Restructuring Sovereign Debt by Incorporating Soft Law as Governing Law or by Reference

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Presentation for D-DebtCon 2020 sovereign debt panel on
"Private enforcement of public debt: managing the externalities"[2]

September 18, 2020

Court enforcement of private voting rights can enable holdout creditors to block a reasonable sovereign debt restructuring plan. For example, certain hedge funds—known as vulture funds—sometimes buy distressed sovereign debt at pennies on the dollar and vote their holdings to block a restructuring plan unless they receive more than their fair share thereunder. Court decisions in the United Kingdom regarding the illegality of exit consents[3] and in the United States regarding pari passu clauses in Argentine sovereign debt[4] further illustrate how holdouts can obstruct otherwise rational sovereign debt restructuring.

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[2] This panel is sponsored by the International Insolvency Institute (III).
[3] The Chancery Division of the English High Court held, in the *Anglo Irish* case Assénagon Asset Management S.A. v. Irish Bank Resolution Corporation Limited (formerly Anglo Irish Bank Corporation Limited) [2012] EWHC 2090 (Ch), that exit consents are illegal, casting doubt on the effectiveness of exit consents to restructure debt under English law. *See, e.g.,* Patrick S. Kenadjian, *The Aggregation Clause in Euro Area Government Securities*, *in* COLLECTIVE ACTION CLAUSES AND THE RESTRUCTURING OF SOVEREIGN DEBT 143 (Patrick S. Kenadjian, Klaus-Albert Bauer & Andreas Cahn, ed. 2013) (observing that the judge in the *Anglo Irish* case "held that it was not lawful for the majority to aid in the coercion of a minority by voting for a resolution which expropriates the majority's rights for nominal consideration[,] thus cast[ing] doubt on the legality under English law of any form of exit consent that imposes less favorable conditions on those who refuse to participate in the associated exchange offer.").
[4] NML Capital, Ltd. v. Republic of Argentina, No. 08–CV–6978 TPG, 2012 WL 5895786 (S.D.N.Y. Nov. 21, 2012) (holding that the pari passu clause in Argentina's defaulted bonds contract "prohibits Argentina, as bond issuer, from formally subordinating the bonds by issuing superior debt" and "prohibits Argentina, as bond payor, from paying [restructured] bonds without paying on the [holdout] Bonds"). Thus Argentina must pay all outstanding sums on its defaulted bonds simultaneously if it makes any payment on its restructured bonds). That decision

In principle, statutory and contractual solutions can solve holdout problems. In practice, though, statutory solutions have not been politically acceptable and contractual solutions have been insufficient. I argue today for more innovative contractual solutions, based on recent research and analysis of the viability of incorporating soft law as governing law or by reference.[5]

A. Existing Contractual and Statutory Solutions are Inadequate.

The contractual solutions to date are based on trying to include collective action clauses (CACs) in sovereign debt contracts. These work by allowing supermajority voting—that is, voting by more than a majority of creditors by principal amount and/or number—to bind dissenting creditors. However, many sovereign debt contracts still lack CACs, and many CACs only purport to bind creditors to specific contracts. In the latter case, parties to any specific sovereign debt contract can act as holdouts with respect to a restructuring plan agreed to by the sovereign's other creditors.

A statutory framework for restructuring sovereign debt, such as the supermajority voting across substantially similar creditor classes—sometimes called aggregate supermajority voting—authorized by § 1126 of the U.S. Bankruptcy Code, would provide a valuable solution to the holdout problem. Several years ago, the UN General Assembly voted to pursue such a multilateral statutory resolution. The United States and the European Union opposed that approach, however, fearing it might somehow cede sovereignty. So far, nothing has come of that UN proposal; and without U.S. and E.U. backing, nothing is likely to happen in the near term.[6]

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was affirmed in its entirety by NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230 (2d Cir. 2013), cert. denied in Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 2819 (2014).

[5] *Soft Law as Governing Law*, 104 MINNESOTA LAW REVIEW 2471 (2020), also available at http://ssrn.com/abstract=3307418.

