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State insolvency: options for the way forward

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The Chair and the co-rapporteurs, with extensive comments and review by study group members, have drafted this report. The report reflects the discussions in the Study Group, but the content of the report should not be attributed to any individual member of the Study Group or taken as representing the view of any institution to which members may be affiliated or the clients of any member.

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Summary

The global financial crisis that started in 2008 resembles the period at the end of the 19th century that triggered many sovereign defaults. Government balance sheets are again under stress as public borrowing soars and governments assume private liabilities. The collapse of banking systems commonly has a severe impact on public balance sheets and solvency. Debt is migrating from the private to the public sector. The non-payment of sovereign debt is returning to the forefront of public policy.

Rapidly growing debt burdens around the world, particularly in developed countries, raise the spectre of future sovereign defaults. Over the last three decades, sovereign debt crises were the exclusive domain of developing countries. The International Monetary Fund played a central role in their resolution. But now, for the first time in two generations, the primary locus of sovereign defaults could lie in developed countries. This is an appropriate time to assess the suitability of existing mechanisms to deal with sovereign defaults.

Between 2000 and 2008 total debt increased by \$ 40 trillion in the UK, Japan, Spain, South Korea, Switzerland, France, Italy, the US and Germany alone. The stock of international debt markets exceeded \$ 45 trillion in 2008, split about equally into international debt securities and bank borrowings. Governmental borrowing, used wisely, can lift an economy's permanent growth potential and be put to productive use. Yet there are also pitfalls of borrowing. Governments have a worrying tendency to over-borrow, and to channel the proceeds of borrowing into current consumption.

These rising debts will have to be addressed, one way or the other. There are four ways high levels of debt have been overcome historically: (1) austerity, (2) default and rescheduling, (3) high inflation, or (4) economic growth. Whether debtor governments in the current crisis will be able to rely on austerity and growth alone to return their debts to sustainable levels is doubtful.

The market for sovereign debt has become truly international since the 1970s. The emergence of global capital markets has profoundly affected the way governments finance themselves. Sovereign borrowers increasingly issue in several jurisdictions, using a variety of instruments, to a wide range of creditors. These developments, and the interlinkages between domestic and international financial stability, raise new challenges for dealing with unsustainable levels of sovereign debt. A novel second set of challenges relates to defaults within a monetary union, such as a member country of the Eurozone or a US state that are unable to inflate their debt away.

Collapse of a domestic economy has trade and investment consequences immediately felt beyond the defaulting state's borders because of the integrated world economy. All creditors share an interest in ensuring that the country has future access to capital to refinance its debts and grow its economy, thereby increasing their chances for repayment.

Key findings of the Study's Groups discussions are:

- Sovereign defaults have been a pervasive historical feature from ancient times. Estimates of the number of sovereign defaults vary over the decades and the centuries but, without doubt, their incidence is high. Since 1980 over one hundred, more than half the total number of states, have experienced a sovereign debt crisis. Almost all states have defaulted over the past century.
- Sovereign defaults have come in clusters, such as the insolvency of emerging countries in the 1980s and the present sovereign debt crisis. In between these generalised collapses, defaults tend to occur at the rate of one to three a year.
- Periodic sovereign debt crises can have a dramatically adverse impact on the welfare of countries and can impoverish their populations. They can lead to the collapse of the insolvent state's financial and corporate sector.

Sovereign insolvency can be systemic in the sense that it has knock-on contagion effects on other countries. Contagion is the ricocheting of perceived default risk beyond the initial defaulting country. Contagion arises from three factors:

1. **Perceived similarity of sovereign borrowers:** states with situations similar to that of an insolvent state, geographically, by asset class (e.g. "emerging markets") or otherwise, are perceived by creditors to likely also get into trouble.
2. **Interconnectedness:** the impact of sovereign insolvency on creditors especially banks, who hold securities of the state or its corporations.
3. **Portfolio adjustments:** investment guidelines often require money managers to sell assets below certain rating thresholds, such as non-investment grade. Creditors reshuffle their portfolios and flee to "safe havens" such as gold and reserve currencies. The result may be cascading waves of selling.

These factors may arise out of a variety of circumstances, such as:

- **Political tension:** Severe political incidents often have ripple effects on financial systems and may prompt countries to default.
- **Economic growth:** World GDP is forecast to increase substantially over the medium-term, partly because of the rise of emerging countries. In 1995, world GDP was about three football fields of \$10 trillion each, comprised of one football field representing the United States, the second football field Europe and the third football field all other countries. Now there are between five and six football fields. By 2030, there are predictions that there will be ten football fields, heavily weighted towards Asia. Such greater prosperity may herald greater risks for two reasons:
 - the size of borrowings and liabilities may be larger; and

- the holdings of banks, insurance companies and other financial sector participants would be larger and therefore possibly more volatile.
- **Demographic changes:** Growing and aging populations may lead to financial strains, e.g. pensions.
- **Antiquated methods:** The conventional institutional modes of dealing with state defaults via the Paris Club, the London Club and bondholder committees may need updating.
- **Absence of rules:** At present, state insolvencies are dealt with by contractual solutions, e.g. bond exchanges. There are no international legal rules reflecting the policies of private sector insolvency. Measures to prevent sovereign insolvencies, such as more responsible borrowing, fiscal management and contingent credit lines, assisted administration or temporary standstills, are likely to gain prominence.

Motivation and goals of the report

This report examines a range of policy options for dealing with situations where a country's financial obligations outstrip its ability to pay. The question is whether the international capacity to achieve orderly sovereign debt restructurings needs to be improved, and if so, by what means.

Insolvency, including sovereign insolvency, attracts widely conflicting views. Controversy is inevitable when there are not enough biscuits and brandy on the raft to go round so that there are questions as to who survives and who does not and questions as to how the decisions are made and who makes them. Similar desires have been expressed in relation to the insolvency of individuals and corporations for centuries.

The key question is whether sovereign defaults or financial difficulties should continue to be exclusively dealt with by voluntary agreement between creditors and the debtor state or whether a layer of legal rules to govern the conduct of the insolvency is needed. In many cases the rules would not be used, just like in the corporate arena where most financial difficulties are dealt with by way of private agreement ("workouts"). The statutory insolvency regime serves as a backdrop against which negotiations are carried out. There is also a debate whether creditor rights ought to be strengthened.

The remit of the Study Group was to study the existing legal framework and to propose the broadest possible range of policy options, without regard to their political feasibility. At this stage the Study Group does not come down in favour of any of the options, one way or another: this task is left to a successor to the Study Group after taking soundings amongst interested parties as to the merits and de-merits of the four main policy options suggested.

Broadly the four policy options are:

- Do nothing and allow debtors and creditors to resolve their affairs by negotiation and contract as has happened for the last one thousand years at least.
- Adopt a limited provision for creditor voting on a debt restructuring plan.
- Adopt a comprehensive regime which reflects relevant aspects of private sector insolvency reorganisation regimes.
- Add measures which go the other way to strengthen creditor rights and dilute debtor protections.

This simple categorization overlooks a range of other policy options, especially in terms of preventing sovereign insolvency, notably contingent credit lines or the IMF's rapid credit facility, and intermediate options, such as temporary standstills, rescheduling, restructuring, e.g. the joint response of the IMF/ECB assistance to Greece or assisted administration.

The causes of sovereign insolvency

The causes of sovereign insolvency vary, but fall into two broad categories: mismanagement and misfortune. In practice both tend to be present to varying degrees in a given sovereign insolvency.

Mismanagement includes over-borrowing, governmental over-spending, poor financial management, weak taxation, inadequate financial statistics, official embezzlement or collapse of the banking system.

Misfortunes outside the reasonable control of the state have included wars, economic and political shocks from abroad, increases in foreign interest rates, fluctuations in commodity prices and natural disasters.

The impact of sovereign insolvency

Sovereign insolvency has a profound effect on the peoples of the state concerned. Commonly the currency collapses, the economy shrinks, and inflation spikes. The banking system may collapse, and the sovereign insolvency usually has a ripple effect on the private sector. The state will be unable to service foreign currency debt. No foreign currency is available or becomes prohibitively expensive because of the depreciating local currency.

Insolvency results in the drying up of credit and foreign direct investment. The financial debacle depletes the ability of the state to develop its economy. Public services often cease to function. People are impoverished. Insolvency is a spoliator, a destroyer. Taken together, these three factors weaken the ability of the state to pay its creditors.

Third parties are often affected by the insolvency of a state: neighbouring countries through instability; trading counterparties by virtue of a sharp decline

in demand; international financial institutions, countries as creditors in their own right, or through the effects on their nationals or companies.

The insolvency has a major impact on creditors. Many creditors are banks and bondholders. If one strips away all the veils of incorporation, strips away all the marks in the books of the corporate registrars, all the insubstantial figments of the ingenious legal imagination, the ultimate creditors in substance are individuals who place their moneys with financial intermediaries (banks, insurance companies, pension or mutual funds). The real creditors in interest are citizens. Likewise, sovereign debt is ultimately serviced by their people by way of higher taxes and/or lesser public services. Inevitably, there are individual people at both ends of the chain, often classified in generational bands.

Accordingly, the contest is finally between the ultimate creditors and the ultimate debtors. The conflicts in both domestic and international insolvency law stem from this basic opposition. Insolvency regimes can be and often are orientated towards either of these contestants. Some seek to protect creditors, while others protect debtors, with many gradations in between. They are locked together by the chains of contract and custom, circling each other with a mixture of hope and fear. Ultimately their interests are mutual.

Chapter 1: Sovereign debt and sovereign insolvency

The definition of sovereign debt

In the case of domestic corporations, insolvency affects whether a debtor or a creditor can petition for insolvency, whether directors are liable for deepening the insolvency and whether insolvency starts the period for voidable preferences.

Like a person, when a state is unable to pay its external debts as they fall due, that state may be considered to be insolvent. The inability to pay usually relates to foreign currency obligations. A state need never be insolvent by reason of liabilities denominated in its domestic currency if it can print its own currency. The usual adverse consequence is inflation, effectively paying creditors a dividend only. States that belong to a currency union, such as members of the European Monetary Union or US states, cannot unilaterally inflate their debt.

Sovereign insolvency is to be distinguished from the repudiation of foreign debt. A state repudiates where it declares it will not meet its liabilities or adopts other legislative measures with equivalent effect. Such measures include whole or partial cancellations, the imposition of excessive exchange controls or taxes and conversion of foreign debt into local currency scrip.

The balance sheet test for insolvency of corporations – deficit of assets over liabilities – is inappropriate because most sovereign assets are not realisable to pay foreign creditors.

