A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings

Christoph G. Paulus

There is no generally applicable process for resolving sovereigns’ financial or economic problems; sovereign debt restructuring is currently handled on an ad hoc basis. The approach lacks transparency, predictability, and efficiency—all critical elements in restructuring debt and for the rule of law in general. As the recent example of Greece and other European countries suggests, the problem affects all countries, not just developing countries.

This chapter examines past sovereign debt restructuring and develops a feasible and desirable approach to restructuring through the establishment of a standing arbitral tribunal (modeled after, for example, the Iran–U.S. claims tribunal). The chapter is organized as follows. The first section describes and rates the techniques applied to date and identifies their deficiencies. The second section proposes the establishment of a tribunal and addresses the nine most important problems related to its creation. The last section provides some concluding remarks.

Deficiencies of the Current System

For many years, the Paris and London Clubs handled the restructuring of sovereign debt when crises occurred. In recent years, the need for their involvement has declined, as the capital markets have emerged as the leading source of credit.
The call for a code of conduct—as voiced, for instance, by the former governor of the Banque de France Jean-Claude Trichet—is commendable. Such a code, which stresses the importance of creditor behavior, would provide an additional tool for developing fair solutions to sovereign debt resolutions (see Couillault and Weber 2003; IIF 2004). However, as a “soft law,” a code of conduct is nonenforceable; there is almost no sanction—at least no legal one—against a violation of this self-imposed obligation. For this reason, the approach lacks predictability.

Many versions of the concept of “odious debt” exist; it remains doubtful that any of them is legally binding (Bohoslawsky 2009; Michalowski and Bohoslawsky 2009; Paulus 2008). Insofar as the discussion of odious debt emphasizes creditors’ co-responsibility, it is likely, however, that legally binding standards will evolve (Buchheit and Gulati 2010), but it is hard to imagine that any such co-responsibility will ever be applicable to ordinary bond holders who invest in sovereigns through the capital market. This approach may be of some help in the future, but because it will not govern most creditors, it will not be an all-encompassing solution.

Collective action clauses have also been viewed as an effective mechanism for handling debt restructurings (see Galvis and Saad 2004; Gugiatti and Richards 2004; Hopt 2009; Schier 2007; Szodruch 2008). Their main advantage is that they address the problem of holdout profiteers by allowing majority decisions to be binding on all creditors. Such clauses exert discipline on creditors by preventing the strategic waiting or action that is possible when unanimity is required (see Paulus 2002).

The problem with collective action clauses is that they are binding only within a single bond issuance. If there are two or more bond issuances, it is difficult to achieve intercreditor equity (see Buchheit and Pam 2004; IMF 2005; Szodruch 2008). This deficiency must not be underestimated, as intercreditor equity is perceived as essential to fairness.

Another reason why collective action clauses do not solve the problem of sovereign debt restructuring is that they are applicable only to bond holders and not to more traditional lenders, such as foreign states or banks. If traditional claims form the bulk of a sovereign’s debts, the collective action clause approach is likely to have little effect.

Taking all these pros and cons into consideration, the most appropriate solution to the sovereign debt-restructuring problem appears to be to learn from the private law model governing commercial and individual insolvency and introduce a full-fledged proceeding. The huge advantage of this approach is that it has the potential to guarantee both transparency and predictability and can lead to an all-encompassing solution through its obligatory inclusion of all (or at least most) creditors. To be sure, the design of such a proceeding needs to balance the interests involved; simply copying the insolvency statute of a jurisdiction will certainly not suffice.

Initial steps along this path have been made (see Buckley 2009; Hagan 2005; Mayer 2005; Paulus 2003b; Schier 2007). Because of political
considerations, however, they are—at least at this point—highly unlikely
to develop into a full-fledged type of insolvency proceeding for sover-
eigns (Setser 2008).

A Procedural Solution: The Sovereign Debt Tribunal

Given this state of affairs, it appears prudent to give up the ambitious goal
of establishing a full-fledged bankruptcy system. A better approach seems
to be to go the longer and probably somewhat thornier route of starting
with a modest first step (Paulus 2009).

Establishment of the Sovereign Debt Tribunal

Court-like institutions already exist. The Iran–U.S. tribunal is the most
prominent example (Gibson and Drahozal 2006). The tribunal estab-
lished for the restructuring of Iraq’s Saddam-era debts, which has been
quite successful so far, is another example (Deeb 2007). A sovereign debt
tribunal based along the lines of these tribunals could provide the legal
structures that are indispensable to establishing smooth procedures for
sovereign debt restructuring.

