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A Sovereign Debt Restructuring Framework for the Euro Area

Sebastian Grund* Mikael Stenström†

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ARTICLE

A SOVEREIGN DEBT RESTRUCTURING FRAMEWORK FOR THE EURO AREA

Sebastian Grund[*] & *Mikael Stenström*[**+]

ABSTRACT

This Article discusses the legal framework for sovereign debt restructuring in the euro area—both de lege lata and de lege ferenda. Sovereign debt restructurings remain exceptional events that come with profound implications for financial stability and monetary policy transmission. However, they may become necessary as part of a financial assistance program to a euro area Member State, as was the case for Greece in 2012. This Article seeks to contribute to the ongoing debate on how to enhance the functioning of the Economic and Monetary Union ("EMU") by exploring the legal aspects of sovereign debt restructuring in the euro area. This includes an analysis on whether and how the procedures for sovereign debt restructurings in the euro area can be made more orderly, fair, and predictable by establishing a European Sovereign Debt Restructuring Framework ("ESDRF"). Drawing upon international standards for sovereign bond documentation, we propose the inclusion of enhanced Collective Action Clauses ("CACs"), as well as certain technical amendment

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* European Central Bank, Directorate General International and European Relations.

** European Central Bank, Directorate General Market Operations.

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clauses. In addition, we discuss two options for a dispute resolution mechanism when contractual techniques to restructure sovereign debt fail: (i) a specialized chamber of the Court of Justice of the European Union ("CJEU") and (ii) a sovereign debt arbitration mechanism. The Article makes no judgment on the economic or political feasibility and necessity for such changes, but seeks to shine a light on the legal aspects that ought to be taken into account in the context of reforming the euro area's sovereign debt crisis resolution framework.

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I. INTRODUCTION

"It would be useful to think about a more predictable and transparent way of how to deal with debt restructurings."

- Klaus Regling, Managing Director of the European Stability Mechanism ("ESM"), October 2017[1]

The euro area sovereign debt crisis revealed important deficiencies in the architecture of the Economic and Monetary Union ("EMU"), notably with regard to two interlinked aspects. First, Member States of the European Union have engaged in lax fiscal policies or built up macroeconomic imbalances without having to face any serious sanction from the market or from the European Union.[2] Second, when the global financial crisis migrated across the Atlantic to

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1. Klaus Regling, Managing Director, European Stability Mechanism, Is Europe Prepared for the Next Crisis? A Discussion with Klaus Regling at the European Stability Mechanism's 5th Anniversary, (Oct. 11, 2017), *available at* https://piie.com/events/europe-prepared-next-crisis [https://perma.cc/ZN79-V6UU].

2. As Lane contends, "the initial institutional design of the euro plausibly increased fiscal risks during the pre-crisis period." *See, e.g.,* Philip Lane, *The European Sovereign Debt Crisis*, 26 J. ECON. PERSP. 49, 50, 65 (2012) (noting that "the origin and propagation of the European sovereign debt crisis can be attributed to the flawed original design of the euro'" and that the "European sovereign debt crisis . . . provides an opportunity to implement reforms that are necessary for a stable monetary union but that would not have been politically feasible in its absence"). With respect to the first deficiency, it is submitted by several commentators that reliance on "soft" mechanisms to ensure compliance with the debt ceiling set out in the Stability and Growth Pact ("SGP"). Between the years 1998 and 2012, fourteen countries violated the public debt rules of the SGP more than 120 times, raising serious doubts about the framework's effectiveness in ensuring sound fiscal policies. *See* Michael A. Hansen*, Explaining Deviations from the Stability and Growth Pact: Power, Ideology, Economic Need or Diffusion?*, 35 J. PUB. POL'Y 477, 481, 479 n.1 (2015).

Europe, the EMU framework lacked fiscal instruments to address acute financing difficulties that arose in both the private[3] and public sector.[4]

Policymakers in Europe have sought to address the outlined problems, most of which came to the fore during the crisis, by significantly reshaping EMU governance and introducing various crisis resolution mechanisms. For instance, the establishment of a Banking Union[5]—together with the changes introduced by the Banking Recovery and Resolution Directive[6]—seeks to prevent taxpayer-funded bailouts of banks in the future and cushion the adverse effects of "sovereign-bank feedback loop."[7] In addition, the European Stability Mechanism ("ESM") is an international financial institution which functions as a lender of last-resort on the basis of an inter-governmental treaty between the nineteen euro area governments.[8] The total lending capacity of the ESM is EU€500 billion, which almost matches the total quota resources of the International Monetary Fund

3. *See, e.g.,* HANS GEEROMS & PAWL KARBOWNIK, A MONETARY UNION REQUIRES A BANKING UNION (2014), *available at* https://www.coleurope.eu/system/files_force/research-paper/beep33.pdf?download=1.

4. Crucially, the infamous "sovereign-bank feedback loop" rendered it close to impossible to disentangle private and public balance sheets, making it difficult to resort to burden-sharing mechanisms to reduce debt levels in either sphere. Indeed, fears of sovereign default undermined confidence in the private banks that held much sovereign debt, forcing these banks to contract their balance sheets, driving the price of sovereign debt still lower.

5. *See e.g.,* JENS-HINRICH BINDER & CHRISTOS V. GORTSOS, THE EUROPEAN BANKING UNION: A COMPENDIUM (2015); DANNY BUSCH & GUIDO FERRARINI, EUROPEAN BANKING UNION (2015); GIUSEPPE BOCCUZZI, THE EUROPEAN BANKING UNION: SUPERVISION AND RESOLUTION (2016); Andreas Dombret, *European Financial Integration: Monetary Union, Banking Union, Capital Markets Union*, *in* EQUITY MKTS. IN TRANSITION 565–73 (2017).

6. Directive 2014/59/EU, of the European Parliament and of the Council of 15 May 2014 Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance, 2014 O.J. (L, 12.6.2014) 190.

7. *See*, *e.g.,* Heather Gibson, Stephen Hall & George Tavlas, *Self-fulfilling Dynamics: The Interactions of Sovereign Spreads, Sovereign Ratings and Bank Ratings During the Euro Financial Crisis*, 73 J. INT'L MONEY & FIN. 371 (2017) (finding that sovereign ratings, sovereign spreads, and bank ratings strongly interacted with each other during the euro crisis, confirming strong doom-loop effects).

8. For an overview of the ESM and its legal framework, *see, e.g.*, Christoph Ohler, *The European Stability Mechanism: The Long Road to Financial Stability in the Euro Area*, 54 GERMAN Y.B. INT'L L. 47 (2011). Also compare more recently Jefferey Atik, *From 'No Bailout' to the European Stability Mechanism*, 39 FORDHAM INT'L L. J. 1201 (2015).

("IMF") of around US$645 billion.[9] In addition, EMU governance and policy coordination was further strengthened through several new instruments to prevent and manage financial crises in the European Union.[10]

However, some argue that these reforms are not sufficient to address situations of sovereign insolvency, i.e., when an analysis of the Member State's debt sustainability yields a negative result.[11] While the ESM may have sufficient resources to provide liquidity to a Member State in crisis, its funds may be rapidly depleted if the country is confronted with unsustainable levels of debt.[12] This is because any crisis resolution framework that involves a lender of last resort for countries, such as the ESM or the IMF, is based on the premise that no credit can be extended to a country that will not be able to repay in the future.[13]

With respect to the euro area, the key question therefore is whether the ESM framework should feature a mechanism to restructure sovereign bonds in cases were the country's debt is deemed

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9. ETIENNE DE LHONEUX & CHRISTOS VASSILOPOULOS, THE EUROPEAN STABILITY MECHANISM BEFORE THE EUROPEAN COURT OF JUSTICE (2014).

10. *See, e.g.,* for an overview of the evolution of EMU after the crisis from a legal point of view, Päivi Leino & Tuomas Saarenheimo, *Sovereignty and Subordination: On the Limits of EU Economic Policy Coordination*, 43(1) EUR. L. REV. 166 (2017). For an economic analysis, *see, e.g.,* Heather D. Gibson, Theodore Palivos & George S. Tavlas, *The Crisis in the Euro Area: An Analytical Overview*, 39 J. MACROECONMICS 233 (2014).

11. One problem that is frequently cited in this context is the so-called "home bias," which reflects the fact that many banks predominantly hold sovereign debt issued by their home country, i.e., Italian banks hold a much higher amount of Italian sovereign bonds than non-Italian banks. This means that sovereign risk is directly translated into credit risk for domestic financial institutions, exacerbating the aforementioned sovereign-bank nexus. S*ee, e.g.,* Gaetano Gaballo & Ariel Zetlin-Jones, *Bailouts, Moral Hazard and Banks' Home Bias for Sovereign Debt*, 81(c) J. MONETARY ECON. 70 (2016).

12. We do not doubt that drawing a line between a solvency and liquidity crises is extremely challenging and subject to enormous controversy, particularly in the context of a sovereign borrower. Yet, the current ambiguity undermines the confidence in and the credibility of the ESM lending framework. *See, e.g.,* Nouriel Roubini, Debt Sustainability: How to Assess Whether a Country is Insolvent (Dec. 20, 2001) (unpublished manuscript), *available at* http://people.stern.nyu.edu/nroubini/papers/debtsustainability.pdf [https://perma.cc/4Y3Q-WKV2]; *see also* Pablo D'Erasmo, Enrique G. Mendoza & Jing Zhang, *What is a Sustainable Public Debt?, in* 2B HANDBOOK OF MACROECONOMICS 2493 (John Taylor & Harold Uhlig eds., 2015).

13. *See, e.g.,* Vincent Bignon, Marc Flandreau & Stefano Ugolini, *Bagehot for Beginners: The Making of Lender-of-Last-Resort Operations in the Mid-nineteenth Century*, 65 ECON. HIST. REV. 580 (2012).

unsustainable.[14] Indeed, as the European Central Bank ("ECB") mentioned in its opinion on the ESM Treaty, "[the ESM's] framework should be designed in a way that minimises moral hazard and reinforces incentives for pre-emptive fiscal and macroeconomic adjustment."[15]

Against this backdrop, the present Article seeks to sketch out an improved European Sovereign Debt Restructuring Framework ("ESDRF")[16] without, however, reaching conclusions as regards the actual feasibility of such framework from an economic or political point of view. This Article draws upon other proposals by academics[17] and policymakers.[18] It incorporates both voices advocating for the establishment of an ESDRF and such cautioning against it.

One strand of the literature argues that an ESDRF may reinforce the credibility of the no-bailout clause[19] *ex-ante* by making sovereign default a feasible option to remedy unsustainable public debt levels within the euro area,[20] anchor market participants' expectations in

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14. *See* DEUTSCHE BUNDESBANK, MONTHLY REPORT: APPROACHES TO RESOLVING SOVEREIGN DEBT CRISES IN THE EURO AREA, 41 (2016), 45.

15. European Central Bank CON/2011/24 (Opinion of the European Central Bank on a Draft European Council Decision Amending Article 136 of the Treaty on the Functioning of the European Union with Regard to a Stability Mechanism for Member States Whose Currency is the Euro), 2011 O.J. (C 140/05) ¶ 2, *available at* https://www.ecb.europa.eu/ecb/legal/pdf/c_14020110511en00080011.pdf [https://perma.cc/JSR6-CRVM].

16. The term ESDRF, as used in this paper, describes a framework for debt restructuring rather than an institution or a mechanism with a strong institutional element.

17. *See* Clemens Fuest, Friedrich `Heinemann & Christoph Schröder, *A Viable Insolvency Procedure for Sovereigns (VIPS) in the Euro Area*, ZEW DISCUSSION PAPER NO. 14-053, 1 (2014), *available at* http://www.zew.de/en/publikationen/a-viable-insolvency-procedure-for-sovereigns-vips-in-the-euro-area/?cHash=ec0bea56b1a938f2c45222a996291dcf [https://perma.cc/WJR9-YHGA]; *see also* François Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir & Jürgen von Hagen, *A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal*, X BRUEGEL BLUEPRINT SERIES, 1 (2010), *available at* http://bruegel.org/wp-content/uploads/imported/publications/101109_BP_as_jpf_jvh_A_European_mechanism_for_sovereign_debt_crisis_resolution_a_proposal.pdf [https://perma.cc/9D8Y-QLN5]; COMM. ON INT'L ECON. POL. & REFORM, REVISITING SOVEREIGN BANKRUPTCY (Oct. 2013).

18. *See* Jochen Andritzky, Désirée I. Christofzik, Lars P. Feld & Uwe Scheuering, *A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area*, (German Council of Economic Experts Working Paper, No 04, July 2016). *See also* André Sapir & Dirk Schoenmaker, *The Time is Right for a European Monetary Fund*, BRUEGEL POLICY BRIEF NO. 4, Oct. 2017, *available at* http://bruegel.org/2017/10/the-time-is-right-for-a-european-monetary-fund/ [https://perma.cc/MC6D-CLFN]; EUR. PARL. THINK TANK, SOVEREIGN DEBT RESTRUCTURING: MAIN DRIVERS AND MECHANISM (2017).

19. *See* Consolidated Version of the Treaty of the Functioning of the European Union art. 125, May 9, 2008, 2008 O.J. (C 115) 99 [hereinafter TFEU].

20. Andritzky et al., *supra* note 18, para. 37 at 15.

sovereign creditworthiness,[21] and facilitate more orderly and equitable debt restructuring *ex-post* by introducing a predefined legal procedure to deter holdout behavior.[22] Another strand focuses on the associated risks, arguing that if not implemented together with other reforms, an ESDRF could immediately weaken banks' balance sheets, thereby reinforcing the so-called "sovereign-bank feedback loop"[23] as well as negatively impact the transmission of monetary policy.[24]

A recent paper by Gourinchas and Martin takes a middle ground, arguing that both narratives hold some truths: (official sector) bail-outs may avoid debt default, but the no-bailout commitment may only be credibly safeguarded by ensuring orderly government debt restructurings.[25]

The present Article neither advocates that an enhanced debt restructuring framework provides a panacea nor that the idea should be dismissed without further investigation. On that basis, it endeavors to shine light on some of the complex and intricate legal aspects of sovereign debt restructurings in Europe, which have so far received little attention. At the same time, it is stressed that any enhancements to the euro area sovereign debt restructuring framework have to be decided on a political level by European governments and EU legislators.[26]

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21. EUR. PARL. THINK TANK, *supra* note 18, at 11.

