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A Debt Restructuring Mechanism for Sovereigns

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Do we need a legal procedure?

edited by

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E. The Importance of Being Prepared – A Call for a European Sovereign Debt Restructuring Mechanism

*Professor Dr. Bettina Nunner-Krautgasser**

I. Basics

The idea of a formal mechanism for sovereign debt restructuring still provokes vague fears and reservations. It's said that an informal procedure could offer options that are better and more flexible, which is why a lot of politicians shy away from the thought of a firmly established formal state bankruptcy procedure. A good example for this restrictive attitude is a statement recently given by an Austrian politician who was asked about the financial crisis in Greece. She said that Greece needed to be economically rehabilitated instead of being sent into bankruptcy.[1] To be more precise, she used the German term "Pleite" that has Yiddish origins and has an original meaning of "escape" or "flight".[2] Obviously, a country can't literally flee from its debtors; in that way she was right. What she actually meant by using this rather colloquial wording was something different, however: She tried to express that all possible measures need to be taken in order to avoid the formal bankruptcy of Greece. Based on the current legal framework for state insolvencies (maybe it would be better to say: because there is no such legal framework yet) and regarding the rating agencies' current working practice, this aim is fairly understandable.

Nevertheless, this statement clearly articulates what the reservations regarding a formal sovereign debt restructuring procedure actually are: An economic rehabilitation doesn't go together with a formal debt restructuring procedure. Such a prejudice deeply hurts the modern bankruptcy lawyer's feelings because it's well known that an economic rehabilitation and a formal debt restructuring procedure do not contradict each other. More than that: An economic rehabilitation – a so called "fresh start" – represents one of the main goals of every modern bankruptcy code.[3] As a matter of fact, bankruptcy law has widely developed from its original alignment as an instrument that should solely guarantee the best possible creditor satisfaction.[4] There is absolutely no reason to assume that the goal of economic rehabilitation can't be achieved in a formal procedure. This is the crux of the matter: On an international scale, there is too much debate about how to informally restructure a country's debts in order to avoid its bankruptcy than about how to achieve the rehabilitation in a formal procedure.[5]

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[1] Der Standard, "Sanieren ist allemal g'scheiter", 18.5.2011, http://derstandard.at/1304552268153/Sanieren-ist-allemal-gscheiter (30.1.2014).

[2] http://www.duden.de/rechtschreibung/Pleite (30.1.2014).

[3] *Jackson*, The Logic and Limits of Bankruptcy Law (1986) 225; *Nunner-Krautgasser,* in: Nunner-Krautgasser, Reissner (eds.), Insolvenz und Arbeitsrecht (2012) 22, 31.

[4] *Paulus*, Some Thoughts on an Insolvency Procedure for Countries (2002), http://www.iiiglobal.org/component/jdownloads/finish/22/342.html (30.1.2014).

[5] *Paulus*, A Statutory Procedure for Restructuring Debts of Sovereign States, RIW 2003, 401.

But that's not all: Furthermore, we need to think about how to employ formal procedural structures at a very early stage of a sovereign debt crisis. Actually, when we take a look at different national bankruptcy codes, this is nothing spectacular: In German bankruptcy law, for example, the imminent inability to pay is an opening reason for insolvency proceedings.[6] Another example: Austrian bankruptcy law allows the opening of a restructuring procedure even before bankruptcy is constituted (bankruptcy has to be impending, however).[7] It is in fact basic knowledge about bankruptcy law that delaying the procedural openings is extremely disadvantageous for both the creditors and the debtor. Rather than that, an insolvency procedure needs to be initiated as fast as possible: This way, the debtor acts under the protective screen of a formal proceeding (including its possibilities of rehabilitation), whereas the remaining assets are hedged in favor of the creditors. When it is about the restructuring of sovereign debts though, stalling is (as the case of Greece impressively shows) still seen as a viable option.

