IS THE INSOLVENCY OF THE STATE LEGITIMATE BASIS TO SUSPEND OR REPUDIATE ON INTERNATIONAL FINANCIAL OBLIGATIONS?

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SUMMARY

The author of this article raised question if the insolvency of a State is the legitimate basis for suspension or repudiation on international financial obligations. Since there is no uniform way to deal with the issue, the attention is given to different practices and guidelines of court’s reasoning. In order to answer the legal question, prove or neglect the hypothesis and fulfill goals descriptive, analytical and comparative methods are used. The paper consists of four major parts and proceeds in the following order.

Part one provides general understanding of State as subject of international law, gives basic legal characteristics of Sovereign debt, introduces the legal definition of insolvent State and explores responsibility of the State in case of unilateral suspension or repudiation on external public debt.

The second part explores the existing judicial regulation, defines the absence of international law containing a uniform or a codified insolvency law of states and outlines the main principles applicable to the dispute resolution between insolvent Sovereign State and its creditors. This section also analyzes the frequent practice of solvency crises resolutions and sifts through main judicial problems. It is concluded that current Sovereign crisis resolution violates the main fundamental principle of the rule of law: that one must not be judge in one’s own cause. Author emphasizes that diversity among creditors creates uncertainty among all participants as to how the restructuring process will unfold and causes litigation problems. Absence of the order of priorities in creditor claims empowers insolvent Sovereign to choose the order of repayment among its creditors based not on justice but rather on its political imperatives or financing needs.

Part three is dedicated to the analysis of circumstances precluding wrongfulness in case of unilaterally breaking the debt contract by refusing to pay or suspension of payments due to states inability to pay caused by state of insolvency. It is concluded in the paper that a Sovereign State has a right to repudiate or restructure if treaty provides such a possibility, or when debt contract was illegitimate, or creditor gave its consent to non-fulfillment of obligation. Finally author draws the conclusion that insolvency can be

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legitimate basis to repudiate or suspend fulfillment of State obligation, but only under limited circumstances - when the fulfillment of financial obligation infringes the basic needs of the people of insolvent debtor state and violates their human rights.

The last part represents proposals for Sovereign crises resolution. Author analyses the benefits as well as limitations the foremost suggestions for Sovereign insolvency regulation, and makes the comparison of them.

KEYWORDS

State, insolvency, international law, insolvent state, suspension of obligation fulfillment, repudiation of obligation fulfillment;

INTRODUCTION

Inability of States to pay its debts is very actual problem in current situation of global financial crisis. Contrary to the universally recognized regulation of insolvent corporate, and in some jurisdictions insolvent private person, the issue of repudiation or suspension of international financial obligations of insolvent Sovereign State is not regulated. Unfortunately, we have no rule of law at the international level for regulating the insolvency of the State and the restructuring of government debts.

From the prospect of recurrent and uncontrolled financial crises such situation of uncertainty creates many legal problems. There is little that is fair and open about unsustainable debt procedures today - usually, when State is insolvent, disputes among debtor and creditors are resolved through an informal arrangement, where creditors are acting as judges, and representatives of debtor countries are only accepting or declining the offer advanced by the creditors. But often, because of diversity of creditor interests and the absence of collective action clauses in all bond instruments, uncertainty is created among all participants as to how the restructuring process will unfold.

Moreover, in the absence of special court, which could under rule of law deal with insolvent Sovereign, litigation and courts decision enforcement problems arise. Because of State immunity there is no enforcement mechanism for creditors to seize assets from insolvent state. And certainly, there is no creditor controls on insolvent State - turnover managers cannot be dispatched to manage the Sovereign that has defaulted on its loans. Creditors cannot easily repossess the collateral that secures their debts. Creditors cannot apply legal mechanism for transferring the assets to the creditors in the event of Sovereigns default. Importantly when a Sovereign State is insolvent, there is no bankruptcy ladder of priorities or equality clause. As well there is no discharge of the debtor, and no retribution for delinquents which repudiated due to unwillingness to pay and not due to pure inability. There is no forced disclosure except via voluntary statistics.

From a legal policy standpoint, this undefined situation creates a sense of lawlessness, which is incompatible with the concept of an international legal order. Significance of the problem of insolvent State in recent years forced academic proposals and debates in international level on Sovereign debt crisis resolution mechanisms which are briefly discussed in the paper. The foremost is the statutory proposal of Anne O. Kreuger, who
suggested amending the International Monetary Fund’s Articles of Agreement to provide a Sovereign with bankruptcy-style protection from its creditors.

The goal of this work is to give an answer to the legal question: is the insolvency of a State legitimate basis for suspension or repudiation on international financial obligations? The aim of this research is to affirm or to negate hypothesis that the insolvency of a State is the legitimate basis for suspension or repudiation on international financial obligations. To achieve it, important tasks are set forth:

1. To analyze the specifics of State as an international subject of law, define the object of the article - insolvent Sovereign State and represent the understanding of State debt.
2. To sift through the current legal regulations, judicial practice and practices for resolving Sovereign solvency crisis.
3. To do an analysis of the right to suspend or repudiate debt repayment on the basis of State insolvency.
4. Define and analyze judicial problems in the absence of rule of law, and compare Sovereign debt restructuring proposals.

In order to be able to prove the hypothesis and fulfill goals established in this article descriptive, analytical, comparative methods are used.

1. SOVEREIGN STATE AS SUBJECT OF INTERNATIONAL LAW

1.1. CONCEPTION OF STATE AS SUBJECT OF LAW

Sovereign State is a political association with effective sovereignty over geographic area and representing population recognized as such by other states. Definition of the State is provided in the Montevideo Convention on Rights and Duties of States in Article 1: “the State as a person of international law should possess the following qualifications: a permanent population; a defined territory; government; and capacity to enter into relations with other States”\(^2\). In describing State as subject of international law, worthy is to mention protection of fundamental rights of states\(^3\) and general principle of equality among states, which is enshrined in United Nations Charter\(^4\) and in Article 4 of the Montevideo Convention on Rights and Duties of States: “states are juridically equal, enjoy the same rights, and have equal capacity in their exercise”\(^5\). These legal principles must be preserved when State exercises its rights to enter into many kinds of international agreements, or when State uses its authority to make rules that govern the people of the society in States territory. Right to exercise, within a territory, the functions of the State,

\(^2\) Montevideo convention on Rights and Duties of States (Montevideo, signed on 1933 12 26; came into force 1934 12 26), Art. 1.
\(^3\) Id., Art. 5: „the fundamental rights of states are not susceptible of being affected in any manner whatsoever”.
\(^4\) Charter of the United Nations (San Francisco, signed on 1945 06 26; came into force on 1945 10 24), Art. 2 (1); “The Organization is based on the principle of the sovereign equality of all its Members”.
\(^5\) See footnote 1: Art 4.
exclusive of any other state and subject to no other authority and the right of entering into international engagements are an attributes of State sovereignty.

An important attribute of sovereignty is its degree of absoluteness. Absolute sovereignty means that sovereign power has unlimited right to control everything and every kind of activity in its territory. In nineteenth century „according to Hinsley, <...> the conception of sovereignty, in its external dimension, had slowly become more and more absolute: "there had slowly re-emerged in the realm of political theory a disposition to force the international implications of the sovereignty of the state to absolute extremes.“

Matter-of-course that absolute and indivisible sovereignty in actual state practice could not be applied since by “they consent and in their own interest States have accepted limitations on their sovereign power under customary law and treaties.”

So, from the middle of twentieth century it has been widely agreed that State has right of relative sovereignty - Sovereigns can now often be held legally liable for breach of commercial contracts with foreign parties in the same manner as private parties. Sovereign State cannot claim that some of the agreed conditions in the Treaty infringe sovereignty of the State. This principle was also pointed out by the Permanent Court of International Justice in the SS Wimbledon case in 1923. The dispute arose due to infringement of Versailles Treaty by Germany. The question before the Court was, whether in refusing the SS Wimbledon passage, Germany had violated the terms of the Versailles Treaty. Court ruled that restrictions imposed by a treaty should not be considered as abandonment of sovereignty, moreover international agreement was an attribute of State sovereignty. So absolute sovereignty of the State is limited due to its own consent and States are held liable for breach of international obligations. The same as Sovereign is now held liable if it unilaterally breaks debt contract and refuses to pay its insolvency. It is not given the “fresh start” as in case of private or corporate insolvencies.

It is essential to take notice, that Sovereigns cannot be sued in foreign courts without their consent due to “sovereign immunity” legal doctrine. „Sovereign immunity can be

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8 The Permanent Court of International Justice case: Case of the S.S. "Wimbledon", Britain, France, Italy and Japan v. German Empire, Series A, No. 1. (August 17, 1923).
9 Facts of the case in brief: According to Article 380 of Versailles Treaty: “the Kiel Canal and its approaches shall be maintained free and open to the vessels of commerce and of war of all nations at peace with Germany on terms of entire equality”. During the war between Poland and the USSR, Germany (a party to the Versailles Treaty) refused to allow the passage through the Kiel Canal of the SS Wimbledon, an English steamer chartered by a French company, carrying a cargo of munitions and artillery stores destined for the Polish naval base at Danzig.
10 Under absolute immunity, which was the prevailing doctrine in the 19th century and in the first half of the 20th century, sovereign immunity applied even to commercial transactions between foreign states and private individuals from another state. However, a more restrictive view of sovereign immunity began to take hold after the Second World War. This view was embodied in USA in the Foreign Sovereign Immunities Act of 1976, which allows private parties to sue a foreign government in U.S. courts if the complaint relates to commercial activity. Two years later in 1978 similar legislation was adopted in the UK in 1978.
derived from the equality of sovereign nations under international law: legal persons of equal standing cannot have their disputes settled in the courts of one of them.”

Importantly Sovereign immunity can be waived. A State can enter in a contractual relationship in which it voluntarily submits to the authority of a foreign court in the event of a dispute. But it is difficult to enforce the judgment against the State: “most sovereigns are not immune from litigation, but it is still hard to use litigation to force payment”.12

It cannot be denied, that State is specific subject of law, and Sovereign immunity is the most exclusive feature of it. States can enter into contracts, ratify international conventions and by their consent accept limitations on their own sovereign power.