22. Gianviti *et al., supra* note 17, at 5.

23. *See generally* Nicola Gennaioli, Alberto Martin & Stefano Rossi, *Sovereign Default, Domestic Banks, and Financial Institutions*, 69 J. FIN. 819 (2014). *See also* Ricardo Hermitte, *Sovereign Debt Restructuring Mechanisms: Mind the Trap, in* SUSTAINABLE GROWTH IN THE EU (Luigi Paganetto ed., 2017); Lorenzo Forni & Massimimiliano Pisani, *Macroeconomic Effects of Sovereign Restructuring in a Monetary Union: A Model-based Approach*, (IMF, Working Paper WP/13/269, Dec. 2013), *available at* https://www.imf.org/external/pubs/ft/wp/2013/wp13269.pdf [https://perma.cc/YEJ9-SWXY].

24. Note for instance that the debt restructuring may negatively affect the eligibility of bonds for monetary policy operations. *See, e.g.,* European Central Bank, Decision on the Eligibility of Marketable Debt Instruments Issued or Fully Guaranteed by the Hellenic Republic in the Context of the Hellenic Republic's Debt Exchange Offer, 2012 O.J. L 77 (Mar. 5, 2012) at 19.

25. *See* Pierre Olivier Gourinchas & Philippe Martin, *The Economics of Sovereign Debt, Bailouts and the Eurozone Crisis*, (May 19, 2017) (unpublished manuscript), *available at* https://cepr.org/sites/default/files/1884_MARTIN%20-%20The%20Economics%20of%20Sovereign%20Debt,%20Bailouts%20and%20the%20Eurozone%20Crisis.pdf [https://perma.cc/RKC4-AFBA].

26. Indeed, depending on the legal basis that is chosen, an ESDRF may require a qualified majority among Member States, if not unanimity *See infra* III.C. for a discussion of the ESDRF's legal basis.

The Article is structured as follows: Section II reviews the euro area's sovereign debt crisis resolution mechanism *de lege lata* with a view to providing an understanding of the existing framework. Section III discusses—*de lege ferenda*—how the legal framework for restructuring of sovereign debt in the euro area could be enhanced. It discusses, in particular, existing proposals to enhance sovereign debt restructurings, the ESDRF's potential legal basis, as well as institutional, procedural, and substantive aspects that ought to be taken into account. Section IV concludes.

II. THE EURO AREA'S CURRENT SOVEREIGN DEBT CRISIS MANAGEMENT FRAMEWORK

"[. . .] the effectiveness and potential costs of debt restructuring depend not only on their economic impact but also on the legal framework."
- Bénassy-Quéré et al., Group of 14 French-German Economists, January 2018.[27]

A. The Greek Sovereign Debt Restructuring of 2012

The start of the recent euro area debt crisis can be traced back to 2009 when the newly elected Greek Prime Minister publicly announced that the country's budget deficit will likely hit twelve percent of Gross Domestic Product ("GDP") in 2010.[28] Markets reacted to this bleak fiscal outlook by increasing the risk premia Greece had to pay on its sovereign bonds.[29] In the following two years, several financial assistance programs were agreed with European and international partners to stabilize the Greek economy. Ultimately, however, deep debt relief proved inevitable and the so-called "Troika," consisting of the IMF, the ECB, and the European Commission, made further financial assistance dependent upon the implementation of a

27. Agnès Bénassy-Quéré *et al.*, *Reconciling Risk Sharing with Market Discipline: A Constructive Approach to Euro Area Reform*, CEPR POLICY INSIGHTS NO. 91, Jan. 2018, at 12, *available at* https://cepr.org/active/publications/policy_insights/viewpi.php?pino=91 [https://perma.cc/5EYZ-Y89D].

28. This led to an upward revision of the deficit projection by Eurostat from 3.7% to 12.5%. *Cf. Provision of Deficit and Debt Data for 2008 – Second Notification,* EUROSTAT NEWS (Oct. 22, 2009), http://ec.europa.eu/eurostat/documents/2995521/5074630/2-22102009-AP-EN.PDF/490aa296-ccc7-4714-91c5-b5c8ddb73948?version=1.0 [https://perma.cc/MJZ2-MK9Y].

29. *See* Lane, *supra* note 2, at 56-57.

nominal haircut on Greek government debt.[30] The Greek Private Sector Involvement ("PSI") of 2012 was not only the biggest debt restructuring operation in history, it was also the first one to take place in an advanced economy.[31] As the zero-risk weighting rule of euro area public debt, defined under the applicable EU Regulations, suggests,[32] sovereign default in an advanced European country was long considered impossible; indeed, some policymakers referred to a Greek default as "death penalty."[33]

In March 2012, Greece successfully imposed a haircut on private bondholders by retrofitting collective action clauses ("CACs") to Greek-law bonds, as mandated in the conditions of the Second Economic Adjustment Programme for Greece.[34] The debt relief, which resulted in creditor losses of more than fifty percent on average, reduced Greece's debt burden by roughly EU€100 billion.[35] From a legal point of view, debt relief was achieved by means of the Greek Bondholder Act ("GBA") 2012, which enabled a majority of sixty-six percent or two-thirds of bondholders to bind a minority of holdouts to the terms and conditions of the debt swap agreed upon with the

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30. *The Second Economic Adjustment Programme for Greece*, 6 EUR. COMM. OCCASIONAL PAPERS 94, March 2012, at 6, *available at* http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp94_en.pdf [https://perma.cc/S74P-KYBQ].

31. *See* Michael Tomz and Mark L.J. Wright*, Empirical Research on Sovereign Debt and Default*, 5 AN. REV. ECON. 247, 257 (2013) (noting that "[t]he largest default in history (by present value) was the 2012 Greek restructuring that covered more than €200 billion of privately held debt, followed by Argentina in 2001 and Russia in 1918.").

32. Regulation 575/13 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation 648/12, 2012 O.J. (L 201) 1. For a recent criticism of this zero-risk weighting rule for euro area sovereign bonds, *see e.g.,* Andreas Dombret, Executive Board Member, Deutsche Bundesbank, Speech at the Annual Conference on the Banking Union: The Other Side of the Coin – Why European Supervision Needs International Regulation (May 15, 2017), *available at* https://www.bis.org/review/r170515a.htm [https://perma.cc/FWX2-2K72].

33. Ralph Atkins, *Interview Transcript: Lorenzo Bini Smaghi*, FIN. TIMES (May 29, 2011), https://www.ft.com/content/91f52140-89e2-11e0-beff-00144feab49a [https://perma.cc/57NT-YJH2].

34. *The Second Economic Adjustment Programme for Greece, supra* note 30. *See, e.g.,* Sebastian Grund, *Restructuring Government Debt Under Local Law: The Greek Case and Implications for Investor Protection in Europe*, 12 CAP. MKTS. L. J. 253 (2017); Jeromin Zettelmeyer, Christoph Trebesch & Mitu Gulati, *The Greek Debt Restructuring: an Autopsy,* 28 ECON. POL'Y 513 (2013).

35. Miranda Xava, *Lessons From the 2012 Greek Debt Restructuring*, VOXEU, (Jun. 25, 2014), http://voxeu.org/article/greek-debt-restructuring-lessons-learned [https://perma.cc/3KM8-VTDE].

Troika.[36] While this mechanism worked smoothly for Greek-law bonds, holdouts blocked the restructuring of EU€6 billion in foreign-law bonds.[37] The latter type of bonds featured single-limb non-aggregated CACs, which, in contrast to the aggregated version implemented through the GBA, required a majority of seventy-five percent in each individual series of bonds.[38]

Fearing protracted litigation in foreign courts and weary of reputational risks, the Greek government paid these holdout funds in full, openly discriminating between holders of foreign and Greek-law bonds. Moreover, and this is a lesser-known fact, the Greek debt exchange offer included a minimum participation threshold, which stipulated that if 90% of bondholders agreed to Greece's restructuring, it would be deemed successful.[39] While holders of foreign-law bonds thus escaped a haircut, several thousands of holders of Greek-law that were exposed to losses challenged Greece in foreign and domestic courts. Remarkably, litigation in respect of domestic-law bonds is still ongoing roughly six years after the debt operation was concluded.[40] It is now widely agreed that the first and only debt restructuring in the euro area revealed significant inefficiencies in the euro area's crisis resolution framework, prompting a set of reforms aimed at making the currency area more resilient to future sovereign debt distress.[41]

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36. Notably, the retrofitted CAC was fully aggregated, which means that bondholders voted not in each individual series but their votes were aggregated across the entire outstanding stock of Greek debt. *See* Press Release, Hellenic Republic Ministry of Finance, (March 9, 2012), *available at* http://www.pdma.gr/attachments/article/80/9%20MARCH%202012%20-%20 RESULTS.pdf [https://perma.cc/TEB8-NJ6R].

37. Lee Buchheit, *The Greek Debt Restructuring of 2012*, *in* ESCB LEGAL CONFERENCE (Oct. 2016), at 46, *available at* https://www.ecb.europa.eu/pub/pdf/other/escblegalconference 2016_201702.en.pdf?e2dea3a78485afe4c70d5d5010f368be [https://perma.cc/2NBZ-E4NT].

38. Hence, holdouts may acquire blocking positions in smaller series, thereby thwarting the entire debt swap. *See, e.g.,* Anna Gelpern, Ben Heller & Brad Setser, *Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds*, GEO L. FAC. PUBLICATIONS & OTHER WORKS 1793 (2015).

39. "Minimum participation thresholds" condition the exchange to a critical level of creditor participation, meaning that a debt restructuring will not be successful if a certain percentage of bondholders does not take part in the deal. They have to be differentiated from CACs, however. CACs enable ensure financial democracy, while minimum participation thresholds are coordinating devices. *See*, *e.g.,* Ran Bi, Marcos Chamon, and Jeromin Zettelmeyer, *The Problem that Wasn't: Coordination Failures in Sovereign Debt Restructurings*, 64 INT'L. MON. FUND ECON. REV. 471 (2016).

40. *See, e.g.,* Grund, *supra* note 34 (reviewing litigation with regard to domestic law bonds after the Greek PSI in different municipal courts across Europe).

41. Bénassy-Quéré et al., *supra* note 27.

B. The European Stability Mechanism

The ESM is at the core of the euro area sovereign debt crisis management framework. The ESM is an international organization in 2012 in the wake of the euro area debt crisis. The ESM has the objective to "mobilize funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States."[42] Given that the ESDRF proposal advanced in this Article foresees a central role for the ESM, this Section briefly outlines the ESM's tasks and its functioning, with a particular focus on its role in debt restructurings.

1. Features and functions

The ESM is an international body that lends to euro area governments that have lost access to international credit markets.[43] It is based on an international treaty that operates outside EU law, but it is still connected to the EU legal framework.[44] For instance, the Court of Justice of the European Union ("CJEU") has limited jurisdiction over the interpretation of the ESM Treaty.[45] The original EMU governance framework did not envisage any permanent mechanism for financial assistance to euro area Member States experiencing or threatened by financial difficulties.[46] Given the fear of contagion sparked by the euro area sovereign debt crisis, policymakers saw no alternative to devising a mechanism that provides temporary liquidity

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42. Treaty Establishing the European Stability Mechanism art. 3, Feb. 2, 2012, [hereinafter ESM Treaty].

43. *See, e.g.,* Ledina Gocaj & Sophie Meunier, *Time Will Tell: The EFSF, the ESM, and the Euro Crisis***,** 35 J. EUR. INTEGRATION 239 (2013).

44. This connection inter alia stems from the fact that the ESM Treaty has to respect EU law, as for instance clarified in the *Pringle* case. *See* Case C-370/12, Pringle v. Government of Ireland, 2012 E.C.R. 756, ¶ 178.

45. *See* ESM Treaty, *supra* note 42, art. 37. To finance its operations, the ESM taps capital markets and thereby leverages the capital paid in by ESM Member States, which allows it to obtain a very favorable credit rating that can be translated into cheap financing for countries in distress, *see* EUR. STABILITY MECHANISM, ANNUAL REPORT 2015 (2016).

46. *See* TFEU, *supra* note 19, art. 125, which entails the no-bailout clause. For a discussion of the no-bailout clause, *see, e.g.,* Jean-Victor Louis, *Guest Editorial: The No-Bailout Clause and Rescue Packages*, 47 COMMON MKT. L. REV. 971, 978 (2010) (noting that "[t]he no-bailout clause is an essential part of the'budgetary code' of the Union, and beyond its literal wording is . . . the expression of the responsibility of each Member State for its own public finance. . . .").

assistance to Member States with the aim of safeguarding financial stability in the euro area as a whole.[47]

In essence, the ESM lends to states that have lost market access, providing liquidity for below-market rates during periods of financial stress.[48] In this sense, the ESM assumes the role of an international lender of last resort to euro area sovereigns,[49] whereby the ESM's claims rank above those of private creditors and only below those of the IMF.[50] The flipside of receiving money from other euro area Member States when regular access to markets is impaired is the macroeconomic conditionality attached to the ESM's lending programs, which—to a large extent—mimics the IMF's long-standing practice of demanding meaningful macroeconomic adjustment in exchange for emergency loans.[51]

At the same time, the ESM entails a very rudimentary legal framework for debt restructuring. The only reference to debt restructuring is in Recital (12) of the ESM Treaty and reads as follows: "[i]n accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programs."[52]

While this provision reflects a compromise between euro area governments not to *ex-ante* rule out the restructuring of bonds to restore

47. *See, e.g.,* ESM Treaty, *supra* note 42, recital (6) (stating that "[t]he ESM may therefore provide stability support on the basis of a strict conditionality, appropriate to the financial assistance instrument chosen if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.").

48. For a discussion of the ESM and previous crisis management mechanisms for the euro area, *see, e.g.,* Matthias Ruffert, *The European Debt Crisis and European Union Law*, 48 COMMON MKT. L. REV. 1777 (2011).

49. While the term "lender of last resort" is often associated with the ECB's function of providing liquidity to banks if market funding dries up, it is also used in the context of the IMF or the ESM, whose role it is to replace market funding for sovereigns in crisis.

50. *See, e.g.,* Klaus Regling, ESM Managing Director, *The Next Steps to Make the Euro Area More Resilient* (Feb. 16, 2016), *available at* https://www.esm.europa.eu/sites/default/files/2017_02_16_kr_speech_munich.pdf [https://perma.cc/9MZF-9WUM].

51. For an overview of the IMF's lending practices, see Olivier Jeanne, Jonathan D. Ostry & Jeromin Zettelmeyer, *A Theory of International Crisis Lending and IMF Conditionality* (IMF, Working Paper No. WP/08/236, 2008), *available at* https://www.imf.org/external/pubs/ft/wp/2008/wp08236.pdf [https://perma.cc/WXW8-XARZ]. So far, ESM loans have been provided to Ireland, Spain, Portugal, Cyprus, and Greece, with Greece remaining the only country which has not yet exited its ESM financial assistance program.