As to where this tribunal would be located, how it would be con-
stituted, and how it would function, various scenarios are imaginable.
Relevant stakeholders could identify an institution with credibility and a
strong reputation that is not an actual or potential creditor to sovereigns.
The procedures might include time-bound mediation as a precursor to
arbitration or as a complement to ongoing restructuring negotiations.
The creation of a sovereign debt tribunal would also build confidence for
ultimately embracing broader reform objectives.

Creation of a sovereign debt tribunal is likely to be confronted with
reservations, concerns, and obstacles. As there is no enforcement mecha-
nism, such a tribunal could be created based only on consensus among
relevant stakeholders that the problems of a defaulting sovereign are bet-
ter solved with a sovereign debt tribunal than without one.

Creating an international arbitral tribunal has several advantages:

- It is based on consensus among key stakeholders.
- It handles disputes between creditors and the sovereign debtor in a
  neutral forum, thereby toning down some of the emotions that affect
  such disputes.
- It brings cohesion and structure to what is often a disorganized
  group of anxious stakeholders who initiate individual strategies
  (usually in different places) to secure the most profitable outcome
  for themselves.
Unlike collective action clauses, it covers both creditors and the sovereign debtor.

It could create confidence on the part of sovereigns and creditors that a pool of expert arbitrators possess the experience and knowledge needed to resolve the complex issues of sovereign defaults.

The proposal described here differs from similar proposals put forward by nongovernmental organizations (NGOs) that have long advocated resolution of sovereign debt restructurings through arbitration. When such NGOs discuss arbitration, they are generally referring to an ad hoc arbitration process like that used in certain types of commercial disputes. In this kind of arbitration, each party typically appoints one arbitrator. The two arbitrators then select a third arbitrator.

Although a number of well-established and well-respected international arbitration institutions, such as the International Chamber of Commerce in Paris, are used in the commercial arbitration context, the pool of potential arbitrators maintained by such institutions is so large that there is a danger of anonymity. This problem could erode coherence, prevent the pool of arbitrators from steadily gaining expertise, and result in inconsistent rulings across panels.

In contrast, the proposal suggested here envisages a model based on the Iran–U.S. Claims Tribunal, which comprises a small number of high-profile panelists. The arbitrators would have the opportunity to become acquainted with one another and discuss issues of common concern, thereby allowing them to develop a common thread of reasoning in addressing similar cases.

The advantages of a sovereign debt tribunal are manifold. By its design and structure, such a body would necessarily develop expertise. Cases would be adjudicated by a small, highly qualified pool of international judges rather than judges from New York, London, or wherever parties agreed to have their forum. In contrast to traditional collective action clauses, a sovereign debt tribunal would establish clear procedural rules, thereby enhancing transparency and legitimacy. A self-imposed constraint on procedural issues would allow for sufficient flexibility in regard to substantive matters, which are often viewed (particularly by nonlegal professions) as more important than procedural issues.

Creation and Composition of an Arbitral Tribunal

In order to enjoy the benefits of institutional backing and international reputation, the tribunal should be established under the auspices of a highly reputed institution that does not lend to sovereigns. This restriction rules out the International Monetary Fund (IMF) and the World Bank Group (Waibel 2007).
Although the International Centre for Settlement of Investment Disputes (ICSID) is a well-established and functioning arbitration center, it could not serve as an sovereign debt tribunal for at least two reasons. First, ICSID belongs to the World Bank Group, a source of perceived bias. Second, although many sovereign debts are investment related, many others are not. The highly complex issue of a sovereign in default must not be stripped of all its complexities, including political, economic, legal, and social implications, and reduced to a mere investment problem.

An international institution that appears appropriate is the United Nations. Alternatively, a country such as the Netherlands or Norway could host the tribunal (the Netherlands is currently exploring the possibilities for such an undertaking). The advantage of housing the institution outside a multilateral institution is that it could be created more quickly than it could under UN auspices, given the United Nation’s many stakeholders.

Some commentators (Reinisch 2003; Stiglitz 2003) have proposed another alternative, namely, establishing a global bankruptcy court associated with, say, the International Court of Justice. As appealing as this idea may appear at first blush, even if a special sovereign bankruptcy chamber were completely separated from the judiciary of the International Court of Justice, it could suffer some of the same acceptance, recognition, and enforcement problems the International Court of Justice has experienced.