1.2. LEGAL CHARACTERISTICS OF THE SOVEREIGN DEBT

State as sovereign subject of law enters into different contracts, owns property, forms budgets. State budget is the plan of states income and expenses in a fixed period of time. “When expenses exceeds income - budget becomes losing. State must borrow in order to refund this difference”.15 It is essential to take notice that „when a government is considered legitimate and seems generally to represent the wishes of its people, the debt is viewed as the collective obligation of the people and should be serviced by current and future governments, as contracted. “16

The concept of "debt" is one which writers do not usually define because they consider the definition as self-evident. International Law Commission of United Nations characterized the State debt as “any financial obligation of a State arising in conformity with international law towards another State, an International organization or any other subject of international law or any other financial obligation chargeable to a State”.17

Relationship created by such an obligation involves three elements:
1) the party against whom the right lies (the debtor);
2) the party to whom the right belongs (the creditor), and

11 F. STURZNEGGER, J. ZETTELMEYER, Has the legal threat to sovereign debt restructuring become real (2006); p.10, <http://profesores.utdt.edu/~fsturzen/legal.pdf> [accessed 2009 03 04]
13 Sovereign’s income is composed of tax revenue (generally the major part of all income), profit from states property and natural resources, municipality fees, fines and ect.
14 Expenses of State budget decomposes from payments for workers of the governmental sector, state purchases, investments, debt and interest payments and ect.
15 P. Wonnacott, R. Wonnacott, Makroekonomika (vert. Zigmas Lydeka) (Litterae Universitatis, 1994), p.77
18 Creditors of the State could be grouped in 4 categories: 1) official Paris Club bilateral creditors; 2) official non-Paris Club bilateral creditors; 3) commercial creditors; 4) multilateral creditors (World Bank, International Monetary Fund).
3) the subject matter of the right (the performance to be effected).

Diagram number 1 shows the composition of the debt of a State.

![Diagram showing composition of total debt]

**Picture no 1: Composition of total debt**


Statistically developing countries owe about one third of their external debt to creditor States and to the International Financial Institutions and about two thirds to private creditors (commercial banks, insurance companies, pension funds, and other institutional investors). 20 It is necessary to emphasize, that State’s debt is any financial obligation of a

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20 But this distribution varies greatly from country to country. In general, countries with strategic raw materials or those which have reached a certain stage of industrialization have an external debt which is to a large extent held by private players (for example Brazil, Argentina, Chile, Malaysia, Turkey, and Slovakia). The poorer countries which are, or are deemed to be, without strategic mineral resources, have an external debt held to a very large extent by rich countries or multilateral institutions, which therefore have almost absolute control over the national governments. 20 It is remarkable, that Sovereign crises have usually materialized in recessions, when government and/or external debt has been large – generally over 60% of GDP (gross domestic product)– and the fiscal balance in deficit (of over 2% of GDP).
State towards another State or any other subject of international law which will be repaid by current and future governments.

1.3. INSOLVENT COUNTRIES IN HISTORICAL OVERVIEW

After 2008 9th of October, when Iceland declared inability to pay its debts, there was widely discussed that it is event without precedent. Historically there have been many defaults on external debt. Medieval history of state insolvencies was one of wars, kings and ruined Italian bankers. For example, "France defaulted on its Sovereign debt eight times between 1500 and 1800, while Spain defaulted thirteen times between 1500 and 1900." In the 19th century, most insolvencies involved defaults on international bond issues. Belligerents defaulted after World War I. Subsequently the Great Depression followed with debt crises and defaults in 1930s. The British and French governments defaulted in the 1930s, considering the needs of their peoples more important those legal obligations to creditors. In the 1980s most emerging countries defaulted. The Asian collapsed in 1998, and then crises spread to Russia. These global crises followed debates and proposals for international bankruptcy regime as an alternative for IMF bailouts. The 21st century started with the biggest collapse of all: most famous Argentina and Ecuador insolvencies. Today’s best examples are Iceland and Latvia. There has been counted that about 40 per cent of states were insolvent in period 1980-2005.

However, note worthy is to mention that insolvent country is not a new phenomenon. The idea of applying bankruptcy principles to Sovereigns goes back to Adam Smith in 1776m., who wrote: "when it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor." To summarize what have been said, insolvency of the State is not a new matter; some countries have even defaulted on their external debt several times.

1.4. DEFINITION OF INSOLVENT STATE

"The debt-claim is worth what the debtor is worth." The debt-claim is worth what the debtor is worth. To this end understanding of

22 The author of the best known proposal is Anne O. Krueger’s (the first deputy managing director of the IMF) which will be analyzed more in detail in chapter 4.
23 Adam Smith (1723 0616 – 1970 0717) was a Scottish moral philosopher and a pioneer of political economy.
when a State can be deemed insolvent must be given. Economists name numbers of criterions that ought to be used to define whenever a country is insolvent or not. Although not even one has been universally recognized – it varies from country to country, and only practically careful analysis of a country and its medium terms prospects may lead to a reasonable assessment that the country may be insolvent.

Generally usable description is that a State is insolvent when it is unable to pay its debts as they fall due. However, attention must be drawn that there is no universally accredited definition of insolvent State, as well as there are no legal criterions to describe when a State can be deemed insolvent as in case of corporate or personal insolvency. So, to make reasonable definition of insolvent State in this paper there will be introduced judicial definitions of corporate and private insolvent persons in several European Union countries (Lithuania, Germany and Finland), Russia and Ukraine. In contrast to all the countries mentioned above, only Lithuania has no bankruptcy procedure for insolvent private person. Notwithstanding the current initiatives to create one, the prepared legal project for private person bankruptcy is very widely criticized and is not yet accredited.

In Germany „Insolvency Statute“ is used for insolvency procedures. It defines insolvent private person and corporate. However Statute makes an exception for insolvent State - there are no insolvency procedures for Sovereign. In Germany insolvency is primarily connected with factual ability to pay one’s debt. Person is defined as insolvent when he is unable to pay its debts when they fall due and his property is less than his obligations. Interestingly „Insolvency Statute“ do not allow to define person as insolvent if he do not pays his debts though his financial abilities allows. In case of insolvent State such a requirement could be difficult to prove, because it can be stated that a Sovereign always can raise taxes and increase its financial ability.

In Finland bankruptcy and insolvency are regulated by 2004 “Bankruptcy Act”. Since 2004 private person, as well as corporate, can go bankrupt. The generally used definition is that a debtor can go bankrupt when he is unable to pay its debts. Insolvency is

26 According to popular theoretical economical criterion - as long as the discounted value of the country foreign debt is non-zero in the infinite limit, the country is solvent; this means only that the country cannot increase its foreign debt faster than the real interest rate on this debt. Nouriel Roubini names a lot of economic ratios to define insolvency of the state: non-increasing foreign debt to Gross Domestic Product (father GDP) ratio; non-increasing public debt to GDP ratio; external debt to exports; debt service to GDP; debt service to exports; trade balances should equal or exceed to the initial foreign debt of the country; public debt to government revenues and etc.

27 Interestingly country that may look today as insolvent may not be so at some future date. For example, a country exporting primary commodities (such as oil) may appear insolvent when the price of such commodities is depressed but may be solvent if commodity price will increase again on a sustained long-term basis.

28 Germany “Insolvency Statute” (1994 10 05, Bundesgesetzblatt 1994 I S.2866), Section 11.

29 Id., section 12.

30 See footnote 27, sections 16-17.


32 Finland “Bankruptcy Act” (2004 09 01, 120/2004; konkurssilaki), Chapter I, Section 3.
defined as status of the debtor when he cannot pay its undue debts more than temporarily.

Bankruptcy law names conditions when a person is insolvent: (1) "when he declares that he or she is insolvent and there are no special reasons for not accepting that declaration"; (2) "the debtor has discontinued payments"; (3) "has been determined in enforcement proceedings during the six months preceding the filing of the petition for bankruptcy that the debtor cannot repay the claim in full"; or (4) "a debtor, who is, or who during the year preceding the filing of the petition for bankruptcy has been, under the obligation to keep accounts, has not repaid the clear and due claim of the creditor within a week of the receipt of a reminder.". 33

In Russia also private person and corporate are subjects of insolvency and bankruptcy. 34 From 2002 definition of insolvent person is provided in federal law "About insolvency (bankruptcy)". Under Russian law insolvency is status of the debtor, affirmed by Court of Arbitration, when debtor is unable to fulfill creditor’s monetary requirements or (and) perform obligatory payments in full. In Ukraine debtor (private person as well as corporate) is insolvent if he cannot fulfill its financial obligations after three months from defined term.

In Lithuania, there are no bankruptcy procedures for insolvent private person, although definition of insolvent corporate is similar to the one used in Ukrainian law. In Lithuania “Bankruptcy law” defines corporate as insolvent when: (1) it do not fulfill its financial obligations after three months from defined term, (2) or after three months from debtors requirement to pay, if the the term was not defined in the treaty, (3) and also when unpaid debts exceed one half of corporate value which is given in its balance-sheet. 35 To summarize, the analysis of judicial definitions of insolvent corporate and insolvent private persons in European Union and not European Union countries has shown that the most widely recognized definition is that a person is insolvent when it cannot pay its debts as they fall due.

As already mentioned, there is no operating bankruptcy framework for highly indebted Sovereign. But the problem of insolvent Sovereign State is widely debated. However no one of the proposals has precisely described when a sovereign is insolvent and when it can apply for the restructuring procedure. Daniel Kaeser, a Swiss treasury official, seems to be the first author to suggest a sovereign bankruptcy mechanism strictly geared to countries that are overindebted. He defined state of insolvency by some “objective” criterion, as opposed to any country in payments difficulties. He proposes "setting a hard, statutory, solvency criterion—for example, a debt-service threshold of 25 percent of export revenues. " 37 This idea fades in the 1990s, but eventually reappears in 2001 by Anne Krueger, the foremost advocate of statutory approach of Sovereign crisis resolution: “it is

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33 Id., Chapter II, section 3.
34 Российская федерация, федеральный закон „О несостоятельности (банкротстве)” (2002 10 26, N 127-ФЗ) Глава I, Статья 1. This law replaced 1998 „Ванкротсю Акт“.
35 Id., Глава I, Статья 2.
36 Литовская Республика, закон об банкротстве (2001 03 20, Nr. IX-216), 2 straipsnis.
envisaged that a Sovereign debt restructuring mechanism would be invoked only in very limited circumstances. Specifically, when the debt burden is clearly unsustainable. In other words, the mechanism would be invoked where there is no feasible set of sustainable macroeconomic policies that would enable the debtor to resolve the immediate crisis and restore medium-term viability unless they were accompanied by a significant reduction in the net present value of the sovereign’s debt. In such cases, the country concerned would probably already have been implementing corrective policies, but would have reached the point where financial viability could not be restored without a substantial adjustment in the debt burden.”

