THE MODEL LAW: AN UNDER-THEORIZED APPROACH TO SOVEREIGN DEBT RESTRUCTURING

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I. INTRODUCTION

Both sides of the debtor-creditor divide have good reason to seek efficient mechanisms for dealing with insolvency. In the absence of such mechanisms, debtors are unable to obtain a discharge of their obligations. Moreover, legal uncertainty causes borrowers to wait longer than they should before they seek a restructuring, causing debts to pile up.[1] Creditors, meanwhile, must fight amongst themselves to get whatever they can, and as fast as they can, therefore reducing the likelihood of an orderly distribution of assets and creating stark differences between winners, who are paid in full, and losers, who recover no value. Worse still, a drawn-out restructuring forces creditors to incur costs, both in the form of paid advisers (e.g. bankers, lawyers, and consultants) and in the form of the opportunity costs attendant upon a delayed payout of interest and principal. Finally, legal uncertainty creates opportunities for holdout creditors to extract value from debtors by refusing to lend their votes to restructuring plans and threatening debtors with costly litigation. These issues apply with the greatest force to private sovereign debt contracts, which are the focus of this annotation. Recent scholarship suggests two solutions: (1) contractual innovations to facilitate the orderly restructuring of debt contracts, and (2) a comprehensive Sovereign Debt Restructuring Mechanism (SDRM) to act as a supranational bankruptcy court. Recently, however, a new school of thought, known as the Model Law approach, has emerged, proposing a jurisdiction-level insolvency regime devoted to sovereign debt workouts. This third approach to sovereign debt restructuring offers a promising alternative to the less satisfying contractual and SDRM options. This annotation discusses the deficiencies of the contractual and SDRM solutions before examining proposals for the Model Law

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1. This is known as the too little, too late problem. COMM. ON INT'L ECON. POLICY & REFORM, BROOKINGS INST., REVISITING SOVEREIGN BANKRUPTCY 6 (2013), https://perma.cc/U2SJ-EH6H.

approach, ultimately suggesting the use of this under-examined mechanism to achieve more effective enforcement of debt restructuring.

II. THE CONTRACTUAL SOLUTION

One theory for dealing with intercreditor and creditor-debtor coordination postulates that sovereign bond contracts provide insufficient guidance about what should be done in case of default.[2] The basic problem, in this view, is contractual uncertainty, and the solution is to clarify contract terms. Existing contracts lack provisions for matters as simple as a communication center for bondholders to seek redress, a stay on litigation pending resolution of the default, or a decision rule to facilitate restructuring.[3] Moreover, those provisions which do exist are often subject to interpretive issues. Thus, the *pari passu* clauses found in some bonds, which provide that they shall rank at par or higher than any other debt obligations of the sovereign, may not give any guidance about what kinds of preferences would violate the clause, or, for example, whether a de facto rather than a legal change in payment priority qualifies as a breach of the provision.[4]

The most popular contractual solution to the holdout problem is a collective action clause (CAC).[5] These clauses provide that a specified threshold number of bondholders must agree to a particular action before it can be carried out. Thus, a majority restructuring collective action provides that some supermajority of bondholders can agree to amend the critical payment terms of the contract—such as principal amount, interest rate, or maturity—in order to force

2. Barry Eichengreen, *Restructuring Sovereign Debt*, 17 J. ECON. PERSP. 75, 83 (2003).

3. *Id.*

4. The answer to this last question remains unclear. *See* Ajdler v. Province of Mendoza, No. 17-cv-1530 (VM), 2017 WL 3635122 at *9–*10 (S.D.N.Y. Aug. 2, 2017) (emphasizing that extraordinary circumstances are necessary to find a breach of a *pari passu* clause); White Hawthorne, LLC v. Republic of Argentina, No. 16-cv-1042 (TPG), 2016 WL 7441699 at *3 (S.D.N.Y. Dec. 22, 2016) (determining that a debtor's mere payment to certain creditors ahead of others does not constitute a breach of a *pari passu* clause); Lee Buccheit & Andrés de la Cruz, The Pari Passu Fallacy—Requiescat in Pace (Jan. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm? abstract_id=3108862 (discussing decisions from the U.S. District Court for the Southern District of New York regarding when a debtor will and will not be found to be in breach of a *pari passu* clause).

5. Lee Buccheit et al., *How to Restructure Sovereign Debt: Lessons from Four Decades* 19 (Peterson Inst. for Int'l Econ., Working Paper 19-8, 2019), https://www.piie.com/system/files/documents/wp19-8.pdf.

would-be holdout creditors to restructure.[6] Likewise, a majority enforcement clause requires that a litigation decision be made by a predetermined number of bondholders.[7]

CACs have now become standard operating procedure in bonds issued under New York and English Law.[8] However, they remain untested in the crucible of a restructuring. Moreover, it does not appear that the benefits of CACs, in the form of more orderly debt workouts, are being factored into the price of the bonds. One might expect that a collective action clause requiring a high threshold would command a higher price, since the more difficult a bond is to restructure, the less likely it is that a debtor will be able to pressure its existing creditors. However, it appears that CACs have no impact on price[9] because passive bondholders lack proper information about whether other bondholders will support or oppose a restructuring when it comes time for them to choose whether to accept an exchange offer.[10] One consequence of this dynamic is that sovereigns may lack incentive to offer bond contract terms that limit their options for future restructurings by making it easier for bondholders to hold out, because the market will not reward such contracts with lower interest rates.[11] Thus, the sovereign who has not made it more difficult for itself to restructure may fall victim to moral hazard and spend excessively, thereby increasing the otherwise average risk of default.[12] The contractual solutions to the holdout problem are therefore far from perfect.