II. The compatibility of a sovereign debt restructuring procedure with the current legal framework

There are fairly good reasons for the implementation of a formal state bankruptcy procedure.[8] Before showing them in detail, two potential legal objections need to be cleared up:

1. Insolvency capability of states

Firstly, the idea of a formal sovereign debt restructuring mechanism doesn't fail because of a lack of insolvency capability of states.[9]

It is true that in some countries the respective national bankruptcy law declares the inadmissibility of an insolvency procedure for the state or the provinces. That is – for example – the case in Germany (§ 12 of the German Bankruptcy Code);[10] but important German lawyers argue that this obstacle can be overcome rather simply.[11]

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[6] § 18 of the German Bankruptcy Code: "Imminent Illiquidity".

(1) If the debtor requests the opening of insolvency proceedings, imminent illiquidity shall also be an opening reason.

[7] § 167(2) of the Austrian Bankruptcy Code.

[8] *Paulus*, Some Thoughts on an Insolvency Procedure for Countries, http://www.iiiglobal.org/component/jdownloads/finish/22/342.html (30.1.2014).

[9] Adam Smith identified the need for a sovereign bankruptcy regime over 200 years ago, when he wrote: "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor and least hurtful to the creditor" (*Adam Smith*, The Wealth of Nations, 1776); *Buckley*, The Bankruptcy of Nations: Let the Law Reflect Reality, UNSW Law Research Paper no. 2009–20, 2.

[10] "Corporations under Public Law"

(1) Insolvency proceedings may not be opened for the assets owned by

1. the Federation or a Land;

2. a corporation under public law under the supervision of a Land, if the law of the Land exempts such corporation from insolvency proceedings.

[11] *Aden*, Insolvenzverfahren über Fiskalvermögen eines Staates, ZRP 2010, 191; *Paulus*, Die Eurozone und das größere Thema eines Staateninsolvenzrechts, in: Kodek, Reinisch (eds.), Staateninsolvenz (2011) 13, 14; *idem*, A Resolvency Proceeding for Defaulting Sovereigns, International Insolvency Law Review 2012, 1, 2.

In Austria, things are quite different: The Austrian bankruptcy law constitutes the insolvency capability of the state, its provinces and even of other states (with regard to their activities in the private sector).[12] Hence in this aspect, the Austrian legal system is fairly progressive. In legal literature, however, the problem of the insolvency capability of the state has so far been dismissed as "solely theoretical",[13] but this opinion might have changed over the last couple of years.

It may also be true that in public international law, the traditional idea of the insolvency incapability of sovereign states is still present.[14] More modern views, however, consider sovereignty and the privileges associated with generally restrictable if the sovereign state does so voluntarily and if the procedure doesn't lead to the state's disbanding. As a matter of fact, the argument of a diminishing sovereignty of states is rather hollow, since the actual losses of sovereignty due to an immense amount of debts are at least as considerable as the losses from a formal insolvency procedure. This is rarely mentioned by critics though.

To sum up: The sovereignty of states does not represent any fundamental obstacle to a formal insolvency procedure for states.[15]

The sovereignty of states constitutes procedural singularities though, which do not matter in a national insolvency procedure. An important one is the initiative for the procedural opening: Unlike in a national procedure, only the debtor state itself shall be allowed to initiate a formal procedure.[16] Also, the means and aims of the procedure are different: A liquidation of the state is out of the question;[17] therefore the whole procedure needs to be tailored towards rehabilitation.[18] The sustainable restoration of solvency – the "turnaround" – needs to be the main objective here. This character of rehabilitation can be well described by the term "resolvency" that is offered by C. Paulus.[19] So instead of using the negative term "insolvency procedure", in the context of states, the expression "resolvency procedure" seems much more desirable.

2. The definition of state bankruptcy

Secondly, the (lack of a) definition of "state bankruptcy" is not a general obstacle for a formal debt restructuring procedure either. There are various approaches to define a state bankruptcy, apart from the rather cynical denial of state bankruptcies

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[12] *Holzhammer*, Österreichisches Insolvenzrecht² (1983) 52; *Petschek, Reimer, Schiemer*, Das österreichische Insolvenzrecht (1973) 21; OGH 21.11.1933, 4 Ob 435/33 ZBl 1934/32.

