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Sovereign Debt Restructuring: Overview

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A Practice Note providing an overview of sovereign debt restructurings, including the participants, the key steps in the process, the issue of holdout creditors and how to prevent them by using collective action clauses, the "re-designation" and "Pacman" strategies, exit consents, anti-holdout creditor legislation and protocols, developments in sovereign debt litigation, and information on recent sovereign debt restructurings in Puerto Rico, Zambia, Ecuador, Argentina, Ukraine, Sri Lanka, and Ghana.

Growing numbers of sovereigns are close to defaulting on bond payments or have already defaulted. According to the Committee for the Abolition of Illegitimate Debt's Global Sovereign Debt Monitor 2022, 135 countries are "critically indebted." The twin crises of COVID-19 and the war in Ukraine have only increased instability, and economies that depend on tourism are facing increasing financial pressure and are struggling to afford energy imports.

Unlike the situation for corporate debtors, no insolvency regime applies to countries, and there is no universally accepted method for a country to undergo debt restructuring. It typically involves one or more processes to manage the sovereign's debt burden and can include the exchange of outstanding debt instruments like loans or bonds for new debt instruments or cash. This Note explains many features that are common to sovereign debt restructurings.

For a list of defined key terms in sovereign debt restructurings, see Box, Key Terms.

Participants in the Sovereign Debt Market

Sovereign debt restructurings are complex and involve several actors, including:

- The national debtor government (see Debtors).
- Other national governments who are creditors (see Bilateral Official Creditors (BOCs)).
- International commercial creditors and creditors' committees (see Creditors).
- International financial institutions, for example, the International Monetary Fund (IMF) (see Multilateral Official Creditors (MOCs)).

Debtors

The Sovereign

The sovereign country or state is both the issuer and debtor. Uniquely, the sovereign does not have the benefit of an insolvency regime, meaning the debtor cannot be discharged from bankruptcy and must reach a consensual settlement with all creditors. The sovereign debt remains a liability of the foreign state regardless of political change, which it must pay or face consequences, including litigation, a seizure of its assets, and an inability to participate in the debt capital markets.

Within the sovereign country or state there can be players with differing objectives, such as a politically driven ministry of finance versus a central bank focused on financial stability.

State-Owned Enterprises (SOEs)

SOEs are formed by the sovereign government through legal means so that it can take part in activities of a commercial nature. SOEs sometimes issue debt, which the sovereign often guarantees. When these SOEs default, it creates a risk of simultaneously destabilizing the sovereign itself and causing it to default. The sovereign guaranties can also cause issues during a restructuring process, where the SOE creditors' interests may not align with those of creditors to the state.

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Creditors

Multilateral Official Creditors (MOCs)

MOCs include:

- The IMF, which monitors the debt restructuring process and provides necessary financing to distressed governments at zero percent interest, as a lender of last resort.
- The World Bank, which provides loans and grants to low- and middle-income countries to pursue capital projects.
- Various regional development banks, such as:
  - the African Development Bank;
  - the Asian Development Bank; and
  - the Inter-American Development Bank.

These international financial institutions (IFIs) play an important role in restructuring the debt of emerging economies by providing support, debt relief, and liquidity. They generally grant concessions when lending money, including lower interest payments and longer repayment periods, compared to the private sector. However, these programs are generally subject to conditions, requiring structural reforms and fiscal constraints to correct imbalances in a country's economy.

MOCs often enjoy a de facto special status in restructurings and are considered preferred creditors. While this status is rarely specified in legal agreements, sovereign borrowers normally pay IFIs in full. The Paris Club Agreed Minutes exempt IFIs from a comparability of treatment clause (see Box, The Paris Club). Similarly, the IMF has a general policy against "lending into arrears," meaning that IMF assistance has traditionally been conditioned on the sovereign's resolution of defaults with private creditors (although the IMF has relaxed this policy in recent years). The preferential treatment is partly explained by the importance of these institutions in solving debt crisis situations for debtors and being a lender of last resort.

Bilateral Official Creditors (BOCs)

BOCs mainly consist of other sovereign states, including the US and a number of Organization for Economic Co-operation and Development (OECD) countries. The most influential grouping of these formed the Paris Club to coordinate a collective approach to debt restructuring discussions (see Box, The Paris Club).

BOCs also include emerging lenders like China. China has become a significant bilateral lender to low-income countries, tripling its overseas lending since 2008 (see The Countries Most In Debt to China [Infographic], Forbes, Aug. 19, 2022). These low-income countries now owe 37% of their bilateral debt to China, as compared to 24% to the rest of the world. China is not a member of the Paris Club and is more likely to negotiate the restructuring of its claims independently.

Commercial Creditors

Commercial creditors (private creditors) encompass a broad group, which can include:

- Banks (see Creditors' Committees).
- Institutional investors (investment funds including hedge funds, pension funds, and insurance companies).
- Suppliers.
- Trade creditors, who usually act on their own, but with political backing.
- Individuals.