There is no clear legal definition of sovereign insolvency. The factual condition of insolvency may:

- Trigger events of default in the debtor's bank loan agreements and bond issues entitling creditors to accelerate existing debt, or suspend new credit if, for example, the debtor has declared its inability to pay external debts as they fall due or there has been a material adverse change in the financial condition of the debtor.
- Entitle buyers of protection under credit default swaps to require cash payments from sellers of protection.
- Lead credit rating agencies to downgrade the state's ratings. These downgrades may:
 - Disqualify investors from acquiring or holding such sovereign debt.
 - Increase the capital the debtor state's banks are required to hold.
 - Disqualify the state's obligations as eligible collateral granted to central banks, clearing systems and other market actors.

- Increase the haircut applied to margin and other collateral.
- Lessen the state's ability to raise new finance.
- Increase the cost of insuring the state's debt.
- Create a run on the debt and the debtor's currency.

Categories of sovereign debt

Two types of sovereign debt are often distinguished: external debt and domestic debt. Regional currency debt may form a third, new category of sovereign debt.

1. External debt is expressed in some foreign currency, typically payable abroad, governed by some external law and subject to the jurisdiction of external courts. The main categories of sovereign external debt are:

- Debt owed to supranationals, such as the IMF or the World Bank.
- Official debt, i.e. debt owed to governments and arms of states, e.g. central banks.
- Commercial bank debt, usually documented as syndicated credits. The debt may be on-sold to non-banks, such as hedge funds or it may be securitized, i.e. sold to special purpose vehicles which are funded by bondholders who in turn take security over the loans.
- Bond debt, i.e. tradable debt securities held by international bondholders. These bonds may also be securitized.
- Trade debt, i.e. miscellaneous obligations for supplies and services or owed to banks through arrangements such as documentary letters of credit.
- Other liabilities, e.g. judgment debts or arbitral awards.

2. Domestic debt is governed by domestic law (usually impliedly), subject to local exclusive jurisdiction (although often implied), denominated in domestic currency and traditionally, though not necessarily, predominantly held by local residents. Provisions on governing law, jurisdiction clauses and waivers of sovereign immunity are rare. Debtor states are able to change domestic debt unilaterally by legislation. Domestic debt is rarely rescheduled.

Some states, especially developed countries, borrow largely or exclusively under instruments governed by domestic law, e.g. 90 percent in the case of Greece. While the large majority of states lack a developed local debt market, and cannot borrow sufficient volumes under domestic law, in recent years a number of developing countries have made important progress in this respect. The main categories of domestic debt are:

- **National debt:** e.g. US Treasuries, UK gilts and the like.
- **Administrative liabilities:** All the general domestic liabilities of a state, e.g. salaries of the civil service. These obligations are normally owed to

local residents in the local currency and are not the subject of international rescheduling.

- **Others:** Local projects financed by foreign creditors are usually conducted through special purpose vehicles to insulate the state although the state itself may enter into a concession agreement or incur foreign currency financing obligations. States sometimes trade and thereby incur direct trading obligations or more usually guarantees of trading contracts.

A novel question is whether debt of members of currency unions is more like domestic or external debt. Currency union members lack the power to unilaterally inflate their debt. But the debt is often governed by domestic law and subject to the jurisdiction of domestic courts. The old dichotomy of purely local or purely foreign currency debt may no longer hold.

Two further types of debt are important. First, the debt of subnational governments, state-owned or state-controlled corporations (para-statal entities). Defaults by subnational or state-owned entities, though legally separate from the government, tend to affect sovereign creditworthiness. Second, states also assume liabilities contracted by the private sector with some frequency. Private debt, especially of the banking sector, may become the government's responsibility, through explicit or implicit guarantees. Both types of liabilities may add to central government debt, especially in crises.

Chapter 2: The existing regime for restructuring sovereign debt

Introduction

Over many decades, a sovereign debt workout regime developed through extensive restructuring practice. The restructuring process has been carried out under the aegis of three key groups of creditors, depending on the make-up of the debt. These are:

- The Paris Club, a group of mainly developed country creditors who reschedule official debt on common terms, was established in 1956 under the chairmanship of the Ministry of Finance of France to deal with an Argentinean default.
- The London Club, an ad hoc group of international commercial banks who have exposures to the debtor state.
- Ad hoc bondholder committees formed at the time of the insolvency.

Historical overview

Prior to the 19th century, most debt on which sovereigns defaulted was either in the form of loans by private banks or sovereign debt instruments. In the 19th century, most of the defaulted sovereign debt was in the form of bonds, many raised in London or other European centres. Later in the 19th century, bonds were constituted with a trustee and bondholders were represented by a semi-official bondholder council. Imperial powers on occasion engaged in gunboat diplomacy to recover the debts of their nationals. Some countries were effectively placed under receivership when creditors e.g. installed customs and tax collectors in the debtor country, e.g. Council of the Ottoman Debt.

In the early part of the 20th century, sovereign debt was a mixture of commercial bank debt and bond issues, some of them now raised in the United States. The two World Wars gave rise to considerable dislocation and defaults on both official and private debts by belligerents.

After the Second World War, there was little borrowing by states from private markets. However, this was reversed in the 1970s when international commercial banks advanced large credits to states under syndicated credit agreements. The new eurobond market centred in London was largely restricted to developed states of undoubted credit standing. During the 1980s, the majority of emerging countries defaulted on their bank loans which had to be restructured by a fairly coherent and small group of international banks.

In the 1990s, states increasingly tapped the international bond market. By 1995, the vast majority of sovereign borrowing from private sources came not from bank loans, but from bond issues by state. The Brady Plan led to a major shift in

the ownership of sovereign debt, and stimulated the modern secondary market. After bondholders gained exposure to emerging market bond debt through Brady Bonds, the market for their sovereign bonds grew rapidly.

Several significant defaults from 1997 onwards culminated in Argentina's default in 2002. Thereafter, there were one or two restructurings per year, until the 2007 financial crisis raised the spectre of a renewed spate of defaults, involving middle income and developed countries.

Paris Club

From the 1950s through the early 1970s, the primary source of lending to countries was other states or their agencies. As a result, when a country defaulted on its debt, it owed financial obligations to other states. Sovereign creditors established the Paris Club to deal with these cases.

Throughout the 1970s and 1980s, the Paris Club routinely rescheduled or reduced the financial obligations owed by debtor countries unable to meet their obligations. These sovereigns included, among others, Brazil, Peru, India, Pakistan, Argentina, and Mexico.

Countries that face default or are already in default approach the Paris Club to reschedule their debts due to Paris Club members. Debtor countries present their case for relief and restructuring to the Club. Creditor countries reach consensus in private and present an Agreed Minute to the debtor outlining the relief being offered. The debtor may respond. The terms and conditions of the rescheduling are memorialized in bilateral agreements between debtor and creditor state.

The Paris Club has developed four principles to guide its work: (1) a case-by-case approach, (2) consensus, (3) conditionality, and (4) comparability of treatment. First, the Paris Club recognizes that each debtor is distinct. Second, decisions of the Paris Club are by common agreement of the creditor countries. Third, in exchange for the restructuring, the Paris Club imposes conditions on the debtor, mainly through the traditional prerequisite of an IMF program.

Fourth, the principle of comparability of treatment requires that the debtor country undertake to seek from other official bilateral creditors that are not members of the Paris Club and private creditors a rescheduling on comparable terms to the Agreed Minutes. The defaulting state may not grant other creditors more favourable treatment.

The composition and mode of operation of the Paris Club is likely to be affected by the emergence of China, India, Russia and Brazil as major capital exporters. These changes may also affect the character of private debtor-creditor relations.

The Paris Club has also been criticized for the clandestine nature of its decisions and for the unfair treatment of certain debtors. The level of debt relief in Paris Club restructurings also depends on political considerations – Iraq, for example, was able to restructure its debt to Paris Club members on generous terms.

Commercial banks and the London Club

The renegotiation of bank debts for Peru, Zaire, Turkey, Sudan, and Poland in the late 1970s led to the creation of the London Club for renegotiating sovereign debt owed to private banks. The London Club is essentially a negotiation forum between the defaulting country and its bank creditors. It follows the Paris Club's basic operative principles, which is feasible because private creditors remained identifiable and small in number. Negotiation is thus a viable option.

Unlike the Paris Club, the London Club lacks fixed membership. Instead, it is set up for each individual case by the banks with the greatest exposure to the defaulting state. A bank advisory committee is established, consisting of the main private bank lenders to the sovereign debtor. Creditors committees are the domestic analogue. The London Club negotiates agreements with each debtor state. Its two operational principles are: (1) case-by-case and (2) voluntary.

First, each debtor is treated pragmatically and a plan developed for restructuring based on its unique needs and ability to pay. Second, restructurings are voluntary in that they are always negotiated between the debtor state and the finite group of creditors represented on the committee.

Bondholder reschedulings and exchange offers

Sovereign bonds are often held by a large number of individuals and institutions who had no direct connection with the state and therefore are essentially indeterminate and anonymous.

Bonds are often more difficult to restructure than bank debt because of rigid terms, often requiring affirmative consent of all bondholders. Many bonds contain an acceleration clause that allows 25 percent of holders to require immediate payment of the principal. Bonds are also often held by institutional creditors whose fiduciary obligations may require them to sell when certain risk conditions are met.

Bonds are typically restructured through take-it-or-leave-it exchange offers. In an exchange offer, the sovereign approaching or in default informs its creditors of its financial situation and then develops a new issue of bonds with modified payment terms. Pakistan, Ukraine and Ecuador used exchange offers in the late 1990s.

Conclusions on restructurings

Some general conclusions about the restructuring process are as follows:

- **Achievability:** On the whole, restructurings by agreement have worked quite well in most cases over recent years, despite some chaotic episodes. For example, the bond exchanges involving Ecuador, the Ukraine and Pakistan around the turn of the 2000s were accepted by over 97% of creditors in each case. The exception is Argentina in 2005; only 74% of

bondholders accepted the exchange offer but this was attributable to the fact that Argentina offered just over 30% and creditors considered this to be way below Argentina's capacity to pay.

- **Private creditors:** Private creditors sometimes have a weak bargaining position as against the debtor state or think that they have. Reasons include the comparative lack of organisation of bondholders, the presence of competing bondholder committees, the difficulty of committees to obtain authority from bondholders and the problem of reaching consensus. Trustees of bondholders are standard in English law but quite unusual under New York law and rarely play a decisive role.

Another reason is that the IMF and the Paris Club, who are much better organised, can set the rules well in advance. The IMF is often quick to assess the financial condition of the debtor state and is therefore in a strong position to suggest sustainable restructuring terms. The IMF's view influences Paris Club creditors. The result is that the combination of the Paris Club's restructuring terms plus a Paris Club requirement that other eligible debt, e.g. bondholder and commercial bank debt, must not be restructured on better terms from the point of view of the creditors, means that the parameters for the restructuring, such as the payment envelope, are fixed before the restructuring of private debt.