Taking everything into account, it is assumed in this paper that Sovereign State is insolvent when it cannot pay its debts as they fall due, and there are no feasible set of sustainable macroeconomic policies that would enable the debtor to resolve crisis and restore viability, and State have been implemented corrective policies but they fail to resolve crises, and “insolvent country cannot pay its foreign debt in spite of making the maximum feasible domestic adjustment”.

1.5. RESPONSIBILITY OF THE STATE

Sovereign State cannot unilaterally repudiate or impose a temporal standstill on fulfillment of international financial obligations. But here two main questions arise: who has the power to enforce the fulfillment of such an obligation against Sovereign State? And can a State simply refuse to pay notwithstanding that there is no legal norm permitting to do so?

Due to sovereign immunity doctrine “creditors could not impose sanctions but could exclude debtor countries from international capital markets.” Despite that, only a few countries had chosen to default on its external debt due to: political pressure, fear of economic dislocation or concerns that default signals will diminish Sovereign's reputation in international capital markets. Absence of legal enforcement mechanism creates the situation that the Sovereign debtor may default on the loan simply because it is unwilling to make the required payments. In other words, the debtor may default opportunistically. That’s why uniform regulation of insolvent State is needed. „Up until World War I countries that were either unable or unwilling to repay their loans were simply occupied militarily by the creditor nations. With the emergence of Pax Americana and the Bretton Wood system (1944-71), gunboat diplomacy was replaced by subtler methods of ensuring ‘repayment morale’ among debtor nations. “ And now, creditors have few remedies when the sovereign debtor defaults on the loan: creditors may not force a sovereign debtor into involuntary bankruptcy, nor may they seek liquidation of the sovereign debtor’s assets in

39 See footnote 11, p.266.
satisfaction of the amounts due under the loan. It is emphasized in this paper, that some kind of bankruptcy framework would create benefit for both sides – the creditor and debtor.

In the absence of court which under the rule of law could enforce contract fulfillment and payment of debts, even using the judicial process to enforce its right to repayment likely will prove difficult for lenders who seek to sue a Sovereign for repayment. If the lender sues in a Sovereign court, it is unlikely that this court would rule in favor of the lender. But suing the Sovereign in another country may not be permitted because sovereign immunity unless debtor State consents. Even when Sovereigns have consented to suit, they generally are used only in a limited number of other nations (mostly, the United States and the United Kingdom).

And, even if the lender is allowed to sue the Sovereign, the success of the litigation depends largely on the lender’s ability to sue before the State has time to move the assets to another location. So, after litigation it is even more difficult to enforce the judgment against the State. It is hard to force a government to pay against its will because of “sovereign immunity” doctrine. It should be noted, that most of the assets or income that could be used for repayment purposes are located inside the State and it can limit attachable assets by locating them outside the reach of foreign courts. There are no enforcement mechanisms for creditors to seize assets in case of governmental debts. “Recent experience indicates that creditors have in general been relatively unsuccessful in devising legal strategies that have allowed them to obtain payment from defaulting nations”.42

Moreover, most sovereign lending is unsecured. And even if the lending ostensibly is secured, sovereign lenders have significantly fewer options upon default than lenders to commercial entities (or to individuals) possess. In general, sovereign lenders cannot exercise the same rights upon default that lenders can exercise when the defaulting debtor is a business or a person. For example, even if a lender has a security interest in the sovereign's oil revenue or exports, if the sovereign fails to repay the loan, the lender cannot "seize" or otherwise take over the sovereign nor can it easily seize control of oil wells or products located within the sovereign. Yet more, "unlike restructuring procedures applied to businesses or individuals, restructuring a sovereign's debt poses particular challenges: turnover managers cannot be dispatched to manage the sovereign, that has defaulted on its loans and creditors cannot easily repossess the collateral that secures their debts."43

To summarize, if the State would refuse to pay opportunistically, and even if court would decide that it is illegitimate and the Sovereign is under the obligation to pay - there is no legal enforcement mechanism to force a Sovereign to obey. Even though, most States avoid debt restructurings because of uncertainty. With no uniform framework available to restructure all debts, sovereigns cannot reasonably predict whether the restructuring will be successful and that present benefit of the default will exceed consequences of economic dislocation. Interestingly there have been a few proposals to create a legal mechanism and unified rules for debt restructurings though they all have been rejected.

42 See footnote 10: p.3-4.
43 Id.
2. CURRENT PRACTICES FOR RESOLVING
SOVEREIGN SOLVENCY CRISES

The proper functioning of fair insolvency procedure depending on the full ability of parties to defend their legal interests is topical and widely discussed issue. However, the current legal situation of insolvent State and its creditors is very indefinite. There are no legal norms or even framework defining what rights and duties have the insolvent Sovereign and its citizens against its creditors and vice versa. And consequences of State insolvency are intimidating - „countries that lack reserves to cover their maturing foreign-currency debts are vulnerable to a run. “44 When State is insolvent and operates in financial crisis: the banking system collapses and people lose their savings, inflation, interest rates and unemployment are growing rapidly, the local currency is depreciating, and so local creditors are incentivized to liquidate.

Despite that, there is no international statutory law that governs the procedures. „Current practices and procedures for dealing with Sovereign liquidity crises have evolved over the past few decades in a pragmatic and flexible manner. “45 Problems of insolvent Sovereign have been resolved through case by case application of a few broadly accepted general principles and left to evolutionary development. Most of the arrangements are informal even though the national authorities and the multilateral institutions are involved.

2.1. GENERAL PRINCIPLES

The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles: “the right of creditors to interest and repayments collides and the principle recognized generally (not only in the case of loans) by all civilized legal systems that no one must be forced to fulfill contracts if that leads to inhumane distress, endangers one's life or health, or violates human dignity.” 46

„International law contains neither a uniform nor a codified insolvency law of states. “47 So, States refusal to pay on the basis of its insolvency under current judicial regulation would be determined as violation of pacta sunt servanda rule. Supporter of this view, Vattel, already a long while ago has stated: „he who has made a promise to anyone has conferred upon him a real right to require the thing promised - and, consequently, that the breach of a perfect promise is a violation of another person's right, and as evidently an act of injustice as it would be to rob a man of his property. The tranquility, the happiness, the security of the human race, wholly depends on justice, - on the obligation of paying a

44 See footnote 11:p.16.
47 German case: German bondholders v. Republic of Argentina, 2 BvM 1-5/03, 1, 2/06, (2007 03 08).
regard to the rights of others.”\textsuperscript{48} Moreover under the Resolution “Responsibility of States for Internationally Wrongful Acts”\textsuperscript{49} such breach of international obligation is characterized as an internationally wrongful act. It is not an international agreement. And it however, leads neither to customary-law application, nor to legally binding application for another reason, but may serve as an indication of a legal conviction as is necessary to form customary law. Ultimately, it is now generally recognized in legal literature and in the view of international courts and tribunals that Articles on State Responsibility constitutes applicable customary international law.

To decide, if insolvent State is responsible for non fulfillment of international obligation, attention must also be drawn to “Agreement of the International Monetary Fund”\textsuperscript{50}, which was adopted by Member States\textsuperscript{51} at the United Nations Monetary and Financial Conference, in July 22, 1944. Agreement entered into force December 27, 1945. According to Article VIII, Section 2: „no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.” The finding is that no Member State of International Monetary Fund can unilaterally refuse to pay on the basis of its insolvency, without the approval of the Fund.

However, in order to determine whether a states refusal to pay its debts due to pure inability to pay contradicts the law, circumstances precluding wrongfulness must be evaluated. Dutch law professor De Louter stated that „a fundamental change of circumstances could negate the binding force of treaties”. The Resolution “Responsibility of States for Internationally Wrongful Acts” enumerates circumstances precluding wrongfulness: distress, necessity, and compliance with peremptory norms. But, in order to defend on one of the above mentioned basis precluding wrongfulness, the debtor must prove the causational link between payment of debt and these circumstances. And it is very difficult to do.

Debtor protection is essential feature of insolvency. “Human rights and human dignity of debtors are given priority over unconditional repayment”\textsuperscript{52} The prioritization the payment obligation and creditor’s interests to get their assets in neglecting the needs of insolvent Sovereign are unjust. It contradicts the \textit{ius cogens} of human rights. Also, it cannot be denied that enforcement of insolvent State payment obligations would risk an interruption of elementary State functions and increase the possibility to violation of human rights. Such pressure is unjust and unacceptable insofar as no equally essential interests were also at stake on the creditor side. So, it is emphasized in this paper that if the

\textsuperscript{48} E. de VATTEL, \textit{The law of nations} (no year, Chitty transl., first published 1758), p.195, thought in text; see footnote 5: p.10.
\textsuperscript{50} \textit{Agreement of the International Monetary Fund}, (Adopted 1944 07 22, the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire; entered into force 1945 12 27), Article VIII, Section 2.
\textsuperscript{51} International Monetary Fund is an organization of 185 countries. With the exception of Taiwan (expelled in 1980), North Korea, Cuba (left in 1964) Andorra, Monaco, Liechtenstein, Tuvalu, Nauru, and Kosovo, all UN member states participate directly in the IMF.
\textsuperscript{52} See footnote 10.
protection of fundamental rights of people of insolvent State are at stake – State has a right to repudiate or impose a temporal standstill on the fulfillment of its financial obligation.

