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PRIVATE CREDITORS AND SOVEREIGN DEFAULT: FROM ARGENTINA TO GREECE

Argentina' sovereign default in 2001 holds an important lesson for Europeans as they debate Greece's de facto insolvency and the framework for restructuring gov ernment debt. This paper will first survey strategy options for private creditors be tween mandatory restructuring, litigation and renegotiation. It will then assess mar ket oriented approaches towards sovereign debt restructuring before the legal frame work for crisis management by the IMF and the EU are introduced. A section on the future of private creditor renegotiation concludes.

Key words: *Sovereign debt. Renegotiation. Collective action problems. Cri sis management in the EU.*

1. SOVEREIGN DEBT IN CRISIS

1.1. Argentina

Argentina's sovereign default marked a watershed in the history of international finance. In 1991, the country had adopted a convertibility plan as a stabilisation device to contain hyperinflation.[1] Severe problems emerged when the Brazilian currency depreciated against the Argentine peso and public debt increased as the result of the economic recession.[2]

[1] International Monetary Fund, Independent Evaluation Office, *The IMF and Ar gentina 1991 2001*, 2004, 14 etc.; M. Mussa, *Argentina and the Fund: From Triumph to Tragedy*, Institute for International Economics, Policy Analyses in International Econom ics 67, July 2002, 20 etc.

[2] International Monetary Fund, *The IMF and Argentina*, 20 etc.; M. Mussa, 25 etc.

In 2000, Argentina had to turn to the International Monetary Fund (IMF) for financial support, as private lenders were unwilling to supply additional funds.[3] A stand-by arrangement was negotiated which did not provide for a mandatory adjustment of domestic policies or a coordination of policy announcements with the IMF.[4] Late in 2001, the IMF suspended the customary policy review of Argentina.[5] Bonded debt amounted to US $ 66 bn. There were 152 different series of bonds, governed by eight different laws from Anglo-Saxon and civil law jurisdictions.[6] Argentina offered a 'voluntary debt exchange'. On 20 December 2001, her long-term foreign currency sovereign credit rating was downgraded.[7] Four days later, the Argentine president decreed the suspension of all external debt.[8] A fortnight later, the country was unable to continue paying interest[9] because the government had run out of cash.[10]

In early 2002, Argentina's total public debt had risen to 150 % of the gross national product (GNP).[11] When Argentina eventually moved to restructure its sovereign debt more systematically, she opted for a strategy of financial independence, and discriminated between the International Monetary Fund (IMF), public lenders, and private creditors unwilling to settle on highly unfavourable terms.[12] Argentina settled with the IMF in order to escape mandated policy constraints.[13] By 2010, the country had

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[3] *Ibid.*, 4, 42 etc.

[4] *Ibid.*, 4, 40, 48 etc.

[5] *Ibid.*, 56; see also M. Mussa, 49 etc.

[6] R. Olivares Caminal, "To Rank *Pari Passu* or Not To Rank *Pari Passu*: That Is the Question in Sovereign Bonds After the Latest Episode of the Argentine Saga", *Law and Business Review of the Americas* 4/2009, 748; Banco de España, *Recent Episodes of Sovereign Debt Restructuring. A Case Study Approach*, Documentos Ocasionales No. 0804, 2008, 12.

[7] Moody's Global Credit Research, *Sovereign Default and Recovery Rates, 1983 2007*, Moody's Investor Service, March 2008, 13.

[8] J. Kim, "From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events", *Fordham Journal of Corporate and Financial Law* 5/2008, 769.

[9] Moody's, *Sovereign Default*, 13.

[10] M. Mussa, 49 etc.

[11] J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring*, Congressional Re search Service, The Library of Congress, 19 October 2004, 1.

[12] J.F. Hornbeck, *Argentina's Defaulted Sovereign Debt: Dealing with the ‚Hold outs'*, Congressional Research Service, The Library of Congress, 21 January 2010, 4 etc.; Banco de España, Documentos Ocasionales No. 0804, 2008, 13 etc.; J. García Hamilton, R. Olivares Caminal, O.M. Zenarruzza, "The Required Threshold to Restructure Sover eign Debt", *Loyola of Los Angeles International and Comparative Law Review* 2/2005, 255 etc. For a detailed account of Argentina's 2005 debt restructuring see also F. Sturzeneg ger, J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*, MIT Press, Cam bridge, Massachusetts 2006, 187 etc.

[13] P. Sester, "Beteiligung von privaten Investoren an der Umschuldung von Staat sanleihen im Rahmen des European Stability Mechanism (ESM)", *Wertpapiermitteilun*

reached restructuring agreements with the 92.6 percent of the bondholders[14] who lost between 68 and 75 percent of their principal[15]. Argentina's default has changed sovereign debt contracting considerably. Her efforts to regain access to international financial markets hold important lessons for market-oriented restructuring efforts.

1.2. Greece

Greece's current financial predicament is due to a combination of international risk factors and domestic macro-economic shortcomings. As early as August 2007, markets changed their attitude towards the economies of EMU member states:[16] International risk factors and individual macro-fundamentals came to be priced on a country-by-country basis.[17] Greece was perceived as a country with a non-fully credible EMU commitment without fiscal guarantees.[18] The convergence in sovereign bond yields observed in the euro zone since 1999 had been reversed. There are remarkable yield spreads on sovereign bond markets for euro zone bonds.[19] Sovereign Credit Default Swaps (CDS's) mirrored this development.[20] In fact, the spreads for Greek CDS's were even more 'dynamic' than those for bonds.[21] By the end of 2012, Greek government debt will rise to over 160 percent of the gross national product.[22]

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gen *Zeitschrift für Wirtschafts und Bankrecht* 65/2011, 1057, 1062; cf. Banco de Es paña, Documentos Ocasionales No. 0804, 2008, 19 etc.

[14] P. Sester, 1057, 1062.

[15] J. Sgard, "Restructuration de la dette: le cas argentin", *Problèmes économiques* 2892/2006, 22, 23, La documentation française.

[16] Cf. M.G. Arghyrou, A. Kontonikas, *The EMU sovereign debt crisis: Funda mentals, expectations and contagion*, European Commission, European Economy Eco nomic Paper 436, February 2011, 2 etc., *http://ec.europa.eu/economy finance/publica tions/economic paper/2011/pdf/ecp436 en.pdf*, last visited 4 November 2011.

[17] *Ibid.*, 3; N. Gaillard, *A Century of Sovereign Ratings*, Springer, New York 2012, 173.

[18] *Ibid.*, 4.

[19] European Commission, Directorate General Economic and Financial Affairs, *European Sovereign Debt Markets Recent Developments and Policy Options*, Note for the attention of the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS), Brussels,14 January 2011 (ECFIN/E/E1), 2, *http://www.eu roparl.europa.eu/meetdocs/2009 2014/documents/cris/dv/bond markets 20 1 2011/ bond markets 20 1 2011en.pdf*, last visited 16 July 2011.

