Sovereign Debt Restructuring: A Study of the Problems and Inadequacies of the International Framework

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ABSTRACT

Distressed sovereign debt ceases to be a rarity. Sovereign debt crisis has become a contemporary international problem affecting not just the State in crisis; but also nations at large. The protracted history of sovereign debt crises and associated problems is not restricted to the developing world and includes developed countries like France and the United Kingdom which defaulted during the Great Depression of the 1930s (Dodd, 2002: 1). Specifically, the developing countries have been facing the hazard of sovereign debt crisis for a long time now as post-1950s; most debt crises occurred in developing or emerging market economies. Latin American countries hit the crisis during the 1980s; Brazil defaulted in 1980 followed by Mexico in 1982[1]; several Latin American countries followed suit in a decade-long debt crisis. Majority of the Asian countries grappled with a financial crisis during the 1990s, followed by other countries across the globe. Starting with Thailand in 1997 the debt crisis spread to Indonesia, South Korea, Philippines, Malaysia, and Singapore. The crisis soon spread to Russia (1998). Argentina's default during 2001 is considered the largest in history amounting to more than USD 100 billion in private debt and has brought back to the front many of the conventional problems related to sovereign debt restructuring. Since 1975, the amount of distressed external debt peaked in 1990 at an estimated more than $335 billion issued by 55 countries (Hatchondo, Martinez, & Sapriza, 2007: 169).

[1] Mexico defaulted again in 1995.

Sovereign debt crisis leads to fall in domestic output, economic dislocation, domestic political disorder, foreign trade sanctions along with a loss of access to capital markets (Krueger, 2002: 2). Often sovereign debt crisis grows into a perpetual nightmare for nations as the process of sovereign debt restructuring is relegated to ad- hoc mechanisms of resolution. As there is no legitimate system of rule of law or internationally recognized codified procedure for sovereign debt restructuring (Herman et al., 2010 c.f. Calitz, 2012: 329) that can prescribe fair and equitable resolution mechanism; restructurings are mostly done on a case-to-case basis, directed mainly by the International Monetary Fund (IMF).

Sovereign debt restructuring has met with a varied response from multilateral and domestic initiatives in the last few decades. These initiatives have curtailed the crippling debt of several countries in the past decades. However, the majority of these initiatives are voluntary, with no legal entity or statutory rules of procedure. Although geared towards debt relief, the process continues to be case-based and ad- hoc; often left to the discretion of the creditors. Frequently loss of access to capital markets triggers a debt restructuring and hence the primary aim of most of the initiatives is to restore market access (Stichelmans, 2015: 10). Non-economic factors or human rights considerations get relatively insignificant attention.

On defaulting, for a nation to successfully restructure its debt, all the creditors involved must unanimously accept an inevitable reduction in their claims. However, there are numerous incentives to not participate in the lengthy and expensive negotiations with the State. Certain creditors hold out from negotiations either to obtain better terms of payment or to free ride. Obstinate creditors may refuse to accept a haircut on their claims or try to negotiate a more profitable deal compared to other creditors on various grounds like seniority of claims, or influencing through powerful creditor lobbies. Once a dispute arises, using legal tactics even one recalcitrant creditor can hold out and refuse to accept the new debt issues, unraveling the restructuring in the process (Wright, 2012: 176).

During the nineteenth century, under the prevailing doctrine of absolute immunity, a State enjoyed immunity while involving in commercial activity and so holdout litigation was restricted to national courts (Waibel, 2007: 714). Over time there is a resolute decline in absolute sovereign immunity, a more restrictive code of sovereign immunity has materialized in response to

increasing government participation in commercial activities (Wright, 2012: 156). Another main reason that countries face significant problems while restructuring their external commercial debt is due to a shift from "bank to bond financing", creditor coordination is complicated to achieve because of the dispersed bondholder group (Krueger, 2002).

The decline in the strength of sovereign immunity protection over time, both through statutory changes and through case laws has opened a window for legal enforcement of contractual claims against sovereign States through litigation and arbitration (Panizza, Sturzenegger, & Zettelmeyer, 2009: 653). Unfortunately, recent times have witnessed a phenomenal increase in arbitration and litigations that evades negotiations with the sovereign and target assets of defaulting countries, not only within the State but across jurisdictions. With the sovereign space eroding overtime, the sovereign acts and assets which do not fall within the strict definition of "sovereign" sphere have fallen prey to such opportunistic legal claims.

Although legal, the recourse to arbitration and litigation raises certain fundamental concerns. The resort to arbitration and litigation pushes the dealing of sovereign debt disputes towards its corporate counterpart. The similarities between sovereign debt restructuring and private debt restructuring are modest, and hence the analogy between the two has its limits. There are technical and legal peculiarities, and most importantly the non- economic factors that differentiate sovereign debt and make it more complicated to deal with. Several reports by the United Nations posit that arbitration and litigation are not only inadequate but also unsuitable for resolving the disputes of sovereign debt restructuring mainly because of their limited consideration for the human rights of the citizens of the indebted State.[2] The major lacuna in the international legal framework persists. As prevention and management of unsustainable sovereign debt continue to baffle the international institutions, in July 2015, the UNGA adopted a resolution on Basic Principles on Sovereign Debt Restructuring Processes (A/69/L.84). Further, the UN Open Working Group observed that a sovereign debt restructuring mechanism is something that should be in place if we were to attain the Sustainable Development Goals.

[2] (2017) Juan Pablo Bohoslvasky submitted- *Report of the Independent Expert on the Effects of Foreign Debt and Other Related International Financial Obligations of States on the Full Enjoyment of All Human Rights, Particularly Economic, Social and Cultural Rights*, A/72/153. UNGA Report.

All too often non- economic considerations are underplayed in the analysis of sovereign debt restructuring. The disputes between a sovereign and its commercial creditors are dealt without due consideration to the larger macroeconomic and socio-political context of the crisis. This dissertation is a corrective step to this neglect. An exploratory research at the interface of public policy and law, the primary motivation of the present thesis is to review the inadequacies that impede timely, efficient and orderly sovereign debt restructuring deteriorating the process thereby. In particular, the dissertation problematizes the dominance of market-based contractual approach over a statutory approach for restructuring sovereign debt and analyzes the inadequate role of international institutions which simultaneously supports and undermines such dominance. With this dichotomy as a backdrop, at a more concrete level, it is used to understand proliferating arbitration claims and litigations against sovereign States. A particular conjuncture- vulture fund- that uses litigation as a tool to impede restructuring process is deliberated upon. Beyond analyzing the legal and regulatory inadequacies around sovereign debt restructuring, the dissertation stresses that both statutory and contractual regimes ought to be employed complimentarily as the nature of intervention necessary for dealing with the multifaceted problems of sovereign debt restructuring does not lend itself to the precise rationality and logic of economics. This dissertation analyzes a corpus of benchmark lawsuits against defaulting sovereigns. The normative contribution of this dissertation lies in reviewing the need to consider fundamental human rights in all forms of international engagements to resolve sovereign debt restructuring problems. The thesis concludes by rethinking the fundamental requisites of any statutory mechanism that may be ordained to alleviate these tensions.

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