52. ESM Treaty, *supra* note 42, recital (12).

debt sustainability, it may cause more confusion than clarification. First, neither the ESM Treaty nor publicly accessible policy documents describe what applying the IMF's practice would mean in the context of an ESM program[53] or suggest that the ESM would follow the IMF's approach to debt restructuring. Second, it is easy to conceive the kind of legal, political, and practical problems that arise when the ESM is to ascertain whether or not a debt crisis is indeed "exceptional." Third, the level of adequacy and proportionality of debt restructuring measures is likely to remain subject to an *ex-post* interpretation by national courts, which have a very mixed track record in supporting the orderly resolution of sovereign debt.[54]

In this regard, it should be noted that the first version of the ESM Treaty, which was signed on July 11, 2011 by seventeen Member States, but never entered into force, entailed much more specific language as regard debt sustainability assessment and private sector involvement.[55] The first version of the ESM Treaty thus suggests that

53. For instance, it is not clear whether this provision refers to IMF practice at the time of the drafting of the ESM Treaty (i.e. 2011) or whether the provision is to be interpreted dynamically. This question is particularly important given that the IMF has already adjusted its Exceptional Access policy since 2011.

54. *See, e.g.*, for recent developments in U.S. jurisprudence in the realm of sovereign debt restructuring in Juan J. Cruces & Tim R. Samples, *Settling Sovereign Debt's 'Trial of the Century'*, 31 EMORY L. REV. 5 (2016); Joseph Cotterill, *Choose Your Own Adventure, Sovereign Debt Trial of the Century Edition*, FIN. TIMES ALPHAVILLE (Feb. 8, 2013), https://ftalphaville.ft.com/2013/02/08/1379162/choose-your-own-adventure-sovereign-debt-trial-of-the-century-edition/ [https://perma.cc/95LB-RW89]; Jesse Kaplan, *Collective Action and the Competence of Courts: The Lessons of* NML v. Argentina, 20 STAN. J. L. BUS. & FIN. 1 (2014). It is also mentioned, however, that US courts have recently reversed course *after* the Argentine government settled with the holdouts. For an overview of the debate, *see, e.g.,* Lee Buchheit & Andrés de la Cruz, *Pari Passu Reinterpreted*, INT. FIN. L. REV. (2018), http://www.iflr.com/Article/3783277/Pari-passu-reinterpreted.html [https://perma.cc/ZLL5-YYZV].

55. *See* Treaty Establishing the European Stability Mechanism, July 11, 2011, *available at* https://www.cvce.eu/obj/treaty_establishing_the_european_stability_mechanism_11_july_2011-en-cb18477d-69e4-4645-81a9-3070e02d245a.html [https://perma.cc/MAT7-AFKS]. Note that this Treaty was not ratified by Member States and thus never entered into force. The relevant provision about debt restructuring reads as follows:

> An adequate and proportionate form of private-sector involvement shall be sought on a case-by-case basis where financial assistance is received by an ESM Member, in line with IMF practice. The nature and the extent of this involvement shall depend on the outcome of a debt sustainability analysis and shall take due account of the risk of contagion and potential spill-over effects on other Member States of the European Union and third countries. If, on the basis of this analysis, it is concluded that a macro-economic adjustment programme can realistically restore public debt to a sustainable path, the beneficiary ESM Member shall take initiatives aimed at encouraging the

the lack of clarity in the current Recital (12) of the ESM Treaty was not the result of an accidental omission. Rather, it is likely to have reflected a political compromise between those pushing for more *ex-ante* rules and those advocating *ex-post* discretion.

For the purpose of this Article, the first draft of the ESM Treaty holds important lessons and truths both legally and politically. First, it circumscribes the outer boundaries of legal language that was acceptable to Member States, at least for the period between July 2011, when the first version of the ESM Treaty was signed, and February 2012, when the current version of the ESM Treaty was signed. Linking the granting of ESM financial assistance to the Member State's commitment to ensure PSI seems not to have raised any constitutional law issues in Member States, given that the Heads of State signed this first version of the Treaty.[56] Second, Member States were ready to clarify the ESM's approach to situations of questionable solvency, i.e., if the debt sustainability analysis ("DSA") yields a negative result.[57] The proposed framework, as discussed further below, essentially reflects the IMF's access policy and, in part, goes even beyond it.[58]

2. Reconciling the no-bailout clause with official-sector financial assistance: The *Pringle* case

The ESM's legality under EU law, particularly with respect to the no-bailout clause and Article 125 of the Treaty of the Functioning of

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> main private investors to maintain their exposure. Where it is concluded that a macro-economic adjustment programme cannot realistically restore the public debt to a sustainable path, the beneficiary ESM Member shall be required to engage in active negotiations in good faith with its non-official creditors to secure their direct involvement in restoring debt sustainability. In the latter case, the granting of financial assistance will be contingent on the ESM Member having a credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decisions on disbursements.

56. *See id.* For further discussion, see also *infra* III.D.1.

57. *See, e.g.,* CINZIA ALDICI AND DANIEL GROS, DEBT SUSTAINABILITY ASSESSMENTS: THE STATE OF THE ART 17 (2018), *available at* http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/624426/IPOL_IDA(2018)624426_EN.pdf [https://perma.cc/MR2P-UG57] (stating that "[a]ny decision to grant financial assistance to a country (or rather its government) must be preceded by an analysis of the sustainability of public finances").

58. *Id.* (discussing the IMF's framework for situations of questionable solvency of a requesting Member).

the EU ("TFEU"), has been questioned from the very first days of its mentioning in official policy papers.[59] At the time of negotiating the Maastricht Treaty, EU governments were reluctant to cede competences in monetary *and* economic policy to the European Union, thus deliberately fostering an asymmetric framework for EMU.[60] Monetary policy tasks were transferred to the ECB and the European System of Central Banks ("ESCB"), while the role of the European Union in economic policy was limited to the adoption of coordinating measures.[61] In the context of the ESM's establishment, the CJEU addressed the question of whether the establishment of the ESM transgressed the boundaries set out by EU law in its f amous *Pringle* case.[62] The CJEU held, on the one hand, that the amended Article 136(3) TFEU did not create a new (economic policy) competence for the Union, and, on the other hand, that the ESM was compatible with the no-bailout clause under Article 125 TFEU.[63]

More specifically, the CJEU found that "Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy."[64]

Strict ESM conditionality, designed to foster sound budgetary policy, and the fact that the recipient Member State remained liable to repay the sums lent, convinced more critical voices in the CJEU that the ESM was not a backdoor to permanent fiscal transfers within the euro area.[65] Regarding the issue of debt restructuring, the *Pringle* decision is silent. This said, one could infer from the CJEU's conclusions that the restructuring of sovereign bonds issued by the

59. *See, e.g., Communication from the European Commission and the Council and the Economic and Financial Committee on the European Financial Stabilisation Mechanism*, COM(2010) 713 final, (Nov. 30, 2011)..

60. *See generally* Paul de Grauwe & Marc-Alexandré Sénégas, *Asymmetries in the Monetary Policy Transmission: Some Implications for EMU and its Enlargement*, 42 J. COMMON MKT. STUD. 757 (2004).

61. Chris Koedooder, *The Pringle Judgment: Economic and/or Monetary Union?*, 37 FORDHAM INT'L L. J. 111 (2013).

62. Case C-370/12, Pringle v. Government of Ireland, 2012 E.C.R. 756.

63. *Id.* at ¶¶ 129-47.

64. *Id*. at ¶¶ 138-41.

65. *Id*.

recipient country does not run counter to EU law.[66] Indeed, the right to restructure public debt is generally deemed to be in the sovereign's discretion, albeit important limitations may result when combined with a financial assistance program.[67]

3. The Euro Area Model CAC (Euro CAC)

The ESM Treaty also introduced a new system for PSI in the EMU, mandating the inclusion of CACs in all euro area government bonds issued after July 1, 2013 ("Euro CAC").[68] The Euro CAC essentially enables a majority of bondholders to approve a restructuring plan proposed by the government instead of requiring unanimous agreement with the debt workout.[69] Their purpose is two-fold: first, the obligation on euro area Member States to use CACs would alleviate holdout problems in future restructuring and second, with the inclusion of CACs, ESM signatories could consider debt restructuring a feasible policy option to remedy deep debt crises in exceptional cases.[70]

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66. Indeed, the Troika required the Greek government to implement a debt restructuring in order to be eligible for additional financial assistance in early 2012; *see The Second Economic Adjustment Programme for Greece*, *supra* note 30.

67. *See, e.g.*, Vassilis Paliouras, *The Right to Restructure Sovereign Debt*, 20 J. INT'L ECON. L. 115 (2017).

68. ESM Treaty, *supra* note 42, art. 12(3).

69. *See* Econ. & Fin. Comm., Sub-Comm. on EU Sovereign Debt Mkts., *Common Terms of Reference of the Euro area model CAC*, EUROPA (Feb. 17, 2012), https://europa.eu/efc/sites/efc/files/docs/pages/cac_-_text_model_cac.pdf [https://perma.cc/K48X-NELK] [hereinafter ESDM]. In addition, to alleviate certain conflicts of interest, the Euro CAC also includes disenfranchisement clauses, which excludes government bonds held by the issuer or by any of its ministries, departments or agencies from the CAC voting procedure. As stated in the Explanatory Note accompanying the Euro CAC, 'disenfranchising an issuer's holdings of its own bonds is appropriate because the losses suffered by the issuer from the modification of the bonds it holds, unlike the losses suffered by an ordinary market participant, are more than offset by the gains realized by the issuer from the resulting reduction in its debt service or debt stock or both.' *See* ESDM, *Collective Action Clause – Explanatory Note*, EUROPA (July 26, 2011), https://europa.eu/efc/sites/efc/files/docs/pages/explanatory_note_draft_on_the_model_cac_-_26_july.pdf [https://perma.cc/U683-7S3C].

70. In our view, this is the only sensible way of interpreting the euro area governments' decision to move to CACs. Before the euro area crisis, CACs were exclusively considered in the context of foreign law government bond issues in Europe; *see, e.g.*, *Implementation of the EU Commitment on Collective Action Clauses in Documentation of International Debt Issuance* (Econ. & Fin. Comm., ECFIN/CEFCPE(2004)REP/50483 final), Nov. 12, 2004, *available at* https://europa.eu/efc/sites/efc/files/docs/pages/cacs_en.pdf [https://perma.cc/TJH7-L29U] (concerning the implementation of CACs for active issuers in the EU who issued debt under a foreign jurisdiction). For a discussion of the rationale of inserting CACs in domestic law-

With the introduction of Euro CACs, the legal technique employed in the Greek PSI of 2012,[71] i.e., to retrofit CACs to domestic law bonds in order to facilitate a 'voluntary' debt restructuring, will no longer be necessary. The introduction of Euro CACs will considerably enhance legal certainty for investors in the event of another debt crisis. Indeed, recent studies suggest that investors value the fact that states are—to some extent—bound to a predefined procedure for PSI.[72] By making the inclusion of Euro CACs mandatory under the ESM Treaty, investors can now expect that states will restructure their debts in line with the statutory voting threshold rather than any other arbitrary, perhaps more expedient, procedure for the state in distress.[73]

However, while the Euro CACs are the single most useful contractual tool to provide for more orderly and fair debt restructurings, they are no panacea.[74] For instance, holdout investors may still acquire a blocking position given that Euro CACs require an affirmative vote of at least sixty-six percent or two-thirds of bondholders in each individual series and that holdouts may act in concert.[75] In this respect, Euro CACs differ from the international standard for sovereign bonds issued in foreign capital markets, which only requires one vote for all series and an affirmative vote of seventy-five percent of bondholders.[76]

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governed debt securities, *see, e.g.*, Michael Bradley & Mitu Gulati, *Collective Action Clauses for the Eurozone*, 18 REV. FIN. 2045 (2013).

71. *See supra* II.A. for an overview of the Greek PSI.

72. *See, e.g.,* Antonio Guglielmi, Javier Suarez & Carlo Signani, *Country Update, Italy: Re-denomination Risk Down as Time Goes By*, MEDIOBANCA SECURITIES COUNTRY UPDATE, (Jan. 19, 2017), http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf.

73. *See, e.g.*, Grund, *supra* note 34.

74. In the pertinent literature, it is widely acknowledged that CACs are insufficient to address inefficiencies in the restructuring process other than the holdout problem. *See, e.g.,* Anna Gelpern, *Sovereign Debt: Now What?,* 41 YALE J. INT'L L. 45, 91 (2016); Ben Emons, *Collective Action Clauses: No Panacea for Sovereign Debt Restructurings*, PIMCO VIEWPOINT (Oct. 2012), https://www.pimco.com/en-us/insights/viewpoints/viewpoints/collective-action-clauses-no-panacea-for-sovereign-debt-restructurings [https://perma.cc/9SPK-X898].

75. In this respect, the Euro CACs differ from the ICMA, which requires a (super) majority of seventy-five percent of bondholders to consent to a contractual modification suggested by the sovereign. The purpose of the so-called "aggregation feature" is to mitigate holdout behavior more effectively. For a comparison of the two different types of CACs, *see, e.g.*, IMF, *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*, IMF Policy Paper (Oct. 2014), at 19-20, *available at* https://www.imf.org/external/np/pp/eng/2014/090214.pdf [https://perma.cc/366X-C4U8]. Also *see infra* III.F.1. for a discussion as to why the Euro CAC should be aligned to the international standard.

76. For the international standard for English and New York law sovereign bonds, *see* INTERNATIONAL CAPITAL MARKETS ASSOCIATION, STANDARD COLLECTIVE ACTION AND *PARI PASSU* CLAUSES FOR THE TERMS AND CONDITIONS OF SOVEREIGN NOTES (Aug.

Not surprisingly, the CAC retrofitted to Greek-law bonds contained full aggregation feature, which meant that they deviated from the standard European governments had agreed upon just months before.[77] This was deemed vital for the success of the Greek debt restructuring operation. Against this backdrop, we propose some amendments to the Euro CACs as explained below.[78]

III. A EUROPEAN SOVEREIGN DEBT RESTRUCTURING FRAMEWORK ("ESDRF")

"While the creation of the IMF's SDRM was rejected on the grounds that it would interfere with national sovereignty, this objection is much less valid at European level where states have agreed to share sovereignty within the framework of the EU's community of law."

- Gianviti et al., Bruegel, November 2010.[79]

A. Introduction

Throughout the past decade, a number of authors have argued that EMU governance still does not contain the requisite tools to remedy

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2014), *available at* https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Primary-Markets/primary-market-topics/collective-action-clauses/ [https://perma.cc/9ZC7-ZDMJ] [hereinafter ICMA]. The ICMA CAC has been perceived relatively positively by the market and approximately 89% of the New York law governed bonds included enhanced CACs, compared with approximately 80% of newly issued English law bonds. *See* IMF, *Second Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts* (Jan. 2017), *available at* https://www.imf.org/external/np/pp/eng/2017/122716.pdf [https://perma.cc/T63Q-ZQPG]. The Euro CAC does have a limited aggregation feature, which however does not resolve the holdout problem; *see infra* III.F.1.

