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Towards a "Rule of Law" Approach to Restructuring Sovereign Debt

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In a landmark vote, the United Nations General Assembly overwhelmingly decided on September 9 to begin work on a multilateral legal framework—effectively a treaty or convention—for sovereign debt restructuring, in order to improve the global financial system. The resolution was introduced by Bolivia on behalf of the "Group of 77" developing nations and China. In part, it was sparked by recent litigation in which the U.S. Supreme Court held that, to comply with a *pari passu* clause (imposing an equal-and-ratable repayment obligation), Argentina could not pay holders of exchanged bonds without also paying holdouts who retained the original bonds. That decision was all the more dramatic because the holdouts included hedge funds—sometimes characterized as "vulture funds"—that purchased the original bonds at a deep discount, yet sued for full payment.

Regardless of what one thinks of that Supreme Court decision, there is a critical need for a sovereign debt restructuring convention. Sovereign debt problems must be addressed systematically for two reasons, of which the first is to avoid the high cost of having to bail out financially troubled nations. As the financial woes of Greece and other European Union countries have shown, that cost can be onerous both to governments and individuals. The European Union, the International Monetary Fund (IMF), and many of the world's leading central banks have essentially been forced to underwrite EU-nation bailouts in order to restore financial market confidence. And citizens of the bailed-out nations have been forced to accept harsh austerity measures as a condition of the bailouts, leading to riots, strikes, and widespread anger.

The second reason that sovereign debt problems must be addressed systematically, through a legal framework, is that (absent such a framework) the only alternative to a bailout is likely to be a default. Yet the growing interrelationship between country debt and financial markets increases the risk that a debt default will trigger a systemic economic collapse. This reveals a phenomenon viewed until recently as limited to large banks—the problem of "too big to fail." A bank whose default could trigger an economic domino effect is, or at least may be perceived to be, too big to fail. It therefore must be bailed out by public funds. This can foster moral hazard: anticipating a bail-out, the bank may lack incentive to take a prudent economic course. Countries, even those as small as Greece, can likewise be seen as too big to fail if their default could trigger wider economic collapse. That too can foster moral hazard. The Greek government, for example, did little to impose fiscal austerity even as debts accumulated.

So what would a sovereign debt restructuring convention look like? Effectively, it would be an international treaty that establishes debt restructuring protocols. The most well-known historical example was the IMF's proposed sovereign debt restructuring mechanism, which was originally conceived by scholars (including the author of this blog; *see* Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach, 85 *Cornell Law Review* 956 (2000)). Whatever example is used, any such convention should have at least two primary goals: a mechanism to penalize

creditors (such as vulture funds) who strategically hold out from fair settlements, hoping that the imperative to settle will persuade others to grant the holdouts more than their fair share; and an incentive to attract sufficient voluntary funding to enable the settlement to work.

The first goal can be achieved by a form of "super-majority" voting on the settlement, in which the vote by the overwhelming majority of similarly situated creditors can bind the few dissenting parties. This is the tried-and-true method by which insolvency law successfully, and equitably, addresses the holdout problem and achieves consensual debt restructuring. Although similar clauses (so-called collective action clauses) are sometimes included in bond contracts, they rarely address problems that go beyond their own bond issue. Moreover, the reality is that many sovereign bond contracts lack these types of clauses, notwithstanding years of discussion about including them. *See* Steven L. Schwarcz, Sovereign Debt Restructuring Options: An Analytical Comparison, 2 *Harvard Business Law Review* 95 (2012) (comparing collective action contracts and a statutory approach).

The second goal—the incentive to attract voluntary funding—can be achieved by enabling financiers of a settlement to be repaid before other creditors. All creditors are protected because if the amount of this financing is too high or its terms are inappropriate, the financing will not receive the overwhelming approval needed to bind all creditors.

Such a consensual restructuring would not undermine the rule of law, as would an attempt by a nation to unilaterally impose a "haircut" on its bonds. Nor should it increase sovereign borrowing costs. A nation whose debt has been restructured should be able to borrow at attractive rates. In the non-sovereign context, for example, the lending rates to restructured companies are much lower than the rates charged before the restructuring.

Ironically, the United States opposed the U.N. resolution on the grounds that an international sovereign debt restructuring convention would be likely to create economic uncertainty. That stance is rather hard to substantiate, especially when one recognizes that such a convention is effectively based on the same principles and legal rules that govern corporate debt restructuring under U.S. bankruptcy law. *See, e.g.*, Steven L. Schwarcz, "Idiot's Guide" to Sovereign Debt Restructuring, 53 *Emory Law Journal* 1189 (2004) (describing why, and how, the same rules of law that underlie Chapter 11 corporate debt restructuring should also apply to sovereign debt restructuring). The reality is that an international sovereign debt restructuring convention should benefit developed nations as much as developing ones. As finance becomes more intertwined, most nations will become too big to fail. Without an effective sovereign debt restructuring mechanism, we will all end up subsidizing those nations that lack the political will or ability to be fiscally responsible.