Whatever institution creates the tribunal, various questions regarding its functioning and operation need to be addressed. These questions regard the selection process for the pool of arbitrators, the establishment of a permanent secretariat, the creation of a Web site, the payment of arbitrators, and related issues.

The selection of arbitrators could be handled in the way the IMF proposed in its attempt to set up its Sovereign Debt-Restructuring Mechanism (SDRM) (Paulus 2003a). A public figure with international stature—such as the secretary-general of the United Nations, for instance—would select 20–30 arbitrators (or, in the interest of even greater neutrality, 10 arbitrators, who would select the 20–30 arbitrators). The selection would reflect a diversity of national and professional backgrounds. The arbitrators would elect one of their members as president of the tribunal.

The selection of arbitrators in this manner has the potential advantage of fostering trust—no small consideration given the importance of perception in sovereign debt restructuring. The president’s task would be to draft the procedural rules for the tribunal, which would be enacted only after all or a majority of arbitrators gave their consent and the public figure responsible for selecting the arbitrators had been informed of the proposed rules. The president of the tribunal would also appoint arbitrators to specific cases. The president would be the only full-time arbitrator; all others would work when called upon by the tribunal’s president.
The details of the panels might depend on the needs of each case. Some cases, for example, might require only a single arbitrator, whereas others might require as many as three arbitrators. Depending on the scope of the tribunal’s tasks, the applicable substantive law might need to be determined.

A necessary feature of any arbitration tribunal is that it have no intrinsic authority to initiate or decide cases on its own. Any such authority will be dependent on the contractual agreement to arbitration by all relevant parties; such agreement to arbitration is the critical underpinning of any international arbitration process. The requirement for prior agreement stands even if the circumstances are as uniquely pressing as they were in the cases of the Iran–U.S. Claims Tribunal and the debt rescheduling of Iraq after 2003.

In both of these cases, the tribunals were created after the onset of the crisis. One cannot assume that such an ex post result can be achieved in every case, however. In most cases, it is unlikely that all stakeholders will consent to a sovereign’s offer for arbitration once a debt crisis has begun. The introduction of an arbitral tribunal will thus usually depend on a precrisis consensus among the parties, making it critical to include an arbitration clause in all issuances of sovereign bonds and other instruments used to issue sovereign debt.

Given this dependence on contractual agreement between the parties, a downside of the proposal is obvious: parties that do not enter such a contractual agreement with the sovereign are not subject to the tribunal’s jurisdiction. Such debts will have to be dealt with in the traditional manner. The proposal thus deals only with contractual obligations on debt instruments such as bond issuances. It is hoped that once such a tribunal is established, it will become generally acceptable and create spillover effects on the legal treatment of other state obligations.

**Jurisdiction and Competence of the Tribunal**

The tasks and duties of a debt-restructuring tribunal can be manifold, depending on the configuration of the debt-restructuring mechanism itself. The type of mechanism used depends on how far one wants to extend the influence of the arbitral tribunal. The scope of its tasks should be carefully delineated in the relevant bond issuance clause or other relevant debt instrument providing for arbitration.

In accordance with what is considered here to be a pragmatic and modest approach, the arbitral tribunal should, at a minimum, be empowered to address matters related to the verification of creditor claims, as well as voting issues related to the approval of the restructuring plan and similar matters. Beyond that, the extent to which the tribunal is empowered to address specific issues should be left to the discretion of the parties. The period during which the tribunal functions must also be determined. One
option is to disband it after the proceeding is closed. Another is to allow it to function until all case-related disputes, even those that emerge after the course of the proceeding, are resolved.

As a practical matter, the bond-issuing sovereign may draft the arbitration clause and propose it to the investor community, which then decides whether to accept it. Depending on the details of the clause proposed, it could create a buying incentive or disincentive for investors. It is conceivable that, with the passage of time and the development of experience in this area, certain practices may gain acceptance in the market, with the result that certain standard arbitration clauses may emerge in sovereign bond issuances.

One of the major issues to be addressed is which disputes the tribunal should be competent to decide. Should the tribunal be restricted to deciding narrow, technical legal issues? Should it be limited to deciding on the legal validity of each individual creditor claim or permitted to determine the legal validity of the sovereign’s proposal for debt restructuring? Other issues that could possibly be handled by the international tribunal (subject to prior contractual agreement by the parties) include the following:

- What constitutes sustainable debt for the sovereign in question (the IMF could be permitted to make submissions on this matter, even though it is not a party to the arbitration, possibly subject to certain confidentiality restrictions, given the sensitivity of the information)
- Whether the economic assumptions underpinning a restructuring plan are reasonable?
- Satisfaction of the commencement criteria for invoking the arbitration mechanism (for instance, the excusability of the default)
- Whether the parties have engaged in good faith negotiations
- The feasibility and reasonableness of any proposed restructuring plan
- Whether the debt in question constitutes a lodgable debt; if so, whether it constitutes an “odious debt”; and what, if any, implications follow from that determination.