77. *See supra* II.A. It became evident that holdout inefficiencies pose real problems to debt restructuring when, during the Greek PSI, several hedge funds thwarted the restructuring of 17 series of English-law bonds by acquiring minority blocking positions. *See* Zettelmeyer et al., *supra* note 34, 538, which noted:

> [u]nlike the English-law bonds, this threshold applied across bonds rather than just bond-by-bond, subject only to a participation quorum of at least 50% of face value. In the end, this aggregation feature turned out to be pivotal for the results of the debt exchange, as it allowed the restructuring of 100% of the Greek law sovereign bonds, which themselves made up over 86% of the bonds covered by the restructuring.

78. *See infra* III.F.1.

79. Gianviti et al., *supra* note 17, at 21.

the sovereign debt problem in Member States.[80] Against the backdrop of existing proposals, as well as the authors' own analysis, the subsequent sections seek to explain how a better debt restructuring framework could be designed, focusing, in particular, on its legal features and functions.[81] For the sake of clarity, it is noted that the term "ESDRF" is neither equivalent to the ESM nor a potential European Monetary Fund ("EMF").[82] Rather, the ESDRF should be understood as an umbrella term that consists of a set of rules with the shared objective of rendering debt restructurings more orderly, transparent, and fair.[83] Moreover, it is emphasized that the ESDRF would not "force" countries into debt restructurings,[84] but rather clarify the mechanics of crisis lending when debt is unsustainable. Whether or not debt should be restructured remains, at all times, a sovereign decision.[85]

B. Existing Proposals

Most of the existing proposals for a debt restructuring mechanism in the euro area have discussed the potential (economic) benefits of a statutory solution to debt restructuring in the euro area.[86] At the center

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80. Charles Wyplosz, *The Six Flaws of the Eurozone*, 31 ECON. POL. 559 (2016). For a recent analysis of the status of sovereign debt restructuring in the euro area from a legal perspective, *see, e.g.,* Lee C. Buchheit & G. Mitu Gulati, *Sovereign Debt Restructuring in Europe*, 9 GLOBAL POL. 65 (2018).

81. A review of the pertinent literature revealed a paucity of in-depth analyses of the legal framework that may underpin such mechanism. Here, this Article aims at making a serious contribution to scholarship that should serve as a starting point for future work and research.

82. The EMF has been proposed as an enhanced ESM anchored in Union law by the European Commission in December 2017; *see infra* III.C.3. for an overview of the proposal.

83. In the given context, an orderly debt restructuring is one where holdouts' interference is reduced and a fair debt restructuring is one where the burden of adjustment is appropriately shared between the private and public sector.

84. As the ECB held in 2012 in the context of the Greek PSI, "it remains the sole responsibility of the Government of the Hellenic Republic to take the necessary action that will ultimately ensure its debt sustainability." *See* European Central Bank, Opinion Of The European Central Bank of 17 February 2012 on the Terms of Securities Issued or Guaranteed by the Greek State, CON/2012/12 (2012), *available at* https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2012_12_f_sign.pdf [https://perma.cc/V5J2-LEEG].

85. Paliouras, *supra* note 67.

86. Andritzky et al., *supra* note 18, at 6-10*; see also* Table 1 for an overview. The debate is closely linked to the establishment of the EMF. *See, e.g.*, Marcel Fratzscher, *Why a Franco-German Bargain Will Help Secure the Euro*, FIN. TIMES (Aug. 9, 2017), https://www.ft.com/content/3a0a4406-7d0b-11e7-ab01-a13271d1ee9c [https://perma.cc/UK4S-VRF3]. *Compare* Daniel Gros & Thomas Mayer, *How to deal with sovereign default in Europe: Create the European Monetary Fund now!*, CEPS POLICY BRIEF No. 202 (May 17, 2010) *with* Laurence Boone & Shahin Vallée, *Europe Needs True Fiscal Integration, Not Its Own IMF*, THE ECONOMIST, (May 9, 2017).

of all proposals for an ESDRF lies the objective of restoring sustainability of public debt levels and, in doing so, ensuring a fair level of burden-sharing between private creditors and the sovereign debtor.[87] A more transparent and efficient framework for debt restructuring in the euro area, so the general argument goes, may considerably enhance the ESM's effectiveness, as the need for ESM liquidity, i.e., bailouts, will likely be lower. As Table 1 illustrates, different designs for an ESDRF have been discussed.

The majority of proposed frameworks entail a pre-positioned crisis resolution mechanism for sovereign default. Most proposals seek to combine *ex-ante* market discipline with an *ex-post* procedure to deal with holdout creditors. With regard to the legal basis, it appears that the majority of commentators prefer the intergovernmental over the EU approach, which means that the enhanced debt restructuring framework would be governed by the ESM Treaty.[88] Agreement also seems to exist in respect of the need to enhance the current design of CACs, which entails a two-limb voting procedure that is more prone to holdout strategies.[89]

Table 1: Overview of ESDRF Proposals

Proposal	Legal basis	Dispute settlement process	Interim financing	Restructuring process
ECRM European Crisis Resolution Mechanism (Gianviti et al., 2010)	EU Treaties	• Specialized chamber at the CJEU to initiate and supervise negotiations • No further details on the set-up	• European Financial Stability Facility as a permanent institution (which is part of today's ESM) • ESM financial assistance	• Debtor country launches negotiations • Moratorium of payments and stay on litigation

87. At least since the proposal of fourteen top French and German economists, who can also be considered relatively independent, the accusation that sovereign debt restructuring is an idea pushed by Germans to impose their ordoliberalist way of thinking to punish countries for expansionary fiscal policies does not hold anymore. *See* Bénassy-Quéré et al., *supra* note 27.

88. *See infra* III.C.2. for a discussion of the potential legal basis of an ESDRF.

89. *See infra* III.F.1. for ways to improve the resilience of CACs used in the euro area.

			(linked to conditionality)	• No further details on haircut size etc.
EMF European Monetary Fund (Mayer/Gros, 2010)	EU Treaties	• Not specified	• Provided by the EMF (similar to the ESM)	• Liquidity measures in a first step • Restructuring of debt in a second step to a level of sixty percent of GDP (akin to a Brady deal)
ESDRF European Sovereign Debt Restructuring Framework (Bagchi, 2013)	ESM Treaty	• Arbitration under the auspices of an independent European Sovereign Debt Restructuring Council • Procedure guided by UNIDROIT Principles of Transnational Civil Procedure	• Not specified	• ESDRF is activated after debt is deemed unsustainable by the ESM • Dispute settlement body oversees ESDRF proceedings and related matters • Moratorium on creditor payments and immunity from creditor enforcement
ESDRR European Sovereign Debt Restructuring Regime (Committee on	ESM Treaty	• Not specified	• ESM lending conditional upon debt restructuring • Seniority of liquidity provision	• Aggregated majority voting • ESM funds immunized from holdout litigation • Restructuring with the aim of

International Economic Policy Reform, 2013)				decreasing debt to 90% of GDP (liquidity crisis) or 60% of GDP (insolvency)
VIPS Viable Insolvency Procedure for Sovereigns (Fuest et al., 2015)	ESM Treaty	• Not specified	• ESM provides shelter loans for three-year period • Seniority of liquidity provision	• Trigger based on the DSA • Restructuring not below sixty percent debt-to-GDP ratio • Aggregated majority voting
MRSDR Mechanism to Regulate Sovereign Debt Restructuring (German Council of Economic Experts, 2016)	ESM Treaty	• Not specified	• ESM financing includes maturity extension	• DSA-based trigger • Debt restructuring only as a second step if maturity extension insufficient • Aggregated majority voting

C. Legal Basis

This Section analyzes the legal basis of an ESDRF. Given that an enhanced framework for debt restructurings is inextricably bound to the ESM's function as a crisis resolution mechanism, two legal bases may be envisaged: EU law or international law (ESM Treaty).[90]

90. The European Commission noted in its Reflection Paper of summer 2017 that several methods for strengthening EMU's legal framework are possible, including by way of the EU Treaties and the EU institutions, an intergovernmental approach, or a mixture of both as is already the case today. *See Reflection Paper on the Deepening of the Economic and Monetary Union*, Eur. Comm. (May 31, 2017), https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf [https://perma.cc/X66A-R5JX].

1. EU law

As Ioannidis points out, "[i]n the field of debt, neither creditors nor Member States should expect solidarity."[91] Indeed, the current Treaty framework is centered around a market-based paradigm, which subjects euro area Member States to market forces by constraining central bank intervention (Article 123(1) TFEU)[92] or inter-country financial assistance (Article 125(1) TFEU).[93] From a primary law point of view, the main question when it comes to government debt restructuring within the euro area is whether the economic constitution prohibits, allows or even encourages it.

In this regard, one ought to consider that the no-bailout clause limits official financial assistance and that the framework for sovereign debt in the euro area relies on market logic.[94] As stated by the CJEU in the *Pringle* case*,* compliance with market discipline contributes at EU level to the attainment of a higher objective, namely maintaining the

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91. Michael Ioannidis, *Debt restructuring in the light of Pringle and Gauweiler – flexibility and conditionality in* ESCB LEGAL CONFERENCE 2016 (Oct. 2016), *available at* https://www.ecb.europa.eu/pub/pdf/other/escblegalconference2016_201702.en.pdf?e2dea3a78485afe4c70d5d5010f368be [https://perma.cc/2NBZ-E4NT].

92. Article 123(1) TFEU stipulates that:

> Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States [hereinafter national central banks] in favor of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

TFEU, *supra* note 19, art. 123(1).

93. Article 125(1) TFEU reads as follows:

> The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.

TFEU, *supra* note 19, art. 125(1). Of course, as explained above, the *Pringle* decision somewhat eroded the strict no-bailout principle.

94. *See* Case C-370/12, Pringle v. Government of Ireland, 2012 E.C.R. 756, ¶¶ 129-47 (interpreting Article 125 of the TFEU rather broadly regarding the establishment of the ESM).

financial stability of the monetary union.[95] The maxim of primary EU law is thus to preserve the incentives for Member States to pursue sound budgetary policies.[96] This rationale has to be respected not just in good times, but especially during economic downturns, where ESM support may become necessary. In the context of ESM lending, debt restructuring ensures that the role of markets is preserved, which is already reflected in the current Recital (12) of the ESM Treaty.[97]

A preliminary conclusion would thus be that the current framework for sovereign debt restructuring under the auspices of the ESM Treaty could be transferred into EU law and that such transfer would not raise serious legal concerns. Also, with respect to an enhanced ESDRF, which is further discussed below,[98] the legal assessment should not reach a different conclusion. First, giving a stronger role to the ESM with respect to debt sustainability analyses would follow the market discipline logic of Article 125 TFEU. Second, enhanced contractual provisions to mitigate holdout problems would make PSIs more orderly and should therefore serve the more general EU objective of increasing financial stability. Third, the creation of a dispute resolution function would mitigate the *ex-post* coordination failures in debt restructuring, thereby ensuring that the adverse effects of debt restructuring would be minimized to the greatest extent possible.

With regard to a concrete legal basis for a crisis resolution mechanism under EU law, Article 352 TFEU has been mentioned.[99] This "flexibility clause" provides for subsidiary powers[100] that enable the Union legislator to adopt an act of secondary legislation necessary to attain the objectives laid down by the Treaty.[101] The application of

95. *Id.* ¶ 135.

96. *Id.* at ¶¶ 136-39.

97. *But see* Paliouras, *supra* note 67, at 120-21 (noting that it remains within the remit of the sovereign's discretion to make the arguably complex decision in favor or against such measure).

98. *See infra* III.D., III.E., and III.F.

99. *See, e.g.,* EUROPEAN UNION COMMITTEE, THE FUTURE OF ECONOMIC GOVERNANCE IN THE EU, 2010-11, HL 124-II, at 113 (UK) (noting, however, "that it is very difficult to build [a sovereign debt restructuring mechanism] under secondary [EU] law").

100. Consolidated Version of the Treaty on European Union art. 5, June 7, 2016, 2016 O.J. (C 202) 18 [hereinafter TEU]. The principle of subsidiarity, as set out in Article 5 TEU, stipulates that the EU may not take action unless such action is more effective in attaining the Union's objective than action taken at national, regional or local level. *Id.*

101. *See* TFEU, *supra* note 19, art. 352. Article 352 requires the European Commission to propose a certain act, which the Council of the European Union has to adopt unanimously and

Article 352 TFEU in respect of the establishment of an ESDRF poses challenges in light of the conditions that must be met in order for it to be activated: (i) the action must be necessary to attain one of the EU's objectives, (ii) no existing provision of the Treaty provides for action to attain the objective, and (iii) the envisaged action must not lead to the EU's competences being extended beyond those provided for by the Treaties.[102] The ESM would then become one of the many EU agencies, without its own statute, its own capital, or a strong legal status.

This analysis suggests that the optimal legal basis for an improved crisis resolution mechanism—that includes the enhanced framework for sovereign debt restructuring proposed herein—would be the EU Treaties. First, as mentioned above, there are no obstacles in the current Treaty to insert new Articles on the ESM. Second, the Treaties provides both a legitimate and a sound legal basis for an important institution like the ESM–be it with or without the debt restructuring features discussed in this paper. Of course, Treaty change may remain a long-term objective. Hence, the next section argues that—over the short-term—the ESM Treaty may be a more realistic legal basis for an enhanced debt restructuring framework.

2. ESM Treaty

It may be necessary in the short to medium-term to capitalize on the existing legal framework to enhance the current framework for debt restructuring. As proposed for instance by the Committee on International Economic Policy and Reform, the ESM Treaty may be amended to effect certain contractual changes aimed at further alleviating holdout inefficiencies.[103] An amendment of the ESM Treaty would require unanimous agreement of all ESM Members (nineteen euro area Member States) and ratification, approval or acceptance of such amendment by these members, in accordance with their national

to which the European Parliament has to consent. National Parliaments, too, need to be involved in the legislative process under Article 352 TFEU, albeit their consent is not required. *Id.*

102. *Id.* Moreover, resorting to Article 352 TFEU means that all actions taken by the ESM and/or EMF must comply with the so-called *Meroni* doctrine, which essentially constrains the Union legislator in respect of the creation of agencies or bodies that enjoy large discretion. For the overview of the issues, *see e.g.,* Pieter Van Cleynenbreugel, *Meroni Circumvented? Article 114 TFEU and EU Regulatory Agencies*, 21 MAASTRICHT J. EUR. & COMP. L. 64, 79-80 (2014).