- **Composition of the IMF:** In view of the rapid changes that are taking place in the economic weight of countries and the rise of important emerging countries, there has been debate as to whether voting power in the IMF should be rebalanced.

The IMF has drawn criticism for the economic adjustment programs associated with the use of its resources. As an international organization, the IMF aims to be politically neutral, is at some distance from national politics and is very experienced. The IMF's leverage in connection with economic adjustment is substantially increased because the Paris Club insists on a prior IMF supported programme.

- **Composition of the Paris Club:** The membership of the Paris Club in a particular case may need to reflect all significant official creditors.
- **Private-public contagion:** A key issue is whether the insolvency of a state extends to the private sector, mostly bondholders and banks, and whether they have to be rescheduled. Once the private sector is involved and there is a general default the complexity of the restructuring increases. Several insolvencies over recent years only involved official creditors since IMF and foreign government resources sufficed to ward off the crisis.

Hence in these cases, achieving agreement can be much more difficult than in former times when the IMF made the decisions and did not have to agree with anyone, except the debtor state.

- **Refinancing and lender of last resort:** An alternative to official sector action is the prioritization of new money from private creditors. Debtor-in-possession gives new creditors priority over old creditors, and would thereby encourage private lending to insolvent states. Debtor-in-possession reprioritization could lower risk ratings on refinancing, thereby giving access to financing from the marketplace at lower interest rates.
- **Early action:** States, just like corporations, often do not take action quickly enough when insolvency is looming. One constant complaint of creditors is that the management of companies act too late. Denial when the situation is obviously hopeless is common. There is nothing special about states.

Many devices have been tried under corporate law to encourage the “stop early” principle, especially by imposing duties on directors to file for when the company is insolvent. These measures are not feasible for states. The question is whether other “stop early” mechanisms for states are feasible, such as objective tripwires or other early warning systems. At the IMF, efforts are ongoing to improve surveillance and early warning mechanisms, and to provide earlier and more agile stand-by or other credit arrangements.

One of the chief challenges in the sovereign context is to distinguish liquidity from sovereign crises, as this borderline is fluid. Solvency is conditional on creditors’ beliefs that the country is liquid. As long as creditors regard a country’s financial distress as a liquidity problem, it will remain one. But once they start having serious doubts about the country’s solvency, creditors adjust their expectations. A sovereign liquidity crisis may quickly morph into a solvency crisis.

In the case of banks in the private sector, the “stop-early” principle is taken much further: regulators in many countries can intervene well ahead of actual insolvency, e.g. when capital sinks below a certain level. In practice, regulators too tend to intervene when it is too late.

- **Time:** Compared to corporate workout practice involving very large corporations, the time taken to achieve a successful resolution of a sovereign insolvency e.g. by an exchange offer or rescheduling of bank loans, is in some cases not longer and more arduous than a large corporate restructuring that lasts for years.

Pre-packagings are a way to fast track a restructuring. A pre-packaging is a reorganisation plan that is negotiated by creditors on the basis that, if some creditors hold out and do not agree, the corporation applies for a judicial reorganisation and the plan is voted on so as to bind dissentient creditors. Thus the judicial insolvencies of General Motors and Chrysler in

2009 lasted about a month each in US Chapter 11 proceedings. However, the preceding negotiations took years.

- **Burden sharing and moral hazard:** A central theme of insolvency theory is that creditors share burdens equally by class, in a manner equitable to the debtor. Bailing out states creates an expectation of future bail outs, which rewards both creditors and debtors that act recklessly (moral hazard). Pressures to bailout may result from systemic concerns for financial stability, political ties, military importance, a common currency or trade or exposure of the banking sector to the defaulting state. When taxpayers bail out the private creditors, they get paid.
- **Comparability:** Virtually all insolvency systems have equitable burden-sharing as one of their main aims. The existing sovereign debt resolution regime seeks to assure equitable burden sharing through the twin principles of comparable treatment for like debt and participation by representative creditors of each type of debt. Without the prospect of comparable treatment, debtors will find it hard to persuade creditors to refrain from holding out for a more favourable settlement through litigation or a side deal. If a group is excluded from the restructuring without adequate justification and repaid the face value of the debts, the cost of those debts must be spread through to all other creditors.
- **Hold-out creditors:** The question of whether hold-out creditors are a serious problem draws different views. Distressed debt investors buy debt at a substantial discount and seek recovery in full, thereby causing considerable dislocation. Pro rata sharing clauses in bank loan agreements (which often contain an exception for execution proceeds), syndicate voting or no-action clauses typically do not inhibit litigation by distressed debt investors. Bank credit agreements do not usually enable the majority to change payments, and no-action clauses preventing banks individually suing for amounts unpaid are rare. The typical bank no-action clause only prevents accelerations without a majority vote.

Sovereign debtors rarely achieve 100% acceptance of a restructuring proposal. Almost invariably, some creditors will have the power to harass the debtor by obtaining judgment and attempting to attach external assets of the state. Such creditors can complicate attempts to borrow money abroad because the proceeds may well have to touch down for at least a moment in the payment system of the country of the currency. In addition, the state has to make sure that all its external assets are shielded by immunity or the veil of incorporation of the central bank or other state entities.

The issue of the hold-out creditors has been acute in the case of Argentina because of the low rate of bondholder acceptance. It continues to be a problem for heavily indebted states stretching back to the 1980s. A notable development is the UK's Debt Relief (Developing Countries) Act of 2010,

which mandates equal participation of private creditors in debt relief to Heavily Indebted Poor Countries before English courts.

- **Grab race:** There is no 'bankruptcy protection' for states. Creditors may therefore pursue claims against debtor states in default. Most litigation on sovereign debt takes place in the important financial centres in the U.S. and Europe.
- **Debt forgiveness:** The absence of the availability of a final insolvency discharge leaves the melancholy result that there are quite a number of heavily indebted countries which have completely unsustainable debt burdens inherited from the past which they are unable to shake off.

Chapter 3: The private sector insolvency law analogy

For insolvency law purposes states differ from corporations and individuals. Corporate insolvency laws themselves can be extremely intricate with highly prescriptive bodies of rules. By contrast, there are virtually no legal rules governing the insolvency of states and the matter is left to negotiations between the parties and the law of contract. At present only consensual work-outs are available. There is no judicial reorganisation and there cannot be a final liquidation.

This difference is also dramatically illustrated by the approach to bank insolvency as compared to states. In the case of banks, some countries have in place strong-arm rules of great complexity which effectively give the authorities powers to coercively reorganise failing banks, even before they have actually failed. These extensive powers and the speed of these intervention procedures are said to be justified by the potentially systemic consequences for financial stability of bank failures.

This chapter examines differences between states, ordinary private sector borrowers, notably corporations, which can justify these diametrically-opposed solutions of total rules for corporations on the one hand as opposed to virtually total freedom for states on the other. The appropriateness of a rule-based mandatory sovereign insolvency regime depends on the relative weight to be given to the major differences outlined in this chapter. The object is to provide some basis for assessing whether the different approaches are justified or whether convergence is desirable.

Private sector work-outs, reorganisations and liquidations

In domestic insolvency law, there are four generic methods of dealing with financial difficulties:

- Voluntary reorganisation: Agreement between the company and its main creditors, typically banks and bondholders, without any judicial intervention (a “work-out”).
- Judicial reorganisation: This typically involves a judicial order staying creditor executions, liquidation petitions and other creditor actions and a reorganisation plan reorganising the debt, e.g. a rescheduling or debt-equity conversion. The plan is voted on by creditors and confirmed by the court. Domestic insolvency laws differ markedly in the insolvency ladder of priorities, the protection of super-priority creditors), the intensity of stays on creditors, the exposure of managers to liability, and the relative decision-making powers of management, the court and creditors.

- Judicial reorganisation “light”: An intermediate procedure between an agreed reorganisation and the judicial reorganisation. This court-supervised procedure facilitates the reorganisation of the business as a going concern. Pre-packs, where a court effectively rubber stamps rapid voting by major creditors on a plan which has typically been negotiated for many months, also fall in this category.
- Final liquidation: The order by a court imposing stays on creditor executions and other freezes and involving a disposal of the company’s assets, the distribution of the proceeds to creditors and the dissolution of the company.

Both work-outs and judicial reorganisations are initiated to rescue the company and its creditors. A final liquidation guillotines the company. Often creditors and debtors can agree on a work-out based on the expected outcome in insolvency. In this sense, the judicial reorganization offers a baseline that tempers irrationality and expedites negotiations.

Chapter 9 of the US Insolvency Code for municipalities has some similarities to states. Most importantly, Chapter 9 does not permit the liquidation of the municipality and the sale of its assets, because to do so would violate state sovereignty and imperil the delivery of local public services.

Differences in status between states and private sector parties

Key differences in the status of states and private borrowers include:

- **Sovereignty:** States jealously guard their sovereignty under international law and resist interference by other states in internal matters.
- **Number of sovereign debtors and impact:** There are hundreds of thousands of corporations and more than 6 billion people potentially eligible for insolvency proceedings. By contrast, the number of states is miniscule. There are only around 194 states. The number of subjects eligible for sovereign insolvency treatment is small, though the number of people affected may be very large. The question here is whether the very low number of potential debtors affects the management of the problem. Each sovereign insolvency has unique features. Unlike corporate insolvency, sovereign insolvency is thus not commoditised.
- **Quantum of debt:** The amount of sovereign debt in the case of the largest countries is massive, e.g. the sovereign debt of, say, the United States and Japan. However the amount of the sovereign debt of most other countries is individually small compared to the world’s largest corporations. For example, the biggest sovereign collapse, that of Argentina in 2001, involved debt of somewhere between \$90 billion and \$130 billion. Greek sovereign debt is around \$ 300 billion. By contrast, the insolvency of Lehman Brothers in 2008 involved debts of around six times as much as

Argentina (around \$630 billion) even though Lehman Brothers was a comparatively small bank compared to the biggest banks in the world.

- **Banking systems are on-balance sheet:** The financial crisis starting in 2007, representing trends which appeared much earlier, shows the vital link between states and their banking systems. This link is two-fold.
 - States effectively have to guarantee the liabilities of their banks in the event of a systemic banking collapse at potentially great loss to the taxpayer
 - Banks often hold large amounts of the sovereign debt of other countries so that the default of those countries can threaten banking systems abroad

The liabilities of banks can be very large in relation to the GDP of states, sometimes a multiple of their GDP, though reduced if bank assets are taken into account. The result is that, although the amount of nominal sovereign debt may appear to be controllable, those amounts can be significantly ratcheted upwards if the state becomes responsible for private sector debts.

