring and the Law: The Holdout Creditor Problem in Argentina and Greece* (Routledge 2023).

[9] Juan Farah-Yacoub, Clemens Graf von Luckner, Carmen M. Reinhart, and Rita Ramalho, 'The Social Costs of Sovereign Default', Policy Research Working Paper, World Bank (2022) 5-12.

[10] ibid.

[11] Tamon Asonuma and Christoph Trebesch, 'Sovereign Debt Restructurings: Preemptive or Post-Default' (2016) 14 Journal of the European Economic Association 175–214; Christoph Trebesch, Josefin Meyer, Carmen Reinhart, and Clemens Graf von Luckner, 'External Sovereign Debt Restructurings: Delay and Replay, *VoxEU*, 21 May 2021, https://voxeu.org/article/external-sovereign-debt-restructurings-delay-and-replay accessed 30 August 2024.

[12] Trebesch et al (n 11).

[13] Chuku Chuku and others, 'Are We Heading for Another Debt Crisis in Low-Income Countries? Debt Vulnerabilities: Today vs the Pre-HIPC Era', IMF Working Paper No 2023/079, 4 April 2023, https://www.imf.org/en/Publications/WP/Issues/2023/04/04/Are-We-Heading-for-Another-Debt-Crisis-in-Low-Income-Countries-Debt-Vulnerabilities-Today-531792 accessed 30 August 2024.

official bilateral creditors rather than bondholders.[14] While, in the aftermath of the COVID-19 pandemic, the Group of Twenty (G20), the premier forum for international economic cooperation, responded by forging a new initiative to bring the main bilateral creditors to one negotiating table, this "G20 Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative" (henceforth "Common Framework") has yet to deliver on promises of expedited resolution.[15]

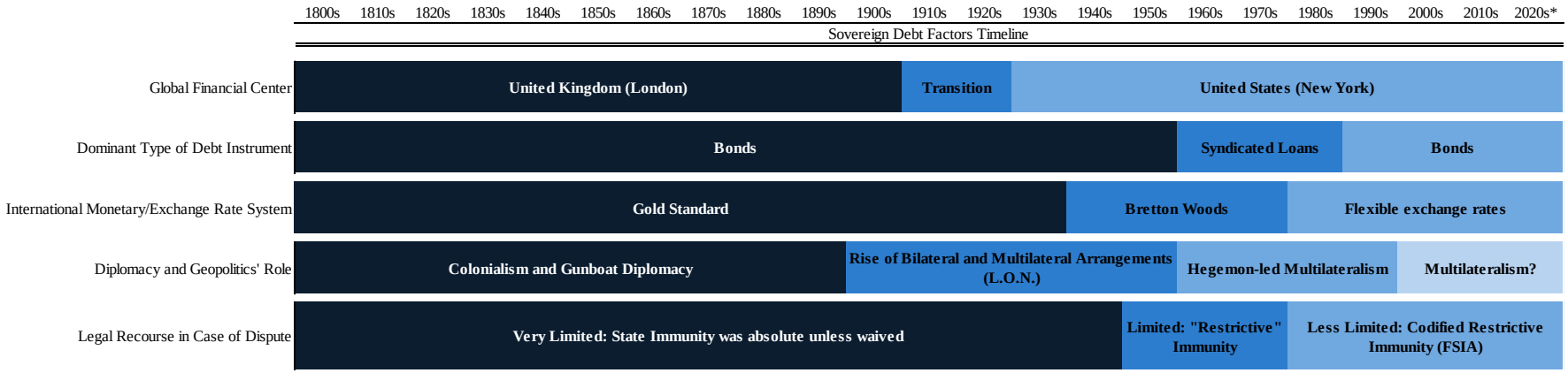
The chapter proceeds first by presenting an historical summary of sovereign debt and its resolution mechanisms. Then we turn to the current architecture, presenting the main players as well as the most salient legal characteristics shaping the international sovereign debt system. Lastly, we offer some forward-looking thoughts on what may be on the horizon.

II. A Short History of Sovereign Debt Arrangements

This section briefly explores the tectonic movements that have contributed to the international sovereign debt system's current configuration. It thus illuminates the most salient historical developments of the field including the construction of a Western-led multilateral order, which, for sovereign debt restructurings entailed the creation of the Paris Club; the codification of restrictive sovereign immunities in the US and UK, which enabled creditors to resort to the courts as opposed to lobbying their government to defend their interests; and the transition from syndicated bank lending to bonds that came with the resolution of the 1980s emerging markets debt crisis. To help the reader appreciate the major timelines and their interactions it is useful to visualize them. Figure 1 below presents a stylized set of overlapping timelines.

[14] See Jorgelina Do Rosario, 'Analysis: Cash-strapped Countries Face IMF Bailout Delays as Debt Talks Drag on' *Reuters*, 2 March 2023; Kejal Vyas and Jin Wu Song, 'The Frantic Push to Solve Sovereign Debt Crises Irks Wall Street' *Bloomberg*, 29 May 2023 (*citing* Mark Weidemaier:'[t]he primary ripple to restructuring now is you have failure to reach agreement among official creditors … That's the primary source of delay').
[15] Kristalina Georgieva and Ceyla Pazarbasioglu, 'The G20 Common Framework for Debt Treatments Must Be Stepped Up', *IMF Blog*, 2 December 2021, https://www.imf.org/en/Blogs/Articles/2021/12/02/blog120221the-g20-common-framework-for-debt-treatments-must-be-stepped-up accessed 30 August 2024.

Figure 1. Stylized Timeline of the Eras of Commercial Sovereign Debt[16]



[16] Authors' own elaboration generally based on Carmen M. Reinhart and Kenneth S. Rogoff, This Time is Different: Eight Centuries of Financial Folly (Princeton University Press 2010); G. Mitu Gulati and Mark C. Weidemaier, 'Differing Perceptions? Market Practice and the Evolution of Foreign Sovereign Immunity', Duke Law School Public Law & Legal Theory Working Paper No. 2016-21; Jeffrey Frankel, 'The Rise of the Renminbi as International Currency: Historical Precedents', *VoxEU*, 10 October 2011, https://voxeu.org/article/rise-renminbi-international-currency-historical-precedents accessed 2 September 2024.

In the absence of a formalized central workout mechanism, sovereign debt markets have always turned to informal arrangements.[17] In the nineteenth century, this largely entailed the creation of ad-hoc creditor groups and, later, the formation of guilds or trade associations. The most important one was the Corporation of Foreign Bondholders of London, established in 1868, incorporated in 1873, and operating until 1988.[18] This 'corporation' was created by investors to gather information on the market and safeguard the interests of bondholders. Sovereign finance practices were different then. Collateralized loans were common, entailing the use of a valuable asset or an expected cashflow (e.g. from exports of a certain commodity) as collateral to secure a loan. If the borrower defaulted on the loan, the lender might seize and sell the asset to offset their loss. Similarly, sovereign interventions were commonplace. The governments of powerful countries even took military action to assert the rights of their creditor subjects. By the early twentieth century, sovereign financing had turned into a realm reserved to other sovereigns due to increased geopolitical tensions.[19] Between the 1910s and the end of WWII, bilateral lending was the rule in sovereign debt. It was largely driven by geopolitical, as opposed to commercial, motives.

Starting in the 1950s the first informal group of state creditors was developed to deal with sovereign debt, then the main source of financial pain for sovereigns.[20] The Paris Club gathered representatives from rich developed nations who had extended credit through their agencies over the preceding two decades.[21] To this day, the Paris Club aims to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries.

