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A Model-law Approach to Restructuring Unsustainable Sovereign Debt

Steven L. Schwarcz

Key Points

- Unresolved sovereign debt problems are hurting debtor nations, their citizens and their creditors, and also can pose serious systemic threats to the international financial system.
- The existing contractual restructuring approach is insufficient to make sovereign debt sustainable. Although a more systematic legal resolution framework is needed, a formal multilateral approach, such as a treaty, is not currently politically viable.
- An informal model-law approach should be legally, politically and economically feasible. Individual countries could enact the proposed model law as their domestic law.
- Because most sovereign debt contracts are governed by either New York or English law, it would be especially valuable if one or both of those jurisdictions enacted a proposed Sovereign Debt Restructuring Model Law as their domestic law.

Introduction

Court decisions in the United Kingdom regarding the illegality of exit consents, and in the United States regarding *pari passu* clauses in Argentine sovereign debt, as well as debt crises in Greece, Venezuela and other countries, have dramatically highlighted the risks of an inadequate legal resolution framework for restructuring unsustainable sovereign debt. Unresolved sovereign debt problems are hurting individual debtor nations and their citizens, as well as their creditors. A sovereign debt default can also pose a serious systemic threat to the international financial system.

The Contractual Approach Is Inadequate

One of the main impediments is that the existing "contractual" approach to sovereign debt restructuring — the use of so-called collective action clauses (CACs) — is insufficient to solve the holdout problem. CACs are clauses in debt contracts that enable a specified supermajority, such as two-thirds or three-quarters, of the contracting parties to amend the principal amount, interest rate, maturities and other critical repayment terms. The holdout problem is a type of collective action problem in which certain creditors, such as vulture funds that may have bought debt in the secondary market

About the Author

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at a deep discount, hope to receive full payment by refusing to agree to a debt restructuring plan that proposes to change critical terms, even though the other debt holders consider the plan reasonable.

For several reasons, CACs are insufficient to solve the holdout problem. Many sovereign debt contracts lack them, requiring unanimity to change critical repayment terms — and thus enabling any party to the contract to act as a holdout. For example, after years of trying to include CACs, relatively few Greek debt agreements actually contained such clauses and those that did were generally restricted to bond issues. Even in contracts that include CACs, the supermajority requirement may be so high (for example, three-quarters) that vulture funds are able to purchase vote-blocking positions that enable them to act as holdouts. Furthermore, a CAC ordinarily binds only the parties to the particular contract that includes it. The parties to any given sovereign debt contract, therefore, could act as holdouts in a debt restructuring plan that requires all of a debtor-state's debt issues to agree to the plan.

CACs have been a step forward in some ways, but they are not a substitute for pursuing a more systematic legal resolution framework for helping debtor-states to restructure unsustainable debt. In the past, the International Monetary Fund (IMF) unsuccessfully proposed, and the General Assembly of the United Nations has voted to pursue, a treaty or convention that would govern sovereign debt restructuring. The political economy of treaty making, however, makes that type of multilateral approach highly unlikely to succeed in the near future.

Advantages of a Model-law Approach

A model-law approach to achieving a more systematic legal resolution framework should be legally, politically and economically feasible.

As explained in the Schwarcz Article,[1] a model law is suggested legislation for national (and

1 An extended version of this paper contains a more detailed and systematic analysis: Steven L Schwarcz, "Sovereign Debt Restructuring: A Model-Law Approach" (2016) 6:2 J Globalization & Dev (Martin Guzman, Domenico Lombardi, José Antonio Ocampo & Joseph Stiglitz, eds) 343 [Schwarcz Article]. It is also available at http://ssrn.com/abstract=2634653.

sometimes subnational) governments to consider enacting as domestic law in their jurisdictions. Each government enacting a model law should therefore take the steps necessary to make the law effective in its jurisdiction. To facilitate cross-border legal comparability, each government enacting a model law should, ideally, enact the same legislative text. For that reason, model laws are sometimes called uniform laws. The UNCITRAL (United Nations Commission on International Trade Law) Model Law on International Commercial Arbitration exemplifies a model law that has been uniformly enacted in an international context; the Uniform Commercial Code (UCC) in the United States exemplifies a model law that has been uniformly enacted in a subnational context.