- **IMF resources:** A central bank can in theory create unlimited amounts of money as a lender of last resort. By contrast, the IMF's resources are finite, though they were tripled in 2008 to reach US\$ 750 billion. Virtually all countries are eligible for IMF last resort financing, accompanied by conditionality. The resources of the IMF would appear adequate for isolated and medium country insolvencies, but a wave of major sovereign insolvencies could stretch the IMF's resources. Other multilaterals and governments may support a state in financial difficulties.
- **Creditor diversity:** Sovereign debtors do not have anything like the diversity of creditor typically applicable to corporations, at least so far as restructurings are concerned. The categories of debts to be restructured in the sovereign context are smaller than in corporate insolvency. States rarely trade and so do not have trading creditors, secured creditors or tort creditors. The claims of civil servants and pension claims are payable in local currency and are never restructured. How holders of claims under bilateral investment treaties are to be treated in future restructurings is an important question.

Creditors of sovereigns may comprise claimants with different interests, e.g. relationship commercial banks as against anonymous bondholders, long-term holders of debt, holders of protection under credit default swaps. But on the whole, the creditor classes are simple and confined primarily to official lenders, bondholders and commercial banks, plus distressed debt investors.

- **Politics:** Geopolitical factors often affect the resolution of sovereign defaults, in particular bail-out money from other governments and the IMF and the degree of pressure put on national creditors to accept a tolerant restructuring, e.g. Iraq and Iceland.

Comparison of legal regimes

The differences and areas of comparison between the legal regime governing sovereign insolvencies and insolvency of corporations and individuals come in six main categories.

1. General legal protections of insolvent states

- 1.1 Immunity
- 1.2 Legislative sovereignty
- 1.3 Monetary sovereignty

2. Commencement and stays

- 2.1 Commencement and entry criteria
- 2.2 Eligible petitioners
- 2.3 Freeze on creditor attachments
- 2.4 Security interests
- 2.5 Contracts and leases
- 2.6 Set-off

3. Control

- 3.1 Control post-insolvency
- 3.2 Insolvency court

4. Plans

- 4.1 Disclosure
- 4.2 Realisation of assets
- 4.3 Binding dissentient creditors
- 4.4 Priorities
- 4.5 Equality between creditors on the same priority rung
- 4.6 Post-commencement financing and new money
- 4.7 Debt-equity conversions
- 4.8 Discharge
- 4.9 Negative pledges and other contract restrictions
- 4.10 Recognition of a restructuring

5. Special classes of claims

- 5.1 Interest
- 5.2 Foreign currency claims
- 5.3 Inadmissible and odious debt
- 5.4 Future and assigned debt
- 5.5 Guarantees and credit default swaps

6. Others

- 6.1 Avoidance of preferences
- 6.2 Governance failures
- 6.3 Continuity and succession
- 6.4 Corporate groups and state entities

These features provide an essential taxonomy of general insolvency issues to consider for sovereign insolvency. The details vary by country.

1. General legal protections of insolvent states

1.1. Immunity

Generally speaking, all the assets of private sector entities are available to creditors and there are no bars to suit by creditors against private sector entities, subject to jurisdiction. In the case of individual insolvency, insolvency laws exempt some essential assets from seizure, such as the homestead exemption in some US states.

States may have a substantial degree of immunity from both suit and seizure of assets. However, many jurisdictions have deimmunised the commercial acts and commercial assets of states, either by statute, or by case law. Moreover, most of the relevant credit contracts, notably bond issues and syndicated bank credits, contain comprehensive waivers of immunity from judgement and enforcement.

Central banks sometimes have higher protections in order to protect their reserves. Their assets at the BIS are commonly ring-fenced. Provinces, municipalities and other administrative sub-divisions may be approximated to states in terms of immunity protection. State-owned corporations are usually deimmunised unless they perform governmental functions.

1.2. Legislative sovereignty

Private sector insolvents do not have legislative insolvency enabling them to postpone their obligations unilaterally. By contrast, states have legislative sovereignty over claims owed by them and either governed by their own law or in some cases if payable and otherwise located within their own territory.

They can therefore impose a moratorium or exchange controls, which courts abroad often do not recognise on various grounds depending on the jurisdiction, e.g. the credit contract is governed by an external governing law and therefore a local decree cannot alter that law (English-based jurisdictions), or the claim is located abroad and is therefore outside the legislative territorial competence of the debtor state (the US the act of state doctrine), or as a matter of public policy, states cannot interfere with these foreign-held claims, regardless of location or governing law. Since most bond issues and syndicated bank loans in a foreign currency are payable abroad in the country of the currency and are expressly governed by an external law, most bondholders and commercial bank claims are not alterable by unilateral action of the debtor state.

Questions have arisen as to whether Article VIII, Section 2(b) of the IMF's Articles of Agreement provides a debtor with protection against litigation in circumstances where arrears arise exclusively from the imposition of exchange controls. Article VIII, Section 2(b) provides that exchange contracts involving the currency of any IMF member, which are contrary to the exchange control

regulations of that member which are maintained consistently with the Articles, shall be unenforceable in the territories of any member. This provision has not been interpreted uniformly by the courts of the IMF's various members. Under the narrow interpretation - prevailing in the United States and the United Kingdom - exchange contracts have been interpreted in such a way that Article VIII, Section 2(b) is not applicable to credit agreements. Under a broader interpretation - prevailing in a number of other jurisdictions - the IMF's temporary approval restrictions that fall within the jurisdiction on current payments (e.g., interest payments and moderate amortization of loan principal) will result in an automatic stay of creditor actions relating to the arrears that arise from the restrictions in question, with the stay lapsing on the expiration of the IMF's approval.

While the IMF could adopt an authoritative interpretation along the above lines, it would not help with respect to other arrears relating to capital payments (e.g., non-payment of bullet payments of principal). There are only two ways such arrears could be treated. Under one scenario, controls that give rise to such arrears would be treated as always being consistent with the IMF's Articles. Alternatively, the term "consistent" could be interpreted more narrowly, as only including restrictions on current payments and transfers, thus controls on capital payments would never be consistent with the IMF's Articles. In any event, neither of these interpretations would enable arrears on capital payments to be temporarily protected on a conditional basis i.e., where the IMF judged the arrears in question to be justified. Accordingly, to achieve symmetry between the treatment of arrears arising from capital and current payments, an amendment of the Articles would be required.

1.3. Monetary sovereignty

A state has power over debt in domestic currency and can therefore inflate it away. Hence the restructuring of domestic debt held by foreigners is rare. An important aspect of monetary sovereignty is the power to change the exchange rate.

A state cannot inflate a foreign currency debt. Euro members cannot unilaterally inflate Euro-denominated debt, unless they unilaterally leave the European Union. Private sector insolvents do not have the power to change the value of the currency in which their debt is denominated.

2. Commencement and stays

2.1. Commencement and entry criteria

A formal insolvency in the private sector is typically commenced by a petition to a court. This crystallizes the creditor stays and the priorities, and starts the plan process.

The equivalent in the case of states is an announcement by the state of a moratorium and a cut-off date, after which new financings are typically not rescheduled.

Private sector insolvencies usually require proof of insolvency, for which there are two main tests:

- liquidity test, i.e. the debtor is unable to pay its debts as they fall due
- balance sheet test, i.e. the debtor's liabilities exceed its assets

Even if adapted, a balance sheet test is difficult to apply to states.

The purpose of requiring insolvency is to ensure that debtors do not gain the protections of insolvency and that creditors do not wield a sledgehammer over the state.

2.2. Petitioners eligible to initiate a proceeding

In the case of private sector insolvency, usually both creditors and debtors can petition for insolvency.

Eligibility is irrelevant at present in the case of a state. Creditors cannot initiate the restructuring process – only withhold credit or seek execution for unpaid or accelerated amounts. Insolvent states commonly propose an exchange offer, declare a moratorium, or both. There can be a period of drift and uncertainty.

2.3. Freeze on creditor attachments and other stays

In the case of private sector insolvencies, the making of a liquidation or reorganisation order universally imposes a stay on attachments of the assets by creditors. This is to avoid a piecemeal seizure of the assets by diligent creditors in the interests of creditor equality and an orderly realisation. In reorganisation proceedings, there is invariably also a freeze on liquidation petitions since the aim is a rescue, not a liquidation. Most proceedings also stay payments and transfers by the debtor.

In the case of states, creditor suits or attachments in external courts cannot be frozen by an insolvency order or judicial moratorium. To escape, the state must transfer its external assets to separate state entities protected from the state's creditors by the veil of incorporation. Domestic governmental assets are usually exempted from creditor execution. Continuing payments and transfers are not stayed.

2.4. Security interests

Security interests protect against the insolvency of a debtor. In normal times, many companies borrow outside secured lending because they have sufficient credit strength to borrow without security. Instead, they borrow unsecured from

banks and bondholders who each require negative pledges prohibiting the company and its group from granting security to third parties.

Judicial reorganisations often interfere with security e.g. by freezing enforcement, by stopping interest or by allowing the administrator to use the collateral. In rescue plans, secured creditors are either not subject to the plan at all or else are treated as a separate class for voting purposes.

Most sovereign debt is unsecured, unlike corporate work-outs. It is also rare for restructured sovereign debt to be secured (apart from the Brady bonds). The reason is partly political, partly because of widespread negative pledges in commercial bank loan agreements. Bond negative pledges are traditionally weak – typically only prohibiting security for external or foreign currency tradable debt securities, thereby theoretically permitting bank security.

Hence the usefulness of a stay on security enforcement would appear to be less relevant in the case of states.

2.5. Contracts and leases

In the case of private sector insolvencies, the administrator almost invariably has power to disclaim, abandon or reject contracts and onerous property or alternatively to call for performance by the counterparty. The underlying idea is that if a company is insolvent, then it can no longer perform its contracts. Administrators must be able to reduce them to money.

In the case of state insolvencies, there are no equivalent provisions. States do not have any special power to disclaim or abandon contracts when they are insolvent. In most cases they can actually do so and simply pay damages, subject to principles of varying intensity about specific performance.

2.6. Set-off

Domestic insolvency regimes differ greatly on set-off. Some jurisdictions, notably in the English common law and Roman-Germanic groups, permit set-off on insolvency, while others, mainly in the Napoleonic group, do not. The effect of insolvency set-off is that the creditor is paid as a super-priority creditor. Some jurisdictions compromise by permitting set-off for financial markets, but not otherwise.

In the case of states, the ordinary set-off rules continue to apply, irrespective of immunity objections. As reciprocal claims with creditors are much less common than in the case of corporations, set-off is not a major issue in the case of state insolvencies.

3. Control

3.1. Control post-insolvency

In private sector insolvency, power after a formal insolvency has commenced, may be enjoyed or shared by an administrator on behalf of creditors, a creditors committee, a court, government official, and the debtor's existing management. The latter is sometimes called "debtor-in-possession". In the case of liquidations, the debtor's management is invariably displaced.