[13] *Petschek, Reimer, Schiemer*, Insolvenzrecht 21.

[14] *Paulus*, On the Way Towards International Rules for State Insolvencies (2002) 2, http://www.iiiglobal.org/component/jdownloads/finish/22/345.html (30.1.2014).

[15] *Paulus*, Some Thoughts on an Insolvency Procedure for Countries, http://www.iiiglobal.org/component/jdownloads/finish/22/342.html (30.1.2014).

[16] *Paulus*, Überlegungen zu einem Insolvenzverfahren für Staaten, WM 2002, 731.

[17] *Gianviti, Krueger, Pisani-Ferry, Sapir, von Hagen*, A European mechanism for sovereign debt crisis resolution: a proposal (2010) 23; *Kratzmann*, Der Staatsbankrott, JZ 1982, 322.

[18] Study of the Board of Academic Advisers to the Federal Ministry of Economics and Technology: "Overindebtedness and state insolvency in the European Union", January 2011, 20 (21).

[19] *Paulus*, Die Eurozone als Probefahrt für ein Resolvenzrecht für Staaten, RIW 2010, 1; *idem*, Braucht Europa eine Insolvenzordnung für Staaten? ifo Schnelldienst 2010, 7 (8); *idem*, Die Eurozone und das größere Thema eines Staateninsolvenzrechts, in: Kodek, Reinisch (eds.), 11 f; *idem*, Prolegomena für die Schaffung eines Resolvenzrechts für Staaten, in: Kadelbach (ed.), Nach der Finanzkrise (2012) 105 ff; *idem*, A Resolvency Proceeding for Defaulting Sovereigns, International Insolvency Law Review 2012, 1 (5).

(which points out that a state can simply raise its taxes and cut its services etc).[20] More recently, the well-known "unsustainability of debt" has become the core criteria for a state bankruptcy. This is an appropriate approach for a formal procedure as well, since it indicates the necessity of the restructuring of debts before there is an actual inability to pay.[21] This approach can therefore contribute to the early opening of the rehabilitation procedure (that was previously discussed). Of course, the long-term lack of financial means has to be taken into consideration here (similar to national state insolvency law, where short term cash shortages do not constitute an insolvency). Also, the appraisal of the burden of debt (in other words: its unsustainability) cannot be done by the state itself but has to be judged by an independent expert panel.

So as a first interim result, it has to be emphasized that a formal sovereign debt restructuring procedure is absolutely compatible with the current legal framework we face today.

III. Reasons for the introduction of a sovereign debt restructuring procedure

The most important arguments for the introduction of a legally framed, formal sovereign debt restructuring procedure are the following ones:

1. Disciplinary Effect

The first important argument is the disciplinary effect of a formal state resolvency procedure: It is a more or less indisputable finding that an efficient insolvency law has a strong disciplinary effect on the actors of business life.[22] Because if there is a risk of bankruptcy, then the creditors and the debtor need to be more cautious when new obligations shall be incurred.[23] Also, even though it might be inconvenient to say, the role of the stigma attached to an insolvency procedure still plays an important role, in spite of the general advance of the so-called "fresh-start" mentality.[24] The mere existence of a formal sovereign debt restructuring procedure has the potential to create a stricter budgetary discipline of states: A system of bankruptcy law can be called successful if there is no need to apply the actual procedure at all.[25] This is not contradictory to bankruptcy statistics: Even the best procedural law cannot completely avoid the phenomenon of "insolvency".[26] Its occurrence can be drastically

[20] *Gianviti*, The International Monetary Fund and External Debt, Academy of International Law, Recueil des cours – The Hague 1989, III, 205 (239); *Ohler*, Der Staatsbankrott, JZ 2005, 591; *Paulus*, Rechtliche Handhaben zur Bewältigung der Überschuldung von Staaten, RIW 2009, 11 (12).

[21] *Krueger*, A New Approach to Sovereign Debt Restructuring, International Monetary Fund (2002) 2.

[22] International Monetary Fund – Legal Department, Orderly & Effective Insolvency Procedures – Key Issues (1999); World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (2001) 25.

