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Monetary Power and Vulnerability to Sovereign Debt Crises: Rethinking the Global Financial Architecture

by

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ABSTRACT

This paper challenges the prevailing view in the sovereign debt literature by arguing that sovereign debt markets, in many respects, behave similarly to other credit markets. These markets are hierarchical rather than flat, inherently hybrid in nature, blending elements of public order and private markets, and regularly suffer from liquidity stress. Therefore, sovereigns, similarly to private actors in the market, are subject to liquidity stress and insolvency crises in a way that is integral to the global financial architecture. Critically, the legal and institutional design of the international monetary system exacerbates this stress. Structural asymmetries, notably the uneven distribution of monetary power, lead to liquidity stress being more pronounced in the periphery than at the apex or core of the system, rendering the former inherently more vulnerable to sovereign debt crises.

The paper argues that such considerations should assume a central role in global policy discussions concerning the most appropriate mechanisms for addressing sovereign debt crises. It advocates for a reformed global financial architecture, emphasizing the necessity of a legally binding framework for sovereign debt restructuring that draws upon principles of corporate restructuring law, with the UK Companies Act 2006 (CA 2006) providing relevant analogies. This approach aims to ensure timely, equitable, and efficient restructuring processes, thereby confronting the challenges posed by the current ad hoc and often inequitable sovereign debt restructuring processes.

Key Words: Sovereign Debt, Monetary Sovereignty, Monetary Power, Currency Hierarchy, Sovereign Debt Restructuring, International Monetary System, International Financial Architecture, Debt Service Suspension Initiative, Common Framework, Paris Club, China, Insolvency, Standstill, Cramdown, Moratorium

I. Introduction

In the conventional literature on sovereign debt, the heightened vulnerability of emerging and developing countries to sovereign debt crises is frequently attributed to either misfortunes or mismanagement, culminating in an inability or unwillingness to fulfil sovereign debt obligations.[1] These attributions commonly lead to moralising narratives that advocate for austerity measures as a demonstration of fiscal discipline towards creditors. Notably, the idea that sovereign debt crises arise either from a government's extraordinary misfortune or from its own mismanagement provides both a logical justification and a moral basis for the lack of formalised legal mechanisms for managing such crises. Logically, it suggests that each crisis results from unique or self-induced situations, making a universal legal remedy unsuitable. Morally, it places blame on the government, suggesting that it should shoulder the consequences of its irresponsibility.[2] This dual reasoning diminishes the perceived necessity for formal legal processes in restructuring sovereign debt, thus preserving the existing practice of ad hoc arrangements.[3]

This working paper has two core aims. Firstly, it challenges the prevailing view in the sovereign debt literature by asserting that sovereign debt markets, in many respects, behave like other credit markets. These markets are hierarchical rather than flat, inherently hybrid in nature, blending elements of public order and private markets, and suffer regularly from liquidity stress.[4] Thus, sovereigns, in an analogous way as private actors in the market, are subject to liquidity stress and insolvency crises in a way that is integral to the global financial architecture. Critically, the legal and institutional design of the international monetary system exacerbates this stress. Liquidity stress is more pronounced in the periphery than at the apex or core of the system, rendering the former inherently more susceptible to sovereign debt crises.[5] This vulnerability stems not just from episodic misfortunes or mismanagement but from structural factors within the international monetary system, notably the asymmetric distribution of monetary power among states. 'Monetary power' is defined here as the confluence of a state's monetary sovereignty and its currency's position within the global hierarchy.

Secondly, the paper argues that these structural asymmetries in the international monetary system should be central to global policy debates on effective mechanisms for managing sovereign debt crises. While current legal frameworks for contracting sovereign debt largely reflect those for commercial entities, this parallel does not extend to the restructuring of these obligations during liquidity stress and insolvency crises. Presently, sovereign debt restructuring processes are

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[1] See, eg, J Ams and others, 'Sovereign Default', in SA Abbas, A Pienkowski, and K Rogoff (eds), *Sovereign Debt: A Guide for Economists and Practitioners* (OUP 2019); International Law Association, 'State Insolvency: Options for the Way Forward', Report of the Sovereign Insolvency Study Group (2010) 6.

[2] K Dyson, 'Moralizing Credit', in *States, Debt, and Power: 'Saints' and 'Sinners' in European History and Integration* (OUP 2014).

[3] See, eg, L Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Brookings Institution Press 2033). For a historical perspective of this approach, see C Laskaridis, 'Refusing to Improve: Sovereign Debt Repayment Difficulties and the Political Economy of Inertia in UNCTAD 1964-1979' in N Samba Sylla (ed), *Imperialism and the Political Economy of Global South's Debt* (Emerald Publishing 2023).

[4] K Pistor, 'A Legal Theory of Finance' (2013) 41(2) Journal of Comparative Economics 315, 316-7; K Pistor, 'Law in Finance' (2013) 41(2) Journal of Comparative Economics 311-14.

[5] K Patrício Ferreira Lima, 'Sovereign Solvency as Monetary Power' (2022) 25(3) Journal of International Economic Law 424-46.

predominantly ad hoc, negotiated arrangements between the indebted state and its increasingly diversified creditor base.[6] In such a legal landscape, debt restructuring often becomes an interplay of creditor bargaining power, goodwill, or scrutiny towards debtor states perceived as disgraced, incompetent, or corrupt. This process is increasingly characterised by a distributional struggle, influenced by geopolitical tensions among creditor states and their key players. Unless contractually bound by majority action clauses in certain types of debt instruments, creditors hold a veto position in the restructuring, leading to prolonged negotiations and often resulting in inadequate debt relief, if any, for the sovereign debtor.

Given this scenario, there is an urgent need to move beyond opaque, ad hoc, and uncertain debt relief initiatives. Adopting rules for sovereigns in debt distress and insolvency crises similar to those governing businesses in search of debt restructuring represents a legally and commercially sound alternative. The paper advocates for an international legal framework that outlines fundamental principles and establishes a sovereign debt restructuring proceeding that is timely and equitable, drawing from established insolvency proceedings in comparative law.

The paper is structured as follows: Section 2 elucidates the concept of monetary power as deployed in this paper; Section 3 examines how monetary power—or the lack thereof—can influence a state's vulnerability to liquidity stress, and consequently, to insolvency; Section 4 posits that such considerations should occupy a central role in global policy discussions about the most appropriate mechanisms for addressing sovereign debt crises. This section advocates transitioning from the current legal framework, based on ad hoc arrangements, to a sovereign insolvency proceeding inspired by 'debtor in possession' models in domestic law, with the UK Companies Act 2006 (CA 2006) providing relevant analogies.

II. Conceptualising Monetary Power

The underlying reason why sovereigns are subject to asymmetric levels of liquidity stress is that they hold asymmetric levels of monetary power. As employed in this paper, the concept of 'monetary power' is defined as the intersection between a state's monetary sovereignty and its currency's position within the global currency hierarchy.

a. Monetary sovereignty

Monetary sovereignty encompasses several legal prerogatives of a state, including the issuance of its own currency, the determination of its interest rates, and the setting of its exchange rate policy.[7] Traditional Public International Law (PIL) views sovereignty as an absolute concept, adhering to the principle of sovereign equality.[8] This principle treats states as equals in their legal

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[6] L Buchheit, G Chabert, C DeLong, and J Zettelmeyer, 'The Restructuring Process' in SA Abbas, A Pienkowski, and K Rogoff (eds), *Sovereign Debt: A Guide for Economists and Practitioners* (Oxford University Press 2019); A Gelpern, 'Sovereign Debt: Now What?' (2016) 41(2) Yale Journal of International Law 45-95.
[7] CD Zimmermann, *A Contemporary Concept of Monetary Sovereignty* (OUP 2013); C Proctor, *Mann on the Legal Aspect of Money* (OUP 2012).
[8] S Besson, 'Sovereignty', in R Wolfrum (ed), *MPEPIL* (Oxford University Press 2011).

capacity to hold and exercise rights.[9] This foundational legal fiction of sovereignty supports, undergirds, and legitimises most, if not all, principles and institutions of international law.

However, this perspective does not reflect the reality for most sovereign states. Systemic erosions in monetary sovereignty are evident in areas like monetary and fiscal policy, and financial regulation.[10] This erosion, albeit often voluntary, has a systemic nature. For instance, currency surrender lies at the root of the international trade system, which is predominantly based on either the world's top currency, the US dollar, or other core currencies. This practical erosion of monetary sovereignty indicates that PIL's traditional view inadequately represents the varying levels of control that states effectively have over their monetary and financial systems.