The next shift was in the source of credit. Emerging countries began to borrow heavily in hard currency from large, internationally-active banks in money centers, notably New York City

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[17] Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Brookings Institution Press 2003), 19.
[18] Paolo Mauro and Yishay Yafeh, 'The Corporation of Foreign Bondholders', IMF Working Paper No WP/03/107 (2003) 3 http://www.imf.org/external/pubs/ft/wp/2003/wp03107.pdf accessed 30 August 2024. See also Annual Report of the Council of the Corporation of Foreign Bondholders (1873) 1, retrieved via Stanford Libraries https://searchworks.stanford.edu/view/357970 accessed 30 August 2024.
[19] See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press 2009).
[20] Rieffel (n 17) 18-21.
[21] Annamaria Viterbo, *Sovereign Debt Restructuring: The Role and Limits of Public International Law* (Giappichelli 2020) 90 et seq.

and London, during the 1970s. As these private creditors took center stage in sovereign lending under a new international order, they resorted to creating their own informal mechanism for sovereign debt workouts: The Bank Advisory Council—dubbed The London Club by the press.[22]

At the same time, the necessity to codify sovereign immunity practices by statute became apparent.[23] Thus, in 1976 and 1978 respectively, the United States passed the Foreign Sovereign Immunities Act and the United Kingdom passed the State Immunities Act.[24] Both statutes codified a doctrine hitherto known as restrictive sovereign immunity, which has since been recognized as customary international law.[25] In essence, a sovereign could from then on be subjected to the jurisdiction of their courts when acting as a private commercial actor would.[26]

Then in the early 1980s another large shift took place and the 'emerging markets debt crisis' gave way to what is now known as the 'lost decade.' As interest rates increased in the United States under the direction of the Federal Reserve System (Fed) Chairman Paul Volcker to fight stubborn inflation, most developing sovereign borrowers came under extreme financial pressure.[27] The emerging markets debt crisis is often thought to have started with the Mexican default of 1982.[28] At its height, in 1986, roughly a third of all independent sovereigns, in total 56 states, were in default to private creditors.[29] As US banks were deeply exposed to foreign sovereigns, this became a systemic issue, which urgently demanded a resolution.[30]

During the first stage of the crisis, in the early 1980s, private creditors rejected proposals for debt write-offs that would have undermined their own solvency given their large exposure to

[22] Raman Uppal and Cynthia Van Hulle, 'Sovereign Debt and the London Club: A Precommitment Device for Limiting Punishment for Default' (1997) 21(5) *Journal of Banking & Finance* 741–756.
[23] See Gulati and Weidemaier (n 16) 11; Mary Kay Kane, 'Suing Foreign Sovereigns: A Procedural Compass' (1982) 34 *Stanford Law Review* 385, 385–86.
[24] ibid.
[25] Mark C. Weidemaier, 'Sovereign Immunity and Sovereign Debt' (2014) 1 *University of Illinois Law Review* 67.
[26] ibid.
[27] See Jérôme Sgard, *The Debt Crisis of the 1980s* (Edward Elgar, 2023).
[28] ibid 80-89
[29] Rieffel (n 17) 156.
[30] Sgard (n 27) 1-2.

emerging markets; they 'extended and pretended.'[31] By 1986 the US Treasury, under the leadership of James Baker, proposed a plan that ultimately failed.[32] In exchange for reforms liberalizing capital flows, import restrictions, and privatization of money-losing state enterprises the U.S Treasury would urge the World Bank, Inter-American Development Bank, and private banks to disburse US$30 billion in net new financing over three years.[33] Creditor wariness, reform fatigue and political pressures meant the plan could not deliver anything either side wanted.[34] By 1987 both debtor-countries and market participants had abandoned the Baker plan and started to experiment with face value reductions and creative restructuring on their own.[35] Additionally, in 1987 the banks finally began provisioning for losses, clearing a path for accepting principal reductions.[36]

The 1988 Mexican debt-exchange offered the blueprint for what would become the Brady plan in 1989, named after yet another US Treasury Secretary.[37] Under this scheme, bank syndicates accepted (a) twenty year bonded debt, which they could sell into secondary markets, that (b) had lower face values than the original loans and (c) were backed by zero-coupon US treasuries.[38] Ultimately, these were the characteristics of the Brady plan: Face value reductions; bonds instead of loans, so as to be able to disperse risk; and the backing of the new principal amounts with zero-coupon treasury bonds in order to entice uptake.[39]

These developments demonstrate the overall fluidity of the sovereign debt system. First, the Brady plan was largely an outgrowth of market innovation and was eventually achieved

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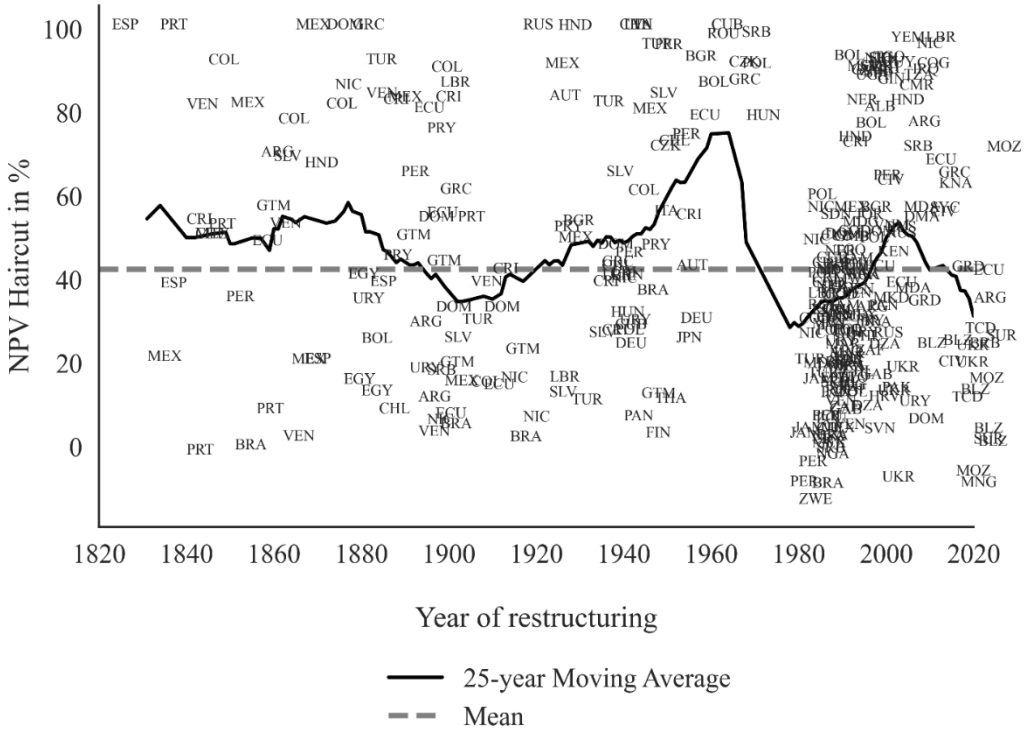
[31] Edwin M. Truman, 'Chapter 8 The Debt Crisis and Its Resolution' in *Current Legal Issues Affecting Central Banks*, Volume III (IMF, 1995).
[32] Christine A. Bogdanowicz-Bindert, 'The Debt Crisis: The Baker Plan Revisited' (1986) 28(3) *Journal of Interamerican Studies and World Affairs* 33, 33–46.
[33] Rieffel (n 17) 163.
[34] Ross Buckley, 'The Facilitation of the Brady Plan: Emerging Markets Debt Trading From 1989 to 1993' (1997) 21 *Fordham International Law Journal* 1802.
[35] Rieffel (n 17) 165.
[36] ibid.
[37] Neil Shenai and Marijn A. Bolhuis, 'How the Brady Plan Delivered on Debt Relief: Lessons and Implications', IMF Working Papers, 2023, No 258.
[38] Buckley (n 34).
[39] Shenai and Bolhuis (n 37).

without resorting to generalized coercive tools.[40] Second, it is during the 1980s that two of the characteristics of the current system developed. Most of the rescheduling and restructuring deals were closely linked to, or indeed conditional on, IMF-supported macroeconomic adjustment programs.[41] This period of stress put the Fund front and center in the current sovereign debt restructuring regime fulfilling both the role of last resort lender and, through its debt-sustainability evaluations, the quasi-arbiter on the size of the debt relief required.

Remarkably, despite the vast political and legal developments, the outcomes of sovereign debt restructuring have remained stable on average. Figure 2 below illustrates sovereign debt restructuring outcomes (i.e. haircuts/creditor losses) from the creditor's perspective for over 300 restructurings since 1800. As Graf von Luckner and others show,[42] the drastic changes in sovereign debt restructuring regimes over that period, the statistical distribution and drivers of creditor losses has no trend: The more things changed, the more they stayed the same.

[40] Manuel Monteagudo, 'The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective' (1994) 28 *International Lawyer* 59.
[41] Shenai and Bolhuis (n 37) 8.
[42] Clemens Graf von Luckner, Josefin Meyer, Carmen Reinhart and Christoph Trebesch, 'Sovereign Haircuts: 200 Years of Creditor Losses', NBER Working Paper No w32599 (June 2024), https://ssrn.com/abstract=4874243 accessed 3 September 2024.

