

An overview of certain aspects regarding the regulation of sovereign insolvency law*

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OPSOMMING

'n Oorsig van sekere aspekte ten opsigte van die regulering van staatsinsolvensiereg

Daar is tans geen internasionale erkende of geldige insolvensiestelsel wat toegepas kan word in die geval van die insolvensie van 'n staat nie. Regeringsamptenare en owerhede regoor die wêreld poog tans om die impak van die huidige internasionale ekonomiese krisis te versag deur gebruik te maak van verskeie kunsmatige ondersteuningsmeganismes en ekonomiese beleidsreaksies. Akademici sowel as beleidmakers pleit reeds geruime tyd vir die ontwikkeling van internasionale maatreëls ten einde so 'n internasionale ekonomiese krisis te hanteer en sodoende die herhaling en erns daarvan te beperk. 'n Doeltreffende en effektiewe insolvensiestelsel is 'n kritiese komponent van elke goed-funksionerende mark-ekonomie en die huidige debat oor ekonomiese globalisering kan ook nie geïgnoreer word nie. Die onlangse ekonomiese ondergang van Griekeland en ander Europese lande het die behoefte beklemtoon om ekonomiese aangeleenthede ten opsigte van staatsinsolvensies op 'n tydig, ordelike en voorspelbare wyse aan te spreek. Die doel van hierdie bespreking is nie om die moontlike oorsake, implikasies en oplossings vir die huidige internasionale ekonomiese krisis te bespreek nie, maar om 'n oorsig van sekere aspekte met betrekking tot staatsinsolvensie te gee en die behoefte aan 'n internasionale insolvensieraamwerk te beklemtoon. So 'n stelsel het die potensiaal om toekomstige finansiële krisisse te voorkom of minstens die impak daarvan te verlig.

1 Introduction

When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor.¹

During the past few years the heightened interest and focus on sovereign insolvency law by international institutions such as the International Monetary Fund (IMF) and the World Bank has been mirrored not only in the international media but worldwide sovereign insolvency law has increasingly become the subject of scholarly articles,

* Part of this research was presented at the INSOL Europe Annual Congress' Academic meeting 2011, Venice as well as a paper delivered at the INSOL Academics' Group Meeting 2011, Singapore.

1 Smith *Of the Revenue of Sovereign or Commonwealth* Book V Ch II of Public Debts (1776).

reflection and debate.² Stories about debt downgrades, a double dip recession and sovereign-debt defaults are dominating the headlines and new proposals to strengthen the global financial safety net are being put to the test on a daily basis. Recently governments and authorities across the globe have also been using a wide array of policy responses to mitigate the impact of the global crisis and in some instances sovereign default.³ These measures range from emergency bailouts to aggressive monetary easing and massive stimulus packages.

When discussing sovereign insolvency law it should be highlighted that to refer to a government as being bankrupt is to use a metaphor.⁴ There is currently no internationally recognised and legitimate system of law or procedure relating to insolvency law that can be applied to assist the creditors of a sovereign debtor.⁵ In recent months it has become apparent that many players in the global financial system have dug a debt hole far larger than they can reasonably expect to escape from and the case of Greece has ushered in the second phase of the financial crisis, namely that of potential sovereign default.⁶ Efforts to improve the framework for the resolution of the international economic crises have been on the international policy agenda for a number of years, but the recent financial crisis has brought new urgency to the matter.

The purpose of this article is not to envisage the possible causes, implications and solutions to the current sovereign debt crisis but to give an overview of certain aspects pertaining to sovereign insolvency law and to stir the debate on the need for an international sovereign insolvency framework or mechanism for sovereign debt crisis resolution. Such a mechanism would have the potential to avert future financial crises or at least alleviate their destructiveness by bringing to situations of state insolvency a similar structure and discipline that at present applies within countries with efficient and effective bankruptcy laws.⁷

2 See *inter alia*: Kolb *Sovereign Debt: From Safety to Default* (2011); Lynn *Bust: Greece, the Euro and the Sovereign Debt Crisis* (2011); Tomz *Reputation and International Cooperation: Sovereign Debt across Three Centuries* (2007) for a detailed discussion of the concept of "sovereign debt".

3 See Arieff "Global Economic Crisis: Impact on Sub-Saharan Africa and Global Policy Responses" in *CRS Report for Congress* (2010); Jara *et al* "The Global Crisis and Latin America: Financial Impact and Policy Responses" 2009 *BIS QR* at: SSRN: <http://ssrn.com/abstract=1513216> (accessed on 2012-07-01); International Monetary Fund (IMF) "Greece: Stand-By Arrangement – Review under the Emergency Financing Mechanism" in *IMF Country Report, No. 10/217* (2010) at: <http://www.imf.org/external/pubs/ft/scr/2010/cr10217.pdf> (accessed on 2012-07-01).

4 Herman *et al* *Overcoming Developing Country Debt Crises* (2010) 3.

5 *Ibid.*

6 In 2010, the public debt of Greece had reached €290 billion and public debt to GDP ratio had reached 12.7 percent. See Akram *et al* "The Greek Sovereign Debt Crisis: Antecedents, Consequences and Reforms Capacity" 2011 *J of Eco and Behavioral St* 306. See also Gros "Towards a Euro(Pean) Monetary Fund" 2010 *CEPS Policy Brief No. 202* at: SSRN: <http://ssrn.com/abstract=1604446> (accessed 2012-07-01); Buckley "The Bankruptcy of Nations: An Idea Whose Time Has Come" 2009 *Int Lawyer* 1189.

