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## **Reforming the Process of Sovereign Debt Restructuring: A proposal for a Sovereign Debt Tribunal**

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

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## I. Introduction

With its proposal in 2001 for a so-called Sovereign Debt Restructuring Mechanism (SDRM), the International Monetary Fund (IMF) triggered a debate about how best to reform the process of restructuring sovereign debt. While the SDRM proposal was shelved by the IMF in 2003 after the proposal faced strong opposition in certain quarters, the importance of addressing the issue of reforming the process of sovereign debt restructuring has not diminished. The experience of the Argentine sovereign debt default, one of the largest sovereign debt defaults in history, reinforced the view of many that a more satisfactory approach for restructuring sovereign debt is required.<sup>3</sup> As has often been expressed in the debate regarding potential reforms to the sovereign debt restructuring process, there continues to be a need for a more orderly, efficient and predictable process for restructuring sovereign debt.

To date, there have been essentially four major approaches to sovereign debt restructuring reform that have been the focus of the public policy debate on this issue. Those approaches are as follows: 1) the “statutory” approach as embodied principally in the IMF’s SDRM proposal; 2) the “contractual” approach as reflected principally in the adoption of so-called collective action clauses (CACs) in bond indentures for sovereign debt issuances; 3)

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<sup>3</sup> Even though the Argentine default occurred in 2002, a final restructuring plan was not approved until 2005 after a long and contentious process, and even then, bonds representing approximately \$25 billion of Argentina’s then outstanding debt did not provide consent to the restructuring plan. For an interesting decision in the context of the battles between Argentina and its creditors, see, e.g., the German Bundesverfassungsgericht (Federal Constitutional Court) – in particular the Dissenting Opinion by Lübke-Wolff, *Neue Juristische Wochenschrift* 2007, 2610, 2617ff. On this decision, see the note by Rudolf and Hüfken, 101 *Am. J. Int’l. L.* 857ff. (2007).

the voluntary approach as reflected in proposed Codes of Conduct for stakeholders in the sovereign debt process; and 4) the reliance on existing institutions, notably the Paris Club (used for the restructuring of official bilateral debt) and the London Club (used for the restructuring of commercial bank debt). We will leave a more detailed description of each of these approaches for the final publication of this paper. Instead, for the purposes of this paper, we will concentrate on considering an alternative approach for reforming the process of sovereign debt restructuring: our approach focuses on the establishment of a permanent international arbitral tribunal for resolving disputes arising in sovereign debt restructurings.

## II. Establishing a Sovereign Debt Tribunal for Sovereign Debt Restructurings

In an ideal world, perhaps the best and most comprehensive solution for addressing the problems of States undergoing a debt restructuring might be the introduction of a full-fledged statutory debt restructuring mechanism for sovereigns. However, for various reasons – ranging from political considerations to issues of perception – it seems unlikely, at least for the present time, that any such initiatives in that direction will come to fruition in the near term.

Under such circumstances, it appears preferable to split up the complexity of a statutory proposal such as the one put forward by the IMF and to concentrate on the introduction of certain of its component parts. Of course, the ultimate goal of such an approach is that ultimately a debt restructuring mechanism as a whole might emerge from those previously installed pieces.

Such pragmatic approach is, of course, still more than likely to be confronted with a bundle of reservations, concerns and obstacles. Therefore, it might be unrealistic to believe that there would be any kind of automatic recognition and realization of any such proposal.

It is for this reason that it is critical to give careful consideration to what aspects of a statutory approach should be looked to as the point of departure for fashioning a new approach.