[6] Even earlier, in 2001, the International Monetary Fund (IMF) proposed its statutory Sovereign Debt Restructuring Mechanism ("SDRM"), based in part on work by Professor Jeffrey Sachs and myself. *See, e.g.*, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL LAW REVIEW 956 (2000), also available at http://scholarship.law.duke.edu/faculty_scholarship/508/. Initially, the U.S. Department of the Treasury supported the SDRM. But when the Treasury Secretary involuntarily resigned in 2002, the Department shifted its position, apparently at the urging of Wall Street. Certain emerging

I have been working with others, including the International Insolvency Institute (III) and the Centre for International Governance Innovation (CIGI), a prominent independent think tank, to propose a more politically acceptable statutory route: a model law for sovereign debt restructuring (the "Model Law") that facilitates aggregate supermajority voting.[7] New York State is now being urged to enact the Model Law, which would be powerful because many sovereign debt contracts are governed by New York law.[8] But, so far, the Model Law has not been enacted into "hard" law by any governmental jurisdiction.

B. Towards More Innovative Contractual Solutions.

In *Soft Law as Governing Law*,[9] I propose an innovative but somewhat iconoclastic idea: that parties to sovereign debt contracts should be able to choose non-governmental rules, or soft law—in particular, the Model Law for sovereign debt restructuring—as the governing "law" for restructuring that debt.[10] Choosing the Model Law as that governing law would help to facilitate aggregate supermajority voting and thereby solve the holdout problem.

The idea of choosing soft law as governing law would be consistent with today's norms of international commercial contracting in financial and other business transactions, which

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market countries, including Turkey, Mexico and Brazil, also opposed the SDRM, concerned (in retrospect, unjustifiably) that it would raise interest rates on their sovereign bonds. Faced with this opposition, the SDRM was deferred in favor of a CAC approach.

[7] The Model Law is set forth and analyzed in CIGI Policy Brief No. 64, A Model-Law Approach to Restructuring Unsustainable Sovereign Debt (Oct. 2017 updated edition), available at https://www.cigionline.org/sites/default/files/documents/PB%20no.64%20Updated_1.pdf.

[8] I have discussed the significance of enacting the Model Law as New York law in *Sovereign Debt Restructuring: A Model-Law Approach*, 6 JOURNAL OF GLOBALIZATION AND DEVELOPMENT 343 (2016 conference issue), also available at http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6185&context=faculty_scholarship, and the significance of enacting the Model Law as English law in *Sovereign Debt Restructuring and English Governing Law*, 12 BROOKLYN JOURNAL OF CORPORATE, FINANCIAL AND COMMERCIAL LAW 73 (2017 symposium issue), also available at http://ssrn.com/abstract=2952776.

[9] *See supra* note 5.

[10] Soft law refers to non-state rules that may be aspirational or reflect best practices but are not yet legally enforceable.

increasingly are conducted under soft law rules. Part of soft law's attraction is that it does not need governmental validation or consent, thereby providing rules of conduct when hard law doesn't apply.

Soft law's unenforceability typically creates uncertainty. Using soft law as a set of rules to choose as all or part of the governing 'law' of business contracts would significantly increase predictability. If respected, this use of soft law would indeed be transformational, making the soft law enforceable against the parties and providing a flexible and practical alternative to treaty-making.

Historically, the contractual right to choose soft law as governing law has been narrowly restricted to arbitration. The Uniform Commercial Code ('UCC') provides the closest US non-arbitration precedent, allowing parties to vary its provisions by choosing soft law promulgated by intergovernmental authorities such as UNCITRAL or Unidroit or trade codes such as the Uniform Customs and Practice for Documentary Credits.[11] The Hague Principles on Choice of Law in International Commercial Contracts also favor the right of parties to choose 'rules' of soft law 'that are generally accepted on an international, supranational or regional level as a neutral and balanced set of rules'.[12]

These precedents are very limited, though. The UCC language ambiguously, at best, covers choice of law, and the Hague Principles are themselves expressed only as non-binding soft law. Furthermore, these precedents strictly limit the sources of the soft law. (The Rome I Regulation, setting EU conflict-of-laws rules, originally proposed allowing contracting parties to