2 Brief Historical Overview

The first important reference in modern economic history goes back to *Adam Smith* who called for an orderly state insolvency in his famous book *The Wealth of Nations* in 1776.⁸ From its earliest days lenders put their fate into the hands of princes and the medieval history of state insolvencies and sovereign debt was one of wars, kings, and every so often the tragic figure of a ruined Italian banker.⁹ For example “France defaulted on its Sovereign debt eight times between 1500 and 1800 while Spain defaulted thirteen times between 1500 and 1900”¹⁰ which in turn makes it a world record.¹¹ The defaults of Philip II, who ruled Spain between 1556 and 1598 and who failed to honour his debts four times during his reign have attained mythical status as the origin of the sovereign debt crises.¹² Over the decades it has been shown that sovereign default has not been a unique phenomenon as among the member states of the Eurozone, Austria, Greece, Germany, Italy, Portugal and Spain have each experienced at least one case of sovereign default since 1824.¹³

After World War I the Great Depression resulted in a major debt crisis and subsequent sovereign defaults in the 1930s as the defaulted states considered the needs of the nation more important than those legal obligations to creditors.¹⁴ Then came the era of the emerging economies’ dramatic economic demise and by the 1980s most emerging economies

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- 7 Bhargava *Global issues for global citizens: an introduction to key development challenges* (2006) 66.
 - 8 Kaiser “Resolving Sovereign Debt Crises: Towards a Fair and Transparent International Insolvency Framework” 2010 *Friedrich Ebert Stiftung Study* 23. On file with the author.
 - 9 Wood “State Insolvency: Bankruptcy without a Bankruptcy Law” 2009 *Allen & Overy’s Special Global Counsel* at: <http://www.allenoverly.com/publications/en-gb/Pages/State-insolvency--bankruptcy-without-a-bankruptcy-law.aspx> (accessed on 2012-07-01).
 - 10 De Paoli *et al* “Cost of Sovereign Default” *Financial Stability Paper* (Bank of England 2006) at: http://www.bankofengland.co.uk/publications/fsr/fs_paper01.pdf (accessed on 2012-07-01).
 - 11 Grigien? & Mockien? “Can a Sovereign State Declare Bankruptcy?” 2010 *Baltic J of L & Politics* 128. See also Sturzenegger & Zettelmeyer *Debt defaults and lessons from a decade of crises* (2006) ch 1 for a detailed discussion on the history of sovereign defaults and restructurings.
 - 12 Conklin “The Theory of Sovereign Debt and Spain under Philip II” 1998 *The J of Political Economy* 483.
 - 13 Gianviti *et al* “A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal” paper prepared on behalf of the Brugel Organization (2010) at: http://www.europolitique.info/pdf/gratuit_fr/282201-fr.pdf (accessed on 2012-07-01).
 - 14 Sturzenegger & Zettelmeyer 3.

defaulted.¹⁵ This was followed closely by the Asian market collapsed in 1998 which eventually spread to Russia. But it was eventually Argentina's spectacular collapse in the beginning of the 21st century that finally lead to numerous debates and proposals for an international bankruptcy regime.¹⁶ Until a few years ago Asian and African financial crises were far less researched than those of Europe and Latin America. Indeed, the widespread belief that modern sovereign default was a phenomenon confined to Latin America and a few poorer European countries was heavily influenced by the scarceness of research on other regions.¹⁷

The financial crisis which arose in July 2007, when investors lost their confidence in the mortgage- and asset-based securities in the United States, has since deepened, affecting a wide range of financial and economic activities and institutions in both developed and developing countries around the world. As the crisis deepened, the governments of major developed and developing countries as well as international financial regulators attempted to take some mitigating actions and coordinate efforts to contain the crisis.¹⁸ What makes the current financial crisis so much more far-reaching is the mere scale thereof and as several European states¹⁹ recently declared their inability to pay their debts and warned the rest of Europe and the world of their potential bankruptcy, a Pandora's box of uncertainties regarding the restructuring process itself – the macroeconomic scenario as well as the behavioural response of European institutions – has been opened.²⁰ Unquestionably the cost of intrusion was increased due to the delay in response to the crisis. Not only does the current global economic crisis represent a critical juncture for the reform of the European Union institutions to introduce provisions to help avoid a similar fate in the future, but the prevailing economic and financial scenario of countries such as Greece has also exposed major flaws in the governance framework of the Economic and Monetary Union (EMU).²¹

15 For a detailed discussion of the financial turmoil in Emerging Economies (EE) see Loser "Global Financial Turmoil and Emerging Market Economies: Major Contagion and a Shocking Loss of Wealth?" 2009 *Global J of Emerging Market Economies* 137.

16 Grigienė & Mockienė 2010 *Baltic J of L & Politics* 129.

17 Reinhart *The Time is Different: Eight Centuries of Financial Folly* (2009) xxxiii.

18 Statistical Economic and Social Research and Training Centre for Islamic Countries (SESRIC) *Reports on Global Financial Crisis a Second Wave of the Global Crisis? The Eurozone Debt Crisis* January-June 2011 at: <http://www.sesric.org/files/article/443.pdf> 2 (accessed on 2012-07-01).

19 Eg Greece, Latvia, Iceland, Portugal, Spain, Ireland.

20 Akram 2011 *J of Economics and Behavioural St* 316.

21 Grigienė & Mockienė 2010 *Baltic J of L & Politics* 128.

3 Some Thoughts on Sovereign Insolvency Law in General

3 1 General Remarks

Virtually every country has adopted some formal legal process for dealing with the insolvency of individual debtors and sub-sovereign public entities.²² Legislatures outline the insolvency regimes, courts interpret the laws and apply them to individual cases, and the executive power regulates and enforces the judgments.²³ In turn another embedded legal principle is that once insolvent corporations are not wound up, they are expected to come out of bankruptcy as self-sustaining entities; in a nutshell, the main objective of modern bankruptcy law is to afford them a “fresh start”.²⁴

The principles relevant to sovereign insolvency law is different and with good reason. There is no global legislature or international institution, no global bankruptcy court to evaluate the claims of creditors or to protect the debtor from abusive practices, and no global government to enforce judgments against sovereigns.²⁵ As signs of convergence begin to materialise with regard to private-sector insolvency procedures the reality of global financial integration has significantly complicated the resolution of sovereign financial distress.²⁶

Another significant observation is the evolving nature of the sovereign debt landscape. During 2004 the international financial community was faced with new challenges in sovereign debt restructuring during the financial crises in Argentina and Iraq.²⁷ Although there were important differences between these two countries’ debts, with Argentina struggling with the concept of holdout creditors and Iraq’s default

22 Herman “Towards a Sovereign Insolvency Mechanism: Why it matters to Small Vulnerable Economies, what it might be like, and how to get it” *Consultative Workshop on Policy Options to address the Looming Debt Problems of Commonwealth Small Vulnerable Economies* Kingston, Jamaica, 2010. On file with the author.