[20] *Ibid.*; see also Bank for International Settlements, *BIS Quarterly Review*, June 2011, 9 etc., and A. Alfonso, D. Furceri, P. Gomes, *Sovereign Credit Ratings and Finan cial Market Linkages Application to European Data*, European Central Bank, Working Paper Series No. 1347, June 2011, 6 etc.

[21] See N. Gaillard, 177 etc.

[22] C. Alessi, *The Eurozone in Crisis*, Council on Foreign Relations, *http://www.cfr. org/eu/eurozone crisis/p22055*, last visited 4 November 2011.

In April 2010, a joint package was drawn up by the IMF and the EU whereby Greece was to receive a total of € 110 bn (as loans) over three consecutive years.[23] The IMF and Greece agreed on a Stand-by Arrangement, based on a conditionality whereby the Greek government pledges to implement fiscal policy and pro-growth measures until 2014.[24] The EU added a total of € 80 bn to the IMF funds payable in several tranches. Conditionality under EU law was achieved by a Memorandum of Understanding between the Greek government and the EU Commission and a Decision of the EU Council of ministers.[25]

When Greece called the second IMF tranche in 2011, the IMF conditioned its support on Greek restructuring efforts and the readiness of Eurozone governments to strengthen the European Financial Stability Facility (EFSF) and to establish programmes to ensure long-term sustainability.[26] On 21 July 2011 the Heads of State or Government of the Eurozone announced a new programme for Greece, including voluntary participation by the private sector.[27] The Heads of State or Government of the Euro zone decided to extend the maturity of future EFSF loans to Greece from 7.5 years to a maximum of 30 years with a grace period of ten years. Lending rates for EFSF loans were frozen at the level of those from the balance of payments facility (i.e. approximately 3.5 %) and the maturity dates of existing Greek facilities were postponed.[28] The international banking community issued a policy statement on a voluntary pro-

[23] See statements of the Eurogroup of 11 April 2010 (Statement on the support to Greece by Euro zone Member States) and of 2 May 2010.

[24] International Monetary Fund, *IMF Reaches Staff level Agreement with Greece on € 30 Billion Stand By Arrangement*, Press Release No. 10/176 of 2 May 2010, and Greece's Memorandum of Economic and Financial Policies of 3 May 2010, *http://www.greekembassy.org/Embassy/files/GREECE%20%E2%80%94%20MEMORANDUM%20TO%20IMF%20ON%20ECONOMIC%20AND%20FINANCIAL%20POLICIES14 05 20100.pdf*, last visited 7 July 2011.

[25] See the update Greek Memorandum of Economic and Financial Policies and the fourth update of the Memorandum of Understanding on Specific Economic Conditionality of 2 July 2011, addressed to the Eurogroup, the European Commission and the President of European Central Bank, in: European Economy Occasional Papers 82, *The Economic Adjustment for Greece Fourth review spring 2011*, Brussels July 2011, 82 etc., *http://ec.europa.eu/economy finance/publications/occasional paper/2011/pdf/ocp82 en.pdf*, last visited 16 July 2011.

[26] International Monetary Fund, *IMF Executive Board Completes Fourth Review Under Stand By Arrangement for Greece and Approves € 3.2 Billion Disbursement*, Press Release No. 11/273 of 8 July 2011, *http://www.imf.org/external/np/sec/pr/2011/pr11273.htm*, last visited 5 November 2011.

[27] Council of the European Union, Statement by the Heads of State or Govern ment of the Euro zone and EU Institutions, Brussels 21 July 2011, *http://www.consilium.europa.eu/uedocs/cms Data/docs/pressdata/en/ecofin/123979.pdf*, last visited 5 Novem ber 2011.

[28] *Ibid.*

gramme of debt exchange and buy backs. In what is essentially a bond swap plan, Greek government bonds would be exchanged into a combination of four instruments: a par bond exchange into a 30 year instrument, a par bond offer rolling over maturing Greek governments into 30 year instruments, a discount bond exchange into 30 years instruments or discount bond exchange via an insurance mechanism into a 15 year instrument.[29] By September 2011, less than 75 percent of private had indicated their inclination to sign up to the bond exchange plan.[30]

Financial assistance from the IMF and EFSF has added more debt to a country experiencing severe economic problems.[31] It is illusionary to expect that Greece will soon be able to obtain pre-crisis conditions for refinancing herself on the capital market. The 26 October 2011 summit of the Eurozone members implicitly acknowledges a *de facto* insolvency of Greece by announcing a 'voluntary' haircut of privately-held Greek bonds by 50 percent.[32] At the same time, the governments of the Eurozone area decided to raise the capital ratio of banks to 9 percent. The financial instruments of the EFSF are to be expanded by leveraging its financial resources.[33] The summit statement envisages two options. Private investors buying EFSF bonds will be offered risk insurance. Alternatively, the EFSF may establish a securitization programme through special purpose vehicles, and the bonds will be guaranteed under the insurance scheme.[34] International investors remain sceptical. On 9 December 2011, Euro area countries decided to accelerate the establishment of the permanent stability mechanism.[35]

[29] Institute of International Finance, Statement by the IIF Board of 21 July 2011, and IIF Financing Offer of 21 July 2011, *http://www.iif.com/press/press+198.php*, last vis ited 15 September 2011.

[30] See Handelsblatt on line,16 September 2011, "Banken drücken sich um Griechen Rettung", *http://www.handelsblatt.com/politik/international/banken druecken sich um griechen rettung/4617904.html*, last visited 17 September 2011.

[31] Cf. D. Marsh, *The Euro The Battle for the New Global Currency*, Yale Uni versity Press, New Haven London, New edition 2011, 288.

[32] Euro Summit Statement, Brussels 26 October 2011, *http://www.consilium.eu ropa.eu/uedocs/cms data/docs/pressdata/en/ec/125644.pdf,* last visited 4 November 2011. The 'voluntary haircut' requires an agreement between Greece, private investors and "all parties concerned" to engineer a bond exchange with a nominal discount of 50 percent on notional Greek debt held by private investors. Euro zone Member States would be pre pared to contribute to the Private Sector Involvement Package up to 30 bn Euro.

[33] *Ibid*.

[34] The envisaged financing technique is reminiscent of the so called Brady bonds of the 1970s when syndicated sovereign debt was 'securitized' by converting loan obliga tions into bonds guaranteed by United States Treasury Bills: Cf. J.M. Hays II, "The Sov ereign Debt Dilemma", *Brooklyn Law Review* 3/2010, 916.

[35] See European Council, Statement by the Euro Area Heads of State or Govern ment, Brussels, 9 December 2011, *http://www.consilium.europa.eu/uedocs/cms Data/ docs/pressdata/en/ec/126658.pdf*, last visited 15 December 2011.

