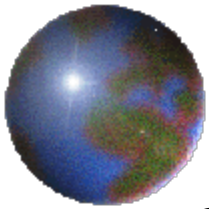

Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign Debt Tribunal

Consultation on "Policy Options for Dealing with the Impact of the Financial Crisis on the External Debt of Developing Countries"

Seventh UNCTAD Debt Management Conference and DMFAS Advisory Group Meeting
November 13, 2009
United Nations Office at Geneva

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Financial Crises and Sovereign Debt Restructuring

- In financial crises, compelling need for an effective mechanism for resolving sovereign debt restructurings
- Need to address sovereign debt issues in timely, orderly and predictable manner
- Basic issue—no insolvency regime applicable to sovereigns (i.e., no Chapter 11-type procedure for countries)
- But globalization of finance means that many more actors are involved in these debt restructurings, especially on creditor side
- Also financial crises can spread more rapidly around the globe affecting multiple sovereigns at same time
- Current sovereign debt machinery not adequate for present circumstances—need for reform

Sovereign Debt Restructuring Reform: State of Play

- Basic issue—need for more orderly, efficient and predictable process
- Four major existing or proposed approaches for reform
  - "Statutory" approach—earlier IMF Sovereign Debt Restructuring Mechanism (SDRM) proposal
  - "Contractual" approach—collective action clauses (CACs)
  - Voluntary approach—Codes of Conduct
  - Existing institutions—Paris Club and London Club

Sovereign Debt Restructuring Reform: State of Play (cont'd)

- These approaches raise certain issues
  - **Statutory Approach**: an issue raised in prior debate was whether this approach could succeed if official institution with lending function was central to its implementation
  - **Contractual Approach (CACs)**: deals with a specific inter-creditor issue—i.e., how to bind minority holdouts among creditors—but not issues between borrower and its lenders (i.e., sovereign and its creditors)
    - also issue of large existing stock of non-CAC debt
    - presumes continued centrality of capital markets for sovereigns
  - **Codes of Conduct:** essentially voluntary in nature, so does compliance depends too much on good will of parties?
    - Note such good will may be lacking in many restructurings
  - **'Club' Approach**: does it involve (and bind) all of the relevant parties, especially in world of more diverse creditor interests and constituencies? Does it ensure predictability, transparency?

Proposal for Creation of a Sovereign Debt Tribunal

- Precedent: one element of IMF's SDRM proposal was "Dispute Resolution Forum"
- Recent example: Iraq restructuring (verification/ reconciliation of claims)
- While comprehensive approach for sovereign debt restructuring may represent ultimate goal, in meantime need to develop pragmatic approach that can be implemented in near future
- Proposal for sovereign debt tribunal is a project of and has been approved by the International Insolvency Institute, a leading organization of international insolvency professionals from around the globe (www.iiiglobal.org)

Proposal for Sovereign Debt Tribunal (cont'd)

- Advantages of Sovereign Debt Tribunal
  - **Independence**: by virtue of its set-up as autonomous body, tribunal and arbitrators not beholden to one party, one set of interests, or one particular institution
  - **Expertise**: draws on a standing pool of arbitrators with experience and expertise in sovereign debt and other relevant areas, thereby giving confidence to stakeholders if and when they have disputes
  - **Neutrality**: neutral forum provides for "de-emotionalization" of disputes
  - **Certainty/Predictability:** as to process issues, provides structure and cohesion to dispute resolution process for sovereign restructurings.
  - **Volition of Parties**: original decision to include arbitration provision and design of arbitration clause is based on consensus among key stakeholders (note parties can also agree to arbitration later)

Where to Situate Sovereign Debt Tribunal

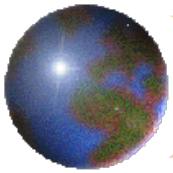
- Existing arbitration institution (e.g., ICC, LCIA, etc.)?
- Multilateral institution (e.g., World Bank, IMF, etc.)?
- ICSID?
- International Court of Justice?
- NGO proposal for ad hoc arbitration on case by case basis?
- UN?

Where to Situate Sovereign Debt Tribunal (cont'd)

- Basic requirements
  - International institution of sufficient standing—needs to have credibility and strong reputation
  - Institution which is not actual or potential creditor to sovereigns
- Need to gain widespread acceptance of choice of institution among relevant stakeholders

Establishing the Tribunal: Initial Steps

- If tribunal to be housed at existing institution, such institution can assist in selection of appointment panel or in direct appointment of arbitrators
  - see, e.g., SDRM model
- Election of president of tribunal—key first step
- Duties of president
  - Draft procedural rules
  - Decide on number of arbitrators for each case
  - Appoint arbitrators for each case



Subject Matter Jurisdiction of Tribunal

- Duties can be manifold
- Depends on ambitions of how far to extend influence of tribunal
- But fundamentally depends on what is delineated by parties—creditors and sovereign—in relevant debt instrument (e.g., bond indenture, etc.)