The less formal process of developing and enacting a model law can be politically appealing. Indeed, adoption of the UNCITRAL Model Law on International Commercial Arbitration, an area of law that had for many years struggled to realize reform, may have been successful, in part, due to its less formal structure as a model law. A model-law approach would not require general acceptance for its implementation. Nations and even subnational jurisdictions could individually enact a model law as their domestic law.

This is especially significant because most sovereign debt contracts are governed by either New York or English law. One or both of those jurisdictions — in the case of New York law, a subnational jurisdiction — could enact legislation based on a model law. Thus, unlike the UCC, the initial goal for a sovereign debt restructuring model law would be enactment by only one or two jurisdictions. A model law could also be pursued in parallel as part of an overall strategy for developing a legal resolution framework for sovereign debt restructuring.

A Proposed Model Law

The Schwarcz Article proposes a Sovereign Debt Restructuring Model Law (see the Appendix). Among other things, the proposed model law addresses the holdout problem by legally mandating supermajority voting that (assuming the requisite percentages agree) can bind dissenting classes of claims. It also enables a debtor-state to aggregate creditor voting beyond individual contracts. Aggregate voting is critical for at least two reasons: it can prevent creditors of individual sovereign debt contracts from acting as holdouts vis-à-vis other sovereign debt contracts; and it allows a debtor-state to designate large enough classes of claims to prevent vulture funds (or similar holdouts), as a practical matter, from purchasing enough claims to block a restructuring plan or otherwise control the voting.

The proposed model law also addresses the critical need for a financially troubled debtor-state to obtain liquidity during its restructuring process. Although this funding has in the past often been provided by the IMF, the IMF may be unable, or unwilling, to continue providing funding in the amounts needed. Absent the IMF, whose loans have de facto priority, no one would lend new money without obtaining a priority repayment claim. Unless (as in the case of Greece) virtually all of a debtor-state's indebtedness is held by a relatively small number of governmental organizations, it would be impractical to get the existing creditors to contractually subordinate their claims to the new money. The model law, however, gives such new-money lenders priority over existing creditors, provided existing creditors have notice and the opportunity to block the new lending if its amount is too high or its terms are inappropriate. (The model law does not, of course, prevent a debtor-state from also, or alternatively, obtaining such financing through a governmental or multi-governmental source, such as the IMF.)

The model law contemplates a "neutral international organization" as the law's supervisory authority. It is currently unclear what organization might qualify as truly neutral; existing organizations such as the IMF, the World Bank or a court of the debtor-state may be considered too political or conflicted.

The very issue of the need for a supervisory authority can also raise confusion. Formal sovereign debt restructuring solutions, such as a treaty, are often conflated with the need for formal supervisory bodies. Under the proposed model law, however, the supervisory authority lacks authority to exercise discretion. All disputes are adjudicated through binding arbitration. The main role of the supervisory authority is administrative and non-discretionary: to fact-check information and to oversee the creditor voting process.

The Sovereign Debt Restructuring Model Law's retroactivity might also raise a controversial legal issue under domestic law, and US law in particular. Retroactivity is essential for restructuring the terms of existing sovereign debt contracts. Legal

retroactivity is respected under international law so long as it is neither discriminatory nor arbitrary. The model law's key operative provisions — supermajority aggregate voting, and the granting of priority to financiers of a debtor-state's debt restructuring — should be neither. US constitutional law, however, would be relevant to interpreting the retroactivity of supermajority aggregate voting if New York State enacts the model law.

The "Contracts Clause" in Article I, Section 10 of the US Constitution prohibits states (as opposed to the federal government) from enacting any legislation that impairs existing contractual obligations. Nonetheless, the Schwarcz Article concludes that New York State should be able to frame its enactment of the model law in such a way as to not violate the Contracts Clause. In general, a state has leeway to retroactively impair contracts if the impairment is reasonably necessary to further an important public purpose and also reasonable and appropriate to effectuate that purpose. This leeway may be even greater if the contractual impairment is not substantial.

