UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

Sovereign Debt Workouts: Going Forward

Roadmap and Guide

UNITED NATIONS
UNCTAD

April 2015

Roadmap towards Sustainable Sovereign Debt Workouts

Overview

Following the 2008 global financial crisis, the socialization of losses from private debts and the subsequent emergence of sovereign debt crises in developing and developed countries, UNCTAD decided to make a proposal to improve the coherence, fairness and efficiency of sovereign debt workouts. For this purpose, it established an ad hoc Working Group on a Debt Workout Mechanism in 2013 composed of stakeholders and independent experts. This roadmap contains six sections:

- A concise summary of the key problems of current practice (A);
- A set of five principles for sovereign debt workouts (B);
- Global reforms recommended for smoothing debt workouts (C);
- Steps to be taken by debtor states prior to debt workouts (D);
- Recommendations for a reformed debt workout process (E);
- Recommendations for courts deciding sovereign debt cases (F).

The Roadmap is accompanied by a Guide, which provides an in-depth explanation of the principles and recommendations contained in this Roadmap.

A. Key Problems of Current Practice

Current restructuring practice suffers from a number of problems known to most stakeholders in the field:

- *Fragmentation and lack of coordination.* The absence of an international forum dealing with the resolution of sovereign debt problems has led to decisions being made across a wide range of institutional settings at the local level and at the expense of global coherence. The multiplicity of tribunals and adjudication bodies dealing with debt issues not only permits a variety of legal procedures, which can be used for forum shopping. It also creates legal incoherence due to variations in legal interpretations. While it may be argued that some degree of variation enhances flexibility and encourages wider participation, the lack of clear, universally applicable rules and principles creates uncertainty and seriously disrupts creditor coordination in sovereign debt restructuring processes.

- *Fairness.* Current practice does not guarantee a fair workout to debtors and creditors. The aforementioned state of fragmentation heightens the possibilities of

bad faith conduct on the part of some creditors who purchase distressed sovereign debt at a steep discount in order to holdout and litigate until they extract the nominal value of their assets. The negotiating structure for sovereign debt workouts does not always respect the need for transparency and due process. Debtors might be exposed to decisions lacking accountability and independence. In addition, creditors might suffer from unilateral conduct of debtor states, which is not justified by economic or political exigency.

- *Efficiency deficit ("Too little too late")*. Restructurings often come too late. Debtor states might delay the decision to restructure their debt for various reasons: uncertainty, lack of information, electoral cycles, and fear of contagion, among others. Deficits in creditor coordination or creditors' fear of moral hazard or unwillingness to accept losses might also lead to delays. In addition, restructurings are often insufficient as a result of uncertainty, over-optimistic growth expectations or the fear of moral hazard. This lack of a 'fresh start' is often the cause of repeated restructuring episodes and may lead to additional costs to all parties.

B. Sovereign Debt Workout Principles (SDWP)

Improved debt workout practices would result from adherence to a set of commonly shared principles. Such principles would provide an orientation for stakeholders when negotiating debt workouts or when adjudicating cases related to sovereign debt workouts. They translate into more specific recommendations for each step of a sovereign debt workout, set out below and in more detail in the Guide. The principles include:

- *Legitimacy* requires that the establishment, operation, and outcomes of mechanisms and procedures for sovereign debt workouts observe the requirements of ownership, comprehensiveness, inclusiveness, predictability, and other aspects of the rule of law.

- *Impartiality* requires that actors, institutions, and information involved in debt workouts are free from bias and undue influence. While it is natural for creditors and debtors to pursue their self-interest, debt workouts require a neutral perspective, particularly with regard to sustainability assessments and decisions about restructuring terms.

- *Transparency* requires that information on debt workout institutions, processes, and the underlying data is available to the public.

- *Good Faith* requires that debt workout procedures and their legal and economic outcomes meet basic expectations of fairness.

- *Sustainability* requires that sovereign debt workouts are completed in a timely and efficient manner and lead to a stable debt situation while minimizing costs for economic and social rights and development in the debtor state.

C. Global Reforms Recommended for Smoothening Future Workouts

In light of the deficiencies inherent in existing practices and accepting the above principles, the following reforms could be considered for discussion at the multilateral level:

1. A Sovereign Debt Workout Institution (DWI) should be established with a mandate to support individual debtor states seeking a workout mainly through the facilitation of an inclusive dialogue with the entirety of its creditors, of mediation and arbitration, and to provide the technical and logistical support for sovereign debt workouts, including a public repository for the complete records of past workouts. The establishment of an institution like the DWI is considered as the preferred option. However, the steps defined in this Roadmap also work independently from its existence.
2. States, creditors, NGOs and international organizations should formulate early warning indicators and indicator benchmarks, beyond which debtor states are actively encouraged to discuss a pre-default restructuring.
3. In the main jurisdictions that host the issuance of sovereign bonds or whose law governs other sovereign debt instruments, specific legislation to protect the outcome of consensual negotiation processes could be adopted.[1] Where necessary, legislation should ensure the consistent application of sovereign immunities against enforcement.
4. States and international organizations might introduce soft measures that discourage uncooperative creditor behavior. One option would be a public list of uncooperative creditors and their parent companies, which could be managed by the DWI (or an appropriate independent body).

D. Steps to be Taken by the Debtor State Prior to a Workout

1. Debtor states, following outreach to market participants, should routinely include robust [aka single-tier] aggregated majority votes on workouts, and any other clauses aimed at making the decision to restructure more predictable.[2]

2. Debtor states, following outreach to market participants, may include in the terms of their debt instruments clauses allowing for mediation and arbitration, in case debt workout negotiations remain unsuccessful.

3. Debtor states, following outreach to market participants, may include contract provisions enabling a standstill of payments and a stay on litigation and enforcement in case of a debt crisis as long as good faith negotiations continue.

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[1] Examples include the UK Debt Relief (Developing Countries) Act 2010.

[2] The new type of Collective Action Clauses proposed by ICMA is the current benchmark for bond issuance. Additional options may be available for other debt instruments.

4. Debtor states, following outreach to market participants, should routinely include contract provisions clarifying that applicable *pari passu* clauses do not amount to a duty of ratable payment.

5. Debtor states should put in place a central debt management office (DMO) that analyses and manages the risks of its sovereign debts. An independent debt stability report relying on early warning debt crisis indicators identifying risks should be regularly published.

E. A Reformed Debt Workout Process

Debtor states that suffer from an acute sovereign debt problem, or that are uncertain about the sustainability of their debt, should seek to find a fair and comprehensive solution through a process involving impartial institutions for the provision of information, for mediation, arbitration and review. The following is a stylized process, which could lead to the desired outcome.

1. The debtor state should first carry out a realistic assessment of the sustainability of its sovereign debt, normally through the expertise of its Debt Management Office.

2. If the assessment reveals that the debtor state faces a liquidity gap only, appropriate multilateral, bilateral or private creditors should be approached for liquidity support. However, liquidity support must not be used to delay a debt workout.

3. A debt workout is necessary if the provision of liquidity support fails to mitigate the risk of a protracted period of inability to service debt. Debtor states should not delay necessary workouts for fear of the political, economic or social consequences. Delays are likely to make things worse.

4. Debt workouts might imply an immediate standstill of debt service, which would last for the duration of the debt workout, provided that the debtor state makes good faith efforts to negotiate a restructuring with its creditors. Standstill is essential in order to ensure a relatively stable economic environment and the fair treatment of all creditors. Debtor states should ensure that sufficient legal protections are in place.[3] Pre-emptive restructurings before a standstill can reduce market turmoil and the overall costs of the crisis.

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[3] While considerations of good faith provide a legal basis for a stay of litigation (see F2 below), legal protection may best be sought through contractual clauses (see D3 above), domestic legislation (see C3 above), or a multilateral treaty.

5. In the case that the debtor state chooses to invoke a standstill, it contacts the DWI, provided that the DWI has already been established (see C1 above), and obtains its endorsement for a standstill of payments for the period of the debt workout. The debtor state notifies all creditors – either directly or through the DWI – of the general standstill of payments. The debtor state immediately ceases to make any payment to any of the country's long-term creditors.

6. The debtor state may also impose restrictions on the convertibility of bank deposits or impose capital controls to limit the effects of sovereign debt restructuring on the broader economy, including its banking sector.

7. The debtor state communicates the decision to restructure to creditors immediately and invites them to an initial roundtable. An effective communication strategy will reduce market turmoil. The DWI would support the debtor state in its outreach to creditors and in the design of the negotiation process. It may moderate the initial roundtable. The initial roundtable should review the debtor state's assessment of its debt sustainability (see E1 above). Unless it reaches consensus that a workout is not necessary, it should seek consensus on a negotiating framework, including mechanisms facilitating the coordination of different groups of creditors. Options include the following:

   - direct negotiations, facilitated by the DWI;
   - a mediation process under a mediator suggested by the DWI and agreed-upon by the parties;
   - a formal arbitration process governed by internationally accepted standards for legitimate and transparent procedures, whether in an ad-hoc manner, through an agreed-upon arbitration institution, or a tribunal hosted by the DWI.

   In principle, the process should start in the most informal way, i.e. direct negotiations. It can be elevated to more formal and immediately binding formats if no agreement is reached on the more informal level. The initial roundtable may set deadlines for each step.

8. Stakeholders should carefully document the initial roundtable as it provides evidence of good faith negotiations.

9. The debtor state needs to be prepared to cover the costs of the negotiation process, as far as this is not already covered by the normal functioning of the DWI. If necessary, the debtor state may ask donors for support.

10. Negotiations under the format agreed upon by the parties begin with a verification of claims. The debtor state verifies the validity of the claims submitted in the restructuring through a transparent process. While claims presented in due form should be presumed to be valid, this process gives all stakeholders, including civil society and competing creditors, the opportunity to question the validity of individual

claims. Claims are declared invalid either by agreement of the parties or by an impartial third-party arbiter.

11. The debtor state secures interim financing for the period until the workout is completed. Interim financing provided after the announcement of the restructuring (cut-off date) is exempt from the restructuring process, irrespective of the creditor providing it.

12. Either the debtor state or – if already in existence – the DWI suggests an institution that could undertake an impartial assessment of the debtor state's debt sustainability with a view to the negotiations. Upon agreement among the parties, the institution provides an assessment of the debtor state's debt situation, including suggestions for restructuring terms.

13. In line with the debt sustainability assessment, the debtor state defines an economic and social recovery program with the full involvement of domestic stakeholders.

14. Negotiations normally take place in the debtor state's capital city. Alternatively, a venue can be chosen on the basis of convenience for creditors or for the facilitator/mediator/arbitrators.

15. The restructuring process will conclude through either of three options:
    - Direct negotiation leading to an agreement accepted by a supermajority of creditors, based on which old debt instruments are exchanged for new instruments according to applicable contractual or legislative provisions.
    - A mediator suggests a solution to the parties, which the debtor and a supermajority of creditors accept and which is directly binding upon the parties (see D2 above), or based on which old debt instruments are exchanged for new instruments according to applicable contractual or legislative provisions.
    - An arbitration panel gives its final award, which is directly binding upon the parties (see D2 above), or based on which old debt instruments are exchanged for new instruments according to applicable contractual or legislative provisions.

16. Further to the implementation of the above debt restructuring terms, including any special treatment accorded to some creditors or groups of creditors (e.g. those providing interim financing), the debtor state resumes payments.

17. Promptly upon completion of the restructuring, the debtor is required to file with the DWI, or an alternative public repository in the absence of DWI, a complete record of the financial and legal terms of the restructuring, a reasoned explanation of the treatment accorded to all creditor groups, a description of the economic and social reform program undertaken in conjunction with the restructuring, and the economic,

financial, and other assumptions supporting the restructuring. Any other stakeholder or observer may file statements and documentation concerning the restructuring with the same repository. This information should be publicly available and searchable in the official language(s) of the debtor state, and in English.

F. Recommendations for Courts Deciding Sovereign Debt Cases

1. If the SDWP have been generally observed in a workout, courts should presume that the negotiations and their outcome respect good faith.

2. Domestic or international courts or tribunals, which have jurisdiction for sovereign debt matters, could not recognize claims of uncooperative creditors to the extent that their enforcement contravenes good faith. This includes claims of abusive creditors, which purchased such claims or sued debtor states debt with the intention to extract a preferential treatment.

Guide For Sovereign Debt Workouts

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I. BACKGROUND

1. Key Problems in Current Debt Workout Practice

The international debate on the need for a sovereign debt workout mechanism to resolve sovereign debt crises has reignited since the onset of the global financial and economic crisis. The aspiration of having a well-established procedure and effective institutional set up to encourage timely, fair, and consistent treatment of sovereign debt restructurings has been considered as vital for maintaining financial stability at both the national and international levels and as a missing link in the international financial architecture. In addition, the development agenda establishes the need to counter the negative effects of debt difficulties on economic growth.[4]

No government in the world can rule out the possibility that it may one day need to restructure its debt. Debt crises are not necessarily the consequence of irresponsible borrowing. They might also result from natural disasters or external shocks such as commodity price volatility or unexpected changes in capital flows. Or they might emerge as a consequence of irresponsible lending decisions, especially in times when liquidity is abundant and sound investment opportunities are lacking. Even the best efforts to prevent debt from spiralling out of control can fail. Orderly debt workouts are therefore necessary. Only when debt crises find no proper or timely response can they become catastrophes. By contrast, there is no strong empirical evidence that the possibility of an orderly debt workout would lead to any serious problem of debt or moral hazard. Most workouts have been, and will be, politically and economically costly for the debtor state.

The 2008 global financial crisis and the resulting debt crises in several developed economies, as well as prolonged legal disputes between hedge funds and debtor states, have revealed fundamental gaps underlying debt restructuring processes and have promoted surprising new legal interpretations and processes. In particular, these include its fragmented nature, its lack of fairness and certainty, and the failure to achieve debt sustainability through debt restructurings.

- **Fragmentation**. Absent a single, comprehensive, and compulsory debt workout mechanism, current workout practice does not provide the means for effective creditor coordination and hinders fair and coherent debt workouts. This is partly due to the variety of creditors, representing various categories of debt and requesting different processes, generating obstacles to the speedy and successful conclusion of debt workout processes.[5] In the past, the Paris Club has tried to ensure coherence and creditor equality by imposing on the debtor the duty of obtaining comparable treatment from all creditors. However, imposing the burden of ensuring comparable treatment on the debtor state not only requires the latter to juggle the diverging

[4] UN GA Resolution 68/304 referring to the MDGs, the SDGs, and the post-2015 Development Agenda.

[5] U. S. Das, M. G. Papaioannou and C. Trebesch, "Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts", IMF Working Paper No. 203 (2012), pp. 26-7.

demands of different groups of creditors, it increasingly faces legal limits. The 2014 US Court decisions in the litigation against Argentina, which might facilitate collection by non-cooperative creditors, has highlighted these limits. It is likely that more creditors will systematically buy distressed sovereign debt at a discount and engage in litigation in order to collect the full nominal value of the debt. Consequently, sovereign debtors might find it increasingly difficult to convince their creditors to agree on a debt restructuring. The costs will ultimately have to be shouldered by the taxpayers of the debtor state.

- **Lack of Fairness**. Current workout practice often gives creditors an upper hand over the most vulnerable debtor states, even though the latter are responsible under international law for the welfare of their people. No impartial institution has the power to 'cram down' a sovereign debt workout, i.e., to compel creditors to accept a restructuring. Recent court decisions and changes in contractual practice make future restructurings difficult to predict. In addition, current practice may enable creditors to unduly interfere in the debtor state's domestic economy. In order to obtain interim finance from multilateral financial institutions and other regional financial arrangements, the debtor state usually needs to commit itself to far-reaching economic adjustment and structural reform policies. These policies should be designed and implemented in transparent ways. International financial institutions play a key role in policy design, although they may not be fully representative of all countries' interests. IFIs are simultaneously creditors and technical experts, which may also affect their decision making. Although formally these commitments are voluntary in nature, pressure from creditors or international institutions often does not leave the debtor state an effective choice. It is in everyone's interest to ensure that the borrowing country recovers from debt problems and grows strongly in a sustainable fashion; policy reforms should be focused on this objective rather than on more short term measures designed simply to ensure creditors' full repayment. The need to agree on such a program should be balanced with the borrowing country's primary duty to determine its own domestic policies in the public interest.[6] Economic downturns caused by policy reform have impaired their acceptance and sometimes sparked social unrest.[7]

- **Lack of Efficiency**. Debt workouts are often insufficient for achieving debt sustainability. As a consequence, debtor states might require repeated restructurings. Debt workouts also often come too late as a result of a lack of creditor coordination, or because governments of debtor states wish to avoid a process that is politically costly for them, lacks fairness, and is unpredictable due to its highly fragmented nature. Borrowers may also be tempted to take excessive risks in order to avoid a restructuring, which, if unsuccessful, makes the eventual restructuring even more costly. As a consequence, the debt crisis intensifies and much time and money is lost. Deferring the social damage a debt restructuring might cause only brings about more social damage and unnecessary hardship for the people of the debtor state, without improving the prospects of increasing creditors' return on their investment.[8]

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[6] Principle 1-8 of the UN Principles on Responsible Sovereign Lending and Borrowing.