[11] UCC § 1-302 cmt. 2 ("Variation by Agreement.").
[12] HAGUE CONFERENCE ON PRIVATE INT'L LAW, PRINCIPLES ON CHOICE OF LAW IN INTERNATIONAL COMMERCIAL CONTRACTS art. 3 at 18 (2015).

choose certain limited, internationally recognized, soft-law rules as governing law.[13] However, that proposal was not ultimately adopted.[14])

I therefore have engaged a more fundamental normative analysis of whether parties should have the contractual right to choose soft law as governing law. An examination of the conceptual underpinnings of choice of law—party autonomy, freedom of contracting, and the governmental interests in ensuring legitimate enforcement—shows that sophisticated parties to business contracts should have the right to choose soft law as all or part of their governing law if several conditions are met: (a) the choice of soft law does not create significant externalities, or the social benefits of that choice are likely to exceed those externalities; (b) the soft law is clear and accessible; and (c) the soft law has legitimacy by virtue of being either generally accepted, promulgated by a respected independent and unbiased organization (such as UNIDROIT, as discussed earlier in the panel by Secretary-General Professor Ignacio Tirado), or manifestly fair.[15]

Applying this choice-of-soft-law framework, the article explains why parties should be able to choose the Model Law, thereby including its aggregate supermajority voting, as part of a new sovereign debt contract's governing law.[16] More significantly, the article argues that parties should be able to choose the Model Law as part of an *existing* sovereign debt contract's governing law by whatever requisite majority vote ordinarily allows amendment of the governing law, rather than requiring a unanimous vote.[17]

I also compare an alternative contractual framework: incorporating the soft law merely by reference into a sovereign-debt or other business contract. This incorporation by reference is not

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[13] *Commission Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Contractual Obligations (Rome I)*, at 14–15, COM (2005) 650 final (Dec. 12, 2005).
[14] *See* Regulation (EC) No. 593/2008, of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations (Rome I), 2008 O.J. (L 177) 6, 10–11 (allowing incorporation by reference under Article 3 and Recital (13)).
[15] *Soft Law as Governing Law*, *supra* note 5, at 2506.
[16] *Id*. at 2506-07.
[17] *Id*. at 2508.

a choice-of-law rule but, rather, a shorthand ‘cutting and pasting’ drafting technique. Sophisticated parties to business contracts should have the right to incorporate soft law by reference into their contracts if the same conditions for choosing soft law as governing law are met—*other than the condition requiring that the soft law has legitimacy*.[18]

By not having to address the requirement of legitimacy, it might appear to be easier to incorporate the Model Law by reference into a sovereign debt contract than to choose it as part of that contract’s governing law. However, because incorporation by reference is subject to applicable mandatory rules of local law, it may not be quite as effective as choice of law.[19] Also, incorporating the Model Law by reference into an *existing* sovereign debt contract could be problematic because the Model Law’s ‘supermajority’ voting would contravene contracts that require unanimity to change key terms such as principal amount, interest rate, and maturities. Although ultimately a matter of contract interpretation, amending that unanimity requirement to incorporate the Model Law by reference would likely itself require a unanimous vote of the contracting parties.[20] Incorporating the Model Law by reference into a *new* sovereign debt contract, however, should be almost as effective as,[21] and also easier to implement than,[22] choosing the Model Law as governing law of the contract.[23]

[18] *Id*. at 2500-01 & 2506-07.
[19] *Id*. at 2507. I recognize, however, that choice of law is itself subject to ‘overriding’ mandatory rules of local law, and there often is little difference between those categories. Furthermore, for reputational and other reasons, parties to business contracts may not want to disobey either category of mandatory rules. *See id*.
[20] *Id*.
[21] *Cf. supra* note 19 and accompanying text (explaining that because incorporation by reference is subject to applicable mandatory rules of local law, it may not be quite as effective as choice of law; but that choice of law is itself subject to overriding mandatory rules of local law).
[22] *See supra* note 18 and accompanying text.
[23] *Soft Law as Governing Law*, *supra* note 5, at 2506-07.