[23] *Paulus*, Some Thoughts on an Insolvency Procedure for Countries, http://www.iiiglobal.org/component/jdownloads/finish/22/342.html (30.1.2014).

[24] *Paulus*, On the Way Towards International Rules for State Insolvencies 4, http://www.iiiglobal.org/component/jdownloads/finish/22/345.html (30.1.2014).

[25] *D. A. Skeel*, States of Bankruptcy, U of Penn, Inst for Law & Econ Research Paper no. 11–24; U of Penn Law School, Public Law Research Paper no. 11–30, 2011, 10.

[26] *Paulus*, On the Way Towards International Rules for State Insolvencies 3, http://www.iiiglobal.org/component/jdownloads/finish/22/345.html (30.1.2014).

reduced though; this has to be true for state bankruptcies too. With regard to the character of a state resolvency procedure as a procedure that solely aims at the rehabilitation of the debtor state, it has to be pointed out that the conditions of restructuring mustn't be too lenient, so that the deterrent effect of the procedure won't be impeded. The resolvency procedure is meant to have a preemptive effect; its mere existence is supposed to avoid sovereign defaults. Therefore a reasonable compromise needs to be found here.

The deterrent effect is optimized by certain warning mechanisms, example given the mechanism according to Art 126 Para 2 TFEU (Treaty on the Functioning of the European Union).[27] The development of rules about responsible bilateral lending and borrowing – esp. by UNCTAD (United Nations Conference on Trade and Development) in Geneva – also plays an important role in this context.[28]

The disciplinary effect is highly relevant with regard to the installation of the ESM: A permanent institution without the sufficient surrounding of a bankruptcy law encourages the moral hazard amongst member states and thus creates counter-productive incentives.[29] Especially politically weak governments of highly indebted countries will tend to rely on this mechanism and therefore constantly claim it. This morally hazardous behavior is also likely to occur among creditors: They can legitimately expect the other EU-member states to support the crisis-ridden debtor state, so that they receive payment for their outstanding claims.[30] That's what some German and French banks did during the Greek-crisis: They filled up their portfolio with Greek bonds.[31] Financially saving the state basically equals saving those credit institutions then, which is indispensable to avoid a situation comparable to the Lehman Bros bankruptcy. Here, an insolvency procedure would have the advantage of sharing the burden between private and public creditors.

This is why the Board of Academic Advisers to the German Federal Ministry of Economics and Technology insisted that the minimum condition for any commitment on aid of the ESM needs to be the successful completion of a sovereign debt

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[27] "The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless:
- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
- or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The reference values are specified in the Protocol on the excessive deficit procedure annexed to the Treaties."

[28] *Buchheit, Gulati*, Responsible Sovereign Lending and Borrowing, UNCTAD Discussion Paper no. 1983, April 2010; *Paulus*, Responsible Bilateral Lending and Borrowing – an Approach to a Legally Binding Concept, forthcoming in: Festschrift Rolf Knieper (2014).

[29] *Issing*, Slithering to the wrong kind of union?, Financial Times, 9.8.2011.

[30] Study of the Board of Academic Advisers to the Federal Ministry of Economics and Technology: "Overindebtedness and state insolvency in the European Union", January 2011, 15, 23.

[31] *Choi, Gulati, Posner*, Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism, February 2011, 13; *Wilson*, Worries persist on exposure to Greece, Financial Times, 30.4.2010.

restructuring procedure. In other words: One, there needs to be a settling agreement between the debtor and all creditors with substantial waivers of claims, and two, there needs to be a convincing economic and financial adjustment program, whose implementation has to be constantly displayed by the debtor.[32] This claim will only partly be implemented by the ESM though.[33]

2. Predictability and reliability through concise procedural structures

One crucial advantage of a formal sovereign debt restructuring procedure is the predictability it entails. The lack of straight rules and structures to overcome a financial crisis tends to lead to three things: An unequal sharing of the burden, the stalling of processes and much higher costs.[34] Above all, however, it causes uncertainties, because the market players don't know which economic measures will be taken. The consequences are chaotic reactions and opportunistic behavior, which again intensifies the existing crisis. Greece is an impressive warning for this, too.[35]