[7] J. Ponticelli and H. J. Voth, "Austerity and Anarchy: Budget Cuts and Social Unrest in Europe 1919- 2019", CEPR Discussion Paper No. 8513 (2011); T. Chapman and E. Reinhardt, "International Finance, Predatory States, and Civil Conflict" (2009); G. Giovannetti et al., "Overcoming Fragility in Africa", European Report on Development (2009), p. 47.

[8] "Sovereign Debt Restructuring - Recent Developments and Implications for the Fund's Legal and Policy Framework", IMF Policy Paper (2013), p. 15; Lee C. Buchheit, Anna Gelpern, G. Mitu Gulati, Ugo Panizza, Beatrice Weder

There is no readily apparent quick fix for these problems. Although **Collective Action Clauses** (CACs) in sovereign bonds can facilitate creditor coordination, well-resourced and sophisticated creditors can circumvent their operation by acquiring, via the secondary market, debt that does not contain them, or a blocking minority in bond issues not bound by a stock-wide vote. More advanced CACs with aggregation clauses might reduce the opportunities for creditor holdouts.[9] But, in any case, CACs do not address challenges such as debtor procrastination and insufficient debt relief. Nor do they provide a solution for the legitimacy deficits of the current framework.

In light of these gaps, there seems to be momentum for change among stakeholders. Such evolution is witnessed by the recent work undertaken in various international fora, including UNCTAD, the IMF, UN DESA, the Commonwealth Secretariat, NGOs, think tanks, and academia, which have been organizing meetings and conducting research to explore the feasibility and configuration of a potential debt workout mechanism.

2. Role and Mandate of UNCTAD

The United Nations Conference on Trade and Development (UNCTAD) has been working on this issue since the 1970s. In 1977, it called for explicit principles for debt rescheduling.[10] In 1980, UNCTAD's Trade and Development Board endorsed a set of Detailed Features for Future Operations Relating to the Debt Problems of Interested Developing Countries. The 1986 Trade and Development Report, UNCTAD's flagship annual report, included a detailed proposal for establishing a procedure for sovereign debt restructuring based on Chapter 11 of the United States Bankruptcy Code. The issue was further discussed in the 1998, 2001, and 2009 issues of the Trade and Development Report. The annual United Nations General Assembly (GA) report on the external debt of developing countries, prepared by the UNCTAD secretariat, has repeatedly highlighted the need for such a mechanism. Many GA debt resolutions adopted unanimously by the Member States of the United Nations have also called for examining the issue.

The ambition to establish ground rules for sovereign debt restructurings was also promoted by a series of institutions and renowned academics with voice at the international level, including the International Monetary Fund, an important stakeholder due to its role as a crisis lender. Following the IMF's unsuccessful proposal for a Sovereign Debt Restructuring Mechanism (SDRM), CACs have come to be used widely in debt contracts to facilitate creditor coordination and reduce the number of holdouts. However, as noted earlier, even the most robust CACs do not address the substantive challenges of sovereign debt restructuring, notably the problem of "too little, too late."

United Nations General Assembly resolutions on the external debt problems of developing countries have repeatedly recognized debt restructuring as a tool for debt crisis resolution and called for enhanced approaches to sovereign debt restructuring and debt resolution

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di Mauro, and Jeromin Zettelmeyer, "Revisiting Sovereign Bankruptcy", Brookings Committee on International Economic Policy and Reform (2013), pp. 10-11.

[9] Cf. International Capital Markets Association, Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes (2014), http://www.icmagroup.org/resources/Sovereign-Debt-Information. For a discussion of this proposal, see Section III.3.5 below.

[10] TD/AC 2/9.

mechanisms.[11] The United Nations has been encouraged to continue to study and examine the need and feasibility of a DWM through a process that ensures the participation of all relevant stakeholders. This policy is also in line with Millennium Development Goal 8, which includes the target to "deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term."

Based on these resolutions and general mandate, as focal point for debt issues in the UN system, UNCTAD undertook to work on principles applicable to all debt workouts with the objective of making them comprehensive, efficient, and fair. Following the work carried out with a view to reducing the advent of debt crises through the formulation of the Principles on Responsible Sovereign Lending and Borrowing (released for endorsement in 2012), UNCTAD decided to build on its experience and expertise in advising nations and actors involved in sovereign debt workouts to formulate a globally applicable normative framework. Under the aforementioned Principles 7 and 15, the path indicating the need for creditors and sovereign debtors to adopt responsible behaviour in regard to debt restructuring events is clearly established. The repeated recognition in various international fora of the need to observe such principles constitutes the basis of UNCTAD's project on Principles for Sovereign Debt Workouts and the recommendations contained in this Guide.

3. Guide for Sovereign Debt Workouts

The **purpose** of this Guide is to reflect at both practical and theoretical levels on the extent to which sovereign debt workouts actually integrate, or should integrate, a set of principles and rules promoting a coherent, legitimate framework for efficient and effective sustainable debt workouts that are able to restore debt sustainability. Such a holistic approach should, where properly applied, mitigate the problems of fragmentation, unfairness, and inefficiency.

As regards **legal status**, the Guide relies on principles relating to debt workouts at the national and international levels and contextualizes them. Their status in international law might differ. Some of the principles already constitute general principles of international law, while others could be considered as emerging general principles or customary international law. Recommendations are flagged as such.

The Guide addresses the following categories of **stakeholders**. First, *governments* may wish to be guided by this instrument when facing a debt restructuring. The Guide provides indications as to what is desirable and acceptable in a debt workout and what can be considered irresponsible or in bad faith. It suggests practical steps for designing workouts in fairer and more efficient ways than current practice. Second, *legal and judicial practitioners* may use the Guide as an instrument to support their legal opinions and judicial reasoning when called upon to resolve issues related to sovereign debt restructurings. Third, *the parties to sovereign debt contracts*, whether sovereigns or private actors, may wish to draw on the Guide to anticipate what is considered internationally acceptable in a restructuring situation. Ultimately, this instrument proposes universally applicable principles.

[11] UN GA Resolutions A/RES/65/144, A/RES/66/189, and A/67/198.

The **scope** of the Guide for Sovereign Debt Workouts necessarily covers all types of sovereign debt, ranging from official sector debt (bilateral and multilateral) to public bond issuances and loans or other investments by the private sector. Debt sustainability cannot be defined with regard to individual types of debt, but only comprehensively with regard to the entire debt stock. This instrument may be applied to all sovereign debt workouts.[12] This includes workouts involving debt issued by subnational entities in domestic or international financial markets. Although the outcome of a restructuring is strongly influenced by the terms of the debt contract, a detailed discussion of these terms and their impact on debt workouts is considered outside the scope of the Guide, with the exception of clauses enabling restructurings (e.g., CACs).

The **drafting** of the Guide was preceded by more than a year of consultations and discussions. This process began with a brainstorming meeting convened by UNCTAD in February 2013 in which the decision to work on a debt workout mechanism was taken and a preliminary list of issues was identified. Following this brainstorming meeting, an ad hoc Working Group was created. The ad-hoc Working Group was composed of widely recognised academics and professionals from the field of sovereign debt, including staff members of international organisations, members of civil society, and the private sector. The members of the Working Group were selected to ensure that all interests were taken into account and reflected in the development of the Sovereign Debt Workout Principles and the recommendations included in the Guide (see appendix for more details).[13]

The ad-hoc Working Group first identified the main problems in current practice and the aspects in need of clarification and improvement. One by one, the ad-hoc Working Group reviewed the legal, institutional, and economic elements of these aspects. The review was guided by a set of **principles** which constituted the axis of the ad-hoc Working Group's deliberations. This process led to the refinement of the initial formulation of the principles reflected in the present instrument. The complexity of the issues at stake as well as the abstract and general character of the principles entail that each principle should not be considered individually but rather as an interacting element to be studied in relation to other principles. The Guide therefore provides a holistic set of principles applicable to sovereign debt workouts.

The Guide further sets out the implications of the principles for each of the main **debt workout stages**: the decision to restructure; the stage before debt restructuring negotiations; the negotiations; and the stage at which negotiations are concluded and the post-restructuring phase begins. The Guide, including the Sovereign Debt Workout Principles, should ultimately be considered as a normative instrument supporting the capacities and legitimacy of actors willing to undergo more timely, sustainable, and fairer sovereign debt workouts.

The deliberations of the ad-hoc Working Group were supported by a series of **background papers**. There was an explicit effort to reflect a balance between the concerns of creditors

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[12] The terms external and domestic debt refer to the applicable law. There is no uniform definition of domestic and external debt. Statistical compilations usually refer to the nationality of the creditor. Although this makes sense for the purpose of measuring the balance of payments, the distinction is not meaningful when it comes to a debt workout, since nationals and non-nationals increasingly own the same debt. For similar reasons, a distinction based on the currency in which the debt is denominated seems problematic. Instead, for debt workouts, the law applicable to a certain debt instrument is of major relevance since it determines the conditions of a potential workout. See U. Panizza, Domestic and External Debt in Developing Countries", UNCTAD Working Paper No. 188 (2008).

[13] The list of members is available at http://www.unctad.info/en/Debt-Portal/.

and debtors in line with the concept of co-responsibility between creditors and debtors promoted by the United Nations. The papers have been made available on the UNCTAD website.[14] Consideration for the public interest constituted an important part of this balancing exercise.

[14] http://www.unctad.info/en/Debt-Portal/Project-Promoting-Responsible-Sovereign-Lending-and-Borrowing/About-the-Project/Debt-Workout-Mechanism/

II. SOVEREIGN DEBT WORKOUT PRINCIPLES

1. Overview

For a fragmented process that operates in a legislative vacuum in multiple fora, sovereign debt restructuring has developed a remarkable degree of regularity. Its patterns are readily apparent and predictable to the small community of repeat players—finance officials, restructuring professionals, specialized investors, and observers—even if they are nonbinding and not always observed. Yet they are obscure to its principal constituents—citizens in borrowing and lending countries and ordinary investors directly or indirectly exposed to sovereign debt distress.

The following set of principles may guide the operation of sovereign debt workouts and provide a basis for its critique. On the one hand, the principles highlight positive developments in sovereign debt workout practice over the last decades. For example, intergovernmental conferences have recognized the need for debt reduction[15] and bilateral and multilateral initiatives such as the Heavily Indebted Poor Countries (HIPC) Initiative have led to considerable debt relief. Also, there is a growing recognition that debt workouts must safeguard the economic, social, and cultural rights of the affected population. These developments are echoed in the 2012 UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.[16]

On the other hand, the principles provide a tool for the identification of problems in current practice. Present arrangements for sovereign debt restructurings suffer from a *legitimacy* deficit as they lack a comprehensive forum where all kinds of debt are negotiated and all stakeholders are included. The backroom-deal character of sovereign debt restructurings impinges on their *transparency*, while the dominant role of official creditors in setting negotiation parameters and structuring the process undermines *impartiality*. A lack of good faith could compromise the successful conclusion and implementation of sovereign debt restructurings and lead to litigation by non-cooperative creditors, which a robust standstill rule would prevent. Past restructurings have not always been successful in reducing debt levels swiftly and sufficiently in order to attain a *sustainable* debt level for a reasonable period of time.[17]

2. Legal Character and Formation of Principles for Debt Workouts

In every sophisticated legal order, the application of the law is guided by principles. Principles serve as frames that narrow down the interpretative leeway inherent in any abstract legal rules, or that provide orientation for filling loopholes in the written law and unwritten rules. By doing so, principles connect specific legal or policy decisions with broad,

[15] E.g., Monterrey Consensus of the International Conference on Financing for Development, 18-22 March 2002.
[16] http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf.
[17] Cf. note 8.

general considerations characterizing the corresponding legal and economic orders as well as the institutional setup.

The legal character of principles may differ from one principle to another. Some of the principles, or certain aspects thereof, may constitute "general principles of law" in the sense of Art. 38(1)(c) of the Statute of the International Court of Justice. As a source of international law proper, general principles of law are binding. Other principles, or aspects thereof, may reflect customary international law, another source of binding international law. A third type of principle, or aspects thereof, may have a recommendatory character (soft law). A fourth type of principle does not represent a source of proper international law, but results from an interpretation of existing international legal rules that express one common underlying principle.

At least in their abstract and general form, most of the Sovereign Debt Workout Principles correspond to the first type and can be considered general principles of law, or at least emerging forms thereof. This does not exclude the possibility that some of the more concrete and specific ramifications of the Principles set out in the Guide may (or may not) independently be considered general principles of law. A general principle of law usually requires (1) an unwritten rule of behaviour (2) recognized in most, though not all, domestic legal systems, (3) which may be meaningfully applied in the context of international law. General principles of law thus originate in domestic legal practice. Usually, they find some degree of confirmation in international practice. General principles are not entirely static, as they can evolve over time. Thus, especially in a transitional phase, opinions on the legal character of a principle might be divided.

3. The Sovereign Debt Workout Principles

The present Guide reflects the following five principles: legitimacy, impartiality, transparency, good faith, and sustainability. Most of these principles are interrelated and partly overlap. This does not dilute the significance of each principle, but rather reinforces the overall message.

Principle 1: Legitimacy

Definition: Legitimacy is the property of a legal rule or a legal regime which makes it acceptable to its addressees, thereby inducing compliance. One might describe legitimacy as the good reasons why one should follow a specific rule or regime. Given the broad and inclusive nature of this concept, legitimacy overlaps with most of the other principles. Legitimacy is mostly a matter of degree, not a categorical distinction. However, every legal regime needs to meet basic legitimacy requirements.

Foundation: Legitimacy should not be understood as a general principle of law. Rather, it represents the fourth type of principle listed above. It expresses an idea that underlies every modern legal order, including international law. An act which lacks legitimacy is illegitimate but not necessarily illegal. Illegitimacy might lead to disobedience and call into question the effectiveness of the respective act. However, the specific conditions and requirements of legitimacy might very well reach the status of general principles of law.

They vary from one legal order to another and change over time. As regards sovereign debt workouts, a contemporary understanding of their legitimacy needs to take into account that states have been less and less protected by sovereign immunities and more and more subject to the decisions of international organizations and other structures like creditor committees. This links sovereign debt workouts to the recent global debate about the conditions under which international organizations may adopt decisions affecting states or individuals. In this respect, issues such as inclusive decision-making, respect for the rule of law, and human rights have emerged as crucial requirements of legitimacy.[18] While human rights are firmly established in international law, inclusiveness and the rule of law might constitute emerging general principles.[19]

Content: At present, one might identify three different dimensions of legitimacy that sovereign debt workouts need to respect:[20]

- *Source legitimacy* requires that the establishment of international institutions and rules, such as a debt workout institution, respect requirements of inclusiveness and the rule of law. State consent is an important, but not necessarily sufficient, component of source legitimacy. Source legitimacy might also benefit from the inclusion of all relevant stakeholders. Another element is transparency, which is treated below in further detail.

- *Process legitimacy* demands that the operation of a debt workout mechanism respect requirements of inclusiveness and the rule of law. It comprises the following aspects:

    - *Ownership*, i.e., the requirement that the people of the debtor state maintain control over their lives to the fullest extent possible.
    - *Comprehensiveness*, i.e., the requirement that a debt workout involve the entire outstanding debt in order to achieve creditor equality and fair treatment.
    - *Inclusiveness*, i.e., the requirement that a debtor negotiating a debt workout seek to involve all stakeholders in order to maximize the acceptance of the outcome.
    - *Predictability*, i.e., the requirement that the results of a debt workout follow recognized procedures. Predictability is enhanced by transparency, which the present Guide treats as a separate principle (see below).
    - *Reasoned decisions*, i.e., the requirement that decisions be justified, especially those taken by non-representative bodies (bureaucracies, experts, courts, and tribunals). This requirement presupposes impartiality in decision-making (see below).
    - *Legal review*, i.e., the requirement that the preconditions, procedures, or outcomes of sovereign debt workouts be challengeable before competent and impartial courts or tribunals (compare below, under impartiality).