For several reasons, it appears to us that the introduction of a dispute resolution panel – or, as we call it henceforth, a Sovereign Debt Tribunal – might be the most appropriate first step. The IMF’s SDRM proposal contained this basic concept as one of its elements; it was called the “Dispute Resolution Forum” and was designed to adjudicate certain disputes stemming from the restructuring process. This concept found some resonance in the recent Iraqi debt restructuring, when an arbitration mechanism was established for the verification and reconciliation of creditor claims.<sup>4</sup>

Such an international arbitral tribunal carries with it several advantages. First, and most importantly, it is based on a consensus among the key stakeholders which is of high importance in a situation of such intense tensions such as a sovereign default. The second advantage – and closely related to the first one – is that an arbitration panel is an institution which elevates the dispute between the creditors and the sovereign debtor to a neutral forum and provides thus for what might be called a “de-emotionalization” of each individual dispute. Furthermore, it provides a forum for bringing some cohesion and structure to what is nowadays in cases of a sovereign default usually a more or less potentially disorganized group of anxious stakeholders who initiate individual strategies (more often than not in different places all over the globe) to secure the most profitable outcome for themselves.

Even though the abovementioned CACs attempt to cope with exactly this problem, they cover necessarily only the creditors and not also the sovereign debtor – a deficit that

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<sup>4</sup>See, e.g., Deeb, “Project 688: The Restructuring of Iraq’s Saddam-Era Debt,” Cleary Gottlieb Restructuring Newsletter Winter 2007, p. 3 ff.

could, at least to a certain degree and depending on the ultimate shape of such an arbitral tribunal, be reduced if not resolved through such a tribunal. Finally, a further advantage of beginning with the introduction of a dispute resolution panel is that it could potentially create a general perception on the part of sovereigns as well as creditors that there is a selected pool of expert arbitrators who possess the experience and knowledge of how to cope with the complex issues of sovereign defaults.

In this respect, our proposal may be differentiated from a somewhat similar proposal put forward by certain NGOs which have advocated for quite some time that sovereign debt restructurings should be managed through arbitration.<sup>5</sup> However, when such NGOs discuss arbitration, they apparently have in mind some form of ad hoc arbitration process used in certain types of commercial disputes in which typically each party appoints one arbitrator who, then, agree on the selection of a third arbitrator.

Even though there are a number of well-established and well-respected international arbitration institutions such as the International Chamber of Commerce in Paris that are used in the commercial arbitration context, the pool of potential arbitrators maintained by such arbitration institutions is so large that there is almost anonymity among those who are appointed as arbitrators by these institutions. The arbitrators in case A usually know nothing about case X, Y or Z, let alone their judges and their rulings. Thus, there is no particular potential for developing expertise within such a pool of arbitrators, and there is also the potential for inconsistency in the rulings from different panels.

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<sup>5</sup> See, e.g., Kunibert Raffer, Vor- und Nachteile eines Internationalen Insolvenzrechts, in: Dabrowski / Eschenburg / Gabriel (ed.) Lösungsstrategien zur Überwindung der Internationalen Schuldenkrise, 2000, 213, 229 f.

In contrast, our proposal envisages as a model something along the lines of the Iran-United States Claims Tribunal, which was (and still is<sup>6</sup>) comprised of a small number of high-profile panelists. The arbitrators would almost certainly have the opportunity to become acquainted with one another and discuss issues of common concern and might thereby develop something resembling a common thread of reasoning in addressing similar cases.

*Creation and Composition of Arbitral Tribunal:* In order to enjoy the benefits of institutional backing and a pre-existing international reputation, the arbitral tribunal should be established under the auspices of a highly reputed multilateral institution which is not a lender institution to sovereigns, i.e., an institution that may ultimately be a creditor in a sovereign debt restructuring exercise. The former (i.e. the need of a multilateral institution) excludes individual States and the latter (i.e. the need of a non-lending institution) excludes the IMF and the World Bank. These exclusions are owed to perception among certain parties of potential bias and conflict of interest. Thus, the question becomes which international institution is of sufficient international standing and is not a potential creditor that it would be well positioned to provide a home for the Sovereign Debt Tribunal. Again, the objective is to gain general and widespread acceptance of the Sovereign Debt Tribunal among those constituencies that have a vested interest in the sovereign debt restructuring process. The result is that, at present, the United Nations appears to be the most appropriate candidate.<sup>7</sup>

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<sup>6</sup> See, e.g., [www.iusct.org](http://www.iusct.org).