And to reach this goal it is necessary to unify dispersive case practice regulating repayment of debt by insolvent Sovereign. It assumed in this thesis that undefined situation of insolvent Sovereign and its creditors could be resolved in several ways:

- By amending the International Monetary Fund’s Articles of Agreement to provide a Sovereign with bankruptcy-style protection from its creditors;
- By compulsively putting a package of new clauses in all debt contracts allowing insolvent Sovereign impose standstill or repudiate on its international financial obligations and clarifying restructuring procedures.
- By imposition of institutional reforms at the international level, to handle debt problems on a unified, international basis. It can be done by creating a new neutral and independent institution (some scholars even claim that special Bankruptcy Court in needed) or by reorganization of the existing body;
- By adoption of main insolvency principles used in corporate and private bankruptcy procedures accompanied with general legal principals in new international agreement.

To summarize, debtors cannot be forced to starve themselves or starve their children to be able to pay. Under recognized general principles of law obligation of a State towards its creditors does not take precedence over the obligation to carry out its essential domestic tasks. The obligations imposed on States cannot be greater than those imposed insolvent private individual. Finally, it is assumed in this paper that, if the debtor State proves circumstances which preclude wrongfulness and shows the link between fulfillment of financial obligation and violation of human rights, – it can be the basis to abolish debt payment.

2.2. FREQUENT PRACTICES FOR RESOLVING SOVEREIGN INSOLVENCY PROBLEM – PARIS AND LONDON CLUBS

Current practices and procedures for dealing with Sovereign insolvency crises have evolved in a flexible manner. Most of the arrangements are informal even though the national authorities and the multilateral institutions are involved. Nowadays, the usual pattern is that Sovereigns can reschedule debts they owe to other States through an informal arrangement known as the Paris Club53. Private negotiations between Sovereigns and their private commercial bank lenders often occur in an arrangement known as the London Club54. It is necessary to highlight, that currently the situation of insolvent State is resolved

53 Paris Club is a cartel of official creditors whose role is to maximize overall returns on their loans. It is a group of 19 creditor countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, United Kingdom, and United States of America. The Club was established in 1954 and meets once every 1-2 months in Paris to rule on countries with debt payment difficulties.

54 London Club often meets in New York. London Club is so named because many of their meetings in the 1980s took place there.
unilaterally by members of Paris and London Clubs. Notwithstanding difficulties to enforce sanctions of non-fulfillment of financial obligations, the common pattern is that, due to uncertainty and fear of usually more powerful creditors, just a few insolvent States have refused to pay. As a general rule, States call for Paris and London Clubs and expect longer repayment periods or debt cancellation.

Paris Club reschedules sovereign’s debt if the International Monetary Fund has certified that the country cannot meet its debt service obligations and the country agrees to comply with certain policy changes specified by the Fund. It encompasses only creditors and its decisions are taken on the basis of unanimity, granting full veto power to the one member. Two trends have emerged in the terms of Paris Club agreements: longer repayment periods\(^{55}\) and debt cancellation\(^{56}\). Banks meet in a club of their own—the London Club to coordinate their own restructuring. It tends to be lengthier and more expensive than in Paris Club. Unlike the relatively limited number of public-sector creditors involved with Paris Club restructurings, private commercial in London Club negotiations requires almost unanimous creditor consent and negotiations are less efficient than in Paris Club.

It is necessary to emphasize, that there are no criterions when a debtor State can apply for debt restructuring. As well as there are no restrictions that only insolvent countries can apply for debt revision. Also, there is no guarantee that if a debtor State is insolvent—Paris or London Clubs must take it in consideration. Notwithstanding that these non-institutions are main and mostly used opportunity for insolvent State to reduce the debt and overcome financial crisis, and that members of Paris Club declare it-self as rescuer of indebted or insolvent countries, critics accuse the Paris Club of being "secretive, arbitrary, unfair, and politically biased"\(^{57}\). There is also a view that “the Paris Club does not have any legitimacy and has not fulfilled its stated mission.”\(^{58}\)

Finally, the attention must be drawn that frequent practice of problem of insolvent State resolution through Paris or London Clubs violates the main fundamental principle of the Rule of Law: that no one must be judge in its own case. Civilized insolvency demands a neutral institution assuring fair settlements. Like all legal procedures insolvency must comply with the minimal demand that creditors must not decide on their own claims. In the absence of legal Sovereign insolvency regulation, Members of the Clubs are creditors and

\(^{55}\) The maximum repayment period is now 23 years (including 6 years of grace) for commercial loans and 40 years (including 16 years of grace) for official development aid loans;

\(^{56}\) There are several agreement terms:

a) **Toronto terms** (33.33% cancellation) - the first agreement was concluded with Mali in 1988;

b) **Naples terms** (up to 67% cancellation) – the first time implemented in 1994 on the debt of the poorest and most indebted countries;

c) **Lyon terms** (up to 80% cancellation) - the first time implemented in 1996 for the countries eligible for the initiative for “Heavily Indebted Poor Countries” (HIPC);

d) **Cologne terms** (cancellation up to 90% or more) – used when necessary to reach debt sustainability.

\(^{57}\) See footnote 11: p. 256.

judges at the same time: the greater part of the negotiating process is concerned with decision-making among creditors alone. Representatives of debtor countries are only able to play a passive role in the process, accepting or declining the offer advanced by the creditors. In conclusion is that current dispute resolution is unfair, illogical and inefficient and there are many legal problems arising due to this indefinite situation.

2.3. MAIN JURIDICAL PROBLEMS

2.3.1. COLLECTIVE ACTION PROBLEMS

One of the main problems in dealing with debt of insolvent Sovereign is diversity among investors in Sovereign bonds. The extent to which various investors hold bonds issued by any particular country differs markedly across countries, and issues of bonds and bondholders of any particular Sovereign debtor continually change as the bonds are traded in the market. Diversity of creditor interests and the absence of collective action clauses in all bond instruments create uncertainty among all participants as to how the restructuring process will unfold, because “usually changes to the bond’s maturity, scheduled interest payments, or principal repayment amount require unanimity.”

As a means of addressing this problem, the official community has made some efforts to promote the incorporation of collective action clauses into bond contracts. Notwithstanding the benefits of this strategy, it has a number of limitations. Firstly, “there is the transitional problem: a large portion of outstanding bonds with long maturities do not contain such provisions. As is evidenced by the terms of a number of recent bonds issues, sovereign debtors facing a crisis actually prefer to exclude such clauses as a way of demonstrating to creditors their firm commitment to pay on the original terms.”

Secondly, collective action clauses only “bind bondholders within the same issue.” Moreover, collective action clauses have no effect on bondholders of other issuances. Taking everything into account, the existing bond contract law does not solve the problems of insolvent State and its creditors and it needs to be changed through unified statutory regulation.

The possibility of litigation also aggravates inter-creditor difficulties. Clearly, not all creditors are prepared to sue a Sovereign. Even those creditors that are more inclined to cooperate, will find it more difficult if they feel that their forbearance will be abused by

59 Governments usually borrow by issuing bonds. Sovereign bonds are held by different kind of banks, insurance companies, pension funds, mutual funds, retail funds, hedge funds, nonfinancial companies, and retail investors. Sovereign bonds can be classified in:

• international bonds - issued by a government in an international financial center (for example, New York, London, or Tokyo) under foreign law. There is also a specific category of international bonds - “Eurobonds”. They are issued in countries other than the one in whose currency the bond is denominated (usually in U.S. dollar) issued in a European jurisdiction (e.g., England, Germany, or Luxembourg),

• domestic bonds - issued in the debtor country under domestic legislation.

60 See footnote 10: p.17. Sovereign can repudiate on its debt and its debt can be rescheduled if it gets unanimity (if the bond is issued under U.S. law) and supermajority (if the bond is issued under English law) and practically it is almost impossible

61 See footnote 26.

62 See footnote 37.
more aggressive creditors who will use litigation as an effective mean of extracting full payment. A 1985 court decision in *Allied Bank International v. Banco Credito Agricola de Cartago case* was widely viewed as illustrating both - the possibility that a single creditor might “hold out,” and the tenuous nature of protections against the claims of such a creditor. In 1981, Costa Rica had suspended debt payments to a 39-member bank syndicate. A restructuring agreement was subsequently reached with all creditors, except one, Fidelity Union Trust of New Jersey, which sued through an agent, Allied Bank. In 1984, a U.S. Court of Appeals initially upheld a lower court ruling in favor of Costa Rica, arguing that “Costa Rica’s prohibition of payments of its external debt is analogous to the reorganization of a business pursuant to Chapter 11 of our Bankruptcy Code. Costa Rica’s prohibition of payment of debt was not a repudiation of the debt but rather was merely a deferral of payments while it attempted in good faith to renegotiate its obligations.” However upon rehearing the case, the court reversed and ruled that “The Costa Rican government’s unilateral attempt to repudiate private, commercial obligations is inconsistent with the orderly resolution of international debt problems.”

To summarize, this case one more time approves that current practice of treatment with insolvent Sovereign obligations is very contradictory. Two courts of the same country in the same case took separate positions. So, without unified judicial regulation it is clear that not only different countries with different legal traditions, but even courts of the same State get confused, and this judicial vacuum needs to be fulfilled. It is emphasized in this paper, that the ruling of U.S. Court of Appeals is much more corresponding to general legal principles. Court compares prohibition of payments of the State to the reorganization of a business procedure. And notwithstanding big differences of corporate and Sovereign State as subjects of law, it is assumed in this thesis that it is legitimate to confer a right to “fresh start” upon a Sovereign, as it is already done in case of corporate and even in some jurisdictions in case of private insolvent persons. In corresponding to the problem of diversity among creditors it is assumed in this paper that problem would be best addressed through unified statutory regulation.

### 2.3.2. ORDER OF PRIORITIES FOR CREDITOR CLAIMS FULFILLMENT

When a Sovereign State is insolvent, there is no bankruptcy ladder of priorities or equality clause. A priority structure is beyond debtor discretion – “sovereignty uniquely empowers a government to choose the order of repayment among its creditors based on its political imperatives, financing needs, reputation concerns, or any other considerations.” A formal insolvency regime typically sets out, in general terms, how different types of claims on a distressed private company will be treated in a restructuring and the order of payment in the event of liquidation. Internationally recognized bankruptcy law principles (which are as well entrenched in Lithuanian Republic corporate bankruptcy law),

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law and Lithuanian Republic corporate restructuring law\(^{64}\) usually indicates: employers and taxes get paid ahead of most private debts. Different kinds of debts may have different levels of priority—for example, debts backed by collateral are treated better than unsecured debts\(^{65}\). These rules tell a firm’s creditors where their claims stand in order.

