



UNCTAD Debt Workout Mechanism (DWM):

Working Group Meeting no 4

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CONCLUDING SUMMARY

The purpose of the fourth WG meeting on a DWM was to discuss the principles of impartiality and legitimacy in the context of a debt workout mechanism. These principles were the final principles to be discussed among those that had been identified as essential to the design and procedural ruling of a potential DWM at the beginning of the project (Feb 2013).

1. Importance of the Principles of Legitimacy and Impartiality for the DWM

In light of recent developments in sovereign debt and sovereign debt litigation, the WG noted a pressing need for a robust DWM, upheld by the principles of legitimacy and impartiality.

- The changing composition and characteristics of sovereign debt, with governments increasingly issuing local currency bonds subject to domestic jurisdiction and foreign investors displaying a growing appetite for emerging market debt, augment the problems resulting from system fragmentation in the absence of sovereign insolvency procedures.
- The recent denial of *certiorari* by the US Supreme Court in the case of *NML v. Argentina Capital* may further undermine existing restructuring procedures by rewarding holdouts and dis-incentivizing investor coordination. While the WG agreed that CACs may be helpful in promoting orderly restructurings to some degree, they also expressed various concerns regarding their suitability as a substitute for a DWM as they can neither be inserted into previously issued bonds nor completely preclude holdout problems.

Against this background, the WG agreed that, to the extent possible, a DWM must entail the principles of legitimacy and impartiality to ensure the long-term adherence of international stakeholders. The participants highlighted the principles' importance both for attracting support *ex ante*, i.e. in the development of a DWM, and for ensuring *ex post* compliance that will lead to sustainable outcomes for both debtors and creditors.

2. Key Concepts

2.1 Legitimacy in a DWM

The WG emphasized the importance of the DWM's legitimacy, which can be defined as an institution having voluntary compliant support. The WG hereby differentiated between three

different types of legitimacy: Source legitimacy, process legitimacy and outcome or substantive legitimacy.

- **Source Legitimacy:** The DWM will likely be considered more legitimate if its source and initial establishment satisfy the key values of the legitimating group. The WG considered a broad-based process of the formulation of a DWM as superordinate to the formulating actor. The formulation process may be strengthened by *state consent*, *democratic legitimation*, legitimacy evolving from the support and input of the underlying people, *participatory legitimation*, including a good faith effort to identify and involve an appropriately broad array of stakeholders, as well as *expertise*, i.e. the contribution to and acceptance of the formulation of the DWM by an accepted authority.
- **Process Legitimacy:** The nature of the implementation and on-going functioning of the DWM may also impact its legitimacy. In particular, processes that adhere to certain procedural standards, including those that guard the impartiality of the DWM and its decision-makers, may grant the DWM greater legitimacy. Such processes may pay attention to *on-going participation* of affected individuals and groups, *ownership* pertaining to the concerns of the sovereign debtor undergoing restructuring, *comprehensiveness or full involvement* of all relevant parties to the process, *transparency* of all information about which parties may have an opinion, *reasoned decision*, i.e. decisions based on analytical and evidentiary foundations, as well as *efficiency* and the *review* of the procedures and decisions by an external entity.
- **Outcome (Substantive) Legitimacy:** The WG agreed that a set of standards for legitimacy of a DWM should also involve the ability to generate successful outcomes and restore the global public good of financial stability. The DWM should prioritize *economic and financial outcomes* such as reasonable recovery on investments for creditors and a return to debt sustainability and capital markets, as well as asset recovery and economic growth on the side of the sovereign debtors. The WG also highlighted the importance of *human rights outcomes* and the *adherence to other substantive principles* as well as *consistency across cases* to the outcome legitimacy of a DWM.

The WG noted that although legitimacy could be considered as a nuanced rather than a binary concept, any restructuring regime should comply with certain minimum standards – even in times of crises and urgency, during which a trade-off between various principles, such as efficiency and transparency, may exist. In this context, some participants further emphasized the importance of minimizing the risks of, on the one hand, legitimizing mechanisms with high procedural deficiencies by prioritizing outcomes and, on the other hand, privileging organizations that have the capacity to host specific process by prioritizing procedural legitimacy. The WG asserted that a well-designed DWM should maximize all components of legitimacy.

2.2 Impartiality in a DWM

The WG agreed that while impartiality, decision-making that is free of bias or preference and grounded in independence and objectivity, might be considered as a core factor within the more comprehensive category of legitimacy, it is also an important and valuable principle in its own. The WG hence discussed three different types of impartiality: institutional impartiality, actor impartiality and informational impartiality.