<sup>7</sup> Further details need to be considered, e.g. where the arbitral tribunal should be located (e.g., New York, Geneva, Delhi, etc.). The idea, however, expressed, e.g., by Raffer in his contribution quoted above (fn 5) that an arbitral panel established by the UN would be in danger of becoming unduly influenced by its powerful member states, in our view, overemphasizes the potential dependencies of the selected panel of experts and neglects the strength and autonomy of what would effectively be a small “elite club.”

Some commentators have proposed that there should be enacted a kind of global bankruptcy court which might, for example, be associated with the International Court of Justice (ICJ).<sup>8</sup> As appealing as this idea may appear to be at first blush, it could potentially suffer from some of the same problems which the ICJ has sometimes been confronted with in the past when it comes to the acceptance of its decisions. Even if a special sovereign bankruptcy chamber would itself be completely separated from the present judiciary of the ICJ and would thus form an affiliated but distinct body of this court, there might remain the risk that this bankruptcy chamber could suffer some of the same acceptance, recognition, and enforcement issues as the ICJ has experienced in certain prior circumstances.

*Creation of Sovereign Debt Tribunal:* Thus, if the UN were to be the “creator” of such an arbitral tribunal, various questions regarding the functioning and operation of such tribunal need to be addressed in due course—questions such as the selection process for the pool of arbitrators, the establishment of a permanent secretariat, the posting of a website, the payment of each arbitrator, and so forth. However, with respect to the selection process itself, there is quite an appropriate model for these points in the earlier attempt of the IMF to set up its SDRM,<sup>9</sup> and we adapt this model to fit within our proposed UN-based framework. Accordingly, the Secretary General would select in the range of ten to twenty arbitrators, or, for the sake of even greater neutrality, the Secretary General would appoint ten individuals who in turn would select ten to twenty arbitrators.<sup>10</sup> (Presumably, the Secretary General

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<sup>8</sup> Stiglitz, “Odious Rulers, Odious Debts,” *The Atlantic Monthly*, Nov. 2003 (available at: [www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=8577](http://www.odiousdebts.org/odiousdebts/index.cfm?DSP=content&ContentID=8577)). Stiglitz also envisages the involvement of the U.N.

<sup>9</sup> For the details, see Hagan, footnote 13 *infra*.

<sup>10</sup> As a matter of fact, the selection process needs careful consideration: There should not only be lawyers from various legal backgrounds, but there might also be economists and development specialists who in appropriate cases might be qualified and capable to serve as arbitrators.



would select individuals, either as members of the selection panel and/or as arbitrators themselves, who would come from a variety of country backgrounds.) This overall group of arbitrators would then elect one of their members as president of the tribunal.

The selection of arbitrators through such a neutral institution has the potential advantage of fostering trust, which is not a minor consideration given that the whole matter of perception is an important and delicate issue in the sovereign restructuring context. The elected president's task would be to draft the procedural rules for the tribunal, which would be enacted when and if all arbitrators (or a qualified majority thereof) give their consent and after the Secretary General has been informed of the proposed rules.<sup>11</sup> Moreover, a further task of the president of the tribunal would be to appoint the arbitrator(s) for each particular case.

The details about the panels might be open to the particular needs of each case. For instance, it might suffice in a given case to appoint just one arbitrator or it might be necessary to have three arbitrators. In addition, depending on the scope of the tribunal's tasks, the applicable substantive law might need to be determined.

It is a necessary feature of any arbitration that the tribunal does not have any intrinsic authority to initiate and decide cases on its own. Any such authority will invariably be dependent on the prior contractual agreement to arbitration by all of the relevant parties, and this prior agreement to arbitration is the critical underpinning of any international arbitration process. Such a requirement for prior agreement is true even when and if the circumstances of the individual case are as uniquely pressing as they were in the cases of the Iran-United

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<sup>11</sup> This special design for the particular needs of this tribunal is what makes the difference vis-a-vis the concerns expressed by some about using ICSID arbitration for sovereign debt restructuring, see, e.g., Weibel, "Opening Pandora's Box: Sovereign Bonds in International Arbitration," 101 *Am.J. Intl L.* 711 (2007).

States Claims Tribunal and the debt rescheduling of Iraq after 2003.<sup>12</sup> The remarkable feature of these two cases is that those tribunals became enacted after the rise of the crisis.