Subject Matter Jurisdiction of Tribunal (cont'd)

- Arbitration clause as a product of interaction between issuer and investors/underwriters
- Minimum: verification of claims and voting issues
- Will jurisdiction be confined to just narrow, technical legal issues? E.g.,
  - Legal validity of each claim, or
  - Legal validity of sovereign's proposal—i.e., is it consistent with applicable law

Subject Matter Jurisdiction of Tribunal (cont'd)

- Other potential issues for tribunal
  - What constitutes "sustainable debt" in context of a particular restructuring
    - practical issue: to what extent would widely agreed upon and understood methodology for debt sustainability analysis be helpful to arbitration process?
  - Whether underlying economic and financial assumptions are reasonable
  - Whether commencement criteria for invoking arbitration mechanism have been properly satisfied
  - Whether parties have engaged in good faith negotiations
  - Feasibility and/or reasonableness of restructuring plan
  - Whether debt is "odious debt"—but note important caveats on this subject

Who is to be Bound by Tribunal's Decisions

- Basic rule—only those creditors whose underlying debt instrument contains arbitration clause
- Issue of inter-creditor equity
- But limitation on applicability of arbitral ruling where no arbitration clause in debt instrument

Triggers for Invoking Arbitration

- Possible Triggers
  - Announcement of default
  - Default under relevant debt documents
  - Consider whether "imminent insolvency" to be included
- Who Can Pull Trigger
  - Will sovereign be willing to be subjected involuntarily to arbitration?
  - Sovereign alone or sovereign and creditors acting in unison?
  - Yet contractual freedom of parties to decide this issue

Governing Law and Applicable Insolvency Rules and Principles

- Law of a particular jurisdiction?
- If so, any role for public international law
- Issue of inter-creditor equity where bonds issued under laws of different jurisdictions (NY law, UK law, German law, etc.)

Governing Law (cont'd)

- Specific insolvency rules and principles
  - Not one jurisdiction, but "law merchant"
- General principles of insolvency set by multilaterals
  - UNCITRAL, World Bank, IMF texts on insolvency law
  - But need to adapt global standards from commercial context to sovereign context

Representation of Creditors in Arbitral Proceeding

- Need to avoid unwieldy process with too many parties participating
  - Would undercut one of key advantages of arbitration mechanism—efficiency of resolution
- Debt instrument would need to specify mechanism for creditor representation in arbitral proceeding
- Who will represent creditor interests
  - Creditors' committee(s)?
  - Indenture trustee for bondholders?
  - Major creditors?

Mediation as Precursor to Arbitration

- General attractiveness of mediation as non-confrontational approach to dispute resolution
- Will mediation be formal prerequisite to invoking arbitration?
- Potential role for mediation regardless of whether formal prerequisite
- Can serve as complement to an ongoing restructuring negotiation
- But mediation must be time-bound process—cannot drag on without clear endpoint
  - Otherwise can be used as delaying tactic by one of parties

Financing and Support for Tribunal

- Need for sponsoring organization to provide secretariat and office space
- Cost of any particular arbitration (including fees of arbitrators) to be borne by parties
  - not unlike what happens in a commercial arbitration
- Arbitration can be expensive process so parties need to factor into decision as to whether to arbitrate

Extraordinary Restructuring Solutions: Dealing with Financial Distress in the Real Economy in Wake of Global Financial Crisis

- Global financial crisis has created a new set of issues for corporate indebtedness in real economy (which could become sovereign debt concerns if not resolved satisfactorily)
  - Lack of liquidity to finance reorganizations and depressed economic activity leading to possible misalignment between supply and demand
- Need for quicker responses than conventional restructuring solutions
- Calls for "Extraordinary Restructuring Solutions"—ability to mobilize interim or bridge finance in larger amounts than may be normally available, ability to work out restructuring solutions on expedited basis, and ability to bring to bear necessary restructuring expertise and experience in real time
  - International Insolvency Institute is undertaking project to recommend new approaches that governments can adopt in order to provide for "Extraordinary Restructuring Solutions"

Conclusion

- Sovereign Debt Tribunal as attempt to develop pragmatic approach to get reform process underway
- Depends on prior voluntary contractual agreement of parties to a sovereign financing—i.e., not a mandatory mechanism in all cases
- Necessary to develop new reform approaches as globalization increase number of actors and complexity in sovereign finance
- Sovereign Debt Tribunal as possible confidence-building measure for ultimately embracing broader sovereign restructuring reform objectives