1.3. A Case for Contracting? – Outline of the Paper

Sovereign bonds are the flipside of government spending. Prior to the 1980's, syndicates of large commercial banks used to organise capital flows solicited by the borrowing countries.[36]. Nowadays, the vast majority of funds for emerging countries originate from bonded debt.[37] Conventional wisdom suggests that contracting with sovereign borrowers is riddled with enforcement problems. The Argentine experience reveals that in the face of default lenders have two strategy options: They may either opt for litigation or restructure debt by negotiation.[38]

Contracting is a crucial ingredient of any issue of sovereign bonds as specific clauses in a sovereign debt instrument may impact on its price.[39] Lenders devise their bond indentures to avert debtor opportunistic behaviour and make restructuring more costly: Securitised borrowing with collateral-like instruments creates obstacles for restructuring negotiations.[40] Credit rating agencies[41] and private organisations of derivatives traders have established *de facto* reputation mechanisms disciplining, both sovereign borrowers and lenders.[42] Enforcement by reputation mechanisms may be perceived as a market-friendly attempt to perform under a debt contract, but it may also disguise lobbying by interest groups for the best deal in the vicinity of a sovereign insolvency. After the Argentine crisis, sovereign debt restructuring has become a tripartite process, involving creditors, the government of the borrowing country and the IMF insisting on conditionality.[43] In the context of Greece's mounting debt, financial assistance and negotiations on a restructuring scheme are entangled in a complex web of private and public law rules where na-

[36] Cf. P.R. Wood, "Essay: Sovereign Syndicated Bank Credits in the 1970s", *Law and Contemporary Problems* 4/2010, 31.

[37] G. Lipworth, J. Nystedt, "Crisis Resolution and Private Sector Adaptation", *IMF Staff Papers* 47/2001, 190.

[38] For a detailed analysis see R. Olivares Caminal, in: R. Olivares Caminal *et al.*, *Debt Restructuring*, Oxford University Press 2011, 387 etc.

[39] See *infra*, sub III.2.

[40] G. Lipworth, J. Nystedt, "Crisis Resolution and Private Sector Adaptation", *IMF Staff Working Papers* 47/2001,190.

[41] Cf. C.M. Bruner, "States, Markets, and Gatekeepers: Public Private Regulatory Regimes in an Era of Economic Globalization", *Michigan Journal of International Law* 1/2008, 125, 136 etc.

[42] See W.M.C. Weidemaier, "Contracting for State Intervention: The Origins of Sovereign Debt Arbitration", *Law and Contemporary Problems* 4/2010, 336, 353 etc., on 'contracts as tools to shape state behaviour'; see generally on reputation mechanisms as an element of sovereign 'respect' for contractual obligations: M. Tomz, *Reputation and International Cooperation Sovereign Debt across Three Centuries*, Princeton University Press, Princeton Oxford 2007, 14 etc.

[43] Cf. W.W. Bratton, G.M. Gulati, "Sovereign Debt Reform and the Best Interest of Creditors", *Vanderbilt Law Review* 1/2004, 3.

tional governments, the EU Commission, the IMF and private lenders are prominent actors. The EU's 2011 summits suggest that the relationship between state actors and the financial institutions may best be characterised as a prisoner's dilemma where repeated games will produce a minimum of cooperative behaviour.

In the following, proposals for mandatory restructuring mechanisms will be assessed prior to traditional litigation. The analysis will then focus market-oriented approaches towards sovereign debt restructuring. Market-mechanism will be monitored as private creditors seek insurance by entering into sovereign credit default swaps. A section on the future of private creditor renegotiation concludes.

2. MORE LAW THAN PRAGMATISM

2.1. Mandatory Instruments: The Sovereign Debt Restructuring Mechanism

In 2002, Anne O. Krueger of the IMF made a proposal on sovereign debt restructuring which was intended to improve the restructuring process, thereby strengthening the architecture of the global financial system.[44] Krueger's analysis focuses on the shortcomings of a bargaining process which suffers from considerable collective action problems. At the heart of her plea to make sovereign debt more attractive is the fundamental distinction between contractual and statutory approaches to crisis management.[45] Borrowing heavily from the corporate reorganisation model of US law, Krueger set out to propagate a mandatory mechanism, envisaging majority restructuring, stay on creditor enforcement during restructuring negotiations, protection of creditor interests while allowing for priority financing by fresh money.[46] The upshot of this new restructuring procedure is the role designed for the IMF. Based on the IMF's responsibilities for providing adequate safeguards, the IMF would acquire a central role in endorsing a stay on creditor action upon the request of a sovereign debtor. In order to trigger an extension of the stay, IMF would have to determine that the debtor country has started to implement the conditionality, making also progress with the creditors. Finally, the effectiveness of a restructuring agreement would have to be conditioned on IMF approval. Krueger's policy recommendations have never been im-

[44] Anne O. Krueger, *A New Approach To Sovereign Debt Restructuring*, Interna tional Monetary Fund, Washington, D.C., April 2002, *http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf*, last visited 18 July 2011.

[45] See analysis by B. Eichengreen, "Restructuring Sovereign Debt", *Journal of Economic Perspectives* 4/2003, 83 etc.

[46] Krueger, 11, 14 etc.

plemented because IMF members resented the *dirigiste* approach, discrediting freely negotiated settlements. Within less than a year after the publication of Krueger's report, the IMF had entered the camp of supporters of collective action clauses as a tool to defuse hold-up situations.[47] The IMF deserves, however, credit for initiating a debate on how much governmental suasion is permissible before a negotiated restructuring of sovereign debt turns into a mandatory one which credit rating agencies and other private institutions resent.

2.2. Litigation – Incentives and Obstacles[48]

The IMF's proposal on mandatory elements for restructuring procedures never sought to bar private creditors from taking a sovereign borrower to court.[49] In fact, the IMF implicitly acknowledges the potential of contracting for sovereign debt *ex ante* as much as it resents the 'poison pill effect' for rescheduling processes. A combination of relaxed standards for sovereign immunity and sovereign preference for quasi-voluntary restructurings[50] has provoked a vigorous strategy of creditor self-defence.[51]

Under the United States Foreign Sovereign Immunities Act of 1976 (28 USC § 1602) a foreign state shall not be immune from domestic jurisdiction, *inter alia*, if the foreign state has waived its immunity or, if the action in court is based on a commercial activity carried out in the United States by the foreign state.[52] When Argentina waived her sovereign immunity in several jurisdictions, she may have improved the marketability of bonds, but she also became more vulnerable to private litigation from

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47 See the comparative study: IMF, International Capital Markets, Legal and Poli cy Development and Review Departments, *Collective Action Clauses: Recent Develop ments and Issues*, Washington, D.C. 25 March 2003, *http://www.imf.org/external/np/psi/2003/032503.pdf*; and IMF, Policy Development and Review, International Capital Markets, and Legal Departments, *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework*, Washington, D.C. 1 August 2003, *http://www.imf.org/external/np/pdr/sdrm/2003/080103.pdf*, last visited 18 July 2011.

48 For a comprehensive survey see R. Olivares Caminal, in: R. Olivares Caminal *et al.*, 389 etc,

49 Landgericht (District Court) Frankfurt Main, judgment of 14 March 2003, *Die Deutsche Rechtsprechung auf dem Gebiete des Internationalen Privatrechts im Jahre (IP Rspr.)* No. 199/2003, 651 etc.