New York State, therefore, could frame its enactment of the Sovereign Debt Restructuring Model Law as an exercise of its police powers to reduce sovereign debt defaults that could lead to a systemic economic collapse, thereby protecting economic activity within its borders. The model law's supermajority aggregate voting and granting of priority to financiers of a debtor-state's debt restructuring are appropriately tailored to reduce that threat. Furthermore, any contractual impairment should not be "substantial"; being limited to changes that are voluntarily agreed to by a supermajority of *pari passu* creditors based on the debtor-state's deteriorating economic circumstances, such changes — and hence the contractual impairment — should reflect the economic reality of what those creditors expect (under those changed circumstances) to receive as payment.

A final question is whether the model law would be economically and politically feasible. Some nations may be concerned, for example, that enactment of the model law would increase their borrowing costs by making creditor claims more subject to bail-in. Economists and other scholars have recently argued and provided empirical evidence to the contrary — that uncertainty due to the absence of an effective sovereign debt resolution framework actually increases the costs of borrowing. However, even if the model law would increase borrowing costs, that increase should not exceed the cost increase resulting from workable CACs being included in all debt contracts, which has been the ideal goal of the contractual approach to sovereign debt restructuring.

The model law should also be politically feasible. As mentioned, its less formal enactment process can be appealing to debtor-states. The model law would not require general acceptance by the world's nations for its implementation: only one or two jurisdictions (New York State and/or England) need enact the law for it to become widely effective.

Furthermore, the model law could be enacted with total political neutrality through a "menu" option. Rather than enacting the model law as its default law governing sovereign debt restructuring, a jurisdiction could enact the model law but provide therein that sovereign debt contracts governed by that jurisdiction's law would only become governed by the model law if the contract so specifies. Article 1(1)(a) of the Sovereign Debt Restructuring Model Law in the Appendix provides bracketed alternative language to include such an option.

It is also informative to assess the model law's political feasibility from the perspective of the politics of the IMF's failed treaty approach. That approach failed for several reasons. Certain emerging market countries feared it would raise their cost of borrowing. As mentioned, however, the model law arguably should reduce or not affect that cost. At the time the IMF proposed its treaty approach, many believed that exchange offers could effectively amend the terms of sovereign debt agreements to enable supermajority voting. Experience, however, has long since undermined that belief. Some also opposed the IMF's treaty approach because of suspicions about the IMF's conflicting role as both treaty sponsor and supervisory authority thereunder. The model law, in contrast, is not designed by the IMF, nor is the IMF part of its supervisory process. Furthermore, as indicated, the model law limits the supervisory process to non-discretionary administrative actions. Debtor-states should therefore want — and creditors, other than rent-seeking holdouts, should want them — to enact the proposed model law.

Recommendations

Interested debtor-states, as well as New York State and England, should consider enacting the proposed Sovereign Debt Restructuring Model Law. Even if that enactment doesn't occur, however, this policy brief and the Schwarcz Article on which it is based provide a conceptual and legal analysis of how a model law could be structured and how a model-law approach could help nations to equitably restructure unsustainable debt burdens. To that extent, they should serve as incremental steps toward developing norms for a sovereign debt restructuring legal framework that goes beyond mere contracting.

Appendix

Sovereign Debt Restructuring Model Law[2]

Preamble

The Purpose of this Law is to provide effective mechanisms for restructuring unsustainable sovereign debt so as to reduce (a) the social costs of sovereign debt crises, (b) systemic risk to the financial system, (c) creditor uncertainty, and (d) the need for sovereign debt bailouts, which are costly and create moral hazard.

Chapter I: Scope, and Use of Terms

Article 1: Scope

(1) This Law applies where, by contract or otherwise, (a) the law of [this jurisdiction[3]] governs [*alternative*: this Law is specifically stated to govern] the debtor-creditor relationship between a State and its creditors and (b) the application of this Law is invoked in accordance with Chapter II.

(2) [*This provision is optional*] Where this Law applies, it shall operate retroactively and, without limiting the foregoing, shall override any contractual provisions that are inconsistent with the provisions of this Law.

