Sovereign debt restructurings: the legal context

Lee Buchheit[1]

Thank you, Diego.

Good morning, ladies and gentlemen. It's a great pleasure to be with you. My job this morning is to try to set out the legal context of sovereign debt restructurings, and then my colleagues will describe in more detail some of the current issues that are raised by this subject.

One starts this analysis from the position that the creditors are each holding debt instruments that are legal, valid, binding and enforceable under the laws of some jurisdiction. They may choose the law of the sovereign's own jurisdiction, they may choose a foreign law, but you start with the principle that they are all holding legally enforceable pieces of paper that call for the repayment of money on a certain date in a certain amount.

Sovereigns are unique debtors. Unique in two senses: they are uniquely vulnerable and they are uniquely protected. They are uniquely vulnerable in that, unlike a corporate debtor or an individual debtor, there is no bankruptcy code that applies to a sovereign. They are not subject to their own bankruptcy codes, nor anyone else's. That means that an over-extended sovereign confronted with a maturing debt obligation has only two choices: pay it or face the prospect of a lawsuit and be compelled to pay it. To put it differently, a sovereign cannot seek the protection of bankruptcy courts; there is no Chapter 11 for a sovereign. In that sense, of all the debtors in the world, sovereigns are uniquely vulnerable.

That said, sovereigns are uniquely protected in this sense: until the middle of the 20th century, most countries recognised a theory of absolute sovereign immunity. A sovereign could not be sued in the courts of another country without its consent. Moreover, sovereign property, wherever held, was treated as immune from any compulsory seizure. This was the doctrine of absolute sovereign immunity. It changed in the middle of the 20th century. For reasons we do not need to go into here, the trend developed in most countries toward a restrictive theory of sovereign immunity; a theory which says that when a sovereign elects to go into the international marketplace and conduct itself as though it were a commercial actor, it ought to be accountable to judicial process as though it ***were*** a commercial actor. And to the extent that sovereigns historically claimed to be affronted if they were hauled into a court in a foreign jurisdiction, the response was "you should have thought about that before you engaged in commercial activities abroad." Moreover, the restrictive theory of sovereign immunity said that, under certain circumstances, sovereign property held abroad would be subject to seizure by a creditor who has obtained a court judgment against the sovereign.

Even in the era of restrictive sovereign immunity, however, the laws of most countries continue to give sovereign property a certain degree of special treatment. Typically such property may not be seized unless the property itself is devoted to a commercial purpose, and that is a very significant hurdle. Sovereigns – the Republic

[1] Partner, Cleary Gottlieb Steen & Hamilton LLP; transcript of remarks.

of Ruritania let's say – will not have, typically, property outside their own jurisdiction that is used in a commercial way, and what properties sovereigns ***do*** have outside of their jurisdictions, things like embassies, consulates, property devoted to a military purpose, are generally clothed with a special immunity from creditor attachment. To be sure, sovereign state-owned instrumentalities may be engaged in commercial activity, but the law in most countries says that if a state-owned entity, even if 100% owned by the sovereign, is nonetheless conducting itself as a separate independent entity, its legal personality, its separate legal personality from the sovereign itself, will be respected with the consequence that one cannot attach property of the entity to satisfy a claim against the government.

So sovereigns are uniquely vulnerable. They will always face lawsuits, and they have no generalised protection against them. But the creditor, once having obtained a judgment, may realise that the judgment conveys a degree of emotional satisfaction, but is unlikely to convey any financial satisfaction unless or until the creditor can find an asset outside the jurisdiction of the sovereign against which it can levy to satisfy its claim.

In that mixture of unique vulnerability and unique protection is the chemistry of all sovereign debt workouts. Each side, debtor and creditor, comes to the table with a unique advantage and a unique weakness. The creditors know that they will be able to get judgments against the sovereign if they want to. There is very little doubt about it. The judiciary in these affairs must act in an inevitably pedestrian way. Remember, it comes down to a question of money due but not paid. It is just like the thousands of other lawsuits that will clog every civil court every day in every jurisdiction. "Your Honour, the defendant owed me some money and he didn't pay it".

