LOS ANGELES
Daily Journal
www.dailyjournal.com
THURSDAY, AUGUST 6 2015
PERSPECTIVE

When sovereign entities default

By Robbin L. Itkin and Alexandra S. Kelly

On Monday, Puerto Rico defaulted on a $58 million bond payment due. Despite carrying prodigious debt for some time, this default was Puerto Rico's first since it came under the jurisdiction of the United States 117 years ago. Unfortunately, Puerto Rico is not the only debt-beleaguered sovereign entity making financial waves in recent months; both Argentina and Greece have taken up permanent occupation on front page news for failing to manage and restructure unsustainable debt.

Despite this evidently common global problem, there is no established process or forum, like bankruptcy, for sovereigns to efficiently resolve issues with all creditors, who often span the globe, in one place at one time. Financial crises of countries not only seriously adversely affect the economy and the well-being of their citizens, but threaten the destabilization of the global economy. Further, access to global capital markets and private and institutional investors may be seriously curtailed if such investors are unable to protect and enforce their investments with some measure of fairness and certainty of process.

Examples of this abound. In 2001, Argentina declared an unprecedented $93 billion bond default. A majority of the affected bondholders were foreign investors, who, under duress, agreed to accept approximately 30 percent of face value in connection with two separate debt exchanges in 2005 and 2010. In 2008, U.S.-based holders of more than $4 billion in Argentine bonds (known as the "holdouts") filed suit to collect on their debts in U.S. courts in litigation that is still ongoing. Initial court rulings found that the holdout bondholders were entitled to be repaid the full face amount of their bonds and that Argentina could not pay other bondholders, who had accepted the terms of the prior debt exchanges, until the holdouts are satisfied in full.

Whether Argentina will ultimately comply with U.S. court orders regarding full repayment to the holdouts remains to be seen. To date, Cristina Fernandez, the sitting Argentine president, has defied prior court orders and shows no inclination to reconsider her stance. As a result of the default and the resulting litigation, Argentina has effectively become a financial pariah, unable to issue a single dollar of new debt globally since 2001, and without access to capital markets during the longest period of sustained low interest rates in recent history. In addition, the lack of a centralized forum has had the effect of favoring certain bondholders over others, further undermining confidence and the perception of fair play in these types of foreign debt disputes.

On the other side of the world, the economic stability of the entire European continent, including its currency, commodities and equities markets, currently hangs in the balance as the fallout from the latest multi-billion dollar Greek debt crisis begins to manifest. Greek government officials and representatives from the European Union and the International Monetary Fund are meeting again this week to discuss yet another enormous bailout for Greece, the third such bailout in five years. Most international banks and private foreign investors sold off their Greek bonds and other holdings years ago, limiting the direct damage that can be done to them by another default. No investors are immune, however, from the worldwide financial impact of persistent instability for the entire Eurozone. Moreover, total stonewall by private investors places the entirety of the burden to refinance the Greek debt on their already overburdened neighboring nations.

Though less concerning on a global scale, the looming default of Puerto Rico's bonds generates further disquietude for private investors prospecting in public securities. Puerto Rico benefits considerably from the massive safety net provided by the Federal Deposit Insurance Corporation and billions in U.S.-provided subsidies, but the inability to utilize the provisions of chapter 9 of the U.S. Bankruptcy Code, reserved for municipalities (Puerto Rico is a commonwealth), have left it rudderless, without a clear legal path to manage and address its debt in a streamlined fashion.

Though the top-ranking world politicians and best minds have been working on these issues, no clear answer regarding how to best resolve these complex cross-border disputes is readily apparent. It is precisely this type of unpredictability that will likely quell future investment in sovereign debt, with worldwide financial repercussions. Accordingly, the implementation of a proactive, rather than reactive, global framework for adjudicating these types of claims is imperative.

The best and worst of bankruptcy laws around the world should be examined by experts representing different nations, with the goal of distilling such laws into an international system for resolution of sovereign debt. This is not a new concept; many scholars and international organizations, such as the United Nations, have been examining ways in which to address the cross-border resolution of sovereign debt. Proposed treaties are being contemplated.

A further example is the work of Professor Steven L. Schwarcz of Duke University School of Law, who has proposed a model-law approach to sovereign debt restructuring. Industry groups, such as the International Insolvency Institute, also have formed working groups to study, discuss and propose how to best approach sovereign debt restructuring from an international perspective.

Most recently, after six months of study, the United Nations, through its ad hoc committee on sovereign debt restructuring process, just announced the unanimous adoption of nine principles for restructuring sovereign debt (right of sovereign states to restructure their debt; sovereign immunity; good faith; transparency; impartiality; equal treatment; legitimacy; sustainability; and respect for majority decision in restructuring processes). While these nine principles are noteworthy and critical to a fair and efficient system, and their publication is a crucial first step, much more work needs to be done to formulate a larger debt resolution scheme that both incorporates these principles and is sufficiently regarded internationally to achieve buy-in by the sovereign nations. Such a global structure, if feasible, would improve and support global economic and political relations and likely propagate new sources of capital for struggling nations to access in the future.

For these reasons, the creation of such a structure, though challenging on numerous fronts, is a worthwhile endeavor and should be a primary focus of political leaders and insolvency professionals in the near term.

Robbin L. Itkin *leads Liner LLP's Business Solutions and Financial Restructuring Group.*
Alexandra Kelly *is senior counsel in the Business Solutions and Financial Restructuring department of Liner LLP.*

ROBBIN ITKIN
Liner LLP

ALEXANDRA KELLY
Liner LLP

Reprinted with permission from the *Daily Journal*. ©2015 Daily Journal Corporation. All rights reserved. Reprinted by ReprintPros 949-702-5390.