Twenty-Fifth Anniversary Symposium

25 Years, Where Are We Now? Global Trade & Sovereign Debt

Keynote Address

Steven L. Schwarcz*

The Minnesota Journal of International Law *celebrated its twenty-fifth anniversary on March 30, 2016. Drawing from its roots in international trade and economics, the Symposium, entitled "25 Years, Where Are We Now? Global Trade & Sovereign Debt" critically analyzed some of today's important challenges at the intersection of law and economics.*

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Thank you very much, Dean Wippman. When you mentioned what it's like to be a dean, it reminded me of a comment by Lance Liebman when he became a dean. At an alumni gathering to meet him, someone said, "Congratulations, you are such an incredible scholar." Lance replied, "Before I became a dean, people thought I was a credible scholar."

I am going to talk about sovereign debt and sovereign debt restructuring. Unresolved sovereign debt problems are hurting debtor-nations, hurting their citizens, and, in some ways, hurting their creditors. Also, a sovereign debt default can pose a serious systemic threat to the international financial system.

Unlike people and unlike corporations, countries cannot use bankruptcy or insolvency laws to restructure unsustainable debt—that is, debt that's beyond their ability to pay. Many blame nations for incurring that much debt. But in many cases, the lenders are equally to blame because they extend credit on very easy terms, expecting to be bailed out if there is a problem.

There has been a debate over the past few decades over how

* Stanley A. Star Professor of Law & Business, Duke University School of Law; Senior Fellow, Centre for International Governance Innovation.

to address the problem of unsustainable sovereign debt. The approach that, until recently, has been, and probably remains, most common, is the so-called contractual approach. I will contrast that with what I call the statutory approach.

In the contractual approach, the parties to the sovereign debt contracts themselves renegotiate these contracts or enter into exchange offers with the debtor-state, whereby they try to find a way to facilitate a restructuring. One of the main problems is that many sovereign debt contracts require unanimity to change essential payment terms: the principal amount, the rate of interest, the maturities, and so forth. It is almost impossible to achieve unanimity. To try to solve that problem, the contractual approach focuses on inserting into sovereign debt contracts (either when they are executed or by amendment at a later date) what are called collective-action clauses—which are often referred to as CACs. CACs allow a form of super-majority voting, enabling creditors to change the terms of that contract without requiring unanimity.

One problem with CACs is that relatively few sovereign debt contracts include them. As illustrated by the Greek debt crisis, most of that country's debt contracts lacked CACs. Another problem with CACs is that, until recently, most CACs only pertained to the contract in which they were included. For example, take a very simple case of a debtor-state with three bond issues. Even if each of these bond issues had a contractual CAC, so the terms of each could be changed by super-majority voting, that voting could only bind the parties to that individual bond issue. What this means is that any of these bond issues could act as a holdout and defeat a settlement among all the bond issues.

The collective action "aggregation" clauses that the International Capital Markets Association has recently been advocating would extend the super-majority voting beyond a particular bond issue. But almost no sovereign debt contracts currently have these CAC aggregation clauses, and—even if CAC aggregation clauses were included in every new sovereign debt contract—it would be decades before most contracts would have them.

Next, contrast the contractual approach with a more statutory approach. Until recently, a statutory approach has focused on an international convention or treaty (those terms are synonymous). The goal would be to have an international treaty governing sovereign debt restructuring.

Let me give you some perspective on how the statutory approach has evolved. The first official proposal for some sort of international treaty framework for sovereign debt restructuring appears in the United States' 1942 initial draft of the charter of the International Monetary Fund, the IMF. Nothing happened at that time, and nothing happened until the mid-1980s when economist Jeffrey Sachs called, in an unpublished paper, for some sort of international sovereign debt restructuring standard. He observed that the IMF, as an international lender of last resort in almost all sovereign debt restructurings, would de facto lead the restructuring effort. But he concluded that "the structure of IMF-led debt restructurings has been woefully inadequate, especially when compared to corporate bankruptcy debt restructurings."

Jeffrey's work inspired a number of scholars, including myself, to write on the topic. In 2000, for example, and with the help of University of Minnesota Law School Professor Fred Morrison, I published an article in the *Cornell Law Review* going methodically through how one could adapt various concepts from corporate bankruptcy law into sovereign debt restructuring.[1] A year after, based on my work and that of other scholars from around the world, the IMF proposed its sovereign debt restructuring mechanism, the so-called SDRM. This was a treaty approach adapting a range of concepts from bankruptcy law to restructuring sovereign debt.