Who Is to Be Bound by the Tribunal’s Decisions: Intercreditor Equity

An agreement could include a rule setting forth the degree to which a decision of the tribunal would be binding on other creditors. If the tribunal is empowered in its decisions to take into account issues of intercreditor equity, its decisions could be binding only on issuances that have their own arbitration clauses. The tribunal could then weigh, for instance, the different maturities, the risk level (rating) of each issuance, the promised interest rates, and all other relevant details.

The binding effect would extend only to creditors that agreed to subject themselves to arbitration when they signed the contract purchasing the
sovereign’s bonds or extending credit to the sovereign in some other manner (such as through bank loans). Creditors that did not sign a contract containing an arbitration clause would not be bound by the tribunal’s decisions. Therefore, arbitration (as distinct from collective action clauses) can address the issue of nonconsenting creditors in a debt restructuring only to the extent that such creditors agreed to an arbitration provision in the underlying debt instruments.

This somewhat sobering legal conclusion does not exclude mechanisms designed to make quasi-voluntary participation in the sovereign debt tribunal process more attractive. One way to incentivize participation would be to bind the public sector, the banking sector, or both—for instance, upon the condition that a certain threshold portion of the private sector be bound.

Decisions by the sovereign debt tribunal would probably not constitute binding precedents, as a tribunal is not a common law court. However, depending on its authority—which, in turn, depends on its convincing and unbiased reasoning—its decisions (like those of existing arbitration tribunals) would form part of an evolving body of public law on sovereign debt restructuring that ultimately could lead to a well-established body of law on its own.

**Triggers for Invoking the Arbitral Mechanism**

The announcement of a default—as defined in the issuance contract—would trigger the use of the arbitration tribunal. Depending on how the parties draft the language of the arbitration clause, a default could commence even before such an announcement, when insolvency appeared imminent. The parties to a sovereign debt issuance should determine whether the tribunal’s competence should include determination of whether the prerequisites of such a default trigger have materialized.

The agreement should also specify which side—only the sovereign or both the sovereign and creditors—shall be allowed to invoke the arbitration mechanism. Although from a disciplining perspective, it would appear to be preferable to bestow such a right on both sides, sovereigns may not be willing to allow creditors to subject them to such proceedings. Thus, for political reasons, pulling the trigger might be left to the sovereign debtor alone or to the sovereign debtor and creditors acting in unison.

**Governing Law and Applicable Insolvency Rules and Principles**

Which laws should govern the proceedings of the sovereign debt tribunal? If it is the law of a particular jurisdiction, should issues of public international law be included, in toto or partially? How should intercreditor
equity be achieved in cases in which some bond holders will be judged under English law, whereas others will be judged under the laws of New York State or Germany?

Given the complexity and intricacy of these questions, it may be worth considering giving the institution that creates the arbitral tribunal (for instance, the United Nations) an option available for all bond issuances that the tribunal would (if agreed to by the parties to the relevant debt instrument) apply something like general insolvency rules and principles. For the sake of gaining the necessary global acceptance, these general rules and principles would not simply be the law of a particular jurisdiction but rather something along the lines of the “law merchant.”

Such rules and principles might be found in the general principles of insolvency law established by leading international institutions (for example, the principles specified in the relevant texts of the World Bank 2005, the United Nations Commission on International Trade Law [UNCITRAL 2004], the IMF, and other international institutions). The insolvency rules that these international institutions have developed apply to commercial enterprises, however, rather than sovereigns. Some adaptation would presumably be required if the sovereign debt tribunal were to look to these principles for guidance.

After it has gained some experience, the tribunal could establish substantive rules regarding the treatment of sovereign debt restructurings. Creation of such rules would obviate the need to draft contractual clauses, as borrowers and debtors could simply add a reference indicating whether all, some, or none of these rules apply.