Each can present their own challenges. For example, certain aggressive investment funds with a low basis may be prepared to hold out or otherwise disrupt the restructuring process to extract value (see Holdout Creditors), while retail investors may be less able to bear losses.

Creditors' Committees

Commercial creditors, including bondholders, may form ad hoc committees to collectively engage the sovereign. This trend began with commercial banks that, in the latter half of the 20th century, became more important to sovereigns and often formed ad hoc committees to deal with the challenges of sovereign debt restructurings (known as the London Club). The London Club was more fluid than the Paris Club in that its members differed from case to case, but the basic principle was to adopt a coordinated approach to restructuring debt.

As the creditors of sovereign debtors have diversified to include investment funds and individuals, sovereign debt instruments now often officially provide for recognition of creditor committees by the sovereign and formalize their participation in the restructuring process. These committees take on the role previously performed by the London Club of coordinating negotiations, information, and responses in a sovereign restructuring. Creditors' committees usually consist of the sovereign's biggest lenders and can verify a deal to assure other creditors that it is the best option available.

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Sovereign debt restructurings use creditors' committees less often than they are used in US restructurings under the Bankruptcy Code (see Practice Note, Chapter 11 Creditors' Committees). Because there is no central authority (like the US Trustee) available to appoint a creditors' committee in sovereign debt cases, the parties are also left to negotiate their formation and to obtain recognition from the sovereign debtor (when not covered in the underlying debt documents).

The Process

Sovereign investors generally do not expect the sovereign to repay the debt in full, but rather to refinance or "roll over" this debt at or before maturity. Typically, a sovereign's nominal debt stocks rise over time, and its bullet loans are replaced by new loans as they mature (see Box, Key Terms for definitions of nominal debt stocks and bullet loans). A crisis arises when a trigger event occurs and the sovereign cannot borrow new money (see Trigger Event).

The restructuring of sovereign debt is a step-by-step process consisting of:

- The trigger event (see Trigger Event).
- An announcement (see Announcement).
- The restructuring "envelope" (see Restructuring Envelope).
- Negotiations (see Negotiations).
- Implementation (see Implementation).

Trigger Event

The circumstances giving rise to the need to restructure can vary, including:

- Financial distress.
- An inability to pay maturing debt.
- Lack of liquidity.
- Increase in interest rates.
- Political upheaval.
- Strategic decisions.

Understanding the root cause of a sovereign default is the first step in a successful restructuring, as the restructuring must address the underlying problem.

Announcement

Typically, the sovereign will make an announcement, either post-default or preemptively, putting creditors on notice that its debt requires restructuring.

Restructuring Envelope

The sovereign debtor, either with financial advisors or the assistance of an MOC like the IMF, take steps to:

- Determine the overall debt relief it requires.
- Conduct a debt sustainability analysis (DSA).
- Identify liquidity needs.

Creditors, including the Paris Club (see Box, The Paris Club), then use the DSA when deciding on the extent of the relief to grant, as the DSA sets out the restructuring "envelope" (for example, how much debt a country can sustainably bear). Most sovereign debt restructurings start with an IMF DSA. The sovereign prepares restructuring proposals setting out the debt relief it is seeking and how it can implement this relief, identifying creditor groups to approach. The IMF can provide stop-gap financing if there is a plausible way to make the debt more sustainable.

To maintain short-term economic stability, certain creditor constituents, such as trade creditors, collateralized debt obligations, and treasury bills, may be exempt from proposed haircuts.

Legal Analysis

A legal review of the sovereign's outstanding debt is necessary to determine a restructuring strategy. Most sovereign debt is governed by New York or English law and must be restructured according to those laws to be binding on creditors.

An initial legal analysis should consider whether:

- The debt is external or domestic. If the debt is external, the analysis should address whether it is:
  - governed by foreign law;
  - issued in foreign currency; or
  - held by foreigners.
- The debt is owed directly by the sovereign or by guaranteed SOEs (see State-Owned Enterprises (SOEs)).
- Collective action clauses (CACs) govern the bonds, and if so, what type (see Collective Action Clauses (CACs)).

Negotiations

Relevant creditor groups, who may form ad hoc committees, will evaluate and consider the restructuring proposal (see Creditors' Committees). The determination of how the debt relief burden is shared across different categories of creditors often results in prolonged discussions and negotiations.

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There is a need for support across the creditor spectrum, and depending on the terms of the underlying documents, this could require the consent of all lenders under a financial instrument, presenting opportunities for holdout creditors (see Holdout Creditors).

Implementation

When reaching an agreement, there are three main options available to restructure the debt:

- Lengthening the maturity dates for either principal or interest amounts falling due or providing a grace period (amend and extend).
- Reducing the interest rate on the debt (coupon adjustment).
- Reducing the principal amount of the debt owed (principal haircut).

Most sovereign debt restructurings use a mix of these options to achieve the necessary relief.

Holdout Creditors

Holdout creditors are often distressed debt investment funds that purchase defaulted sovereign debt on the secondary market at a fraction of the face value, with the specific agenda of not participating in any restructuring and seeking to recover the full face value of the debt.