In contrast, no formal rules of priority lay out how different types of claims on a distressed Sovereign will be treated\(^{66}\). A court also has no power to force a Sovereign government to respect any rules of priority. Different creditors will argue that their claims should be given priority—so, the relative standing of various claims on a Sovereign government is often ambiguous. Since insolvent Sovereign usually is unable to grant absolute priority\(^{67}\) to many—if any—creditors, the debate is usually focused over relative priority\(^{68}\). Interestingly to mention that despite present legal vacuum of bankruptcy framework for Sovereign states, under Paris Club debt revision procedures there is generally recognized, though unwritten rule, that International Monetary Fund gets money from the country debtor first. *Most sovereigns do respect a number of informal rules, avoiding total chaos. The priority traditionally granted to creditors like the IMF, the World Bank, and other multilateral development banks is almost always respected*\(^{69}\).

However, these informal rules leave a lot of controversy—should domestic creditors be treated better or worse than external creditors, or should private external creditors have priority over other governments. It cannot be denied that a transparent, enforceable priority system for Sovereign debt could reduce the risk of involuntary subordination, the attraction of lending to over indebted governments, and make restructuring less messy.

The extraordinary aspect of State insolvency is that it operates in a legal vacuum without a bankruptcy law. To summarize all above mentioned judicial problems, it is assumed in this paper that absence of insolvent State status regulation cause problems for both, creditor and debtor, and creation of insolvency procedure is needed to eliminate this judicial gap.

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\(^{66}\) Noteworthy is to mention that in some countries, certain public entities are subject to an insolvency regime. Municipalities in the United States, for example, are subject to Chapter 9 of the US bankruptcy code.

\(^{67}\) **Absolute priority** means that claims at the top get paid in full, those in the middle get paid in part, and those at the bottom get nothing.

\(^{68}\) **Relative priority** assures only those at the top of the priority structure better treatment than those at the bottom and nobody may get paid in full.

\(^{69}\) See footnote 11: p.250.
3. ANALYSIS OF CIRCUMSTANCES PRECLUDING WRONGFULNESS IN CASE OF SUSPENSION OR REPUDIATION ON INTERNATIONAL PUBLIC DEBT

3.1. GENERAL CONDITIONS WHEN A STATE CAN REPUDIATE

The State, whenever it is insolvent or not, can abolish the fulfillment of financial obligations when:

1. **Treaty provides possibility to repudiate or restructure.** Generally if the borrower and lender agree *ex ante* how to adjust payments in the event of negative shocks, there is no need to renegotiate the contracts *ex post*, when crisis occurs. However, it is difficult to specify and foresee all potential economic shocks and contingencies in a debt contract. The 1969 Vienna Convention on the Law of the Treaties\(^{70}\) in articles 54 and 56 entrenched the possibility to withdraw from the payment of financial obligations justly – that is under provisions of the treaty or by consent of the parties. Convention also gives conditions when a financial obligation based by a treaty containing no provision regarding termination, denunciation or withdrawal can be lawfully suspended or terminated: (a) when “it is established that the parties intended to admit the possibility of denunciation or withdrawal; or” (b) “a right of denunciation or withdrawal may be implied by the nature of the treaty”.\(^{71}\)

2. **Creditor State gave its consent to non-fulfillment of the interest obligation:** In cases relating to interest on a debt imposed by an international instrument, wrongfulness of the conduct adopted by a State is precluded where the State, towards which it had an obligation, explicitly or implicitly gave its consent to non-fulfillment of the obligation\(^ {72}\). However, “the consent of the State must be valid in international law, clearly established, freely given and really expressed (which precludes merely presumed consent), internationally attributable to the State and anterior to the commission of the act to which it refers”.\(^ {73}\) Decision of the permanent Court of Arbitration of 11 November 1912 in the *Russian Indemnity case* between Russia and Turkey\(^ {74}\) is a good example\(^ {75}\). The Permanent

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\(^{71}\) Id., Art.56.

\(^{72}\) Responsibility of States for Internationally Wrongful Acts, Resolution 56/83 (2002 01 28, United nations), Art.20;

\(^{73}\) See footnote 16: p 112.

\(^{74}\)Permanent Court of Arbitration case: Russian Claim for Interest on Indemnities, Russia v. Turkey, (1912, Hague).

\(^{75}\)Facts of the case in brief: Under the Treaty among States (of 27 January 1879), Turkey was required to pay an indemnity to Russia in reparation for damage suffered by the latter during the Russo-Turkish war. Since Turkey was not in a position to make immediate payment of the entire amount, it spread the payment over a period of more than 20 years, until 1902. In 1891, the Russian Government made a formal demand to the Ottoman Government for payment of the principal plus interest, but when the subsequent installments were paid, the creditor Government made no
Akvilė Mockienė, „Is the insolvency of the state legitimate basis to suspend or repudiate on international financial obligations?” Teisės apžvalga Law review No. 1 (6), 2010, p. 16-52

Court of Arbitration, to which the dispute was submitted, decided: „the Imperial Ottoman Government was under an obligation to the Imperial Russian Government for the payment of moratory compensation as from 31 December 1890/12 January 1891, the date of receipt of a demand for payment that was explicit and in due form. However, inasmuch as the rights of the Imperial Russian Government under that demand for payment had in fact been extinguished as a result of the subsequent waiver by its Ambassador in Constantinople, the Imperial Ottoman Government is now under no obligation to pay interest to it according to the dates on which payment of the indemnity was effected“\(^76\). The Court found that Russia’s consent was lawful, although it would otherwise have constituted a breach of an international obligation incumbent on Turkey.

3. **Debt contract was illegitimate.** There are certain debts which are not expected to be repaid because the debt itself is “against the law or not sanctioned by law, unfair, improper or objectionable, or infringes some public policy.“\(^77\) It is assumed that „illegitimate debt consists of loans which were improperly granted and are thus the liability of the lender and are not to be repaid“.\(^78\) Doctrine of odious debts was universally recognized after the United States seizure of Cuba from Spain in 1898 when Spain demanded that the United States to pay Cuba’s debts, and the United States refused, on the grounds that the debt had been imposed upon the people of Cuba without their consent and by force of arms. The concept of odious debt was also recognized in 1998 by the British House of Commons International Development Committee when it wrote that “the bulk of Rwanda’s external debt was incurred by the genocidal regime which preceded the current administration.“\(^79\) Outstanding arbitration ruling was also given by United States Supreme Court Chief Justice Taft in 1923. The case was about a Costa Rican dictator, Frederico Tinoco, who was overthrown and the new government renounced to repay loans made by the Royal Bank of Canada to the Tinoco government. The renouncement was made on the ground that it is not a State’s debt, but a personal debt of F. Tinaco. Judge Taft ruled in favor to Costa Rican Government and pointed out that: “the bank knew that this money was to be used by the retiring president, F. Tinoco, for his personal support.“\(^80\) Preeminent ruling was made by Federal Judge Dr Jorge Ballesteros in Argentina’s debt case. In 1976 – 1983 when military junta was in power in Argentina foreign debt rose from $8 billion to $46 billion. In 2000 Federal Judge Dr Jorge Ballesteros ruled that the debt contracted during the dictatorship was illegal and illegitimate.

reservation as to interest and did not apply any part of the amounts received to interest. It was only in 1902, upon completion of the payments, that Russia demanded the payment of moratory interest, which the Ottoman Government refused to make.

\(^76\) See footnote 73.
\(^80\) See footnote 40.
To summarize, State can refuse to pay, when debt contract was illegitimate, creditor explicitly or implicitly gave its consent to non-fulfillment of the obligation, or parties from the beginning agreed how payments will be adjusted in case of insolvency. This is applicable whenever a state is insolvent or no.

3.2. ANALYSIS OF CIRCUMSTANCES WHICH SHOULD PRECLUDE WRONGFULNESS IN CASE OF STATE INSOLVENCY

3.2.1. STATE OF NECESSITY

State of necessity is a general legal principle which sets the boundaries of the enforceability of claims— in particular with regard to the protection of life and health of people of insolvent State. “Invocation of state necessity is recognized in customary international law in those legal relationships which are exclusively subject to international law.” In case of non fulfillment of international obligation, Sovereign State can claim that its conduct was not wrongful because adopted in situation of economic necessity. “As necessity is a defense of last resort, it would be necessary to establish that the debtor state exhausted all other possibilities to avert the economic crisis and to protect the social rights of its people before it could succeed with the defense”. In Article 25 of State Responsibility, state of necessity is described as a grave and imminent peril for an essential interest of the State could not otherwise be avoided and the defense is only available where the state did not contribute to the situation of necessity it finds itself in.

A defense of economic necessity was invoked by Argentina when it defended itself in court proceedings brought by bondholders in Germany to enforce payment on Argentinean bonds that had been in default. Argentina relied on its inability to pay because of economic crisis. The arguments raised by Argentina were that economic necessity is a recognized defense in public international law and is directly applicable to the relationship between the Argentinean state and its private German creditors. In the view of the Republic of Argentina, „necessity was said to apply if major state interests were at risk. It was not possible to objectively define these interests in a manner that would be universally valid, but it was not necessary for the existence of the state itself to be at stake in order to justify necessity. State insolvency was said to be a vital interest that was worthy of protection. If a state was insolvent, the ability to perform all state purposes was said to be impaired. It was said to follow from international jurisprudence and doctrine that a state could also invoke state necessity if it were in dire economic and financial straits. Moreover, “a State cannot, for example, be expected to close its schools and universities and its courts, to disband its police force and to neglect its public services to such an extent as to expose its

81 See footnote 46.
84 Id.
community to chaos and anarchy merely to provide the money wherewith to meet its moneylenders, foreign or national."\(^{85}\) The obligation of a government to ensure the functioning of its essential public services must take precedence over an obligation to pay its debts.

Question of economic necessity as a defense in international law was referred to Federal Constitutional Court of Germany. The Court in 2007 8\(^{th}\) of May ruled that "no general rule of international law is ascertainable which entitles a state to temporarily refuse to meet private-law payment claims due towards private individuals by invoking state necessity declared because of inability to pay"\(^{86}\). In certain case, the German Constitutional Court discussed the existence and scope of economic necessity in international law. The majority of the Court reasoned that while customary international law recognized the principle of economic necessity as a defense between states, neither a rule of customary international law nor a general principle of international law could be established that would allow a state to rely on economic necessity in its dealings with private creditors. But courts ruling only explain that insolvency of the Sovereign cannot be the basis to refuse to pay the debt when creditor is a private person. However, attention must be drawn that there is still an open question left whatever the defense of state of necessity can be enforced in disputed among sovereign state creditor and sovereign state debtor.