50 Cf. A. Gelpern, "Domestic Bonds, Credit Derivatives, and the Next Transfor mation of Sovereign Debt *Symposium: Law and Economic Development in Latin Ameri ca: A Comparative Approach to Legal Reform*", *Chicago Kent Law Review* 1/2008, 172, on 'quasi voluntary' exchange offers.

51 For an Argentine litigation perspective: C.M. Wilson, "Note Argentina's Repa ration Bonds: Analysis of Continuing Obligations", *Fordham International Law Journal* 3/2005, 821 etc.

52 28 USC § 1605 (a) (1), (2).

creditors[53] who had bought on the primary and secondary markets.[54] In the US, bondholders rely on class actions in order to engineer a more favourable outcome of restructuring proceedings.[55] In spite of Argentine protestations that a class action proceeding might jeopardize ongoing negotiations, US courts have certified a class action even though they were aware that some members of the class might opt-out at a later stage if an attractive restructuring offer would be made.[56] One court recognised the trade-off between a class action proceeding and restructuring negotiations: It pledged to accelerate the claim procedure to determine the participants in a class action.[57]

Apart from class action specificities, similar rules exist under German rules of civil procedure, as interpreted in the light of customary public international law.[58] When Argentina issued bonds she left the area of sovereign immunity. She could be taken to German courts. German courts could not take notice of temporary stay of payments imposed under Argentine law, if the choice of law clause in the indenture provided for the application of non-Argentine (i.e. German) law.[59] Moreover, as long as Argentina acted within the framework of private law, she was not entitled to raise a defence of a state of necessity in order to escape her payment obligations under a debt contract.[60] Private creditors are entitled to take

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[53] Parallel developments were observed in the field ICSID arbitrations: The *mere* possibility of arbitration may have incentivised some bondholders to abstain from restruc turing negotiations: M. Waibel, *Sovereign Defaults before International Courts and Tribu nals*, Cambridge University Press, Cambridge 2011, 320.

[54] Cf. Lavaggi v. The Republic of Argentina, 2005 WL 2072294 (S.D.N.Y., 2005); Urban GmbH v. The Republic of Argentina, 2004 WL 307293 (S.D.N.Y., 2004); J.E. Fisch, C.M. Gentile, "Vultures or Vanguards: The Role of Litigation in Sovereign Debt Restructuring", *Emory Law Journal*, Special Edition 2004, 1088 etc.

[55] See the court's obiter in Seijas *et al*. v. The Republic of Argentina, 606 F. 3d 53 (57) (2nd Cir., 2010): "*... the hunt for assets capable of satisfying Argentina's obligations to plaintiffs is at present a predominant concern and is common to all members of the classes"*.

[56] See Brecher v. The Republic of Argentina, 2009 WL 857480 (S.D.N.Y., 2009); Urban GmbH v. The Republic of Argentina, 2006 WL 587333 (S.D.N.Y., 2006); Urban GmbH v. The Republic of Argentina, 2004 WL 307293 (S.D.N.Y., 2004); Applestein v. The Republic of Argentina, 2003 WL 21058248 (S.D.N.Y., 2003).

[57] See report by J. García Hamilton, R. Olivares Caminal, O.M. Zenaruzza, 27 *Loyola of Los Angeles International and Comparative Law Review* 2/2005, 265 etc.

[58] *Bundesverfassungsgericht* (Federal Constitutional Court), decision of 8 May 2007, *IPRspr.* 2007 No. 125, 344 etc.; *Bundesgerichtshof* (Federal Supreme Court), deci sion of 4 July 2007, *IPRspr.* 2007 No. 126, 353 etc.

[59] *Landgericht* Frankfurt Main, judgment of 14 March 2003, *IPRspr.* 2003 No. 111, 329.

[60] *Bundesverfassungsgericht*, decision of 8 May 2007, *IPRspr.* 2007 No. 125, 344 etc.; *Oberlandesgericht* (Court of Appeal) Frankfurt judgment of 13 June 2006, *IPRspr.* 2006 No. 105, 205. In another case, the Oberlandesgericht Frankfurt/Main explicitly re

Argentina to court even though this may slow down the country's financial restructuring.[61]

3. MARKET ELEMENTS IN SOVEREIGN DEBT

3.1. Credit Rating Agencies – Informational Intermediaries

Sovereign bond ratings transmit signals to the market which are decisive for pricing the risk associated with government debt. Ratings affect a sovereign's ability to borrow as they translate into interest rates which, in the case of Greece, had become unsustainable.[62] There is a direct spill-over from sovereign ratings to bond and CDS spreads.[63] Risk premiums in the Euro zone differ considerably, making arbitraging between government bonds highly attractive.[64] Moreover, ratings transmit signals to the market, operating as benchmarks for credit institutions whether to hold sovereign debt or to sell on secondary markets in order to fulfil their Basel II obligations.[65]

Credit rating agencies have been accused of ignoring a fundamental conflict of interest in performing their role as gatekeepers of information: They are paid by the issuers to whom they supply advice.[66] In fact, even governments accept that they have to pay for being assigned a rat-

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fers to the stand arrangement with the IMF which had enabled Argentine to resume re structuring processes: decision of 16 February 2006, juris.

61 *Oberlandesgericht* Frankfurt, decision of 6 June 2008, *IPRspr.* 2008 No. 107, 352.

62 Cf. S.L. Schwarcz, "Private Ordering of Public Markets: The Rating Agency Paradox", *University of Illinois Law Review* 1/2002, 11 fn 69.

63 R. Arezki, B. Candelon, A.N.R. Sy, *Sovereign Rating News and Financial Mar kets Spillovers: Evidence from the European Debt Crisis*, International Monetary Fund, IMF Working Paper WP/11/68, March 2011, *http://www.imf.org/external/pubs/ft/wp/2011/wp1168.pdf*, and A. Afonso, D. Furceri, P. Gomes, *Sovereign Credit Ratings and Financial Markets Linkages Application to European Data*, European Central Bank Working Pa per Series No. 1347, June 2011, *http://www.ecb.int/pub/pdf/scpwps/ecbwp1347.pdf*, last visited 18 July 2011.

64 For a study on risk premiums in pre crisis times see K. Bernoth, J. v. Hagen, L. Schuknecht, *Sovereign Risk Premia in the European Government Bond Market*, European Central Bank Working Paper No 369, June 2004, *http://www.ecb.int/pub/pdf/scpwps/ecbwp369.pdf*, last visited 4 November 2011.

65 See P. Van Roy, *Credit Ratings and the Standardised Approach to Credit Risk in Basel II*, European Central Bank Working Paper Series No. 517, August 2005, *http://www.ecb.int/pub/pdf/scpwps/ecbwp517.pdf*, last visited 21 July 2011; and D.E. Alford, "Core Principles for Effective Banking Supervision: An Enforceable International Financial Standard?", *Boston College International and Comparative Law Review* 2/2005, 289 etc.