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[18] B. Kingsbury, N. Krisch, and R. Stewart, "The Emergence of Global Administrative Law", 68 *Law and Contemporary Problems* (2005), pp. 15-62; with a view to sovereign debt workouts: O. Lienau, *Rethinking Sovereign Debt* (2014), pp. 41-43; A. von Bogdandy and M. Goldmann, "Sovereign Debt Restructurings as Exercises of Public Authority: Towards a Decentralized Sovereign Insolvency Law", in C. Esposito, J. P. Bohoslavsky, and Y. Li (eds.), *Responsible Sovereign Lending and Borrowing: The Search for Common Principles* (2013), pp. 39-70.

[19] Cf. UN GA Resolution A/RES/66/102 on the rule of law at the national and international levels (2012).

[20] Cf. O. Lienau, "Legitimacy and Impartiality in a Sovereign Debt Workout Mechanism", http://www.unctad.info/en/Debt-Portal/Project-Promoting-Responsible-Sovereign-Lending-and-Borrowing/About-the-Project/Debt-Workout-Mechanism/.

Principle 2: Impartiality

Definition: Impartiality may be defined as the absence of bias. As such, it fosters the acceptance of decisions by generating or reconfirming trust in actors and institutions. It is closely related to the principle of legitimacy.

Foundation: The idea of impartiality is inherent in the idea of the rule of law and therefore familiar to any legal order respectful of the latter. The precise content and scope of impartiality might vary from one jurisdiction to another and from one institution to another. In the abstract, one might characterize impartiality as a general principle of law.

Content: In the context of sovereign debt workouts, the principle of impartiality has three different dimensions:[21]

- *Institutional impartiality*. Institutions involved in debt workouts which do not represent the debtor or creditors should enjoy independence in order to ensure impartiality. This ideally includes their financial situation, decision-making process including the choice of their personnel, and their physical independence.

- *Actor impartiality*. Actors other than the parties charged with the examination or review of debt situations must not receive instructions from debtors, creditors, or third parties and should abide by codes of conduct against corruption and other forms of improper practice. Note that actor impartiality does not apply to actors with representative functions, who may receive instructions from those represented. By contrast, actor impartiality is particularly important for judges, arbitrators, and officials with responsibilities for coordination between and activities involving both debtors and creditors. Measures ensuring their independence such as open appointment processes strengthen their impartiality.

- *Informational impartiality*. Institutions charged with sovereign debt workouts should seek to obtain information which is untainted by the interests of any of the parties involved. This aspect of the independence principle is particularly relevant for the use of indicators, for example, during debt sustainability assessments. One way of ensuring informational impartiality is by soliciting information from multiple sources, or by relying on high-quality, state-of-the art indicators.

Principle 3: Transparency

Definition: Transparency addresses the availability of information about the exercise of public authority to the general public or at least to interested stakeholders. It is closely related to the rule of law and the idea of legitimacy (process legitimacy).

Foundation: Transparency is a principle of relatively recent origin. With some exceptions, in

[21] Ibid.

the past most public administrations were dominated by a tradition of secrecy. This includes international organizations. Only during the last few decades has the idea of transparency gained ground both among domestic administrations and in international organizations. It is currently an open question whether transparency has become an established general principle of law. One might also classify it as an emerging one.

Content: The principle of transparency has two dimensions which are of particular relevance for sovereign debt workouts:[22]

- *Data transparency.*
    - *Data on debt sustainability.* The transparency principle requires that the debtor state make available accurate information demonstrating the unsustainability of its debt. This not only applies in the event of a debt crisis but at all times, in particular in order to prevent delayed restructurings.[23]
    - *Data on projections underlying proposed restructurings.* The transparency principle requires that the debtor and any other stakeholder share information on the economic, financial, and social projections underlying a proposed restructuring, based on impartial assessments of economic fundamentals.
    - *Indicators.* Any indicator used in the context of debt restructurings should be made transparent.
    - *Creditor data.* Creditors need to provide information about their debt holdings and potential conflicts of interest.

- *Institutional and process transparency.*
    - Transparent institutions and processes allow stakeholders to determine whether their functioning is in line with their goals and likely to result in positive outcomes, as opposed to the backroom character of some past debt workout negotiations.
    - Institutional and process transparency might have to be balanced against legitimate needs for confidentiality, especially in situations where transparency would jeopardize the success of a measure. Limitations placed on transparency should follow rules and ex-post transparency should be considered.

Principle 4: Good Faith

Definition: Good faith is a principle which encompasses basic requirements of fairness, honesty, and trustworthiness.

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22 Cf. M. Goldmann, "Good Faith and Transparency in Sovereign Debt Workouts", http://www.unctad.info/en/Debt-Portal/Project-Promoting-Responsible-Sovereign-Lending-and-Borrowing/About-the-Project/Debt-Workout-Mechanism/.

23 Cf. Principle 10, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

Foundation: Good faith is widely accepted as a general principle of law. The core content of good faith, which arguably includes the idea of *pacta sunt servanda*, enjoys virtually universal recognition. Outside its core content, the scope and significance of the good faith principle might vary from one jurisdiction to another. Traditionally, its significance has been larger in continental legal systems. Nevertheless, in recent decades, good faith has gained importance for the interpretation of contractual obligations in common law jurisdictions.

Content: Generally, the principle of good faith protects legitimate expectations in the interpretation and application of the law. It has a bearing upon both the substance and the process of sovereign debt workouts.[24]

- *Substantively* good faith implies that the legal and economic outcomes of sovereign debt workouts meet legitimate expectations. In this respect, good faith overlaps with the principles of legitimacy (see above) and sustainability (see below).

- *Process-wise* the good faith principle has at least the following implications:

    - *Equality*. Good faith requires inter-creditor equality at all stages of the debt workout process. Debtors need to treat creditors fairly and may not discriminate against them arbitrarily.[25]
    - *Standstill on payments*. Good faith requires a standstill, i.e., a temporary suspension of debt service where the continuation of debt service would put equal and fair treatment of creditors at risk.
    - *Stay on litigation*. Good faith also foresees a stay of enforcement litigation by non-cooperative creditors. This ensures creditor equality and also contributes to legitimate and sustainable outcomes.[26]
    - *Duty to negotiate*. Good faith comprises a duty for both creditors and debtors to enter into negotiations in case of an unsustainable debt burden.[27]
    - *Negotiations*. Good faith has a bearing upon the structures and procedures for debt workout negotiations. For example, the unjustified exclusion of certain creditors from creditor committees or their absence from scheduled negotiations without valid cause might violate good faith.
    - *Conflicts of interest*. Good faith bars conflicts of interest both among creditors and among debtors that might lead to irregularities in negotiations or voting.
    - *Abusive creditor holdouts*. Good faith requires that only legitimate expectations be afforded legal protection. While this does not override contractual clauses, it might have a bearing upon the freedom of the parties to accept or reject a negotiated outcome. Abusive creditor holdouts are therefore incompatible with the good faith principle.[28]

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[24] Cf. Goldmann (note 22)

[25] Cf. Principle 15, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

[26] See Section III.2.2 below.

[27] Cf. Principles 7 and 15, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing; IMF, The Acting Chair's Summing Up—Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion, Executive Board Meeting 02/92, September 4, 2002.

[28] Cf. Principle 15, 4th implication, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing; see also Section III.4.4 below.

Principle 5: Sustainability

Definition: Sovereign debt is sustainable if it can be serviced without impairing the social and economic development of society.

Foundation: Sustainability constitutes an (at least emerging) general principle of law. Over the last decades, the concept of sustainability has spread from environmental regulation to other policy fields, including political economy. It now characterizes large parts of domestic policy and has received recognition in many international documents.

Content: The principle of sustainability has implications for the procedure as well as for the substantive outcomes of sovereign debt workouts.

- *Procedural sustainability:* Sustainability constitutes a standard for the debt workout process:
    - *Timeliness.* Debt workouts need to be initiated as soon as debt levels are perceived to be above the debt servicing capacity of debtor countries. For this purpose, debtors and other stakeholders should use early warning indicators.
    - *Efficiency.* This requires both creditors and debtors to structure debt workouts efficiently with a view to achieving their timely resolution.[29] The need to be expedient has to be balanced against requirements of legitimacy.

- *Substantive sustainability:* Sustainability constitutes a standard for the outcomes of debt workouts, including restructuring terms, the design and application of indicators, and structural adjustment programs.
    - *Debt sustainability in the narrow sense.* Commonly, debt sustainability requires that debt workouts bring states into a financial situation that allows them, with high probability, to roll over or reduce their debt in the foreseeable future without a major correction in the balance of income and expenditure.[30]
    - *Debt sustainability that includes economic and social sustainability.* Debt sustainability is not just a financial category. Rather, full debt sustainability is only achieved when debt service does not entail intolerable sacrifices for the well-being of society. Debt workouts must not lead to violations of economic or social rights or prevent the attainment of internationally agreed development goals.[31]

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[29] Cf. Principles 7 and 15, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

[30] Cf. IMF, "Assessing Sustainability" (2002), p. 5; IMF and IDA, "Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications" (2004), p. 8; IMF, "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis" (2011), p. 6.

[31] Cf. Principle 8, Guiding Principles on Foreign Debt and Human Rights, UN Doc. A/HCR/20/23 of 10 April 2011, adopted by the Human Rights Council under Resolution A/HCR/RES/20/10 of 18 July 2012.

III. DEBT WORKOUT STAGES IN LINE WITH THE SOVEREIGN DEBT WORKOUT PRINCIPLES

1. The Decision to Restructure

1.1 Overview

The following section discusses the debt workout process at various stages from the moment where the potential need for a debt workout is realized to the resumption of debt servicing on the basis of a mutually consented restructuring agreement. In this way, the Roadmap and this Guide intend to help sovereign debtors and their creditors find their way out of an unsustainable debt situation. They are meant to be as practical and applicable as possible, using all options available under the current framework. However, they also highlight key loopholes in the current framework and make suggestions on how to close them in line with the Principles set out above.

The first phase begins with the decision of the debtor state to restructure. It is closely related to two further issues, namely, the comprehensive identification of debts and stakeholders and the question of a standstill.

1.2 Decision to Restructure

Current Practice

The first step towards a sovereign debt workout is the government's decision to restructure once it realizes that its debt might be unsustainable. This is never an easy decision. One major issue with the current system is the lack of political will to make that decision in due time. This leads to an accumulation of debts, which is very harmful for the debtor country and which ultimately results in major losses for creditors.

There are several important reasons why governments may be hesitant in deciding to engage in restructurings:

- *Political costs of debt workouts.* Electoral cycles push governments to think on a short-term basis when in fact they should think long-term for the benefit of their constituencies.
- *Fear of loss of access to international capital markets.* Debtor states risk losing access to international capital markets once it is revealed that their debt is unsustainable and requires restructuring. Without a swift restructuring, this worsens their financial situation.
- *Lack of information.* Governments might delay a necessary workout because they lack information on whether their situation is one of insolvency as opposed to one of

illiquidity.[32] The decision to restructure therefore requires sound information about debt sustainability risks in a context where the line between insolvency and illiquidity is not clear, while the temptation to fight market expectations by showing commitment to repay the debt is high.

- *Fear of contagion*. Stakeholders might fear a spread of the crisis to the private sector of the debtor country and to other countries in fragile financial situations.
- *Access to liquidity support*. Individual lenders might feel that a bailout would provide them with a better deal than a restructuring. Consequently, they may offer liquidity support in order to keep the debt service flowing. International and supranational institutions like the IMF or the EU, or the host government of important banks with high exposure to the debtor, might also offer financial support, although IMF and EU financing requires structural adjustment.[33] Such injections can be a tempting option for the debtor state's government, as they preserve it from the political costs of restructuring. The option is all the more tempting when there are upcoming elections. And it may ultimately be successful. Bail-outs with new money do not necessarily deserve the negative reputation they acquired during the recent European sovereign debt crisis. In the event of an incipient crisis, as long as debt is not clearly unsustainable, they could under certain circumstances prevent a downward spiral. In cases of systemic crises, they could prevent contagion. However, the injection of liquidity necessarily shifts the costs of the crisis to those providing fresh money and burdens future generations in the debtor state, unless the terms of the new funds are not more favourable than those of the old debt. And the stakes are high: in cases where liquidity failed to safeguard debt sustainability, the result of the operation was a crisis that was far more costly to resolve than the one the new money was meant to tackle.

Current practice partly addresses these problems. In particular, the IMF carries out Debt Sustainability Assessments (DSAs), which aim to provide succinct information about a country's debt situation. However, such DSAs face a number of challenges:

- DSAs necessarily involve projections about expected growth and other macroeconomic figures that are difficult to predict;
- DSAs have at times focused on new money rather than on debt restructuring;
- DSAs have at times been based on weak empirical assumptions. In particular, they have overestimated the potential to reduce public expenditure without jeopardizing economic recovery.[34]

Other information having an influence over a sovereign debtor's decision to restructure comes from credit rating agencies. However:

- in the past, credit rating agencies have frequently failed to recognize debt crises in time;
- credit rating agencies might suffer from conflicts of interest, given that debtor states pay for their ratings. International standards and domestic regulations adopted in the aftermath of the 2008 financial crisis have attempted to mitigate this risk, but it may still exist.

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32 IMF, "Assessing Sustainability" (2002), pp. 4-5.

33 See Section III.2.5 below.

34 On related problems with structural adjustment programs, see Section III.2.5 below.

Recommendations in line with the SDWP

General Considerations

- *Sustainability*. The conviction is now well established that debt restructurings might be unavoidable in order to achieve debt sustainability. However, past practice has more often than not failed to recognize the need for restructuring (e.g. Greece 2010) or even taken on additional risks in an attempt to avoid restructuring (e.g. Argentina 2001). The provision of liquidity support and the continuation of debt service might preserve debt sustainability if it prevents a bad situation from turning worse, especially in case of systemic risks, and does not unnecessarily delay a restructuring. Other purposes, such as the government's desire to stay in office, do not justify the provision of liquidity support.
- *Timely action*. The sustainability principle requires that the debtor state not ignore an imminent debt crisis or postpone an inevitable restructuring. Action should be timely and decisive.
- *Debtor options*. Debtors should consider all options available to maintain or regain debt sustainability, including pre-emptive restructurings, which do not include a standstill, and debt liability management operations.
- *Debtor communication strategy*. Should the debtor state decide to restructure, past practice (e.g., Jamaica 2010, 2013) shows that a clear communication strategy helps manage stakeholder expectations. It presupposes that the debtor state has a realistic idea about the restructuring required and the procedure to be followed.

DSAs and Other Assessments

- *Legitimacy*: DSAs are carried out by IMF staff in a technical, standardized process. While the collection and assessment of data necessitates technical capacity, current practice does not always take fully into account the policy choices inherent in DSAs.
- *Impartiality*: While the IMF Staff carries out DSAs independently of the member states, the IMF has a Board of Directors whose state-appointed directors report to their various capitals. In the present arrangement, the role of independent expert is commonly assigned to the IMF and the World Bank. In reality, no creditor can play an independent role in a debt workout.
- *Transparency*: DSAs have not always been fully transparent.
- *Independent expertise*: To establish whether debt is unsustainable, an independent expert assessment should be conducted by an institution which meets three essential requirements: Technical expertise, transparency, and complete independence to avoid conflicts of interest. Institutions which fulfil these requirements may include:
    - Private entities, such as consultancy firms that are paid by and respond to independent actors, provided that safeguards to ensure their independence and transparency are taken.
    - International organizations, provided that their staff act on an independent basis and are not unduly influenced by political views of important member countries or by other reasons (i.e., they are not involved as a creditor or

governed by either party's interests). Since the IMF is usually the institution with the best data, its databases certainly need to be used together with data from debtor governments and other sources; however their interpretation must be in the hands of an independent entity.
  - Non-governmental institutions, such as specialized NGOs and competent think tanks.