However, it is generally not in the interests of the holdout creditors to prevent the sovereign debt restructuring from occurring. Indeed, once a restructuring has been completed, the sovereign is in a better financial position to meet their demands. The holdout creditor's aim is to receive a better return or be paid to sell out of their bond position. They use litigation tactics to obtain judgments and seize the sovereign's assets abroad where they can, in an attempt to pressure the sovereign to pay the obligation.

Preventing Holdouts

Due to the impact that creditor holdout actions can have on the restructuring process and the sovereign, including economic and social instability, many approaches have been developed to counteract creditor actions like protracted litigation and delayed debt relief, including:

- Collective action clauses (see Collective Action Clauses (CACs)).
- The "re-designation" and "Pacman" strategies (see Testing the Limits of CACs).
- The exit consent strategy (see Exit Consents).
- Legislative measures and protocols (see Legislative Measures and Protocols).

Collective Action Clauses (CACs)

One of the most common ways to address holdout creditors is the use of CACs. Since 2003, CACs have been a typical feature in sovereign bonds governed by New York or English law, and according to the IMF, almost all sovereign bonds issued since 2014 include some form of CAC.

Originally designed to allow a specified supermajority of bondholders (typically 75%) to agree and bind the remaining bondholders in the issuance to a restructuring (first generation CACs) (see CAC Option Table, Option 1), CACs have now developed into a sophisticated tool operating across a series of bonds to aid restructurings and prevent holdout creditor actions (second generation CACs) (see CAC Option Table, Options 2 and 3). These newer generations of CACs allow the sovereign debtor to modify or restructure multiple series of bonds without requiring the consent of a majority of creditors in each series. This makes any potential holdout far more expensive and difficult to achieve, because when the vote is aggregated across series, it becomes significantly harder to buy a blocking position.

Increasingly, bond documents provide for a menu of choices, giving the sovereign flexibility to choose from all three options in the CAC Option table (third generation, or enhanced CACs).

CAC Option Table

The following table sets out the most common types of CACs contained in sovereign debt bonds.

Option	Type of CAC	Voting Thresholds
Option 1	Modification of a single series of bonds, with series-by-series voting.	**Must be agreed to by:** 75% or 50% of bondholders of each series, for reserved and non-reserved matters, respectively.*

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Option	Type of CAC	Voting Thresholds
Option 2	Modification of multiple series of bonds with two-limb series-by-series and aggregated voting (see Two-Limb Voting).	**Must be agreed to by:** • 50% of bondholders of each individual series in the aggregated pool. • 66.6% of all bondholders in the aggregated pool.
Option 3	Modification of multiple series of bonds with single-limb aggregated voting (see Single-Limb Voting).	**Must be agreed to by:** 75% of all bondholders in the aggregated pool.

*Reserved matters are key terms requiring greater majority approval.

While CACs limit the risk that a minority of creditors will disrupt an orderly restructuring process, holdout creditors are still a risk because CACs are a recent feature in sovereign debt instruments, including bonds, bilateral loans (both commercial and official), and syndicated loans, and older debt instruments exist that do not include CACs.

Single-Limb Voting

Where the sovereign issuer makes the same proposal to all creditors across multiple series of debt instruments, single-limb CACs allow for the majority vote to take place at an aggregated level, without the need for a majority at each individual series (see CAC Option Table, Option 3). This makes sovereign debt restructuring more orderly and predictable. These clauses are typically contingent on 75% (or sometimes, two-thirds) approval to the terms of a restructuring from creditors in the aggregated pool, with this approval binding on all creditors in the series.

The European Union (EU) has required bonds issued in the eurozone to use single-limb CACs since January 1, 2023.

Two-Limb Voting

Two-limb CACs provide for restructurings based on an agreement from a specified majority of all the sovereign issuer's bondholders (typically 75% or two-thirds), as well as two-thirds or a majority of bondholders of each series of bonds (see CAC Option Table, Option 2). In other words, there must be a minimum threshold of support in:

- Each individual series.
- Across all series being restructured.

Two-limb CACs ensure that the outcome for a class of creditors is determined, at least in part, by the votes of investors in the same debt instrument, and not the votes of those in a different series.

Testing the Limits of CACs

Single-limb voting CACs have allowed sovereigns to pursue the controversial "re-designation" and "Pacman" strategies, both of which circumvent the requirements of CACs in debt restructurings (see Collective Action Clauses (CACs)). Re-designation is essentially gerrymandering the votes, while Pacman is the use of multiple restructuring offers to obtain a supermajority of individual bond series sequentially, and then offering a marginally better deal using the aggregated supermajority process to restructure all bonds.

Both Argentina and Ecuador threatened to employ these strategies after they defaulted in 2020, with much pushback from bondholders. In the end, they agreed to make certain changes to their use of these strategies, but Argentina was still able to impose worse financial terms on holdouts who did not tender their bonds. In the future, there may be litigation testing the validity of these tactics.