Thus, this working paper, along with a range of contemporary scholars, introduces a departure from this traditional view by advocating for the notion of monetary sovereignty as a spectrum.[11] This approach highlights the different degrees to which states exercise their monetary sovereignty. The spectrum illustrates various levels of control over monetary sovereignty, from complete absence to full sovereignty. While the extremes are only theoretical, the spectrum offers a comparative analysis of sovereign states' control over their monetary and financial systems. The disparity between potential and actual sovereignty becomes more pronounced lower down the hierarchy of monetary power.

The focus here is on a specific aspect of monetary sovereignty: the ability of a state to issue debt in its own currency. The more a state can exercise this right, the greater its monetary sovereignty.

b. Currency hierarchy

Currency hierarchy, originating from Keynesian theory, is defined as the degree to which a national currency fulfils the essential functions of money—unit of account, medium of exchange, and store of value—at an international level.[12] In particular, money that can function as an international reserve currency is highly sought after, as it provides security in the face of economic uncertainty.

Currency hierarchy is a well-established concept in both Anglo-American and Latin American International Political Economy (IPE). Anglo-American IPE tends to focus on how a currency performing the functions of money at an international level provides the issuing state with greater macroeconomic flexibility.[13] Post-Keynesian literature, especially in the Latin American

[9] J Kokott, 'States, Sovereign Equality', in R Wolfrum (ed), *MPEPIL* (OUP 2011); TH Lee, 'International Law, International Relations Theory, and Preemptive War: The Vitality of Sovereign Equality Today' (2004) 67(4) Law and Contemporary Problems 147-67; PJ Baker, 'The Doctrine of Legal Equality of States' (1923-24) 4 British Year Book of International Law 1; ED Dickinson, *The Equality of States in International Law* (Harvard University Press 1920).

[10] RM Lastra, *Legal Foundations of International Monetary Stability* (OUP 2006).

[11] S Murau and J van't Klooster, 'Rethinking Monetary Sovereignty: The Global Credit Money System and the State' (2023) 21(4) Perspectives on Politics 1319-36; K Pistor, 'From Territorial to Monetary Sovereignty' (2017) 18(2) Theoretical Enquiries in Law 491-517.

[12] BJ Cohen, *The Geography of Money* (Cornell University Press 1998); BJ Cohen, *The Future of Money* (Princeton University Press 2004); S Strange, *State and Markets* (Printer Publishers 1988).

[13] J Kirshner, 'Dollar Primacy and American Power: What's at Stake?' (2008) 15 Review of International Political Economy 418; KR McNamara, 'A Rivalry in the Making? The Euro and International Monetary Power' (2008) 15 Review of International Political Economy 439-59; BJ Cohen, 'The Macrofoundations of Monetary Power', in DM

tradition, builds on this by highlighting how asymmetries in the international monetary and financial systems have grown since the post-Bretton Woods era, intersecting with technological and productive disparities emphasised by classic Latin American structuralism.[14]

Despite its established role in IPE, legal scholars and practitioners have largely overlooked currency hierarchy's implications, creating a gap in the analysis of legal and institutional frameworks supporting it. However, it appears uncontroversial that two key legal infrastructures are crucial in shaping these hierarchies. The first is the use of a national currency as the unit of account and medium of payment in international transactions, both private and public.[15] Within this framework, international trade and finance can be conceptualised as a network of multiple contracts, a pivotal element of which is the currency designated for account and payment of the obligations arising therefrom. The aggregate level of utilisation of a national currency determines its position in the hierarchy—by definition, the top state is the one whose currency is most frequently employed as the predominant unit of account and medium of payment in contracts for the sale of key commodities. The second legal infrastructure concerns the extent to which a national currency functions as a store of wealth and value at an international level.[16] This role is notably, though not exclusively, manifested by the currency constituting the unit of account for assets held in the foreign reserves of central banks.

This paper primarily focuses on the first infrastructure, interpreting currency hierarchy as a result of collective decisions about the unit of account and medium of payment for international financial obligations. States voluntarily undertake these obligations, either through financial contracts with private entities or via international agreements with other subjects of international law, including states and international financial institutions (IFIs).

III. Monetary Power and Vulnerability to Sovereign Debt Crises

In macroeconomic theory, it is widely understood that credit markets are driven by cycles of optimism and high liquidity, followed by periods of greater uncertainty and liquidity stress.[17] This principle is equally applicable to sovereign debt markets, where liquidity stress can significantly constrain the ability and terms under which states issue or rollover their financial obligations. A key factor in this dynamic is the asymmetric distribution of monetary power among states. This disparity leads to increased vulnerability to liquidity stress in countries on the

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Andrews (ed), *International Monetary Power* (Cornell University Press 2006); CP Kindleberger, *The World in Depression* (University of California Press 1973); B Eichengreen, 'Hegemonic Stability Theories of the International Monetary System', NBER Working Paper No 2193 (1989).

[14] RP Andrade and DM Prates, 'Exchange Rate Dynamics in a Peripheral Monetary Economy (2013) 35 Journal of Post Keynesian Economics 399-416; BM de Conti and DM Prates, 'The International Monetary System Hierarchy: Current Configuration and Determinants' (28th Annual EAEPE Conference, Manchester, 3-5 November 2016); LF de Paula, B Fritz, and DM Prates, 'Keynes at the Periphery: Currency Hierarchy and Challenges for Economic Policy in Emerging Economies' (2017) 40(2) Journal of Post Keynesian Economics 183-202.

[15] RSJ Martha, *Financial Obligations in International Law* (Oxford University Press 2015).

[16] J Gold, *Legal and Institutional Aspects of the International Monetary System: Selected Essays*, vol II (IMF 1984) 194-237; E Ilzetzki, CM Reinhart, and KS Rogoff, 'Exchange Arrangements Entering the 21st Century: Which Anchor Will Hold?', NBER Working Paper No 23134 (2017).

[17] HP Minsky, *Stabilizing an Unstable Economy* (first published 1986, McGraw-Hill 2008).

periphery of the international monetary system, compared to those at its core, making the former more prone to sovereign debt distress and insolvency crises.[18]

Two critical features of the post-Bretton Woods system are crucial to understanding the inherent vulnerability of monetarily weaker countries to such crises. Firstly, the establishment of the fiduciary dollar standard has created a global hierarchical system where the US dollar, as the top currency, fully performs the functions of money at an international level, including acting as a unit of account, medium of exchange, and store of value, especially as an international reserve currency. Other core currencies also serve as reserve currencies, albeit with varying levels of liquidity, while most currencies, particularly from the monetary periphery, function mainly as financial assets rather than international money. Secondly, the liberalisation of capital accounts, codified in legal instruments such as the OECD's Code of Liberalisation of Capital Movements and European Commission rules[19] (later incorporated into the 1991 Maastricht Treaty)[20] and widely promoted by the International Monetary Fund (IMF),[21] has accentuated the pro-cyclical nature of capital flows towards the monetary core during times of heightened uncertainty and crises.[22]

This framework results in a highly unstable system for the monetary periphery, marked by significant volatility in capital flows and characterised by cycles of inflows and sudden stops.[23] Since 1970, these dynamics have led to five distinct boom-bust cycles, culminating in crises such as the 1980 debt crisis, the 1996 Asian crisis, the 2007 Global Financial Crisis, the 2013 taper tantrum, and the 2020 COVID-19 crisis. The inherent instability of the global dollar-based system is closely linked to periods of expansionary and contractionary monetary policy in the United States. Lower interest rates in the US lead to a surge of capital into global markets, fuelling debt booms and asset inflation, and appreciating exchange rates globally. In contrast,

[18] Patrício Ferreira Lima (n5).

[19] European Economic Community Council (ECC), First Directive for the implementation of Article 67 of the Treaty [12/07/1960] OJ 43, 921; Council Directive 72/156/EEC of 21 March 1972 on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity [18/04/1972] OJ L 91, 13; Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty [08/07/1988] OJ L 178, 5.

[20] These principles on free movement of capital are now consolidated in Articles 63 to 66 of the Treaty on the Functioning of the European Union (TFEU).