Figure 2. Creditor Losses since 1820.



Source: Graf von Luckner et al. (2024)

III. The Current Landscape

As in the past, the present international debt system consists of a smattering of international law customs and norms, and the legal frameworks of select jurisdictions like the US and UK, including pertinent subnational laws.[43] Most commercial (private creditor to country debtor) loans and bonds are issued in these two jurisdictions.[44] In most current cases, crisis resolution involves the provision of financing by the IMF, other multilateral lenders, or large bilateral creditors. Given the variety of creditor interests—especially bilateral and multilateral lenders—the restructuring

[43] For an overview, see Grund (n 8) 1-30. Note that while English and New York law govern the vast majority of international sovereign debt instruments, UK and US (federal) laws encompass some of the essential norms regulating the relationship between foreign states and domestic entities, such as sovereign immunity statutes.
[44] IMF (n 1).

process cannot be de-politicized. In addition, rules bind actors to different degrees, which may result in asymmetric burden-sharing outcomes. Private creditors are usually subject to domestic regulatory requirements and fiduciary duties, official bilateral creditors operate within the bounds of their political constraints, and international financial institutions are enjoined by their charters from writing off loans. Yet, voluntary participation in restructurings dictates that, in principle, creditor losses imposed by a default are shared by all creditors.

The first characteristic of the current structure is the heterogeneity of debtor entities and creditors. Countries generally borrow at the central government level but may also incur liabilities through their state-owned enterprises. Additionally, countries borrow in different currencies (predominantly US dollars) and, importantly, under different governing laws. There are also many creditors with different aims; not all of whom are simply profit-maximizing investors. The creditor mix is not static even over relatively short periods. Capital is dynamic and adaptive, as are the borrowers seeking it. The sources and directions of capital flows can change, thus continuously altering the compendium of applicable practices, customs, and laws often referred to as the 'International Financial Architecture'.

There are three main groups of creditors.[45] First, private creditors chiefly include bondholders and banks. These creditors are generally interested in maximizing portfolio returns and, in the case of bondholders, are mostly represented by large fiduciary investment managers, mostly 'real money' investors such as insurance companies and pension funds. The explosion in bonded debt is one the most notable development of the past two decades.

Second, bilateral creditors provide country-to-country loans, as well as export-import bank loans and development financing through agencies such as the US Development Finance Corporation. In general, these creditors can be seen as pursuing policy aims. This group has historically participated in restructurings as a bloc represented by the Paris Club. Herein lies the

[45] Our focus lies on external sovereign creditors that provide financing in a foreign currency. For an analysis of the two different types of sovereign debt, see, eg, Anna Gelpern and Brad Setser, 'Domestic and External Debt: The Doomed Quest for Equal Treatment' in Barry Eichengreen and Ricardo Hausmann (eds), *Other People's Money: Debt Denomination and Financial Instability in Emerging Market Economies* (University of Chicago Press 2005).

second notable development of the past two decades: the rise of large non-Paris Club bilateral creditors such as China, Saudi Arabia, and the United Arab Emirates. Chinese bilateral lending now constitutes the relative majority of international debt for more than 50 countries.[46] For this group—all low-income countries as classified by the World Bank—amounts owed to China far exceed those owed to bond holders.

Third, multilateral creditors include, most notably, the IMF, the World Bank and regional development banks, such as the European Bank for Reconstruction and Development, or the African Development Bank.

Figure 3: Creditor Restructuring Forums and Treatment[47]

<table>
<tr><td></td><td colspan="6">Creditors</td></tr>
<tr><td>Debtor</td><td>IMF</td><td>Multilateral Development Banks</td><td>Bilateral</td><td>Banks</td><td>Bonds</td><td>Suppliers</td></tr>
<tr><td>Sovereign</td><td colspan="2">Direct negotiation, preferential treatment</td><td rowspan="2">Paris Club but important non-PC creds. insist on direct negotiation/ priority.</td><td rowspan="2">London Club historically. Smaller player now, so more direct negotiation.</td><td>Ad-hoc creditor committee. Mostly joint negotiation under CACs.</td><td rowspan="2">Ad-hoc</td></tr>
<tr><td>State-Owned Enterprises</td><td>No lending</td><td>Direct negotiation, priority</td><td>Idiosyncratic, largely as if it were a regular corp.</td></tr>
</table>

1. Is there a Seniority Structure to Sovereign Debt Claims?

In the absence of an international sovereign bankruptcy regime, the ranking of claims is a fluid concept in sovereign borrowing.[48] Under bankruptcy law, a creditor who has a senior claim ranks

[46] Author's calculations based on World Bank, International Debt Statistics https://databank.worldbank.org/source/international-debt-statistics# accessed on 21 April 2024.
[47] Rieffel (n 17) 21; authors' own elaboration and additions based on the information presented in this chapter.
[48] Anna Gelpern, 'Building a Better Seating Chart for Sovereign Restructurings' (2004) 53 Emory Law Journal 1119–1161 (explaining that while no *de jure* seniority structure exists, there are a set of conventions that help guide the market); Nouriel Roubini and Brad Setser, 'Seniority of Sovereign Debts', in George A. Von Furstenberg (ed), *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (Peterson Institute for International Economics 2003) 249–287.

highest in the order of repayment, and thus receives a payout before other creditors. In sovereign debt, there is no such *de jure* structure. Nonetheless creditors often jockey for *de facto* seniority.

As a general matter, the IMF and World Bank, along with other multilateral and regional development banks are treated as preferred to other creditors.[49] However, there are few robust empirical studies on the *de facto* seniority structure among sovereign creditors. One oft-cited paper by Schlegl, Trebesch and Wright finds the following pecking order: Multilateral creditors led by the IMF, private creditors, and lastly bilateral lenders.[50] However, as a matter of principle, private creditors have often been deemed junior to bilateral creditors in debt restructuring cases.[51] In sum, while no *de jure* seniority structure exists in the international debt system, a fluid set of conventions has helped to guide the system *de facto.*

2. Sovereign Commercial Debt and Its Restructuring

This section focuses on the peculiarities of sovereign liabilities vis-a-vis commercial or private lenders, and the restructuring of such obligations. As mentioned before, no single coordinating framework similar to national insolvency law exists on the international plane. Commercial debts incurred by sovereigns are typically governed by contract but they are carved-out from domestic insolvency or bankruptcy laws.[52] While some standardization of contract terms exists in the bond space, the sheer heterogeneity of contractual clauses across commercial debt instruments demonstrates the malleability, flexibility, and dynamism of the field. And so does the fact that

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[49] Matthias Schlegl, Christoph Trebesch and Mark Wright, 'The Seniority Structure of Sovereign Debt', CESifo Working Paper No 7632 (2019), https://EconPapers.repec.org/RePEc:ces:ceswps:_7632 accessed 2 September 2024.

[50] Their test focused on identifying who bears the brunt of losses upon a restructuring: the group of creditors taking the largest haircut is deemed to be de facto junior, while the group of creditors taking the lion's share of repayment is regarded as *de facto* senior. ibid.

[51] See, eg, European Central Bank, 'The IMF's role in sovereign debt restructurings', ECB Occasional Paper No 262 (September 2021) 30 https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op262~f0e9e1e77e.en.pdf accessed 2 September 2024 (noting that "[b]ilateral claims are mostly treated via the Paris Club; they have a lower seniority than multilateral claims but should generally be senior to private claims."); also see Tito Cordella and Andrew Powell, 'Preferred and Non-Preferred Creditors' (2021) 132 *Journal of International Economics* 103491.

[52] See Paul Lejot, 'Sovereign Debt' Oxford Bibliographies (OUP 2017) https://www.oxfordbibliographies.com/display/document/obo-9780199796953/obo-9780199796953-0155.xml accessed 2 September 2024. For instance, Chapter 9 of the US Bankruptcy Code, which deals with municipal bankruptcies, explicitly excludes sovereign states from its provisions.

certain clauses have evolved and proliferated in recent years. In other words, contracts can be written and re-written.