The Re-designation Strategy

Re-designation is a strategy allowing a sovereign to exclude one or more series of bonds from the aggregated voting pool in a single-limb CAC after voting has taken place. Arguably this conflicts with New York law CACs, which tend to provide that the issuer's selection of modification and voting pool be final. However, this finality provision is not typically a "reserved matter," so it can be modified or waived with a simple majority consent of each series (that is, a simple majority of creditors in each series can agree to waive the finality requirement).

Where a restructuring offer fails to obtain the support of the majority of the voting pool (second limb voting), but succeeds in attracting support in one or more individual series (first limb voting), the issuer may:

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- Exclude those series where voting majorities were not received.
- Agree to restructure those series where majorities were received.

This essentially divides the once aggregated pool into restructured and unrestructured series of bonds.

Re-designation has been criticized as going against the spirit of CACs. There are also concerns about the lack of transparency for bondholders about how their votes and other creditors' votes will be counted if these votes can be discounted or applied in a different manner by re-designation.

The Pacman Strategy

The colloquial "Pacman" strategy refers to a sovereign's use of one or more successive rounds of single-limb voting to impose a restructuring on the dissenting or unrestructured bonds following the re-designation round (round 1) by harnessing the voting power of the restructured bonds (see The Re-designation Strategy). The sovereign aggregates the restructured bonds from round 1 together with the unrestructured bonds and makes an offer that is marginally better than the offer made to the restructured bonds in round 1. As the same offer is made to all bonds, whether restructured or not, it is deemed "uniformly applicable," permitting aggregation and single-limb voting.

The restructured bonds would most likely vote overwhelmingly in support of the enhanced offer, being better than the offer they had previously accepted. This then offsets the dissenting votes from the unrestructured series to achieve the aggregated majority required to bind all aggregated series in the voting pool. This tactic can be used a number of times together with re-designation to achieve the desired result of binding the entire series of bonds in the voting pool, should one or more series dissent.

By way illustration, imagine that a country has four series of bonds (A, B, C, and D), each with an outstanding principal of $100. The bonds are aggregated for single-limb voting to consider a restructuring proposal (for example, see CAC Option Table, Option 3). The approval of creditors holding 75% of the aggregated pool is needed to approve the restructuring proposal and impose it on all four series (or $300 of principal in this example).

If the holders of $75 of series A bonds and $75 of series B bonds vote to approve the proposal, but holders of only $60 of series C and D bonds approve, then the 75% threshold for the aggregated pool ($300/$400) is not reached (as $75 + $75 + $60 + $60 = $270). However, the sovereign may then re-designate the voting pool to:

- Exclude series C and D.
- Limit the pool to A and B.

Because 75% of holders in series A and B ($150/$200) voted to approve the proposal, both series will be restructured into a new series X in the aggregate principal amount of $200.

In the second round, the restructured series X is again pooled with series C and D with a new proposal on slightly better terms than what A and B obtained the first time around. This time series X votes 100% in favor of the proposal (because they are now going to receive additional consideration for free), meaning that $200 of the required $300 (75% of A, B, C, and D together) has been reached. If a simple majority of series C and D vote to approve the proposal (51% of C and D, which amounts to $51 + $51 = $102), the restructuring can be "crammed down" on all $400 since $300 (or 75.5%) have consented.

If, on the other hand, the $100 threshold is not reached, for example, if series C votes 75% in favor but only a low percentage of series D votes in favor (for example, 10%), then the aggregated pool majority is not obtained ($100 + $100 + $75 + $10 = $285). The sovereign may once again re-designate, excluding series D and restructuring series X and C into a new series Y. A third round could then take place aggregating the restructured series Y with D for a vote on a proposal with, again, slightly improved terms. If 100% of series Y voted in favor of the proposal, it would also bind D.

Exit Consents

An issuer may also make use of "exit consents" to incentivize holders to participate in a proposed exchange or other restructuring, by offering all bondholders new bonds in exchange for existing bonds, on the condition that the tendering bondholders must consent to amend the terms of the existing bonds to make them less attractive. The intention here is to remove key protections and provisions to prevent potential hold-out creditors wanting to retain those bonds and vote in favor of the offer.

This technique is relatively common in commercial restructurings and can be used by sovereigns too. However, there may be limits to how coercive exit consents can be, particularly in English law-governed bonds. The English courts have recognized an implied duty in favor of minority creditors (see *Assenagon Asset Mgmt. SA v*

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Irish Bank Resolution Corp. Ltd. (formerly Anglo Irish Bank Corp Ltd) [2012] EWHC 2090 (Ch) (discussing the "abuse" principle and finding exit consents to be unduly coercive and abusive to minority creditors)).

Legislative Measures and Protocols

Contractual protections like CACs are useful only to the extent they are incorporated in debt documents, and much outstanding sovereign debt does not contain these protections. Therefore, and to prevent or otherwise make aggressive holdout creditor actions unattractive, certain countries have enacted national anti-holdout creditor legislation ("anti-vulture" laws), including Belgium, France, and the UK. The US has considered federal legislation, and New York is considering a bill. These laws limit the recovery rights of bondholders who purchased distressed sovereign debt at a discount (often referred to as "vulture funds") and sue, or threaten to sue, debtor countries for the full amount of their debt obligations.