23 Stiglitz “Sovereign Debt: Notes on Theoretical frameworks and Policy Analysis” in *Overcoming Developing Country Debt Crises* (ed Herman) (2010) 35. See also UNCITRAL *Legislative Guide on Insolvency Law* (2005) 2 at: http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (accessed on 2012-07-01).

24 Herman *op cit* 1. Also note that a fundamental goal of the American federal bankruptcy laws enacted by Congress is to give debtors a financial “fresh start” from burdensome debts. The US Supreme Court made this statement about the purpose of the bankruptcy law in the decision of *Local Loan Co v Hunt* 292 US 234 244: “[I]t gives to the honest but unfortunate debtor ... a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt”.

25 Herman *op cit* 1.

26 Lubben “Out of the Past: Railroads & Sovereign Debt Restructuring” 2004 *Georgetown J of Int L* 14.

27 Olivares-Caminal *Legal Aspects of Sovereign Debt Restructuring* (2009) 103.

reflecting features of an “odious debt”²⁸ scenario, what was more significant was that both incidents were laying down the foundation for future sovereign debt crises.²⁹

Debt has been a large source of capital flow to developing countries during the past few decades and previous periodic debt cycles were characterised by their own unique character *vis-a-vis* the financial instruments that were used.³⁰ During the late 1980s syndicated loans were replaced by international bonds as one of the most important mechanisms for raising long term finance in the international capital markets.³¹ One of the challenges experienced during the restructuring of Argentina’s debt had indeed been that the credit base had been enlarged from a limited number of banks involved in a syndicated loan to thousands of creditors holding Argentine bonds. This has essentially been the trend worldwide with private creditors increasingly becoming numerous, anonymous and difficult to coordinate.³²

It should however also be noted that there is a definite link between sovereign risk and corporate access to foreign capital.³³ Private corporations has lately gained unequaled access to external finance and especially in emerging markets business have become more reliant on foreign sources of capital and funding, resulting in increased exposure to international economic forces.³⁴ In the wake of the current financial crisis, corporations will thus be struggling to raise capital in international markets with grave consequences for domestic investment and economic growth.³⁵

The proposal to emulate features of domestic insolvency in order to solve the problem of sovereign debts, which dates back to Adam Smith, is no longer as controversial as it once was.³⁶ The key difference is evidently the difference in status between that of a state and private sector parties as a result of a state’s sovereignty as states jealously guard their sovereignty under international law and resist interference by other states or international institutions.

28 Howse “The Concept of Odious Debt in Public International Law” 2007 UNCTAD discussion papers paper no 185 at http://unctad.org/en/docs/osgdp20074_en.pdf. (accessed on 2012-07-01).

29 Olivares-Caminal 104.

30 *Idem*.

31 *Ibid* 105.

32 *Ibid* 106.

33 Das *et al* “Sovereign Default Risk and Private Sector Access to Capital in Emerging Markets” in *Debt Relief and Beyond: Lessons Learned and Challenges Ahead* (ed Braga) (2009) ch 7.

34 *Idem*.

35 Das “Spill overs of Sovereign Default Risk: How much is the private sector affected” in *Sovereign Debt: From Safety to Default* (ed Kolb) (2011) 33.

36 Raffer “Considerations for Designing Sovereign Insolvency Procedures” 2005 *Law, Social Justice & Global Development*] at: http://www.go.warwick.ac.uk/elj/lgd/2005_1/raffer (accessed on 2012-07-01).

3 2 Comparisons Between Sovereign and Corporate Insolvency

At national level the principle benefits and purposes of a personal bankruptcy system are generally stated as being to divide the assets of an insolvent debtor fairly and equitably among the creditors, and to allow an insolvent debtor the opportunity to make a fresh start free of the burden of accumulated debt.³⁷ What could also be mentioned is that an effective bankruptcy system will always improve the allocation of credit within an economy and thus make the economy more stable.³⁸

The question could be asked whether lessons may be drawn for the development of a sovereign insolvency framework from the principles underlying national policies for corporate and personal insolvency law. A state is presumed to be insolvent when it is unable to meet its foreign currency liabilities as they fall due.³⁹ According to Wood⁴⁰ the alternative test of insufficiency of assets to cover liabilities is not applicable as most of a state's assets are not realisable. The famous banker Walter Wriston was legally quite correct when he once declared that "countries never go bankrupt", as indeed countries cannot legally become bankrupt without a body of rules under which they may be declared to be so.⁴¹ However throughout history countries have become substantively bankrupt, typically with horrendous consequences for the living standards and human rights of their more vulnerable citizens.⁴²

For insolvency law purposes states differ from corporations as corporate insolvency laws can be extremely complex with highly prescriptive bodies of rules and rigid procedures.⁴³ By contrast as mentioned there are virtually no statutory rules or procedures governing the insolvency of states and the matter is left to negotiations between interested parties and the century old debate surrounding the enforcement of *pacta sunt servanda*.⁴⁴

37 Buckley "The Bankruptcy of Nations: Let the Law Reflect Reality" 2010 *Banking and Financial Services Policy Report* 1.

38 See also Buckley *The International Financial System: Policy and Regulation* (2009) 145; Buckley "Sovereign Bankruptcy" 2003 *Bond LR* 100.