The affairs of insolvent states cannot be taken over and managed by a receiver, trustee in insolvency, judicial manager or other creditor representative. The government of the debtor stays in possession. Direct intervention, as adopted by capital-exporting countries in the nineteenth and early twentieth century, would violate international law, unless the agreement of the debtor government free from coercion is obtained. The proxy solution is IMF or other official conditionality.

In the case of private sector judicial rescues, the debtor company can sometimes carry on business in the ordinary course. Unusual transactions, such as borrowing or large sales, may require the approval of the administrator or the court so that there are constraints on the continued operation of the business.

In sovereign insolvency, there are no restraints on operations, asset disposals or fresh borrowings, unless agreed, e.g. under an IMF standby. These constraints may include a ceiling on expenditures and the budget deficit, privatization of state-owned companies and a reduction in the number and pay of civil servants. Such conditionality may be problematic, but an assessment of them is beyond the scope of this report.

In corporate insolvencies, most jurisdictions give exclusive power to the insolvency administrator to put forward a draft reorganisation plan. An exception is the United States where management has an exclusive right to prepare a plan for a period.

Sovereign debtors typically prepare proposals to restructure sovereign debt, though. In most cases these proposals are borne out of negotiations with creditors, and heavily influenced by the IMF and the Paris Club.

3.2. Insolvency court

In private sector bankruptcies, courts supervise the proceedings. Their usual functions are:

- to commence proceedings if the eligibility criteria are met
- to appoint a provisional administrator, pending any selection by creditors
- to decide disputes

- to approve motions for the implementation of stays or freezes, priority of new money, trumping existing creditors or the forced novation of contracts with third parties
- approval of a reorganisation plan to ensure that fairness is observed and in order to enhance recognition of the plan abroad.

In the case of states, there is no international insolvency court to undertake the functions of a national insolvency court. Nevertheless, state insolvencies do not operate in a legal vacuum. For example, national courts can and do resolve disputes regarding sovereign debt and they also give judgment in favour of creditors and order execution or attachment, subject to sovereign immunity. In addition, creditors may potentially bring arbitration claims against states based on debt, notably proceedings under bilateral investment treaties. But there is no collective proceeding that centralises all claims and oversees all aspects of the case.

4. Plans

4.1. Disclosure

Companies are generally required to deliver a statement of affairs explaining the causes of the insolvency, elaborate financial statements, details of the plan itself, financial statements, a description of the corporate group, including the circumstances giving rise to the filing, and risk factors. Prior to insolvency, corporations must also publish periodic financial statements conforming to accounting rules.

States are under no international obligation to disclose the same level of detail as corporations. The IMF's Special Data Dissemination Standard, the Financial Sector Assessment Program (FSAP), the Reports on Standards and Codes (ROSCs) macroeconomic data drawn up by international financial institutions, such as the joint Statistics on External Debt, partly fill the gap. Notwithstanding these, a state in financial difficulties is under no legal obligation to publish a comprehensive disclosure document to creditors detailing a restructuring plan and its economic condition.

4.2. Realisation of assets

The essence of private sector liquidation is that the assets of the bankrupt are realised as a pool in accordance with the insolvency ladder of priorities.

In contrast to private sector insolvency, the domestic assets of a state, such as its land, cannot normally be forcibly realised by creditors for division amongst the creditors. It is hence only the foreign assets which are potentially exposed, such as bank accounts, foreign investments, bullion and trading contracts. In practice some of these foreign assets are likely to have been run down by the state in an attempt to ward off the insolvency. A state could also transfer some of its assets to other entities protected by the veil of incorporation.

Final liquidation is not available - only a consensual debt reorganisation. The emphasis must therefore be on rehabilitating the state's foreign earning capacity out of which the external debt must be paid and encouraging necessary economic reform.

4.3. Binding dissenting creditors

In the case of private sector insolvencies, the problem of dissenting creditors outside rescue proceedings can be partially dealt with by the collective action clauses in bonds discussed below. In insolvency, there are typically mechanisms for binding dissenting creditors to a plan, such as majority voting on a restructuring plan and cram-down procedures.

In the absence of collective action clauses and in contrast to court-approved plans over the objections of minority creditors in domestic law, reorganisations of sovereign debt cannot be imposed on dissenting creditor minorities by majority creditor vote or judicial sanction. The consent of each creditor is needed to modify the terms. This has to be achieved by agreement, by peer pressure, recognition of mutuality, and moral suasion by the official sector. The effect is that the state has to offer rescheduling terms acceptable to a preponderant majority of its creditors.

4.4. Priorities

In private sector insolvencies, it is often said that the most fundamental principle of insolvency is the equal payment of creditors (*pari passu, pro rata*). The justification for the priorities in the insolvency ladder of priorities are sometimes functional, sometimes a political reality, sometimes ideological. Creditors lower on the ladder often bitterly contest the super-priority and priority ranks.

In practice, however, the *pari passu* principle is nowhere honoured across creditor classes. Creditors are paid according to a ladder of priorities. Nowhere is there a flat field, but rather an intricate series of steps as creditors scramble for a higher position, gasping for the bubble of oxygen at the top. It is not unusual to have an insolvency ladder of priorities of 30 to 40 or even more steps.

It is therefore no surprise that there should be debates about the priority ladder for of sovereign debtors. The IMF priority is generally justified on the basis that last resort emergency new money is always accorded priority.

The ladder usually comprises at least six main rungs:

1. **Super-priority creditors:** Secured creditors, title finance creditors, creditors with a set-off and beneficiaries under trusts.
2. **Priority creditors:** Mainly post-commencement administrative claims, post-insolvency new money, taxes, employee remuneration.

3. **General unsecured creditors:** Unsecured creditors without special priority, include unsecured banks, bondholders and trade creditors for goods sold or work done.
4. **Subordinated creditors:** post-commencement interest, creditors whose loans were substantially equity, and creditors subordinated for misconduct.
5. **Equity shareholders.**
6. **Excluded creditors:** e.g. claims for foreign revenue or penalties and in some countries any foreign creditor; foreign currency creditors by virtue of the near-universal rule that foreign currency debts owing by an insolvent are converted into local currency on the commencement of the insolvency at the official market rate.

The black-letter ladder of priorities can be and often is subverted or turned upside down by realities. For example, in many corporate rescue plans, trade creditors are not involved, and therefore enjoy effective priority. They are simply paid out of new money provided by the banks in relation to the plan or else out of cash released by disposals, by the rescheduling of banks and bondholders or by a debt-equity conversion.

For states, priority or equality of payment hinges on agreement. The regime operates without a statutory insolvency ladder of priorities. There is an informal ladder of priorities based on consensus, notably that the main multilateral creditors (IMF, World Bank) must be kept current and that ordinary trade, domestic and similar creditors can be paid. Hence, mainly banks, bondholders and bilateral creditors are restructured.

Some of the corporate classes do not exist at all in the case of states, e.g. equity shares. Tiered debt capital structures with senior and junior creditors are unheard of. Some of the most contentious priorities in corporate insolvencies, e.g. taxes and wages, do not fall within the scope of state reschedulings and therefore are effectively prior.

The shared understanding of the informal ladder of creditors in sovereign debt restructurings results from negotiation and market practice. Rescheduled creditors agree with the debtor state that the preferred creditors will not be rescheduled and may be paid when due. The traditional approach for each class of rescheduled creditors (e.g. bank creditors, bond creditors, and official creditors), requires an undertaking from the debtor state that (in effect) the debtor will: (1) not pay creditors of the class eligible for rescheduling but who do not agree to reschedule, and (2) obtain comparable treatment from other classes of creditors who are required to be rescheduled on equivalent or worse terms. So the debtor agrees not to pay non-accepting creditors in each class on better terms and also agrees not to pay creditors of other classes who are to be rescheduled on better terms. There is no inter-creditor agreement between the various classes of

creditor so that the priority ranking is like the spokes of a wheel without the rim, with the debtor as the hub.

4.5. Equality between creditors on same priority rung

Private sector insolvency regimes invariably provide that on liquidation creditors who are on the same priority rung share equally. This principle is generally recognised in reorganisation statutes mandating a plan: the plan must reflect the insolvency ladder of priorities, although there are often various exceptions and sometimes judicial discretions. The priority ladder serves as the basis for assessing inter-creditor fairness.

In the case of states, since there is no mandatory ladder, there is also no equality of creditors who are similarly situated. Again, the equality of creditors on the same rung is achieved by agreement and by the comparability clauses described above.

Syndicated bank credits generally contain a pro rata sharing clause whereby discriminatory receipts and set-offs applied by one syndicate member to its debt must be shared with the other syndicate members. Both bank term loan agreements and bond issues contain *pari passu* clauses which generally assert *pari passu* mandatory ranking: it is disputed whether these prohibit actual discriminatory payments.

Collective action clauses in bonds may include a term that, after a default, the debtor must make all payments to a trustee for bondholders who then accounts to the bondholders pro rata. In practice few sovereign bonds are constituted with a bondholder trustee and hence this weak pro rata clause is relatively unusual in current practice.

4.6. Post-commencement financing and new money

If a company is to be rescued, it almost invariably needs new money. Cash can be generated by a moratorium on payments, by disclaiming onerous contracts or a debt-equity conversion. In addition, most rescue statutes allow the administrator or debtor-in-possession to raise new money enjoying priority over existing creditors and sometimes trumping existing security, though often subject to adequate protection of the secured creditor. If the rescue fails, existing creditors are subordinated to the new money.

Insolvent states also require new money in most cases and, as with corporations, this may effectively be provided by a rescheduling of bank and bondholder debt. This may not be enough and hence the IMF and other governments may step in to fill the gap. In the 1980s, the international banks, mainly to avoid default on interest payments so that they did not have to report losses in their financial statements, provided new money.

If last resort new money is to come from banks, then there would have to be arrangements in place to assure these banks that they will not be dragged into

the rescheduling and will be entitled to enjoy the priority generally accorded by consensus to last resort bail-out creditors. At present, there is no machinery to assure this, other than reliance on a consensus that it is only existing debt at the cut-off which is rescheduled, not bail-out money. The question is whether this is enough to promote bank or official post-commencement finance.

4.7. Debt-equity conversions

Debt-equity conversions are a common technique for restructuring debt in corporate restructurings. They can at a stroke render an insolvent company solvent.

As a state has not equity holders, it cannot be rendered solvent by a conversion of debt into equity. There are rough approximations, such as the conversion of creditors into equity of local companies, or the exchange of heavily discounted bonds which are indexed to the GDP growth.

4.8. Discharge

In most countries a bankrupt individual can secure a discretionary discharge. A company can be dissolved, and its liabilities can remain unpaid.

A state cannot obtain a discharge for debts which it cannot pay, and is unlikely to be able to pay, unless creditors are prepared to cancel debt or where the debt is governed by the state's own law. Hence a state cannot usually wipe the slate clean of the misfortunes or excesses of previous administrations. The abstract claim for the debt can remain forever, assuming creditors keep the claim alive under prescription legislation.