[21] During the late 1980s and early 1990s, the IMF began to actively promote capital account liberalisation in the global periphery, despite lacking legal authority or a mandate for such actions. Although the Fund's management endeavoured to codify this policy change, it was unsuccessful in this regard. A more cautious approach to capital account management was adopted by the IMF in 2012, marked by the launch of a new 'institutional view'. This perspective acknowledged that, under specific circumstances, the regulation of cross-border capital movements is justifiable. In its 2022 Review, the IMF further expanded the available toolkit for policymakers, allowing the pre-emptive use of capital flow management measures on inflows in situations where stock vulnerabilities pose threats to economic and financial stability. See International Monetary Fund, 'Review of the Institutional View on the Liberalization and Management of Capital Flows' (30 March 2022); International Monetary Fund, 'The Liberalization and Management of Capital Flows: An Institutional View' (14 November 2012). See also B Mercurio, *Capital Controls and International Economic Law* (Cambridge University Press 2023); KP Gallagher and JA Ocampo, 'IMF's New View on Capital Controls' (2013) 48(12) Economic and Political Weekly 10-13; R Abdelal, *Capital Rules: The Construction of Global Finance* (Harvard University Press 2007).

[22] Y Akyuz, *Playing with Fire: Deepened Financial Integration and Changing Vulnerabilities of the Global South* (Oxford University Press 2017).

[23] K Gallagher and R Kozul-Wright, *The Case for a New Bretton Woods* (Polity 2022).

when US policy tightens, capital flows reverse, leading to debt crises, recessions, and a slowdown in global growth.[24]

These institutional features of the post-Bretton Woods system make periphery currency states significantly more vulnerable to sovereign debt crises. Sovereign insolvency in today's financialised world should be viewed not just as a state's unwillingness or inability to pay its debts but more critically as its capacity to consistently secure or access liquidity. The direction and availability of capital flows have a cyclical effect in the monetary periphery and a counter-cyclical effect in the core. This creates structural limitations on the periphery's ability to avert sovereign debt crises, indicating that causes of sovereign insolvency extend beyond a state's fiscal policies and do not necessarily align with fiscal indiscipline. Instead, they originate from monetary factors.[25]

In this legal and institutional environment, monetary power plays a pivotal role in determining vulnerabilities to sovereign insolvency by impacting the fiscal capacity of the state, the state's ability to rollover sovereign debt, and the state's level and conditions of access to the Global Financial Safety Net (GFSN). Firstly, a state's fiscal capacity is significantly influenced by its level of monetary sovereignty, which encompasses control over key macroeconomic variables such as currency issuance, interest rate settings, and exchange rate management. A state's foreign currency debt inversely affects its control over these variables, which are vital for fulfilling financial obligations.[26] Yet, even when indebted in their own currency, peripheral currency states are more vulnerable to rapid capital outflows and significant currency depreciations,[27] leading to increased fiscal constraints and a diminished capacity to meet sovereign debt obligations.[28]

Secondly, a state's ability to refinance sovereign debt is another aspect heavily influenced by monetary power. The evolution of state finance, particularly in developing economies, has seen an increased reliance on capital markets for funding.[29] This shift, facilitated by cross-border capital flow liberalisation, has led to a diversification of debt instruments such as bonds and syndicated loans.[30] In this financial landscape, perceptions of sovereign debt safety increasingly hinge on the market's willingness to refinance at maturity, rather than solely on a state's fiscal ability to repay.[31] However, access to liquidity for rollover and the resulting perceptions of sovereign debt vary markedly between states with core and peripheral currencies, influenced by their positions within global liquidity cycles.

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[24] O Jeanne, A Subramanian, and J Williamson, *Who Needs to Open the Capital Account?* (Peterson Institute for International Economics 2012).

[25] JA Ocampo, Resetting the International Monetary (Non)System (Oxford University Press 2017).

[26] B Eichengreen and R Hausmann, *Other People's Money: Debt Denomination and Financial Instability in Emerging Market Economies* (University of Chicago Press 2005).

[27] A Kaltenbrunner, 'A Post Keynesian Framework of Exchange Rate Determination: A Minskyan Approach' (2015) 38(3) Journal of Post Keynesian Economics 426-48.

[28] M Amstad, F Packer, and J Shek, 'Does Sovereign Risk in Local and Foreign Currency Differ?' (2020) 101(C) Journal of International Money and Finance 1, 9-11; BM De Conti, DM Prates, and D Plihon, 'The Hierarchy of Currencies and Its Implications for Peripheral Countries Exchange, Interest Rate Dynamics and Economic Policy' (2014) 23(2) Economia e Sociedade 341-72.

[29] F Fastenrath, M Schwan, and C Trampusch, 'Where States and Markets Meet: The Financialization of Sovereign Debt Management' (2017) 22(3) New Political Economy 273.

[30] International Monetary Fund, 'The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options' (23 September 2020).

[31] L Buchheit, 'The Process of Sovereign Debt Restructuring' (Lecture, Florence School of Banking and Finance, 24 April 2018) <https://www.youtube.com/watch?v=v1nMSXu5a68&t=112s> accessed 7 December 2023.

Lastly, a state's access to the GFSN is significantly shaped by its monetary power. The GFSN, comprising mechanisms like foreign reserves, bilateral currency swaps, Regional Financial Agreements (RFAs), and IMF financing, acts as a critical buffer against liquidity stress.[32] However, apart from a state's own foreign reserves, the availability and terms of accessing these resources are determined externally and vary across states. This results in a hierarchy of access to the GFSN, characterised not only by the amount of liquidity available to different states but also by the conditions attached to this access.[33] For example, while core currency states may benefit from unconditional and unlimited swap arrangements with the US Federal Reserve,[34] other states often face challenges such as refinancing existing debts at higher interest rates, depleting their reserves, or seeking limited liquidity from the IMF under stringent conditions.[35] This disparity in access to the GFSN further exacerbates the vulnerability of peripheral currency states to sovereign debt crises, as they frequently have limited options to effectively manage liquidity stress.[36]

In conclusion, the asymmetric distribution of monetary power among states influences their fiscal capacity, ability to refinance sovereign debt, and access to vital international liquidity sources. These factors collectively heighten the vulnerability of periphery currency states to sovereign debt distress and insolvency crises. Thus, it is crucial to understand sovereign debt crises as integral to the current legal and institutional design of the international monetary system, extending beyond simplistic narratives of mismanagement or corruption and traditional frameworks of fiscal discipline. While such factors may be relevant in specific cases, sovereign debt crises should be viewed through the lens of monetary dynamics inherent to the current legal and institutional design of the global financial architecture.

IV. Rethinking the Global Financial Architecture: Towards an Established Legal Framework for Sovereign Insolvency

The preceding sections of this paper have established that sovereign debt crises are fundamentally intertwined with the current legal and institutional design of the international monetary system. A critical discussion arises on how these vulnerabilities might be addressed through reforms. Key among the proposed reforms is the idea of replacing the dominance of the dollar with a global reserve currency. This shift could potentially offer a more balanced and equitable financial landscape. Additionally, there is the suggestion of transforming the inherently contractionary nature of the international monetary system. Inspired by Keynes' proposal of an International Clearing Union,[37] this transformation would involve establishing a mechanism for

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[32] L Mühlich, B Fritz, WN Kring, and K Gallagher, The Global Financial Safety Net Tracker: Lessons for the COVID-19 Crisis from a New Interactive Dataset', GEGI Policy Brief No 10 (April 2020).
[33] L Mühlich, B Fritz, and W Kring, 'Towards the Marginalization of Multilateral Crisis Finance?', GEGI Policy Brief No 15 (April 2021).
[34] P Mehrling, 'Elasticity and Discipline in the Global Swap Network', INET Working Paper No 27 (Institute for New Economic Thinking 2015).
[35] M Perks and others, 'Evolution of Bilateral Swap Lines', Working Paper 21/210 (IMF 2021).
[36] L Mühlich, B Fritz, and WN Kring, 'No One Left Behind? Assessing the Global Financial Safety Net Performance During COVID-19' (2022) 13(1) Journal of Globalization and Development 123-47.
[37] JM Keynes, *The Collected Writings of JM Keynes*, vol 26 (Royal Economic Society [1944] 1978).

balancing the financial positions between countries with surpluses and those with deficits.[38] Such reforms, however, confront challenges in their practical implementation, primarily due to the current lack of sufficient international coordination and agreement.