39 Thomas "Bankruptcy Proceedings for Sovereign State Insolvency and their Effect on Capital Flows Paper" paper presented by *World Institute for Development Economic Research* (UNU-WIDER) 2002 at: <http://www.wider.unu.edu/stc/repec/pdfs/rp2002/dp2002-109.pdf> (accessed on 2012-07-01).

40 Wood *Principles of International Insolvency* (2007) 756.

41 Buckley 2010 *Banking and Financial Services Policy Report* 1; Buckley 2009 *Int Lawyer* 1189; Buckley 2003 *Bond LR* 97.

42 Buckley 2003 *Bond LR* 95.

43 Portes "Resolution of Sovereign Debt Crises: The New Old Framework" in *Economic Integration and Social Responsibility* (ed Bourguignon) (2007) 176.

44 Schlemmer "The Enforcement of Sovereign Debt" in *International Monetary and Financial Law: The Global Crisis* (ed Giovanoli) (2010); Schlemmer "Die staat is na sy swernoot ... en *pacta sunt servanda*?" 2001 *TSAR* 203.

Substantial differences however do exist between the insolvency of a state and that of a corporate entity. Wood⁴⁵ mentions the following differences:

- (a) The economic affairs of a state cannot be taken over and managed by a receiver, trustee or administrator and we thus deal with a debtor that stays in possession. The IMF vaguely simulates the role of a company “doctor” albeit with much less power as the administrator in a corporate insolvency.
- (b) Creditor suits or attachments in external courts cannot be frozen by a bankruptcy order of judicial moratorium as domestic government assets are usually exempted from creditor execution.
- (c) In contrast to municipal laws allowing judicially approved creditor plans, debt reorganisations of state debt cannot be imposed on dissenting creditor minorities by majority creditor vote as consensus is needed.
- (d) There are also no international enforced disclosure obligations at the same level of detail as corporate financial statements crawled over by auditors. There are also no statutory rules for the recovery of preferential payments or transfers although in practice insolvent debtors are advised not to prefer certain creditors as this could sour restructuring negotiations.
- (e) Most state debts are unsecured and the priority or equality of payment must be settled by the difficult process of agreement.

Lending to governments is also distinct as such loans are usually made without collateral and there is no legal mechanism to impose settlements comparable to the legal enforcement of a court finding on a private loan contract.⁴⁶ There is instead the confidence that governments will fully service their debts to ensure a positive credit rating which may be regarded as a very uncertain incentive.⁴⁷ In turn a firm that goes bankrupt keeps an intrinsic value, which can be sold by creditors. This is not the case for a state as aggregate gross domestic product (GDP) cannot be shipped home by creditors.⁴⁸ Some kind of inclination to pay on the part of the state is always required. Moreover, because creditors have no collateral and as a result of the absence of any legal recourse; the value of a creditor’s claim is proportionate to the harm that they can inflict on a defaulting state.⁴⁹ As the historian Max Winkler observed in 1933:

In the case of a private default the lender can follow up the defaulter to his very fount and origin, and discover for himself his prospect of repayment. When a government defaults, the creditor must seek his way through myriad miles of tape of all colours, must track and backtrack across a road obscured by the prints of a thousand red herrings, before he can even come to the surface of the facts.⁵⁰

45 Wood 756.

46 Herman 7.

47 *Ibid* 7-8.

48 Portes in *Economic Integration* 176.

49 Serra *The Washington Consensus Reconsidered Towards a new Global Governance* (2008) ch 9.

50 Winkler *Foreign Bonds: An Autopsy* (1933) (reprinted 1999) 18.

4 Recent Proposals

4.1 General Remarks

In 2009 the US Committee on Capital Markets Regulation issued a report on the regulation of the financial system post crisis and admitted the following:

The US financial system is best viewed as an integral part of the overall global financial system. No longer can the United States regulate in a vacuum. Coordination with other national regulators and cooperation with regional and international authorities is required.⁵¹

As Keiser mentions:

On Monday the 12th of July 2010, German Finance Minister Wolfgang Schäuble proposed to his fellow members of the EU Task Force on the Strengthening of the European Monetary Union the creation of an international sovereign insolvency framework. Such an initiative by Europe's most powerful economy would have been unimaginable just half a year earlier. The de-facto insolvency of the Greek state had not only shattered the old continent's financial and banking system. It had also brought about important changes in some of the key orientations of policymakers. Strong discontent among the populace about the big bailouts of states as well as private investors pushed the conservative/liberal government in Germany towards the search for alternatives. While at first controversial among European governments, the proposal thus met with more positive responses from key academics and also some fellow European governments.⁵²

At present there are several proposals or alternative approaches for dealing with sovereign insolvency and debt restructuring on the table. As far back as the early eighties authors have debated the reform of the international financial architecture in the aftermath of recent economic crises.⁵³ Academics and policy-makers alike have advocated a number of measures to deal such a crisis in an attempt to limit the frequency and severity thereof.⁵⁴

51 Committee on Capital Markets Regulation "The Global Financial Crisis – A Plan for Regulatory Reform" 2009. On file with the author.

52 Keiser 23.

53 Oechsli published a detailed proposal of how to adapt Chapter 11 of the US Code, (11 USC §§ 1101–74 (2000)) well before Aug 1982, the date considered by many as the official beginning of the debt crisis. See Oechsli "Procedural Guidelines for Renegotiating LDC Debt: An Analogy to Chapter 11 of the US Bankruptcy Reform Act" 1980–81 *Virginia J of Int L* 305; See also regarding Internationalising US Municipal Insolvency: Raffer "A Fair, Equitable, and Efficient Way to Overcome a Debt Overhang" 2005 *Chicago J of Int L* 263.

54 Gai *et al* "Crisis Costs and Debtor Discipline: The Efficacy of Public Policy in Sovereign Debt Crises" (May 2001) Bank of England Working Paper No. 136 at SSRN: <http://ssrn.com/abstract=274288> or <http://dx.doi.org/10.2139/ssrn.274288> (accessed on 2012-07-01).