One cannot assume, however, that such an “ex post” result can be achieved in every case. Generally speaking, in the majority of cases, it is not very likely that all stakeholders will consent to a respective sovereign’s offer for arbitration once a debt crisis has begun in that particular State. It is the very experience throughout the history of sovereign defaults that so-called free riders holding a minority stake may attempt to obstruct action where a majority may be willing to act in concert. Given these facts and legal necessities, the introduction of an arbitral tribunal will usually (but not necessarily) depend on a pre-crisis consensus among the parties. This makes it critical to include an arbitration clause in each respective issuance of sovereign bonds – similar to the inclusion of CACs in issuances of sovereign bonds—or in any other relevant debt instrument used for the purposes of issuing sovereign debt.

*Jurisdiction of Tribunal:* The tasks and duties of a dispute resolution panel can be manifold, depending on the individual configuration of the debt restructuring mechanism in general.<sup>13</sup> And this, in turn, depends on the ambition of how far one wants to extend the influence of the arbitral tribunal. The details of its range of tasks can (or should) be carefully delineated in the relevant bond issuance clause or other relevant debt instrument providing for arbitration.

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<sup>12</sup> For this, see Deeb, “Project 688: The Restructuring of Iraq’s Saddam-Era Debt,” Cleary Gottlieb Restructuring Newsletter Winter 2007, p. 3 ff.

<sup>13</sup> For an overview, see Hagan, “Designing a Legal Framework to Restructure Sovereign Debt,” 36 *Georgetown Journal of International Law* 299 ff. (2005); see also Paulus, *Die Rolle des Richters in einem künftigen SDRM*, in: Gerhardt/Haarmeyer/Kreft (ed.), *Insolvenzrecht im Wandel der Zeit, Festschrift für Hans-Peter Kirchhof*, 2003, p. 421 ff.

In accordance with what we consider to be our pragmatic and modest approach, we believe that, at a minimum, the arbitral tribunal should be empowered to address matters related to the verification of creditor claims as well as voting issues related to the approval of the restructuring plan and other similar matters. As a general observation, however, it should be noted that the extent to which the tribunal shall be empowered to address specific issues is to be left to the discretion of the parties.

As a practical matter, it may be that it is the bond-issuing sovereign which will design the respective arbitration clause and propose such a clause to the investor community, but then it will be left to the investor community to decide whether or not to accept the arbitration clause that has been proposed. Depending on the specific contours and details of any such arbitration clause that is proposed by the sovereign, this could either create a buying incentive or disincentive for investors. However, it is not inconceivable that, with the passage of time and the development of experience in this area, certain practices may or may not gain acceptance in the market with the result that certain standard arbitration clauses may emerge in sovereign bond issuances.

The issue thus arises as to which disputes shall the tribunal shall be competent to decide. Should the tribunal be restricted to deciding narrow, technical legal issues? For example, would the tribunal be limited to deciding on the legal validity of each individual creditor claim? Or, in a broader formulation, should the tribunal be permitted to decide on the legal validity of the sovereign's proposal for debt restructuring?

Other issues that might handled by the international tribunal (subject, of course, to the prior contractual agreement of the parties) include the following:

- what constitutes “sustainable debt” for the sovereign in question (in this context, one might allow the IMF to make submissions on this matter even though it is not a party to the arbitration, possibly subject to certain confidentiality restrictions given the sensitivity of the information);
- whether the underlying economic assumptions underpinning any particular restructuring plan are reasonable or not;
- satisfaction of the commencement criteria for invoking the arbitration mechanism;
- whether the parties have engaged in good faith negotiations;
- the feasibility and/or reasonableness of any proposed restructuring plan; and whether the debt in question constitutes “odious debt” and what, if any, implications follows from that determination (recognizing that “odious debt” is itself a controversial concept, and there is sharp disagreement as to whether it even constitutes a valid or recognized legal doctrine under international law).<sup>14</sup>

*Who is to Bound by Tribunal’s Decisions—Issue of Inter-Creditor Equity:* A more ambitious approach would be, for instance, to include a rule setting forth the degree, if any, to which degree a decision of the tribunal would have a binding effect on other creditors.<sup>15</sup> But if the tribunal is empowered in its decisions to take into account

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<sup>14</sup> On this topic, see, e.g., Paulus, “The Concept of Odious Debts: A Historical Survey,” available under: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1077688](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1077688).