103. COMMITTEE ON INT'L. ECON. POL'Y AND REFORM, REVISITING SOVEREIGN BANKRUPTCY, (Brookings Institution, Oct. 2, 2013), 40.

constitutional requirements, which includes the involvement of national parliaments in some Member States.

While, therefore, the process entails some significant political steps, amending the ESM Treaty involves less complexity than revising the EU Treaties, as part of which referenda may have to be held in several euro area Member States.[104] Given that the ESDRF would make debt restructuring more transparent, rather than fundamentally changing the market logic that is already reflected in the current ESM Treaty, there should be no obstacles to making the amendments suggested below.

Of course, introducing an ESDRF via the ESM Treaty means that its scope of application would remain constrained to euro area countries and that the concerns created by having a crisis resolution framework outside the Treaty framework would linger on.[105] Hence, Treaty change, which also seems warranted in several other policy fields, should be the preferred legal vehicle for policy and lawmakers to enhance the functioning and resilience of EMU.

3. The European Commission's proposal to establish a European Monetary Fund

While not directly relevant for an ESDRF, it is recalled that the European Commission has released plans to transform the ESM into a European Monetary Fund ("EMF").[106] In its recent EMF proposal, the European Commission has proposed to resort to Article 352 TFEU, as a legal basis for establishing the EMF.[107] With this proposal, the European Commission sent a strong signal to the co-legislators that the strengthening of the EMU should be pursued progressively and, importantly, by making use of the existing Treaty framework.[108] Thus, while the European Commission does not lack determination, it has opted for a very modest proposal that reluctantly or deliberately

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104. This is why many scholars consider the ESM Treaty to be the better vehicle for sovereign debt reform; *see, e.g.,* Lee C. Buchheit, G. Mitu Gulati & Ignacio Tirado, The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings, (Jan. 22, 2013) (working paper), https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5485&context=faculty_scholarship [https://perma.cc/C5NK-K482].

105. *Id*. at 9.

106. *Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, COM (2017) 827 final (Dec. 6, 2017) [hereinafter EMF Regulation].

107. *Id*.

108. *Id*.

overlooks some of the essential legal and economic aspects of international crisis lending.[109]

First, the European Commission proposes not to transfer Recital (12) of the ESM Treaty into EU law, according to which an adequate and proportionate form of debt restructuring may be considered in exceptional cases.[110] Second, and closely linked to this point, the European Commission did not replicate the obligation for Member States to insert CACs in domestic government bonds in the EMF proposal.[111] Without further delving into the politics of the ongoing discussions, it should be noted that the EMF proposal—for whatever reason—would introduce an even higher degree of ambiguity with respect to the ESM's crisis management functions.

D. Institutional Aspects

The analysis of a suitable legal framework for an ESDRF is conducted against the backdrop of existing proposals,[112] as well as recent jurisprudence by the CJEU and the European Court of Human Rights ("ECtHR").[113] The Article assumes that, regardless of the legal basis chosen, the enhanced debt restructuring framework proposed

109. *Id.* Perhaps surprisingly, the European Commission's proposal is even more muted on the issue of government debt restructuring than the ESM Treaty: in recital (12), the ESM Treaty states that "[i]n accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme." Conversely, the EMF Statute makes no reference whatsoever to the possibility of a debt restructuring; *see Annex to the Proposal for a Council Regulation on the Establishment of the European Monetary Fund*, COM (2017) 827 final, (Dec. 6, 2017), [hereinafter Annex to the EMF Regulation].

110. ESM Treaty, *supra* note 42, recital (12).

111. *See* EMF Regulation, *supra* note 100, at (52). Rather, the European Commission noted in a Recital (52) of the EMF Regulation that '[t]his Regulation should not affect the commitment agreed between the Contracting Parties to the Treaty establishing the ESM pursuant to Article 12(3) of that Treaty, namely that collective action clauses must be included in all new euro area government securities, with a maturity above one year, in a way which ensures that their legal impact is identical.' *Id.* However, it can be argued that, once the ESM Treaty ceases to be in force, no obligation exists under international or Union law to insert CACs in euro area government bonds. While the European Commission has not further explained why it chose to propose the deletion of Article 12(3) of the ESM Treaty, its decision seems to reinforce the negative sentiment vis-à-vis PSI, given that CACs are the most effective means to secure debt relief.

112. *Cf.* Table 1.

113. *See infra* III.E.1.

herein would have to comply with EU law, as well as pertinent CEJU jurisprudence.[114]

In order to attain the objective of rendering future debt restructuring more efficient and more orderly, the ESDRF could have four different features that build on and complement each other. These features serve and are thereby organized under three different functions, namely a financial, an economic and a legal function. Table 2 illustrates these features and functions and explains how they are connected to one another. It is also noted that, akin to other proposals, such as the famous IMF blueprint for a Sovereign Debt Restructuring Mechanism ("SDRM"),[115] the scope of the ESDRF procedure would only pertain to government bonds rather than other debt instruments, such as loans or guarantees.[116]

Table 2: Matching the ESDRF's features and functions

Feature	Function	Description and objective(s)	*Status quo*
1. Activation of ESDRF in case of negative DSA	Financial function[117]	The activation of the ESDRF, and thus a government debt restructuring, should be required in exceptional cases as part of an ESM lending program, if the Member State's debt is	Very weak link between debt restructuring and ESM financial assistance program (Recital (12) ESM Treaty)

114. *See, e.g.,* Press Release, General Court of the European Union, Judgements in Case T-680/13, K. Chrysostomides & Co. and Others v. Council and Others, and T-786/14 Bourdouvali and Others v. Council and Others, *available at* https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-07/cp180108en.pdf [https://perma.cc/LS36-966U] (*inter alia* clarifying that EU institutions may be held accountable for their actions as part of ESM financial assistance programs).

115. *See* Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring* IMF PAMPHLET SERIES, 2002, *available at* https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf [https://perma.cc/68C4-SQY9].

116. *See* Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36 GEO. J. INT'L L. 299, 396.

117. *See infra* III.D.1.

		deemed unsustainable by the ESM Board of Governors (in line with existing IMF practices). It remains within the government's discretion to activate the ESDRF and the ESM Board of Governors to demand a debt restructuring: in other words, there should be no automatic debt restructuring.	
2. Enhanced majority voting complemented by an emergency procedure if a CAC vote fails	Legal function[118]	A (super-)majority of creditors must be in a position to approve or reject a debt restructuring plan against the will of a minority of holdouts. In exceptional cases, if a CAC vote fails, the Member State would use the power to override existing contractual arrangements in line with existing constitutional legal limits, subject to review by the ESDRF legal function.	Current Euro CACs lack full aggregation feature and no emergency procedure is in place in case a CAC vote fails (repeatedly).
3. Statutory immunization of ESM funds	Legal function[119]	ESM funds disbursed to Member States should be protected from litigation by immunizing them from	No legal safeguards exist to protect ESM funds from creditor

118. *See infra* III.D.2.
119. *See id.*

		attachment orders rendered by national courts. This would significantly reduce the attractiveness for litigious holdouts to attack debt restructurings that are accompanied by ESM financial assistance programs.	attachment attempts.
4. Dispute settlement process	Legal function[120]	All vertical (creditor-debtor) and horizontal (inter-creditor) disputes, for instance on the equal application of the haircut size across different types of debt instruments, shall be settled by the ESDRF legal function, i.e., a specialized chamber at the CJEU or a sovereign debt arbitration tribunal.	Disputes are currently resolved by national courts resulting in highly fragmented judicial review procedures across the euro area.

1. Financial function

Pursuant to Article 12(1) of the ESM Treaty, "[i]f indispensable to safeguard the financial stability of the euro area as a whole and of its Member States, the ESM may provide stability support to an ESM Member subject to strict conditionality." The ESM's lending decisions are the result of an intricate coordination procedure between different institutions, as set out in Article 13 of the ESM Treaty.[121] However, as

120. *See infra* III.D.2.

121. *See* ESM Treaty art. 13, Feb. 2, 2012, Eur. Comm'n DOC/12/3 states that, more specifically, stability support can only be granted after an assessment by the European Commission, in liaison with the ECB, of: (a) the existence of a risk to the financial stability of the euro area as a whole or of its Member States; (b) sustainability of public debt (wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF);

mentioned above, the provisions of the ESM Treaty[122] concerning government debt restructuring are characterized by "constructive ambiguity."[123] This approach, albeit being the result of a deliberate political decision at the height of the crisis, may in the medium to long-term undermine the reliability and credibility of the crisis resolution mechanism. The lack of formal or informal rules and practices to address situations when the Member State's debt is deemed unsustainable, may increase uncertainty, result in "gambles for redemption," and overburden the ESM in the case of large countries.[124]

The majority of SDRM proposals for the euro area therefore aim at addressing this supposed "gap" in the ESM lending framework. When juxtaposed to IMF practices, the ESM lending framework differs on two points.

- First, the IMF plays a catalytic, albeit informal, role as facilitator of debt restructuring negotiations. While the IMF Articles of Agreement do not require countries seeking to access Fund assistance to restructure their debts, the IMF encourages a member—wherever possible—to restructure unsustainable debt without a default.[125] Indeed, as explained by IMF staff, "[w]here the debts being restructured are claims held by the private sector, the debt restructuring is normally implemented at the outset of the program or as a condition for the program's first review."[126]
- Second, the IMF's Lending into Arrears ("LiA") policy limits Fund assistance to Member States that have not

(c) the actual or potential financing needs of the ESM Member concerned. Ultimately, however, the ESM's Board of Governors has the sole decision-making authority to grant stability support to an ESM Member.

122. *See id.,* recital 12.

123. *See* Guntram Wolff, *Europe needs a broader discussion of its future*, VOXEU, (May 4, 2018), https://voxeu.org/article/europe-needs-broader-discussion-its-future (talking about the "current constructive ambiguity on when [a] restructuring would happen").

124. As noted above, the first version of the ESM Treaty, which never entered into force, entailed rules to manage such situations; *see* Treaty Establishing the European Stability Mechanism, *supra* note 55.

125. *See, e.g.,* Sean Hagan, Maurice Obstfeld & Poul M. Thomsen, *Dealing with Sovereign Debt—The IMF Perspective,* IMFBLOG (Feb. 23, 2017), https://blogs.imf.org/2017/02/23/dealing-with-sovereign-debt-the-imf-perspective/.

126. *Id.*

> cleared arrears to private[127] or official creditors.[128] Through the LiA policy, the IMF can influence debt restructuring by (i) requiring a 'haircut' on investors' debt as part of the required domestic adjustment and (ii) playing an active role in encouraging restructuring negotiations.[129]

As Table 3 illustrates, the IMF, on the basis of its LiA policy, has developed a flexible yet clear framework to deal with situations for debt restructurings.

Table 3: The IMF's debt restructuring framework[130]

	2002 Framework	2010 Framework	2016 Framework
Debt is unsustainable	Definitive debt restructuring/ official concessional financing[131]	Definitive debt restructuring/official concessional financing	Definitive debt restructuring/ official concessional financing
Debt is sustainable but not with high probability		Definitive debt restructuring/ official concessional financing	Maintain non-Fund exposure (e.g. re-profiling or official financing) to improve debt

127. INT'L MON. FUND, IMF POLICY ON LENDING INTO ARREARS TO PRIVATE CREDITORS, (1999), *available at* https://www.imf.org/external/pubs/ft/privcred/ [https://perma.cc/8JJT-AQ89]. The LiA policy aims at reducing private investors' leverage in a debt restructuring deal by allowing the Fund to lend to countries even if arrears are outstanding. *Id.*

128. *Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors*, IMF POLICY PAPER, Dec. 2015, *available at* https://www.imf.org/external/np/pp/eng/2015/101515.pdf [https://perma.cc/Q3XP-D7JA].

129. Aitor Erce, *Sovereign Debt Restructurings and the IMF: Implications for Future Official Interventions* 3-4 (Fed. Res. Bank of Dallas, Working Paper No. 143, Apr. 2013), https://www.dallasfed.org/~/media/documents/institute/wpapers/2013/0143.pdf [https://perma.cc/JW2H-3KE4].

130. *See, e.g., IMF Survey: IMF Reforms Policy for Exceptional Access Lending*, IMF SURVEY, Jan. 16, 2016, *available at* https://www.imf.org/en/News/Articles/2015/09/28/04/53/sopol012916a [https://perma.cc/43YS-SM58].

131. "Official concessional financing" refers to special programs for highly indebted poor countries, and would thus be irrelevant in the context of (highly developed) euro area economies. For an explanation, *see e.g.*, *IMF Support for Low-Income Countries*, IMF (Oct. 11, 2017), http://www.imf.org/en/About/Factsheets/IMF-Support-for-Low-Income-Countries [https://perma.cc/QPD5-R6RJ].

		Invoke systemic exemption	sustainability and enhance safeguards for Fund resources
Debt is sustainable with high probability	Exceptional access without debt restructuring	Exceptional access without debt restructuring	Exceptional access without debt restructuring

Overall, one may argue that the ESM lending framework could benefit from closer alignment with the IMF's long-standing practices in sovereign debt restructurings. For one, additional clarity may allow investors to better anticipate the actions of the ESM. For another, the burden stemming from a debt crisis in the euro area may be more appropriately shared between the ESM, as contributor of liquidity assistance, and the private sector's contributions by agreeing to debt relief measures.

To this end, one may consider introducing an LiA policy for the ESM, as well as a stronger and more formalized role in facilitating negotiations between the private sector and the debtor state.[132] This could provide decisions taken by the ESM Board of Governors in this regard with more legitimacy, given that the debtor state's citizens as well as affected bondholders would have more clarity on the procedures that apply in the context of financial assistance programs in the euro area. For this purpose, one could also revisit the first draft of the ESM Treaty, which contains much clearer language on the procedure that ought to apply if countries' debt levels are deemed unsustainable and if ESM financing is requested.[133] Finally, the ESM may assume a more authoritative function in the context of analyzing the sustainability of a requesting Member State's public debt.[134] In the recent Meseberg Declaration on the future of EMU, the governments of Germany and France, for example, recalled that "any decision to

132. European Central Bank, *supra* note 15. Consequently, as mentioned in the ECB legal opinion, one may consider clarifying the ESM Treaty to cater to the "fundamental need for the ESM to be safeguarded against the moral hazard inherent in any crisis management mechanism." *Id.*

133. *See* ESM Treaty, *supra* note 42, art. 12(2).

134. *Id.* art. 13(1) (requiring the COM to assess whether the public debt of a Member State requesting financial assistance is sustainable).

provide ESM stability" includes a DSA.[135] Of course, what role the ESM's financial function may ultimately play—and how it then interacts with other EU institutions—is to be decided on a political level and can hardly be anticipated at the current juncture.