There are two major jurisdictions for commercial sovereign debt issuance: New York and England. They display a few commonalities and some punctuated differences. Among the contractual tools to restructure sovereign debt, Collective Action Clauses, or CACs, reign supreme. These provisions, which are standard boilerplate in almost all newly-issued sovereign bonds in New York or England[53], enable restructuring negotiations by binding a minority of holdouts to a restructuring deal endorsed by a creditor (super-)majority. Importantly, however, no similar majority voting provisions exist in the loan context, which renders syndicated debt more prone to holdout risks than bonds. Moreover, even in the presence of CACs, some creditors may seek enforcement of their claim against the sovereign in municipal courts or international arbitral tribunals, as recently evidenced by the *Hamilton Reserve Bank v. Sri Lanka* suit.[54] Since sovereign debt litigation and arbitration is a highly technical and complex subject, we will only cover it in broad strokes. This subsection shows that there are strong incentives for bondholders and debtor countries to negotiate and little to gain from holdout creditor behavior under current contractual standards.

A. Collective Action Clauses (CACs)

CACs are provisions in *bond* contracts that allow a majority or supermajority of bondholders to make decisions binding on all holders of the same bond or bonds capable of aggregation, including restructuring payment terms.[55] CACs have evolved to become a key feature of the international financial architecture for resolving sovereign debt crises.[56] These provisions first emerged in

[53] See IMF (n 1) (noting that approximately 91% of new international sovereign bond issuances have included the enhanced CACs between 2018 and 2020).
[54] See *Hamilton Reserve Bank Ltd v The Democratic Socialist Republic of Sri Lanka*, 22cv5199 (DLC) (SDNY 1 November 2023). Also see for a discussion of this issue, Mark C Weidemaier and F Andrew Hessick, 'The Judgment-Holder Problem in Sovereign Debt Workouts', UNC Legal Studies Research Paper No 4821478, 8 May 2024, https://ssrn.com/abstract=4821478 accessed 3 November 2024.
[55] Anna Gelpern and G. Mitu Gulati, 'The Wonder Clause' (2013) 41 *Journal of Comparative Economics* 367, 368.
[56] IMF (n 1).

English-law bonds in 1879.[57] The lawyer who conceived of them, Francis Beaufort Palmer (1845–1917), stated that their purpose was to enable a majority of bondholders to prevent a minority from adopting unreasonable conduct and creating deadlock.[58] The operation of CACs is equivalent under US and English law.[59]

'First Generation' CACs allowed a specified supermajority of bondholders (typically 75% of principal) voting at a meeting to approve modifications to some of the key bond terms relevant for a debt restructuring, binding all holders.[60] Though widely adopted in English-law bonds, they were rare in US-law bonds, but gained new prominence after the IMF proposed them as a policy response to the difficulty of restructuring New York-law bonds that required unanimous consent, following Mexico's 'Tequila Crisis' in 1995 and especially Argentina's default in 2001.[61] In 2002, the G-10 working group drafted 'Second Generation' model CACs suitable for New York-law bonds, updating the clauses for modern US markets while providing greater minority bondholder protections. [62] The differences between first- and second-generation CACs were largely procedural.[63] A key limitation of these early CACs was that they only operate within a single bond series.[64] A separate vote was required to restructure each series, enabling holdout creditors to potentially acquire blocking positions in individual bond series.[65]

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[57] Lee C. Buchheit and G. Mitu Gulati, 'The Argentine CAC Controversy', Duke Law School Public Law & Legal Theory Working Paper No 2020-72 (2020).
[58] ibid.
[59] Gelpern and Gulati (n 55) 367-370.
[60] Buchheit and Gulati (n 57) 2-8.
[61] ibid.
[62] IMF, 'A Guide to Committees, Groups and Clubs' https://www.imf.org/en/About/Factsheets/A-Guide-to-Committees-Groups-and-Clubs#:~:text=The%20Group%20of%20Ten%20%28G10%29%20refers%20to%20the,are%20estimated%20to%20be%20below%20a%20member%E2%80%99s%20needs accessed 26 July 2024 (explaining that 'the Group of Ten (G10) refers to the group of countries that have agreed to participate in the General Arrangements to Borrow (GAB), a supplementary borrowing arrangement that can be invoked if the IMF's resources are estimated to be below a member's needs. The GAB was established in 1962, when the governments of eight IMF members—Belgium, Canada, France, Italy, Japan, the Netherlands, the United Kingdom, and the United States—and the central banks of two others, Germany and Sweden, agreed to make resources available to the IMF for drawings by participants and, under certain circumstances, for drawings by nonparticipants.')
[63] Buchheit and Gulati (n 57) 2-8.
[64] See, eg, Key Nakajima, 'Collective Action Clauses: Contractual Regulation of Holdout Litigation' in Kei Nakajima (ed), *The International Law of Sovereign Debt Dispute Settlement* (CUP 2022) 100–138..
[65] ibid. This is what happened in the Greek debt restructuring of 2012; see Grund (n 8) 97-110.

Uruguay's 2003 bond exchange introduced the first 'Third Generation' CACs capable of aggregation, allowing a majority vote to restructure multiple bond series together.[66] To prevent majorities from discriminating against a minority series, Uruguay required an 85% aggregate vote and a 66.67% majority of principal for each series.[67] Similar 'two-limb' aggregation clauses were introduced in Argentina (2005) and in euro area sovereign bonds.[68]

In 2014, the International Capital Markets Association (ICMA) promulgated a 'Fourth Generation' Enhanced CAC model, which was the result a highly collaborative international public–private partnership spearheaded by US Treasury staff.[69] These Enhanced CACs allow for: (i) traditional series-by-series voting (66.67% threshold), (ii) two-limb aggregated voting (66.67% aggregate and 50% per series), or (iii) single-limb aggregated voting (75% aggregate) if the restructuring gives all bondholders the same instrument or same menu of instruments.[70] This last condition is called the 'uniformly applicable offer' requirement.[71] The single-limb option was the key innovation, enabling a restructuring to bind all series without holdouts controlling a series.[72] In 2020, Ecuador and Argentina were the first sovereigns to use enhanced CACs with aggregated voting in their restructurings.[73] Both used the two-limb option and reached participation rates exceeding 90%,[74] although creditors voiced concerns about the way in which the aggregation

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[66] See Anna Gelpern and Ben Heller, 'Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds' in Martin Guzman, José Antonio Ocampo and Joseph E Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press 2016) 109–143.
[67] IMF, 'The Restructuring of Sovereign Debt—Assessing the Benefits, Risks, and Feasibility of Aggregating Claims' (September 2003) 6 https://www.imf.org/external/np/pdr/sdrm/2003/090303.pdf accessed 2 September 2024.
[68] Gelpern and Heller (n 66) 111.
[69] See, eg, Mark Sobel, 'Strengthening Collective Action Clauses: Catalysing Change—The Back Story' (2016) 11 Capital Markets Law Journal 3.
[70] ICMA, 'Standard Aggregated Collective Action Clauses ("CACS") for the Terms and Conditions of Sovereign Notes' (August 2014) https://www.icmagroup.org/assets/documents/Resources/ICMA-standard-CACs-August-2014.pdf accessed 2 September 2024.
[71] ibid.
[72] IMF (n 5) 20-22.
[73]Andrés de la Cruz and Ignacio Lagos, 'CACs at Work: What Next?: Lessons from the Argentine and Ecuadorian 2020 Debt Restructurings' (2021) 16 *Capital Markets Law Journal* 2, 14–31.
[74] ibid.

features were employed.[75] The single-limb voting mechanism under enhanced CACs has so far not been used.

While CACs are now widespread and can facilitate a relatively smooth restructuring of bonded debt, they are not a complete solution.[76] Notably, the restructuring of syndicated bank loans or subnational debt, which often lack majority modification provisions, as well as collateralized debt that offers protection to some creditors, may continue to pose challenges.[77]

B. Sovereign Debt Litigation and Arbitration

Even though sovereigns enter into binding contractual agreements with their private creditors, successful enforcement is far from certain. In the past, sovereign immunity was an absolute barrier to enforcing private contracts against states. Private individuals could not sue a sovereign because a foreign court could not exercise jurisdiction over them. However, since the 1950s, the doctrine has evolved from an absolute to a relative constraint in both the US and UK, and resulted in the adoption of the 1976 Foreign Sovereign Immunities Act (FSIA) and the 1978 Sovereign Immunities Act (SIA), respectively.[78] Accordingly, foreign sovereigns are presumed immune unless the activity for which they are being sued falls under one of the exceptions to immunity. Both sets of statutes contain exceptions to immunity for commercial activities[79] and sovereign borrowing has long been considered one, meaning that states can generally not invoke the immunity defense.