4.9. Negative pledges and other contract restrictions

Only some domestic insolvency laws allow corporate reorganisation plans to override negative pledges and other contract restrictions, sometimes giving rise to claims to damages for breach (commonly not of great value).

There is no machinery for overriding these contract restrictions in the case of states. In practice, this is not usually very important because negative pledges in sovereign bond issues usually only prohibit security for comparable traded debt instruments (and therefore allow security to be given to banks) and because states do not usually grant security even on a restructuring. By contrast, the grant of security in the case of corporate restructurings and workouts is extremely common, especially for bail-out money.

4.10. Recognition of a restructuring

Cross-border corporate insolvency is governed by an extremely complicated international regime, often dysfunctional, regarding the recognition of the creditor stays, the recognition of foreign insolvency representatives, the acceptance of the foreign insolvency regime's ladder of priorities and the

recognition of its insolvency law generally e.g. as to the avoidance of preferences or provable debts.

Notwithstanding this, the UNCITRAL Model Law on Cross-border Insolvency evidences a developing trend towards comity.

In the case of states, international recognition of the restructuring is not usually an issue, because the restructuring is consensual and not coercive (as domestic insolvency laws are). The recognition of restructuring agreements and of exchange offers depends upon private international law, e.g. for contracts and jurisdiction.

5. Special classes of claims

5.1. Interest

Post-insolvency interest is usually not claimable, or equivalently, is subordinated to other creditors in private sector insolvency.

In state insolvencies, interest continues to run and may be capitalised by contract. As a result, the interest piles up and can massively increase the defaulted capital.

5.2. Conversion of foreign currency claims

In domestic insolvency regimes, foreign currency claims are commonly compulsorily converted into the local currency at the conversion rate applying at the commencement of insolvency. Indexation clauses are very rare. The effect is that if the local currency is depreciating rapidly, the foreign currency creditor is expropriated.

This does not occur in a sovereign insolvency. Instead, the equal treatment of different currencies has to be achieved by private agreement, e.g. by the offer of currency bonds at prescribed conversion rates.

5.3. Inadmissible and odious debts/succession into debt

In most private sector insolvencies, all types of claims are claimable, except those which are unauthorised, illegal or contrary to fundamental morality. It is extremely rare for a commercial bank loan or bond to fall into this class of disqualified debt.

State practice on the succession of sovereign debt is erratic. It both supports and opposes the proposition. On a narrower question, some commentators have argued that a class of debts, commonly called odious debts, are not binding on the state. These are said to include regime debts, subrogation debts and war debts which are not the responsibility, it is said, of successor states. There is some slight state practice to support this proposition. Otherwise, the assertion that there is a wider category of odious debt beyond those which would be illegal

under domestic insolvency law seems to have been rarely successful in restructuring practice.

5.4. Future and assigned debt

In the case of liquidations, some jurisdictions reduce claimable debts maturing in the future by discounting them back from the future date at which they would otherwise have been payable. In practice, this is not particularly important since most credits, e.g. bank loans, are accelerated so are not discounted. Otherwise all debts, whether of long or short maturities, are eligible for dividend at their nominal amount.

For states, a distinction may be made between short-term claims and medium-term or long-term claims as regards the menu of exchange notes which are offered.

In the case of private sector insolvencies, assignment of claims is usually permissible. Almost invariably the assignee can claim the full nominal amount, even if the debt was acquired at a substantial discount.

In state restructuring practice, the position is broadly the same. Because of trades in the obligations of the state after a moratorium, it can sometimes be difficult to know who the creditors are. But this anonymity is in any event a feature of bond markets, despite the use of securities settlement systems. It is considered neither realistic nor desirable to limit trades after the announcement of a moratorium.

5.5. Guarantees and credit default swaps

A third party may guarantee obligations of a corporate debtor. Corporate insolvencies have complex rules about whether the creditor or the guarantor is permitted to claim in the insolvency of the debtor, including both contractual and insolvency rules preventing them from both claiming at the same time.

In the case of states, guarantees are unusual. The restructuring is entered into either by the creditor concerned or, if the guarantor has paid in full, by the guarantor. Creditors have to check that the guarantee is not invalidated by the acceptance of a restructuring.

Obligations of corporate debtors, typically bonds, may also be the subject of credit default swaps. A credit default swap is similar to a guarantee in overall effect, though not in legal intent or form. Under a credit default swap, the seller of protection, equivalent to a guarantor, agrees to pay the buyer of protection (equivalent to the creditor) the loss in the market value of a bond or other instrument if the reference obligor (equivalent to the principal debtor) defaults on a reference obligation (equivalent to the guaranteed debt) in the specified ways. Credit default swaps are usually callable in the case of corporate debtors in the event of non-payment, formal insolvency, insolvency or restructuring.

Very often credit default swaps are “cash-settled”. This means that the seller of protection pays the loss on the crystallising event to the buyer of protection but does not take over the obligation paid so that there is nothing like any subrogation or indemnity. The seller of protection just pays over cash in an amount that is commonly settled by an auction arranged by ISDA. One reason that there is no subrogation is that the buyer of protection may be “insuring” an obligation different from the reference obligation, such as an equity holding in a private company.

Credit default swaps written against sovereign obligations generally have four crystallising events: (1) failure to pay; (2) moratorium; (3) repudiation; or (4) a restructuring (defined along the lines of a material change in the terms of a borrowed money obligation caused by financial difficulties). The definitions are very technical. A voluntary exchange is typically not caught. As with corporate credit default swaps, sovereign swaps could be expected to be cash settled at a price determined by auction. The number of cases so far has been few.

It is sometimes said that buyers of protection have an incentive in a default in order to get paid. This might be the case if the sovereign debtor is in serious financial difficulties but in that case the sovereign debtor will normally have to propose a moratorium to its creditors in any event.

6. Others

6.1. Avoidance of preferences

Domestic insolvency laws often provide for the recapture of assets transferred by the debtor in the twilight suspect period prior to the commencement of formal insolvency proceedings. The fundamental and universal requirements for a transaction to qualify as preferential are: (1) the transaction prejudiced other creditors of the debtor; and (2) the transaction occurred while the debtor was actually insolvent. The suspect period typically ranges from 3 months to 2 years. Typical examples of preferences include payments outside the ordinary course of business to a particular creditor, gifts or transfers of assets at less than market value and the grant of security for pre-existing unsecured debt.

The objectives are to prevent the concealment of assets, to introduce equality at the point where the debtor is actually insolvent and to discourage creditors with special leverage from harassing the debtor into paying them off in priority. By contrast, preference avoidance can create unpredictability and can make it more difficult for debtors to avoid insolvency since the non-payment of some creditors can lead to forfeitures and cancellations.

For states, there are no statutory rules for the recovery of preferential payments or transfers to a creditor while the state is insolvent and no statutory disgorgement of fraudulent preferences. In practice, insolvent debtors are often advised not to pay some financial creditors preferentially, since this is likely to inflame the others and sour restructuring negotiations. Nevertheless discriminatory payments are sometimes made, though information is difficult to obtain.

6.2. Governance failures

In the case of corporate bankruptcies, many jurisdictions impose liability on directors and managers for violations of corporate law, the grant of preferences, false accounting, embezzlement or other misappropriation of corporate assets, for acting in conflict of interest and for deepening the insolvency. In some jurisdictions, such as France and Germany, directors are required to file on insolvency. Directors and officers may be protected by a business judgment rule for business mistakes.

In the case of states, there is generally no regime for holding government officials to account, either by retributive sanctions or by the disgorge of assets into the insolvency estate.

6.3. Continuity and succession

In the case of individuals, successors on death are generally not personally liable for his or her debts, i.e. there is a break in continuity. Corporations may merge or de-merge, usually pursuant to a statutory procedure involving creditor and shareholder voting. Similar issues arise for states. Questions of state succession arise where there is a replacement of one state by another in the responsibility for the international relations of territory. Examples are partitions and unifications. The law of state succession determines who is responsible for sovereign debt and who acquires the foreign reserves, for example. There is abundant state practice, but not a complete consensus. The Vienna Convention on Succession of States in respect of State Property, Archives and Debts of 1978 never came into force, but is a valuable source of data.

Generally the predominant view is that mere political changes in a state's government or form of government do not affect the state's obligations. In other words, a state's obligations continue independently of changes of regime, constitutional or otherwise. This view of state continuity has not gone unchallenged in state practice.

6.4. Corporate groups and state entities

In the case of corporate insolvencies, almost invariably each company in the group, of which there may be many thousands, is treated as a separate legal entity, in the absence of extreme comingling or other factors justifying the piercing of the veil of incorporation and insolvency consolidation. The effect is that only the assets of each group member can be used to pay its creditors. Those assets are not available to creditors of another company.

States are not holding companies of a group but the overall effect may not be greatly different. They commonly have separate administrative sub-divisions, provinces, regions and municipalities. They commonly own their central banks and other separate state entities. These separate legal entities are insulated by the veil of incorporation. For example, central bank reserves are insulated from creditor execution in cases where only the state is liable to the creditor.

Conclusions

From the legal point of view, corporate insolvencies are often more complicated and intricate than sovereign insolvency. A corporate regime has to deal with a greater diversity of creditors, with a wide variety of contracts and leases, with security interests, with set-off, with a very finely-strung insolvency ladder of priorities, with a reorganisation plan which is more complicated in a large case (numerous classes of creditors, debt-equity conversions, new money priorities).

The issue here is whether this much greater private sector complexity, especially in the case of interconnected banks, requires an elaborate set of hard rules. The *relative* simplicity may help explain (along with the absence of international consensus and impetus) why the pressures for a wider regime have been less in the case of states.

Major differences:

- The absence of freezes on credit attachments and other stays.
- The inability to bind dissentient creditors, outside collective action clauses.
- The inability of creditors to realise domestic assets of the state which means that their bargaining power is weakened.
- The inability of creditors to control the future conduct of the state's financial affairs, outside IMF or other conditionality.
- The inability of states to achieve a debt discharge.
- The absence of a mechanism to adjudicate disputes if negotiation fails.

If we weigh these major differences in the balance, there is an absence of *debtor* protections in the form of a freeze on attachments, of the power to bind the dissentient creditors, and a discharge (mandatory debt forgiveness). These must be balanced against the absence of *creditor* protections in the form of the realisation of assets and control of the management of the state's finances.

A debtor protection may be a creditor protection and vice versa, depending on the circumstances. Thus, a freeze on creditor attachments and the ability to bind dissentient holdout creditors is mainly a debtor protection, but it can help creditors who are seeking a stable resolution.

Chapter 4: Policy options for the way forward

Introduction

This section sets out four broad policy options for the way forward. The Study Group is neutral on these options and is concerned only with setting out, albeit in outline, a comprehensive range of alternatives, without recommending a particular policy.