66 F. Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeep ers*, University of San Diego School of Law Research Paper No. 07 46, May 2006, *http://papers.ssrn.com/sol3/papers.cfm?abstract id 900257*, last visited 4 November 2011.

ing.[67] The reputation of credit rating agencies has suffered considerably since the collapse of the Lehman Bank Group. Agencies were accused of announcing excellent ratings even though the writing of Lehman's downfall could be read at the wall. Nonetheless, it is crucial to reflect on the function of sovereign ratings as they are intended to assure market efficiency in the market for sovereign debt prior to insolvency.[68] Current ratings agencies proceed on a multi-item evaluation process[69] which may include interviews with officials of the sovereign if permission has been given.[70] Ideally, rating agencies should serve as intermediaries transmitting standardised information on sovereign borrowers to the market.[71] This is not to portray the role of credit rating agencies in an overly optimistic manner. But it is noteworthy, that standard setters and international credit institutions rely on ratings in order to structure their portfolios and to calibrate the liquidity and minimum capital reserves.[72] The ECB and central banks of the Member States of the EMU have a vital interest in relying on external ratings:[73] External ratings supply these institutions with a tool to maintain their independence from political lobbying. If the ECB and national central banks were to switch to exclusive in-house rating methods, political pressures to deliver favourable sovereign ratings are likely to increase dramatically.[74]

[67] N. Gaillard, 36.

[68] Cf. S.S. Schwarcz, "Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach", *Cornell Law Review* 4/1999 2000, 993 maintaining that private funding will reduce moral hazard only if the IMF allows the market to work. Arguably, the main field of operation for credit rating agencies is the pre default phase of sovereign debt finance.

[69] Standard & Poor's, *Sovereign Government Rating Methodology And Assumptions*, Ratings Direct on the Global Credit Portal, 30 June 2011, *http://www2.standardandpoors.com/spf/pdf/japanArticles/1204866805563.pdf?vregion jp&vlang jp*, last visited 18 July 2011, Fitch, *Sovereign Ratings Rating Methodology*, *http://www.fitchratings.com.bo/UpLoad/methodology.pdf*, last visited 18 July 2011; for a detailed analysis see N. Gaillard, 39 etc.

[70] Fitch, *Sovereign Ratings*.

[71] Cf. the critical assessments by W. Gerke, C. Merx, "Chancen und Nutzen von Finanzmarktregulierung", *Festschrift für Klaus Jürgen Hopt zum 70. Geburtstag* (eds. S. Grundmann *et al.*), De Gruyter, Berlin 2010, 1844, 1848 etc., and D. Zimmer, "Rating Agenturen: Reformbedarf nach der Reform", *Festschrift für Klaus Jürgen Hopt zum 70. Geburtstag* (eds. S. Grundmann *et al.*), De Gruyter, Berlin 2010, 2692 etc.

[72] See the policy statements by the Financial Stability Board, "Financial Stability Board publishes principles to reduce reliance on CRA ratings", Press Release No. 48/2010 of 27 October 2010, *http://www.financialstabilityboard.org/press/pr 101027.pdf*, and id., Principles for Reducing Reliance on CRA Ratings, 27 October 2010, *http://www.financialstabilityboard.org/publications/r 101027.pdf*, last visited 16 July 2011.

[73] For a detailed analysis of the use of ratings for regulatory purposes Basel Committee on Banking Supervision, The Joint Forum, *Stocktaking on the use of credit ratings*, June 2009, *http://www.bis.org/publ/joint22.pdf*, last visited 7 November 2011; passim N. Gaillard, 186.

[74] See interview with President J. Weidmann of the German Bundesbank, in: *Die Zeit*, 14 July 2011, 24.

Sovereign ratings are the cornerstone of a system of bond contracts, credit default swaps and signalling devices which private lenders have devised to stave off a premature restructuring of sovereign debt. Credit rating agencies contribute to maintaining the reputation of 'credit event clauses' for the benefit of private lenders as long as moral hazard does not settle in.[75] Realistically, this system does not foreclose a sovereign default, but it drives up the price for a sovereign default in current Europe.[76] Involuntary restructurings, including 'haircuts', will trigger 'credit event clauses' under sovereign bond and CDS contracts. As a consequence credit rating agencies should downgrade the rating of the respective debtor country, thereby threatening financial institutions which bought or insured debt of the embattled government.

3.2. How to Address Collective Action Problems

US Treasury officials classified the IMF's proposals for a mandatory sovereign default as a challenge to market-based mechanisms.[77] The then US government began to campaign for having collective action clauses inserted into sovereign bond contracts in order to avoid creditor hold-up during negotiations for restructuring sovereign debt.[78] Collective action clauses which required a super-majority to reform the debt instrument won the favour of those attacking creditor hold-up and resolution schemes imposed by *fiat*. In 2003, Mexcico and Uruguay became the countries to issue bonds under New York law which incorporated collective action clauses.[79] In addition to its Mexican counterpart, the Uruguay bond indenture included aggregation rules and provided for a weak-trustee structure.[80] These bond indentures build on the insights of a report prepared in 2002 by a working group of the G 10.[81]

[75] Private risk strategies are, of course, more refined. In devising their strategies, investors will go beyond the mere observance of sovereign debt ratings. R. Maronilla, K.D. Anderson, "The Changing Landscape of Global Sovereign Risk", *Journal of Inter national Business and Law* 1/2011, 99.

[76] The 'voluntary haircut' envisaged by the Euro Summit Declaration of 26 Octo ber 2011 does not come without a price for the public budget as governments had to offer certain guarantees to private lenders: J. Aumüller, "50 Prozent sind nicht immer die Hälfte", *Süddeutsche Zeitung on line*, 27 October 2011, *http://www.sueddeutsche.de/wirt schaft/ergebnisse des bruesseler gipfels prozent sind nicht immer die haelfte 1.1174557*, last visited 4 November 2011.

[77] R. Quarles, "Herding Cats: Collective Action Clauses in Sovereign Debt The Genesis of the Project to Change Market Practice in 2001 Through 2003", *Law and Con temporary Problems* 4/2010, 30 etc.

[78] *Ibid.*, 35 etc.

[79] J.M. Hayes II, "Note The Sovereign Debt Dilemma", *Brooklyn Law Review* 3/2010, 922 etc.

[80] *Ibid.*, 925 etc.

[81] Group of Ten, *Report of G 10 Working Group on Contractual Clauses*, 26 Sep tember 2002, *http://debtagency.be/Pdf/gten08.pdf,* last visited 9 July 2011. See also the

The report by the G 10 working group is motivated by the quest for "effective procedures to resolve sovereign debt crises expeditiously". In order to facilitate an early dialogue with the sovereign borrower, the working group proposes the appointment of a bondholder representative to negotiate modifications of the bond instrument which would have to be ratified by the bondholders themselves. A supermajority clause in the indenture would ensure that the payment terms could be amended. In order to facilitate majority voting, the G–10 report distinguishes between amendments which reform payment terms and other terms. For the latter, a quorum of 66 2/3 is considered sufficient. The G–10 report expresses sympathy for aggregation clauses, but prefers a master agreement such as a medium-term programme in order to co-ordinate creditor behaviour.