- Institutional impartiality: In order to avoid systematic bias in favour of one interested group, a DWM should emphasize *institutional independence*, including attentiveness to *financial independence*, *personnel independence*, and *physical independence* (i.e. geographic location in a neutral setting) as well as *transparency and review*.
- Actor Impartiality: Impartiality of the actors involved in a DWM may be preserved by *actor independence*, the independence of decision-makers and mediators from the negotiating parties, as well as *reasoned decision* and *multi-person decision-making* to mitigate actor bias through the involvement of multiple individuals.
- Informational impartiality: Among others, impartiality of informational inputs can be preserved through *indicators*, as discussed by the WG in the previous meeting, *economic models* as well as impartial expert knowledge.

While all members of the WG concurred on the significance of impartiality in any decision-making setting, several WG members also highlighted the potential trade-off between impartiality and representativeness as well as accountability of decision-makers.

3. The Practical Role of Legitimacy and Impartiality in Overcoming Existing Challenges

Following the identification of concrete problems encountered in past and present debt restructurings such as inconsistency, creditor incoordination and “too little too late”, the WG noted various channels through which legitimacy and impartiality may practically contribute to overcoming such challenges in future sovereign debt restructurings. Examples of institutions dealing with debt (not necessarily public) were mentioned to exemplify possible options for improvement in cases where source and process legitimacy as well as overall impartiality are being questioned.

- Forum and legal fragmentation can lead to sovereign restructurings with varying procedures and rule interpreting that undermine the predictability and stability of the sovereign debt market. A universal DWM that respects the legitimizing principle of *case consistency* could thus enhance predictability and stability, thereby benefitting sovereign borrowers and investors alike.
- Existing narrow fora may allocate greater control to some creditors without equal attention to the concerns of others. Inclusive processes that comply with the legitimizing principles of *on-going participation* and *full involvement*, as well as *institutional impartiality*, may counter such creditor incoordination within multi-party frameworks.
- Similarly, “too little” may result from the existing forum fragmentation that occasionally allows creditors to uniquely focus on their own institutional goals without having to compromise or think comprehensively across parties. *Legitimacy of economic and financial outcomes* may focus on preventing disruptive serial restructurings by contributing to long-term debt sustainability through, for instance, *reasoned decisions* as well as informational impartiality, using a range of *indicators* and *economic models*.
- When necessary, processes that encourage states to participate in a DWM at an early stage are likely to reduce restructuring costs in the medium- to long-term. Such processes should aim to limit any stigma attached to debt workouts through attentiveness to legitimating features such as objective *indicators*. Procrastination may also be reduced by ensuring that outcomes are acceptable and fair to both creditors and debtors and the burden of adjustment shared across

all stakeholders. Such stakeholder acceptance would likely result from *inclusive* processes and *consistent* outcomes that also account for the *human impact* of debt restructuring.

4. Concluding Remarks

- The principles of legitimacy and impartiality are grounded in international law and, in light of recent developments in sovereign debt and sovereign debt litigation, are important not only for the *ex ante* establishment but also the *ex post* success of any DWM.
- As legitimacy and impartiality of a DWM may help to motivate conforming actions through the belief or normative approval of the relevant audience, such audience should encompass all those affected, including states and governments, judicial practitioners, creditors and investors, as well as citizens of countries undergoing debt workouts.
- As various actors may place different value on the three subcomponents of legitimacy, source, process and outcome (substantive) legitimacy, a DWM should aim at maximizing all three components. This is particularly important as a focus on outcomes may legitimize mechanisms with numerous procedural deficiencies while a focus on processes may unfairly favour powerful institutions with the capacity to host specific processes.
- While impartiality constitutes a core factor of legitimacy, it is an important and valuable principle in its own. Impartiality can result from institutional, actor and informational impartiality and, along with impartial expert knowledge, ensures fair decision-making that is free of bias or preference and grounded in independence and objectivity.
- The perception of the DWM's legitimacy and impartiality should not be limited to the considerations of ex-ante standards but also take into account the outputs of restructurings, including asset recovery by creditors and the ability to overcome common challenges in sovereign debt restructuring such as forum fragmentation, creditor incoordination, procrastination and insufficient restructuring (“too little too late”).
- The DWM should be structured around thresholds for legitimacy and impartiality as well as on resolving the conflict between legitimacy and efficiency in times of crises on the one hand and the trade-off between impartiality and representativeness on the other.
- Such trade-offs should always reflect the need to balance the legitimate interests of all negotiating stakeholders in line with the principle of good faith and ensure that no party be put proportionally more at a disadvantage than another.
- Following the meeting, the WG will begin to incorporate the discussed principles and technicalities in a more concrete recommendation for a DWM.