Dissenting Judge Lübbe-Wolff disagreed with the majority’s interpretation and came to the conclusion that necessity is not only a recognized rule of customary international law, but also a general principle of international. Under his considerations, "prioritization of fundamental responsibilities towards a state’s own citizens permits a state to temporarily refuse to make payments to other states in a period of necessity"\(^{87}\).

The conclusion, attention must be drawn that necessity is a temporary defense. It is assumed in this paper that necessity should be an admissible plea when dealing with insolvent Sovereign. But it should have certain limitations which have not been fixed with sufficient clearness. It is emphasized that once the necessity no longer exists - the State should have to repay the debt. In such a manner legitimate expectations of creditors would not be infringed, and dishonest debtor States would be prevented from unjust enrichment.

3.2.2. WHEN SOVEREIGN CAN REPAY DEBT ONLY AT THE EXPENSE OF NEGLECTING THE BASIC SOCIAL NEEDS OF THEIR PEOPLE

Debt repayment obligations of many developing countries often exceed their economic possibilities\(^{88}\). From a legal perspective, debtor States might have a right, or even

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\(^{85}\) This statement, submitted by the government of South Africa to the Preparatory Committee of the 1930 Hague Conference for the Codification of International Law, thought in text: see footnote 45.

\(^{86}\) See footnote 46.

\(^{87}\) Id.

\(^{88}\) In order to analyze the debt obligation correctly, the question how countries are repaying the debt must be asked. Practically most loans are in the currencies of industrialized countries, and under IMF and World Bank structural adjustment policies, countries were forced to devalue substantially. For
be under an obligation, not to repay their debt where they can only do so at the expense of neglecting the basic social needs of their people.

Legal analyzes will be started with international human rights documents: The Universal Declaration of Human Rights, the International Covenant on Economic, Social and Cultural Rights, and national Conventions. In international level social rights of a human have been widely protected. Article 25 of The Universal Declaration of Human Rights grants the right to an adequate standard of living, “including food, clothing, housing and medical care and necessary social services”, as well as the right to social benefits in cases of need, Article 22 - “the economic, social and cultural rights indispensable for his dignity and the free development of his personality”, Article 26 - and “the right to education”89. International Covenant on Economic, Social and Cultural Rights guarantees the right to social security (Article 9); to social protection (Article 10); to an adequate standard of living and to food (Article 11); to the highest attainable standard of health (Article 12), and right to education (Article 13)90. In many states, similar rights are also guaranteed by their national constitutions. However, in order to claim, that due fulfillment of financial obligations is related to violation of social rights, the effects and causation link must be proved, what is often difficult to do.

There is a view that creditor state must take responsibility, because loans made to developing countries did enrich them. If fulfillment of financial obligation forces to move funds from securing basic social needs or citizen to pay the debt for rich country, the fulfillment of such obligation could be deemed due unreasonableness and therefore invalidity or unconstitutionality, which the State would have the burden to rebut. However, another view is that debt owned by debtor is creditor’s property and by the contractual obligation it must be repaid. It has been argued that states that assume international obligations must be expected to meet those and defend them against demands to adopt policies that would violate their international obligations.

The proponents of this view also note that foreign creditor (who is not bound by legal or moral obligation) is forced to assume the bill for the protection of the social rights of the people of the debtor state. Moreover, “it has been argued that to enable debtor states to avoid debt repayment by relying on their social rights obligations would be tantamount to an unjustified forced transfer of resources.”91 Contradictors of this view claim, that creditor state is not forced to pay the bill of protecting social rights of debtor state, he just is expected to accept that the debt will not be repaid at the expense of the protection of the core of social rights of the people in the debtor country. If comparing with bankruptcy procedures for private persons in national laws, over-indebted individuals would be deprived of the means to satisfy their basic needs if they were forced to repay their debts. Additionally, rights to basic social needs of people of the debtor state cannot be abolished.

example, Mozambique devaluation was so rapid that between 1986 and 1990 the interest rate in local currency was 123%.

89 The Universal Declaration of Human Rights (Geneva, 1948 12 10), Art 22.
due to inability of representatives of debtor state to withstand the pressure of usually economically and politically more powerful state or corruption of representative.

Remarkable example is the Argentinean Zero Deficit Act which was enacted in July 2001, when Argentina was already in a very grave economic and social situation. “This statute introduced a policy according to which every month the effective tax income would first be used to service the interests of the debt, and the remaining balance would then be dedicated to other public expenditures. It empowered the executive to reduce, inter alia, pensions and the salaries of public employees if public spending exceeded the State’s assets.”[^76] The statute was nullified as unconstitutional by the Supreme Court. This was partly based on considerations that resemble economic and social rights protection. The argument was based on the fact that, “as long as social rights violations occur, it would not be constitutional to use funds for purposes that are of lesser constitutional importance, including debt repayment”. The same view was expressed by judge of German Constitutional Court Lübke-Wolff in his dissenting opinion in case German bondholder’s against Argentina. He noted, that “as far as financial obligations of the state are concerned, certain fundamental tasks and obligations of the state, in particular those on which the life and health of its citizens directly depend, deserve usually to be given priority over the timely satisfaction of the interests of creditors, that is unless on the other side equally essential interests come into play.”[^46]

Given examples demonstrates that social rights-based arguments are convincing and can make difference in practice in the future. However, it must be agreed that notwithstanding the fact that above cited opinions were persuasive, there is no legal practice in recognizing the violation of fundamental rights of citizens of insolvent Debtor State as a condition allowing to terminate or to suspend the financial obligations of the State. However, it should be, because otherwise fundamental rights of people of insolvent State are violated. Finally, it is emphasized in this paper that under current legal regulation there is no legal norm permitting the Sovereign State to repudiate or suspend the fulfillment of international obligations on the basis of insolvency. And as analysis has shown the case practice is also contradictory. Even so academic debates in the legal and economic literature argue that it must be a basis, because it would be useful for both sides – debtor and creditor. Academics call for an open, fair international insolvency procedure for sovereign states, and emphasize that “under any insolvency procedure... human rights and human dignity of debtors are given priority over unconditional repayment.”[^109]

### 4. PROPOSALS FOR STATE DEBT CRISES RESOLUTION

In this section the evolution of ideas to apply bankruptcy reorganization principles to Sovereign debt crises will be described. Attention is drawn to inefficiencies

[^76]: See footnote 76.
[^46]: See footnote 46.
[^109]: Professor Kunibert Raffer of the University of Vienna, thought in text: Kris Millegan, “Paris Club is not an institution, it’s a non-institution” (2003) <http://www.mail-archive.com/ctrl@listserv.aol.com/msg109744.html> [accessed 2009 02 15]
that motivate proposals, and how proposals seek to change insolvent debtor State and creditor relations.

4.1. EARLY IDEAS ON SOVEREIGN DEBT
RESTRUCTURING

A paper by an international lawyer, Christopher G. Oechsli (in 1981), is the first publication dealing with problems with Sovereign insolvency. He calls for “better creditor coordination and the development of a formal restructuring process for international debt.”95, institution of “honorable bankruptcy”. He explicitly invoked procedure which should “provide a predictable timetable for restructuring and a clear communications channel for the parties involved.”96 Oechsli emphasized three main procedures: (1) a creditor committee, (2) an independent examiner, a monitoring party which does not displace the debtor from control of its business, and (3) a formal initiation procedure with either the debtor or the creditor taking the initiative for restructuring. Oechsli suggests an alternative for IMF - the form of the creditors specifying binding arbitration procedures in their loan contracts. He also stressed on the need for the inclusion of the debtor in the process of formulation of the restructuring procedure. A formal initiation procedure with either the debtor or the creditor taking the initiative for restructuring was also one of the elements of Oechsli’s proposal, but it have never materialized because of resistance from the creditor countries.

A second notable initiative was the Debevoise (1984) proposal to use Article VIII, Section 2 of the Agreement of the International Monetary Fund Articles97 to extend legal protections to debtor countries declaring a unilateral payments moratorium. “Debevoise’s proposal is to “establish a deferral mechanism” that exploits the IMF’s power, under Article VIII, Section 2(a), to approve exchange restrictions.”98 To deal with the problem that courts might still not recognize controls approved by the IMF, Debevoise suggests three alternative resources: (1) domestic legislation “providing that in any case in which an Article VIII(2)(b) issue is raised, a Fund decision involving the controls at issue will be determinative,” (2) making the IMF’s deferral authority part of the debt contract, and (3) an authoritative, broad IMF interpretation of Article VIII(2)(b). However, the Debevoise proposal does not seem to have had practical consequences. It has been criticized as made not to protect sovereigns during payments suspensions, but rather to promote more uniformity in the interpretation of the“Agreement of the International Monetary Fund”.

95 See footnote 36: p.472.
96 See footnote 39: p.3.
97 Agreement of the International Monetary Fund Article VIII, Section 2 reads as follows:
   a) “Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.
   b) "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. (...)”.
98 See footnote 36: p.479
However the notion that the IMF might use its powers under Article VIII, Section 2 to legalize standstills proved popular, and periodically reappears in the literature.

In 1984 Barnett, Galvis, and Gouraige presented an extensive legal analysis and proposed to impose institutional reforms at the international level, to handle debt problems on a unified, international basis. Barnett, Galvis, and Gouraige envisage a supranational, multilateral body that would be “independent from the IMF both in administration and decision making. Its powers would include the authority to: (1) convene mandatory discussions between a debtor state and its commercial bank creditors; (2) order the commencement of and preside over debt renegotiation proceedings; (3) preempt unilateral creditor suits; (4) determine fair terms of debt renegotiation and establish a ceiling on those terms; (5) preclude the parties from undertaking other renegotiation efforts; (6) permit creditor banks’ suits to proceed as a sanction against a debtor which refused to accept the renegotiated terms; and (7) require the debtor to adopt internal adjustment measures as a condition to renegotiation”.