Gelpern/Gulati find that collective action clauses as such do not produce signalling effects as to the quality of a sovereign debt instrument.[82] However, in the context of the Greek crisis, collection action clauses impacted on the prices of sovereign bonds. There is empirical evidence on how an EU and IMF-sponsored bail-out may set the wrong incentives for future contracting: Choi/Gulati/Posner have studied the pricing terms in Greek sovereign debt contracts.[83] In scrutinising the contractual stipulations of Greek government bonds, they found that the majority of indentures were subject to Greek law whereas only five percent had a choice of law clause for English law.[84] The stipulations of English law bonds offered better protection (including collective action clauses) from involuntary restructuring than their Greek counterparts.[85] Choi/Gulati/Posner find a discernible difference in yields from English and Greek law bonds. This spread was found to increase when, in November 2009, the probability of restructuring Greek sovereign debt increased.[86] Conversely, this spread disappeared when the 2010 bail-out by the EU and the IMF was announced. This suggests a subsidizing effect for the benefit of those creditors who had accepted riskier terms at the expense of those who had opted for risk management through private ordering.[87]

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comparative study by the IMF, International Capital Markets, Legal and Policy Development and Review Departments, *Collective Action Clauses: Recent Developments and Issues*, 25 March 2003, *http://www.imf.org/external/np/psi/2003/032503.pdf*, last visited 4 November 2011.

[82] A. Gelpern, M. Gulati, "Public Symbol in Private Contract: A Case Study", *Washington University Law Review* 7/2006, 1712.

[83] S.J. Choi, M. Gulati, E.A. Posner, "Pricing terms in sovereign debt contracts: a Greek case study with implications for the European crisis resolution mechanism", *Capital Market Law Journal* 2/2011, 163 etc.

[84] *Ibid.*

[85] *Ibid.*

[86] *Ibid.*

[87] *Ibid.*

The Choi/Gulati/Posner paper sends a complicated message. It alerts to potential moral hazard of EMU sovereign debtor who might delay restructuring because its co-partners have made it understood they are prepared to save the monetary union.[88] It also emphasises the risk of opportunistic creditor behaviour. Those who were better protected *ex ante*, might be tempted to extract a higher price *ex post* if they realise that monetary union and credit institutions of systemic importance are to be preserved at (almost) any cost. Conversely, if they are pressurised into burden-sharing in a restructuring, they will only oblige if appropriate incentives are given. Currently, private ordering for sovereign debt, diligent financial intermediaries (credit rating agencies) and concerns about bank liquidity largely offset efforts to impose a mandatory restructuring. Politicians tend to obscure, however, that a renegotiation of sovereign debt (i.e. a restructuring) basically entails the creation of a public good.[89] Sovereign lenders are required to bear the cost for the production of the public good.[90] They will only do so if the incentives to invoke a collective action clause are appropriate and negative external effects can be ruled out.[91] Insights from secured transactions and securitisation processes suggest that a voluntary restructuring is predicated on adequate securities, but not on a bail-out.[92]

4. CRISIS MANAGEMENT BY THE IMF AND THE EUROPEAN UNION

4.1. IMF – The Legal Framework

Under art. V (3) (a) of the IMF Agreement stand-by arrangements shall assist fund members to solve their balance of payments problems provided that the provisions of the Agreement and adequate safeguards for the temporary use of the general resources of the Fund are observed.[93] Stand-by arrangements are based on a letter of intent by the member country and an approval of the IMF setting out the terms of payments as a measure to support the policies and intentions as specified in the letter

[88] See generally on government moral hazard: J. Tirole, *Financial Crises*, 76 etc., 97 etc.

[89] R. Schmidtbleicher, *Die Anleihegläubigermehrheit*, Mohr Siebeck, Tübingen 2010, 45 etc.

[90] *Ibid.*

[91] Cf. *ibid.*, 63 etc.

[92] When collective action clauses were introduced, the Clinton Administration came to consider collective action clauses as an alternative to bail outs: A. Gelpern, M. Gulati, 1666.

[93] See Articles of Agreement of the International Monetary Fund *http://www.imf.org/external/pubs/ft/aa/index.htm*, last visited 13 July 2011.

of intent which sets out the terms of the payments, referring to the policy commitments setting out the sequence of payments.[94] Stand-by arrangements typically cover a period of 12 to 24 months, but in view of their temporary character may not exceed a total of three years.[95]

In deciding on a stand-by arrangement the IMF proceeds on a case-by-case analysis, depending on a member country's financing needs, its capacity to repay and history of using IMF resources.[96] Financing under stand-by arrangements (i.e. loans) has been used in crisis situations and is usually conditioned on members implementing significant policy adjustments. They will be paid out in tranches and allow for continuing IMF country reviews as the members anti-crisis plan proceeds.[97] Due to the technique of stand-by arrangements the IMF assumes a crisis prevention-resolution role,[98] and leaves an important mark on domestic policies of the applicant member.[99] IMF lending schemes are closely associated with conditionality. The Fund will not commit to a stand-by arrangement unless a guideline for macroeconomic and structural policy adjustments has been negotiated with the applicant member country.[100] Over the years the IMF has refined its conditionality, combining macroeconomic policy measures with specific efficiency criteria.[101] It has been recommended that the Fund should avoid overambitious timetables for implementation which are doomed to fail.[102] The conditionality for stand-by arrangements has been devised as an *ex post* policy instrument.[103] However, the financial crisis has demonstrated that an IMF *ex post* conditionality may create moral hazard problems if the solvency of the applicant member country will not be re-established.[104] Under these circumstances, it may be more

[94] J. Gold, 45.

[95] IMF, *IMF Stand By Arrangement*, Factsheet, 31 March 2011, *http://www.imf.org/external/np/exr/facts/sba.htm*, last visited 13 July 2011.

[96] *Ibid*.

[97] See IMF, Statement by the European Commission, the ECB and the IMF on the Fifth Review Mission to Greece, Press Release No. 11/359, 11 October 2011, *http://www.imf.org/external/np/sec/pr/2011/pr11359.htm*, last visited 4 November 2011.

[98] IMF, *Review of the Fund Facilities*.

[99] Cf. J. Morgan Foster, "Note The Relationship of IMF Structural Adjustment Programs to Economic, Social, and Cultural Rights: The Argentine Case Revisited", *Michigan Journal of International Law* 2/2003, 620 etc.

[100] IMF, *IMF Conditionality*, Factsheet, 18 March 2011, *http://www.imf.org/exter nal/np/exr/facts/conditio.htm*, last visited 13 July 2011.

[101] IMF, Policy Development and Review Department, *Review of the 2002 Condi tionality Guidelines*, 3 March 2005.