**Representation of Creditors in the Arbitral Proceeding**

For the sake of transparency, creditor participation is important. It is clearly not practical, however, for all sovereign creditors to participate in an arbitral proceeding. Creditors thus have to develop and specify a mechanism for creditor representation (see Buchheit 2009; Group of Ten 2002). For example, bondholders in a sovereign debt issuance could specify in one of the underlying debt instruments (the bond indenture, the trust indenture, another document) who would represent the creditors in the arbitral proceeding.9

If the bond-issuing sovereign wants a creditors’ committee to represent creditors, the clauses have to address a variety of issues. How would the committee be selected and constituted? Would it consult with the larger body of creditors, or would it be the indenture trustee acting on behalf of and taking instructions from the bondholders in a prescribed manner? These issues need to be confronted head on before the issuance of the sovereign bonds. If they are not, the arbitration process may become unwieldy and unworkable.
Mediation as Precursor to Arbitration

As a complement to the proposal for a sovereign debt-restructuring tribunal presented here, it may be worth having the parties to a sovereign debt issuance consider whether they wish to require mediation, which by its nature is nonbinding on the parties, as a precursor to a binding arbitration procedure. The parties could specify in their arbitration clause whether mediation is a necessary step to be exhausted before they are permitted to resort to arbitration. Even if mediation is not specified as a formal prerequisite to arbitration, the parties could still resort to mediation if they think it might help resolve disputes or otherwise advance the restructuring process. To inhibit procedural abuse (and to discipline stakeholders), it is probably necessary to impose time restrictions within which mediation would have to be initiated and completed.

The possibility of mediating disputes could provide parties with a less adversarial forum for resolving their disputes before they turn to a higher stakes and potentially more protracted and adversarial arbitration process. Whether or not mediation is a formal prerequisite to binding arbitration, it can be seen as a tool to bridge the differences between the parties on any outstanding negotiating issues, assisting them in any ongoing efforts to reach a restructuring agreement. In this light, mediation can be viewed as a useful mechanism for helping the parties reach the necessary thresholds of creditor support set forth in any applicable collective action clauses.

Financing and Support for an Arbitral Tribunal

The basic financing and support for the arbitral tribunal should come from the sponsoring organization (for instance, the United Nations or the country hosting the tribunal). This financing would need to cover the salary of the tribunal president, office space, and a small secretariat to handle general administrative matters, including keeping tribunal members abreast of current developments in sovereign debt restructurings and defaults and coordinating the roster of designated arbitrators. The parties to an actual arbitration proceeding would be solely responsible for defraying the costs of the arbitration, including the fees and expenses of the arbitrators, which can be significant.

Concluding Remarks

The proposal outlined here is merely the initial formulation of an idea. The idea may deserve serious consideration in order to address a problem that may grow more acute with the growing gaps between rich and poorer countries. As the United Nations (2004, p. 2) notes in its report A More Secure World: Our Shared Responsibility, “combating poverty
will not only save millions of lives but also strengthen the State’s capacity to combat terrorism, organized crime and proliferation. Development makes everyone more secure.” Moreover, as globalization is increasing the complexity and the number of relevant actors in the world of sovereign finance, the need to develop a predictable and reliable procedure for resolving the problems of sovereigns in default is likely to become more pressing, requiring the attention of policy makers and stakeholders.

Successful use of the sovereign debt tribunal proposed here could build confidence for embracing broader objectives in the area of sovereign debt reform. Positive experiences—particularly a series of positive experiences—could increase the willingness of stakeholders in sovereign debt restructurings to consider other more fundamental reforms to the sovereign debt-restructuring process.

Notes

1. See also the Equator Principles (www.equator-principles.com).
2. Paulus (forthcoming) draws conclusions from the so-called Ultimatum Game in order to explain the prominence of any bankruptcy system.
3. This section is based on an unpublished paper written by the author and Steven T. Kargman.
4. For full information on the tribunal, see www.iusct.org.
5. In the spring of 2010, the German government came up with a proposal to enact a kind of insolvency law for overindebted states within the Euro Area. In this context, the establishment of an insolvency court was briefly considered. Ultimately, attempts to enact such a law were put off until some later time.
6. As these clauses will not be retroactive, problems are likely to arise for some time when debt obligations without such clauses exist alongside those with such clauses.
7. A sovereign may have overlooked obvious possibilities of reducing costs—by cutting the 13th salary for state employees, for instance, an important cost saver when this group is large.
8. To the degree that the issues listed include economic analysis, the pool of arbitrators must include some with expertise in economics.
9. There is a somewhat parallel mechanism in the determination of a trustee of an indenture.
10. Doing so would to a certain degree follow the example of ICSID’s conciliation mechanism.

References


———. Die Weltbank und das Insolvenzrecht.