- The terms of reference for the expertise requested should be as standardized as possible, in order to avoid any bias that might impair the whole process. In addition, validation of data should precede decision.
- *Debtor's assessment*. While debt sustainability analyses conducted by international organizations or independent experts are important to ensure sound debt management practices, they do not replace the need for each sovereign state to undertake its own assessment of the sustainability of its debt based on indicators that are most relevant to its circumstances. Debtor states should carry out a realistic assessment of the sustainability of their sovereign debt before deciding to restructure.
- *Early warning indicators*. The process dimension of the sustainability principle urges debtor states to put in place indicators of risks to the sustainability of their debt. Debtor states, creditors, civil society, and international organizations should formulate indicator benchmarks, beyond which debtor states are actively encouraged to discuss a pre-default restructuring. When using debt-to-GDP projections for early warning, debtor states should take into account:
  - the possibility of exogenous shocks to growth;
  - the country's historic track record of fiscal reactions to changes in growth;
  - currency risks if debt is denominated in foreign currency;
  - contingent government liabilities emanating from the banking sector.[35]
- *DMO*. The debtor state puts in place a central debt management office (DMO) that analyses and manages the risks of its sovereign debts. An independent debt stability report relying on early warning debt crisis indicators and identifying risks is regularly published.
- *Creditors' perspective*. Good faith and legitimacy require giving creditors the opportunity to comment on debt sustainability analyses carried out by the debtor, e.g., at an initial roundtable.[36]

Liquidity Support

It may often be difficult to predict whether the provision of liquidity support will prevent debt sustainability problems. Both debtors and creditors need to keep in mind the problem of uncertainty. Creditors and debtor states are well advised to consider the following before granting or soliciting liquidity injections in the event debt service becomes difficult:

- Creditors and debtor states should consider the provision of new liquidity as an option for stabilizing an overall sustainable debt situation without (or with only a

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[35] For an innovative proposal for early warning indicators, see J. Lukkezen and H. Rojas-Romagosa, "Early warning indicators in a debt restructuring mechanism", available at http://www.unctad.info/upload/Debt%20Portal/Lukkezen_Romagossa_%20debtindicatorsFinal_29apr2014.pdf.

[36] See Section III.2.2 below.

minor) restructuring as long as most indicators for debt sustainability stay below agreed thresholds.

- Liquidity support should be distinguished from interim financing.[37] In contrast to liquidity support, interim financing and debt restructuring do not rule each other out. Interim finance serves to keep essential services running during workouts, or to finance growth-enhancing investment, not to keep debt payments on track.
- As a matter of good faith, the continuation of debt service with liquidity injections should not discriminate against creditors who choose not to provide new liquidity.

1.3 Comprehensive Identification of Claims and Creditors

Current Practice

When debtor states decide to restructure they need to gain an overview of their debts and who holds them as soon as possible. For this purpose, the government hires legal and financial advisors and determines the scope of the debts to be restructured and the creditors holding them. While holders of government-to-government and bank loans are usually known to the debtor and operate in non-public markets, sovereign bonds are publicly tradable securities. Debtors might therefore find it difficult to identify their creditors.

Recommendations in line with the SDWP

- Difficulties in the identification of bondholders might delay debt workouts and compromise debt sustainability. In order to identify their creditors as quickly as possible with a view to achieving a timely and sustainable restructuring, the sovereign debtor should seek to track the holders of their debt, including foreign residents holding domestic debt.
- In cases of widely dispersed bondholders, the terms of issuance might authorize trustees to act for bondholders.

1.4 Standstill and Capital Controls

Current Practice

Debt crises may start with a disorderly cessation of payments to some creditors, while others continue to be serviced partly or in full. Different from such disorderly defaults, a “standstill” refers to the full or partial cessation of debt service in the event of a debt crisis as part of an orderly workout procedure. In the past, disorderly cessation of payments has been practiced in many sovereign debt crises. In recent years, pre-emptive restructurings, which do not include standstills have become more common.[38] Debtors and creditors might also

37 See Section III.2.4 below.

38 Das et al. (note 5), p. 8.

continue debt service for fear of contagion spreading to their financial industry or to other states, as demonstrated by the case of Greece in 2010-2011.

The purpose of an orderly standstill is to provide the leeway for a restructuring during a predefined and limited time. To be effective, standstills require a stay on litigation or enforcement actions against the debtor state. Although much of the creditor litigation in recent years seeks to free-ride on completed restructurings, in several cases—notably in Argentina in 2005 and in Grenada in 2012—litigation has interfered with the restructuring process itself. Litigation risks might influence future practice. The Guide addresses holdout litigation comprehensively below.[39]

The imposition of capital controls or the suspension of the convertibility of bank deposits have been common features of sovereign debt crises in emerging and developing economies alike, with mixed success.[40] Sovereign debt crises will often give rise to fears concerning the stability of the banking sector. Alternatively, a banking crisis might be at the root of a sovereign debt crisis. Either situation might trigger capital flight that could further deepen the crisis, turning fears into a self-fulfilling prophecy. This could justify the imposition of capital controls or convertibility suspensions. Capital controls alone do not prevent a bank run to claim foreign currency in cash, which is just as damaging as a run to foreign bank accounts. Whether capital controls or convertibility suspensions are necessary also depends on the country's specific situation. Factors include the currency in which domestic private debt is denominated, dependence on crucial imports, and the pass-through rate of currency fluctuations to the domestic economy. The effectiveness of convertibility suspensions and capital controls is subject to debate. Sometimes they can do more harm than good. For example, they present obstacles to investments and distort the efficient allocation of resources. Their prolonged use might make market participants create evasion strategies that render them less effective and fuel inflation. To mitigate negative effects of capital controls, a timely restructuring is essential.

Recommendations in line with the SDWP

- In the interest of *debt sustainability*, the debtor state should consider an immediate standstill of all debt-related payments to individual creditors when deciding to restructure its debt. It is also an essential demonstration of *good faith* on the part of the debtor to refrain from any bilateral payments to individual creditors, which are not mandated by (domestic) law. Creditors must be able to have confidence that the overall substance of the debtor's assets, based upon which the quotas are later calculated, will not be diminished by payments to competing creditors. This applies to all creditors, including multilateral institutions.
- However, there might be situations in which the debtor state may legitimately choose to continue servicing its debt. As a rule debtor states should consider the option of a pre-emptive restructuring which does not include a standstill. In case of pre-emptive restructurings, it is crucial that the decision of the debtor state respect good faith and refrain from unjustifiably discriminating against some creditors.

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39 Section III.4.4.

40 C. Reinhardt and K. Rogoff, "Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten", IMF Working Paper No. 13/266 (2013).

- To enhance the *legitimacy* of a standstill, the debtor state should seek approval by an independent institution, such as the DWI. Further, the conditions of a standstill require clarification.
    - Trigger. Ideally a standstill should be declared by the debtor state with the backing of an impartial, competent institution.
    - Duration. Standstills need to be limited in time and related to the restructuring process.
- Any exceptions from the standstill need to be narrowly construed and geared towards the objective of debt sustainability.
    - An exception may be made for short term debt (i.e., with a maturity of less than one year). In most cases this would refer to claims stemming from trade credits, which should not be interrupted in order to keep basic state functions intact.
    - Another exception should apply to interim financing provided after a specified cut-off date.[41]
- The debtor state notifies all creditors – either directly or through the DWI – of the general standstill of payments. The debtor state immediately ceases to make any payment to any of the country's long-term creditors.
- The suspension of the convertibility of bank deposits or capital controls should only be imposed after careful consideration and for paramount reasons of debt sustainability, for example, to prevent an impending collapse of the banking sector. Once such measures have been introduced, a swift restructuring is essential in order to mitigate any potential negative consequences.
- Good faith obliges creditors to refrain from asset grabbing in case of a standstill that respects the SDWP. Debtor states should ensure that sufficient legal protections are in place for that purpose.[42]

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41 Section III.2.4 below.

42 See Section III.4.4 below.

2. Preparing for Debt Restructuring Negotiations

2.1 Overview

This section addresses issues that the debtor state needs to consider, together with creditors and other stakeholders, after deciding to restructure and before entering into negotiations. Once the debtor government has acknowledged that a debt restructuring is in its best interest, it should decide on the desired setup for the negotiation process, verify claims, consider interim financing, and work on an economic and social recovery program. Each step involves different stakeholders.

2.2 Choice of Forum and Procedure

Current Practice

Once the debtor state has decided to restructure, debtors and creditors need to find an institutional and procedural framework for the debt workout. Under current practice, there is no comprehensive forum in which all sovereign debts may be restructured. Six different categories of debt exist, each of which receives a restructuring in a different setting.

- ***Bilateral debt***. For debt owed to other states, whether concessional or not, the Paris Club has been established as the chosen forum for negotiations during the past decades. The Club has fairly well-defined standard terms for restructurings, which vary according to the economic situation of the debtor state. However, it only comprises 19 members, who are also members of the OECD. The IMF and multilateral development banks participate in the Paris Club as observers. While in the past Paris Club members have been the most important bilateral creditors, this has changed considerably in the last fifteen years. New sovereign creditors with considerable weight include China, Brazil, Venezuela, and Taiwan, Province of China, along with several oil-rich states from the Middle East. The Paris Club has invited some of these new lenders to become members of the Club, but they have not joined. The Paris Club has attempted to establish its restructurings as a standard for other bilateral creditors through the "comparability of treatment" clause contained in its Agreed Minutes. The clause obliges the debtor state to seek restructurings from other creditors on terms that are comparable to the concessions of the Paris Club.[43] However, non-members of the Paris Club are reluctant to follow the terms set by the Paris Club. Some of these creditors have so far cancelled significant amounts of debt bilaterally at their own pace.

- ***Multilateral debts***. Debts owed to international institutions are usually excluded from restructurings on the basis of an assumed "preferred" or even "exempt" creditor status. However, as the HIPC initiative evolved, it became clear that multilateral debts were so dominant for some countries that debt sustainability would be impossible without restructuring them. Starting in 2005, the Multilateral Debt Relief

[43] See Section III.3.2 below.

Initiative officially brought relief from some multilateral financial institutions to the HIPCs and later to some other heavily indebted countries. This led to a successful restoration of debt sustainability in many, but not all, of the affected countries. The initiatives, however, have been closed in the meantime. The situation is different for states with a significant quantity of bonded debt. For them, IFIs sometimes play a critical role in providing confidence to avoid a catastrophic refusal to roll over such debt. In these circumstances, the preferred status of multilateral debt is tied to the fact that they provide crucial funding after a restructuring has been initiated.[44] In some very specific cases, however, where a debt crisis has continued for many years, a country that once had a significant amount of commercial debt may find itself with a very large share of multilateral debt. If this country requires further debt reduction, possibly as a result of a failure of a sequence of IFI managed programs, multilateral lenders should consider debt reduction. This does not apply if IFI programs are successful.

- ***Bank loans***. Commercial banks traditionally rely on the informal processes collectively referred to as the London Club. In the 1980s debt crisis, for example, when bank loans were the most common debt instrument from the private sector, Bank Advisory Committees (BACs) were established to represent creditors and engage with sovereign borrowers. Those committees could be quite efficient in negotiating a workout with the sovereign debtor, though some agreements took a significant amount of time. The limited number of BAC members involved in each case tended to contribute to the capacity for efficiency in London Club restructurings. However, smaller banks sometimes were not adequately represented and holdouts persisted in this context as BACs attempted to convince non-BAC banks to agree to negotiated terms. In the 2012 Greek Private Sector Involvement, the Institute of International Finance negotiated on behalf of international bank lenders.

- ***External bonds***. Today, bonded debt is the prevalent form of private finance. Around the turn of the twenty-first century, sovereign bonds had grown so much in relative weight that, in a few cases, the restoration of debt sustainability was not imaginable any longer if they were not part of the package. Overall, bond restructurings have proceeded swiftly since the late 1990s, contrary to the early predictions of extreme coordination problems. In some cases, particularly involving small countries with a small number of closely-held bond issues, substantial negotiations are possible. In those and selected other cases, creditors' committees might represent groups of bondholders in negotiations that resemble bank loan renegotiation. Normally, though, bond restructurings involve a much larger set of creditors than syndicated bank loans. Debtors and creditors have therefore tended to eschew the committee negotiation model. Constituting a representative committee and maintaining confidentiality within it becomes extremely challenging in a complex restructuring. Also, while it may be argued that debt trading during negotiations provides liquidity and a way out for those who are willing to accept a haircut, it creates deeply disruptive opportunities for abuse of good faith and violations of securities regulations, such as insider trading. Reflecting these and other concerns, the prevailing process for bond restructuring looks more like a new bond offering than a loan renegotiation. The choice of institution and procedure may be contained in the terms applicable to the debt instrument.

[44] See Section III.2.4 below on interim financing and cut-off dates.

- **Domestic bonds and other credits:** Sovereign bonds issued domestically, under the sovereign's own law, often far eclipse its external bonds. These bonds may be denominated in domestic or foreign currency and held by domestic or foreign residents. Governing law accounts for significant differences in the debtor's restructuring options. For example, under some circumstances the debtor government may unilaterally and retroactively change the terms of domestic debt, or otherwise affect its value with trading restraints, withholding taxes, etc. Although such actions may be challenged before domestic and international courts, enforcement is considerably more difficult when debt is governed by the debtor's own law. On the other hand, domestic debt is often the base asset in the national financial system and public and private pension funds. Restructuring such debt can have dramatic political consequences for the debtor state and may not bring the desired relief, for example, if banks and pension funds must be supported out of the state's strained fiscal resources.

- **Other credits** like short term[45] trade credits have often been excluded from restructuring owing to widespread recognition of the importance of trade financing for the debtor state's recovery. Nevertheless, in some cases, notably Iraq, trade credits—many of them decades old and in default for a long time—were a large part of the debt stock and participated in the restructuring.

As a result of the highly fragmented institutional structure, there are strong incentives for creditors not to make concessions, because they have to fear that other, less compromising groups of creditors will benefit. The debtor faces the challenge of coordinating potentially conflicting requirements of the various fora involved. For example, the Paris Club usually requires that the debtor state obtain comparable debt relief from all other bilateral creditors. However, it does not provide any procedure for the debtor to actually reach such arrangements with other creditors, who have not been consulted in the context of Paris Club negotiations. This is why such debts often remain in place, without being serviced or restructured. As a result, they provide inroads for holdouts and distressed debt fund litigation.

In order to juggle the diverging demands of the different fora involved, important parts of debt workouts often take place in informal, non-public channels. This has the consequence that *non-creditor stakeholders, such as the local population, trade unions, pensioners, or entities representing a certain public interest (e.g., climate preservation or regional health initiatives), which can be heavily impacted by a debt workout and which one might consider in a non-legal sense as indirect claimants, do not have an institutionalized opportunity for direct participation in debt workout negotiations*.

Recommendations in line with the SDWP

Current practice falls dramatically short of the Principles due to its lack of comprehensiveness, an important aspect of the principle of legitimacy. Current practice is noncomprehensive in two respects: across the different categories of debt, because there is no single type of debt and no overarching forum for debt restructuring; and within each

[45] "Short term" refers to loans with maturities below one year.

category of debt, because of heavily fragmented creditor and negotiating structures.[46] The legitimacy of debt restructurings is further compromised by a lack of inclusiveness. Inclusiveness requires a process and an institution in which all stakeholders have a fair chance to make their voices heard. Finally, the fragmented nature of current debt workout practice seriously undermines its transparency. Choosing transparent institutions and processes would enhance comprehensiveness and inclusion.

To improve the comprehensiveness, inclusiveness, and transparency of debt workouts, debtors and creditors may contractually determine a forum and a procedure ahead of a crisis. In the absence of such determination, the debtor state should convene an initial roundtable for deciding on institutions and procedures for the workout (a). Options include mediation and arbitration (b). The debtor state needs to be prepared to cover the costs of the negotiation process.[47]

(a) Initial Roundtable

For purposes of comprehensiveness, the debtor should take the initiative and invite all its creditors, either directly or through proper representatives, to an initial roundtable in order to set the stage and agree on institutions, principles, and procedures for the debt workout. Consideration should be given to holding this event in the debtor state's capital city in order to facilitate the participation of key domestic constituencies and encourage country ownership of the process. The open "roundtable" format is appropriate for the start of the negotiation process, because it allows creditors to organize themselves either as a whole or in different asset classes, including for their representation on an arbitration panel or in the nomination of a mediator.[48] The principle of legitimacy implies that every creditor needs to have a place in (or at least access to) the roundtable. In the event of dispersed creditors, the debtor state or any other independent institution may facilitate creditor representation. Creditors who voluntarily refrain from participating directly or indirectly might lose their right to vote on any outcomes.