[102] *Ibid*.

[103] IMF, *IMF Conditionality*.

[104] O. Jeanne, J.D. Ostry, J. Zettelmeyer, *A Theory of International Crisis Lending and IMF Conditionality*, IMF Working Paper WP/08/236, October 2008.

efficient to announce *ex ante* under what circumstances a country would qualify for financial support from the IMF.[105]

4.2. European Union

4.2.1. Temporary Crisis Management

In order to stabilise monetary union, European Union relies on specific treaty provisions on monetary and economic policy. Although the language of the Treaty is comprehensive, Denmark and the United Kingdom have invoked a right to opt-out of monetary union. Other Member States which might eventually qualify for the introduction of the Euro are classified as "Member States with a derogation".[106]

With respect to the economic policy of the EU, art. 122 (2) TFEU specifies the circumstances under a Member State may apply for financial assistance from the Union. Thus a Member State which is in difficulties or seriously threatened with severe difficulties caused, *inter alia*, by exceptional circumstances beyond its control may be granted Union financial assistance from the Council of Ministers upon a proposal from the Commission. This provision has to be read in conjunction with art. 125 TFEU, which the President of the German Bundesbank classifies as a prohibition of sovereign bail-outs.[107] Under art. 125 (1) TFEU neither the Union nor a Member State shall be liable for or assume commitments of central governments, regional, local or other public authorities, or any public undertaking of any Member State without prejudice to mutual financial guarantees for the joint execution of a specific project. Moreover, overdraft facilities or any other credit facility with the European Central Bank or with the central banks of the Member States in favour of Union or Member State public bodies are outlawed (art. 123 (1) TFEU). Unless based on prudential considerations, privileged access by Union or Member public bodies are proscribed (art 124 TFEU). Art. 21 of the Protocol on the Statute of the European System of Central Banks and of the European Central reiterates this policy approach for the decision-making process of the ECB. The Protocol expressly bars the ECB and national central banks from the direct purchase of debt instruments issued by Union insti-

[105] *Ibid.*, see also Banco de España, Documentos Ocasionales No. 0804, 2008, 10, 73.

[106] See Article 139 (1) TFEU: *"Member States in respect of which the Council has not decided that they fulfil the necessary conditions for the adoption of the euro shall ... be referred to as "Member States with a derogation.""*

[107] J. Weidmann, *The crisis as a challenge for the euro zone*, Speech at the *Verband der Familienunternehmer* (Association of Family Enterprises), Cologne 13 September 2011, *http://www.bundesbank.de/download/presse/reden/2011/20110913.weidmann.en.pdf*, last visited 4 November, and id., Finanzmarktreform: Was wurde erreicht, was bleibt zu tun?, Speech at the *Bayerischer Finanzgipfel*, Munich 27 October 2011, *http://www.bundesbank.de/download/presse/reden/2011/20111027.weidmann.pdf*, last visited 4 November 2011.

tutions, central governments or other public bodies, or undertakings of Member States.

When Greece suffered the first round of illiquidity in spring 2010, the Council of Ministers moved to step up Union efforts to ensure financial stability and to establish a medium rescue mechanism. The May 2010 plan for crisis management pretends to operate in accordance with the letter of framework of Union law, but also side-steps the prohibitions of bail-outs. In fleshing out art. 122 (2) for Union assistance to Member States, the Council of Ministers founded a (temporary) European Financial Stabilisation Mechanism (EFSM) which was intended to provide loans or a credit line to a Member State in distress.[108] The EFSM is modelled after Union legislation for non-euro Member States with balance of payments problems.[109] The EU Commission finances the EFSM assistance programme by contributions from Euro zone Member States and by issuing bonds on behalf of the Union. The proceeds from the sale of bonds will be disbursed as Union loans to the applicant Member State. The EU Commission has repeatedly placed bond issues in order to raise EFSM funds for Ireland, Romania and Portugal.[110] When the EFSM was launched, EU issuing notes received their AAA rating from major credit rating agencies.[111] When sovereign risk problems became more pressing there was some concern whether the sheer existence of AAA-rated bonds would not accelerate the down-spiralling of bonds issued by high-risk Member States.[112] Assistance under the EFSM scheme is predicated upon strict conditionality. The recipient Member State will usually have to submit to a programme of fiscal and structural adjustments.[113]

Under the May 2010 crisis resolution measures Greece was to receive loans up to € 60 bn. The larger part of financial assistance, however, was provided by the IMF under a stand-by arrangement[114] and the newly

[108] See Council Regulation (EU) No. 407/2010 of 11 May 2010 establishing a Eu ropean financial stabilisation mechanism, *O.J.* L 118/1 of 12 May 2010.

[109] European Commission, *Communication from the Commission to the Council and the Economic Financial Committee on the European Financial Stabilisation Mecha nism,* Brussels 30 November 2010 (COM(2010) 713 final).

[110] European Commission Press Releases, *€ 5 billion bond issue for Ireland*, Brussels 5 January 2011 (MEMO/11/4); *€ 4.6 billion bond issued to assist Ireland and Romania*, Brussels 17 March 2011 (MEMO/11/180); *€ 4.75 billion bond issued for EU's assistance packages to Ireland and Portugal*, Brussels 24 May 2011 (MEMO/11/336); *Second € 4.75 billion bond issued this week to support EU's assistance packages*, Brussels 25 May 2011.

[111] European Commission Communication on the EFSM, 5.

[112] Cf. European Commission Communication on the EFSM, 9.

[113] K. Regling, Chief Executive Officer of the European Financial Stability Facili ty, *Europe's Response to the Financial Crisis*, Speech Singapore 1 December 2010.

[114] EFSF Framework Agreement between Belgium, Germany, Ireland, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland, Greece and the European Financial Stability of 7 June 2010, § 18 (1),

established European Financial Stability Facility (EFSF).[115] The EFSF is a temporary crisis mechanism to expire by 30 June 2013. The EFSF Framework Agreement of 7 June 2010 shall be construed in accordance with English law[116]. The EFSF is a *société anonyme* established under Luxembourg law.[117] Its shareholders are the Member States of the euro zone. The authorised share capital is relatively small in view of the total amount of € 440 bn of loans which the EFSF may make to Member States in distress.[118] The EFSF is to raise funds by issuing bonds, notes, commercial paper, debt securities and other financing instruments which, in turn, are guaranteed irrevocably and unconditionally be the euro zone Member States.[119] Each euro zone Member State has made a guarantee commitment in proportion to its economic strength.[120] As under the EFSM, an applicant country will have to implement the conditionality attached by the EFSF to a loan.[121] As the results of the 26 October 2011 summit of Euro zone governments still have to be translated into legal rules, the Euro area has decided to establish a new fiscal rule which is intended to introduce greater budget discipline.