Initially, the U.S. Department of the Treasury supported the SDRM. But the Secretary of the Treasury was then fired for other political reasons, and the new Secretary opposed the SDRM. Furthermore, various emerging market countries, including Turkey, Mexico, and Brazil, opposed the SDRM, concerned that it would raise the interest rates on their sovereign bonds.

The most recent official support of the statutory approach was the 2014 United Nations General Assembly vote, led by the Group of 77 developing nations, to begin working on a treaty (calling it a multilateral framework) to restructure sovereign debt. Although this U.N. effort has come up with some very general principles, in reality it appears to be going nowhere because the United States and the European Union are opposing it. The reasons for their opposition are not completely clear.

1. *See* Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956 (2000).

There may be concerns that such an international treaty could take some sovereign prerogatives away from the United States and the European Union. Whatever the reasons, efforts to solve the problem of unsustainable sovereign debt are effectively at a standstill.

I would like to raise today at least a partial solution, what I call a model-law approach to sovereign debt restructuring. Many of you should be familiar with a model law. It is essentially a statute that is proposed and is intended to be enacted in the same form by multiple individual jurisdictions. The most common example of a model law in the United States is probably the Uniform Commercial Code, or UCC. An international example of a model law would be the UNCITRAL (United Nations Commission on International Trade Law) Model Law on International Commercial Arbitration.

When multiple nations enact the same form of a model law, it resembles a treaty. But there are important differences between a model law and a treaty. A treaty is more binding in the sense that, once a nation agrees to it, it is harder to get out of it or modify. Once a nation (or other jurisdiction) enacts a model law, it can choose to modify or revoke it at any time, simply by passing internal legislation. A model law is thus more flexible and informal than a treaty, and it also could be pursued in parallel to a treaty approach (such as the effort by the United Nations to develop a treaty for restructuring sovereign debt). For these reasons, a model-law approach is valuable for experimenting with ideas as to which there are not standard norms, like sovereign debt restructuring. To this end, I recently drafted a model law—which I'll hereafter call the "Model Law"—that proposes norms and detailed rules for restructuring sovereign debt.[2]

More critically, a model-law approach could be a very powerful debt-restructuring tool in today's sovereign debt environment because 95% of all sovereign debt contracts are governed by either New York law (the slight majority) or English law. Thus, if New York State—a sub-national entity that enacts its law through a state legislature in Albany—were to enact a

2. *See* Steven A. Schwarcz, *Sovereign Debt Restructuring: A Model-Law Approach*, 6 J. GLOBALIZATION & DEV. 343, 377–81 (2016) (proposing a model law for sovereign debt restructuring). *See also* CENTRE FOR INT'L GOVERNANCE INNOVATION, A MODEL-LAW APPROACH TO RESTRUCTURING UNSUSTAINABLE SOVEREIGN DEBT (2015), https://www.cigionline.org/sites/default/files/pb_no.64.pdf.

state law in the form of the Model Law, that would enable all of the sovereign debt contracts governed by New York law to go from a unanimity voting requirement to super-majority voting. Additionally, the Model Law would facilitate private-sector interim funding, which has in the past been provided by the IMF. The IMF itself has recognized that it does not have enough funding to continue this for all nations that need interim funding.

If in addition to New York State enacting the Model Law, England (which legislates through Parliament) also enacts the Model Law, 95% of all sovereign debt contracts would be governed by the Model Law. You'd only need these one or two jurisdictions to make a massive impact.

And I should emphasize that the Model Law is intended to be retroactive. Its enactment by New York State and/or the United Kingdom could therefore immediately solve a lot of the major problems we currently have with sovereign debt. I will talk a bit about the legality of retroactivity, but under international law, retroactivity is permitted as long as it does not discriminate and is not arbitrary, neither of which occurs here. Under English law, retroactivity is permitted. New York state law permits retroactivity, but the potential problem, as I will shortly discuss, is the Contracts Clause under the Constitution.