United Kingdom

The UK's Debt Relief (Developing Countries) Act 2010 (UK Act) was introduced to assist heavily indebted poor countries (HIPCs), and limits recoveries in line with any agreed restructuring of the sovereign's debt. The UK Act was limited in scope and time. It is not available for non-HIPC countries and is not relevant to current or upcoming sovereign debt restructurings.

United States

A proposed amendment to New York's banking law (NY Assembly Bill A2102A and NY Senate Bill S5542) would override contractual terms to introduce a CAC-style feature (see Collective Action Clauses (CACs)). The law would allow a sovereign debtor to propose a restructuring plan to creditors, which if approved by two-thirds of the creditors in value and one-half of the total number of creditors, would bind all creditors. This legislation would also:

- Subject sovereign bondholders to broad discovery into their investments.
- Presume that any sovereign debt claim brought by a bondholder that bought debt at a discount or refused to participate in a restructuring was champertous (a common law prohibition on a third party maintaining a suit in return for a financial interest in the outcome). For more information on champerty, see Practice Note, Third-Party Litigation Financing in the US: Champerty).

Because New York law is the choice of law for many sovereigns, and given the retrospective nature of the legislation's application, it could have a significant impact on investment in distressed sovereign debt, the New York sovereign capital markets, and future restructuring. Bondholders are likely to challenge these laws (see Litigation Challenging Anti-Vulture Laws).

For more information on New York's proposed legislation, see Legal Update, Squire Patton Boggs: New York's Sovereign Debt Restructuring Proposals.

France

In December 2016, France amended its existing laws relating to "transparency, the fight against corruption and the modernization of economic life" ("*relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique*") and included provisions that aim to protect foreign states against vulture funds (Article 60, Law no 2016-1691 of 9 December 2016 (Sapin II Law)). Article 60 provides that a creditor may not seize the assets of a foreign state if:

- The foreign state was on the list of recipients of official development assistance drawn up by the Development Assistance Committee of the OECD when it issued the debt instrument.
- The holder of the debt security acquired this security while the foreign state was in default on this debt security or had proposed a modification of the terms of the debt security.
- One of the following applies:
  - the situation of default on the debt instrument dates back less than 48 months when the holder of the debt instrument requests an order of execution or a protective measure from the judge;
  - the first proposal to modify the terms of the debt instrument dates back less than 48 months when the holder of the debt instrument requests from the judge an order on request authorizing it to practice a measure of forced execution or precautionary measure; or
  - a proposed modification, applicable to the debt security, has been accepted by creditors representing at least 66% of the principal amount of the eligible debts, regardless of the threshold required, if any, to become effective.

(Article 60, Sapin II Law.)

Accordingly, a creditor may still seek enforcement measures against a state's property for the threshold amount obtained by creditors that have participated in and accepted debt restructuring negotiations.

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The French law applies only to debt that was purchased after the effective date of the amendment (meaning, it does not apply retroactively).

Belgium

The Belgium Federal Parliament passed two pieces of legislation to assist countries achieving sustainable debt and to discourage litigation initiated by vulture funds. The anti-vulture fund laws enacted in Belgium are concise. The first piece of legislation was enacted in 2008 to safeguard "funds disbursed towards development cooperation and debt relief" from vulture funds' action (Draft final report of the Human Rights Council Advisory Committee on the activities of vulture funds and the impact on human rights, pg. 10). The legislation was adopted in response to the claims initiated by vulture funds seeking to seize the funds allocated to developing poor countries under official development assistance programs. For example, vulture funds lodged ten lawsuits against the Democratic Republic of the Congo in 2007 (see Devi Sookum, *Stop Vulture Funds Lawsuits: A Handbook* (Commonwealth Secretariat, London, p. 88, 2010)).

The second piece of legislation provides that when a creditor pursues an "illegitimate advantage" by repurchasing a loan or claim on a state, the rights in relation to the debtor state must be limited to the price paid to repurchase that loan or debt, preventing a creditor from recovering more than the actual price of the sovereign debt (Anti-Vulture Funds Law (Loi relative à la lutte contre les activités des fonds vautours), 12 July 2015).

There are **two** conditions that must be fulfilled to conclude that a creditor is pursuing an illegitimate advantage:

- There must be a "manifest disproportion" between the repurchase price of the loan or debt and the face value or the amounts that the creditor seeks to recover from the state.
- At least one of the following applies:
  - the debtor state was insolvent (or a default was imminent) at the time of the debt buy-back;
  - the creditor is based in a tax haven or similar jurisdiction;
  - the creditor systematically uses legal proceedings to obtain repayment;
  - the creditor refused to take part in debt restructuring efforts;
  - the creditor abused the weakness of the state to negotiate a repayment that is manifestly unbalanced; or
  - the total reimbursement of the amounts demanded by the creditor would have a measurably adverse impact on the public finances of the state and would likely compromise the socioeconomic development of its population.