4.2.2. The Treaty on the Permanent Stability Mechanism

As the crisis deepened, it became clear that the EMU needed a permanent anti-crisis mechanism. Late in November, the Eurogroup issued a statement announcing a European Stability Mechanism based on a strict conditionality programme, rigorous surveillance, private creditor participation consistent with IMF policies, junior status only to IMF loans and reliance on collective action clauses to change the terms of payment.[122] Contrary to the EFSF, the establishment of the European Stability Mechanism (ESM) requires an amendment to the TFEU.[123] The ESM

http://www.efsf.europa.eu/attachments/20111019 efsf framework agreement en.pdf, last visited 4 November 2011.

[115] Cf. K. Regling, Chief Executive Officer of the European Financial Stability Facility, *Europe's Response to the Financial Crisis*, Tokyo 11 November 2010, Speech at the DAIWA Capital Markets Conference.

[116] EFSF Framework Agreement, § 16.

[117] See European Financial Stability Authority, *Société Anonyme*, *Status Coordonés suite à un Constat d'Augmentation de Capital du* 15 *décembre* 2010, Luxembourg.

[118] *Ibid*. (chapter II), EFSF Framework Agreement, Regling, Tokyo Speech, 11 November 2010.

[119] EFSF Framework Agreement.

[120] See Annex 3 to the EFSF Agreement (Contribution Key).

[121] Regling, Singapore speech, 1 December 2010.

[122] Statement by the Eurogroup, 28 November 2010, *http://www.consilium.europa.eu/uedocs/cms data/docs/pressdata/en/ecofin/118050.pdf*, last visited 14 July 2011.

[123] See also the term sheet on the ESM, prepared by the Dutch government's *Rijksoverheid*, *http://www.rijksoverheid.nl/documenten en publicaties/verslagen/2011/03/22/term sheet esm.html*, last visited 14 July 2011.

will have a lending capacity of € 500 bn. Financial assistance from the ESM can be obtained by subscribing to a strict conditionality including a macro-economic adjustment programme and an analysis of public-debt sustainability.[124] The president of the ECB has observed that the ESM should discourage incentives for moral hazard by insisting on pre-emptive and macroeconomic adjustment.[125]

On 11 July 2011, finance ministers of the Euro zone Member States signed the Treaty establishing the permanent stability mechanism (the ESM Treaty) as an intergovernmental organisation under public international law.[126] The stability mechanism will be authorised to impose sanctions as envisaged by the European Stability and Growth Pact.[127] The new intergovernmental organisation shall be governed by a board consisting of the Ministers of Finance of the euro zone Member States with the European Commissioner for Economic and Monetary Affairs and the President of the ECB as observers.[128] The total subscribed capital of the ESM shall amount to € 700 bn which shall be raised in several instalments and by Member State guarantees.[129] It is understood that the ESM will cooperate with the IMF.[130] The Euro area governments insist on private sector participation in the Greek *de facto* sovereign insolvency while emphasizing that this scenario is highly unique and exceptional.[131]

5. WHITHER PRIVATE CREDITOR RENEGOTIATION?

In the aftermath of the Argentine default courts have adopted a more liberal approach towards the sovereign immunity defence. As sov-

[124] European Commission Press Release, *European Stability Mechanism (ESM) Q&A*, Brussels 1 December 2010 (MEMO/10/636).

[125] J. C. Trichet, *Introductory statement*, Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels 21 March 2011, *http://www.ecb.int/press/key/date/2011/html/sp110321 1.en.html*, last visited 14 July 2011.

[126] Treaty Establishing the European Stability Mechanism, *http://consilium.europa.eu/media/1216793/esm%20treaty%20en.pdf*, last visited 14 July 2011; see also European Commission News, Eurogroup Meeting, Brussels 11 July 2011, Ref. 78856, *http://ec.europa.eu/avservices/services/showShotlist.do?out PDF&lg En&filmRef 78856*, last visited 14 July 2011.

[127] European Council of 24/25 March 2011, Conclusions, Brussels 25 March 2011 (EUCO 10/11 CO EUR6/CONCL3), Annex II (Term Sheet on the ESM), *http://www.european council.europa.eu/council meetings/conclusions.aspx*, last visited 14 July 2011.

[128] *Ibid.* and Articles 5, 6 (2) of the ESM Treaty.

[129] Article 36 of the ESM Treaty and European Council Conclusions of 25 March 2011.

[130] See art 33 of the ESM Treaty and European Council Conclusions of 25 March 2011.

[131] See European Council, Statement of the Euro Area Heads of State or Government, Brussels, 9 December 2011.

ereign debt contracts came to be examined by judges (though not necessarily enforced), private lenders pursue contracting strategies to avert a restructuring situation or a coercive settlement. Realistically, this will not foreclose future sovereign defaults. But the interface between contractual stipulations about a 'credit event' and the activities of market intermediaries (such as rating agencies and professional organizations) drives up the price for a sovereign default.

Collective action clauses seek a way out of potential hold-up strategies by introducing a renegotiation mechanism. Nonetheless, collective action clauses will not deter opportunistic behaviour. The debtor may have an incentive to generate excessive crises, if creditors are pushed into co-operating in the face of an impending sovereign default.[132] Both, sovereign debt contracts and conditionalities by the IMF and the EU illustrate that moral hazard occurs when the sovereign borrower does not commit to put in an effort *ex ante*, and does not commit to bargain *ex post* either.[133] The current Greek debt crisis highlights to what extent interference by the IMF or the EU may distort the price mechanism for sovereign bond contracting and restructuring. When the ECB relaxed its rules on collateral, credit ratings became less damaging because the interface between private contracting and the signals issued by informational intermediaries was temporarily suspended.[134] It will become crucial again once the ECB tightens its rules on collateral.

Politically motivated insistence on private participation in restructuring has served to defuse the potential of private action clauses, as private lenders have found a way to extract promises for renegotiating or rescheduling bonds at acceptable rates or against securities offsetting losses.[135] As a corollary, the quest for a 'voluntary' participation has sharpened the awareness for private lenders' profit-maximising strategies, the laws of the financial markets and the role of informational intermediaries.

In addressing Greece's predicament, a series of Euro zone summits has attempted to pacify private lenders with forebodings about financial difficulties in other European countries. A combination of loans, guarantees and securitization programmes is intended to calm down the markets. But the European Union still has demonstrate that it is capable of handling national budget deficits which may translate into refinancing problems for banks and the need for additional stabilisation tools.

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[132] S. Ghosal, M. Miller, "Co ordination Failure, Moral Hazard and Sovereign Bankruptcy Procedures", *Economic Journal* 487/2003, 284.

[133] B. Eichengreen, A. Mody, *Would Collective Action Clauses Raise Borrowing Costs?*, National Bureau of Economic Research Working Paper 7458, January 2000, *http://www.nber.org/papers/w7458*, last visited 9 July 2011. For less credit worthy borrowers, advantages of orderly restructuring will be set off by moral hazard and default risk associated with renegotiation friendly loan provisions.

[134] Cf. N. Gaillard, 185.

[135] From a procedural perspective: N. Jacklin, "Addressing Collective Action Problems in Securitized Credit", *Law and Contemporary Problems* 4/2010, 182.