4 2 Sovereign Debt Restructuring Mechanism

In 2001 the IMF proposed its own solution to the problem of sovereign insolvency in the form of the “Sovereign Debt Restructuring Mechanism” (SDRM) first proposed in a signal speech by Anne Krueger, First Deputy Managing Director of the IMF, in November 2001.⁵⁵ This is probably the most well-known proposal and was introduced when the IMF proposed its own solution to the problem of sovereign insolvency. In the words of the IMF: “[w]e are not proposing a bankruptcy mechanism for countries, but simply a mechanism to facilitate debt workout negotiations between a debtor and its creditors”.⁵⁶

Limited as it was, the IMF’s proposed scheme drew strong criticism from creditors and the US Treasury, and considering these criticisms, the IMF consequently revised its program considerably.⁵⁷ Nonetheless, at a 2003 meeting of the Board of Governors of the IMF, the SDRM initiative was suspended.⁵⁸ One of the interesting elements of the IMF’s proposal was the introduction of a Sovereign Debt Dispute Resolution Forum (SDDRF) which was designed to adjudicate certain disputes stemming from the restructuring process.⁵⁹

4 3 International Club and Institutional Approach

Another approach is the so called club approach where at international level, certain classes of lenders are coordinated through “clubs” – the *Paris Club* comprising rich-country government lenders, and the *London Club*, which brings together commercial-bank lenders.⁶⁰ The *Paris Club*

55 Buckley 2010 *Banking and Financial Services Policy Report* 1 1–17. See also Buckley *The International Financial System: Policy and Regulation* (2009) 145; Krueger “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring” a speech delivered at the National Economists’ Club Annual Members’ Dinner, Washington DC 2001 at: <http://www.imf.org/external/np/speeches/2001/112601.htm> (accessed on 2012-07-01). The proposal was substantially modified in a later speech, Krueger “A New Approach to Sovereign Debt Restructuring” at <http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm> (accessed on 2012-07-01). See generally White “Sovereigns in Distress: Do They Need Bankruptcy?” 2002 *Brookings Paper on Economic Activity* 20.

56 Buckley *The International Financial System: Policy and Regulation* (2009) 145; Buckley 2003 *Bond LR* 100 and Buckley 2010 *Banking and Financial Services Policy Report* 31; see also Setser “The Political Economy of the SDRM” in *Overcoming Developing Country Debt Crises* (ed Herman) (2010) 317.

57 Raffer “The IMF’s SDRM – Another Form of Simply Disastrous Rescheduling Management?” in *Sovereign Debt at the Crossroads* (ed Jochnick) (2005) 246.

58 Buckley 2010 *Banking and Financial Services Policy Report* 32.

59 Kargman & Paulus “Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign debt Tribunal” paper presented at the 8th Annual International Insolvency Conference (IIC), Humboldt University, Berlin, Germany, 2008; Paulus “Some Thoughts on an Insolvency Procedure for Countries.” 2002 *Am J of Comp L* 531–39.

60 Kaiser 5.

was founded in 1956, when Argentina had repayment difficulties and the French Treasury hosted a meeting of official creditors.⁶¹ The Club is an *ad-hoc* negotiation forum with no legal status, nor rules of procedure. Although negotiations at, for example the *Paris Club* result in a multilateral agreement on debt rescheduling, it is still not meant to be applied as a permanent mechanism.⁶² Kaiser mentions that the Club's informal character has been useful for flexible solutions to individual debtor cases.⁶³ However, this flexibility has also meant that countries were not treated consistently, rather political considerations have often influenced the outcome of negotiations – thus undermining the Club's basic rationale: that creditors and interested parties should be treated equally.⁶⁴

There are also a number of well-established and well-respected international arbitration institutions, such as the International Chamber of Commerce in Paris and the International Centre for Settlement of Investment Disputes (ICSID).⁶⁵ Although the ICSID offers tremendous benefits to investors and host states willing to settle their disputes by arbitration it is not the specialised and dedicated institution that may be needed to deal with claims arising out of sovereign debt in a systematic manner and to effectively resolve future sovereign debt crises.⁶⁶

4 4 The Contractual Approach

A contractual approach is also reflected in the so called collective action clauses (CAC) which have also in recent times been viewed as an effective mechanism for handling debt restructurings.⁶⁷ Such clauses exert discipline on creditors by preventing the strategic “hold out” scenario that is likely when unanimity is required. Some of the criticism voiced against collective action clauses by authors such as Paulus is that they are applicable only to bond holders and not to more traditional lenders, such as foreign states or banks. If traditional claims form the bulk of a sovereign's debts, the collective action clause approach is likely to have little effect.⁶⁸ Although a statutory approach may have a

61 *Idem*.

62 For a detailed discussion on the creation, development and framework of the *Paris Club* see UNCTAD Discussion Papers: Cosio-Pascal “The Emerging of a Multilateral Forum for Debt Restructuring: the Paris Club” Nov 2008 at: http://www.unctad.org/en/docs/osgdp20087_en.pdf (accessed on 2012-07-01).

63 As late as 2003, the *Paris Club* started to communicate with the broader public through their website at: <http://www.clubdeparis.org> (accessed on 2012-07-01).

64 Kaiser 5.

65 Weibel *Sovereign Defaults before International Courts and Tribunals* (2011) 209.

66 Couillault *et al* “Toward a Voluntary Code of Good Conduct for Sovereign Debt Restructuring.” 2003 *Financial Stability Review* 154.

67 Paulus “A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings” in *Sovereign Debt and the Financial Crisis – Will This Time be Different?* (ed Braga) (2010) 318.

68 *Idem*.

significant role to play as it could act as a comprehensive instrument designed to coordinate different creditor groups prior to and during a debt crisis, it still falls short of an inclusive and effective framework needed for the restructuring of sovereign debt.