The principle of legitimacy further requires opening the initial roundtable to all stakeholders concerned in the restructuring, including civil society. The roundtable should decide on mechanisms to enable the participation of these groups in the subsequent process. This may include notice-and-comment procedures and amicus curiae briefs.

As a matter of good faith, debtors should spare no efforts to inform creditors and other stakeholders about the upcoming roundtable and the possibility of participating, whether directly or through representatives. It should be publicized as widely as possible. This includes publications in important newspapers and on the internet. Creditors as well as other stakeholders might also be approached through existing networks and institutions (e.g., industry associations, trade unions). Creditors and stakeholders should be required to react within a reasonable period of time. A DWI, once established, could support the debtor state in its outreach to creditors. It may moderate the initial roundtable.

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[46] For an analysis of specific comprehensiveness problems persisting within certain categories of debt, see Section III.3 below.

[47] See Section III.1.2 above.

[48] See below on a Debt Workout Institution.

At the initial roundtable, stakeholders should review the debtor state's assessment of its debt sustainability, on which it based its decision to restructure, and compare it with their own assessments. Unless the initial roundtable reaches a consensus that a workout is not necessary, it should proceed with the preparation of a negotiating framework.

The debtor state, perhaps supported by the DWI, should propose an impartial negotiation framework to the creditors. It should also make transparent how it intends to guarantee equal treatment to all creditors. One way of doing so consists in setting up a comprehensive negotiating format including all classes of creditors. In contrast to the times when bank lending was prevalently on the private creditors' side, the atomized bondholder community will not be able to be part of such a process in its entirety. Therefore the debtor may wish to agree on a representation scheme with relevant bondholder associations, thus allowing for the highest possible degree of transparency and participation. In some debtor countries, these associations are already in existence from earlier debt restructurings; in others they could be set up under the guidance of associations such as EMTA, ICMA, or the IIF.[49] The Institute of International Finance has demonstrated its ability to co-ordinate private creditors in the difficult Greek restructuring in 2012. Should stakeholders consider a comprehensive, all-encompassing negotiating format inadequate, different classes of creditors may negotiate in different venues. In this case, the initial roundtable should find a procedure for creditor coordination across different creditor classes in order to ensure that no creditor class objects to the outcomes for other classes.

It is very important that debtor states carefully document their efforts to set up a comprehensive, inclusive, and transparent initial roundtable. If uncooperative creditors try to enforce their claims through litigation, the documentation might help the debtor to prove their good faith attempts to reach a consensual workout.

(b) Mediation and Arbitration

The initial roundtable should agree on a framework for the debt workout. In principle, an informal negotiation format is easier to handle, less expensive, and most flexible. However, parties should agree from the outset on a more formal institutional and procedural framework for dispute settlement in the event of disagreements over the debt sustainability diagnosis, the required restructuring terms, or other political or economic issues that cannot be solved within a defined time period. Provided that the expediency of the process does not suffer disproportionately, it is also possible to start an informal process first and then to decide to move on to a more binding mechanism – either because no informal agreement could be reached and some form of cram-down turns out to be necessary or because the parties agree that even an informally reached consensus should be supported by a legally binding decision. The initial roundtable may set deadlines for each step.

Options for dispute resolution range from highly formal court-ordered arbitration to informal policy dialogue.[50] The debtor should have a clear preference when entering into dialogue with its creditors during an initial roundtable regarding institutional options and

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[49] Emerging Markets Traders Association: http://www.emta.org/template.aspx?id=32; International Capital Market Association: www.icmagroup.org; International Institute for Finance: https://www.iif.com/.

[50] F. Orrego Vicuña, "Arbitration in a New International Alternative Dispute Resolution System" 18(2) *ICSID-News* (2001).

individuals whom it would prefer to have playing a role in the process. Creditors should organize promptly and decide on what is acceptable to them ahead of the initial roundtable.

Two options have particular potential for the smooth resolution of distressed debt:

- **Mediation**. Parties might attempt to reach a conciliatory solution by taking recourse to mediation based on independent expertise upon request of the sovereign. This can be implemented through a single mediator or a group of mediators, possibly chosen upon nomination by the proposed Debt Workout Institution.[51]

- **Arbitration**. Choosing arbitration requires selecting arbitrators, a procedural framework, and substantive rules. Each aspect needs to take into account potential challenges to the *legitimacy* of arbitral proceedings.[52]

  Arbitrators: Arbitrators would be selected in equal numbers by the parties. Arbitrators thus selected would identify an additional person in order to have an uneven number of arbitrators. Decisions would require a simple majority. In contrast to BIT-based arbitration, no restrictions would apply with regard to the selection of arbitrators. The parties would be free to select persons whom they trust.[53]

  Procedure: Arbitration could be based on internationally accepted standards for arbitration. Such standards might need to be modified in order to take into account the public character of sovereign debtors. The Principles provide guidance for that purpose. In particular, to the extent that the efficiency of proceedings is not compromised, such proceedings require a maximum of transparency and legitimacy. Hearings should in principle be public. All documents should in principle be publicly accessible.

  Substantive law: Arbitration should apply the law governing the debt instruments in question. However, this must not lead to legal fragmentation and defeat the purpose of a comprehensive mechanism. Therefore, arbitrators should give strong consideration to the Principles, in particular sustainability and good faith. This includes respect for the debtor state's responsibilities towards its people, for its ownership of its domestic policy, and for creditor equality within all categories of debt.

Debtor states, following outreach to market participants, may include in the terms of their debt instruments clauses that facilitate mediation and arbitral proceedings in case debt workout negotiations remain unsuccessful.

[51] An example of a successful mediation in a fairly complicated debt situation is the agreement reached on Indonesia's external debt in 1969/1970. See A. Hoffert, "The 1970 Indonesian Debt Accord", Ruhr-Universität Bochum, Economics Department Discussion Paper No. 05-01 (2001); a short summary is provided in J. Kaiser, "Resolving Sovereign Debt Crises", *Friedrich Ebert Foundation Dialogue on Globalization* (2013), pp. 26-27 (Box 3).

[52] For specific proposals, see A. von Bogdandy and I. Venzke, *In Whose Name?: A Public Law Theory of International Adjudication* (2014), pp. 156 et seq.

[53] For a more detailed description of a debt arbitration process, see K. Raffer, "What's Good for the United States Must Be Good for the World. Advocating an International Chapter 9 Insolvency", in *From Cancún to Vienna. International Development in a New World*, Bruno Kreisky Forum for International Dialogue, Vienna (1993), pp. 64-74.

2.3 Claim Verification

Current Practice

Claim verification: In general, the debtor and its legal and financial advisers determine the validity of creditor claims. The current framework already provides for some opportunities for claim verification. The Paris Club normally starts its negotiations with a "verification of claims". This serves the harmonization of debt data from various sources in order to agree on restructuring terms. In the complex case of Iraq, where the debt stock was very heterogeneous and many trade credits poorly documented, an arbitration procedure was established, devoted entirely to claim verification.

Claim legitimacy verification: An individual loan may have been contracted in violation of recognized standards of responsible behaviour on the part of the creditor.[54] Current practice does not provide for a systematic review of claims for such violations. Nevertheless, in individual cases, debt has been cancelled for this reason. In 2007, Norway cancelled USD 80m in debt owed to it by five countries, establishing that it had extended loans primarily in order to support its ailing ship manufacturing industry, even though the loans were not beneficial for the development of the recipient states.

Recommendations in line with the SDWP

- Claims presented in due form should be presumed to be valid and legitimate.
- In case of doubt, claim verification increases the transparency of debt restructurings and reduces contestations of their legitimacy. The UNCTAD Principles on Promoting Responsible Lending and Borrowing along with the SDWP set out above provide a solid legal basis to consider the claims in question to be a legitimate part of the debt stock.
- Creditors and debtors should maintain accurate records of claims and transfers, including all relevant contracts and other documentation.
- A central verification procedure should be established before debt workouts. This process gives all stakeholders, including civil society and competing creditors the opportunity to question the validity of individual claims. This information should be freely available to the public.
- The debtor state may collect evidence about potential challenges against the validity or legitimacy of individual claims. After carefully scrutinizing evidence, it should set in action the claim verification procedure to remove invalid or illegitimate claims from the country's debt stock.
- Claim verification needs to be legitimate. Claims are declared invalid either by agreement of the parties, or by the decision of an impartial third-party reviewer, such as auditors, mediators, or arbitrators who possess the necessary qualification.

[54] See Principles 1 to 7, UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

2.4 Interim Financing and Cut-Off Date Concept

Current Practice

The announcement of a restructuring and the imposition of a standstill usually have the consequence that the debtor state loses access to capital markets. It therefore needs to look for alternative sources of finance in order to pay for its current account deficit or trade credits until it regains access to capital markets, normally after restructuring is completed. The IMF through its various lending programs, along with other multilateral institutions, provide such interim financing (or "debtor-in-possession financing"). It is regularly conditional upon the implementation of an economic and social recovery program.[55] International Financial Institutions also require preferred creditor status.

In principle, the IMF only lends to states with a high probability of medium-term debt sustainability. Otherwise, debtor states need to restructure until they reach that point. Exceptions have been made in cases of systemic crises.[56] The IMF used to lend only to states not in default towards their private creditors. Otherwise, debtor states had to restructure before they could tap into the Fund's resources. Since 1989, the IMF has pursued a policy of lending into arrears, providing interim financing to states in default towards their private creditors if they make a good faith effort to obtain a restructuring.

Recommendations in line with the SDWP

- *Cut-off date concept*. Interim financing should be exempt from comprehensive restructurings, provided that it serves the sustainability goal of debt workouts. The exemption should apply to debt incurred after a cut-off date, ideally the date on which the government decides to restructure.[57] The principle of good faith does not oppose cut-off dates. It allows for a different treatment of creditors for pertinent reasons. Interim financing is one of them. This does not only apply to interim financing provided by International Financial Institutions.
- *Sustainability*. The provision of interim finance is necessary for keeping the country afloat during restructuring. However, interim finance must not delay an unavoidable debt restructuring or lead to insufficient restructurings. Therefore, unlike liquidity injections,[58] interim financing should not be used for debt service, with the exception of short term trade credits, but for allowing the country a fresh start. The intermediate period covered by the new financing must be realistic and the volume generous enough not to further compromise debt sustainability and growth. This goal can sometimes be achieved by bonds with GDP-indexed interest rates.
- *Transparency*. The exemption of interim financing from restructurings should always be transparent. Creditors have a right to know and question the actions of debtor states. Impartial review might be necessary in the event of contestation.

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55 See Section III.2.5.

56 IMF, Sovereign Debt Restructuring–Recent Developments and Implications for the Fund's Legal and Policy Framework, 26 April 2013, p. 19.

57 See Section III.1.2 above.

58 See Section III.1.2 above.

2.5 Economic and Social Recovery Program Design

Current Practice

When debtor states decide to restructure, they usually need to participate in a structural adjustment program governed by the IMF as part of its lending activities. This is an explicit requirement for Paris Club restructurings[59] and a de facto requirement for restructurings of privately-held debt since such a program lends credibility to the debtor state's exchange offers.

Structural adjustment programs are a regular part of IMF lending conditionality, in accordance with Art. I(v) of the IMF's Articles of Agreement. Conditionality is based on the idea of ownership, according to which structural adjustment programs should be in the debtor state's best interest in order to ensure compliance.[60] Structural adjustment programs are set out in letters of intent of the debtor state addressed to the IMF, comprising memoranda of understanding detailing the projected measures. They are preceded by negotiations with the IMF. Only if the program is accepted by the IMF Executive Board will the Fund grant a loan. Payment of each tranche is preceded by an assessment of progress in adjustment and structural reform.[61] Hence, although structural adjustment programs are non-binding from a legal point of view, they effectively commit the debtor state, since financing from the IMF, and with that its reputation with other creditors, depends on program compliance.

In substance, structural adjustment programs stipulate macroeconomic benchmarks and structural reform measures. They build on assumptions from the DSA[62] and recommendations which were part of bilateral surveillance. Structural adjustment often touches upon sensitive issues of economic and social policy, such as privatizations and public service. It tends to follow the IMF's view of economic development.

The success of structural adjustment has been mixed. Certain elements of these programs have been criticized as not really taking into full consideration the economic conditions of debtor countries and have led to negative results, notably in case of the Asian financial crisis. They have often been based on unrealistic growth expectations,[63] not taking into consideration that expenditure cuts beyond a critical threshold might stall growth. The experience of Greece since 2010 has shown how deteriorating growth rates have obliterated debt reduction efforts and thus aggravated the debt problem.[64] This has caused avoidable economic and social hardship for the people of the debtor state.

One of the reasons for the limited success of structural adjustment might be that the problem of debtor moral hazard has been overstated. In reality, policymakers on the debtor side tend to avoid confrontations with their creditors as much as possible. Such confrontations can often bear a higher political risk than extracting further resources out of the country.

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59 For exceptions see Section III.3.2 below.

60 Cf. Principle 3, IMF Guidelines on Conditionality (2002).

61 IMF, Guidelines on Conditionality (2002), No. 11. However, benchmarks for structural reform have been discontinued.

62 See Section III.1.2 above.

63 O. Blanchard and D. Leigh, "Growth Forecast Errors and Fiscal Multipliers", IMF Working Paper No. 13/1 (2013).

64 IMF, Greece 2013 Article IV Consultation (CR 13/154).

Recommendations in line with the SDWP

- *Ownership.* The principle of ownership as an aspect of legitimacy is meant to ensure that structural adjustment programs respect the sovereignty of the debtor state and its domestic decision-making processes. However, ownership has been difficult to secure. The voluntary nature of letters of intent alone does not ensure effective ownership. Ownership is best served if there is a direct link between structural reform proposals and growth. It is in everyone's interest for the borrower to attain a strong level of sustainable and inclusive growth. Moreover, where programs are developed, they should protect poor and vulnerable groups. In order to attain this goal, the debtor state should seek consensus about feasible expenditure cuts, for example, through open round-tables and other procedures allowed by the constitution. This should provide a guideline for the structural adjustment program and subsequent debt restructuring proposal.
- *Sustainability.* Structural adjustment has not always met its objective of enabling medium-term debt sustainability. Also, it has caused serious hardship for the people in the debtor state. In line with the principle of sustainability, debtor states need a comprehensive, holistic economic and social recovery program. Economic and social recovery should not be geared towards the short-term refinancing needs of the debtor state or the commercial interests of its creditors alone.
- *Human rights.* Sustainable economic and social recovery requires that debtor states, creditor states, and international organizations respect the human rights, especially the socio-economic rights, of people in the debtor state, in accordance with international legal obligations.
- *Non-discrimination.* Any measure provided for in an economic and social recovery program that directly affects the economic and social rights of the population concerned must be non-discriminatory and proportionate. Particular attention should be paid to the effects of such measures on marginalized groups.
- *Impartiality.* There is no impartial review of structural adjustment programs and their effects on the socio-economic rights of people in the debtor state. The impartiality principle creates the need for economic and social recovery programs to be based on impartial assessments of the debtor state's debt.[65] Also, individuals and groups need to have access to independent institutions, including international or supranational courts, tribunals, and committees, competent to review measures provided for in the economic and social recovery program to detect possible discriminatory or disproportionate effects.
- *Transparency:* The IMF has made significant progress on transparency over the past two decades. Its transparency policy follows clearly stated rules.[66] Nevertheless, increasing transparency with regard to negotiations on structural adjustment programs might improve their acceptance.

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65 On the need for an impartial assessment, see Section III.4.2 below.

66 Cf. IMF, Review of the Fund's Transparency Policy, 14 May 2013.

3. Negotiations

3.1 Overview

Current Practice

Currently, negotiations between sovereign debtors and their creditors proceed in a fragmented way intelligible only to a limited group of insiders and experts. Debtor states need to negotiate with five distinct groups of creditors. Three of these groups restructure as a result of an international, fully negotiated process: holders of external commercial bank loans, bilateral official credit, and, where applicable, multilateral credit. Domestic sovereign debt tends to be treated idiosyncratically, sometimes in line with foreign debt workouts, sometimes separately. The source legitimacy of negotiations is diffuse—grounded in a mix of contracts, market norms, and state practice. Wide variation in legal and economic leverage for the debtor and its creditors creates opportunities for differential treatment and abuse of good faith. Process legitimacy suffers from lack of transparency and inclusion, leading to accusations of bias. This continues notwithstanding the fact that some participants, such as the Paris Club, have made an effort in recent years to improve public understanding of their role, and others, such as the IMF, have made their work more accessible to the public.