And in contrast to Oechsli’s view, the exclusive right to initiate proceedings would rest only with the debtor State.

In 1989 Benjamin Cohen introduced his proposal which has many similarities to the one of Barnett, Galvis, and Gouraige’s proposal discussed above. B. Cohen suggested creation of a wholly new “International Debt Restructuring Agency (IDRA)” by multilateral convention which would be neutral and independent. Its primary role would be that of a facilitator, mediators and monitor. In contrast to Barnett, Galvis, and Gouraige’s proposal, it would have a more heavy-handed role if necessary: ”for example, dissenting creditors might be obliged to accept terms agreed by a qualified majority if IDRA declared the proposed settlement to be ‘fair and equitable’. "

B.Cohen’s solution to collective action problem is requirement of less than unanimous creditor support for the restructuring proposal, and if necessary the IDRA could impose a settlement as well. Coinciding with Cohen’s proposal is Raffer’s (1990) proposal that envisaged a “neutral court of arbitration”. Another proposal by Reinisch (1994) also finds a mention as the first one to advocate a supranational bankruptcy statute. The centerpiece of a little-known proposal by Daniel Kaeser (1990) is the creation of a sovereign debt workout mechanism under the auspices of the IMF or some other international agency.

The influential attitude was proposed by Jeffrey Sachs in 1995. He suggested to reorganize activities of the IMF so that it plays the role of an international bankruptcy court rather than an international lender of last resort to member governments. “He argues that the IMF’s existing mandate to approve exchange rate restrictions under Article VIII (2) (b) of its charter might give it legal cover to sanction payments moratoria, adding that “of course, more directly, the Articles themselves could be amended.”

Sachs’s innovation consisted in taking a much broader view of the problems that a bankruptcy mechanism might help resolve the solvency crises. J. Sachs established the base for IMF sanctioned standstills and administrative priority of new private lending. His suggestions had a widespread impact to the G-10 paper on Sovereign Liquidity Crisis. His suggestion was
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Towards a contractual approach to orderly debt resolution which was first proposed by Eichengreen and Portes (1995) and the G-10 Deputies Working Group (1996)\textsuperscript{102}.

At the time when Sachs was delivering his lecture, the IMF Legal Department (1995) was preparing an extensive paper on how an international bankruptcy mechanism could work under IMF auspices. Their proposal provides the counterpoint to Sachs’s proposal. And, it is more specific than any of the previous studies. The paper recognizes the potential usefulness of temporary standstills, but does “not consider that it would be feasible to operate any formal mechanism for signaling the official community’s approval of a suspension of payments by the debtor. Interestingly it is the first proposal containing a detailed discussion of the desirable scope for a sovereign bankruptcy mechanism, arguing that it ought to cover domestic as well as all external debt. Admittedly, notwithstanding the fact that the Legal Department’s document served as the basis for an IMF Executive Board discussion in 1995, it did not result in any public initiative, and was never registered in public. John Chun (1996) was also the supporter of Sachs ideas. Together with Macmillan (1995) and the G-10 Working Group, Chun is one of the first authors to invoke the moral hazard argument to argue for a sovereign debt restructuring mechanism, a point not made by Sachs.

James Hurlock (1995), Eichengreen and Portes (1995), Macmillan (1995) reject a centralized international bankruptcy mechanism based on a new convention or an amendment of existing treaties, arguing that this is unfeasible and undesirable. Instead, „they seek to improve crisis resolution via legal changes in some creditor countries, IMF and debtor country policies, and changes in bond contracts between sovereign debtors and private creditors”.\textsuperscript{103} James Hurlock rejects an IMF-based bankruptcy court as a ill-suited to the role of neutral arbiter of sovereign debt disputes” because of its “political nature and voting structure.” Instead, he proposes working through the U.S. and U.K. legal systems to deal with problems of Collective Action clauses: “to close their courts on a limited basis to creditors seeking to undermine a legitimate and fair restructuring process that had been endorsed by an overwhelming majority of similarly situated creditors.”

Study by Eichengreen and Portes (1995) dismissed the of closing the courts to rogue creditors, as suggested by Hurlock, on the grounds that a change in statute in a single country would not solve the problem, and enacting a treaty seems unlikely given “the trend in recent years away from sovereign immunity,” as well as international human rights law guaranteeing court access. The most influential idea among Eichengreen and Portes’s proposals was to use majority clauses in debt contracts as the main device for overcoming creditor collective action problems in the aftermath of a debt crisis. By pushing for the universal adoption of such clauses, Eichengreen and Portes became the fathers of what is now referred to as the “contractual approach” to orderly crisis resolution.

Rory Macmillan (1995) is also concerned with coordination problems among bondholders. His own proposal comprises two main elements: first, the creation of an international bondholder council (or several national bondholder councils in the major financial centers, each representing the holders of bonds issued there); second, addressing

\textsuperscript{102} Id.
\textsuperscript{103} See footnote 36: p.487
the free rider problem among bondholders, through one of two alternative solutions. His second approach is to “engineer solidarity” among bondholders by changing some of the rules under which creditors could sue. He proposes: (1) “a sharing obligation imposed by simple legislation” that would force bondholders to share payments received from a court judgment with other bondholders; (2) legislation requiring that “all legal actions over the bonds be consolidated into a single legal action”; and (3) a legal minimum threshold of bondholders to bring a suit. This threshold would need to be sufficiently high to solve the free rider problem (Macmillan reckons that 10 percent would be sufficient)

4.2. CURRENT DEBATE – STATUTORY VERSUS CONTRACTUAL APPROACHES

Currently the focus has been on two prevailing approaches to legal reform—contractual and statutory. The contractual approach aims to change the restructuring process by changing the provisions in existing debt contracts. The statutory approach would create a body of international law to govern the restructuring of at least the sovereign’s external debts—in some proposals, all of the sovereign’s debt. 104 These proposals are discussed below.

4.2.1. THE STATUTORY APPROACH

The IMF’s First Deputy Managing Director Anne Krueger in 2001 (in 2002 the proposal was upgraded) proposed amending the IMF’s Articles of Agreement to provide a sovereign with bankruptcy-style protection from its creditors105. The IMF makes the initial judgement on the unsustainability of the sovereign’s debt and then borrower State gets a legal protection for a limited period while negotiating restructuring in return for pursuing corrective action. “The criteria that would guide the Fund’s endorsement of the request could be a determination that: (i) even with effective implementation of policies, the member’s debt burden is unsustainable and that there are limited prospects for future market access, and (ii) the member is implementing a Fund-supported program or is actively negotiating such a program.”106 After suspension of payment, the member is expected to work with the IMF on the development of an appropriate economic adjustment policy framework. As the framework would need to have the force of law throughout the world, this could best be achieved by creation of a treaty obligation through an amendment of the IMF’s Article of Agreement. Anne Krueger gives four guiding principles of the model:

1. **Stay on creditor enforcement** – creditors are prohibited from taking “action that would disrupt negotiations prior to a restructuring agreement.”107

2. **Protecting creditor interests** – there must be the assurance that debtor State is negotiating in good faith and refrain from any measures that would prejudice creditor interests: firstly, the sovereign debtor would be required not to make payments to no

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104 See footnote 11:p.308.
105 See footnote 36: p.8.
106 Id: p.10.
107 See footnote 31.
priority creditors; secondly, there would have to be assurances that the debtor would conduct policies in a fashion that preserves asset values.

3. **Priority financing** - Anne Kreuger asserts that a mechanism for existing creditors (who stand to benefit from preserving asset values) is needed to give those providing new money some degree of seniority. Under the existing legal framework, however, individual creditors have no incentive to provide new money in such circumstances, as the benefits would be shared among creditors as a group, and there would be no assurance that the new financing would not also get caught up in the restructuring.

4. **Majority restructuring** - "the mechanism would need to be able to bind minority creditors to a restructuring agreement that has been accepted by the requisite majority."\(^{108}\) From the perspective of creditors, such a mechanism would provide confidence that any forbearance exercised by the majority when agreeing to a restructuring would not be abused by free riders who could otherwise press for full payment after an agreement was reached. From the perspective of the Sovereign, the resolution of these collective action issues will make it more likely that it will be able to reach early agreement with creditors on a debt restructuring.

The adoption of Sovereign debt restructuring mechanism (SDRM) has advantages and disadvantages. It is able to deal with multiple issues of bonds and its applicability to existing debt, it "would reduce the costs resulting from litigation following any default and may speed up the restructuring process."\(^{109}\) Many creditors may favor a mechanism that is both orderly and predictable. This would facilitate the pricing and management of risk. Creditors with long-term commercial interests would presumably favor a mechanism that supports orderly adjustment and prevents a grab race, and thereby helps to preserve asset values. A restructuring negotiated by the supermajority of creditors would be binding on all creditors subject to the restructuring. The debtor state would have protection from disruptive legal action by creditors while negotiations were under way. However, the SDRM offers no formal procedure to involve small or retail investors in the negotiations and, instead, offers a legal mechanism designed to reduce their power. A substantial limitation of the SDRM is its failure to address intercreditor fairness in the restructuring process -the majority creditors are the ones who negotiate. SDRM suggests that a sovereign's domestic debt be excluded from the restructuring process; creditors outside the sovereign's borders reasonably questioned whether such a system would permit the sovereign to treat, unfairly and favorably, its domestic debt\(^{110}\). The proposal was also criticized as leaving too much power with the creditors and its attempts to give IMF a special role - it is clearly unacceptable because IMF is one of the creditors. SDRM create some sort of international bankruptcy court - a judge or some type of official would resolve...

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\(^{108}\) Id.

\(^{109}\) See footnote 37: p.10.

disputes among creditors but, unlike the bankruptcy process, the judge would not evaluate the substantive terms of the restructuring for fairness. There is a view that “similar crisis should be treated similarly, but not all crises should be treated in the same way”.111

The SDRM was not accredited.112 Some concluded that the SDRM was rejected because it would make restructuring too easy and ultimately would raise the price of credit. Subsequently followed (and they still continue) calls to create a code of conduct that might make it easier for a sovereign debtor to reach agreement with its creditors113. The conclusion is that the failure to enact a statutory system to restructure sovereign debt may suggest that the international community is still unwilling to adopt a unified global response to insolvency issues. Notwithstanding that the SDRM failed to gain support, it does not mean that sovereigns and their creditors would reject all statutory approaches or that a contractual approach would be more effective than a well designed statutory approach.