There are broadly four ways forward:

- A. A voluntary, contractual regime, leaving the resolution of sovereign insolvency to market participants, with or without some official prodding.
- B. Adopt a limited provision for creditor voting on a plan.
- C. Adopt a wider regime that so far as possible reflects the relevant aspects of insolvency reorganisation regimes.
- D. Adopt measures to strengthen creditor positions and dilute protections for insolvent states.

Under Option A, market participants evolve their contracts over time to deal with sovereign insolvency in ways they consider most appropriate, subject to the agreement of each creditor. The yardstick for success is positive feedback by creditors and debtor states. Option B and C, in contrast, employ a limited or comprehensive set of hard rules that are known in advance to resolve sovereign insolvencies. These options may be complementary. All restructurings start with negotiations (Option A), but Option B and C may help to achieve greater inter-creditor and debt relief.

Option A: Contractual regime

The contractual regime is characterized by negotiations and contract, i.e. sovereign insolvencies are dealt with by the existing voluntary methods. Credit agreements provide for the mechanisms to deal with the contingency of insolvency, or not, as the case may be. For this mechanism to work, each relevant credit agreement needs to provide for the eventuality of sovereign insolvency.

Contracts are able to mimic certain principles of insolvency. While bonds governed by English law have traditionally included provisions allowing for majority voting on changes to a bond's payment terms, bonds governed by New York law traditionally did not include these provisions, instead requiring the unanimous consent of bondholders. Many sovereign bonds issued today contain collective action clauses that are designed to address the collective action problem typical of insolvency and the issue of non-participating creditors.

This approach focuses on mechanisms for a super-majority of bondholders to bind a holdout minority to new payment terms. The purpose of these collective action clauses is to alleviate the collective action problems that arise when a

country has numerous dispersed creditors with divergent interests and attempts to restructure its debts.

Full collective action clauses have three limbs:

1. majority voting on changes, including changes to the payment terms;
2. no-action clauses whereby only the trustee or a 15%-20% bondholder vote can compel accelerations and recovery action; and
3. a provision whereby after notice of default the trustee can require all payments by the debtor to be made to the trustee for pro rata distribution to the bondholders.

The inclusion of voting provisions is quite common in international bonds, regardless of the governing law. No-action clauses are often found. A trustee plus sharing of post-default receipts is rare. There have been suggestions that bonds should also include provisions for the appointment of bondholder representatives and bondholder committees and for the supply of information.

There may be room for an agreed set of non-binding principles. The development of work-out principles in relation to private sector corporate restructurings are precedents (e.g. the "London Approach" initially promulgated by the Bank of England; INSOL Guidelines). Such semi-official, non-binding workout guidelines for private sector corporate insolvencies can have persuasive force in national situations where the authorities can bring pressure on regulated firms to comply (soft law). No supranational authority can bring to bear the same degree of suasion, but soft codes can be influential.

The arguments said to be in favour of the contractual approach include:

- The system has so far worked reasonably well, or at least as well as ordinary work-outs in the corporate sphere. Corporate workouts invariably take time, are costly and imperfect and one should not expect a sovereign work-out to be any different.
- The present system balances the bargaining power of the parties. Compared to corporate insolvencies, creditors do not have the leverage of ultimately forcing a sale of the debtor's assets, control over the state's financial affairs, a right to enforce full disclosure or a right to sanction misfeasance.
- A contractual regime allows the creditors and the debtor stake to devise a restructuring solution appropriate for sovereign insolvency on an ad hoc basis, also in view of the systemic consequences that could follow. Because each insolvency has its unique features, a standard approach under a statutory regime is infeasible and undesirable.
- A debtor state must offer terms which are acceptable to virtually all creditors if it is to escape future litigation and damage to its credit reputation.

- Market associations can adopt contract practices which are designed to achieve an orderly resolution. The widespread adoption of collective action clauses in New York bonds and elsewhere testifies to the reasonable efficacy of this approach.
- Both debtors and creditors have an incentive to adopt sound contract methods of dealing with insolvency.
- Obtaining international agreement to a statutory regime might be difficult.

The arguments said to be against include:

- Many legacy debts do not have collective action clauses.
- Negotiated resolutions may be much slower. They often take several years.
- Contract negotiations may result in inadequate debt relief for the debtor so that after the restructuring the basic human rights of the debtors' peoples are compromised by the need to service the remaining debt.
- Creditors would be better protected if they had some method of binding hold-out creditors to an arrangement considered by the majority to be beneficial.
- Good faith debtors are unprotected against hold-out creditors. This decreases their chances of successfully returning to the market.
- Contract solutions have so far not been successful in dealing with such issues as aggregation of voting (i.e. the majorities apply to all bond issues on a consolidated basis). Collective action clauses can be cumbersome. They typically vary from issue to issue.
- Private work-outs work better against the baseline of compulsory regime for negotiation.
- Market solutions may be inefficient in systemic debt crises, where the amount of debt and the number of countries concerned is large.
- A lack of uniformity in bond clauses may lead to unequal treatment of creditors.

Option B: Limited "statutory" regime

Introduction

A limited statutory framework would allow relevant creditors by majority voting to approve a plan which would be binding in the courts of contracting states on all the creditors concerned. This solution would require an international agreement amongst a preponderance of states and subsequent enactment into domestic law.

The possible methods of adoption include:

- A model law
- A treaty
- An amendment of the IMF Agreement (which requires acceptance by three-fifths of the IMF's members having an 85% majority of the total voting power).

Draft articles providing for majority voting on a plan

The following are some draft articles in outline which implement one version of a limited statutory regime.

Article 1 -- Binding effect of approved plans

- (1) Any plan which is approved by the holders of not less than 75 per cent of the nominal principal amount of the holders of plan claims owed by a debtor member state (excluding plan claims held or controlled directly or indirectly by the debtor member state) and which is also approved by the debtor member state shall be binding on all the holders of plan claims and shall be treated as binding by the courts of member states.
- (2) Where plan claims are denominated in different currencies, the 75 per cent shall be calculated for each currency.

Article 2 -- Definition of plan claims

Plan claims are loans and credits together with those that have a similar effect to loans and credits, plus interest and fees in respect of those loans and credits. Plan claims do not include each of the following

- (1) Claims which are secured by a security interest or by any arrangement having a similar commercial effect to a security interest, except to the extent of any unsecured portion,
- (2) Claims held by any member state, other than the debtor member state, or by the central bank of, or by an entity controlled by, a member state, other than the debtor member state,
- (3) Claims held by the IMF, the World Bank or any of its affiliates, or by any similar multilateral organisation, including regional organisations,
- (4) Claims governed by the law of a member state or of one of its subdivisions, and denominated in its own currency.

Article 3 -- Scope of plans

A plan may provide for a waiver, change of the terms of plan claims including payment terms, an exchange, a cancellation, the priority of any creditors providing new credit, or any other arrangement without limitation affecting plan claims.

Article 4 -- Invalidity of plans

A plan is invalid:

- (1) to the extent that it increases the liabilities of a holder of a plan claim without its consent,
- (2) if it is grossly unfair as between the holders of plan claims or any class of holders, or
- (3) if it is manifestly contrary to public policy.

Voting majorities

Some of the issues regarding voting majorities are:

- The manner of verifying claims.
- The process for approving claims.
- The percentage level by bond issue or class, with or without a numerosity requirement.
- Whether the level should be measured according to those present and voting, and whether there should be quorums and percentages for adjourned meetings. The holding of meetings attracts considerable procedural mechanics.
- The exclusion of votes on claims held by the debtor member state or those it controls and whether the concept of control should be widened.
- Whether voting should be by the nominal principal amount or include unpaid interest and fees.
- Whether voting should be by classes.
- How claims in different currencies should be dealt with.
- Whether unimpaired plan claims should be excluded from the 75 per cent so that a plan could deal only with a smaller class of debt.

Plan claims by type of claim

The issues include:

- Whether plan claims which are subject to the 75 per cent vote should be limited to loans and the like (such as purchase money credits and financial leases).
- The scope of excluded debt (wide or narrow): whether plan claims should specifically include or exclude, for example, trade claims, small claims, interbank claims, tort claims, expropriation claims, or claims under bilateral investment treaties, domestic debt, subnational debt, official debt, multilateral debt, and, if so, how they should be defined.
- Whether plan claims should exclude secured claims so that the secured creditor relies on its security to the extent secured.
- The treatment of guarantees. Guarantors may become plan claimants when they pay the guarantee and take over the plan claim by subrogation or indemnity.

The exclusion of a class of creditors has the following main effects:

- The excluded creditors have de facto priority over included creditors. They are not subject to the same haircut as rescheduled creditors.
- The excluded class are not bound by the plan, e.g. they can attach assets in pursuit of their claims and are not bound by a majority vote on the plan.

Scope of plan

The main issue is how wide the scope of a plan should be. Other issues include:

- Whether the principle of comparable treatment of classes of debt should be recognised, e.g. between Paris Club and private creditors.
- Whether to include a most favoured debt clause in their plan which states that, if the debtor accords any other eligible debt more favourable treatment, e.g. by paying it more quickly, then all the other plan creditors will be entitled to the same treatment.
- Whether to allow priority of new money.
- Who prepares the plan or whether there is any exclusivity in its preparation.

Invalidity of plan

The main issue here is the scope of objections which can derail a plan, including whether a plan should be set aside for fraud or on grounds of public policy.

The options would seem to be either to state some general test of unfair prejudice or to set out tests along the lines of a corporate cram-down.

Cram-down tests in corporate reorganisations generally allow a class of dissentients to be ignored if:

- The plan does not observe the priority order on liquidation.
- The claim is not impaired and so is not entitled to vote.
- There is some other gross unfairness.

Disclosure

This limited regime does not provide for disclosure by the debtor, any stays on creditor action, or judicial oversight other than through normal access to national courts.

The most prominent proposals among many for a limited regime is the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the International Monetary Fund, and discussed for a brief period through early 2003. The final version of the SDRM proposal set forth a framework providing that key decisions would be taken by a qualified majority of creditors. These key decisions included: stays on creditor enforcement after the date of activation but prior to the certification of a restructuring; the treatment of post-activation financing transactions; and the terms of a restructuring agreement. The only decision-making organ to have been created under the proposal was the Dispute Resolution Forum (DRF), whose responsibilities would have been limited to:

- (i) administrative functions associated with notification of creditors and the administration of the verification and voting process;
- (ii) dispute resolution functions associated with resolving disputes that arose during the SDRM restructuring process; and
- (iii) suspending enforcement actions (at the request of the debtor and with the approval of creditors or their representatives) in circumstances where enforcement actions could seriously undermine the restructuring process.