In light of these challenges, it is crucial to prioritise the structural asymmetries of the international monetary system in global policy discussions regarding the most effective mechanisms for managing sovereign debt crises. Addressing these structural imbalances is essential for fostering a more stable and equitable global financial architecture.

a. Current sovereign debt restructuring framework

The legal frameworks for contracting sovereign debt today largely mirror those that apply to commercial entities. This perspective is based on the conception that sovereign borrowing is a commercial activity, comparable to that of private businesses.[39] This approach stems from a gradual erosion of the principle of sovereign immunity in PIL. Sovereign immunity traditionally prevented states from being subject to the jurisdiction of another state's courts, upholding the equality and sovereignty of states. Historically, sovereigns enjoyed almost complete immunity from legal action, meaning creditors had no recourse in cases of default.[40] However, the modern state's broad spectrum of functions has led to a distinction between sovereign acts (acta iure imperii), which are covered by immunity, and commercial acts (acta iure gestionis), which are not.[41]

Throughout the late nineteenth and twentieth centuries, this distinction has led to a gradual erosion of sovereign immunity, particularly in key jurisdictions like New York and England & Wales. Legislation such as the US Foreign Sovereign Immunities Act (1976) and the UK State Immunity Act (1978), along with significant court decisions, have allowed private creditors to take legal action against defaulting states.[42] Consequently, broad immunity waivers in sovereign debt contracts have become ubiquitous, allowing creditors to sue debtor states in the commercial courts of New York and England & Wales in cases of default or other breaches of contract.[43]

Despite this commercial framing, the legal mechanisms available for businesses to restructure their debts in domestic law do not extend to sovereign states. In the UK, for instance, corporate insolvency law, governed by the Insolvency Act 1986 (IA 1986) and the Insolvency Rules 2016, provides a comprehensive framework for managing the insolvency of companies, including liquidation and administration. In addition, English insolvency law allows companies to undertake reorganisations or compromises, potentially avoiding administration or liquidation, or

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[38] M Amato and L Fantacci, 'Back to Which Bretton Woods? Liquidity and Clearing as Alternative Principles for Reforming International Money' (2014) 38(6) Cambridge Journal of Economics 1431-52.
[39] H Kupelyants, *Sovereign Defaults before Domestic Courts* (Oxford University Press 2018) 12-20.
[40] Yale Law Journal, 'The Jurisdictional Immunity of Foreign Sovereigns' (1954) 63(8) Yale Law Journal 1148.
[41] PH Verdier and E Voeten, 'How Does Customary International Law Change? The Case of State Immunity' (2014) 59(2) International Studies Quarterly 1, 6; H Fox, *The Law of State Immunity* (2nd edn, OUP 2008) 201-36; M Waibel, *Sovereign Defaults before International Courts and Tribunals* (CUP 2011) 252-72.
[42] See, eg, *NML Capital Ltd v Republic of Argentina* [2011] UKSC 31, para 111; *Cardinal Financial Investment Corp v Central Bank of Yemen (No 1)*, 2000 WL 1544744, para 17 (regarding promissory notes endorsed by central banks); Trendtex Trading Corporation v Central Bank of Nigeria [1977] QB 529 (regarding letters of credit); *Weltover v Argentina*, 504 US 607 (1992) (regarding sovereign bonds).
[43] H Kupelyants, *Sovereign Defaults before Domestic Courts* (Oxford University Press 2018).

as a means to conclude a company's administration. Numerous businesses opt for consensual agreements with creditors. In cases where such consensus is unattainable, the law offers pathways to enforce a binding statutory compromise through mechanisms like a Company Voluntary Arrangement under Part 1 of the IA 1986, a scheme of arrangement under Part 26 of the CA 2006, or a restructuring plan under Part 26A of the same Act. These instruments, lauded for their flexibility, enable companies to negotiate compromises with creditors and/or shareholders in circumstances of insolvency or financial difficulties. Similarly, the United States Bankruptcy Code outlines the procedures for bankruptcy filings in the United States Bankruptcy Courts. This Code, constituting Title 11 of the US Code, delineates various types of bankruptcy cases, including reorganisations and liquidations. Chapter 11, in particular, affords distressed companies the opportunity to restructure, offering relief from unsustainable debt levels and the ability to renegotiate onerous contracts. Post-agreement, these entities can receive a fresh start with a balance sheet that is aligned with their current operational realities.

Unlike the situation for corporate debtors, where established insolvency regimes offer a structured approach to debt resolution, sovereign states find themselves in a markedly different position. There exists no parallel domestic or international legal framework that provides for a structured and binding process for states to negotiate compromises with their creditors in the face of debt distress or insolvency. Instead, the resolution of sovereign insolvency is typically navigated through debt restructuring processes that are transactional in nature. These processes are characterised by ad hoc arrangements between the debtor state and an increasingly diversified creditor base. Negotiations often include a variety of participants ranging from the debtor and creditor states to international organisations, international fora with no legal personality under international law, and firms. This approach to sovereign debt restructuring is devoid of any formal, binding procedures akin to those found in corporate insolvency law, thereby reinforcing the transactional and often fragmented nature of sovereign debt restructuring.

The existing framework for sovereign debt negotiation includes various elements: the Paris Club and its associated bilateral official negotiations, official bilateral negotiations outside of the Paris Club, voluntary renegotiations with private creditors, and occasional ad hoc debt-relief initiatives, such as the Brady Plan, the Highly Indebted Poor Countries (HIPC) Initiative, and more recent programmes like the G20's Debt Service Suspension Initiative (DSSI) and the Common Framework for Debt Treatment beyond the DSSI, which focus on the debt of Low-Income Countries (LICs).[44] During restructuring processes, the financial integrity, ethos, and commitment of the debtor to various policy initiatives are rigorously scrutinised by creditors, as well as by IFIs like the IMF, to determine the appropriate terms for restructuring on a case-by-case basis.

Bilateral official creditors, comprising sovereign states, form a significant group in this framework. The Paris Club, an international forum of traditional lending states, coordinates a collective approach to debt restructuring discussions. This forum stipulates that a debtor country must agree to an IMF programme before it can receive debt relief. In addition, emerging lenders like China, India, and Saudi Arabia have significantly increased their international lending over the past decades. Notably, China has become the largest official bilateral creditor to developing

[44] L Buchheit, G Chabert, C DeLong, and J Zettelmeyer, 'The Restructuring Process' in SA Abbas, A Pienkowski, and K Rogoff (eds), *Sovereign Debt: A Guide for Economists and Practitioners* (Oxford University Press 2019) 328-64.

and emerging countries. These emerging lenders frequently negotiate the restructuring of their claims independently, outside the ambit of the Paris Club.

Commercial creditors comprise a diverse array that includes banks, institutional investors (such as hedge funds and pension funds), trade creditors, and individual investors, primarily based in OECD countries, particularly the US and the UK. Each category of creditor brings its own set of challenges to the restructuring process. For example, high-risk investment funds may pursue aggressive strategies to maximise returns, whereas retail investors might be less capable of absorbing losses. The restructuring of sovereign bond debt, a key financing tool for states, is influenced by a transactional approach that often relies on collective action clauses (CACs).[45]

Lastly, IFIs, including the IMF and the World Bank, play an integral role in these restructuring processes. The IMF, in particular, is central to guiding the debt restructuring process.[46] A sovereign typically initiates debt restructuring only when the IMF deems it no longer feasible to provide financing without such an arrangement. When restructuring is necessary, the IMF's Debt Sustainability Analysis (DSA) and the financial parameters of an IMF-supported programme determine the required amount of debt relief to restore debt sustainability. These restructurings are often supplemented by complementary multilateral financing, usually under the guidance of the IMF.

As discussed further below, IFIs often enjoy a Preferred Creditor Treatment (PCT). While this status is not legally formalised, it is customarily adopted. Sovereign borrowers usually prioritise repayments to IFIs due to their critical role in resolving debt crises and their function as lenders of last resort. The IMF, for instance, has traditionally made its assistance contingent upon resolving defaults with both private and bilateral official creditors, although these policies have been somewhat relaxed in recent years.

b. Enduring and emerging challenges facing the current sovereign debt restructuring framework

Marked by its fragmented, voluntary, and transactional characteristics, the current legal framework for sovereign debt restructuring underscores the persistent problem of 'too little, too late'.[47] In this setting, sovereign debt restructurings are often delayed until a state's over-indebtedness has already caused severe consequences for its ability to service debts. When restructurings do occur, they frequently lead to suboptimal results in terms of debt rescheduling and reduction. As a result, these terms often fall short in providing sovereign debtors with a true fresh start, a fundamental goal of insolvency law in domestic market economies.

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[45] D Zandstra, 'New Aggregated Collective Action Clauses and Evolution in the Restructuring of Sovereign Debt Securities' (2017) 12(2) Capital Markets Law Journal 180-203; A Gelpern, B Heller, and B Setser, 'Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds', in M Guzmán, JA Ocampo, and JE Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press 2016); S Choi, M Gulati, and E Posner, 'The Dynamics of Contract Evolution' (2013) 88(1) New York University Law Review 1-50.