<sup>15</sup> The additional question of enforceability outside of the ICSID rules and the applicability of the New York Convention needs to be considered separately.

issues of inter-creditor equity, this necessarily can be done only for those issuances that have their own respective arbitration clauses. The tribunal could then weigh, for instance, the different maturities, the risk level (rating) of each individual issuance, the promised interest rates, and all other relevant details.

However, it should be noted that the described binding effect extends only to those creditors who have agreed to subject themselves to arbitration by signing the contract by which they have bought their respective bonds or by which they have otherwise extended credit to the sovereign such as in the form of bank loans. But other creditors who have not signed such a contract containing an arbitration clause will not be bound by the tribunal's decisions. Therefore, to the extent that arbitration (as distinct from CACs) can help address the issue of potentially non-consenting creditors in a debt restructuring, this can only happen to the degree of such creditors' inclusion in the contractual binding force of an arbitration provision contained in the underlying debt instruments applicable to such creditors.

*Triggers for Invoking Arbitral Mechanism:* Another feature that needs to be fixed in a respective clause is the issue of when (and under which circumstances) the arbitral tribunal's task to decide on relevant issues comes into existence. In other words, what are the triggers for this mechanism and who shall be permitted to pull these triggers? The advisable answer to the first question seems to be that it is the announcement of a default – as defined in the respective issuance contract – constitutes the relevant trigger.

Moreover, depending on the determination of the parties as to how they draft the specific language of a given arbitration clause, a default might commence even in something that parallels “imminent insolvency” in the commercial insolvency regime. Furthermore, as

noted above, the parties to a sovereign debt issuance should consider whether the tribunal's competence should include the examination of whether or not the prerequisites of such a default trigger have in fact materialized.

As to the second question, it should also be specified which side shall be allowed to invoke the arbitration mechanism. The alternatives are either the sovereign alone or the creditors as well. Even though it would appear to be preferable – seen from a disciplining perspective – to bestow such a right on both sides, it might not be acceptable to sovereigns to be subjected involuntarily to such proceedings. Thus, for political reasons, pulling the trigger might be left alone to the sovereign debtor or to the sovereign debtor and creditors acting in unison.

However, since these are all contractual issues to be addressed in the respective arbitration clauses, this issue will, as a matter of fact, be left to the contractual freedom of the parties to decide whether to confer the right of invoking the arbitration proceeding to the creditors as well (whether it is each creditor individually, a certain “head”-majority of the creditors, a certain “sum”-majority of the creditors, etc.).

*Governing Law and Applicable Insolvency Rules and Principles:* What shall be the relevant law for a proceeding of the Sovereign Debt Tribunal? If it is the law of a particular jurisdiction, shall issues of public international law (such as, for instance, the controversial question of “odious debts”) be neglected, in toto or partially? What about the eminently important question of inter-creditor equity in cases where some bondholders, because bonds were issued under the laws of various jurisdictions, will be judged under English law, whereas other bonds, for example, will be judged under the laws of New York and yet others under German law?

Given the complexity and intricacy of these questions, it might be worthwhile considering whether or not the institution which creates the arbitral tribunal (e.g., the UN) offers as an additional option available for all respective bond issuances that the tribunal would (if agreed to by the parties to the relevant debt instrument) apply specific insolvency rules and principles. For the sake of gaining the necessary global acceptance, it may be that this would not simply be the law of a particular jurisdiction but rather something perhaps along the lines of the “law merchant.”