In the US, the FSIA is the sole basis for obtaining jurisdiction over a foreign state.[80] Generally, the creditor-plaintiff will have to demonstrate that the activity for which they are suing

[75] ibid 17.
[76] Note that CACs have been successfully employed in recent bond exchanges, such as Zambia's and Sri Lanka's 2024 restructurings.
[77] IMF (n 44) 32.
[78] See Gulati and Weidemaier (n 16) 11. See also Kay Kane (n 23) 385-86.
[79] See 28 USC § 1603; State Immunities Act 1978, s 3.
[80] *Argentine Republic v Amerada Hess Shipping Corp* 488 US 428, 434–35 (1989) (citing *Verlinden BV v Central Bank of Nigeria* 461 US 480, 493 (1983)).

is commercial in nature.[81] The inquiry about the nature of the action falls to the courts, but unsurprisingly borrowing money normally qualifies.[82] If no clause submitting the debtor to the jurisdiction of a particular court exists, then the creditor-plaintiff would need to show that the activity and matter at hand have sufficient contact with the venue or a direct effect there.[83] Marketing activities for the bonds, payments, and subsequent visits to creditors (roadshows) are generally sufficient evidence under US law.[84] The UK statute yields the same result but takes a shortcut that avoids court interpretations for the term 'commercial transactions' in the case of sovereign debt. Unlike the US statute, it states that suits related to sovereign borrowings serviced 'wholly or partly in the United Kingdom' are not subject to immunity.[85]

However, even if creditors obtain judgments or awards against a sovereign debtor, executing these against sovereign assets is an uncertain and costly endeavor. Most sovereign assets are protected either by *de jure* immunity or because they lay on their own soil—*de facto* immunity. For example, central bank assets, embassy property, and many assets deemed to be in use by the country for public or sovereign purposes, such as military equipment, enjoy jurisdictional immunity from attachment actions under the FSIA and SIA.[86] Therefore, most recovery actions

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[81] See 28 USC § 1603(d). ('A 'commercial activity' means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose'); see also *Republic of Argentina v Weltover, Inc.* 504 US 607, 614 (1992) (holding that '[a] foreign state engaging in commercial activities do[es] not exercise powers peculiar to sovereigns'; rather, it 'exercise[s] only those powers that can also be exercised by private citizens' and citing *Alfred Dunhill of London, Inc. v Republic of Cuba* 425 US 682, 704 (1976).)

[82] See eg, Bruce W. Nichols, 'The Impact of the Foreign Sovereign Immunities Act on the Enforcement of Lender's Remedies' (1982) *University of Illinois Law Review* 253, 255 (explaining that the congressional history makes it clear that contracting and repayment of sovereign indebtedness are to be regarded as commercial acts under the FSIA). See also, *Shapiro v Republic of Bolivia* 930 F 2d 1013, 1018 (2d Cir 1991).

[83] See 28 USC § 1391(f). See also *SerVaas Inc v Republic of Iraq* 686 F Supp 2d 346, 356 (SDNY 2010); *Capital Ventures Int'l v Republic of Argentina* 552 F 3d 289, 293 (2d Cir 2009).

[84] *Republic of Argentina v Weltover, Inc.* 504 US 607, 618-19 (1992) (explaining that New York being designated by some creditors as the place of payment and payments having been effectuated there meets the criteria for a direct effect).

[85] State Immunities Act 1978, s 3(1)(b)('A State is not immune as respects proceedings relating to … an obligation of the State which by virtue of a contract (whether a commercial transaction or not) falls to be performed wholly or partly in the United Kingdom.) and s 3(3)(b) ('In this section "commercial transaction" means … any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation.').

[86] See Grund (n 8) 142-148.

for a creditor depend on their ability to find commercially used assets that are legally owned by the sovereign or to pierce the corporate veil between a sovereign and a state-owned enterprise.

Breaking through the legal separation between a sovereign owner and its corporations is difficult. There is a presumption in favor of maintaining it in both key jurisdictions.[87] The tests in both the US and UK will consider multiple factors, but the inquiry is generally concerned with the extent to which the sovereign *controls* the firm.[88] Sovereign control of day-to-day operations and governing bodies staffed by government officials can constitute a main factor. Another important consideration is the level of independence granted to the SOE under the laws of the state that created it.[89] In the UK, courts ultimately assess similar factors, making the veil generally as hard to pierce as in the US.[90]

3. Bilateral Sovereign Lending and Restructuring

Since the 1950s, the Paris Club has served as the prime forum to bring together sovereign creditors and coordinate a response to sovereign debtor distress.[91] While the Paris Club has remained 'an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries' and thus remains 'a non-institution', more than US$600 billion of bilateral sovereign debt has been restructured under its auspices in a total of 479 agreements concluded with 102 debtor countries. The Club is organized around six core principles: solidarity, consensus, information sharing, case-by-case decisions.[92] The Paris

[87] Mark C. Weidemaier, 'Piercing the (Sovereign) Veil: The Role of Limited Liability in State-Owned Enterprises' (2021) 46 *Brigham Young University Law Review* 795, 800 (citing *First National City Bank v Banco Para El Comercio Exterior de Cuba* (Bancec), 462 US 611, 626 (1983)).
[88] See Weidemaier (n 87) 817-20 (explaining that in U.S federal courts '[o]utcomes appear to turn on relatively minor distinctions, which supposedly illuminate the extent to which the state controlled the entity's day-to-day operations'); *see also First National City Bank v Banco Para El Comercio Exterior de Cuba* (Bancec), 462 US 611, 629 (1983); *Walker International Holdings Ltd v Republique Populaire du Congo* [2005] EWHC 2813 (Comm) [97]–[100]; *Kensington International Ltd v Republic of Congo* [2005] EWHC 2684 (Comm).
[89] *Walker International Holdings Ltd v Republique Populaire du Congo* [2005] EWHC 2813 (Comm) [73]–[75].
[90] ibid [93].
[91] For an overview, see Annamaria Viterbo, '10 - The Role of the Paris and London Clubs: Is It under Threat?' in Michael Waibel (ed), *The Legal Implications of Global Financial Crises* (Brill | Nijhoff 2020).
[92] Club de Paris, 'The Six Principles' https://clubdeparis.org/en/communications/page/the-six-principles accessed 27 July 2024.

Club has 22 members, which essentially reflect the dominant sovereign lenders during the second half of the 20th century. While several large emerging bilateral creditors, such as Brazil and Russia, have joined the Club, the biggest bilateral lender, China, has not.

The rapidly evolving creditor landscape, notably the rise of private finance and the emergence of large 'non-traditional' bilateral creditors like China or Saudi Arabia have exposed some of the flaws in the mechanism. Unsurprisingly, the shift has been the subject of intense and politicized debate. This chapter does not take a position on this issue, but, a study of Chinese debt contracts highlights the emergence of a powerful and savvy lender to developing countries.[93] It shows that these loans feature a number of payment safeguards that go beyond those used by China's peers in the official creditor market, although they exhibit a difference in degree, not in kind from commercial and other official bilateral lenders.[94] Moreover, while some of the terms may be unenforceable in major financial jurisdictions, they could still create a source of informal or formal pressure on the debtor.[95]

The introduction of the 'Common Framework' by the G20 to support low-income countries with unsustainable debt in 2021 was largely driven by the need to respond to the evolving creditor landscape as well as some of these structural changes in sovereign loans. Indeed, much of the discussion at the time focused on trying to bring non-Paris Club lenders onto the same table as other official creditors and to achieve consensus on a broadly applicable set of principles—if not rules—that could guide negotiations.[96]

[93] Anna Gelpern et al, 'How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments' (2023) 38 *Economic Policy* 345 (analyzing 100 debt contracts between Chinese state-owned entities and government borrowers in 24 developing countries and shedding some light on China's lending practices and how they differ from those of other official and private creditors). See also Michael Himmer and Zdenec Rod, 'Chinese Debt Trap Diplomacy: Reality or Myth?' (2022) 18 *Journal of the Indian Ocean Region* 250–272.
[94] Gelpern et al (n 93) 353.
[95] Gelpern et al (n 93) 355.
[96] See below VI.1. for a more detailed discussion.