[46] L Buchheit, G Chabert, C DeLong, and J Zettelmeyer, 'The Restructuring Process' in SA Abbas, A Pienkowski, and K Rogoff (eds), *Sovereign Debt: A Guide for Economists and Practitioners* (Oxford University Press 2019) 328-64.

[47] M Guzmán, JA Ocampo, and JE Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press 2016).

The 'too little, too late' issue becomes more pronounced considering the rising prominence of both private and non-Western official bilateral lenders in the sovereign debt landscape. From 1995 to 2021, the share of private creditors in the external debt of low- and middle-income countries, as well as that of non-Paris Club creditors, increased by 145% and 65% respectively.[48] Official bilateral lending, especially from Chinese institutions, consists significantly of loan-based agreements, often involving a syndicate of official financial institutions.[49] Private creditors, comprising not only syndicated lending by Western banks but also bond debt, bring additional complexity to the debt landscape.[50] Despite differences in the creditor profiles of bilateral official and private creditors, the legal instruments used in their lending are largely similar, consisting of bonds and loans governed by the laws of major jurisdictions in sovereign debt, like New York and England & Wales. The contractual terms of these instruments are often drafted by the same leading law firms based in those jurisdictions. Moreover, the diversification of creditors has led to greater diversity and complexity in contract terms and conditions, as well as in the structuring of loan agreements. This diversification includes the emergence of new and hybrid creditors that amalgamate features and lending terms of both official and commercial institutions.[51]

China's rise as a sovereign lender represents a major shift in the 21st-century sovereign debt landscape.[52] For many developing nations, debts owed to China surpass those owed to all 22 Paris Club creditors combined. However, China's integration into the sovereign debt regime is marked by distinctive approaches to lending and debt relief, differing from those of traditional, Western official bilateral lenders. This lack of coordination among China and other bilateral creditors complicates negotiations between the debtor and the IMF.[53] Many Chinese loans incorporate features that enhance the seniority of the lenders' claims, such as requiring borrowers to establish escrow accounts for debt settlements.[54] Moreover, Chinese lenders frequently

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[48] RM Alkhareif and E Moulin, 'What the Chad Debt Deal Means' (Finance for Development Lab, 19 April 2023).
[49] S Horn, CM Reinhart, and C Trebesch, 'China's Overseas Lending' (2021) 133 Journal of International Economics 1-32.
[50] Research indicates that since 1970, over half of the restructuring episodes involving private creditors have resulted in either a subsequent restructuring or a default within five years: M Guzmán and JE Stiglitz, 'A Soft Law Mechanism for Sovereign Debt Restructuring Based on the UN Principles' (2016) Friedrich Ebert Stiftung, International Policy Analysis Paper.
[51] See S Horn, CM Reinhart, and C Trebesch, 'China's Overseas Lending' (2021) 133 Journal of International Economics 1-32; A Gelpern, S Horn, S Morris, B Parks, and C Trebesch, *How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments* (Aid Data Peterson Institute for International Economics, Kiel Institute for the World Economy, Center for Global Development, and AidData at William & Mary, 31 March 2021).
[52] S Horn, CM Reinhart, and C Trebesch, 'China's Overseas Lending' (2021) 133 Journal of International Economics 1-32.
[53] LL Ferry and AO Zeitz, 'China, the IMF, and Sovereign Debt Crises' (17 October 2022) <https://shorturl.at/mHIR6> accessed 20 November 2023.
[54] AA Malik, B Parks, B Russell, JJ Lin, K Walsh, K Solomon, S Zhang, T Elston, and S Goodmann, *Banking on the Belt and Road: Insights from a New Global Dataset of 13,427 Chinese Development Projects* (AidData at William & Mary 2021); S Horn, CM Reinhart, and C Trebesch, 'China's Overseas Lending' (2021) 133 Journal of International Economics 1-32; A Gelpern, S Horn, S Morris, B Parks, and C Trebesch, *How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments* (Peterson Institute for International Economics, Kiel Institute for the World Economy, Center for Global Development, and AidData at William & Mary 2021).

mandate confidentiality in loan terms and any debt restructurings.[55] China's preference for bilateral resolution of debt crises further hinders cooperation among official creditors.[56]

These dynamics, however, are nowhere exclusive to China's involvement. Sovereign debt restructuring has been a challenging exercise long before China's emergence as a significant official bilateral creditor. Rather than a new theme introduced by the diversification of official bilateral lenders, the major factor contributing to complexity is the increasing participation of private creditors in the debt portfolios of emerging and developing countries— a participation not accompanied by the legal mechanisms found in corporate debt restructuring. The significant lack of private creditor participation has been a major drain on the resources of emerging and developing countries since the COVID-19 pandemic.[57] This was particularly evident in the DSSI, where standstills by official bilateral creditors effectively subsidised debt repayments for private creditors, consequently diverting funds from healthcare and social expenditures.[58]

The G20's Common Framework for Debt Treatments Beyond the DSSI serves as a prime example of these challenges.[59] Established in late 2020, this initiative aims to facilitate coordination between Paris Club and non-Paris Club official creditors in restructuring the sovereign debt of LICs. Despite its objectives, the Framework has encountered difficulties in achieving effective coordination. This is highlighted by the limited number of applications and even fewer agreements reached under it — since its inception, only one out of four applicant countries has successfully reached an agreement. The Framework mandates comparable treatment from private creditors, but disputes over specific financial terms among various creditors have impeded its effectiveness, preventing it from offering a viable path toward the swift restoration of debt sustainability for any of the applicant countries. For instance, nearly three years after Zambia applied for debt restructuring under the Common Framework, negotiations continue to be hampered by disagreements between China-led official creditors and Western-based private creditors.[60]

The situation in Chad, the only case of concluded restructuring under the Common Framework, further highlights these complexities.[61] Unlike Zambia, Chad's debt composition is less influenced by Chinese lending, with one third of its external debt owed to commercial creditors, and almost all of that to Swiss commodity trader Glencore in oil-for-cash deals dating back to 2013 and 2014. Less than 10% of its debts are owed to Chinese official creditors.[62] Despite

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[55] AM Strange, A Dreher, A Fuchs, B Parks, and MJ Tierney, 'Tracking Under-Reported Financial Flows: China's Development Finance and the Aid-Conflict Nexus Revisited' (2017) 51(5) Journal of Conflict Resolution 935-63.
[56] K Acker, D Brautigam, and Y Huang, 'Debt Relief with Chinese Characteristics', Working Paper No 2020/39, China Africa Research Initiative (Johns Hopkins University, June 2020) 3.
[57] I Diwan and B Harnoys-Vannier, 'The Collapse of External Finance to Developing Countries' (Finance for Development Lab, 10 February 2024).
[58] Debt Justice, 'How the G20 Debt Suspension Initiative Benefits Private Creditors' (October 2021) <https://shorturl.at/bpGWY> accessed 20 November 2023.
[59] LE Breydo, 'Health of Nations: Preventing a Post-Pandemic Emerging Markets Debt Crisis' (2023) 23(2) Nevada Law Journal 463-532.
[60] J Cotterill, 'Zambia's Debt Restructuring Derailed After Official Creditors Reject Deal' (Financial Times, 20 November 2023).
[61] African Sovereign Debt Justice Network, 'Sixty Second Sovereign Debt News Update: Chad Becomes the First Country to Reach a Debt Treatment Agreement with Official and Private Creditors under the G20 Common Framework' (31 December 2022).
[62] World Bank and International Monetary Fund, 'Chad: Joint World Bank IMF Debt Sustainability Analysis' (February 2022) 3 <https://shorturl.at/gsAP4> accessed 20 November 2023.

reaching an initial agreement with bilateral official creditors in June 2021, negotiations with private creditors were prolonged, with the debt treatment agreement only being reached in January 2023. It called for Chad's creditors to reprofile or reschedule Chad's debt in 2024, the last year of its current $572 million programme with the IMF, to ensure that its debt level remains below the threshold of moderate risk of debt distress. However, no actual debt relief was achieved. This outcome has been met with mixed responses, with the IMF praising the agreement,[63] while the World Bank's president David Malpass expressed concerns over Chad's long-term debt sustainability.[64]

These scenarios underline the limitations of the current voluntary and charitable model of debt restructuring. Relying upon so-called 'gentlemen's agreements' and shared codes of conduct among creditors with aligned geopolitical interests is increasingly unviable, as these no longer reflect the reality of sovereign debt markets. This approach creates collective action problems, where some creditors may seek to benefit from the debt relief offered by others, exacerbating the free-rider dilemma and undermining cooperative efforts. This situation is underpinned by emerging distributive struggles among creditors, driven by conflicting geopolitical interests. For instance, the reluctance of Chinese official creditors to offer debt relief without similar commitments from private creditors reflects a hesitancy to indirectly subsidise Western private lenders. Conversely, Paris Club official bilateral creditors also exhibit a similar reluctance to provide debt relief without credible commitments from Chinese official creditors. The lack of a binding mechanism to enforce participation diminishes the willingness of creditors to collaborate in debt relief efforts, thus reducing the effectiveness and efficiency of the restructuring process.