4 5 Elements of an International Chapter 9

A number of proposals⁶⁹ also put forward the US bankruptcy law as model and in particular Chapter 9 of the US Bankruptcy Code,⁷⁰ which concerns the procedure to deal with municipality debts. Commentators such as Raffer⁷¹ agree that there is a strong and convincing case for one specific type of insolvency procedure appropriate for sovereign debtors, but links this procedure to an arbitration process based on the principles of the US Chapter 9. There are two particular reasons why Raffer chooses Chapter 9, which is conceived for sovereign public municipalities: It protects the sovereignty of a public debtor, and it establishes the right to a hearing as a means of involving the affected population in proceedings leading to a restructuring agreement.⁷²

Chapter 9 was created during the Great Depression, when a number of local governments were unable to service their debts, and was in fact introduced specifically to avoid prolonged and ineffective negotiations and rescheduling, to allow speedy, fair, and economically efficient resolutions for over indebted US municipalities.⁷³ Some commentators are also of the opinion a Chapter 9-procedure could solve the sovereignty matter as it represents a legal institution which takes account of all creditors and in which the sovereign debtor still has full capacity to act.⁷⁴

69 Berensmann "An insolvency procedure for sovereign states: a viable instrument for preventing and resolving debt crisis?" in *Sovereign Debt: From Safety to Default* (ed Kolb) (2011) 383; Raffer "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face" 1990 *World Development* 301; Raffer "What's Good for the United States Must Be Good for the World: Advocating an International Chapter 9 Insolvency" in Kreisky Forum for International Dialogue (ed) *From Cancún to Vienna, International Development in a New World* (1993) 64ff; Buckley 143.

70 Also referred to as the Bankruptcy Code, Code, 1978 Act or Bankruptcy Reform Act of 1978. (Pub l no 95-598, 92 Stat 2549 (1978) 11 USC par 101 *et seq* which was signed into law on 1978-11-06 and became effective on 1979-10-01.

71 Raffer *World Development* 301. See also Herman 468; Raffer "Sovereign Debt Workout Arrangements" in *After Neoliberalism – Economic Policies That Work for the Poor* (eds Weaver *et al*) a collection of papers presented at a conference on "Alternatives to Neoliberalism", 2002-05-23/24 in Washington, DC, *The New Rules for Global Finance Coalition* 88-102.

72 Berensmann & Herzberg "International Sovereign Insolvency Procedure: A Comparative Look at Selected Proposals" 2007 Discussion Paper/ Deutsches Institut für Entwicklungspolitik 3.

73 Herman 468.

74 Chun "'Post-Modern' Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?" 1996 *Fordham LR* 2647.

4 6 Individual Proposals

Lastly, there have also been number of individual proposals for the establishment of a standing arbitral tribunal modelled after, for example, the Iran-US claims tribunal.⁷⁵ Most recently, Paulus and Kargman⁷⁶ outlined their proposals for a Sovereign Debt Tribunal. The proposal entails that such tribunal would address disputes specified by such interested parties and would range from basic issues such as the confirmation of creditor claims to the more elaborate and complex matters relating to debt restructuring.⁷⁷ It is submitted that the most significant advantage of this proposal is that the tribunal would elevate disputes and sovereign debt restructuring obstacles to a neutral forum empowered to make binding decisions.⁷⁸ Paulus further suggests that the tribunal should be established under the auspices of a highly reputed institution that does not lend to sovereigns.

5 Challenges to an International Bankruptcy Regime

When observing the abortive history of the precursor to the United Nations (UN), the League of Nations and the International Trade Organisation history, it clearly teaches us to never underestimate the difficulty of establishing an international institution.⁷⁹ The scale of accomplishment in establishing the IMF and World Bank should also itself not be undervalued, as it took a global cataclysm, preceded by the Great Depression, to summon the political will to realise these ideals.⁸⁰ Indeed, fifty years was also roughly the gestation time for the International Criminal Court that relatively recently came into being in The Hague.⁸¹

A significant challenge to the proposed sovereign debt model is the concept of sovereignty. Although much criticised, the concept of “sovereignty” is still central to most thinking about international relations

75 Paulus in *Sovereign Debt and the Financial Crisis* 317.

76 Proposal for a sovereign debt tribunal is a project of the International Insolvency Institute (III) and has been approved by the International Insolvency Institute at: www.iiiiglobal.org (accessed on 2012-07-01); see *Kargman & Paulus IIC paper* 318.

77 *Kargman & Paulus IIC paper* 318. Schwarcz “Facing the Debt Challenge of Countries that are Too Big to Fail” 2010 *Duke Law Working Papers*, paper 30 at: http://scholarship.law.duke.edu/working_papers/30 (accessed on 2012-07-01); Paulus in *Sovereign Debt and the Financial Crisis* 317.

78 “A fair and transparent debt work-out procedure: 10 core civil society principles” a report from the European Network on Debt and Development (Eurodad) (2009) 7 at: http://www.eurodad.org/uploadedFiles/Whats_New/Reports/Eurodad%20debt%20workout%20principles_FINAL.pdf?n=13 (accessed on 2012-07-01).

79 Buckley *International Financial System: Policy and Regulation* 140.

80 Buckley 2003 *Bond LR* 97.

81 Buckley *International Financial System: Policy and Regulation* 141.

and particularly international law.⁸² Although globalisation is reshaping the fixed and firm boundary between domestic and international spheres and challenging our perceptions of international politics and law, the old “Westphalian” concept is still prized and harboured by most states who wish to prevent foreign or international powers and authorities from interfering in a national government’s decisions and activities.⁸³ Yet the development of humanitarian intervention and extended integration of sovereign debt into international and regional monetary institutions marks a key development in the traditional meaning of sovereignty.⁸⁴

It is also clear that the crisis in the Eurozone poses a further threat to state sovereignty. One significant cause has been the absence of a coordinated fiscal policy across member states. As a long term solution to the current European debt crisis, a recent proposal has been to further dilute national sovereignty in fiscal and economic policies, for instance in respect of budget deficits and the creation of a single strong bank regulator.⁸⁵