Such law in this context might be found in the general principles of insolvency law established by leading international institutions (e.g., the principles specified in the relevant texts of the World Bank<sup>16</sup>, UNCITRAL<sup>17</sup>, IMF<sup>18</sup>, etc.). However, it should be noted that these international institutions have developed principles of insolvency law that are to be applied in general to commercial enterprises as to opposed to sovereigns, and thus some adaptation of such principles would presumably be required if the sovereign debt tribunal were to look to these principles for guidance

*Representation of Creditors in Arbitral Proceeding:* Obviously, it would be totally impractical for the entire universe of creditors of a sovereign to participate in an arbitral proceeding. Instead, the creditors would have to develop and specify a mechanism for creditor representation in such a proceeding. This might mean that the bondholders in a sovereign debt issuance would specify in one of the underlying debt

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<sup>16</sup> See World Bank, *Principles and Guidelines of an Effective Insolvency System*.

<sup>17</sup> See United Nations Commission on International Trade Law (UNCITRAL), *UNCITRAL Legislative Guide on Insolvency Law*.

<sup>18</sup> See International Monetary Fund, *Orderly & Effective Insolvency Procedures*.

instruments—whether in the bond indenture, trust indenture or otherwise—who would represent the creditors in the arbitral proceeding.

Would it be a creditors committee, and if so, how would such a creditors committee be selected and constituted, and what would be the process of consultation with the larger body of creditors? Or would it be the indenture trustee acting on behalf of the bondholders and taking instructions from the bondholders in a certain prescribed manner? These issues would need to be confronted head-on in the period prior to the issuance of the sovereign bonds. Otherwise, the arbitration process might become completely unwieldy and unworkable.

*Mediation as Precursor to Arbitration:* As a complement to our proposal for a sovereign debt international tribunal, we would propose that the parties to a sovereign debt issuance should seriously consider whether they wish to require mediation among the parties, which by its nature is non-binding on the parties, as a precursor to a binding arbitration procedure. In other words, the parties could specify in their arbitration clause whether or not mediation is a necessary step to be exhausted before they are permitted to resort to arbitration. Even if mediation is not specified as a formal prerequisite to arbitration, the parties could still resort to mediation to the extent that thought it would help resolve any disputes or otherwise advance the restructuring process.

In sum, the possibility of mediation of disputes could provide the parties with a less adversarial forum for resolving their disputes before they turn to a higher stakes and potentially more protracted and adversarial arbitration process. Furthermore, any mediation, whether or not as a formal prerequisite to binding arbitration, could be seen as a tool to bridge the differences between the parties on any outstanding negotiating issues



and thereby assist the parties in any ongoing efforts to reach a restructuring agreement. In this light, mediation might be seen as a useful mechanism for helping the parties reach the necessary thresholds of creditor support set forth in any applicable collective action clauses (CACs).

*Financing and Support for Arbitral Tribunal:* The basic financing and support for the arbitral tribunal should come from the sponsoring organization, e.g., the United Nations. Such an organization would provide office space and a small secretariat to handle general administrative matters, including staying abreast of current developments in sovereign debt restructurings and defaults as well as coordinating with the roster of designated arbitrators. However, in the event of an actual arbitration, the parties involved in the arbitration would be solely responsible for defraying the costs of the arbitration, including the fees and expenses of the arbitrators. As in any complex international arbitration, the costs of such proceedings can potentially be very significant, so the parties would have to be prepared to bear such costs.

### III. Conclusion

Needless to say, the proposal we have outlined above is simply the initial formulation of an idea. Nonetheless, this is an idea which, in our opinion, deserves serious consideration in order to address a problem that may grow more acute with the increasing discrepancies between the wealthy countries and the poorer countries. Moreover, as globalization is increasing the complexity and the number of relevant actors in the world of sovereign finance, the need to develop a predictable and reliable procedure for resolving the problems of sovereigns in default is likely to become a more pressing issue requiring the attention of policymakers and stakeholders.

Finally, if our proposal for the Sovereign Debt Tribunal can be successfully established and then successfully utilized in specific sovereign debt restructurings, it could be a useful confidence-building measure for embracing broader objectives in the area of sovereign debt reform. Any such positive experiences with the Sovereign Debt Tribunal—and particularly an ensemble of such positive experiences—might lead the stakeholders in sovereign debt restructurings to be more willing to consider other more fundamental reforms to the sovereign debt restructuring process.