

Sovereign Debt Restructuring: A Study of the Inadequacies of the Contractual Approach

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Abstract : In absence of a comprehensive international legal regime for sovereign debt restructuring, majority of the complications arising from sovereign debt restructuring are frequently left to the uncertain market forces. The resort to market forces for sovereign debt restructuring has led to a phenomenal increase in litigations targeting assets of defaulting sovereign nations, internationally across jurisdictions with the first major wave of lawsuits against sovereigns in the 1980s with the Latin American crisis. Recent experiences substantiate that majority of obstacles faced during sovereign debt restructuring process are caused by inefficient creditor coordination and collective action problems. Collective action problems manifest as grab race, rush to exits, holdouts, the free rider problem and the rush to the courthouse. On defaulting, for a nation to successfully restructure its debt, all the creditors involved must accept some reduction in the value of their claims. As a single holdout creditor has the potential to undermine the restructuring process, hold-out creditors are snowballing with the increasing probability of earning high returns through litigations. This necessitates a mechanism to avoid holdout litigations and reinforce collective action on the part of the creditor. This can be done either through a statutory reform or through market-based contractual approach. In absence of an international sovereign bankruptcy regime, the impetus is mostly on inclusion of collective action clauses in debt contracts. The preference to contractual mechanisms vis- a vis a statutory approach can be explained with numerous reasons, but that's only part of the puzzle in trying to understand the economics of the underlying system. The contractual approach proposals advocate the inclusion of certain clauses in the debt contract for an orderly debt restructuring. These include clauses such as majority voting clauses, sharing clauses, non- acceleration clauses, initiation clauses, aggregation clauses, temporary stay on litigation clauses, priority financing clauses, and complete revelation of relevant information. However, voluntary market based contractual approach to debt workouts has its own complexities. It is a herculean task to enshrine clauses in debt contracts that are detailed enough to create an orderly debt restructuring mechanism while remaining attractive enough for creditors. Introduction of collective action clauses into debt contracts can reduce the barriers in efficient debt restructuring and also have the potential to improve the terms on which sovereigns are able to borrow. However, it should be borne in mind that such clauses are not a panacea to the huge institutional inadequacy that persists and may lead to worse restructuring outcomes.

Keywords : sovereign debt restructuring, collective action clauses, hold out creditors, litigations

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