4. Multilateral Creditors

Multilateral creditors play an important role in providing financing to countries, usually on special terms and in specific circumstances. They rely on the principle of risk sharing by pooling resources to promote certain common policy objectives. The IMF and the World Bank are the most prominent multilateral lenders and deserve closer scrutiny. Since their creation in the wake of World War II, these institutions have been instrumental in addressing international financial crises and promoting development. Given their unique ability to provide lending when most other creditors have become unwilling or unable to do so, their operational frameworks tend to shape the rules of the game beyond the remit of their own functions. Zooming in on the IMF and the World Bank, this subsection sheds light on this evolution.

A. The IMF

The IMF was founded in 1944 at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire.[97] Aside from its role as overseer of the international monetary system, the IMF could also make available its resources to support members in addressing temporary balance-of-payments (BoP) problems Today, almost all sovereigns are members of the IMF and more than 60 currently have lending arrangements with the IMF.[98]

Given the IMF's financing role in BoP crises, the vast majority of debt workouts are executed in the context of an IMF-supported program. The program provides both a macroeconomic anchor for the parties involved as well as an envelope that quantifies the overall financing contribution from the restructuring.[99] From a legal perspective, the IMF is required to only lend subject to 'adequate safeguards'[100], which means that IMF financing can only be

[97] IMF, 'The Fund's Mandate—An Overview', IMF Policy Paperm, 22 January 2010, https://www.imf.org/external/np/pp/eng/2010/012210a.pdf accessed 2 September 2024.
[98] IMF, 'IMF Lending Arrangements as of September 30, 2024', September 2024, https://www.imf.org/external/np/fin/tad/extarr11.aspx?memberKey1=ZZZZ&date1key=2024-09-30 accessed 2 September 2024.
[99] See IMF (n 1).
[100] IMF, Articles of Agreement, art V, s 3(a).

provided in support of a member's economic policies that are capable of resolving the member's BOP problems and restoring medium-term external viability.[101] This legal precondition is epitomized and specified in the IMF's sovereign debt policy framework, notably the financing assurances and debt sustainability policies.[102] Broadly speaking, in situations where the member's debt is assessed as unsustainable under the Debt Sustainability Analysis (DSA), the IMF is precluded from providing financing unless the member takes steps to restore debt sustainability over the medium term, including through a debt restructuring.[103] However, these policies do not prescribe the burden sharing between creditors, including between official and private creditors.[104]

Several other IMF policies also influence the restructuring process, a detailed description of which would go beyond the scope of this chapter.[105] Perhaps most importantly, if the member has defaulted on one or more of its creditors, the IMF's arrears policies must generally be satisfied for the IMF to lend.[106] With respect to commercial creditors, the Lending Into Arrears (LIA) policy would be met if (i) prompt IMF support is considered essential for the implementation of the member's adjustment program and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors.[107] With respect to arrears to official and multilateral creditors, the 'Lending-Into-Official Arrears' (LIOA) and the 'Non-

[101] IMF, 'Guidance Note On The Financing Assurances And Sovereign Arrears Policies And The Fund's Role In Debt Restructurings', IMF Policy Paper, 18 November 2024, at 4 https://www.imf.org/en/Publications/Policy-Papers/Issues/2024/11/18/Guidance-Note-On-The-Financing-Assurances-And-Sovereign-Arrears-Policies-And-The-Fund-s-557389 accessed 20 November 2024.
[102] For a detailed discussion, see ibid.
[103] ibid 50.
[104] ibid 10.
[105] For a detailed description of the arrears policies, see IMF, 'Reviews of the Fund's Sovereign ARREARS Policies and Perimeter', IMF Policy Paper, 18 May 2022, https://www.imf.org/en/Publications/Policy-Papers/Issues/2022/05/18/Reviews-of-the-Fund-s-Sovereign-ARREARS-Policies-and-Perimeter-517997 accessed 3 September 2024.
[106] The Fund's LIA policy has never formally defined the scope of 'payments arrears', but it is generally understood that they arise from 'commercial financial obligations of a contractual nature' that are not paid when due (taking into account any contractual grace periods). See IMF (n 105) 25.
[107] See, IMF, 'Consolidated Executive Board Understanding of the Fund's Arrears Policies and Perimeter Executive Board Meeting', Summing Up, May 4, 2022, https://www.imf.org/en/Publications/Selected-Decisions/description?decision=SM/22/47 accessed 3 September 2024.

Toleration Policy' (NTP)[108] set a stricter standard than the LIA policy, reflecting that the IMF considers additional safeguards necessary when financing is provided to a member that is in arrears to bilateral or multilateral creditors.[109]

Responding to observed delays in the approval of IMF-supported programs due to creditor coordination problems in the past few years, the IMF Executive Board approved new policies to promote the IMF's capacity to support countries undertaking debt restructurings in April 2024.[110] The revised policies essentially seek to support and accelerate restructurings where Paris Club creditors are in the minority, either within or outside the G20 Common Framework. As several recent sovereign debt restructurings have revealed, creditors of all stripes still face issues in sequencing negotiations and fostering mutual trust.[111] Even with the recent policy updates, however, the IMF's core role remains that of a lender of last resort and not of an arbiter between creditors. Indeed, in line with its self-imposed duty of neutrality, the IMF does not involve itself in the details of debt restructurings and will continue to take a neutral stance in intercreditor disputes.[112]

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[108] These policies apply to the respective creditor groups in cases with 'official sector involvement' (OSI), which means that official claims need to be subject to a debt treatment in the context of an IMF-supported. In non-OSI cases, however, the NTP also applies to bilateral creditors while the LIOA applies to certain IFIs in OSI cases. For details, see IMF (n 101).

[109] ibid. Under the NTP, the Fund requires that either an 'agreed plan' (for the World Bank and certain other international financial institutions (IFIs)) or a 'credible plan' for other IFI creditors is in place before approving a financing arrangement. Under the LIOA policy, the IMF can provide financing in four different scenarios: (i) if there is an adequately representative Paris Club agreement, (ii) if an official bilateral creditor consents to financing despite the official bilateral arrears, (iii) if 'three criteria' are fulfilled (prompt financial support essential; debtor is making good faith efforts to reach agreement in line with program parameters; decision does not have undue negative effect on Fund's ability to mobilize official financing packages in future cases), or (iv) if the other three strands are not met but the Fund's has additional safeguards. See IMF, 'Policy Reform Proposals To Promote The Fund's Capacity To Support Countries Undertaking Debt Restructuring', IMF Policy Paper, 16 April 2024, https://www.imf.org/en/Publications/Policy-Papers/Issues/2024/04/16/Policy-Reform-Proposals-To-Promote-The-Funds-Capacity-To-Support-Countries-Undertaking-Debt-547821 accessed 3 September 2024.

[110] IMF (n 109).

[111] See, eg, Ceyla Pazarbasioglu, 'Sovereign Debt Restructuring Process Is Improving Amid Cooperation and Reform', *IMF Blog*, 29 October 2024, https://www.imf.org/en/Blogs/Articles/2024/06/26/sovereign-debt-restructuring-process-is-improving-amid-cooperation-and-reform accessed 3 September 2024 (noting that some restructurings have faced significant delays, while also showing that the trend is pointing towards faster workouts).

[112] This principle is epitomized in the Fund's disputed claims doctrine, whereby the Fund accepts a member's representation that the validity or amount of a debt claim is in dispute, such disputed claim does not give rise to

B. The World Bank and Other Multilateral Development Banks

Compared with the IMF, the World Bank and other Multilateral Development Banks (MDBs) play a lesser role in today's debt restructurings. Typically considered senior to the creditors providing debt relief through restructuring, they do not participate in the restructuring negotiations. This senior creditor status allows them to provide additional financing when sovereigns are excluded from other external sources of credit. For the sovereigns this can help cover the cost of essential imports during crisis situations. Moreover, for the debt restructuring envelope, additional net inflows in the form of long-term concessional debt can alleviate the hard currency shortages that typically constrain the post-default period. The role of MDBs as co-lenders in distress situations, along with their consistent disbursement of funds to countries shunned by capital markets are the substantive source of their *de facto* seniority. However, there are no clear legal underpinnings for it. The above-mentioned IMF arrears policies act as a key guardrail for these institutions during restructurings.[113] Notably, the NTP mentioned above applies to IFIs whose clearly specified mandate and functional characteristics are closely linked to the IMF's mandate, which includes the World Bank as well as MDBs and other IFIs meeting that standard.[114] Under the NTP, the IMF may only provide financing to members in arrears to IFIs if a plan to clear these arrears is either credible (most IFIs) or has already been agreed (World Bank).[115]

IV. Outlook—*Quo Vadis* International Financial Architecture?

The international sovereign debt ecosystem has multiple defining characteristics: protracted negotiations; heterogeneous and new creditors; the related holdout problem; and competing priorities between domestic and international policy aims that yield rigidities where more

arrears for all Fund purposes The IMF has long held that, as an international organization, it must maintain a neutral position with respect to claims whose underlying validity or amounts are in dispute between members. See IMF (n 101) 61-62.