Article 2: Use of Terms

For purposes of this Law:

(1) "creditor" means a person or entity that has a claim against a State;

(2) "claim" means a payment claim against a State for monies borrowed or for the State's guarantee of, or other contingent obligation on, monies borrowed; and the term "monies borrowed" shall include the following, whether or not it represents the borrowing of money per se: monies owing under bonds, debentures, notes, or similar instruments; monies owing for the deferred purchase price of property or services, other than trade accounts payable arising in the ordinary course of business; monies owing on capitalized lease obligations; monies owing on or with respect to letters of credit, bankers' acceptances, or other extensions of credit; and monies owing on money-market instruments or instruments used to finance trade;

(3) "Plan" means a debt restructuring plan contemplated by Chapter III;

(4) "State" means a sovereign nation;

(5) "Supervisory Authority" means [name of neutral international organization].

Chapter II: Invoking the Law's Application

Article 3: Petition for Relief, and Recognition

(1) A State may invoke application of this Law by filing a voluntary petition for relief with the Supervisory Authority.

(2) Such petition shall certify that the State (a) seeks relief under this Law, and has not previously sought relief under this Law (or under any other law that is substantially in the form of this Law) during the past

2 In writing this model law, the author benefitted greatly from discussions with colleagues on the International Insolvency Institute (III) Working Group on Sovereign Insolvencies and the CIGI ILRP Working Group on Cross-Border and Sovereign Insolvencies. Besides the author, the members of these working groups are, respectively, Donald Bernstein, Zack Clement, Allan Gropper, Robin Itkin, Steven T. Kargman, Kenneth N. Klee, Christopher Klein, Bruce Leonard, Charles W. Mooney, Christoph Paulus and Ignacio Tirado; and Mona Davies, Oonagh Fitzgerald, Mark Jewett, Bruce Leonard, John Murray, Catherine Walsh and Miranda Xafa.

3 This would refer to a jurisdiction enacting this model law, for example, New York, England, a nation, etc. Articles 3(3) and 12 further expand this law's application.

[ten] years, (b) needs relief under this Law to restructure claims that, absent such relief, would constitute unsustainable debt of the State, (c) agrees to restructure those claims in accordance with this Law, (d) agrees to all other terms, conditions, and provisions of this Law, and (e) has duly enacted any national law needed to effectuate these agreements. If requested by the Supervisory Authority, such petition shall also attach documents and legal opinions evidencing compliance with clause (e).

(3) Immediately after such a petition for relief has been filed, and so long as such filing has not been dismissed by the Supervisory Authority [or this jurisdiction] for lack of good faith, the terms, conditions, and provisions of this Law shall (a) apply to the debtor-creditor relationship between the State and its creditors to the extent such relationship is governed by the law of [this jurisdiction]; (b) apply to the debtor-creditor relationship between the State and its creditors to the extent such relationship is governed by the law of another jurisdiction that has enacted law substantially in the form of this Law; and (c) be recognized in, and by, all other jurisdictions that have enacted law substantially in the form of this Law.

Article 4: Notification of Creditors

(1) Within 30 days after filing its petition for relief, the State shall notify all of its known creditors of its intention to negotiate a Plan under this Law.

(2) The Supervisory Authority shall prepare and maintain a current list of creditors of the State and verify claims for purposes of supervising voting under this Law.

Chapter III: Voting on a Debt Restructuring Plan

Article 5: Submission of Plan

(1) The State may submit a Plan to its creditors at any time, and may submit alternative Plans from time to time.

(2) No other person or entity may submit a Plan.

Article 6: Contents of Plan

A Plan shall

(1) designate classes of claims in accordance with Article 7(3);

(2) specify the proposed treatment of each class of claims;

(3) provide the same treatment for each claim of a particular class, unless the holder of a claim agrees to a less favorable treatment;

(4) disclose any claims not included in the Plan's classes of claims;

(5) provide adequate means for the Plan's implementation including, with respect to any claims, curing or waiving any defaults or changing the maturity dates, principal amount, interest rate, or other terms or cancelling or modifying any liens or encumbrances; and

(6) certify that, if the Plan becomes effective and binding on the State and its creditors under Article 7(1), the State's debt will become sustainable.

Article 7: Voting on the Plan

(1) A Plan shall become effective and binding on the State and its creditors when it has been submitted by the State and agreed to by each class of such creditors' claims designated in the Plan under Article 6(1). Thereupon, the State shall be discharged from all claims included in those classes of claims, except as provided in the Plan.

(2) A class of claims has agreed to a Plan if creditors holding at least [two-thirds] in amount and more than [one-half] in number of the claims of such class [voting on such Plan[4]] [entitled to vote on such Plan] agree to the Plan.