4.2.2. THE CONTRACTUAL APPROACH

In this approach, sovereign borrowers and creditors put a package of new clauses in their debt contracts. „Collective Action Clauses (CACs) involve provisions or contingency clauses placed in sovereign bond issues and other debt instruments, such as bank loans. Unlike other proposals tabled at the official negotiations, CACs are not only more decentralized, but also grant private-sector creditors, and their respective national judicial systems, far more control over their outstanding foreign public debts.“114 The author of this proposal is John Taylor, undersecretary for international affairs at the U.S. Treasury.

Contractual approach has its advantages and disadvantages. It avoids the shortcomings of a more intrusive regulatory solution. However the insertion of CACs into new issues of bonds does not address concerns regarding existing bonds. Due to the long-term nature of sovereign bonds, the full utility of CACs would not be realized until a considerable point in the future. CACs address the coordination problem caused by the fact that an increasing percentage of sovereign debt is held by dispersed public investors. But “they offer little help in dealing with coordination and collective action problems in a country like Argentina, which is attempting to restructure 152 different bond issues involving seven different currencies and the governing laws of eight different countries.”115

111 See footnote 11: p. 21.
112 The model proposed a treaty framework that would create, and then implement, the SDRM by amending the IMF’s Articles as long as three-fifths of IMF’s member governments that had eighty-five percent of the total voting power voted in favor of the amendment. Because the United States holds over seventeen percent of the voting power and currently does not support the SDRM, even if all other members endorsed the SDRM, it cannot be enacted until U.S. officials endorse it and Congress approves it. US Treasury Undersecretary John Taylor alleged that that immediate action to introduce new contractual provisions into sovereign debt contracts is needed but not a bankruptcy mechanism.
113 The leaders of the proposition of a code of conduct to guide a sovereign debt restructuring were both the Banque de France and the Institute of International Finance.
114 See footnote 77.
This approach permit a majority or supermajority of bondholders to change the payment terms of an issue of bonds and lessen the problem of creditor coordination by allowing the debtor to negotiate with representatives of a majority or supermajority of the bondholders. CACs reduce the holdout problem by enabling a majority of the holders to force a restructuring upon a recalcitrant minority. But this creates the risk that majority bondholders will deal unfairly with the minority. Moreover CACs do not eliminate the strategic use of litigation. CACs may spawn a new class of intercreditor suits as dissenting bondholders challenge the restructuring terms imposed by the majority or supermajority of bondholders. Indeed, the uncertainty associated with judicial review of all these claims may offer a partial explanation for the failure of the market to attribute greater value to bonds subject to CACs.

Admittedly, sovereign bondholders and sovereign borrowers at first rejected this statutory approach, as it did with the IMF’s bankruptcy plan. These real parties in interest preferred the status quo. But their motives were suspect. To the extent that the status quo makes unconditional IMF bailouts more likely, the sovereigns and their lenders have reason to oppose reform, whether mandatory or contractual.

4.2.3. COMPARING IDEAS

“Despite the apparent dissonance, the approaches taken by the IMF and the US Treasury could be complementary rather than contradictory.” Common to the statutory and contractual approaches is the desire to avoid the moral hazard attributed to large scale crisis lending. Given the concern with collective action problem, both, the statutory and contractual approaches contain elements to create creditor incentives. The statutory approach proposes “changes in national and international law to create institutions and rules so as to impose majority-backed agreements on holdouts and to provide seniority to new financing.” The contractual approach proposes “the incorporation of Collective action clauses in bond contracts whereby a majority backed restructuring be imposed on dissenters.” Both the approaches, implicitly or explicitly also provide debtor incentives in the form of stay of litigation or protection from holdout creditors.

However, there remain some potential problems. While the contractual approach suffers from the problems of transition and aggregation, the statutory approach gives new judicial powers to the IMF or a bankruptcy court. The main advantage of the contractual approach is that it proposed a necessary radical institutional change. The main benefit of contractual approach is that it included a de facto standstill provision. However even a contractual approach would require changes in legislation in some major legal jurisdictions. It is possible therefore that the two approaches, statutory and contractual, work together to reform the sovereign debt restructuring in insolvent States.

118 Id.
CONCLUSIONS

According to the analyzed material, the following conclusions can be made:

- The State is very specific subject of law: it poses a right of relative sovereignty, can be sued in foreign courts only with its consent, and like an individual and unlike insolvent corporate, the insolvent State cannot be liquidated - it will continue to exist whether it repays its debts or not.
- Sovereign State is insolvent when it meets all these criterions: (1) it cannot pay its debts as they fall due; (2) there are no feasible set of sustainable macroeconomic policies that would enable the debtor to resolve crisis and restore viability; (3) State have already been implemented corrective policies but they fail to resolve crises, and (4) insolvent country cannot pay its foreign debt in spite of making the maximum feasible domestic adjustment.
- The historical analysis showed that insolvency of the State is not a new matter - some countries have even defaulted on their external debt several times.
- Most of the arrangements in case of States inability to fulfill its financial obligations are resolved through Paris and London clubs. Frequent practice of problem resolution in Paris and London clubs violates the main fundamental principle of the rule of law: that one must not be judge in one's own cause. In the absence of legal Sovereign insolvency regulation, members of the Clubs are creditors who are acting as judges in their own case.
- Obligation of a State towards its creditors does not take precedence over the obligation to carry out its essential domestic tasks.
- In case of state insolvency human rights of debtor's citizen are given priority over unconditional repayment. If the debtor State proves circumstances which preclude wrongfulness and shows the direct link between fulfillment of financial obligation and violation of human rights, – it is the basis to abolish or temporary suspend debt payment. The obligations imposed on States cannot be greater than those imposed insolvent private individual.
- State of necessity should be an admissible plea when dealing with insolvent Sovereign. But it should have certain limitations which have not been fixed with sufficient clearness. Once the necessity no longer exists - the State should have to repay the debt. In such a manner legitimate expectations of creditors would not be infringed, and dishonest debtor States would be prevented from unjust enrichment.
- All Sovereign debt crises resolution proposals were not enacted. This response means that the international community is still unwilling to adopt a unified global response to insolvency issues, but it also must be noted that all discussed proposals have their limitations and it is possible therefore that if these approaches work together, eventually it would be acceptable for both sides.
- Problem of repudiation or suspension of international financial obligations of insolvent Sovereign State could be resolved in several ways: (1) by amending the International Monetary Fund’s Articles of Agreement to provide a Sovereign with bankruptcy-style protection from its creditors; (2) by compulsively putting a unified
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package of new clauses in all debt contracts (3) by imposition of institutional reforms at the international level, or (4) by adoption of main insolvency principles used in corporate and private bankruptcy procedures accompanied with general legal principals in new international agreement.

There is no straight answer to the raised issue is the insolvency of the State legitimate basis for suspension or repudiation on international debt obligations. Under current rules of law insolvency is not the basis for non fulfillment of financial obligations. But analysis of existing controversial case practice showed that in certain circumstances violation of fundamental rights of citizens of insolvent debtor State could be the condition allowing to terminate or to temporarily suspend fulfillment of international financial obligations. It can be said that the hypothesis raised in the paper has been partially approved.

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SANTRAUKA

Darbo tikslas yra atsakyti į klausimą, ar valstybės nemokumas yra teisėtas pagrindas sustabdyti arba panaikinti tarptautinių įsipareigojimų vykdymą. Jam pasiekti naudojami aprašomas, analitinis bei palyginamasis metodai. Magistro baigiamasis darbas yra sudarytas iš keturių pagrindinių dalių.

Pirmiausia yra pristatoma valstybės kaip tarptautinės teisės subjekto samprata, bendra valstybės skolos charakteristika, pateikiamas nemokios valstybės apibrėžimas bei analizuojama valstybės įsipareigojimų atsakomybė vienašališkai sustabdydant tarptautinių įsipareigojimų vykdymą arba jų atsisakant. Nors istoriniu kontekstu nemokė valstybė nėra naujiena, tačiau net ir tuo atveju kuoas valstybė tiesiog atsisako vykdyti savo įsipareigojimus, vis dar nėra jokio teisinio mechanizmo priverčiantių ją mokėti.

Antrojoje dalyje atskleidžiama nemokios valstybės ir jos kreditorių santykių reglamentacija, aptariami bent dvi teisės principai taikyti valstybės nemokumui. Analizuojama dabartinė nemokų valstybių problemų sprendimo praktika bei atskleidžiamos pagrindinės teisinės problemas. Pastebima, kad dauguma susitarimų, susijusių su nemokios valstybės skolų mokėjimu, yra palikta evoliuciniam procesui ir nors yra buvę keletas iniciatyvų sukurti teisinę mechanizmą ir unifikuoti valstybės skolos pertvarkymo mechanizmus, jie visi buvo atmeti. Šiuo metu dauguma susitarimų dėl nemokios valstybės skolos peržiūrėjimo yra vykdomi Londono ir Paryžiaus klubuose, kur sprendimus priimine šalis kreditorės. Tuo būdu pažeidžiamas kertinis teisės principas, kad niekas negali būti teisėjo savo paties byloje.
Trečioji dalis yra skirta sąlygų, kurioms esant nemoki valstybė gali teisėtai atsisakyti vykdyti savo finansinius įsipareigojimus, analizei. Prieinama prie išvados, kad valstybės nemokumas gali būti teisėtas pagrindas sustabdyti arba panaikinti tarptautinių įsipareigojimų vykdymą, tačiau tik esant tam tikroms aplinkybėms – kuomet tarptautinių finansinių įsipareigojimų vykdymas pažeidžia pagrindinius nemokios valstybės piliečių poreikius bei teises.

Paskutinėje dalyje pristatomi siūlymai kaip galima būtų teisiškai reguliuoti nemokios valstybės ir jos kreditorių santykiai. Pateikti projektai palyginami, aptariami jų trūkumai ir privalumai.

**REIKŠMINIAI ŽODŽIAI**

Valstybė, nemokumas, tarptautinė teisė, nemoki valstybė, įsipareigojimų vykdymo sustabdymas, įsipareigojimų vykdymo atsisakymas.