[113] See above III.4.A.

[114] IMF (n 101) 23.

[115] As explained above, this high standard does not apply to bilateral or private creditors.

flexibility would be desirable, for example in the face of climate change. This section provides a brief analysis of three key areas of reform that are currently discussed: (1) the G20 Common Framework and the Sovereign Debt Roundtable, (2) climate-focused solutions to address both the climate and debt crisis simultaneously, and (3) state-contingent instruments. While the envisaged changes in these areas seek to improve upon the existing ad-hoc approach to sovereign debt restructuring, many of them draw inspiration from past experiences and practices.

1. Common Framework and Sovereign Debt Roundtable

At least since the Debt-Service-Suspension Initiative (DSSI) in response to the Covid-19 pandemic, the G20 has taken a prominent role in shaping the sovereign debt ecosystem.[116] As noted above, this development was largely driven by the rise of China as a major creditor to developing countries. Building upon the G20 DSSI, which offered temporary debt service relief to eligible countries, the Common Framework seeks to facilitate timely and orderly debt treatments, including debt reductions, on a case-by-case basis, but drawing on the Paris Club's principle.[117] Eligible debtor countries are required to seek debt treatment from all their official bilateral creditors, as well as from private creditors, on comparable terms. The process is initiated by the debtor country, which must request a treatment of its sovereign debt stock. Creditor committees are then formed to negotiate the terms of that treatment.[118]

However, the implementation of the Common Framework has faced significant challenges[119], with the 2024 restructuring in Zambia highlighting the need for greater clarity and

[116] The DSSI means that bilateral official creditors are, during a limited period, suspending debt service payments from the poorest countries (73 low- and lower middle-income countries) that request the suspension. On the history of the G-20, see eg Jan Wouters and Sven Van Kerckhoven, 'OECD and the G20: An Ever Closer Relationship' (2011) 43 *George Washington International Law Review* 345, 352-355.
[117] G20, 'Annex: Common Framework for Debt Treatments Beyond the DSSI', 2021, https://clubdeparis.org/sites/default/files/annex_common_framework_for_debt_treatments_beyond_the_dssi.pdf accessed 3 September 2024.
[118] ibid.
[119] For a critical assessment of the Common Framework, see Brad Setser, 'The Common Framework and Its Discontents', *Council on Foreign Relations Blog*, 26 March 2023, https://www.cfr.org/blog/common-framework-and-its-discontents accessed 2 November 2024.

consensus among creditors.[120] In response to these challenges, efforts are underway to enhance the Common Framework, including proposals for clearer timelines and comparability of treatment principles.[121]

With the Common Framework being not only a novel but primarily a case-by-case restructuring mechanism, the need arose for a standing committee to deal both with general and operational questions concerning the Framework's implementation.[122] The Global Sovereign Debt Roundtable (GSDR), an informal forum for sovereign debt stakeholders convened by the IMF and World Bank, has emerged as this platform.[123] It brings together representatives from debtor countries, official and private creditors, as well as civil society to explore ways to improve the effectiveness, efficiency, and fairness of sovereign debt resolution processes. As of late 2024, the GSDR has published three progress reports as well as an overview of technical issues discussed so far, which include restructuring timelines, information sharing issues, and the restructuring perimeter and parameters.[124]

2. Climate-focused Solutions

As concerns about climate change have grown, there has been increasing interest in incorporating environmental considerations into sovereign debt instruments and restructuring processes.[125]

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[120] Government of the Republic of Zambia, 'Press Release: Government of the Republic of Zambia Reaches Agreement on Debt Restructuring Terms with the Steering Committee of the Ad Hoc Creditor Committee of Holders of Zambia's Eurobonds', Ministry of Finance and National Planning, 25 March 2024, https://www.mofnp.gov.zm/?p=7786 accessed 3 September 2024.
[121] See, for example, Diego Rivetti, 'Achieving Comparability of Treatment under the G20's Common Framework' EFI Note, World Bank Group, http://documents.worldbank.org/curated/en/426641645456786855/Achieving-Comparability-of-Treatment-under-the-G20-s-Common-Framework accessed 3 August 2024.
[122] G20 (n 117).
[123] Global Sovereign Debt Roundtable (GSDR), 'GSDR 3rd Cochairs Report', 23 October 2024, https://www.imf.org/-/media/Files/About/FAQ/gsdr/gsdr-cochairs-progress-report-october-2024.ashx accessed 14 November 2024.
[124] GSDR, 'Compendium of GSDR Common Understanding on Technical Issues', 23 October 2024, https://www.imf.org/-/media/Files/About/FAQ/gsdr/gsdr-compendium-of-common-understanding-on-technical-issues.ashx.
[125] Lauren Gifford and Chris Knudson, 'Climate Finance Justice: International Perspectives on Climate Policy, Social Justice, and Capital' (2020) 161 *Climatic Change* 243, 243.

Green bonds, sustainability-linked bonds, debt-for-nature swaps, and Climate Resilient Debt Clauses (CRDCs) are among the tools being explored to align sovereign debt with climate goals and provide relief to countries facing climate-related challenges.

Green bonds are debt instruments that raise funds for environmentally friendly projects or incentivize the achievement of sustainability targets.[126] Sustainability-linked bonds, on the other hand, tie the coupon rate to the achievement of specific environmental, social, or governance (ESG) targets, providing a financial incentive for the issuer to meet these goals.[127] There is no specific legal framework to govern the terms and conditions of ESG bonds, but industry standards have emerged. From a contractual perspective, ESG bonds are, in essence, basic sovereign securities entailing various additional commitments. However, a review of over 1000 green bonds by Curtis et al found that enforcement of environmental promises is anything but certain, raising significant doubts as to instruments' green *bona fides*.[128]

Debt-for-nature swaps are another 'green instrument', and they already had their first moment in the limelight in the late 1980s. These involve the cancellation of a portion of a country's debt in exchange for a commitment to invest in conservation or environmental protection projects. In a recent example, Belize reached an agreement with the US Development Finance Corporation to receive a political risk guarantee for a new debt instrument, the proceeds of which were used to repurchase US$553 million of its external debt, at a 45% discount.[129] In exchange for the political risk guarantee, Belize committed to invest in marine conservation. Barbados, Ecuador, and Gabon

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(highlighting that 'In the 2015 Paris Agreement, the United Nations Framework Convention on Climate Change (UNFCCC) established, for the first time, the international community's intention to direct sufficient finance to address climate change … Article 2 of the Agreement recognized that "finance flows" were essential to achieve these longstanding goals of "low greenhouse gas emissions and climate-resilient development".')

[126] International Capital Market Association (ICMA), 'Green Bond Principles Voluntary Process Guidelines for Issuing Green Bonds', June 2021, with June 2022 Appendix 1, https://www.icmagroup.org/assets/documents/Sustainable-finance/2022-updates/Green-Bond-Principles-June-2022-060623.pdf accessed 3 September 2024.

[127] ICMA, 'Sustainability-Linked Bond Principles Voluntary Process Guidelines', June 2024, https://www.icmagroup.org/assets/documents/Sustainable-finance/2024-updates/Sustainability-Linked-Bond-Principles-June-2024.pdf accessed 3 September 2024.

[128] Quinn Curtis, W Mark C Weidemaier and Mitu Gulati, 'Green Bonds, Empty Promises' (2023) 102 *North Carolina Law Review* 131.