In sum, the diversification of creditors highlights the inadequacy of the current legal framework for sovereign debt restructuring. The ongoing systemic crisis has tested the resilience of this framework, with the Common Framework failing to deliver timely debt relief. The complexities introduced by the diversification of creditors in sovereign debt markets emphasise the urgent need for a more effective and binding mechanism in the sovereign debt restructuring process.

c. Towards a new legal governance framework for sovereign debt restructuring

The inherent complexities of sovereign debt crises and the limitations of the existing legal system for sovereign debt restructuring underscore the need for a legal framework that sets out basic principles and procedures for a restructuring process that is timely, equitable, and reasonable. Given that sovereign debt today is largely governed by commercial law principles, it is logical to base this new framework on the proven practices of corporate restructuring proceedings in comparative insolvency law.

A critical insight from the Common Framework is the uniqueness of each restructuring case, considering the varied creditor profiles, legal instruments, maturity dates, and repayment capacities of each state. A new legal framework should reflect this specificity, positioning sovereign debt restructuring as a fundamental aspect of global economic governance. It should adhere to key governance principles such as transparency, effectiveness and efficiency, equity,

[63] International Monetary Fund, 'IMF Executive Board Completes First and Second Reviews of ECF Arrangement for Chad and Approves US$ 149.3 Million Disbursement', Press Release No 22/458 (22 December 2022).
[64] A Shalal, 'World Bank's Malpass Criticizes Chad Creditors' Plan for Failing to Reduce Debt' (Reuters, 11 November 2022).

and the rule of law. The framework must be flexible enough to handle a diverse range of sovereign debt restructuring cases while addressing the current system's shortcomings, including the lack of established proceedings, an adjudicating authority, and legally binding restructuring terms.

d. Guiding principles of good governance

Transparency, a fundamental norm of good governance and the rule of law, is essential in sovereign debt restructuring, which involves multiple issues of public interest. Therefore, transparency should be a foundational principle in international sovereign insolvency law, ensuring stakeholders have access to essential information about the restructuring process and related documentation. For instance, information on the financial obligations included in or excluded from restructuring offers, and the terms of such offers, should be publicly available.

Effectiveness and efficiency are key components of good governance. The OECD defines effectiveness as achieving the objectives of an activity and efficiency as achieving maximum output with given resources.[65] Like corporate markets, sovereign debt markets necessitate a reliable legal, regulatory, and institutional framework. This includes an effective and efficient insolvency framework for reconciling the interests of different stakeholders and overcoming the problem of excessive delays in restructuring processes.

In the context of sovereign debt restructuring, equity refers to the principle of fair and equitable treatment among various stakeholders.[66] This involves ensuring that no particular group of creditors is unfairly favoured or disadvantaged in the restructuring terms. Equity is key to balancing the interests of different creditor groups and cultivating a cooperative environment essential for successful sovereign debt restructuring.

Finally, the rule of law is essential for the effective functioning of credit markets. A market economy, with its array of private and public actors engaged in economic relationships, relies on business law as a foundation for predictable economic activity.[67] Given the inherent nature of liquidity stress in sovereign debt markets, an insolvency framework that comes into play when a sovereign debtor faces financial distress and needs to restructure its obligations is a critical element of effective credit markets. Under the rule of law, an established proceeding for debt restructuring is necessary, balancing creditors' bargains and the sovereign debtor's other financial responsibilities, including providing essential services to its population. This principle is crucial for minimising delays and avoiding suboptimal restructuring terms, thus ensuring economic stability and maintaining basic public welfare levels.

The need for structural legal reform in the global financial architecture, anchored in fundamental governance principles, is urgent and cannot be addressed by transactional arrangements alone. For instance, while debt-for-nature swaps may offer benefits in specific agreements, they are insufficient for tackling broader sovereign insolvency crises.[68] Efficient debt restructuring is

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[65] OECD Glossary of Statistical Terms (OECD 2008).
[66] A Iversen, *Intercreditor Equity in Sovereign Debt Restructuring* (Oxford University Press 2023).
[67] S Bufford, 'International Rule of Law and the Market Economy - An Outline' (2006) 12 Southwestern Journal of Law and Trade in the Americas 303-12.
[68] I Fresnillo, *Miracle or Mirage: Are Debt Swaps Really a Silver Bullet?* (Eurodad, 4 December 2023).

especially critical in the context of climate change, as heavily indebted countries often face severe climate impacts. These impacts, in turn, often exacerbate debt vulnerabilities.[69] Therefore, an international legal framework for debt restructuring is essential. It should enable states facing debt distress or insolvency to effectively renegotiate their financial obligations and create fiscal room, avoiding the current delays and uncertainties associated with restructuring processes. This would enable them to allocate resources more effectively for critical issues, including climate change mitigation and adaptation.

e. Comparative law analogies for sovereign insolvency proceedings

In addressing sovereign insolvency, drawing upon the experiences of restructuring processes in comparative law is crucial. These experiences can provide essential procedural guidelines and principles. An ideal framework would also involve a qualified body overseeing and affirming the fairness of the restructuring plan.

The example of municipal insolvency, particularly under Chapter 9 of the US Bankruptcy Code, has been referenced in international discussions on sovereign debt restructuring. However, the stringent eligibility criteria and the often protracted and contentious processes for municipalities suggest that a more fitting analogy might lie in Chapter 11's reorganisation proceedings. This approach could address the delays currently plaguing sovereign debt restructuring, which tend to exacerbate macroeconomic instability due to the surrounding uncertainty.

Thus, this working paper proposes that the insights from corporate financial restructuring in comparative law are highly relevant to forming an international framework for sovereign insolvency. Such a framework would enable sovereigns to enter a compromise or arrangement with their creditors (or specific classes of them) to restructure various types of financial obligations. The approach should be sufficiently flexible to respect state sovereignty, allowing them to initiate proceedings and manage their operations without external interference.

The discussion in this paper focuses on the provisions of Parts 26 and 26A of the UK's CA 2006, which deal with schemes of arrangement and restructuring plans, respectively. The rules established under the Part 26A restructuring plan by the Corporate Insolvency and Governance Act 2020 (CIGA 2020) are particularly instructive for drawing comparative lessons for a potential sovereign insolvency proceeding. This section of the Act refines the existing framework outlined in Part 26, incorporating over a decade of practical application in the United Kingdom. Exploring these provisions is key to understanding how a sovereign insolvency proceeding could be structured and governed.

Valuable principles from restructuring plans that could inform an international sovereign insolvency proceeding include:

i. Eligibility

The restructuring plans under Part 26A are broad in terms of eligibility, aimed at companies facing serious financial difficulties, whether current or anticipated. The Act does not stringently define 'financial difficulties', allowing for a wide interpretation. The primary requirement is that

[69] I Fresnillo, *A Tale of Two Emergencies: The Interplay of Sovereign Debt and Climate Crises in the Global South* (Eurodad, 17 December 2020).

these difficulties could potentially impact the company's ability to continue as a going concern. Additionally, the plan should aim to 'eliminate, reduce, prevent, or mitigate' the effects of these difficulties.[70]

This flexible interpretation and the aim to mitigate financial difficulties could be aptly applied to sovereigns experiencing debt distress or insolvency crises. The goal would be to enable these states to promptly regain access to liquidity, fostering economic growth and minimising social costs. This is also beneficial for creditors, as longer restructuring processes tend to result in higher losses, mainly because prolonged insolvency issues hinder economic recovery, impacting the state's capacity to service its debt.[71] Thus, prompt restructuring, ideally before a default occurs, can lead to more favourable outcomes for all parties involved.[72]

ii. Composition of the restructuring plan

Composition refers to the process of proposing a compromise or arrangement to creditors for a collective agreement. Under the CA 2006, the company has the discretion to determine with whom it proposes a compromise or arrangement. This means that a scheme or restructuring plan's composition is not necessarily collective and may not involve all creditors. The company may exclude any members or creditors it wishes, even those with similar rights against the company as those included within the plan.