It is also important to review the difficulties facing any version of an international bankruptcy court without teeth. Without a legal framework such as a treaty or international agreement, such a body could not enforce seizure of any collateral, if such existed. It would also not have the power to introduce a similar procedure to that of the debtor-in-possession (DIP) financing under the US Chapter 11 by awarding a preference to so called new money.⁸⁶ More to the point, national bankruptcy codes differ widely, specifically on the role of the bankruptcy courts. The highly activist involvement of the bankruptcy judge in Chapter 11 proceedings, for example, contrasts with UK, where “the receiver is king”. It is therefore unrealistic to expect a simple agreement on a uniform international bankruptcy code, with legislative backup in the near future.⁸⁷

6 The Benefits of an International Sovereign Debt Procedure

If we consider the current state of affairs there have been numerous calls for a new international debt framework as well as the establishment of a

82 Jackson “Sovereignty – Modern: A New Approach to an Outdated Concept” 2003 *The Am J of Int L* 784.

83 *Ibid* 786. The general perception is that the concept of sovereignty as it is thought of today, particularly as to its “core” of a monopoly of power for the highest authority of what evolved as the “nation-state,” began with the 1648 Treaty of Westphalia.

84 “Financial crisis reshapes sovereignty” 2010 *OxResearch Daily Brief Service*, Oxford: 2010-08-05.

85 *Ibid* 24. See also Kalmo *Sovereignty in Fragments: The Past, Present and Future of a Contested Concept* (2010) 102 for a discussion on the concept of sovereignty within the European Union (EU).

86 Portes in *Economic Integration* 181.

87 *Ibid*.

regulatory and institutional framework for sovereign insolvency.⁸⁸ The globalisation of finance has resulted in the creation of many new frontiers as well as actors involved in debt restructurings and negotiations, especially on the creditor side. The thread of contagion has also become more challenging as financial crises can spread far more rapidly around the globe affecting multiple sovereigns at the same time.⁸⁹ The current European debt crisis has forced European and international government and financial leaders to implement various short term solutions in an attempt to stem the crisis and prevent spillovers from the European financial crisis to the global economy.⁹⁰ Globally it is almost unthinkable that an economy as a system would offer no relief from an unsustainable debt burden. When nations have unsustainable debts, they typically must service these debts, as there is no viable alternative, save a highly destabilising default which will deny the nation access to commercial capital for extensive periods of time.⁹¹ These debts are usually serviced through higher taxes and lower social services in countries that are already facing the inconvenience of intense austerity measures.

One of the responses by the European Union has been the creation of the European Financial Stability Facility (EFSF) created by the Eurozone Member States following the decisions taken on 9 May 2010 to safeguard financial stability in Europe by providing financial assistance to the Member States.⁹² Eurobonds⁹³ have been floated as a possible solution to the debt crisis and several European leaders have also called for the European Central Bank (ECB) to play a more active role in extinguishing

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- 88 Hagan "Designing a Legal Framework to Restructure Sovereign Debt" 2004-2005 *Georgetown J of Int L* 299; Paulus in *Sovereign Debt and the Financial Crisis*; Bolton & Skeel "Inside the Black Box: How Should a Sovereign Bankruptcy Regime be Structured?" 2004 *Emory Law Journal* 763; see also Kargman & Paulus "Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign Debt Tribunal" paper presented at the 8th Annual International Insolvency Conference, Humboldt University, Berlin, Germany, June, 2008, unpublished draft.
- 89 Kargman & Paulus IIC paper 6; see also Sussman & Yafeh "Institutional Reforms, Financial Development and Sovereign Debt: Britain 1690-1790" 2006 *The J of Econ Hist* 906-935 for an interesting discussion of the financial development in Britain.
- 90 Panetta "Life in the Eurozone with or without Sovereign Default" in *Life in the Eurozone with or without Sovereign Default* (ed Allen) (2011) 9.
- 91 Buckley 2003 *Bond LR* 101.
- 92 Since then a further decision was taken by the European Heads of State which resulted in a second rescue package for Greece, the maximisation of the resources of the EFSF, the recapitalisation of the European banking sector and the strengthening of economic and fiscal coordination and surveillance. See official website of the EFSF available at: <http://www.efsf.europa.eu/about/index.htm> (accessed on 2012-07-01) for further information on the mandate and instruments used by the Fund.
- 93 A Eurobond is a debt capital market instrument issued in a Euro currency through a syndicate of issuing banks and securities houses, and distributed internationally when issued; see also Choudhry *An Introduction to Bond Markets* (2010) ch 6.

Europe's spiralling debt crisis.⁹⁴ These responses were however developed in an *ad-hoc* manner and on a temporary basis only and do not provide a permanent mechanism or framework for dealing with any possible future global debt crises.⁹⁵

The need to address sovereign debt issues in a timely, orderly and predictable manner has become more evident as the recent examples of Greece and other European countries suggest. Without providing a detailed exposition or comprehensive overview of European Union law or international economic law it should be mentioned that the current European economic crisis has exposed some of the institutional flaws of the Eurozone, which was established more than a decade ago. Even though the earlier detection of the Greek crisis would not have changed the fact that the Greek economy suffers from structural deficits and the lack of competitiveness, the question should be asked whether an effective global mechanisms for crisis prevention and management could not have averted the current crisis or at least could have curbed the size thereof and the potential domino effect.⁹⁶ It has been widely agreed by international financial commentators such as Stiglitz⁹⁷ that if Europe had developed a better solidarity and stabilisation framework, the deficits in the periphery of Europe might have been smaller and more manageable.

Although there are substantial differences between the insolvency of a state and a corporate entity or individual it is submitted that the current global crisis has shown that within the concept of sovereign insolvency there is no formal mechanism to ensure that sacrifice is equivalent or appropriate across the groupings of creditors or that overall relief is sufficient for realising the presumed general goal, being that the remaining debts not prevent economic growth and rehabilitation.⁹⁸ The regulation of a national insolvency system is essential to assure the efficiency and effectiveness of the system, and to maintain the integrity of, and public confidence in, the system. It is submitted that within the concept of sovereign debt and state insolvency the underlying theme should also be the need to instill trust and confidence in the system, in

94 "Eurozone crisis: David Cameron says ECB must act now" *The Guardian* 2011-11-10.