(Anti-Vulture Fund Law, 12 July 2015.)

The legislation is applicable to all countries (it is not limited to the HIPCs), and it requires judges to consider the impact that the repayment of the debt might have on the socioeconomic situation of the debtor state and on the well-being of its population.

NML Capital, a subsidiary of Elliot Capital Management, challenged the validity of this law in June 2018. However, the Belgian Constitutional Court refused the arguments put forward, including that the law's application violated the creditor's property rights under Article 1 of Protocol I to the European Convention on Human Rights (ECHR), and its right to a fair trial under Article 6 of the ECHR. The court considered that limitations to a creditor's property rights were justified by the public interest and proportionate to the aim pursued.

International Protocols

International financial institutions and forums, such as the Group of Twenty (G20), have introduced guidelines and protocols aiming to increase transparency and regulate creditor behavior, including:

- The World Bank's and the IMF's Heavily Indebted Poor Countries Initiative (HIPC Initiative), which reduced the external debt of countries that satisfied specific criteria to ensure no poor country faced an unmanageable debt burden (launched in 1996). The HIPC Initiative has provided about $76 billion in debt service relief for 37 countries (31 of them in Africa).
- The Group of Eight's (G8) Multilateral Debt Relief Initiative (MDRI), which supplemented the HIPC Initiative and allowed countries completing the HIPC Initiative to receive 100% relief on eligible debts by the IMF, the World Bank, and the African Development Bank (launched in 2005).
- The IMF's Sovereign Debt Restructuring Mechanism (SDRM), which provides a blueprint to restructure the sovereign bonds of countries whose debt is deemed unsustainable (launched in 2002).

The effectiveness of the HIPC Initiative and the MDRI was based on multilateral and Paris Club lenders owning most of poor countries' debt (see Box, The Paris Club). However, restructuring efforts have become more complicated as

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private commercial creditors and non-Paris Club states, such as China, have increased exposure to sovereign debt.

In response to the COVID-19 crisis, international debt relief initiatives have included:

- The World Bank's, the IMF's, and the G20's Debt Service Suspension Initiative (DSSI), which was intended to provide liquidity to countries early in the pandemic by postponing debt payments from the world's poorest countries to G20 bilateral creditors, if requested by a country's government (May 2020 to December 2021). Under the DSSI, 48 of 73 eligible low and lower-middle income countries postponed $12.9 billion in debt service payments. As this was an initiative during COVID-19, it is no longer available.
- The G20's Common Framework for Debt Treatments beyond the DSSI (Common Framework), which seeks to set out a framework for restructuring debt in line with Paris Club principles and to ensure comparability of treatment across creditor groups (adopted November 2020). The Common Framework allows creditor countries to negotiate with DSSI-eligible countries on a case-by-case basis, with an opportunity for private creditors to participate. So far only three countries (Chad, Ethopia, and Zambia) have sought relief under the Common Framework.

International guidelines and protocols are not binding principles, especially in relation to commercial creditors, where the risk of holdout is greatest (see Holdout Creditors).

Sovereign Debt Litigation

Litigation Challenging Anti-Vulture Laws

Litigation is likely to occur over anti-vulture legislation in the next wave of sovereign debt defaults, particularly in New York. Most sovereign debt is governed by New York law, and creditors therefore bring many cases enforcing sovereign bonds in New York courts. Opponents may seek to challenge these laws as unconstitutional on the following grounds:

- **Impairment of contracts.** The Contracts Clause contained in Article I, Section 10, of the US Constitution prohibits states from enacting laws that substantially interfere with contractual obligations without a legitimate public purpose.
- **Preemption.** The Supremacy Clause contained in Article VI, Section 2, of the US Constitution renders invalid a state law where federal law is so pervasive that it would be reasonable to infer that Congress left no room for states to supplement it or the federal interest is so dominant that it is assumed to preclude the enforcement of state laws on the same subject. Opponents could challenge New York's proposed law as preempted by:
  - the Bankruptcy Code, which already provides a comprehensive regime for dealing with restructurings (as opponents of Puerto Rico's restructuring law enacted in 2014 successfully argued to the US Supreme Court) (see *P.R. v. Franklin Cal. Tax-Free Tr.*, 136 S. Ct. 1938 (2016)); and
  - national foreign affairs powers (see *Am. Ins. Ass'n v. Garamendi*, 539 U.S. 396, 413-13 (2003)).

Efforts to Strip Bondholder Standing

Centralized clearing systems, such as Euroclear, Clearstream, or the Depository Trust & Clearing Corporation (DTCC), function as intermediaries to aid efficient market transactions and hold financial instruments, typically including sovereign bonds (see Practice Note, Clearing and Settlement of Debt Securities: Overview). Under this arrangement, the clearing system (holder) is the registered owner of the bond, and the investor bondholder is the beneficial owner.

Since 2015, some sovereign borrowers have included language in bond indentures that arguably permit only the holder to sue on bond obligations, stripping these rights from the beneficial owner. This appears contrary to well-accepted practice, where the holder grants a proxy or otherwise conveys the right to sue to bondholders. As clearing systems are unlikely to take legal action to enforce the bondholders' rights, these provisions could strip bondholders of all enforcement rights.