III. THE INSTITUTIONAL SOLUTION

A second widely discussed approach to sovereign debt restructuring begins with the premise that a market-based approach

6. Steven L. Schwarcz, *A Model-Law Approach to Restructuring Unsustainable Sovereign Debt*, 64 CTR. FOR INT'L GOVERNANCE INNOVATION 1 (2015), https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6212&context=faculty_scholarship.

7. Eichengreen, *supra* note 2, at 83.

8. Buccheit et al., *supra* note 5, at 20.

9. IMF, SECOND PROGRESS REPORT ON ENHANCED CONTRACTUAL PROVISIONS IN SOVEREIGN BOND CONTRACTS 6 (2016), https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/01/13/PP5085-Inclusion-of-Enhanced-Contractual-Provisions-in-intl-Sovereign-Bond-Contracts; Robert Scott et al., *Anticipating Venezuela's Debt Crisis, Hidden Holdouts and the Problem of Pricing Collective Action Clauses*, 100 B.U. L. REV. 253, 261–63 (2020).

10. Scott et al., *supra* note 9, at 263.

11. *Id.* at 261.

12. *Id.*

cannot solve the complex problems arising from sovereign defaults, particularly when contracts are issued for different periods of time, in different currencies, and under the laws of different jurisdictions. Under this view, the contractual approach is hampered by the problem of unequal bargaining strength and the creation of inefficient and inequitable outcomes.[13] Critics point out that no domestic jurisdiction has successfully relied on markets to fashion a contractual solution to the problem of insolvency.[14] Why, then, should the international approach be any different?

In 2002, Anne Kreuger, the First Deputy Managing Director of the International Monetary Fund (IMF), proposed an SDRM in some ways analogous to domestic insolvency legislation. She suggested that restructuring proceed against a background of stayed creditor enforcement and follow a majority decision rule to prevent holdouts from derailing the process. It would also provide for the protection of creditor rights by preventing payments not in accordance with the debt priority structure, and attempt to limit creditors from dissipating asset values.[15] The IMF would play an important role throughout by acting as the arbiter of the workout process, deciding when to impose the stay and providing emergency financing to the sovereign.[16] The purported advantage of an SDRM, as distinct from the ad hoc contractual approach to sovereign debt workouts, was that it would create a set of settled expectations about legal outcomes, allowing parties to bargain in the shadow of the law[17] and raising the value of sovereign debt as an asset class.[18] Proponents also argued that an SDRM would lead to more responsible lending because it would force creditors who do not conduct adequate due diligence to bear the risk of default.[19]

Like so many other international governance initiatives, the IMF's SDRM proposal failed to obtain the approval of the international community.[20] A recent Brookings Institution report

13. Martin Guzman & Joseph E. Stiglitz, *Creating a Framework for Sovereign Debt Restructuring that Works*, *in* TOO LITTLE, TOO LATE: THE QUEST TO RESOLVE SOVEREIGN DEBT CRISES 3, 15 (Martin Guzman et al. eds., 2016).

14. *Id.*

15. ANNE O. KREUGER, INT'L MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 14–20 (2002), https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf.

16. *Id.* at 23–28.

17. *Id.* at 10.

18. *Id.* at 20.

19. Guzman & Stiglitz, *supra* note 13, at 8.

20. *See* Sean Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, 36

argues that while the case for an SDRM is enjoying a revival, it acknowledges that "the main difficulty is to obtain a critical level of political support" and therefore alternatively proposes a series of reforms "that are increasingly more ambitious and deliver better solutions at the price of requiring a greater degree of consensus across governments."[21] In other words, coordination among international stakeholders remains a fundamental problem. Moreover, the SDRM proposal did not address the question of enforcement. The law does not affect bargaining positions merely because it exists, but rather because it is enforceable. Thus, while a SDRM would offer certain distinct advantages over the contractual method of sovereign debt management, it is an extremely difficult approach to implement.

IV. A MIDDLE ROAD

A third method of sovereign debt restructuring, known as the Model Law approach, offers a comfortable middle ground and seeks to remedy many of the contractual and institutional solutions' and deficiencies. However, it has received comparatively little attention. A Model Law, like the Uniform Commercial Code or the UNCITRAL Model Law on International Commercial Arbitration, is a form of suggested legislation that is designed to be implemented uniformly across national or subnational jurisdictions.[22] In this case, however, a proposed Model Law would not need to be accepted by any critical mass of countries. It could be effective even if only a single jurisdiction adopted it, provided that jurisdiction issues sovereign debt.[23] Suggested provisions of the law would mimic those of the U.S. Bankruptcy Code. For example, they would allow bondholders to vote on a restructuring proposal, while also providing for emergency liquidity and an arbitration mechanism to settle disputes between the parties.[24] Arbitration could be carried out under the

GEO. J. INT'L L. 299, 301 (2005) (noting that the IMF ceased developing the SDRM proposal after it failed to gain the requisite three-fifths vote of member countries).