In *Sea Assets v PT Garuda Indonesia*,[73] Peter Gibson LJ noted that the proposer of a scheme has the freedom to select the creditors involved, as long as the rights of the creditors and the scheme's effect on these rights are not so dissimilar as to prevent those creditors from consulting together in their common interest. However, courts will only approve a scheme that excludes certain creditors if the company can provide a rational commercial justification for such exclusion, beyond merely attaining the requisite statutory majorities. For instance, in *Re The Co-Operative Bank Plc*,[74] the court found that there were several good commercial reasons why retail noteholders were not included in the creditor scheme. This was due to several factors, including the possibility that it might not align with their interests to be issued with new equity in an unlisted company with no certainty of any return, and that it was not possible for the company to offer the 'cash-out' option offered to the retail noteholders to all noteholders, given its financial resources.

These principles are particularly applicable to sovereigns seeking to restructure distressed debt, as they provide a rational justification for including or excluding similar types of debt in a restructuring plan. Sovereigns ought to retain the flexibility to design their restructuring plans, choosing which debts to restructure and how to categorise creditor classes in their initial proposal.

[70] *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2191 (Ch), paragraph 39.
[71] C Reinhart, V Reinhart, and K Rogoff, 'Debt Overhang: Past and Present', NBER Working Paper 18015 (2012) 16.
[72] MLJ Wright, 'Restructuring Sovereign Debts with Private Sector Creditors: Theory and Practice' in CAP Braga and GA Vincelette (eds), *Sovereign Debt and the Financial Crisis: Will This Time Be Different?* (The World Bank 2010); D Benjamin and MLJ Wright, 'Recovery before Redemption: A Theory of Delays in Sovereign Debt Renegotiations' (8 April 2009).
[73] *Sea Assets v PT Garuda Indonesia* [2001] EWCA Civ 1696 [51].
[74] *Re The Co-Operative Bank Plc* [2017] EWHC 2112 (Ch).

The ongoing debt restructuring in Zambia exemplifies this.[75] When the IMF programme was approved in September 2022, Zambia's authorities announced their intention to exclude local-currency debt from the restructuring. This decision was driven by concerns over financial stability in the domestic banking sector. The Zambian financial sector held the majority of this debt, constituting almost one-third of banking sector assets, or about 12 percent of GDP. Restructuring this debt could trigger significant financial instability, necessitating public support for the sector, and potentially leading to broader economic risks such as weakened market confidence, capital outflows, and restricted access to finance for the private sector.

The IMF's DSA for Zambia, which is based on residency rather than currency, included local-currency debt held by non-residents in the external debt stock. This led to discrepancies in the restructuring scope and created tensions among creditors, particularly affecting the distribution of debt relief among official bilateral creditors and Eurobond holders. According to Setser, non-resident holdings constituted just over 15% of the external debt stock but accounted for a significant portion of Zambia's debt servicing capacity in the early years of the IMF programme.[76] It was estimated that non-resident holdings consumed over 50% of the cash flows available for debt service to all external creditors from 2022 to 2026. Additionally, other debts excluded from the restructuring, such as those to multilateral organisations, payables, and Special Drawing Rights (SDR) allocations, were expected to utilise another 32%, leaving limited resources for official creditors and Eurobond holders.

In the case of Zambia, those pressures were alleviated by outflows of foreign investors from the domestic debt market in 2022, which contributed to reducing the impact of non-resident holdings on the external debt stock. Furthermore, in June 2023, the Bank of Zambia announced it would limit foreign participation in domestic debt auctions to a maximum of 5% of the annual planned issuance, at face value. This measure enabled the IMF to project a reduced debt service on non-resident holdings in the coming years, potentially facilitating an agreement with official creditors and bondholders. However, as Maret noted, significant damage had already been inflicted, severely impacting Zambia's financing capabilities.[77] Most notably, the case illustrates the structural point that, as Gelpern and Setser argue, despite important concerns about inter-creditor equity, the ability to treat domestic and foreign creditors differently remains a necessary policy option for governments in financial crisis.[78]

Whilst differentiating holders by residency presents significant challenges, a sovereign insolvency proceeding that draws upon similar plan composition rules found in comparative insolvency law could potentially enable the debtor to assemble a restructuring plan tailored to its specific circumstances. In the case of Zambia, for instance, the restructuring plan could include only non-resident holdings of domestic securities, on the basis that such holdings are likely to consume most of the short-term debt servicing capacity. Concurrently, domestic holders could be excluded on the basis that their exclusion would avoid material spillover risks.

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[75] This case is extensively discussed in T Maret, 'The Cautionary Tale of Zambia's Domestic Debt' (Sovdebt Oddities, 11 September 2023) and T Maret, 'Zambia: The Official Sector Strikes Back' (Sovdebt Oddities, 13 November 2023).
[76] B Setser, 'The Common Framework and Its Discontents' (Council on Foreign Relations, 26 March 2023).
[77] T Maret, 'The Cautionary Tale of Zambia's Domestic Debt' (Sovdebt Oddities, 11 September 2023).
[78] A Gelpern and B Setser, 'Domestic and External Debt: The Doomed Quest for Equal Treatment' (2004) 35(4) Georgetown Journal of International Law 795-814.

An important discussion that arises regarding the composition of the restructuring plan for sovereigns pertains to the possibility of including financial obligations to IFIs in the proposal. Namely, the IMF and the main multilateral development banks (MDBs) are commonly perceived to enjoy PCT in their sovereign lending.[79] This implies that they are expected to be repaid even if the borrower restructures private or bilateral debt. The justification for such treatment often hinges on their role as providers of emergency or concessional funding where markets are unwilling to lend to sovereigns.[80]

However, while PCT is pivotal for the operating model of these IFIs, and the Paris Club Agreed Minutes exempt IFIs from a 'comparability of treatment' clause, their preferred status is not underpinned by any form of domestic or international law. Thus, the status of preferred creditor is de facto and self-asserted. This introduces complexities with the establishment of the IMF's lending into official arrears policy. Post-2015, the Non-Toleration of Protracted Arrears (NTP) essentially covers only multilateral claims and direct bilateral claims, for which full payment is contemplated under the programme (i.e., non-Official Sector Involvement (OSI)-related direct bilateral claims). Therefore, it is now more crucial than ever to unambiguously characterise institutions considered 'multilateral creditors' and the treatment of their claims.[81]

It is irrefutable that the so-called risk-free lending, facilitated by PCT, allows IFIs to lend to sovereigns counter-cyclically and under terms and in circumstances that markets are not prepared to endorse. This serves a public purpose that must be preserved. Concurrently, despite their public mandate, these institutions are financial entities that should be held accountable for their financial decisions. This is particularly pertinent when such decisions involve multilateral financing of debt service to private creditors, rather than genuine development finance. This working paper does not seek to provide a definitive answer on whether IFI financing should be eligible for inclusion in a restructuring plan. However, two issues merit consideration. Firstly, strictly from a legal standpoint, there is currently no impediment to their inclusion in principle, particularly in scenarios where debt service to IFIs constitutes a significant portion of a distressed sovereign's debt profile. Secondly, a potential approach to reconcile the merit of PCT with the necessity of debt restructuring could involve classifying these debts separately, acknowledging the preferential servicing and repayment treatment of IFI debt above other liabilities.

iii. Class composition

The class composition within restructuring plans is a critical aspect, involving the debtor's discretion to define classes which are subsequently assessed by the court based on established principles. This process, offering flexibility in determining class composition, is especially suitable for the diverse scenarios encountered in sovereign debt restructuring.

The main principle for class composition is that members of a class must have similar rights to allow them to consult together for their common interest. This was established in the case

[79] Boosting MDBs' Investing Capacity, *An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks* (2022) 18; RSJ Martha, 'Preferred Creditor Status under International Law: The Case of the International Monetary Fund' (1990) 39(4) International and Comparative Law Quarterly 801-26.
[80] T Cordella and A Powell, 'Preferred and Non-Preferred Creditors', Policy Research Working Paper No 8941 (World Bank Group, July 2019).
[81] International Monetary Fund, 'Reviews of the Fund's Sovereign Arrears Policies and Perimeter', IMF Policy Paper (24 February 2022) 41.

Sovereign Life Assurance Company (In Liquidation) v Dodd,[82] which stated that a class should only include those with sufficiently similar rights to enable joint consultation.

Further clarification on class composition was provided in *Re Hawk Insurance Co Ltd*, where the Court of Appeal, led by Chadwick LJ, outlined key considerations: (1) determining whether the rights affected by the scheme are so different that the scheme should be treated as an arrangement involving multiple classes of members or creditors; and (2) assessing whether the scheme introduces new rights that create distinct classes.[83] This approach acknowledges that rights within a class need not be identical, advocating for a broader interpretation of what constitutes a class.