There were differences of view as to the desirability of establishing a statutory sovereign debt restructuring mechanism at the time the final version of the SDRM proposal was discussed. Ultimately, the SDRM did not gain the necessary support that would have been required to amend the IMF's Articles of Agreement to implement the proposal. Central concerns were the double role of the IMF as a creditor and decision-maker, the impact on the cost of sovereign financing, the intervention in contractual rights, the move towards rules even though it may be said that the individual nature of each sovereign insolvency calls for ad-hoc solutions, and the desire to maintain room for governments to influence the terms of restructurings.

Option C: A wider "statutory" regime

This section outlines a regime which mirrors the features of private sector insolvency with a view to examining how they would work and identifying their pros and cons.

Summary of possibilities for a comprehensive regime

A comprehensive regime echoing so far as possible corporate reorganisations could have the following features:

- Apply for the declaration of a moratorium by reason of insolvency.
- Stays on creditors of varying degrees of intensity.
- Preparation of a plan by the debtor state or by representatives of creditors.
- Establishment of creditor committees.
- Provision for the contents of a plan, the division of creditors into classes, voting majorities and a cram-down.
- An explicit insolvency ladder of priorities which must be reflected in any plan.
- A governing law of the proceedings, for the jurisdiction of a tribunal, for the admission of claims, for the lifting of immunity, for restraint on transfers and disposals by the debtor state and its controlled entities.
- Terms of the plan to displace the terms of the debt concerned.
- A supranatural authority, such as the IMF, to require economic and other reforms. The plan could be conditioned on these reforms being complied with.

Achieving this high degree of control of insolvent states and of creditors is challenging under current conditions and would meet with objections.

One option for a wider regime is the internationalisation of the basic elements of Chapter 9 of the US Insolvency Code. Notable features include:

1. decision making by arbitration.
2. only the debtor may file a plan.
3. guarantee of essential public services.
4. equal treatment of all creditors including international financial institutions.
5. representatives of the affected population have a right to be heard.
6. verification of the legality of all debt claims.

Detailed design considerations for a comprehensive regime

The following provides an overview of design considerations for a comprehensive regime.

Scope of creditors

A wider regime could cover all classes of claim, or be limited to commercial debt. Political acceptance might be easier to secure with comprehensive coverage, including official, private and multilateral debt, with the possible exclusion of domestic debt.

Scope of debtors

A second issue would be whether subordinate divisions of a state should be eligible for a plan on similar principles to states, e.g. provinces, municipalities, central banks and state-owned entities performing governmental functions. Those which do not perform governmental functions are generally subject to an insolvency regime in any event although this is not always the case. There would arguably be a gap for those creditors who are neither subject to a private sector insolvency regime nor to a sovereign restructuring regime. Entities which are already subject to an insolvency regime might be subject to overlapping and conflicting regimes.

The arguments said to be against extending the scope of debtors include:

- These subordinate units are the responsibility of the state concerned.
- Their inclusion could complicate the regime.

Temporal scope

The question here is whether the regime would cover only sovereign debt that came into existence from the time of the regime's enactment or apply retroactively to the existing universe of sovereign debt.

Stay on creditors

The issue here is whether there should be a stay on creditor attachments before a plan is worked out.

Some of the issues are:

- Whether a stay is desirable before the approval of a plan. On the one hand creditors may rush to the court-house door to beat the plan. Capital flight might accelerate, and the debtor country's bonds might be sold in large quantities.
- Conditions on the stay (as set out below). Domestic regimes in relation to judicial reorganisations display the full range of solutions – from no conditions at all to tough conditions of the above type with many gradations in between.
- Other possible conditions to a stay would include:
 - i. approval of the declaration of insolvency by a resolution forum;
 - ii. the plan offers a minimum prescribed percentage of payments within a prescribed period;
 - iii. the plan demonstrates feasibility of compliance;
 - iv. the plan contains an appropriate waiver of immunity.
- The duration of the stay and whether it could be extended and on what conditions. Restructurings often take more than 90 days.
- Whether other stays would be desirable in this event. Some examples of private sector stays sometimes found are:
 - i. stay on the payment by the debtor of plan claims (and other prescribed claims to avoid unfair priorities or the dissipation of assets) with exceptions for permitted claims which therefore achieve priority.
 - ii. Stay on the transfer of state assets to state entities.
 - iii. Stay on the grant or enforcement of security or the like for plan claims during the moratorium period, or on litigation generally.
 - iv. Stay on set-off.
- How to operationalize the stay, nationally and internationally.

A sample article could provide, for example (in outline):

Article 5 -- Stay on creditor executions

- (1) A debtor state may by public notice stay all creditor executions in respect of plan claims for a period not more than 90 consecutive days in any one year. The stay is binding on all holders of plan claims and shall be treated as binding by the courts of each member state.
- (2) A member state may not stay creditor executions unless all the following are fulfilled:
 - (a) the member state is unable to pay its plan claims as they fall due or is likely to be unable to pay them as they fall due
 - (b) the member state has disclosed to the holders of plan claims a statement setting out details of plan claims and a proposal as to how the plan claims and other claims to be restructured should be dealt with, as well as details of claims which will not be restructured, and
 - (c) more than 50 per cent by nominal principal amount of the holders of plan claims have approved the stay.

This stay only stays the seizure of assets. It does not stay accelerations of loans or bonds, the commencement of litigation for unpaid amounts, obtaining judgement or litigation generally.

Information

Creditors often lack information as to the situation they are in and this may delay the process. State insolvencies are prone to suspicions and fears, e.g. that a debtor state will delay so that it can buy back its debt cheaply, or that one class of creditors is receiving preferential treatment.

Article 6 -- Disclosure statement

A debtor member state which proposes moratorium on the payment of plan claims or which stops payment of plan claims as they fall due or which proposes a plan shall within not more than 90 days furnish to the holders of plan claims a disclosure statement setting out details of plan claims, of other claims which it proposes to restructure, of claims which it does not propose to restructure, comprehensive information on its economic and financial condition and prospects, and of the measures it proposes to take in relation to the restructuring of its indebtedness.

Issues here include:

- The feasibility of this obligation.
- What event should crystallise the obligation.
- Scope of required disclosure.

Creditors committee

The issue here is whether a regime should facilitate the formation of a single committee as liaison group.

Article 7 -- Creditor committee

If a debtor member state proposes a moratorium on its plan claims or stops payment of plan claims as they fall due or proposes a plan, the holders of more than 50 per cent of the nominal principal amount of plan claims may appoint a creditors committee to liaise with the debtor member state and other creditors of the state. A creditors committee may appoint an independent firm of accountants to verify plan claims and the debtor member state shall cooperate with the firm.

The issues include:

- Whether a formal committee would be desirable or whether this should be left to practice and negotiation. Creditors often appoint their own committees, sometimes competing, particularly for bondholders.
- The competence of the committee.
- Payment of the Committee's costs.

Resolution forum

A forum for resolving disputes could be a dedicated international court of final appeal or could be a court of exclusive jurisdiction or could be a court of parallel jurisdiction requiring the consent of the parties to its jurisdiction.

The advantages of a court might include:

- The court could monitor the process.
- The court could avoid competing or irreconcilable judgments of national courts.

The disadvantages include:

- Difficulties of international acceptance.
- Cost and capacity.
- If the forum has exclusive jurisdiction, it would override jurisdiction clauses in credit contracts.
- If the forum has exclusive jurisdiction, it would override any national jurisdiction clause in a plan.

Article 8 -- Resolution Forum

- (1) A Resolution Forum shall be constituted in accordance with Schedule 1.
- (2) The Resolution Forum shall have appellate jurisdiction from the highest courts of member states / exclusive jurisdiction /

jurisdiction only if so agreed by the parties, over any legal dispute in relation to these Articles or any plan.

- (3) The Resolution Forum shall apply the law applicable to the plan claims in question and international law.
- (4) A decision of the Resolution Forum shall be treated as binding by the courts of each member state as if it were a final judgment of a court of that state.

Other matters

Some other items could be covered, including:

- the recapture of preferences, e.g. preferential payments by the debtor after it is actually insolvent – either by some hotchpotch method (a preferred creditor is not entitled to anything under a plan until other creditors have equalised) or by actual disgorge (difficult to enforce).
- stopping of interest on pre-commencement claims during the stay.
- class voting on a plan.
- an explicit ladder of priorities and.
- debt forgiveness, i.e. a discharge binding on all creditors subject to the fulfilment of conditions.

Option D: A less protective regime

There is much disagreement on whether existing creditors remedies against states lack effectiveness. One view holds that an augmentation of existing legal remedies is necessary as an in terrorem device to ensure that borrowing states do not turn to debt restructuring as an easy and convenient method of addressing a chronic lack of fiscal discipline. A second view cautions that strengthening creditor remedies could encourage a minority of creditors to exploit a country's financial distress and undermine the willingness of other creditors to provide debt relief.

Proponents of strengthening creditor rights have variously argued that currently creditor rights against sovereign states are deficient, that disincentives to overborrowing by sovereign states should be strengthened, that there should be more fiscal discipline and that strong creditor rights are desirable for orderly financial markets.

Measures which some commentators say could strengthen creditor rights or encourage fiscal discipline include tougher official and market sanctions for overborrowing by states, more international monitoring, more cautious policies on bail-outs to prevent moral hazard, improved private enforcement remedies in courts, greater protections for individual creditors in creditor documentation with sovereign states, greater transparency of information and disclosure by sovereigns, and a range of other possibilities.

For example, the Institute of International Finance's Principles for Emerging Markets' Crisis Management and Debt Restructuring (2002), supported by six industry bodies (EMCA, IIF, SIA, EMTA, IPMA, TBMA) emphasise the need for much greater transparency. In the current crisis, transparency has once again become a focal point.

Collective action clauses and other contractual mechanisms (Option A) affect creditor rights, as does a stay on creditor enforcement (Option B). Likewise, one of the primary goals of domestic insolvency law is to maximise returns for creditors in a collective procedure (Option C). The proper calibration of creditor and debtor interests in sovereign debt restructurings is therefore an overarching issue that is central to each of the four broad policy options discussed in this chapter.

Conclusion

This report is submitted to the International Law Association as the interim report of the Sovereign Insolvency Study Group. A review of history confirms that sovereign insolvency is a perennial problem. Some countries are serial defaulters, and no country is safe over a long period of time. The international community as a whole therefore has a strong interest to ensure orderly sovereign debt restructurings. Further, the sovereign debt market is in constant evolution. There is great variety in creditors, and creditor interests.

The Study Group hopes that this interim report forms a useful basis for discussion. The International Law Association may decide to take this work forward by requesting the existing Study Group or a different set of individuals to amplify the report in specific areas, to carry out detailed consultations with interested parties and to prepare a fuller final report with more decided conclusions – such as specific proposals to improve the state of sovereign insolvency.