Litigation has arisen from sovereigns' efforts to severely restrict bondholders' ability to sue in this manner, as occurred in bonds issued by Sri Lanka.

Sri Lankan Bond Litigation

Bondholders holding about $250 million in Sri Lankan bonds sued Sri Lanka in the US District Court for the Southern District of New York after Sri Lanka defaulted on the bonds in July 2022. The Sri Lankan bond indenture did not include a contractual provision expressly allowing the holder (in this case, Cede & Company (Cede)) to authorize beneficial owners of the bonds to sue.

Sri Lanka moved to dismiss, partially on the basis that the beneficial holders had no standing because they were not the registered owner of the bonds and the indenture did not allow Cede to proxy the right to sue to the bondholders. The

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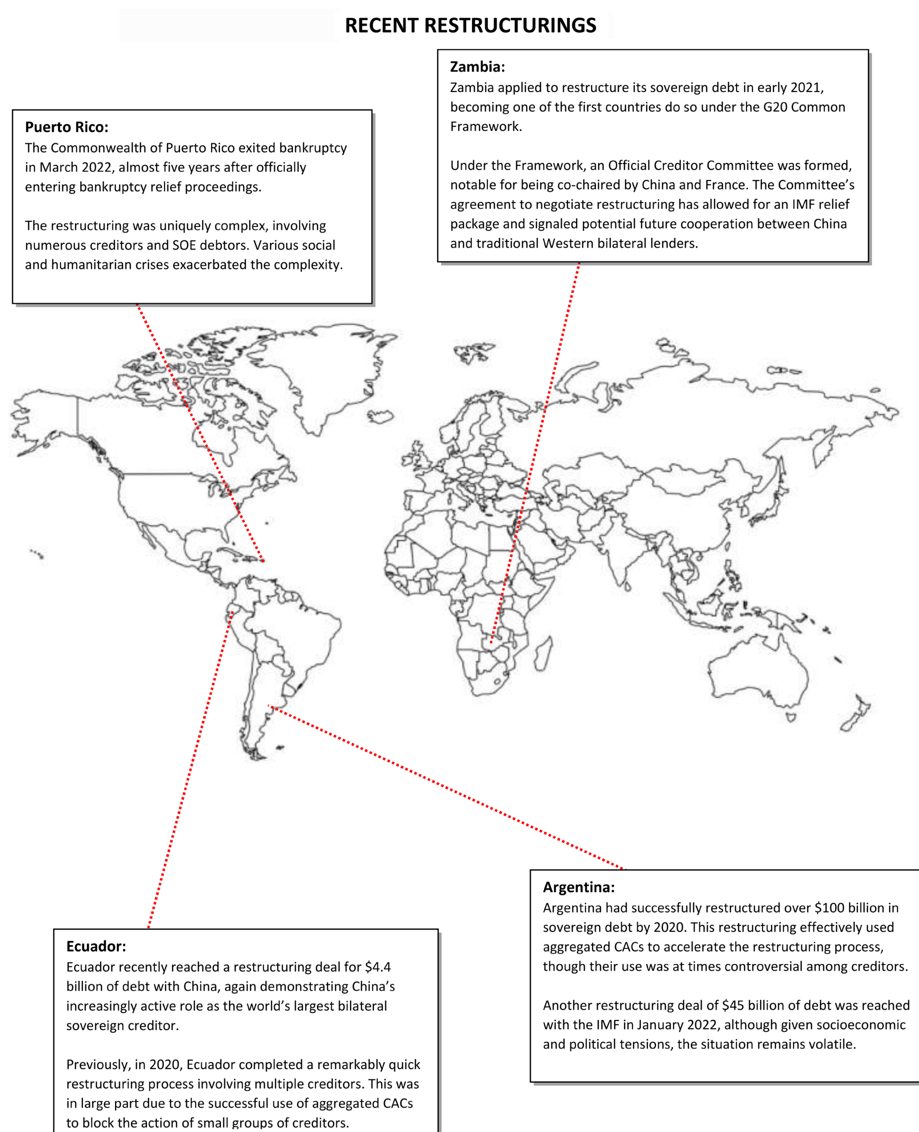
bondholders argued that nothing in the indenture expressly prohibited bondholders from suing on Cede's behalf. However, in a letter dated September 23, 2022, Cede authorized bondholders to take any actions and exercise all rights and remedies that Cede was entitled to take.

On March 24, 2023, the court denied the motion to dismiss, finding that the letter conferred contractual standing on the bondholders to sue, which made it unnecessary to address the bondholders' argument that they had the right to sue under the terms of the bonds. Sri Lanka asked for a six-month stay of the litigation to allow restructuring talks to proceed. The request has been supported by the US, UK, and France. The suit remains pending, and the judge has not yet ruled on the stay.

Recent Restructurings

The map below provides information on sovereign debt restructurings in:

- Puerto Rico.
- Zambia.
- Ecuador.
- Argentina.
- Ukraine.
- Sri Lanka.
- Ghana.