(3) Each class of claims shall consist of claims against the State that are pari passu in priority, provided that (a) *pari passu* claims need not all be included in the same class, (b) claims of governmental or multi-governmental entities each shall be classed separately,

4 The Plan can be more easily approved if this alternative is selected, but reliable notice to creditors then becomes more important.

and (c) claims that are governed by this Law or the law of another jurisdiction that is substantially in the form of this Law shall not be classed with other claims.

Chapter IV: Financing the Restructuring

Article 8: Terms of Lending

(1) Subject to Article 8(3), the State shall have the right to borrow money on such terms and conditions as it deems appropriate.

(2) The State shall notify all of its known creditors of its intention to borrow under Article 8(1), the terms and conditions of the borrowing, and the proposed use of the loan proceeds. Such notice shall also direct those creditors to respond to the Supervisory Authority within 30 days as to whether they approve or disapprove of such loan.

(3) Any such loan must be approved by creditors holding at least two-thirds in amount of the claims of creditors responding to the Supervisory Authority within that 30-day period.

(4) In order for the priority of repayment (and corresponding subordination) under Article 9 to be effective, any such loan must additionally be approved by creditors holding at least two-thirds in principal amount of the "covered" claims of creditors responding to the Supervisory Authority within that 30-day period. Claims shall be deemed to be "covered" if they are governed by this Law or by the law of another jurisdiction that is substantially in the form of this Law.

Article 9: Priority of Repayment

(1) The State shall repay loans approved under Article 8 prior to paying any other claims.

(2) The claims of creditors of the State are subordinated to the extent needed to effectuate the priority payment under this Article 9. Such claims are not subordinated for any other purpose.

(3) The priority of repayment (and corresponding subordination) under this Article 9 is expressly subject to the approval by creditors under Article 8(4).

Chapter V: Adjudication of Disputes

Article 10: Arbitration

(1) All disputes arising under this Law shall be resolved by binding arbitration before a panel of three arbitrators.

(2) The arbitration shall be governed by [generally accepted international arbitration rules of (name of neutral international arbitration body)] [the rules of the International Centre for Settlement of Investment Disputes/ International Centre for Dispute Resolution/ International Chamber of Commerce International Court of Arbitration/ specify other international arbitration organization].

(3) Notwithstanding Article 10(2), if all the parties to an arbitration contractually agree that such arbitration shall be governed by other rules, it shall be so governed. Such agreement may be made before or after the dispute arises.

(4) The State shall pay all costs, fees, and expenses of the arbitrations.

Chapter VI: Opt In

Article 11: Opting in to this Law

(1) Any creditors of the State whose claims are not otherwise governed by this Law may contractually opt in to this Law's terms, conditions, and provisions.

(2) The terms, conditions, and provisions of this Law shall apply to the debtor-creditor relationship between the State and creditors opting in under Article 11(1) as if such relationship were governed by the law of [this jurisdiction] under Article 3(3).

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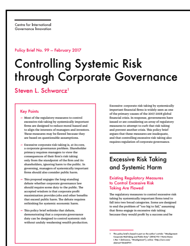
Policy Brief No. 112
Steven L. Schwarcz

Unsustainable sovereign debt is a serious problem for nations, as well as their citizens and creditors, and a threat to global financial stability. Because a significant percentage of sovereign debt is governed by English law, there is an opportunity to modify the law to fairly and equitably facilitate the restructuring of unsustainable sovereign debt. This policy brief proposes a novel legal framework, focusing on governing law, for doing that. Even absent the legislative proposal, the analysis in this policy brief can contribute to the incremental development of sovereign debt restructuring norms.