2. Legal function

As mentioned above, the crisis resolution mechanism under the auspices of the ESM lacks a legal function.[136] To ensure an independent review of debt restructuring measures by the legal function, the dispute resolution function should not be allocated to the body that also carries out the financial and/or economic function of the ESM.

Some may question the very rationale for a dispute resolution mechanism. However, one important lesson from the Greek PSI is that the EU's common response to the crisis was subject to review at the national level. Judges at civil or commercial courts in Germany, Austria, and Greece, as well as investment arbitrators at the International Centre for the Settlement of Investment Disputes ("ICSID"), were asked to assess the legality and proportionality of a debt restructuring that had been decided at the central Union level.[137] Moreover, the judgments rendered after the Greek PSI suggest that

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135. Meseberg Declaration – Renewing Europe's Promises of Security and Prosperity, Jun. 19, 2018, *available at* https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806 [https://perma.cc/954K-HVAJ].

136. *See* Gianviti et al., *supra* note 17, at 27. Out of the proposals referred to in Table 1, the ECRM proposed by Gianviti provides the most detailed description of a potential legal function an ESDRF could entail. It notes the following in this context:

> The legal body would have the authority to open a debt-restructuring procedure upon the request of a euro-area sovereign borrower and upon approval by the economic body that the debtor's debt is actually unsustainable. It would be a common judicial organ capable of sorting out and assessing claims by the parties, of ruling on disputes between creditors or between a creditor and the debtor, and of enforcing the decisions taken by the parties within the framework of the mechanism.
> *Id.*

Moreover, Bagchi elaborates on the legal framework for a debt restructuring mechanism in Europe, concluding that the ESM Treaty would provide the best legal basis for further reform. *See* Kanad Bagchi, *Proposals For a Future European State Bankruptcy Law*, SAAR BLUEPRINTS (2015), *available at* http://jean-monnet-saar.eu/wp-content/uploads/2013/12/Proposals-for-a-future-European-State-Bankruptcy-law.pdf [https://perma.cc/S5R7-SK6F].

137. For a typical domestic law bond of a euro area government in Ireland, *see, e.g.*, *4.50% Treasury Bond 2018*, NTMA (Oct. 16, 2007), http://www.ntma.ie/download/government_bonds/Ireland_4_5pc_Treasury_Bond_2018_Offering_Circular.pdf [https://perma.cc/6WKY-Z4UD].

foreign municipal courts are ill-equipped to address the intricate legal questions that arise in sovereign debt restructurings, notably because of the ambiguity regarding their jurisdiction, as well as the lack of substantive rules to balance investor rights with the foreign governments' public interest in restructuring its public debt.[138]

E. A Dispute Resolution Mechanism for Sovereign Debt Restructuring

Krueger,[139] in 2002, and Gianviti et al.,[140] in 2010, proposed the establishment of an independent legal body tasked with resolving both creditor-debtor and creditor-creditor disputes that arise in the course of a debt restructuring.[141] In the same vein, this Section presents two different options for establishing a dispute resolution mechanism for debt restructurings in the euro area: (i) a specialized chamber at the CJEU, or (ii) an independent arbitration mechanism at a newly-established body. Such dispute resolution mechanisms would be responsible for disputes relating to private bondholders' claims and would not allow the CJEU to second-guess judgments made by creditors regarding the viability of a restructuring.[142] A dispute resolution would, *inter alia*, be confronted with the following types of claims: verification of claims for the CAC vote; bondholder claims for performance of contract or damages in restructuring of non-CAC bonds or if CACs fail; inter-creditor disputes that arise from an alleged discrimination against specific bondholder classes; and disputes relating to the interpretation and application of a CAC as well as other clauses, such as *pari passu* clauses or bond acceleration clauses.

138. *See, e.g.,* Sebastian Grund, *The Legal Consequences of Sovereign Insolvency – A Review of Creditor Litigation in Germany Following the Greek Debt Restructuring*, 24 MAASTRICHT J. EUR. & COMP. L. 399 (2017) (analyzing post-PSI litigation in Germany). Among the many reasons as to why municipal courts and investment tribunals have a very mixed track-record are the lack of expertise, the lack of authority as well as the lack of rules that would allow these bodies to balance the creditors' right to repayment with the debtor's need to reduce the level of debt – indeed the central question of bankruptcy law.

139. *See* Krueger, *supra* note 115.

140. *See* Gianviti et al., *supra* note 17.

141. *See also* Bagchi, *supra* note 136 (advocating for an arbitration-like dispute resolution procedure).

142. For rationale behind these limits, see Hagan, *supra* note 116; Gianviti et al., *supra* note 17.

1. Dispute Resolution at the CJEU

It could be argued that the CJEU would be the most appropriate legal body to render the final decision in disputes that emerge in the wake of a debt restructuring in the euro area before national courts.[143] The CJEU is not only enshrined in EU law and enjoys strong statutory independence, it also benefits from a high level of legitimacy, as well as a sound governance framework. Given that the type of disputes the CJEU would have to adjudicate as part of the ESDRF, a specialized chamber, which would be established *ad-hoc* and comprise of experts in the field of sovereign debt, seems most appropriate.[144]

At the current juncture, the ESM Board of Governors and, after some escalation, the CJEU only have jurisdiction for disputes pertaining to the interpretation of the ESM Treaty.[145] However, this leads to gaps. First, the ESM Treaty only includes the requirement for the signatories to include CACs as agreed by the Economic and Financial Committee ("EFC")—it does not set out the details of the CAC.[146] Second, the ESM Treaty lacks provisions that would assign jurisdiction over disputes between the parties involved in a debt restructuring to the CJEU, or any other (quasi-)judicial authority—this choice is left with the Member States, which tend to choose their own courts as dispute settlement forum.[147] Given that any ESM program involves financial assistance from all nineteen Member States and taking account of the multiple nationalities of holders of euro area debt

143. *See* Sapir & Schoenmaker, *supra* note 17; Louis, *supra* note 46. Such a separate chamber may be established by virtue of Article 257 TFEU, which sets out the following: "[t]he European Parliament and the Council, acting in accordance with the ordinary legislative procedure, may establish specialized courts attached to the General Court to hear and determine at first instance certain classes of action or proceeding brought in specific areas." TFEU, *supra* note 19, art. 257.

144. For some inspiration regarding the establishment of such a specialist chamber, *see, e.g.,* Daniel Sarmiento, *The Reform of the General Court: Unleashing the Forces of Change*, EU LAW ANALYSIS (Dec. 15, 2015), http://eulawanalysis.blogspot.de/2015/12/the-reform-of-general-court-unleashing.html [https://perma.cc/XC3L-D6KF]. Whether changes to the Treaty would be required to cater for the establishment of a specialized chamber cannot be answered conclusively.

145. *See* ESM Treaty, *supra* note 42, at art. 37; *see also* Federico Fabbrini, *The Euro-Crisis and the Courts: Judicial Review and the Political Process in Comparative Perspective*, 32 BERKELEY J. INT'L L. 64, 72 (2014).

146. *See* Antonio Sainz de Vicuña, *Identical Collective Action Clauses for Different Legal Systems: A European Model*, *in* COLLECTIVE ACTION CLAUSES AND THE RESTRUCTURING OF SOVEREIGN DEBT 15-26 (Klaus-Albert Bauer, Andreas Cahn & Patrick Kenadijan, eds., 2013).

147. *See*, *e.g.*, Grund, *supra* note 34, at 255.

securities, one could see merits in enabling bond investors and the debtor country to make a final appeal to the CJEU.[148]

The main objective of providing the CJEU with jurisdiction over such bondholder disputes would be to mitigate externalities stemming from divergent national court decisions, thereby fostering consistency across the euro area.[149] Virtually all sovereign debt restructurings entail some expropriatory element, for the debtor country needs to renegotiate or unilaterally amend contractual agreement with its bondholders.[150] Thus, delicate questions pertaining to the protection of the creditors' property rights arise in the context of sovereign insolvency, which requires the state's public interest in attaining debt relief to be balanced against the investors' contractual right to be satisfied in full and on time.[151] Such questions should ultimately be addressed by a judicial authority at the European level with a view at harmonizing the standard of legal review in euro area debt restructuring.[152]

With respect to the substantive law applicable to the disputes, relevant national, as well as EU law, could be used. In this context, it is recalled that European (constitutional) laws have a common denominator, which could circumscribe the legal perimeter for debt restructuring measures: the European Convention on Human Rights

148. The problem with decentralized dispute resolution in the wake of euro area sovereign debt restructurings is for instance discussed by Grund, *see* Grund, *supra note* 138.

149. As stated above, the question of dispute settlement would only apply in the event of CACs failing to bind holdouts to a restructuring deal.

150. *See*, *e.g.,* Julian Schumacher, Christoph Trebesch & Henrik Enderlein, *Sovereign Defaults in Court: The Rise of Creditor Litigation* (CESifo Working Paper Series No. 6931, Mar. 7, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189997 [https://perma.cc/3SVD-GQBT].

151. For a discussion, *see, e.g.*, Patrick R. Wautelet, *The Greek Debt Restructuring and Property Rights. A Greek Tragedy for Investors?*, (July 2, 2013) (unpublished manuscript), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2373891 [https://perma.cc/J8FF-Y8ZM].

152. For a similar reasoning, see Hagan, *supra* note 116, at 382-90. Many European courts have adopted a broad interpretation of sovereign immunity while U.S. courts tend to look exclusively at the contractual agreement underpinning the debt instrument and award money judgements or injunctive remedies to any investors who undertakes to sue the insolvent sovereign. For an overview of municipal court decisions in Europe, *see, e.g.,* Grund, *supra* note 138. For US case law, see Republic of Argentina v. NML Capital, Ltd., 573 U.S. 134 (2014); Allied Bank Int'l. V. Banco Credito Agricola, 566 F. Supp. 1440 (S.D.N.Y. 1983). With respect to Greece, the German Federal Supreme Court granted immunity to Greece for its CAC Retrofit while the Austrian Supreme Court rejected its immunity and referred the case to the CJEU to determine the court's jurisdiction under the relevant provisions of EU secondary law. *See* Bundesgerichtshof [BGH] [Federal Court of Justice] Dec. 19, 2017, XI ZR 796, 2016 (Ger.); Oberster Gerichtshof [OGH] [Supreme Court] Dec. 20 2017, 10 Ob 37/17t (Austria).

("ECHR"). The Convention sets a certain minimum standard for the protection of bondholders' (property) rights and was transposed in the domestic laws of all euro area Member States.[153] Another potential basis for the judicial review of debt restructuring measures could be the EU Charter of Fundamental Rights ("CFR"), which belongs to EU primary law and is thus directly enforceable against all EU Member States.[154] However, the CFR only applies when EU law is implemented, typically excluding its applicability in sovereign debt restructuring cases.[155] Of course, if the ESDRF was to be enshrined in EU law, then it may also be relevant for disputes pertaining to sovereign debt restructurings.

In this context, the judicial review of official sector measures taken during the European sovereign debt crisis yielded some important insights as regards the boundaries for governments' and/or EU institutions' interference with private property rights.[156] Notably, one decision by the ECtHR and two by the CJEU shone light on the legal relationship between private investors and sovereigns (as well as their central banks).[157] First, following the Greek PSI,[158] the ECtHR was confronted with several thousands of bondholder claims for compensation for the haircut imposed by Greece. In the seminal *Mamatas v. Greece*[159] case, the ECtHR clarified important constitutional legal limits for signatories of the ECHR, holding that a haircut on privately held government debt is necessary and

153. For disputes not related to bondholders' property rights, the ESM Treaty, which would then be transposed into national law, could set out certain rules, for instance on the verification of creditor claims for the CAC vote.

154. Frank Emmert & Chandler Piche Carney, *The European Union Charter of Fundamental Rights vs. the Council of Europe Convention on Human Rights on Fundamental Freedoms – A Comparison*, 40 FORDHAM INT'L L.J. 1047, 1090 (2017).

155. *Id*. at 1171 (noting that "to the extent the Charter [of Fundamental Rights] might provide substantially better protection, the Member States are not bound by it when adopting or implementing their own law outside of the sphere of application of EU law").

156. René Repasi, *Judicial protection against austerity measures in the euro area: Ledra and Mallis*, 54 COMM. MKT. L. REV. 1123 (2017).

157. For a recent and compelling overview of the CJEU's jurisprudence on sovereign debt programs during the euro area debt crisis, *see* Claire Kilpatrick, The EU and Its Sovereign Debt Programmes: The Challenges of Liminal Legality, Eur. Univ. Inst. Dep't. of Law Working Paper 2017/14, Nov. 2017), http://cadmus.eui.eu/bitstream/handle/1814/48205/LAW_2017_14.pdf?sequence=1 [https://perma.cc/2NS3-NJ26].

158. *See supra* II.A. (discussing Greek debt restructuring).

159. Mamatas & Others v. Greece, No. 63066/14 Eur. Ct. H.R. (2016). More specifically, the judgement takes account of the fact that the market value of bonds has typically dramatically deteriorated in the run-up to a sovereign debt restructuring, implying that the face value should no longer serve as a benchmark for the creditors' property rights.

proportionate if there is an imminent risk of default and the haircut does not place an excessive burden on private investors.[160] Second, in *Accorinti v. ECB*,[161] bondholders challenged the ECB's carve-out from the PSI of 2012. The EU General Court decided that the ECB's preferential treatment in a debt restructuring was justified since it acquired the bonds in the public interest.[162] Third, in *Ledra Advertising v. European Commission and ECB*,[163] the CJEU had to decide whether EU institutions could be held liable for a haircut on Cypriot depositors, which they required as part of the financial assistance programs to Cyprus.[164] The CJEU found that while EU institutions must comply with the EU Charter of Fundamental Rights,[165] and hence respect the right to property, such a right is not absolute and can be limited on grounds of public interest provided that the limitations do not constitute a disproportionate and undue interference with the very substance of the right guaranteed.[166]

With respect to the procedural rules applicable to such disputes, the Rules of Procedure of the CJEU[167] should, in principle, provide a sufficient basis to create a specialized chamber for the resolution of sovereign debt disputes.[168] In this context, it should be mentioned that

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160. For a discussion of the judgement, *see,* Grund, *supra* note 34.

161. Case T-79/13, Accorinti & Others v. ECB, 2015 *available at* http://curia.europa.eu/juris/liste.jsf?num=T-79/13 [https://perma.cc/S8CW-RXMU].

162. *Id.* ¶ 92.

163. Case C-8/15, Ledra Advertising v. Commission & ECB, 2016, *available at* http://curia.europa.eu/juris/liste.jsf?language=en&num=C-8/15%20P [https://perma.cc/VBX3-R6P4].

164. *Id.* The legal basis for the challenge was under Article 340 TFEU. *See* TFEU, *supra* note 19, art. 340. The investors' challenged the decision by the two EU institutions to require the Cypriot government to impose the respective losses on depositors as part of the EU's conditions to grant financial assistance to Cyprus.