95 Gianviti *et al* 3.

96 See "Greece's Debt Crisis: Overview, Policy Responses, and Implications" prepared by Nelson *et al* as CRS Report for Congress (Prepared for Members and Committees of Congress) (2011) for a complete discussion of the Greek debt crisis.

97 Stiglitz "A principled Europe would not leave Greece to bleed" *The Guardian* 2010-01-25.

98 Herman "Unfinished business in the international dialogue on debt" 2003 *Cepal Review* 81; see also Stiglitz "Participation and Development: Perspectives from the Comprehensive Development Paradigm" 2002 *Review of Development Economics* 164.

order for any proposed system to act as a pillar for both fiscal and social policy considerations.⁹⁹

Raffer¹⁰⁰ made the following apt remark regarding the need for an international sovereign debt framework:

With good reason, any decent legal system demands an impartial and uninterested entity to be vested with the authority to make certain decisions. It is the courts, rather than creditors or debtors, which must have this power. The very foundation of the Rule of Law demands that one must not be judge in one's own cause. So far, international public creditors have been judge, jury, experts, bailiff, and occasionally even the debtor's lawyer all in one, mocking the very foundation of any legal system.

7 Conclusion and Recommendations

An efficient and effective insolvency system is a critical component of every well-functioning market economy and in the wake of the current financial crisis designing effective and efficient, formal and informal insolvency mechanisms, and building institutions capable of implementing them thus became a high priority for the crisis-hit countries.¹⁰¹ At the time of writing this article, there has been great effort amongst European politicians to resolve the increasingly worsening sovereign debt crisis and there is mounting pressure on the European Central Bank to become the Eurozone's lender of last resort. Obviously, the rules-based framework for fiscal policy created by the Excessive Deficit Procedure and the Stability and Growth Pact was insufficient to prevent the debt crisis despite its emphasis on promoting the implementation of radical austerity measures.¹⁰²

The principle of Kant¹⁰³ that “the master is himself an animal, and needs a master” is surely also relevant to the current situation. Moving the field of sovereign debt reform away from diplomacy and official intervention will remain incomplete until an international tribunal or judicial mechanism is established and charged with adjudicating sovereign defaults and provide countries in genuine financial distress with the machinery to carry out an orderly and rapid restructuring of their debt.¹⁰⁴

99 “Insolvency Law Reform: Promoting Trust and Confidence” New Zealand Law Commission Study (2001) Paper 11 Wellington at: http://www.lawcom.govt.nz/sites/default/files/publications/2001/05/Publication_101_256_SP11.pdf (accessed on 2012-07-01).

100 Raffer 2005 *Chicago J of Int L* 364.

101 “Insolvency Systems in Asia: An Efficiency Perspective” OECD report 2001 at: www.oecd.org/dataoecd/60/7/45747128.pdf (accessed on 2012-07-01).

102 Gianviti *et al* 20.

103 “Idea for a Universal History from a Cosmopolitan Point of View” translation by Beck of Kant “*On History*” (1963).

104 Weibel 327.

It is also clear that the current financial crisis is not only a calculation of debit and credits but has in turn led to a deep division and instability in the Eurozone. In turn the global crisis has also taken away not only the pride of individuals but that of an entire nation as the previous Greek Prime Minister admitted that his country had accepted “a partial surrender of sovereignty ... our struggle will be to recover our autonomy and liberate Greece from the surveillance imposed by the forces of conservatism”.¹⁰⁵

This article has merely presented an overview of certain ideas regarding sovereign insolvency law. The challenge will lie in creating a balance between, on the one hand designing a model which will optimise the regulatory outcome, while on the other hand bearing in mind that this should take place within an achievable and sustainable approach. Further research is inevitable as globalisation is increasing the complexity and the number of relevant actors in the world of sovereign debt. It is submitted that although we are observing an exceedingly politicised debate in international financial diplomacy on the issue of sovereign debts I am hopeful that the overwhelming scale of the current global crises would highlight the need to develop a predictable and reliable procedure for resolving the problems of sovereigns in financial distress and working towards a collective goal of building and maintaining global financial stability.

It is also submitted that the reworking of any area of our law and more specifically the regulation of sovereign insolvency law, should be done against the background of a well-managed policy process, generally accepted social and economic goals, and not a combination of political ideology and private advantage. It is also important to capitalise on the enormous investment that the international community has already made in thinking through the problems that arise in a sovereign debt restructuring.¹⁰⁶ It would be a shame if the numerous proposals and research already done did not ultimately result in the implementation of a series of tangible improvements and developments in the sovereign debt and insolvency regime.

While the concept of European unity has been held hostage by countries such as Greece hovering on the edge of default, the potential impact on both the citizens of the defaulting sovereign states and the global economy are currently forcing global economic leaders to come up with a sustainable solution. All these ideas or reactions to the current global crisis basically underline the central theme of this article that a

105 “Backlash grows over Greek rescue plan” *Financial Times* 2010-04-25.

106 Roubini & Setser “Improving the Sovereign Debt Restructuring Process: Problems in Restructuring, Proposed Solutions and a Roadmap for Reform” paper presented at conference on “Improving the Sovereign Debt Restructuring Process” co-hosted by the Institute for International Economics and *Institut Francais des Relations Internationales*, Paris, March 2003.

global crisis demands a global solution. As stated by Kofi Annan¹⁰⁷ in 2000:

I would go a step further and propose that, in the future, we consider an entirely new approach to handling the debt problem. The main components of such an approach would include ... establishing a debt arbitration process to balance the interests of creditors and sovereign debtors and introduce greater discipline into their relations.

¹⁰⁷ Annan “Freedom from Want” in: *We, the People, The Role of the United Nations in the 21st Century* (publ UN 2000).