Let's first talk about some of the key provisions of the Model Law. The Model Law's goal is to restore debtor-states to debt sustainability. That would relieve undue economic burden on the debtor-states' citizens; enable the debtor-state to pay its debts, thereby avoiding a default that could have systemic consequences; reduce creditor uncertainty; and reduce the need for costly debt bailouts, which create, or at least foster, moral hazard. The claims covered by the Model Law include not only long-term debt claims, like sovereign bonds, but also short-term debt claims, the equivalent in the sovereign debt world of corporate commercial paper. Lee Buchheit, the head of Cleary Gottlieb's sovereign debt restructuring department, identifies rollover risk of short-term sovereign debt—the risk that a country borrowing on a short-term basis cannot refund the maturing debt by issuing new debt—as the major future sovereign debt risk. This is the same problem that the United States government found itself in, a few years ago, when the U.S. Congress was quagmired as to whether it would raise the debt ceiling. If Congress did not raise the debt ceiling, the United States would have been unable to issue more indebtedness to refund its maturing debt and could have defaulted.[3]

The Model Law contemplates a supervisory authority to administer the sovereign debt restructuring process. This sometimes raises a political concern because many, including U.S. officials, have conflated the concept of a supervisory authority with the restructuring process itself. They fear that the supervisory authority could impede on national sovereignty. At least under the Model Law, any supervisory authority would have only ministerial power, such as counting votes.

The central part of the Model Law is its solution to the so-called holdout problem, a collective action problem. This is the main problem of sovereign debt restructuring which I mentioned at the outset, the need for unanimity to change the maturity, or the interest rate, or the principal, or some of the other key terms of sovereign debt contracts. This problem is nicely illustrated in a movie I show each year to my bankruptcy class, "Waking Ned Divine."

The movie is set in some small town in, I think, Ireland. Ned Divine wins the national lottery and promptly drops dead of shock. He has no heirs. His winnings are going to go back to the state unless the town's people have someone pretend to be Ned Divine. Ned's best friend proposes to do this, but he needs all the town's people to back him up. In return, he agrees to share the winnings equally and ratably among the people. But one person refuses to cooperate unless she gets a bigger share. That's the holdout problem. You may not want to solve it as done in the movie—the holdout is in a phone booth calling the authorities, when a car with the lottery people careens out of control and hits the phone booth, which goes flying into the ocean. Far better to try to solve the holdout problem with super-majority voting. The Model Law provides that super-majority voting.

The Model Law also provides incentives for private-sector interim funding. Although the IMF has provided that in the past, I mentioned that it does not have enough money to continue funding all the nations that need it during the restructuring process. Furthermore, many countries may not want IMF interim funding. The IMF imposes what is called "conditionality" on borrowing nations, requiring those nations to adopt strict austerity measures. In Greece, for example, there was a lot of controversy about the harm that may have been

3. *See, e.g.*, Steven A. Schwarcz, *Rollover Risk: Ideating a U.S. Debt Default*, 55 B.C. L. REV. 1 (2014).

caused.

So how does the Model Law incentivize private-sector interim funding? Nobody is going to lend to a debtor in trouble unless their repayment claims have priority. In corporate bankruptcy, section 364 of the Bankruptcy Code subordinates those repayment claims as a matter of law to the interim funding. In theory, the contractual approach could accomplish that if all holders of those claims agree to contractually subordinate their claims. In practice, however, that is very unlikely to happen. The Model Law would accomplish that like section 364, legislatively subordinating repayment claims to the interim funding. The Model Law also protects holders of those claims by requiring their consent, by super-majority voting, to such subordination.

That's the outline of the Model Law. Let's now turn to its legal feasibility, which has only one real issue: whether its retroactivity would be restricted by the Contracts Clause of the U.S. Constitution, art. 1, § 10. Although the federal government can retroactively impair contracts, the Contracts Clause prohibits states themselves from doing so. The U.S. Supreme Court, however, has created various exceptions to the Contracts Clause, of which two should apply to the Model Law's retroactivity.

One exception is under a state's police powers. A contractual impairment is permitted to the extent it's a reasonable exercise of a state's police powers. If New York State enacted the Model Law to try to mitigate or solve half of the world's sovereign debt problem that would protect its economy because it would greatly reduce the chance of a sovereign debt default, which could trigger a broader systemic economic collapse.

The other exception is based on reasonableness. In order for a contractual impairment to violate the Contracts Clause, it must be a significant impairment. Because the Model Law requires any retroactive modification to be agreed to by a super-majority of similarly situated creditors, any such modification would reflect what those creditors believe, based on the then reasonable expectations, they could realistically expect to receive as payment.

Let's next turn to the Model Law's economic feasibility and its costs and benefits to nations and their creditors. Certainly, a nation whose debt has been restructured is going to benefit. One question is whether the Model Law, by its existence, would increase a country's ex ante borrowing costs—a country, for example, that is not in default. Recall that certain emerging market countries opposed the IMF's SDRM because they feared it would make their sovereign debt more expensive. Many economists have recently studied this, and they conclude to the contrary: that the absence of an effective sovereign debt-restructuring framework increases the cost of borrowing, and that any costs would probably go down if there were such a framework.