165. Charter of Fundamental Rights of the European Union art. 17, 2010 O.J. C 83, at 392.

166. *Ledra Advertising*, states that:

> In view of the objective of ensuring the stability of the banking system in the euro area, and having regard to the imminent risk of financial losses to which depositors with the two banks concerned would have been exposed if the latter had failed, such measures do not constitute a disproportionate and intolerable interference impairing the very substance of the appellants' right to property.

Ledra Advertising, Case C-8/15 ¶74.

167. Rules of Procedure of the Court of Justice of the European Union, 2012 O.J. (L 265) 1. In particular, one would need to consider amending Chapter 7 of the Rules of Procedure, which pertain to the different formations of the Court. *Id.* ch. 7.

168. *See, e.g.,* Daniel Sarmiento, *Reform of the General Court: An Exercise in Minimalist (but Radical) Institutional Reform*, 19 CAMBR. YRBK. OF EUR. LEG. STUD. 236 (2017).

the proposal to introduce specialized chambers as part of the institutional reform of the EU General Court, the CJEU's first instance, was ultimately rejected.[169] However, the discussion about advantages of specialized chambers will continue, not least since the CJEU itself has changed its position on the issue in the past.[170] Even if a specialized chamber will not see the light of day, conferring jurisdiction over government bondholder disputes to the CJEU would go far in ensuring harmonized dispute settlement procedures in cross-border sovereign debt disputes that inevitably emanate from debt restructurings—indeed, the lack of such mechanism was one of the central obstacles to establishing an SDRM on the international level.[171]

2. Establishing a Sovereign Debt Arbitration Mechanism

Another potential forum for the settlement of sovereign debt-related disputes would be an arbitral tribunal. In this respect, the late Professor Sandrock argued in favor of a stronger role for international arbitration in settlement of sovereign debt disputes against the backdrop of the Greek crisis.[172] Sandrock essentially argued that international arbitration has unjustifiably been dismissed by policymakers as a means of dispute resolution when sovereign debt is to be restructured.[173] Others have, for instance, discussed the potential advantages of arbitration in the context of the recent Puerto Rican debt restructuring.[174]

But how could such arbitration mechanism credibly be designed in the context of an ESDRF? First, a specialized arbitral institution for sovereign debt disputes could be established at the ICSID, which has a

169. *Id.* at 242.

170. *Id.* at 242-34.

171. Notably, *see* Hagan, *supra* note 116, 385 (noting that "[a]s work on the SDRM proposal progressed, it became increasingly clear that, no matter how streamlined its design, there would need to be a number of technical rules that it would be inappropriate to specify in the treaty itself").

172. *See generally* Otto Sandrock, *The Case for More Arbitration When Sovereign Debt is to Be Restructured: Greece as an Example*¸ 23 AM. REV. INT'L. ARB. 507 (2012).

173. *See id.* Others have been less positive and warned that subsuming sovereign bonds under the definition of "investment" may incentivize holdout investors to leverage their bargaining position by invoking Bilateral Investment Treaties ("BITs") against countries that seek to restructure their debts. *See, e.g.,* Michael Waibel, *Opening Pandora's Box: Sovereign Bonds in International Arbitration*, 101 AM. J. OF INT'L L. 711, 716-17 (2007).

174. Melika Hadziomerovic, Note, *An Arbitral Solution: A Private Law Alternative to Bankruptcy for Puerto Rico, Territories, and Sovereign Nations*, 85 GEO. WASH. L. REV. 1263, 1285 (2017).

long-standing history in adjudicating investment-related disputes,[175] or at least emulate its elaborate rules of procedure.[176] For instance, arbitrators could be selected from a preconceived list of experts in the field, as is the procedure for ICSID arbitration.[177] In addition, one may consider requiring a panel to consist of arbitrators from the country which underwent a debt restructuring, as well as arbitrators whose nationality is identical to the claimants', though this is currently not the procedure for arbitration cases before the ICSID.

A more contentious issue concerns the substantive law which the specialized arbitral tribunal would have to apply.[178] In this context, recent free trade agreements ("FTAs"), such as the Comprehensive Economic and Trade Agreement ("CETA"),[179] could serve as a source of inspiration, given that they include provisions on sovereign debt restructurings. CETA for example protects "negotiated restructurings,"[180] i.e., restructurings that have been approved by seventy-five percent of investors, from arbitration in investor-state tribunals. In light of this provision, two conclusions may be drawn. First, CETA limits investor-state arbitration to cases where the debt exchange did not attract sufficient investor support (referred to as "negotiated restructuring"), introducing a "check" on states not to

175. *See, e.g.,* ANTONIO R. PARRA, THE HISTORY OF ICSID (2nd ed. 2018); Andreas F. Lowenfeld, *The ICSID Convention: Origins and Transformation*, 38 GA. J. INT'L & COMP. L. 47 (2009).

176. For different views, see Sandrock, *supra* note 172, at 543; Waibel, *supra* note 173, at 728 (rejecting the role of investment arbitration).

177. *See* Chiara Giorgetti, *Who Decides Who Decides in International Investment Arbitration*, 35 U. PA. J. INT'L L. 431, 486, 447 (2013) (noting that "[i]n his choice of arbitrators, the Chairman of the ICSID Administrative Council is restricted to those people listed in a Panel of Arbitrators, which contains names of arbitrators selected by ICSID Contracting Parties and by the Chairman").

178. For some a discussion of issues that may arise in this regard, *see, e.g.,* Gregory D. Makoff, *Simplifying Sovereign Bankruptcy – A Voluntary Single Host Country Approach to SDRM Design*, CIGI PAPERS NO. 76, Sept. 2015, *available at* https://www.cigionline.org/sites/default/files/cigi_paper_76_0.pdf [https://perma.cc/9YKS-3T5N].

179. Comprehensive and Economic Trade Agreement, Can.-E.U., Oct. 30, 2016 [hereinafter CETA].

180. According to Annex 8-B CETA, a "negotiated restructuring means the restructuring or rescheduling of debt of a Party that has been effected through (a) a modification or amendment of debt instruments, as provided for under their terms, including, their governing law, or (b) a debt exchange or other similar process in which the holders of no less than seventy-five per cent of the aggregate principal amount of the outstanding debt subject to restructuring have consented to such debt exchange or other process." *Id.* at 332.

restructure opportunistically.[181] Crucially, the protection of negotiated restructurings is independent from the success of a potential CAC vote, implying that the state may also resort to other (contractual or statutory) measures as long as this is in agreement with a supermajority of investors.[182] Second, CETA implicitly acknowledges that investor-state arbitration may be a means to resolve disputes related to sovereign debt restructuring where contractual or other mechanisms have failed.[183] Consequently, under certain conditions, a CETA tribunal may—on the basis of the text of CETA—decide whether debt restructuring measures have unduly expropriated sovereign debt holders.

While an in-depth review of the merits of sovereign debt arbitration would go beyond the scope of this Article, it is clear that policymakers have already recognized a potential role for arbitration in balancing the investors' and the states' interests during economic and financial crisis.[184] Whether a similar logic could apply to sovereign debt restructuring seems worth exploring.

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181. *See, e.g.,* Kei Nakajima, *An Elusive Safeguard with Loopholes: Sovereign Debt and Its Negotiated Restructuring in International Investment Agreements in the Age of Global Financial Crisis*, 2016 INT'L REV. L. 1, 20 (2016).

182. This conclusion can be drawn from an analysis of Annex X of the CETA, which does not refer to the use of CACs but defines "negotiated restructurings" broadly:

> "negotiated restructuring" means the restructuring or rescheduling of a debt instrument that has been effected through (i) a modification or amendment of such debt instrument, as provided for under its terms, or (ii) a comprehensive debt exchange or other similar process in which the holders of no less than 75 percent of the aggregate principal amount of the outstanding debt under such debt instrument have consented to such debt exchange or other process.

CETA, *supra* note 179, annex X.

183. This follows from the fact that the CETA only excludes "negotiated restructurings" from the scope of dispute settlements in Annex X – *argumentum e contrario,* all other (coercive) government debt restructurings can be challenged before a CETA arbitration tribunal. *Id.* annex X.

184. For a discussion of the experience with CACs in the euro area and the envisaged introduction of single-limb CACs, see Christoph Grosse Steffen, Sebastian Grund & Julia Schumacher, *Collective Action Clauses in the Euro Area: A Law and Economic Analysis of the Airst Five Years*, CAP. MKTS. L.J. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318570 [https://perma.cc/G8EM-8KQF].

F. Enhancing the Contractual Framework

1. Enhancing the Euro CAC

To make debt restructuring more orderly, the current Euro CAC could be revised.[185] An enhanced Euro CAC could be modeled on the CAC standard developed by the International Capital Market Association ("ICMA") for international sovereign bonds,[186] which, according to the IMF, is now used in the majority of new bond issuances. [187] The key rationale of enhancing the Euro CAC is to ensure the success of a debt restructuring by reducing the incentives for holdout behavior.[188] This does not mean that debt restructuring would become more likely but rather that, if the decision to restructure debt is taken, the operation can be carried out in a smooth manner.[189] The different contractual enhancements presented in the following sections all cater to this overarching objective.

a. Introducing aggregation features and a single-limb voting procedure

To align the Euro CAC with the international standard, it would have to be equipped with more robust aggregation features designed to alleviate holdout inefficiencies.[190] The two-limb voting process of the current Euro CAC, which requires the debtor to achieve majority approval in each individual series *and* for the aggregate of outstanding bonds, would be replaced by a single-limb mechanism.[191] As a result,

185. *See infra* III.F.1. for an analysis of the Euro CACs' arguable shortcomings.

186. *See* ICMA, *supra* note 76.

187. *See* INT'L MON. FUND, *supra* note 76.

188. Mark Sobel, *Merits of single-limb CACs*, OFFICIAL MONETARY & FIN. INSTITUTIONS FORUM, July 10, 2018, *available at* https://www.omfif.org/analysis/commentary/2018/july/merits-of-single-limb-cacs/ [https://perma.cc/6ZEU-9QLA].

189. The benefits of resorting to CACs to restructure sovereign debt stem from the possibility to "cram-down" dissenting minority holdouts. CACs do not mean that the country is more likely to default; for an overview, *see, e.g.,* Christian Hofmann, *Sovereign-Debt Restructuring in Europe under the New Model Collective Action Clauses*, 49 TEX. INT'L L. J. 385, 444 (2014).

190. For the advantages of single-limb CACs over double-limb CACs, see *id.* at 404 (noting that "[the Euro CAC] establishes two conditions to be met cumulatively for the modification of the debt terms to succeed if the cross-series modification clause is invoked: A certain percentage of the accumulated bond debt that is subject to the aggregated vote must approve, and, in addition, a certain number of bondholders of each series must accept."). For other design flaws in the Euro CAC, see Giuseppe Bianco, *Collective Action Clauses in the Eurozone: One Step Forward, Two Steps Back*, 16 EUR. J. L. REFORM 713, 727 (2014).

191. *See, e.g.*, DEUTSCHE BUNDESBANK, *supra* note 14.

a proposed bond modification, and hence the restructuring plan, would have to be approved by a (super-) majority of seventy-five percent of the aggregate principal amount of the outstanding bonds.[192] This would reduce the likelihood of holdouts acquiring smaller series of sovereign bonds with a view at blocking the modification of these series under a double-limb voting mechanism.

Moreover, while the Euro CAC allows for "partial cross-series modifications," aimed at avoiding the blocking of small series, the procedure seems overly complex and difficult to use in practice.[193] In essence, this type of cross-series modification rests on a legal fiction, according to which the modification of certain blocked series is deemed successful if, within a pre-defined amount of certain other series, the required majorities are reached.[194] While this provision allows the debt restructuring to go ahead, holdouts will still hold the original claim and are not bound to the debt restructuring deal.[195] The ICMA Model CAC, in contrast, does not need such complex legal fictions to resolve holdout problems in individual series; it simply binds all dissenting bondholders to the proposed modifications.[196] With the objectives of increasing transparency, decreasing complexity, and ensuring the integrity of the CAC voting procedure, it seems warranted to also move to a single-limb, fully aggregated CAC standard in the euro area.[197] Indeed, as Sobel has recently noted, "[s]ingle-limb CACs will help tackle the hold-out creditor problem and limit ensuing litigation, which have often bedeviled restructurings" and "[e]uro area governments would be well advised to modernize the CACs in their sovereign bonds by including the single-limb feature."[198]

Indeed, if designed properly, an enhanced Euro CAC can guarantee a sufficient level of investor protection.[199] In the euro area,

192. *See* ICMA, *supra* note 76. For a discussion of the features of the ICMA CAC, see Leland Goss, *Sovereign Debt Restructuring Made Easy*, 32 INT'L FIN. L. REV. 62, 63 (2013).

193. *See* ESDM, *supra* note 69, art. 2.4.

194. *See* Hofmann, *supra* note 189, at 404-05.

195. For an explanation of this feature, *see* ALLEN & OVERY, GOVERNMENT BOND RESTRUCTURING "MADE IN GERMANY": THE RISE OF ANTI-HOLDOUT CLAUSES (2012), *available at* http://www.allenovery.com/SiteCollectionDocuments/Government%20bond%20restructuring.pdf [https://perma.cc/HJQ7-USCB].

196. *See* ICMA, *supra* note 76, at 4.

197. In support of this suggestion, *see, e.g.,* Bénassy-Quéré et al., *supra* note 27, at 13.

198. Sobel, *supra* note 188.

199. Regarding the enforceability of CACs in Europe, *cf. Assenagon Asset Management SA v. Irish Bank Resolution Corporation Ltd* [2012] EWHC 2090 (Eng.) (in this decision, the High Court of England and Wales concluded that in certain, extreme cases, resolutions passed

all countries have ratified the ECHR, which means that the same minimum level of protection of property rights applies in the whole currency union.[200] In this regard, the ECtHR has recently confirmed the legality of applying a single-limb CAC with full aggregation features in a sovereign debt restructuring inside the euro area.[201] Against this backdrop, it seems excessive to dismiss the enforceability of CACs on constitutional grounds.[202] Finally, the Euro CAC could—as does the ICMA CAC—leave the issuer the option to either apply a single or a double-limb voting mechanism, should there be jurisdiction-specific legal constraints with respect to conducting a single vote that applies across all series.