The implementation of a state insolvency law with accompanying restructuring tools would instead provide a well-defined and clearly set procedure that allows affected persons, companies and states to adjust to the next steps on time. Above all, legal mechanisms cannot easily be altered by political influence and divergent interests or changed with regard to the circumstances of the specific case. This is generally recognized, so there is hope that this aspect will be more and more discerned as a considerable advantage. This is especially true for Greece, whose case – for a fair amount of time – rather curbed than promoted the discussion about a formal debt restructuring procedure within the eurozone.

3. Restructuring of debts instead of new borrowing

Another convincing reason for implementing a formal sovereign debt restructuring procedure can be examined at the handling of the Greek crisis: Financial aids can only be a temporary solution. Instead of constant new borrowing, the old debts need to be thoroughly restructured. The best way of doing so is a formal restructuring procedure that includes all creditors and not only bondholders. For that purpose, reliable restructuring tools of bankruptcy law (such as the Chapter 11-plan of the US Bankruptcy Code or its European counterparts) are available.[36]

4. Body of creditors and majority rule

In this context there is another advantage: In a formal resolvency procedure, all creditors that are affected by the sovereign default are bundled to a body of

[32] Study of the Board of Academic Advisers to the Federal Ministry of Economics and Technology: "Overindebtedness and state insolvency in the European Union", February 2011, 34.

[33] Press Release Board of Academic Advisers to the Federal Ministry of Economics and Technology, 10 January 2011.

[34] *Horst Köhler*, Reform of the International Financial Architecture: A Work in Progress (Washington DC, 5 July 2002), http://www.imf.org/external/np/speeches/2002/070502.htm (30.1.2014): "… And the experience in Argentina demonstrated that the present arrangements for resolving sovereign debt crises are not sufficiently transparent or predictable, and that they impose unnecessary costs on debtors, creditors, and the system as a whole."

[35] *Paulus*, A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings, in: Sovereign Debt and the Financial Crisis: Will This Time Be Different? (2010) 317 ff.

[36] *Paulus*, RIW 2003, 401.

creditors. This bundling enables the restructuring of debts through majority voting. A similar benefit is provided by "collective action clauses" (that were recently established in state bonds).[37] The crucial advantage of a formal debt restructuring procedure, however, is that not only bondholders, but all categories of creditors are included in the body (and thus in the majority voting).[38]

5. Institutional Framework

As any other bankruptcy procedure, a sovereign debt restructuring procedure needs an adequate institutional and legal framework. On this, the eurozone is heavily privileged, since such an institutional framework is already successfully established and quite suitable for a state insolvency procedure. There are (for example) suggestions for the creation of a Sovereign Debt Tribunal as a special chamber of the European Court of Justice or at the Permanent Court of Arbitration in The Hague.[39]

6. Possible transfer of experience from national bankruptcy law

Despite certain singularities, there is a lot of common ground between the requirements of a national insolvency procedure on the one hand and a state resolvency procedure on the other hand. Many procedural principles of national bankruptcy law can thoroughly be transferred to a state resolvency procedure, such as: The principle of equal treatment of creditors, the distinction between old obligations (that were incurred before the opening of the procedure and are satisfied equally) and new obligations (that are incurred for the sake of the procedure and need to be fully satisfied) or the general unaffectedness of in rem securities. Especially the well-proven debt restructuring mechanisms of insolvency law (or at least elements of it) can be transferred to a state resolvency procedure. All this reflects the wide field of experience that can be benefitted from.

[37] *Galvis, Saad*, Collective Action Clauses: Recent Progress and Challenges Ahead (2004) 1 f; *Schwarcz*, A Minimalist Approach to State "Bankruptcy", UCLA L. Rev. 2011, 329 (331).
[38] *Paulus,* in: Sovereign Debt and the Financial Crisis: Will This Time Be Different? 318.
[39] *Paulus,* in: Sovereign Debt and the Financial Crisis: Will This Time Be Different? 319 f.