Recommendations in line with the SDWP

These observations corroborate the recommendation that a comprehensive negotiating format would be advantageous. It would end the practice of individual creditor groups dealing with the debtor in dispersed fora and would organize creditors in various asset classes into one single process.[67] Comprehensive negotiations would normally start in the debtor state's capital city. Alternatively, a venue can be chosen on the basis of convenience for creditors or for the facilitator/mediator/arbitrators. If negotiations take place in different fora for different creditors, comprehensiveness could be achieved by conducting negotiations simultaneously and ensuring that creditors in each forum do not object to the outcomes of negotiations in other fora.

3.2 Official Bilateral Debt

Current Practice

The Paris Club typically negotiates with the debtor country after the state has agreed on an IMF loan and related structural adjustment program but before it has restructured debt to private creditors. As a result, by the time the debtor engages with the Paris Club, the scope for negotiation is limited. The IMF program supplies financing and conditionality, which forms the underlying economic assumptions for the workout. In at least two recent cases—Nigeria and Argentina—the Paris Club reached an agreement with sovereigns without insisting on a

[67] See Section III.2.2 above.

disbursing IMF program. In these and several other cases, notably Ecuador, the debtor had reached a settlement with most of its private creditors before the Paris Club.

Debt workouts ("treatments") in the Paris Club cover medium-term export credits and development assistance. Debt with maturity under one year is excluded. New debt incurred after the country approached the Paris Club for the first time—the cut-off date[68]—is also excluded from treatment.

A Paris Club negotiation ends in "Agreed Minutes." This is not a binding legal document, and does not specify all the terms with precision. It must be implemented by individual creditors in bilateral government-to-government agreements. Notably the bilateral agreements may set different interest rates, consistent with the guidelines in the Agreed Minutes.

The Paris Club insists on "comparability of treatment" in its agreements with sovereign debtors. This is a device to reduce free-riding on taxpayer concessions. Combined with the IMF program, the Paris Club terms effectively set the scope and terms of the overall workout, albeit in a rather general and flexible way. Debtor states agree to seek debt restructuring terms comparable to those they obtained from the Paris Club from all its other private creditors and official bilateral creditors that are not part of the Paris Club. Comparability runs one way: the Paris Club itself does not consider itself to be bound in any way by private creditor concessions that precede a Paris Club agreement. Requests for "reverse comparability" have been consistently rejected. Nor does the Club provide the debtor with any hint of how it should enforce comparable treatment against third parties.

It is important to note that comparable treatment does not mean identical treatment. It is based on a methodology that is not made public. Moreover, the requirement of comparability does not cover all claims against the sovereign. Domestic and multilateral debts are excluded. In theory, the sanction for breaching the comparability undertaking is the dissolution of the Paris Club's agreement with the debtor. In practice, it has never happened – not least because it would not make much sense for Club members to insist on payments which they have previously renounced because they were considered unrecoverable.

Through much of its history, the Paris Club has been understood as a forum for negotiating debt problems. In reality, creditors set the terms, mostly in accordance with predefined standards. In the context of a more comprehensive process, which is being advocated here, the Club should continue to exist as the representation of an important asset class, if possible with the inclusion of the broader official creditor community.

Recommendations in line with the SDWP

- *Sustainability*. The Paris Club's case-by-case approach ("Evian Terms") to individual cases is more efficient in reaching sustainable workouts than the earlier formulaic approach. Nevertheless, the case-by-case approach creates new challenges under the principles of transparency and good faith. Similarly-situated countries can be treated differently for reasons that are difficult to discern from the outside, which

[68] See Section III.2.4 above.

leads constituents to call the process into question.

- *Transparency*. The Paris Club is presently more *transparent* than it was for most of its history. Nevertheless, transparency would be enhanced by disclosing restructuring methodology *ex ante* and publishing reasoned decisions *ex post*. This could marginally diminish the forum's capacity to deal with diverse debtor and creditor country circumstances in a flexible way. However, it would assure constituents that the outcomes of a workout are not arbitrary. It would also enable outside monitoring, potentially also improving process efficiency.
- *Good faith*. Although the Paris Club principle of comparability is designed to promote equal treatment and good faith, it is applied unilaterally and thus inequitably. The *good faith* character of Paris Club restructurings would benefit from more comprehensive workouts as explained above.

3.3 Multilateral Debt

Current Practice

Multilateral debt restructurings, like the ones carried out in the frame of the HIPC initiative, did not involve substantial negotiations between multilateral creditors and their debtors, but rather followed a more standardized approach. The IMF and the World Bank first defined a debt sustainability level which constituted the basis of the whole process. In the next step, the Paris Club waived 90% of bilateral debts under its Cologne terms, with some of its members waiving the entire debt altogether. Applying the comparability of treatment clause, it urged other creditors, public and private, to provide equivalent relief. Subsequently, the IMF, the World Bank, and multilateral development banks waived as much of their claims as was necessary to reach debt sustainability. While the standard approach was to reduce the stock of multilateral debt, it seems that individual countries involved in specific crisis situations benefited from the larger frontloading effects of an extension of maturities and reduced interest rates. The Multilateral Debt Relief Initiative (MDRI) waived all concessional loans from the soft loan windows of four important multilateral institutions.

Recommendations in line with the SDWP

- *Sustainability:* The experience of the MDRI demonstrates that, in specific cases, multilateral debt might need to be restructured or cancelled in order to reach long-term sustainability. This depends on the debt structure of the affected state. All stakeholders should regularly consider whether multinational creditors should participate in a workout. This does not necessarily mean that multilateral claims should be restructured under the same terms as bilateral claims. Interim financing granted after a defined cut-off date should usually be exempt.[69] Other multilateral financing may be related to anti-poverty programs and other specific programs that assist vulnerable groups or may be a priority action to boost growth. These programs should, wherever possible, be protected.

[69] See Section III.4.3 below.

- *Good faith:* Restructuring multilateral debt under the conditions set out in the previous paragraph can enhance creditor equity. Multilateral creditors should participate in negotiations on equal terms.
- *Impartiality:* Given that multilateral institutions are regularly involved in debt workouts simultaneously as creditors and as providers of expertise, conflicts of interest might arise and need to be addressed. The creation of a Debt Workout Institution, as proposed in Part IV, could be an option for addressing this issue.

3.4 Foreign Bonds

Current Practice

For some governments, particularly those with a small number of outstanding bonds, the creditor coordination challenge is limited, much less daunting than bank loan restructurings in former decades. Others governments with more outstanding and more widely dispersed bonds need to convince thousands of bondholders with very different interests, legal entitlements, and economic and regulatory constraints. There are several ways to ensure that debtors obtain adequate relief and minimise free-riding among creditors. Below we address collective action clauses (CACs), minimum participation thresholds, and exit consents, which have been important in restructuring foreign-law sovereign bonds. We then address domestic-law bonds separately.

Depending on the sovereign's bond contracts, the debtor may be able to use majority amendment CACs to bind dissenting creditors to the terms agreed by the majority. Three versions of majority amendment CACs exist. The most basic and prevalent version operates bond series by bond series. If a requisite majority (e.g., 2/3 or 3/4) of the series votes in favour of the restructuring, the remaining bonds are bound. However, any given series where a holdout creditor could buy a blocking minority can stay outside the restructuring and demand payment in full. In practice, majority amendment clauses have been used relatively rarely, even where the debtor had them in its debt. With the possible exception of foreign-law debt in the 2012 Greek debt restructuring, where more than half of the series that voted under CACs held out, traditional series-by-series collective action clauses have helped facilitate restructurings.

Besides euro area member states, a few other states have recently introduced two-tier aggregated majority amendment clauses; however, none has used them to date. Such clauses gives more power to the overall bondholder majority, stock-wide, and lower the threshold needed to secure the participation of any given series. Thus, for example, a restructuring that has secured the backing of 75% of the creditor body as a whole and a simple majority of each individual series can bind the lot. This reduces the scope for holdout behaviour, but does not eliminate it.

A single-tier aggregated voting mechanism was introduced by statute in Greece in 2012. It dispensed with per-series voting altogether, reducing or eliminating the risk of holdout behaviour. Thus if 75% of the stock voted in favour of the restructuring, the full bond stock is bound, even if an entire small series votes against. The International Capital Market

Association recently put forward a contractual model of a single-tier aggregation mechanism.[70] As a condition for using single-tier aggregation, the sovereign debtor must make an identical offer to all affected bondholders. This might raise issues of inter-creditor equity, since all affected creditors will be offered exactly the same instrument, even though they might incur significantly different economic losses—the presumption is that all creditors face the same high likelihood of imminent default. Where this is not the case, one might resort to single-series or two-tier aggregated votes, or "sub-aggregate" the outstanding bonds in single-tier votes, each one comprising only part of the outstanding bond issuances. But this would resurrect internal fragmentation, and with it the possibility that financially powerful actors could gain a blocking minority. The design and application of CACs always faces a difficult tradeoff between equality and effectiveness. Moreover, the inclusion of single-tier voting procedures in the terms of sovereign bonds remains voluntary and will only apply to future issuances. It might take up to a decade from the point where a debtor begins to include them in its terms until they become effective.

Like CACs, exit consents are a contractual majority voting mechanism. They do not change the financial terms of the old bonds, sometimes because they cannot secure the unanimous or high majority vote to do so. Instead, they change other bond terms to make them unattractive to potential holdouts in a restructuring. Thus, for example, a debtor state might ask bondholders that agree to participate in a debt exchange, when they "exit" the old bonds, to vote to remove submission to jurisdiction terms in their old bonds. Once a majority votes to amend the entire stock in this way, the old bonds become illiquid and lose value. Although the technique has been challenged in extreme cases—for example, when the non-participating bonds were stripped of substantially all value, rather than reduced in line with the participating bonds—it remains valid within a more constrained set of parameters under English law and New York law. Creditors tend to view exit consents as coercive and inequitable. As a result, the same contracting practices that have introduced series-by-series CACs have also removed the scope for the most robust exit consent tactics, such as those stripping status and jurisdiction provisions in the old bonds.

Before CACs were widely adopted, debtors used a combination of minimum participation thresholds and exit consents to sharpen the choice for voting bondholders. For example, a debtor might announce that it would not proceed with the restructuring unless a minimum of 90% of its bondholders voted in favour. With or without CACs, a bondholder facing a minimum participation threshold must contend with the possibility that the entire restructuring would fail without their vote—and the alternative of a prolonged default. Minimum participation thresholds, along with exit consents, have been credited with supporting multiple restructurings in recent years. Because they promote equal treatment among all affected bondholders, minimum participation thresholds are not generally viewed as coercive by private creditors. However, they do raise the risk of a restructuring failing and may prompt the debtor to offer more favourable terms that imply less relief.

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[70] See note 9 above.

Recommendations in line with the SDWP

Sustainability:

- Contractual creditor coordination techniques can promote sustainable debt workouts to the extent that they prevent creditor holdouts. Debtor states should include CACs in the terms of their bonds. Currently, CACs with single-tier voting appear to be the most effective solution, offering at the same time a high degree of creditor equality.
- However, the limitations of CACs might compromise swift and sustainable workouts. This creates risks for human rights, including socio-economic rights.

Good Faith:

- Inter-creditor equity is partial at best. Contractual clauses limit free-riding, promoting good faith and creditor equality. However, in the event they lead to the exclusion of one or several series of bonds from a restructuring, they can exacerbate inequality among creditors, raising concerns with debtor and creditor good faith.
- Paradoxically, single-series and two-tier aggregated CACs potentially create a greater disparity among creditors than either contracts with no majority voting provisions at all or contracts with single-tier aggregated CACs. This is because only bondholders with the capacity to buy blocking positions in a series can hold out and secure preferential treatment. This creates opportunities for abuse of good faith. By contrast, where any bondholder can hold out, all creditors have the same opportunity to free-ride. Where all bondholders are bound by a single aggregated vote, all obtain the same restructuring outcome.
- Similarly, exit consents that go beyond equalizing the treatment of participating and non-participating creditors contribute to disparities among similarly situated creditors, raising further concerns with respect to good faith.
- Creditors buying debt with the purpose of extracting a preferential treatment in the restructuring act abusively. Creditors should therefore not attempt to buy distressed debt with the intention of withholding from the negotiation process.[71]
- Following outreach to market participants, Debtor states should routinely include clauses that clarify that *pari passu* does not give the right to ratable payments.

Legitimacy:

- Bond restructurings do not give voice to all stakeholders. The assumption is that bond restructurings are only a matter to be dealt with between government and creditors. They therefore leave much power in the hands of private actors, in particular large ones. However, in many cases the welfare of the people in the debtor state, including social entitlements, heavily depend on the bond restructuring, which is intrinsically related to the economic and social recovery program. Negotiating formats which do not take this into account compromise the acceptance of a debt

[71] The issue of abusive creditors is explored below in further detail. See Section III.4.5.

workout and related economic and social recovery programs and compromise the effectiveness of the workout. Comprehensive negotiation formats are therefore preferable.

Transparency:

- Sovereign bonded debt to private creditors is restructured for the most part without negotiation, following informal outreach to disparate groups of bondholders, sometime giving rise to a situation of "take it or leave it." Most of the process is invisible to the public.

3.5 Bank Loans

Current Practice

Since the late 1970s, commercial bank loans to sovereigns have been renegotiated in Bank Advisory Committees (BACs, or the "London Club" process). A lead bank, usually with the largest exposure to the sovereign, would coordinate the creditors. Subcommittees addressed particular issues, such as data and surveillance, relations with multilateral creditors, new financing, and special debt categories (e.g., trade credits). The BAC would hire legal and other advisors, sometimes—but not always—paid by the sovereign. It would reach an umbrella agreement with the debtor government, and endeavour to convince all other bank creditors to sign on, including those that were not members of the BAC.

However, BACs had no separate legal personality or capacity to bind their members, much less other groups of creditors. There is no voting mechanism to bind all bank creditors to the outcome agreed by the debtor and the majority of its creditors. Thus, even when bank lending dominated foreign sovereign finance, the London Club process was riddled with free-rider problems. Negotiation and coordination could take years. Participants reported that many smaller and some large banks defected. When bank debt began to be traded in the late 1980s and early 1990s, defecting creditors were able to sell their claims to speculative investors, including those inclined to hold out and sue for full repayment. However, syndicated bank loan contracts typically contained clauses that required litigating syndicate banks to share the proceeds with the rest.

Until the late 1980s, London Club restructurings did not take debt reduction into consideration, only refinancing or maturity extension. The Brady Plan, announced in 1989, first broached the topic of principal reduction. Special regulatory and accounting concessions in creditors' countries created incentives for banks to write off the debt.

The London Club process has been on the wane since the 1990s, when tradable bonds re-emerged as the dominant means of private financing to sovereigns. Although banks are often the dominant holders of sovereign bonds, they tend to participate in bond exchanges along with other bondholders. In the 2012 Greek private sector involvement, the Institute of International Finance represented the banking industry. The current relevance of the London Club is primarily that of a model for workout institutions, especially creditor committees, which has yet to be adapted to a large scale.

In negotiations with banks, regulatory issues might come up. Banks that hold distressed sovereign loans or bonds may be particularly vulnerable to runs, although they are frequently held alive by their respective central banks' liquidity windows. When they are thinly capitalized, a restructuring can cause insolvency or require capital injections or even a public bail-out. On the other hand, banks also tend to be susceptible to regulatory incentives and pressure from their supervisory authorities, which might ensure their persuasion.

Recommendations in line with the SDWP

Sustainability and Good Faith:

- Creditor committees following the London Club model are a coordination device that can help limit free-rider problems. In that sense, they can contribute to the sustainability of the process, and reduce the opportunity for unequal treatment, provided that they represent all creditors of one class.
- On the other hand, because BAC-style committees only coordinate discrete subsets of creditors and do so by diminishing the scope for outside monitoring, their contribution to sustainability and good faith may be very limited in all but the simplest cases.

Legitimacy:

- BAC-style committees also come at a cost to legitimacy. Even in its heyday, the London Club process was neither inclusive nor transparent. BACs generally accounted for 25-35% of the government's bank creditors.[72] Other creditors, including smaller banks, and stakeholders had no access to the process and limited insight into it.
- Ideally, the composition of BAC-style committees should give equal weight to adequate creditor representation, thus enhancing legitimacy, and the need to keep their size manageable.

Transparency:

- To the extent possible, creditor committees should ensure transparency. This might require specific standards, which are yet to be developed.