In the sovereign case, of course, the sovereign may wave its arms in the courtroom and speak about the terrible economic crisis in Ruritania and its effects upon the global financial system. And they will speak about their IMF programme and they will speak about their Paris Club deal. The judge will typically endure this great tsunami of rhetoric but eventually the judge will look down his spectacles and say "Son, did you borrow the money?" And you will say, "Sí señor." And the judge will say, "Did you pay it back?" And you will say, "Nope." Judgment for plaintiff.

The judiciary, much as we on the sovereign side might like them to take into account the geopolitical context in which a sovereign debt case is brought before them, are typically debarred from doing that. That is the consequence of submitting the claim to the municipal laws of a jurisdiction.

In the negotiating room, the sovereign sits there knowing that the creditors have the ability to get court judgments. Something that a corporate debtor sitting in the same room would know he could stop if he wanted to. If he wanted to, he could say, "If we cannot come to a deal, I'm going to Chapter 11, and that will prevent you from proceeding against me." It is not pleasant for the debtor; that's why they don't do it except as a last resort.

Confronted with this reality, sovereign debtors and most of their creditors will come to a negotiated solution. This is the essential chemistry of sovereign debt negotiations. An interesting footnote here: it is now the policy of the United States government to encourage precisely this situation. The United States has taken the position, since 1985, but most explicitly in a brief they filed in the Argentine case as recently as 28 December of last year, that sovereign debt restructurings require this balance of terror. As a matter of policy, the United States neither wishes to see the sovereign debtors find some technique that will insulate them completely from creditor claims, nor does it wish to see the creditors develop a legal theory that will defeat the sovereign's ability, if necessary, to escape and evade the enforcement of a judgment by shielding its property.

It is also obvious that, while legal remedies may be useful to an individual creditor, were the creditors as a class to attempt to exercise those remedies, they would be utterly futile. Even if there are some stray assets that could be seized outside the country's own jurisdiction, they are not going to be adequate to satisfy every creditor's claim. So viewed as a class, the creditors have virtually no choice but to negotiate. They cannot all look to their legal remedies. If everyone bolted to the courthouse, by definition, all or virtually all of them would get judgments, but all or virtually all of those judgments would remain unsatisfied.

So the great majority of creditors are, in effect, forced into a negotiated resolution. But what is good for the many is not always good for the few or for the one. The individual creditor may conclude that the best way to play this game is to allow the majority of others to accept some form of debt relief in a negotiated context. If you have the stamina to stay out of that arrangement, then you may have a rifle shot against the sovereign debtor. Now you might say, "you just told me there aren't many assets out there." Well, there aren't. But stray assets available for seizure can occasionally be found. Or maybe the holdout can develop a legal theory that will give it some leverage over the sovereign debtor. In any event, that holdout creditor has the ability to cause disturbing *Financial Times* headlines going forward.

Sovereigns, even in the depth of a restructuring, will look forward to the day when they can resume market access. And the very last thing they want is to have some creditor left behind from the last restructuring, holding a defaulted bond, standing up and saying – as they are trying to go back to the market – "wait a minute I still haven't been paid." Some years ago I was in the Loire Valley and did a tour of the chateaux, and there was a bedstead, a carved oaken bedstead, from the 14th-century plague time in Europe. On top of the bedstead, there was a carving that showed on the left a skeleton, dressed with a hooded robe and pointing a finger like this, and on the right were a group of young people dancing around a maypole. The legend underneath read, and this is in the mouth of the skeleton, pointing to the young people, "What you are, I once was. What I am, you soon shall be." No sovereign wants to go on its first road show to sell a new bond and have a creditor in the back stand up waving a defaulted bond, looking at the other bright-eyed prospective investors and saying, "What you are, I once was. And what I am, you soon shall be." That is the leverage that a holdout creditor will always have, even if it is not lucky enough to find an asset.

Holdout creditors come in two types. Some may not even be aware that a debt restructuring is going on; they may not have any idea of what is happening. A sovereign may have in its hold-out population a group of people who are really quite innocent. And then there are the others. There are some who analyse this situation, more or less as I've just described it to you, and say here is an opportunity, there is a gap in the legal system that will keep me from being forced into a general debt workout as I would be in a corporate setting. I can stay out, I can take my chances, I will be a holdout creditor, I will try to extract a preferential recovery, preferential in comparison to the sheep who went into the restructuring, either through the threat of litigation or the reality of it.