21. COMM. ON INT'L ECON. POLICY & REFORM, *supra* note 1, at 29.

22. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Model-Law Approach*, 6 J. GLOBALIZATION & DEV. 343, 348 (2016).

23. *Id.* at 347 ("Because most sovereign debt contracts (if not governed by the debtor-state's law) are governed by New York or English law, it would be sufficient if England and New York State—and it would be valuable if merely one of those jurisdictions—enact a model law.").

24. Mark Jewett & Maziar Peihani, *How Ontario Could Lead the World in Sovereign Debt Restructuring* 108 CTR. FOR INT'L GOVERNANCE INNOVATION 3 (2017), https://www.cigionline.org/publications/how-ontario-could-lead-world-sovereign-debt-restructuring.,

supervision of an international body or the courts of the debtor state, depending on what provisions legislators choose to include in the Model Law.[25]

An effective decision mechanism for resolving disputes over sovereign debt must provide for the effective enforcement of payment obligations against the sovereign. Another advantage of the Model Law method is that it helps bridge the enforcement gap by offering an opportunity to assert jurisdiction through legislation over the parties in the payment system. While the Foreign Sovereign Immunities Act of 1972 allows private parties to bring sovereigns to court when they behave as commercial actors, the assets of the sovereign are immune to attachment. Therefore, until recently, a sovereign could simply ignore a court's demand for payment. Such was the state of play until the Second Circuit Court of Appeals' ground-breaking injunction in *NML Capital, Ltd. v. Republic of Argentina*, 727 F.3d 230, 232 (2d Cir. 2012) (*NML*), which enjoined Argentina from paying its other creditors until the debt to NML Capital, a subsidiary of Elliott Management, had been paid in full. The court even extended the injunction to cover banks and other agents operating the bond payment system on Argentina's new, non-defaulted obligations.[26] The decision thus froze Argentina's debt servicing mechanism, transforming a totally unenforceable order into a powerful tool that forced sovereigns to choose between paying all of their debts or none of them. Since then, however, the Second Circuit has walked back its decision, virtually limiting *NML* to its facts.[27] It is unlikely that the Second Circuit will use this kind of injunction in future cases unless faced with another uniquely recalcitrant debtor, leaving the obstacle of contractual enforceability in place.[28]

The authors of a Model Law on sovereign debt restructuring could authorize *NML*-style injunctions in the new legislation, providing a powerful tool for the enforcement of sovereign payment obligations. The effectiveness of such an approach would be bolstered by the fact that any debt issued under the contract law of a jurisdiction with a Model Law on sovereign debt restructuring would be underwritten by a local bank, over which a local court could exercise jurisdiction. The sovereign, meanwhile, would be insulated

25. Schwarcz, *supra* note 6, at 2–3.

26. NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230, 242 (2d Cir. 2012).

27. Buccheit & de la Cruz, *supra* note 4, at 3–4.

28. *Id.*

from the worst consequences of holdout behavior while being able to commit upon issuance that it will pay out its bonds in full. Moreover, the aggregate voting mechanism would fill in where CACs are not present. CACs only prevent holdout strategies as to the contracts in which they are written, and most outstanding debt contracts still do not contain CACs. Therefore, absent a Model Law to the contrary, holdouts can still exercise their holdout strategy in a restructuring that requires participation from multiple classes of bondholders.

The Model Law idea is not necessarily a panacea for the problems of sovereign debt management. Because the idea is under-theorized, a number of associated issues have yet to be explored. For example, there is uncertainty regarding the market's reaction to bonds issued under a Model Law regime. It is possible that the market would exact a high risk premium because it fears that sovereigns with debt issued under a Model Law regime will be more likely to default, since any ensuing restructuring would be more orderly than a default on debt not governed by a Model Law. This is the problem of moral hazard. On the other hand, an aggregation procedure bringing all parties into the restructuring would help to counter the informational problem hampering the effectiveness of CACs by forcing bondholders to be more forthcoming about their strategies before the restructuring. More concerning still is the possibility that enactment of a Model Law may be pre-empted in certain jurisdictions. This would not present an issue in the United Kingdom because any such law would likely be passed by the U.K. Parliament. In the United States, however, there is an argument that Congress's constitutional authority to enact "uniform laws on the subject of bankruptcies throughout the United States" would interfere with a state-level effort to pass a Model Law on sovereign debt restructuring.[29]

V. CONCLUSION

The Model Law approach to sovereign debt restructuring offers a compelling alternative to the more popular contractual and institutional approaches. It suggests a promising avenue for systematically dealing with the enduring problem of sovereign default and the attendant economic—and frequently political—dislocation that such a default can cause. However, because this approach has received scant analysis and discussion, its implications need to be further explored.

29. U.S. CONST. art. I, § 8, cl. 4.