3.6 Domestic Debt and Other Credits

Current Practice

Domestic loans and bonds.[73] In addition to its distinct advantage in workouts, i.e., the ability of the debtor state to change the terms of debt instruments by legislation or other domestic economic and monetary measures, domestic sovereign debt also presents special challenges. Domestic debt (especially debt sold at auctions) generally lacks elaborate contract terms. As

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[72] Das et al. (note 5), citing Reed 1987.

[73] For a definition of domestic debt, see note 12 above.

a result, creditor rights, inter-creditor rights and duties, and amendment procedures are not specified, creating considerable uncertainty about the workout and recovery values. Creditors might sue before domestic and international courts and tribunals.[74]

Domestic holders of sovereign bonds (foreign or domestic) tend to behave unlike foreign holders. Pension funds, insurance firms, and banks might be subject to legal mandates or at least be more susceptible to suasion by the sovereign debtor government. Where the domestic creditors are banks or other effectively insured institutions, their concessions do not solve the debt problem—the government may end up using the freed-up funds to recapitalize the domestic financial system.

Central bank holdings of sovereign debt present a special challenge. Sovereign bonds are used in monetary policy operations and as collateral for the lender of last resort, by definition exposing central banks to risk of loss from default and restructuring. While central banks are of primordial importance for the debtor state's economy, the bankruptcy of Lehman Brothers demonstrated their capacity to absorb losses.

Trade credits. Short-term trade credits are usually exempt from workouts in order to keep the debtor state's economy operational. In the case of Iraq after 2003, poor and heterogeneous documentation and limited international experience with restructuring trade credits created room for innovations, including the aforementioned arbitration procedure for claim verification. The Security Council supported this in a binding resolution.[75]

Recommendations in line with the SDWP

Domestic Debt

- In principle, domestic debt should be included in debt workouts in order to:
    - achieve a *sustainable* debt burden;
    - ensure inter-creditor equality in line with the principle of *good faith*; and
    - make debt workouts comprehensive and therefore more *legitimate*. In this respect, the exemption of central bank holdings faces particular challenges. Policy design should account for the unavoidable risks ensuing from their monetary policy operations up front. It is inadvisable for central banks or any other creditors to pre-commit to particular positions in advance of a hypothetical restructuring. Any such pre-commitment distorts incentives and is unlikely to be credible.

- However, when deciding whether to include domestic debt in workouts, stakeholders should consider the following:
    - the effects of domestic debt restructurings on the economy must not compromise the goal of *sustainability*, especially by endangering systemically important institutions;
    - the inclusion of domestic debt creates opportunities for unjustified discrimination among different creditor groups and other claimants thus

[74] See Section III.4.5 below.
[75] UN Security Council Resolution 1483 (2003), 22 May 2003, para. 15.

contravening *good faith*;
  - the *legitimacy* of unilateral actions to restructure domestic debt might face challenges, both on a political level and before courts.

Other Credits

- The principle of *legitimacy* supports comprehensive restructurings. *Good faith* requires in principle that all creditors receive equal treatment. However, the exclusion of short-term trade creditors is justified to the extent that it enhances the *sustainability* of the debtor state's financial situation by leaving its trade relations unaffected.

All Domestic Debt

- *Transparency* on the part of the debtor is critical at this stage, in respect of both data disclosure of its financial status and disclosure of its proposed treatment of different creditor groups. Creditors can condition their participation in restructuring on such disclosure. Nevertheless, the contractual nature of the bond restructuring process, as well as securities law constraints, by definition limit process transparency. Debtor states should seek to make the success of their exchange offers and the restructuring process transparent.

- Should creditors have reason to believe that the debtor state falls short on its disclosure obligations, an *impartial* review process might be appropriate, whether in the form of an audit or arbitral proceedings.

4. Restructuring Terms and Post-Restructuring Issues

4.1 Overview

As noted in the preceding section, sovereign debt workouts are currently disjointed and loosely-sequenced enterprises. As a result, there is no "magic moment" when all the creditors have come on board and the debtor gets a fresh start. There is no publicly visible moment of closure for the debtor or the creditors. Each forum decides separately on the restructuring and its terms. It also determines the scope of debt covered and defines cut-off dates. But this does not mean that the workout is over. Holdout litigation might threaten its success.

4.2 Determination of Restructuring Terms

Current Practice

In theory, the terms of a sovereign bond restructuring are determined by the mix of IMF program and Paris Club comparability requirements, as well as interim financing, if any, from other multilateral and bilateral sources. Unlike bank loan restructuring, bond restructuring does not generally contemplate new money, but rather aspires to achieve debt stock and service reduction and restore the debtor's access to the capital markets in the future. Within these parameters, outcomes vary case by case, depending to a critical extent on the number and composition of bondholders and on the bond contracts involved, as well as the geopolitical importance of debtor countries.

In most but not all cases, restructuring parameters are determined by the debtor state's IMF program. The program indicates, first, the external financing needs for the coming three to five years, and, second, the amount of debt relief required to return the debtor state to debt sustainability. The figures derive from the IMF's DSA.[76] They are based on expectations of economic performance, taking into account domestic policy changes (macroeconomic adjustment and structural reform) and expected external financing. Both can vary widely. For example, a poorly-performing country cut off from new private financing may not be advised to restructure if it gets large-scale transfers from other governments; on the other hand, a country that undertakes painful reforms but does not receive additional official support may have to ask its private creditors for substantial debt relief.

Until the mid-1990s, the Paris Club generally treated only the debt coming due during the IMF program period, using pre-set formulae. It began granting "stock" relief to low-income countries in 1994 under the "Naples Terms." In these operations as well as in standardized terms established for a group of debtor states, static debt indicators have been used in order to identify the need for debt relief and its extent. For example, the Paris Club's debt reduction ratios under its various frameworks for low-income countries amount to 33%, 50%,

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[76] See Section III.1.2 above.

or 67% of eligible debt.[77] The assumption behind these fixed ratios is that identical ratios would be sufficient for similarly situated over-indebted states. However, due to ever-insufficient relief some debtor states ended in serial restructurings.

When the G7 acknowledged the need for the reduction of multilateral debt, it established debt sustainability targets defined as debt/export earnings or debt/revenue ratios. This brought sustainability targets in line with the individual debtor state's situation. Nevertheless, in the interest of equal treatment and predictability, creditors continued applying fixed sustainability thresholds in the framework of the HIPC initiative, established in 1996. As thresholds turned out to be too high, HIPC 1996 had to be reformed in 1999 and 2002. The MDRI established in 2005 returned to a debt reduction ratio—although an extremely ambitious one, namely, the almost complete cancellation of all debt owed to four important multilateral creditors.[78]

Beginning in 2003, the Paris Club opened the possibility of stock relief for middle-income countries. With the implementation of its Evian Terms in 2004, the Paris Club sacrificed equal treatment for flexibility.[79] Briefly put, the Evian Terms allow for Club members to, once they have invoked this particular framework, treat the debtor however they like. So far, the Evian Terms have allowed speedy and significant debt relief in some cases. Some therefore consider it very successful. Others criticize the lack of consistency.

The IMF and World Bank's Debt Sustainability Framework (DSF)[80] has been designed to assess the borrowing needs of low-income countries. While traditional debt sustainability analyses compared common debt indicators with some benchmarks defined by the Fund itself, two important qualitative elements have been added in the revisions of the framework:

- The calculation of stress scenarios has become far more sophisticated, and their results form part of the final decision.[81] Although some elements of stress tests could be more transparent, the assumptions underlying each of the scenarios as well as the baseline have been made transparent.

- Some threats to debt sustainability, such as political uncertainty or the likelihood of natural disasters, are being considered and assessed in heat maps. While they are not fully transparent, this method constitutes a huge step forward in the Fund's methodology.

On the whole, sustainability has been recognized as a goal for debt workouts. Nevertheless, restructuring terms still deliver unsustainable results that bring the debtor back for more relief in just a few short years. This detracts from efficiency.

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77 Toronto, London, and Naples Terms, respectively. Some of them are not operational any more. See www.clubdeparis.org.

78 IDA, PRGF, AdDF, and FSO, belonging to the World Bank, the IMF, the African Development Bank, and the Inter-American Development Bank, respectively.

79 http://www.clubdeparis.org/sections/types-traitement/reechelonnement/approche-d-evian. Evian Terms were defined ahead of the Paris Club's dealing with the huge and complex case of Iraq's post-Saddam debt, which would have escaped any of its existing frameworks.

80 For an overview of the IMF/WB scheme for low income countries, see IMF, *The Joint World Bank/IMF Debt Sustainability Framework for Low Income Countries. A Factsheet*, 18 March 2014, https://www.imf.org/external/np/exr/facts/jdsf.htm. For Market Access Countries, see IMF, *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis*, 5 August 2011.

81 By declaring the sovereign to be at "low," "moderate," or "high" risk of debt distress.

Recommendations in line with the SDWP

- *Debt Sustainability as an Objective*

    - Restructuring terms need to lead to debt sustainability. This requires a financial situation of the debtor state that allows it, with high probability, to roll over or reduce its debt in the foreseeable future without a major correction in the balance of income and expenditure.[82] Consecutive restructurings should be avoided.

    - As a holistic concept, sustainability requires going beyond merely economic considerations in debt restructurings. Respect for human rights, particularly socio-economic rights, and political risks need to be taken into consideration.

- *Restructuring Terms for Achieving Debt Sustainability*

    - Restructuring terms should be tailored to the specific situation of the debtor country, as well as to the potential effects of the restructuring on financial markets and other states. Although some degree of standardization might be unavoidable, it should only provide rough guidance.

    - Stakeholders should refrain from establishing any predefined, inflexible quantitative benchmarks, which rigorously bind the decision-making body. Over-reliance on econometric data would be ill-advised. It tends to suffer from historical biases, as in the case of DSF stress tests.

    - The restructuring terms might provide for certain differentiations, such as the exemption of post-cut-off-date debt, different treatments of concessional and non-concessional debt, preferred status for debt incurred to finance disaster relief, or benefits to creditors who commit to provide new financing. In the end, this may not be very different from the "preferred creditor" arrangements common for some International Financial Institutions. The difference is that it would apply to all creditors contributing to interim financing.

- *Impartial assessment*. Experience with delayed debt relief underlines the need for an impartial assessment providing debt and economic information on the debtor country as a basis for restructuring terms, guided by the principle of sustainability. The role of assessments should be that of rebuttable presumptions about the required debt relief, rather than strictly binding criteria. The indicators used for such assessment should meet the same requirements as indicators used for the decision to restructure.[83] Either the debtor state or, if available, the DWI would be able to suggest an institution that could undertake such impartial assessments.

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[82] Cf. IMF, "Assessing Sustainability" (2002), p. 5; IMF and IDA, "Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications" (2004), p. 8; IMF, "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis" (2011), p. 6.

[83] See Section III.1.2 above.

- *Legitimacy and good faith*. It is in the interest of the debtor to maximize participation; however, the simplest way to reach this goal might be by treating different creditor groups differently, raising concerns regarding good faith and legitimacy.

- *Transparency*. To avoid conflicts arising from unequal treatment, data transparency and restructuring terms based on transparent and consistent criteria are essential. The DSF of the IMF provides important insights as it includes stress tests and political risks, although its transparency could be improved and it is tailored to low-income countries. Also, it continues to reflect a creditor's perspective. Comprehensive restructuring terms, including the legal and financial terms of all successor agreements, could be made public by the debtor, for example, on the finance ministry website.

4.3 Concluding Debt Workouts

Current Practice

There is a large variation in the duration of debt workouts. Some debt workouts extend for over a decade, with creditor groups coming on board piecemeal, and multiple rounds of restructuring blurring together in a protracted crisis spell.[84] This includes the debt relief initiatives in heavily indebted poor countries, where staged debt reduction mounted successive rounds of policy conditionality, delaying relief by years or even decades. In other cases, however, debt workouts take only months to conclude. This is particularly true for pre-emptive restructurings which occur prior to a payment default. In the full sample of 1978-2010 debt crises, pre-emptive restructurings took only one year to conclude, while post-default restructurings took five years.[85]

Delays can occur due to coordination problems on the debtor side or on the creditor side. Moreover, both the sovereign and creditors can have an incentive to delay a restructuring, if the country has not yet recovered and default risk remains elevated.[86]

Among creditor coordination problems, holdout strategies and creditor litigation have become increasingly relevant, given recent developments in Argentina and beyond. Litigation can seriously disrupt a restructuring process, even many years after it was understood to be concluded. In theory and in practice, holdout creditors can chase the debtor's assets and make its life difficult for an extended time and at great cost to its citizens.

The absence of a template for concluding a sovereign debt workout has had several negative consequences:

- It creates uncertainty, undermining economic recovery and thus debt *sustainability*.

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[84] See C. Reinhart and C. Trebesch, "A Distant Mirror of Debt, Default and Relief", NBER Working Paper No. 20577 (2014).

[85] See T. Asonuma and C. Trebesch, "Sovereign Debt Restructurings: Preemptive or Post-Default", forthcoming IMF Working Paper (2015).

[86] See R. Bi, "'Beneficial' Delays in Debt Restructuring Negotiations", IMF Working Paper No. 08/38 (2008).

- The absence of a comprehensive restructuring agreement that has the direct or indirect consent of all the relevant constituents opens the outcome to *legitimacy* challenges.
- Inasmuch as the overall debt restructuring parameters are rarely certain or intelligible from the outside, lack of closure also contributes to lack of transparency. Implementation of debt restructuring is impossible to monitor if it is never concluded. The piecemeal and sequenced nature of debt restructuring is inequitable for the creditors and for the citizens of debtor countries. It creates constant opportunities for burden-shifting and abuse of *good faith*.

Recommendations in line with the SDWP

Procedure for the Conclusion of Workouts

A clear procedure to mark the conclusion of the debt restructuring process as a whole, rather than any individual sub-component, would go a long way to remedying the identified shortcomings and enhancing the legitimacy of the process and outcome.

- The procedure for conclusion should be determined at the initial roundtable.
- The procedure could define a deadline by which negotiations with all groups of creditors need to be concluded.
- Voting should require a supermajority of creditors (e.g., 75% of all outstanding debt), without prejudice to applicable contractual or legislative provisions.
- If the deadline is missed, parties should seek a solution through mediation or arbitration within a defined period of time. The timeline should be tailored to the complexity of the case.
- The procedure should ideally provide for public approval of the restructuring terms within the debtor country within a defined period of time, whether through *ex ante* legislative authorization of a negotiating mandate, *ex post* ratification, or other publicly accountable means. This would contribute to debt workout legitimacy.
- Relevant creditor and other stakeholder approvals should be publicly disclosed. Any constituents objecting to the outcome would be required to do so within a defined period of time (for example, three months). If no objection is raised within this period, courts may take it as tacit consent, provided that the applicable law allows such conclusion.
- The procedure should provide for an act that marks the successful conclusion of the workout. This would send a signal to the market. Also, it should encourage stakeholders to make the result binding through the execution of contracts or any other legal means, including legislation.
- After implementation of the restructuring agreement, the debtor state resumes payments.

Voting

- Negotiations conclude with a vote on the proposed restructuring agreement. Approval requires the consent of the debtor state and a supermajority of creditors (e.g., 75% of all outstanding debt), without prejudice to applicable contractual or

legislative provisions.

- The exercise of voting rights needs to respect good faith. No party should reject debt workouts for reasons which it could have articulated during negotiations but failed to do so.
- Debtor states should refrain from exercising voting rights if they own debt instruments issued by themselves, either directly, or through intermediaries controlled by them.
- Based on the approved restructuring, old debt instruments are exchanged for new debt instruments according to applicable contractual or legislative provisions.

Mediation and Arbitration

- A mediator suggests a solution to the parties, which the debtor and a supermajority of creditors (e.g., 75% of all outstanding debt) accept, being directly binding upon the parties pursuant to specific contractual clauses on mediation, or based on which old debt instruments are exchanged for new instruments according to applicable contractual or legislative provisions concerning restructurings.
- An arbitration panel issues its final award, which is directly binding upon the parties pursuant to specific contractual clauses on arbitration, or based on which old debt instruments are exchanged for new instruments according to applicable contractual or legislative provisions concerning restructurings.