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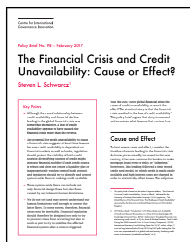

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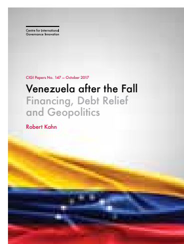

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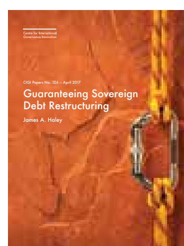

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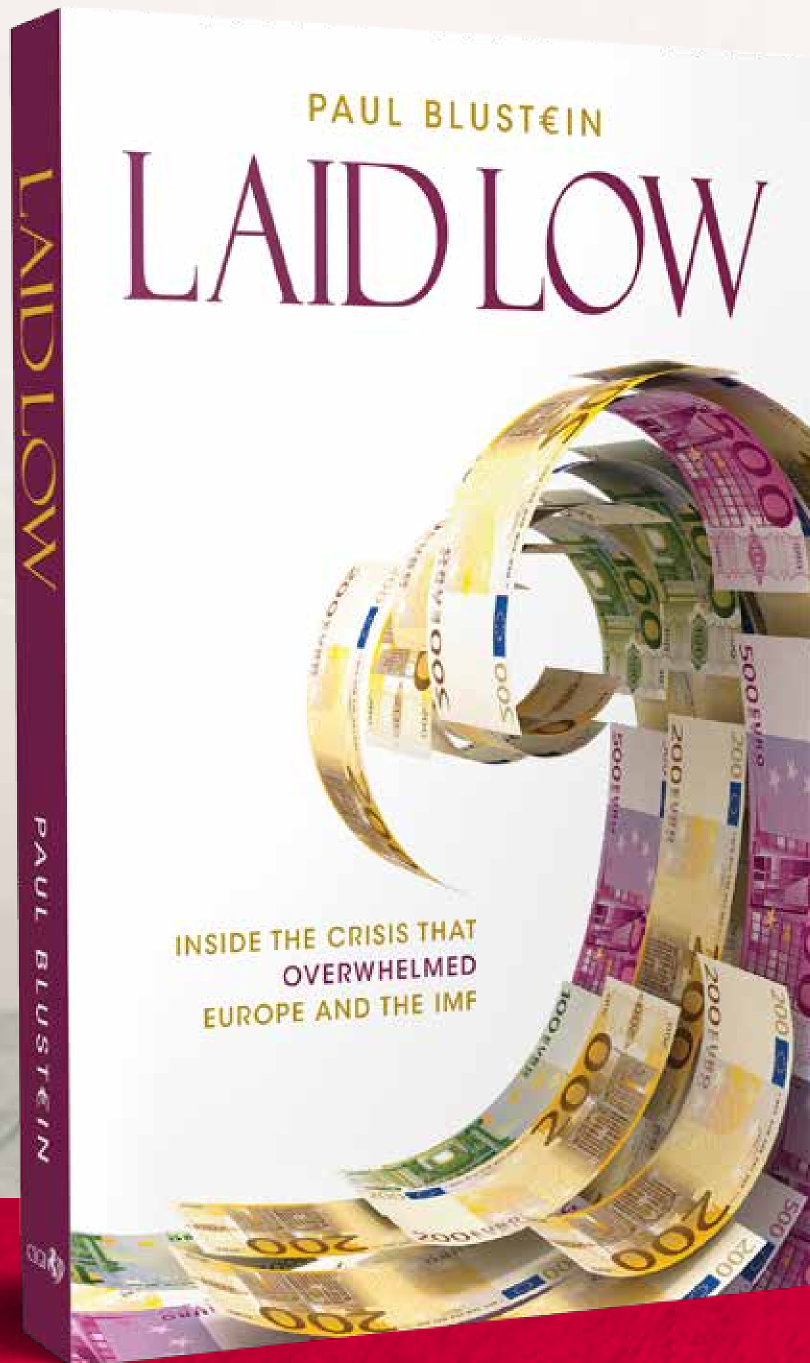

Laid Low

Inside the Crisis That Overwhelmed Europe and the IMF

Paul Blustein

An absorbing account of the world's financial firefighters and their misadventures in the euro zone.The latest book by journalist and author Paul Blustein to go behind the scenes at the highest levels of global economic policy making, *Laid Low* chronicles the International Monetary Fund's role in the euro-zone crisis. Based on interviews with a wide range of participants and scrutiny of thousands of documents, the book tells how the IMF joined in bailouts that all too often piled debt atop debt and imposed excessively harsh conditions on crisis-stricken countries.

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"Countless articles and books have analyzed the euro crisis, but until now, a serious treatment of the International Monetary Fund's role in the crisis has been missing."

– *Foreign Affairs*

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