In addition, the super-majority, aggregate voting contemplated by the Model Law would be no different than if all sovereign debt contracts had super-majority aggregation CACs. Everyone, even those who advocate the contractual approach, believes that's an ideal goal. Finally, there is empirical work, including by my colleague Mitu Gulati who does a lot of excellent sovereign debt work, suggesting that the inclusion of CACs does not increase sovereign interest rates and may even decrease them.

From a political feasibility standpoint, I have mentioned that the Model Law should be more feasible than a treaty. You do not need all nations to agree, all you realistically need is New York State and/or England. Furthermore, one could assess the Model Law's political feasibility by comparing it to the failure of the IMF's SDRM. There are two principal reasons the SDRM failed. One reason, besides the unjustified fear of the increase in rates, is that at the time it was proposed, in 2001, many believed that coerced exchange offers, combined with the ability to amend sovereign bond contracts, provided an adequate mechanism for sovereign debt restructuring. Experience has taught us otherwise. In fact, in many jurisdictions, coerced exchange offers are probably not legal. Secondly, some countries opposed the SDRM because they were suspicious about the IMF's role. The IMF, under the SDRM, was the supervisory body for a process designed by the IMF. This sparked concern about conflicts of interest and excessive IMF conditionality. Of course, none of that is relevant here.

In closing, I am not saying that a model-law approach is absolutely feasible. I hope it is feasible, and in fact the Centre for International Governance Innovation, with which I'm a Senior Fellow (in addition to my role at Duke), is beginning to engage in a major effort to try to facilitate the Model Law. Cornell University and its Law School are also very interested in working with us on this. We hope to have a major conference soon that may even include leading New York State officials and legislators. But even if nothing goes forward on a model-law front, the very discussion of that approach and its ability to facilitate sovereign debt restructuring can hopefully help to develop norms about how sovereign debt should be restructured to sustainable levels.

QUESTION 1

You mentioned Professor Stieglitz. He is not deeply loved on Wall Street, so I wonder if this type of arrangement has been introduced to Goldman Sachs or JP Morgan? What do they say? Do they say that it is great for the creditors?

STEVEN SCHWARCZ

We are doing this on a very preliminary basis. A week and a half ago, the head of CIGI's international law research program and I were in Washington, D.C. and had meetings with the IMF and leading organizations that advocate fair approaches to sovereign debt restructuring, including Jubilee Network USA. We next intend to meet with major Wall Street investors in sovereign debt.

QUESTION 2

Very interesting, Steven. I wonder in the restructuring process whether the most important issue wouldn't be determining how much to reduce the debt owed, and exactly how that would be done under this model law. Part of that, I assume, would be determining what kinds of policy reforms would be necessary to cover the restructured debt. I wonder who is going to make those decisions about the impairment and the policy reforms.

STEVEN SCHWARCZ

The Model Law contemplates that a debtor nation itself would begin the process by certifying that it needs a restructuring to achieve debt sustainability. The restructuring plan, which would have to be approved by the nation's creditors (under super-majority voting) before it became effective, would set out the means by which the nation expects to make its debt sustainable again. By analogy to corporate bankruptcy law, this would parallel section 1129(a) of the U.S. Bankruptcy Code, including the condition that the restructuring plan is feasible and should restore the debtor's financial viability. So a debtor nation under the Model Law has the burden to put forth a plan that persuades its creditors that it is going to be successful. If it can't, its creditors are going to vote no. This is a give-and-take consensus process, as opposed to being micromanaged from on top.

QUESTION 3

Does the statutory approach you are proposing also apply for U.S. states, for example, Puerto Rico right now?

STEVEN SCHWARCZ

The statutory approach I am proposing, the Model Law, is intended to, at least as drafted, to deal with sovereign nation debt. Its restructuring norms, however, would be applicable to Puerto Rico. But the most direct way to address Puerto Rico's debt problems would probably be for Congress to include it within Chapter 9 of the Bankruptcy Code. I do not think that introducing the Model Law idea into U.S. domestic politics would go very far, but I do not know.

QUESTION 4

What do the rating agencies think about the model law?

STEVEN SCHWARCZ

I have only discussed this so far with a senior executive at Moody's, who thinks it's an interesting idea but has not studied it in any systematic way. I do not see why the rating agencies should be troubled. Companies are subject to the same types of statutory debt restructuring provisions, yet their debt is routinely rated.