[129] Stephanie Fontana-Raina and Sebastian Grund, 'Debt-for-Nature Swaps: The Belize 2021 Deal and the Future of Green Sovereign Finance' (2024) 19(2) *Capital Markets Law Journal* 128.

recently followed suit and implemented similar deals.[130] While debt-for-nature swaps can provide significant debt relief and support environmental goals, their scope remains limited, constrained by the availability of development actors willing to provide guarantees or new money in exchange for green commitments. Moreover, since debt swaps require the involvement of various parties and services, they may be financially and economically inferior to conditional grants or outright debt restructurings in achieving the stated objectives.[131]

Climate Resilient Debt Clauses (CRDCs), also known as 'hurricane clauses', constitute a related innovation.[132] These provisions allow for the automatic deferral or reduction of debt service payments in the event of a natural disaster or other climate-related shock. Grenada, for instance, included CRDCs in its 2015 debt restructuring, which provided for the deferral of principal and interest payments for up to two years in the event of a qualifying hurricane. Others, such as Barbados and Jamaica, have included similar clauses in their issuances since. In August 2024, the first CRDC was triggered after Hurricane Beryl devastated Grenada, suspending $12 million in interest payments on a $112 million bond.[133]

These climate-focused solutions represent important innovations in their use of existing tools to address new problems. Debt-for-nature swaps, for instance, have been used since the 1980s, albeit on a limited scale. Similarly, the concept of state-contingent debt instruments, such as CRDCs, has a long history.

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[130] White & Case, 'Debt-for-Nature Swaps: A Viable Alternative for Vulnerable Economies amid Global Challenges' (2023) https://www.whitecase.com/insight-our-thinking/africa-focus-winter-2023-debt-for-nature accessed 4 September 2024.
[131] Marcos Chamon, Erik Klok, Vimal Thakoor and Jeromin Zettelmeyer, 'Debt-for-Climate Swaps: Analysis, Design, and Implementation', IMF Working Papers 2022/162 (2022), https://doi.org/10.5089/9798400215872.001 accessed 4 September 2024.
[132] Enrico Mallucci, 'Natural Disasters, Climate Change, and Sovereign Risk' (2022) 139 *Journal of International Economics* 103672.
[133] Joseph Cotterill and Lee Harris, 'Grenada Triggers "Hurricane Clause" to Suspend Bond Payments' *Financial Times*, 22 August 2024, https://www.ft.com/content/06bdabb2-2abb-45ab-9ee4-94e1c328598f accessed 20 September 2024.

3. State-contingent Instruments

Traditional sovereign debt instruments often lack the flexibility to adjust to unexpected shocks or changes in a country's circumstances.[134] State-contingent instruments, such as GDP-linked bonds or warrants, aim to address this issue by tying debt service obligations to specific outcomes or events.[135] The idea behind these instruments, which are also referred to as Value Recovery Instruments (VRIs), is to provide a degree of risk-sharing between the debtor and creditors.[136]

GDP-linked bonds, for instance, tie the coupon rate or principal repayment to the issuing country's economic growth.[137] Generally, if the country's GDP growth exceeds a certain threshold, creditors receive a higher payout. This structure can help align the interests of creditors and debtors, as both benefit from stronger economic growth. Recent restructurings in Suriname, Zambia, and Argentina have featured elements of state-contingency, though their effectiveness remains a subject of ongoing debate and, in some cases, litigation.[138]

For instance, Argentina's 2005 GDP-linked warrants, which were issued as part of the country's debt restructuring following its 2001 default, were first praised for aligning creditor and debtor incentives, but later criticized for their complexity and potential to create future debt sustainability challenges.[139] A recent judgment by a London court serves as a case in point. Certain

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[134] See Juan Pablo Bohoslavsky, Miguel Attaguile, and Roberto Kozulj's chapter in this Handbook on the flexibility needed to cope with other contingencies, such as social crises that follow natural or economic catastrophes.
[135] See, eg, IMF, 'State-Contingent Debt Instruments for Sovereigns' (2017) Policy Papers 2017/023 A001 https://doi.org/10.5089/9781498346818.007.A001 accessed 4 September 2024;
[136] Mark H Stumpf, 'Sovereign State-Contingent Debt Instruments: Risk Taxonomy and Case Studies' (2019) 14(3) *Capital Markets Law Journal* 320.
[137] David Barr, Oliver Bush, and Alex Pienkowski, 'GDP-Linked Bonds and Sovereign Default' in Joseph Stiglitz and Daniel Heymann (eds), *Life After Debt: The Origins and Resolutions of Debt Crisis* (Palgrave Macmillan 2014) 246–275.
[138] See for a recent analysis of these instruments and selected case studies, Bretton Woods Committee, 'State-Contingent Debt Instruments: Prospects for Enhancing Growth' (2024) https://www.brettonwoods.org/sites/default/files/documents/BWC-SDWG-Paper-SCDI-2024-FNL3-web.pdf accessed 2 September 2024.
[139] Luca A Ricci, Marcos d Chamon, and Alejo Costa, 'Is There a Novelty Premium on New Financial Instruments? The Argentine Experience with GDP-Indexed Warrants', IMF Working Papers 2008, at 109, https://doi.org/10.5089/9781451869699.001.A001 accessed 4 September 2024.

holders of these warrants successfully argued that Argentina had understated its GDP growth and were awarded US$1.3 billion in compensation.[140]

Other state-contingent instruments, such as commodity-linked bonds, have also been used in sovereign debt markets on a limited scale. Commodity-linked bonds tie debt service obligations to the price of a specific commodity such as oil or copper.[141] In its 2023 restructuring deal, Suriname agreed on a VRI in the form of oil-linked securities that will pay holders if Suriname generates sufficient oil royalties from a recently discovered oil field.[142]

While state-contingent instruments offer the potential for greater flexibility and risk-sharing in sovereign debt markets, they also face several challenges:[143] They can be difficult to design and price, present opportunities for moral hazard and adverse selection, and risk creating future debt sustainability problems if the contingent liabilities are not properly accounted for. Moreover, most contingent instruments share key substantive characteristics with equity securities, which limits potential investor interest. The gist of the issue has long been a reluctance by money-center investors to take the risks associated with direct investment in emerging economies, instead preferring fixed-income instruments that essentially require the sovereigns to shoulder risks (and potentially reap the rewards) of developing their economies. Finally, VRIs do not necessarily result in increased debt relief ('haircuts'), creating unwarranted upside risks for investors and potentially degrading the sovereign's repayment capacity in the future.[144]

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[140] *Palladian Partners v Republic of Argentina* [2023] EWHC 711 (Comm).
[141] Joseph Atta-Mensah, 'Commodity-Linked Bonds: A Potential Means for Less-Developed Countries to Raise Foreign Capital', Bank of Canada Working Paper 2004-20, June 2004.
[142] Republiek Suriname, Ministerie van Financiën en Planning, 'Restructuring of Bondholders Finalized' December 2023, https://gov.sr/restructuring-of-bondholders-finalized/ accessed 2 September 2024.
[143] Charles Cohen et al, '*The Role of State-Contingent Debt Instruments in Sovereign Debt Restructurings*', IMF Staff Discussion Notes SDN/20/06 (2020) https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2020/11/13/The-Role-of-State-Contingent-Debt-Instruments-in-Sovereign-Debt-Restructurings-49732 accessed 10 December 2024.
[144] See, eg, Ugo Panizza, 'The Pitfalls of Value Recovery Instruments in Sovereign Debt Restructuring' *Finance for Development Lab* (6 September 2024) https://findevlab.org/the-pitfalls-of-value-recovery-instruments-in-sovereign-debt-restructuring/ accessed 20 September 2024.

V. Conclusion

This chapter sought to canvas the breadth of the international sovereign debt system, introducing the reader to its key features and current setting. At the same time, it highlighted the malleability and constantly evolving nature of what the literature often calls the international financial architecture for sovereign debt restructuring. As new challenges emerge and the global economic landscape shifts, this ecosystem continues to adapt with stakeholders seeking to find a balance between the need for orderly and efficient restructurings and the competing interests of debtors, creditors, and other affected parties.

While many of these innovations draw upon past experiences and practices, they also reflect the unique challenges and opportunities of the current moment. The rise of new and influential sovereign creditors, such as China, and the increasing importance of environmental and social considerations in sovereign debt markets, have created new pressures and incentives for reform. State-contingent instruments, for their part, have long been around and the feasibility of restructurings underpinned by them depends largely on risk-appetite and trust in the monitoring structures around them. All this being said, the very nature of the international financial landscape may well prevent efforts to build something more akin to a stable and rigid architecture. In the meantime, the ad-hoc system continues to serve as the foundation for the most important asset class in the world, albeit one built along many tectonic fault lines.