Accordingly, in most sovereign debt restructurings there will be an inevitable residuum of holdout creditors; either harmless, innocent ones, like retail holders, or those who have approached the matter with malice aforethought.

How to deal with them? There are two basic approaches: carrots and sticks. The carrots involve the sovereign building into its restructuring package various inducements that will encourage creditors to come along. Ultimately, of course, the restructuring medicine is bitter for the creditors to swallow. The sovereign would not be at the table if it had the money to repay all of its debt in full and on time, and therefore, to use a Clintonesque phrase, some "contribution" from the creditors is going to be required in a sovereign debt restructuring.

How do you make it at least slightly less bitter? There are a variety of ways. You can offer different instruments that accommodate the differing preferences and regulatory idiosyncrasies of creditors. You can include so-called value recovery instruments, something like this: give us the debt relief we are asking for today and we will give you a warrant that will make payments to you in the future if the gross domestic product of Ruritania exceeds a certain benchmark. An oil exporter may give an oil warrant that says that, if the price of oil ever exceeds a benchmark, inflation-adjusted, we'll begin making payments.

The "stick" techniques may involve seeking the consent of the majority of the holders of an instrument to amend its non-payment terms in order to make the instrument less attractive in the hands of a holdout. These are referred to as "exit consents". Some instruments will contain collective action clauses that allow a specified supermajority of holders to amend the instrument – even its payment terms – in a manner that binds all holders.

For 30 years sovereign debt restructurings have gotten done. We have done them, as Hung Tran said last night, more or less satisfactorily. There has been remarkably little litigation in sovereign debt workouts in 30 years, considering the size of the affected debt stocks.

When Argentina initially defaulted, the IMF, under the leadership of then Deputy Managing Director Anne Krueger, proposed something called the sovereign debt restructuring mechanism, which was intended to be nothing less than a transnational bankruptcy code for sovereigns. It attempted at every level to replicate the protections and procedures of Chapter 11, a corporate reorganisation scheme in the United States. It had a prohibition on creditor lawsuits and attachments as well as a requirement that the sovereign provide information. It embodied the notion of a supermajority creditor control of the process. In Chapter 11, in any corporate reorganisation statute, if you get a supermajority of creditors to agree to a plan, the judge will probably approve that plan, and it will bind any naysaying minority. Ultimately the SDRM did not garner the necessary political support. The Europeans, by the way, were by and large in favour of it but the United States was not. There is talk, as you see from the *Financial Times* yesterday and this morning, there's talk about resurrecting that initiative, at least in the context of Europe.

The alternative approach that Uncle Sam ***did*** embrace was collective action clauses. The problem is that CACs had never existed in American law sovereign bonds. So what we need to do, the US Treasury said, is import them into New York law bonds, and, if we do, holdout creditors will be substantially reduced. Why? Because 75% of the creditors who decide to go along can bind the rest. The Americans therefore put their weight, and the G10 put its weight, behind collective action clauses. Most sovereign bonds issued in the New York market and, of course, in the London market today will carry collective action clauses.

One final comment: on 22 May 2003, shortly after the coalition invasion of Iraq to oust Saddam Hussein, the UN Security Council, acting pursuant to Chapter 7 of its charter, that's the one where the Security Council decision binds all Member States, decided to order that Iraqi financial assets, its oil exports and all the proceeds from its oil sales, are immune worldwide from any form of judicial attachment. The UNSC did this for two reasons. First, obviously Iraq was facing, once the war was over, a major reconstruction, and the UNSC didn't want Iraq's money being diverted to Saddam-era creditors. But second, there was $140 billion of Saddam-era debt that had built up since the sanctions that were imposed in 1990. That debt had to be restructured. The Security Council knew that if you wanted to encourage Saddam-era creditors to go along with a restructuring, you needed to disabuse them of the belief that they will easily be able to recover their claims through legal action. What the Security Council did was crush the expectation that the creditor would be able to satisfy a judgment, because now there was a worldwide immunity granted to Iraqi assets. The UNSC immunities continued in force until mid-2011.

Let me stop there and let my friends pick up.