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Ukraine:
Ukraine came close to default in August 2022, before creditors agreed a two-year payment freeze. However, with an economy in crisis and escalating loan amounts, a future default remains possible, irrespective of the speed with which the Russian invasion is resolved.

Additionally, the central government has guaranteed the debt of several SOEs that are themselves in distress. Although the SOE creditors have, for now, agreed to a similar payment moratorium, future action on this debt could potentially push the sovereign itself into default.

Sri Lanka:
Sri Lanka has among the highest debt-to-government revenue ratios in the world, at more than 1,000%. Debt payments were halted in April 2022, constituting the first default in the nation's history and causing significant socio-political turmoil.

The country has secured World Bank relief and is nearing the end of discussions with the IMF, but has had to offer major concessions, including dramatic reductions in the budget deficit and a change in status to a low-income country.

Ghana:
Ghana, economically damaged by COVID-19 and high inflation, has been forced to turn to the IMF for assistance. However, the nation also owes a significant portion of debt to commercial (private) creditors, who have signaled a reluctance to enter negotiations.

A staff-level agreement has recently been reached with the IMF, constituting a $3 billion extended credit facility and a series of economic policies and reforms. Irrespective of the final outcome, the crisis exemplifies the issues that many sub-Sahara African nations may face in the coming months and years.

The Paris Club

The Paris Club is an informal grouping of 22 key creditor countries (and some ad hoc members) that coordinates to resolve sovereign debt crises. Over the last 60 years, the Paris Club has completed 433 successful reorganizations with 90 countries. Significantly, the Paris Club excludes large BOCs, such as China, but some cooperation has occurred in the past.

The Paris Club operates according to the following six foundational principles that ease the challenges of debt restructuring negotiations:

- **Solidarity.** All members of the Paris Club agree to act as a group in their dealings with a given debtor country and to be sensitive to the effect that the management of their particular claims may have on the claims of other members.
- **Consensus.** Paris Club decisions cannot be taken without a consensus among the participating creditor countries.
- **Information sharing.** Paris Club members regularly share views and information with each other on the situation of debtor countries,

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benefit from participation by the IMF and World Bank, and share data on their claims on a reciprocal and confidential basis.

- **Case-by-case.** The Paris Club makes decisions on a case-by-case basis to tailor its action to each debtor country's individual situation.
- **Conditionality.** The Paris Club only negotiates debt restructurings with debtor countries that have a current program supported by an appropriate arrangement with the IMF (Stand-By, Extended Fund Facility, Poverty Reduction and Growth Facility, or Policy Support Instrument). The level of the debt treatment is based on the financing gap identified in the IMF program (see Restructuring Envelope).
- **Comparability of treatment.** A debtor country that signs an agreement with its Paris Club creditors should not accept from its non-Paris Club commercial and bilateral creditors debt treatment terms less favorable to the debtor than those agreed with the Paris Club. This is the most important principle, given that negotiations can break down if even one creditor appears to be getting a better deal than others. However, IFIs are exempted from this requirement (see Multilateral Official Creditors (MOCs)).

Key Terms

Terms commonly used in the context of sovereign debt restructurings include:

- **Bilateral debt.** Debt contracted by the government of a country with another country's government, by which countries finance each other under more favorable conditions than those of the market. Bilateral lenders can negotiate at the Paris Club or individually (see Box, The Paris Club).
- **Bullet loans.** A type of loan structure, standard in sovereign borrowing, where the borrower must make regular interest payments over the term of the loan, but pays off the principal in a lump sum at maturity. Alternatively, borrowers may have the option to make no payments during the term of the loan, increasing the lump sum due at maturity.
- **Debt distress.** When a country cannot satisfy its financial obligations and debt restructuring is required.
- **Debt restructuring.** Adjusting the terms of sovereign debt to ease a country's debt service. This can involve changing maturities, adding grace periods, reducing the principal amount of the debt, reducing the interest rate, or suspending debt service.
- **Debt service.** The money needed to cover the payments on the principal and interest on an outstanding debt over a particular time period.
- **Nominal debt stock.** The total amount of debt that an entity owes at a specific time, which is not adjusted for inflation, interest rate fluctuations, or any other factors that could affect the real value of the debt. It represents the face value or the original value of the debt as recorded when it was issued, without accounting for changes in purchasing value over time.
- **Sovereign debt.** The debt issued by a country's government to borrow money, including the principal and interest. It is also known as government debt, public debt, and national debt. Like private debt, sovereign debt is repaid with interest that reflects the risk of default, as determined by credit ratings agencies that consider a range of factors.
- **Sovereign default.** When a government fails or refuses to pay its debt service, usually followed by a credit rating downgrade and loss of access to additional borrowing.
- **Sub-sovereign obligation (SSO)**. Borrowings issued by hierarchical tiers below the ultimate governing body of a nation, country, or territory. SSOs come from bond issuances made by states, provinces, cities, or towns to fund municipal and local projects.

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