Information and Documentation

- The transparency principle requires that, promptly upon completion of the restructuring, the debtor state file with the DWI, or an alternative public repository in the absence of a DWI, a complete record of the financial and legal terms of the restructuring, a reasoned explanation of the treatment accorded to all creditor groups, a description of the economic reform program undertaken in conjunction with the restructuring, and the economic, financial, and other assumptions supporting the restructuring.
- Any other stakeholders, including but not limited to creditors, civil society groups, and international organizations, may, if they wish, file with the DWI or an alternative repository, additional statements and documentation concerning the restructuring.
- This information should be publicly available and searchable in the official language(s) of the debtor state and in English.

4.4 Holdout Litigation and Stay of Enforcement

Current Practice

Workouts can be disrupted by holdout litigation both before and after the conclusion of negotiations. Where the restructuring process comports with the principles for debt restructuring, incentives to disrupt the restructuring should be minimal. Nevertheless, in the absence of bankruptcy discharge and comprehensive enforcement, opportunities for disruption would remain.

For example, creditors that refuse to go along with the majority, and are not bound by CACs or similar mechanisms, can free-ride on participating creditors by interfering with the payments due to them on restructured debt. Where courts grant expansive injunctions to support the contractual claims of holdouts, a country might be effectively cut off from external financial dealings and suffer another economic crisis.

Going forward, creditors who might otherwise agree to reduce their claims in exchange for the certainty of receiving lower amounts face the prospect of never receiving such lower amounts, which would be blocked by holdouts. Moreover, if holdouts are able to recover disproportionate amounts, more creditors have incentives to hold out, which would stall restructurings. Holdout litigation can threaten payment and clearing infrastructure, and a wide range of financial intermediaries. Damage to third parties is likely to reduce the willingness of service providers to deal with distressed sovereigns, which would complicate crisis resolution considerably.

Holdout litigation seems to be on the rise rather than declining.[87] This should not come as a surprise given the increasing significance of bonded debt held by dispersed creditors. Courts have scarcely recognized a stay on litigation and enforcement for the benefit of a debtor state. This contrasts with the fact that a stay on enforcement is enshrined in practically all domestic insolvency laws. Hence, one might argue that it constitutes a general principle of law in relation to insolvency issues.[88] Unaffected by such considerations, a series of conflicts among jurisdictions, including the United States, the United Kingdom, and the European Union, threatens to undermine the predictability of both restructuring and enforcement. Conflicting judicial and administrative orders and court orders directed against financial institutions caught in the crosshairs of holdout litigation can contribute to financial instability. On the other hand, courts have refrained from enforcement because of concerns related to foreign sovereign immunities.[89]

Recommendations in line with the SDWP

Stay on Litigation and Enforcement

- *Good faith* enables a stay on litigation and enforcement during the restructuring once a defaulting debtor state has decided to restructure and stays its debt service.[90] The stay begins as soon as the decision to restructure is announced. The stay ceases to apply once the restructuring has been completed. In case of uncooperative, bad faith behaviour on the part of the debtor state, there may be reason to lift the stay.
- In the interest of *sustainability* and inter-creditor equity, creditors should refrain from bringing lawsuits, seizing property, interrupting the financial flows to or from the sovereign debtor, and entering into any arrangements with the debtor that would give any creditor or group of creditors a preference over the others, for the duration

[87] J. Schumacher, H. Enderlein, and C. Trebesch, "Sovereign Defaults in Courts", SSRN (2014), http://ssrn.com/abstract=2189997.

[88] M. Goldmann, "Responsible Sovereign Lending and Borrowing: the View from Domestic Jurisdictions" (2012), http://www.unctad.info/upload/Debt%20Portal/RSLB_MGoldmann_02-2012.pdf.

[89] Corte di Cassazione, Sezione Unite Civile, n. 11225, 27 May 2005, see 88 *Rivista di diritto internazionale* (2005) 856; similarly, Landgericht Konstanz, Case 2 O 132/13 B, 19 November 2014, The issue is currently pending before the European Court of Justice, case C-226/13 et al. (*Fahnenbrock et al. v. Hellenic Republic*).

[90] Cf. IMF (note 27).

of the restructuring process.

- Decisions on a stay and its removal should be made by *impartial institutions*, such as competent courts. At present, there is no central institution for the determination of a stay. It might be advisable to charge one institution with this task and to give legal effect to its decisions by means of contractual clauses, legislation, or treaty.

Holdout litigation.

- *Debt sustainability* requires that decision-makers not grant uncooperative creditors full remedies where this would violate the economic and social rights of citizens in the debtor state. Also, free-riding distorts restructuring incentives in the future.
- *Good faith as a defence*. If a workout was generally conducted in accordance with the SDWP, good faith requires that courts refrain from granting a minority of uncooperative creditors full contractual remedies at the expense of the vast majority of creditors who accept the restructuring. Consequently, uncooperative creditors who are not legally bound by the restructuring may only sue for, or enforce, a fraction of their claims, which affords them comparable treatment. When determining whether creditors are uncooperative, courts should take into account the following considerations:

    - Creditors that purchase debt or sue debtor states for the purpose of extracting a preferential treatment are uncooperative ("abusive creditors").[91] In establishing whether a creditor intends to extract a preferential treatment, courts or other competent institutions should take into account:

        - whether the creditor has made good faith efforts to negotiate a debt workout in line with the SDWP;
        - whether other creditors or multilateral institutions like the DWI have made a call for a voluntary debt moratorium before the purchase of the debt at issue or the filing of the suit;
        - the difference between the nominal and market price at the time of the acquisition of the debt;
        - the time of the acquisition;
        - the volume acquired, especially whether the creditor acquired a blocking minority under the applicable collective action clause.

      In no case should the provision of legitimate liquidity support or interim financing in line with the SDWP be considered abusive.

    - Creditors who had the opportunity but refused to actively participate in good faith negotiations conducted in accordance with these principles are uncooperative.

- *Prevent asset grabbing*. In order to ensure good faith and equitable treatment of all stakeholders, the debtor's assets outside its borders should be immunized against seizure to satisfy claims of abusive creditors. Service providers and institutions engaged in clearing, settlement, and payment processing with respect to restructured debt should be absolutely insulated from creditor enforcement and related actions throughout the length of the payment chain. Where necessary, legislative

[91] Cf. Principle 7 of the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing.

amendments should ensure the consistent application of sovereign immunities against enforcement. In the US context, such legislation would prevent injunctions that affect assets immune from attachment.

- *Preventive contract clauses*. Debtor states, following outreach to market participants, may include in the terms of their debt instruments the possibility of a standstill of payments and enforcement in case of a debt crisis, as long as good faith negotiations continue. An example is the ISDA 2014 Resolution Stay Protocol. It provides for the contractual recognition of cross-border resolution regimes for systemically important financial institutions.

- *Preventive legislation*. States, especially the main jurisdictions which host the issuance of sovereign bonds or whose law is governing other sovereign debt instruments, should consider adopting legislation that bars litigation by uncooperative creditors to the extent that their claims exceed what they would have received had they participated in a workout.[92] Such legislation should protect the outcomes of negotiated debt workouts respecting good faith. Alternatively, states may choose to adopt a multilateral treaty.

- *List of uncooperative creditors*. To deter holdout litigation, states or international organizations may consider the introduction of a public list of uncooperative creditors and their parent companies. The list would have to be managed by an impartial institution and according to transparent criteria with full respect for due process rights. Investors or states may commit to refrain from engaging in business with listed uncooperative creditors.

- *Disclaimer*. These recommendations are without prejudice to the exceptions applicable to the provision of interim finance or in case of serious risks for systemic stability.

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92 Recent example of such legislation includes the UK Debt Relief (Developing Countries) Act 2010.

IV. IMPLEMENTATION

Reforming the Present System

This Guide has amply documented the shortcomings of current debt workouts from the perspective of the Sovereign Debt Workout Principles that have been identified in Part II. It has also suggested recommendations for debtors, creditors, and other stakeholders to improve sovereign debt workouts in line with such Principles. The gradual adoption and implementation of the Principles and recommendations by the stakeholders and institutions involved in debt restructurings should ultimately mitigate the key problems of fragmentation, lack of fairness, and inefficiency, which impair current restructuring practice. The Sovereign Debt Workout Principles and the recommendations are not designed to reform the current system in an abrupt fashion; rather, they aim to provide the basis for a gradual reconciliation of practices that have been identified as disruptive, inefficient, or unfair.

An Incremental Approach

The implementation of the suggestions made in this document on the basis of the Sovereign Debt Workout Principles builds on other instruments, with the shared goal of making sovereign debt governance more comprehensive, fair, and efficient. These additional instruments include the Monterrey Consensus, the Financing for Development process, and the Principles on Promoting Responsible Sovereign Lending and Borrowing. Stakeholders have the opportunity to use these instruments as guides on their journey through the complexity of a sovereign debt workout. In doing so, they will set a precedent that will lead to an incremental recognition of the Principles.

Domestic and international courts and tribunals may also use the SDWP and the recommendations when called upon to decide cases related to sovereign debt restructurings. This might be especially valuable when the resolution of a case leads them into legally uncharted territory. Reference to the SDWP and the recommendations may reinforce the legitimacy of their decisions, particularly in politically sensitive cases that courts, but especially private dispute settlement bodies, might feel uncomfortable to resolve on their own.

Many of the recommendations set out in the Guide can be implemented by progress in contractual terms. The potential for innovation comprises clauses enabling single-limb majority vote restructurings, standstill during workouts, and mediation or arbitration. In addition, legislators may choose to deny recognition to claims by uncooperative creditors, provided that the workout respected the Principles.

States and international institutions, fora, and conferences dealing with sovereign debt may endorse the SDWP and the recommendations contained in the Roadmap and this Guide. This would enhance the legal status of the SDWP and also encourage the observation of the SDWP and the recommendations in practice.

Towards a Debt Workout Institution

The Guide has been designed to also contain the elements that could be used to set up a more ambitious institutional solution facilitating debt workouts at the international level, which would bolster the incremental approach advocated here. States and international organizations could therefore consider the establishment of a Debt Workout Institution (DWI) in line with the Sovereign Debt Workout Principles. The mandate, institutional framework, and legal basis of such an institution deserve careful consideration.

The mandate of any Debt Workout Institution may range from very informal, technical tasks to more formal, binding measures. The assignment of tasks must not compromise the impartiality of the DWI. Possible tasks include the following:

- Technical Support. As an impartial body, the DWI would not act as advocate of the debtor state, but would rather lend its support to the debtor, which is usually in charge of organizing the restructuring. For this purpose, the Debt Workout Institution could establish an inventory of best practices, rules, and regulations on debt sustainability and for creditor aggregation. It should also host a public repository for the complete records of past workouts.

- Facilitation of initial roundtables and negotiations. The DWI would advise the government on the organization of an initial roundtable and negotiations, which meet the requirements of good faith, transparency, and legitimacy.

- Commissioning of debt sustainability analyses, or support for the search for expertise in this respect.

- Assistance in the establishment and implementation of a procedure for the conclusion of debt workouts. For example, the DWI could publicly determine the successful conclusion of a restructuring.

- Mediation for conciliatory workouts, or debt arbitration if more informal mechanisms have not led to a consensual restructuring.[93] Mediation and arbitration could address issues such as the examination of restructuring terms proposed by the debtor state, debt sustainability assessments, and economic and social recovery programs.

- Maintaining a list of abusive creditors and their parent companies, and possibly hosting a mechanism ensuring due process and an opportunity of review for those listed.

Regarding the **institutional framework**, a Debt Workout Institution would need only a very small permanent staff. In case of a debt crisis, it could lead the selection of experts, facilitators, mediators, and arbitrators in line with pre-agreed criteria. The selection process should be transparent and uphold the highest standards of integrity and good faith. It would also cooperate with existing fora and institutions in the field. This would follow the 2001 IMF proposal for a Sovereign Debt Restructuring Mechanism (SDRM), for which Anne Krueger suggested that the Paris Club could continue to function as the well-established

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[93] On the role of mediation and arbitration in debt workouts, see Section III.2.2 above.

representation of bilateral official creditors within the frame of the SDRM.[94]

At a later stage and after accumulating experience with the more informal mechanisms for which it would originally be designed, the Debt Workout Institution could host a non-permanent **sovereign *debt restructuring tribunal*.** The tribunal would be composed of judges or arbitrators elected by the member states in a transparent procedure and solely on the basis of their qualifications. Each sovereign debt case would be handled by a panel of judges or arbitrators including a national of the debtor state, if necessary on an *ad hoc* basis. Respect for the perspective of creditors needs to be ensured both in the election of judges or arbitrators and in the composition of panels. For example, institutions representing the industry could be allowed to nominate candidates for election and creditors could nominate a number of judges and arbitrators hearing a particular case. The procedural and substantive law applied by the tribunal would be the same as in the case of arbitration.[95] Compared to arbitration, the tribunal option would have the advantage of possessing greater legitimacy, an important asset given the economic, political, and social implications of its decisions. Also, it would probably cost less.

Regarding the **legal basis** of a Debt Workout Institution, there are several options. Broadly speaking, the more effective an option, the more difficult is its establishment:

- A treaty-based international organization. Generally speaking, an international treaty would increase the effectiveness of a Debt Workout Institution because awards rendered as a result of an arbitration process would bind its member states. This would effectively discourage holdout litigation. Also, a treaty-based organization could host a tribunal. However, ratification of an international treaty might be politically costly and take a significant amount of time to be made operational.

- A subsidiary body of the UN General Assembly. The political costs might be lower compared to a treaty-based institution. But the effectiveness and comprehensiveness of such an institution would be limited since its awards would only be legally binding if the parties agree, either by a provision in the terms of the debt instrument or by special agreement. Effectiveness and comprehensiveness would increase if states enact legislation giving legal force to the decisions of such an institution. Also, the institution could host a tribunal.

- An independent institution, which could be established as a non-profit organization governed by private law, whose members would be states only, along the lines of the Bank of International Settlements. The UN could express its support by a resolution of the General Assembly, urging Member States to cooperate. On a technical level, the institution could be run by representatives of domestic Debt Management Offices. Their decisions would thus be subject to political override. This would be the least costly option, but also the least effective in preventing holdout litigation insofar as it is not supported by specific legislation in major legislatures, such as the UK 2010 Debt Restructuring (Developing Countries) Act, which is applicable to HIPCs.[96]

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94 IMF, *The Design of the Sovereign Debt Restructuring Mechanism - Further Considerations*, 27 November 2002, pp. 23 et seq.

95 See Section III.2.2 above, recommendation (b).

96 UK Debt Relief (Developing Countries) Act 2010. See M. Waibel, "Debt relief to poor countries: Rules v.

Appendix

This document was coordinated and finalized by UNCTAD under the Globalization and Development Strategies Division. The members of the ad-hoc Working Group were selected on the basis of their expertise as well as the sectors they represent, thereby forming a group of widely diverse interests.

The drafting process was guided by Ms. Yuefen Li and Ms. Marie Sudreau. UNCTAD is grateful to the drafting committee members for their work. The drafting committee members included Anna Gelpern (Georgetown University); Matthias Goldmann (Max Planck Institute for Comparative Public Law and International Law); and Jürgen Kaiser (Erlassjahr Jubilee Germany). UNCTAD would also like to extend its warm thanks to the members and observers of the ad-hoc Working Group on a Debt Workout Mechanism who actively participated in the design and content of this document by sharing their comments during Working Group meetings. The ad-hoc Working Group is formed by the drafting committee members and: Yilmaz Akyuz (South Center); Peter Bakvis (ITUC Global Unions); Reza Baqir (International Monetary Fund), observer; Juan Pablo Bohoslavsky (Independent Expert on the effects of foreign debt on human rights); Aldo Caliari (Center of Concern); Bodo Ellmers (Eurodad); Kalidou Gadio (African Development Bank); Sudarshan Gooptu (World Bank), observer; Leland Goss (ICMA), observer; Mitu Gulati (Duke University); Robert Howse (NYU School of Law); Olav Jones (European Committee of Insurers); Clotilde l'Angevin (Paris Club), observer; Jason Lee (Asian Development Bank); Eric LeCompte (Jubilee USA Network); Odette Lienau (Cornell University); Travis Mitchell (Commonwealth Secretariat); Raphael Otieno (Macro-Economic and Financial Management Institute of Eastern and Southern Africa); Andrew Powell (Inter-American Development Bank); Christoph Trebesh (University of Munich); Michael Waibel (Cambridge University); and Jeromin Zettelmeyer (European Bank for Reconstruction and Development). This document represents a compromise among the members of the Working Group.

Discretion", *International Financial Law Review*, May 2010.