Heeding these calls, euro area finance ministers rendered a political declaration of intent at the Eurogroup meeting of December 4, 2018 "to introduce single limb collective action clauses (CACs) by 2022 and to include this commitment in the ESM Treaty."[203] This political agreement will need to be translated into a legal text in the near future.[204]

b. Majority voting on bond acceleration

An enhanced Euro CAC should also restrict the acceleration of the bond's principal payment in the event of default to a predefined majority of investors. The ICMA CAC already entails majority voting requirements with respect to the acceleration, requiring twenty-five percent of bondholders to consent.[205] With respect to euro area

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by the majority of bondholders to expropriate minority bondholders may be illegal under English contract law).

200. *See* Emmert & Carney, *supra* note 154.

201. *See* Mamatas & Others v. Greece, No. 63066/14 Eur. Ct. H.R. (2016).

202. Indeed, the aggregated CAC retrofitted to local-law bonds in the Greek PSI featured a 66.67% threshold for bond modifications to be successful. This means minority investors' rights were affected even more strongly than under the 75% threshold we propose in this paper (and which has become the standard for international sovereign bonds).

203. Council of the EU, *Term Sheet on the European Stability Mechanism Reform* (Dec. 4 2018), https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf [https://perma.cc/CMZ9-E6QL].

204. For a general analysis of (single-limb) CACs, see Grosse Steffen et al., *supra* note 184.

205. *See* ICMA, *supra* note 76, at Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes 16. The provision states the following:

> If any of the following events (each an "Event of Default") occurs and is continuing:

government bonds, this threshold could be set even higher, e.g., at fifty percent. As a consequence, holdout investors would be discouraged from buying distressed debt. This is because holdouts may accelerate a bond to demand repayment of interest and principal.[206] If acceleration becomes subject to approval by a certain number of investors, which is the case for most emerging market sovereign bond contracts,[207] the appeal to engage in such tactics is significantly reduced.[208]

The EFC Sub-Committee on EU Sovereign Debt Markets ("ESDM") that negotiated the Euro CAC in 2011 found that such provisions may run into serious legal difficulties in some euro area Member States, without however further specifying the nature and extent of these problems.[209] Given that the ICMA acceleration clause is deemed consistent with English and New York law, and given that these two jurisdictions have a relatively high standard of minority creditor and shareholder protection[210], there should be few legal concerns that acceleration features would infringe national constitutional law in the euro area.[211] Of course, further analysis may be required to confirm this assumption.

> then the holders of at least 25 per cent. in aggregate principal amount of the outstanding Notes may, by notice in writing to the Issuer (with a copy to the [Fiscal Agent/Trustee/other bondholder representative]), declare all the Notes to be immediately due and payable, whereupon they shall become immediately due and payable at their principal amount together with accrued interest without further action or formality. Notice of any such declaration shall promptly be given to all other Noteholders by the Issuer.

206. For the mechanics of acceleration clauses, see Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 147, 180 (2012). According to the authors, acceleration provisions vary a great deal. Some allow individual creditors to accelerate their obligations should an Event of Default occur. Most bonds today, however, provide that a vote of twenty-five percent of the bonds is required before acceleration can take place.

207. *Id*. at 163.

208. Indeed, the holdout creditor could only sue for the (immediate) repayment of coupon payments, which is typically dwarfed by the principal amount. Holding out would therefore become even more risky and financially unattractive, as the holdout would have to either buy a much larger stake in the sovereign's debt stock or convince other investors to join forces.

209. *See* ESDM, *supra* note 69, at 7. *Contra*, Hofmann, *supra* note 189, at 405-06 (suggesting that the Euro CAC also features acceleration provisions, which the authors could however not confirm when analyzing the legal text of the Euro CAC).

210. For an overview, see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Wishny, *Law and Finance*, 106 J. POL. ECON. 1113, 1155 (1998).

211. This assumption presents the Authors' view. Of course, whether acceleration features would clear potential constitutional law obstacles in every single Member State would require further in-depth research that would go beyond the scope of this Article.

c. Majority voting on stays of enforcement

As proposed by the IMF in 2002 in the context of the SDRM, an enhanced Euro CAC could enable a certain pre-defined majority of creditors, e.g., twenty-five or fifty percent, to impose a stay on enforcement proceedings by individual bondholders.[212] Stays are ubiquitous in domestic insolvency law in order to prevent a "rush to the courthouse" by creditors trying to attach the debtor's (remaining) assets.[213] In the sovereign context, a stay on an enforcement action is no doubt contentious and should be narrowly circumscribed to mitigate any adverse effects on financial transactions, especially those pertaining to derivative contracts, most notably credit default swaps ("CDS").[214]

At the same time, as the Greek PSI illustrated, even if a country opts for a market-friendly approach by retrofitting CACs, CDS are likely to be triggered.[215] If a majority of creditors decides to impose an enforcement moratorium with the objective of facilitating negotiations, the biggest threat would stem from the size of the CDS exposures, given that they could bankrupt the CDS protection seller.[216] Again though, as the Greek case implies, the CDS exposures may be overestimated, as well as the contagion risks inherent to a default event being triggered in one euro area country.[217]

212. For the IMF's proposal, see Hagan, *supra* note 116, at 363-68. Hagan notes that the context of the IMF's SDRM proposal, the idea of an automatic stay was originally conceived. However, it was perceived in the course of the negotiations that an automatic stay would constitute an unnecessary and inappropriate shift in legal leverage from creditors to debtors-one which, on the margin, could encourage (or be perceived as encouraging) defaults by debtors. *Id.*

213. *See generally*, Frank R. Kennedy, *The Automatic Stay in Bankruptcy*, 11 U. MICH. J.L. REFORM 175, 268 (1978).

214. *See* Anna Gelpern & Mitu Gulati, *CDS Zombies*, 13 EUR. BUS. ORG. L. REV. 347, 377 (2012).

215. *Id.*

216. *See id.*, at 350-46.

217. For an analysis, *see, e.g.,* Grzegorz Halaj, Tuomas Peltonen & Martin Schleicher, *How Did the Greek Credit Event Impact the Credit Default Swap Market?*, 35 J. FIN. STABILITY 136, 158 (2018) (finding very little discernible direct impact of the Greek credit event on CDS spreads overall, which provides evidence that the credit event was well anticipated by most market participants). If anything, the main lesson from the Greek Crisis has been to better regulate sovereign CDS. The Greek Crisis could be compared with the EU's "Short Selling Regulation." For a description of the Short Selling Regulation, see Regulation 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps, 2012 O.J. (L 86) 1. This Regulation essentially prohibits certain speculative transactions with sovereign CDS, referred to as "naked" or "uncovered" short selling. *Id.*

In any event, a stay on enforcement, agreed upon by a certain majority of investors, could significantly increase the prospect of a successful negotiation outcome, for uncooperative investors have little incentive to launch asset attachment attempts if their claims are, by virtue of contract, not enforceable for a certain limited period of time.[218] Some lessons may also be learned from the handling of very recent cases of sovereign debt distress, notably the case of Puerto Rico.[219] The law adopted by the US Congress to address Puerto Rico's debt crisis goes even further and imposes an automatic stay on all creditor action with the objective of facilitating an orderly debt restructuring.[220] While Puerto Rico cannot be compared to a euro area Member State, given the ambiguous constitutional relationship with the United States, the stay serves as an insightful example as to how holdout inefficiencies can be *ex-ante* deterred.[221]

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218. A rational holdout creditor would weigh her chances to successfully attach sovereign assets with costs for pursuing such enforcement attempts. If the enforcement is ex-ante restricted, it would not make economic sense for the holdout to launch proceedings.

219. For a general overview of the Puerto Rican debt restructuring, see Mitu Gulati & Robert K. Rasmussen, *Puerto Rico and the Netherworld of Sovereign Debt Restructuring*, 91 S. CAL. L. REV. 133, at ii (2017).

220. For an overview of Puerto Rico's debt restructuring, *see generally* Lorraine S. McGowen, *The Impact of the New Restructuring Law on Puerto Rico Creditors*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Aug. 20, 2016), https://corpgov.law.harvard.edu/2016/08/20/the-impact-of-the-new-restructuring-law-on-puerto-rico-creditors [https://perma.cc/8L78-W32S] (noting that "the automatic stay operates as a general moratorium and court-ordered injunction, and no court order is is necessary as the injunction is automatically triggered by the enactment of [Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA")].

221. More specifically, § 2194 of the Puerto Rico Oversight, Management, and Economic Stability Act imposes a stay on acts, such as:

> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the Government of Puerto Rico that was or could have been commenced before the enactment of this chapter, or to recover a Liability Claim against the Government of Puerto Rico that arose before the enactment of this chapter;
> (2) the enforcement, against the Government of Puerto Rico or against property of the Government of Puerto Rico, of a judgment obtained before the enactment of this chapter;
> (3) any act to obtain possession of property of the Government of Puerto Rico or of property from the Government of Puerto Rico or to exercise control over property of the Government of Puerto Rico;
> (4) any act to create, perfect, or enforce any lien against property of the Government of Puerto Rico;

Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C.S. § 2194(a)(1-4).

This said, in a monetary union of financially highly developed economies, the euro area, subtler and less invasive methods to achieve the objective of a stay may be preferable. In this respect, the UK Debt Relief Act 2010[222] could serve as a blueprint for European lawmakers. In essence, this UK law limits the amount recoverable in respect of a claim against the sovereign debtor to the level agreed internationally as part of a debt relief deal.[223] Consequently, holdouts may not force a country into paying more than it had paid to the restructured creditors, thereby *ex-ante* reducing the appeal of engaging in speculative litigation.[224] While the UK Debt Relief Act applies to countries that have participated in the Highly Indebted Poor Countries ("HIPC") initiative, its technique could well be emulated in the ESM Treaty framework.[225] For instance, one may consider stipulating in the ESM Treaty that creditors shall not recover more than the market value of their bonds at the time of the restructuring offer being accepted by creditors. This would discourage holdout litigation in the euro area.

2. Immunizing ESM funds from holdout litigation

In 2013, Buchheit et al. put forward an elegant and straightforward proposal to improve the euro area crisis resolution mechanism, which would complement the ESDRF advanced herein.[226] In essence, they propose to insert a new provision into the ESM Treaty, which immunizes the assets of a euro area country from creditor

For further analysis, *see*, *e.g.*, Michael Cooley, PROMESA Shields Puerto Rico Behind a New Automatic Stay, BRYAN CAVE LEIGHTON PAISNER: GLOBAL RESTRUCTURING & INSOLVENCY DEV (July 21, 2016), http://bankruptcycave.com/promesa-shields-puerto-rico-behind-a-new-automatic-stay/ [https://perma.cc/JL9N-333R].

222. Debt Relief (Developing Countries) Act 2010, c. 22, § 3 (UK) [hereinafter UK Debt Relief Act]. Note that a similar act has been introduced in Belgium and France too; *see* Lucas Wozny, *National Anti-Vulture Funds Legislation: Belgium's Turn*, 2017 COLUM. BUS. L. REV. 697, 747 (2017).

223. For an analysis, see UK Debt Relief Act, *supra* note 222, § 3.

224. Wozny, *supra* note 222, at 742.

225. Of course, one would need to analyze specific constitutional constraints to imposing limits on bondholder recovery rights in the nineteen-euro area Member States. However, positive signals regarding the legality of such recovery limits come from Belgium, where the Constitutional Court has rejected a legal challenge against a law that limits the enforcement of sovereign debt in specific circumstances. *See* Bodo Ellmers & Antonio Gambini, *Justice prevails at the Belgian Constitutional Court: Vulture law survives challenge by NML Capital*, Eurodad Newsletter (June 5, 2018), https://eurodad.org/vulture-funds-blog [https://perma.cc/2GSD-7LRF].

226. Buchheit *et al*., *supra* note 104, at 8. A similar proposal has been put forward by Bagchi, *supra* note 136, at 15.

attachment if that country was engaged in an ESM-supported adjustment program.[227] As the authors outline, inserting such a provision would ensure that financial support provided by the ESM is not diverted to the repayment of existing debt obligations, that beneficiary states can deflate the expectations of holdouts to extract preferential treatment and that the euro area becomes a safe harbor for recipient states to hold assets and conduct their financial affairs during times of crisis.[228] Such immunization of ESM funds would provide for an additional layer of protection, complementing other elements of the ESDRF and with the overall goal of minimizing holdout inefficiencies and legal uncertainty. Given that the insertion of such a provision would simply require an amendment to the ESM Treaty and that there are international precedents for using such technique in the context of debt restructurings,[229] the authors of this Article strongly support the proposal.

IV. CONCLUDING REMARKS

The purpose of this Article is to contribute to the debate on reforming the EMU. More specifically, it discusses the legal aspects of government debt restructurings in the euro area and analyzes how a revised framework could make restructurings more orderly, fair, and predictable. While several proposals have been advanced in existing literature, the legal intricacies associated with such mechanism have

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227. COMM. ON INT'L. ECON. POL'Y AND REFORM, *supra* note 103, at 40. The Committee suggests adding the following Article to the ESM Treaty:

> Immunity from judicial process
> 1. The assets and revenue streams of an ESM Member receiving stability support under this Treaty which are held in, originate from, or pass through the jurisdiction of an ESM Member shall not be subject to any form of attachment, garnishment, execution, injunctive relief, or similar forms of judicial process, in connection with a claim based on or arising out of a debt instrument that was eligible to participate in a restructuring of the debt of the beneficiary ESM Member after the effective date of this Treaty.
> 2. The immunities provided in the preceding paragraph shall automatically expire when all amounts due to the ESM from the beneficiary ESM Member have been repaid in full.

Id. at 40.

228. *Id.* at 8-9.

229. *See* Buchheit *et al.*, *supra* note 104, at 9-10 (noting that the European Union immunized Iraqi assets in 2003 in order to facilitate a debt restructuring in Iraq without interference by holdout investors).

received little to no attention. The idea behind this paper is our conviction that the unparalleled degree of legal, political, and economic integration between euro area Member States would allow for a more progressive approach to enhancing government debt restructuring than is currently foreseen at the European or international level.

A well-designed framework could fulfil several functions. On the one hand, it may cater for a more transparent approach to address sovereign debt sustainability crises, replacing a regime that is fraught with ambiguity that is dangerous rather than constructive. On the other hand, it could promote an orderly process and reduce the costs of sovereign debt restructuring by shielding sovereigns from disruptive legal action whilst ensuring an appropriate degree of protection for holders of euro area debt securities. From a technical point of view, euro area governments may resort to existing statutory instruments, such as the ESM Treaty, or indeed EU law, to mandate the inclusion of enhanced contractual clauses in government bonds. Complementing these contractual improvements, this Article also discusses two options for a dispute settlement mechanism: a specialized chamber at the CJEU or an arbitral tribunal.

One should not fall prey to the illusion that inefficiencies, risks, and deadweight losses associated with government debt restructurings can be "regulated away." However, an informed discussion about the ways in which the existing framework can be improved seems indispensable to ensure a more resilient, transparent, and legitimate framework to address sovereign debt crises in the euro area.