The emphasis in class composition lies on the rights held by members, rather than their individual interests, as emphasised in *Re BTR plc*[84] and reaffirmed in *Re Telewest Communications plc (No 2)*.[85] The decision on whether members constitute one or several classes is contingent upon the specific circumstances of each case. For example, in situations involving bondholders with claims denominated in different currencies, classification hinges on the similarity of their rights against the company, not on their interests derived from those rights.

In *Re Apcoa Parking Holdings GmbH*, the court emphasised the importance of considering both existing creditor rights and those introduced by the scheme, focusing on rights against the company rather than commercial interests.[86] This broad perspective is crucial to prevent any minority group from unduly wielding a veto power. A significant divergence in rights is necessary to justify the formation of separate classes, as summarised in *Re CFLD (Cayman) Investment Ltd*.[87]

In cases like *Re Stronghold Insurance Company Ltd*, the court differentiated between policyholders with contingent claims and those with accrued claims, due to the uncertainty surrounding contingent claims.[88] This distinction underlines that substantial differences in rights may require the creation of separate classes.

Similarly, in *Re VEON Holdings BV* [2022] EWHC 3473 (Ch), where the company was solvent, the court determined that different maturity dates of notes did not warrant separate classes, as payment was expected regardless of the scheme's approval.[89] However, in the context of potential sovereign insolvency cases, factors such as maturity dates might justify dividing creditors into distinct classes, reflecting the pressure of debt servicing on the debt sustainability of the sovereign debtor.

iv. Class cramdown and cross-class cram down

Key aspects of restructuring plans under the CA 2006 are the provisions for class cramdown and cross-class cramdown. These features can significantly influence sovereign insolvency

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[82] *Sovereign Life Assurance Company (In Liquidation) v Dodd* [1892] 2 QB 573.
[83] *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241.
[84] *Re BTR plc* [1999] 2 BCLC 675.
[85] *Re Telewest Communications plc (No 2)* [2004] EWHC 924 (Ch).
[86] *Re Apcoa Parking Holdings GmbH* [2014] EWHC 3849.
[87] *Re CFLD (Cayman) Investment Ltd* [2022] EWHC 3496.
[88] *Re Stronghold Insurance Company Ltd* [2018] EWHC 2909 (Ch).
[89] *Re VEON Holdings BV* [2022] EWHC 3473 (Ch).

proceedings by binding dissenting creditors and addressing the 'too little, too late' problem previously discussed.

Notably, the cramdown in Part 26A restructuring plans requires a 75% majority in value within each class, without the necessity for a majority in the number of creditors, contrasting with the requirements for schemes of arrangement.[90] These provisions are particularly beneficial in sovereign debt restructurings, especially for bondholders lacking CACs or where contractual majorities are unattainable. They are also relevant for debts like syndicated loans from official or private creditors.

Furthermore, Part 26A introduces a cross-class cramdown, allowing courts to sanction a plan even without the agreement of 75% in value of a class.[91] This is instrumental in preventing obstructive investors from unduly influencing the restructuring process. The court may approve such a plan if the dissenting investors are not worse off under the plan than in the likely alternative, and if at least one class with a 'genuine economic interest' in the company approves the plan.

For a plan to be sanctioned using cross-class cramdown, two conditions must be met:

1. The 'no worse off' condition: The court must be satisfied that members of the dissenting class would not be worse off than in the likely alternative if the plan were not sanctioned.
2. The approval by at least one class with a 'genuine economic interest': This involves assessing whether a class of creditors would receive any payment in the likely alternative to the plan.

The 'no worse off' and 'genuine economic interest' tests could be adapted in sovereign debt restructuring to facilitate a comprehensive approach that ensures equitable distribution of losses among all stakeholders involved in the restructuring. This approach would involve imposing reductions in principal and interest, as well as reprofiling maturities, based on a holistic debt sustainability assessment.

v. Moratorium

A crucial element in comparative insolvency law is the necessity for a moratorium period to prevent instability and a 'race to the bottom' following the submission of a restructuring plan application.

The CIGA 2020 introduces a significant addition, Part A1, to the IA 1986, which establishes an independent restructuring moratorium, not necessarily a precursor to an insolvency process. Under CIGA 2020, a CVA, scheme of arrangement, or a new restructuring plan under Part 26A of the CA 2006 may be proposed while the company is under moratorium. Unlike the administration-attached moratorium, this restructuring moratorium enables directors to continue managing the company under a licensed insolvency practitioner (the monitor), subject to certain restrictions. Its primary objective is to protect the company from adverse creditor actions during restructuring efforts. Directors can initiate a moratorium through a court application.

In sovereign debt restructuring, a moratorium provision is vital to prevent premature litigations, including claims against the state before the International Centre for Settlement of Investment

[90] Section 901F, CA 2006.
[91] Section 901G, CA 2006.

Disputes (ICSID) tribunals. The UNCTAD Principles on Responsible Sovereign Lending and Borrowing advocate for a stay of proceedings during restructuring (Principle 7) to avoid impairment by holdout litigation.[92] A moratorium would help avert risks associated with holdouts attempting to seize state assets, which may complicate international borrowing and lead to the potential seizure of unprotected state assets.

Distinctively, the UK's restructuring moratorium, unlike those in other jurisdictions, applies to all creditors without an option to exclude specific groups, for example trade creditors or other creditors on whom the burden of the moratorium might fall disproportionately. It also fails to account for debt restructurings carried out via a scheme or restructuring plan involving only a subset of creditors.[93] This lack of flexibility, particularly in the absence of provisions for debt restructurings involving a subset of creditors, is a notable shortcoming that warrants reconsideration in the context of sovereign insolvency, especially as court applications could address potential unfair discrimination on a case-by-case basis.

The duration of the moratorium is another critical consideration. In the UK, the moratorium initially lasts 20 business days, extendable by another 20 days without creditor consent and up to 12 months with creditor or court approval. The initial 40 business days may be insufficient for extensive restructuring negotiations, indicating that extensions are likely necessary. This duration is notably shorter than the three-month period suggested by the Insolvency Service[94] and the 4-month initial period (extendable up to 12 months) of the EU Restructuring Directive.[95]

When developing a sovereign insolvency framework, these international experiences should be taken into account to prevent premature litigation if the moratorium ends before the restructuring is approved. While protecting creditors with a reasonable moratorium length is essential, it must be balanced against the need for states to have sufficient time for negotiations during restructuring.

V. Concluding Remarks

Sovereign debt distress and insolvency crises, as this paper has shown, are not mere outcomes of episodic misfortunes or mismanagement by individual governments. They are deeply embedded in the structure of the international monetary system itself. In this system, sovereigns, similarly to private market actors, are at risk of facing liquidity stress and insolvency crises. This risk is particularly high for countries in the monetary periphery, highlighting the need to discuss these structural issues in global policy debates about sovereign debt crises.

The legal frameworks for incurring sovereign debt today, as discussed in this paper, largely mirror those for commercial entities. However, this similarity does not extend to how these debts are restructured during financial difficulties. Today's approach to restructuring sovereign debt is mainly ad hoc, involving brokered agreements between indebted states and their diversified

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[92] United Nations Conference on Trade and Development, *Principles on Promoting Responsible Sovereign Lending and Borrowing* (UN 2012).
[93] J Payne, 'An Assessment of the UK Restructuring Moratorium' (4 January 2021) 10.
[94] Insolvency Service, *A Review of the Corporate Insolvency Framework: A Consultation on Options for Reform* (May 2016), para 7.7.
[95] EU Restructuring Directive, (EU) 2019/1023, Arts 6(6) and 6(8).

creditor bases. These processes are manifestly inefficient and inequitable. Therefore, this paper argues for a structured, legally binding approach to restructuring sovereign debt, drawing on corporate insolvency practices.

In advocating for a new legal governance framework for sovereign debt restructuring, this paper has proposed a set of guiding principles and procedural analogies from comparative corporate insolvency law. These include the application of good governance principles such as transparency, effectiveness, equity, and rule of law; the flexibility in composition and class composition of restructuring plans; and the adoption of mechanisms like class cramdown and cross-class cramdown. Additionally, the importance of a moratorium is emphasised to safeguard against premature litigations and to provide a conducive environment for effective restructuring negotiations.

The main goal of this proposed framework is to enable timely, equitable, and reasonable restructuring processes. It aims to ensure that sovereign debtors can regain access to liquidity, maintain economic growth, and minimise social costs, while also safeguarding inter-creditor equity. This would represent a significant step towards a more stable, fair, and efficient international financial architecture.