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UK PARLIAMENT RESPONSES TO DEAL WITH SOVEREIGN DEBT CRISES: PROPOSALS FOR LEGISLATIVE REFORM

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Executive Summary

Developing countries are facing mounting sovereign debt burdens and financial crises. Most low-income countries (LICs) are either at high risk of, or are already experiencing, debt distress. Additionally, many developing and emerging economies (DEEs) are servicing high levels of debt at the expense of other public expenditures, including health and education. This current debt crisis has been exacerbated by deficiencies in the legal framework and governing regime for sovereign financing and the shortcomings in the international architecture of public finance.

A key area of concern is the lack of appropriate mechanisms to deal with the debt owed by sovereigns to private creditors and the reluctance of private creditors to participate in debt restructuring schemes. As most debt owed by DEEs and LICs to private creditors is governed by English law, the UK is well-placed to address the sovereign debt crisis in those countries through domestic legal responses.

This briefing outlines the challenges faced by sovereigns facing debt distress under the current international financial architecture and offers two proposals for legislative reform in the UK. These reforms aim to encourage major creditors to participate in coordinated debt restructuring schemes, ensure equitable treatment between creditors, and to enable orderly sovereign debt workouts.

Contents

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1. Sovereign Debt Restructuring: Global Challenges and the Strategic Role of English Law

Global debt burdens are currently at its highest level since records began, with DEEs shouldering the highest debt burdens.[1} The COVID-19 pandemic severely impacted DEEs that were already facing fragile and perilous conditions. The situation has been further exacerbated by climate crises and global trade disruptions, such as those resulting from the war and conflict in Ukraine and the Middle East, alongside rising interest rates by core central banks. These factors have led to a series of liquidity and solvency crises in these countries as their debt levels rapidly rise in response to these disruptions.

The scale of these crises has been exacerbated by deficiencies in the international financial architecture. Unlike corporate debtors, where established restructuring and insolvency regimes offer a structured approach to debt resolution, sovereign states find themselves in a markedly different situation. There is no parallel legal framework that provides for a structured and binding process for states to negotiate with their creditors in the face of debt distress or insolvency. Instead, the resolution of sovereign debt distress is typically navigated through debt restructuring processes that are transactional and ad hoc, involving an increasingly diversified creditor base.

Negotiations often include a variety of participants ranging from the debtor and creditor states to international organisations and corporate entities. This approach lacks any formal, binding procedures with predetermined rules of engagement similar to those found in corporate restructuring or insolvency law. At the same time, there have been no significant changes to the corresponding architecture for sovereign financing, exacerbating the liquidity crises and storing up future solvency crises in LICs and in other DEEs which will have spill-over effects on LICs due to the globalized and interdependent nature of the international financial system and global economy.

A key area of concern in the legal and regulatory architecture of sovereign debt is the absence of appropriate mechanisms to deal with the burgeoning debt owed by sovereigns to private creditors and what has been classed as 'non-traditional' or non-Paris Club bilateral creditors. The diversification of the creditor base for DEEs, especially LICs, has created significant challenges for coordinating collective action during times of sovereign debt distress over the past few years.

First, the proportion of external debt owed to private creditors has sharply increased. By the end of 2021, low- and middle-income economies owed 61 percent of their public and publicly guaranteed debt to private creditors, a 15-percentage point increase from 2010. Countries eligible to borrow from the International Development Association (IDA) saw their external debt owed to private creditors rise to 21 percent, a significant jump from 2010. Second, the share of debt owed to non-Paris Club official creditors, such as China, India, Saudi Arabia, United Arab Emirates, and others, has also significantly increased. By the end of 2021, China was the primary bilateral lender to IDA countries, accounting for 49 percent of their bilateral debt stock, a substantial rise from 18 percent in 2010.[2]

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[1] Martin, Matthew (2023), 'The Worst Debt Crisis Ever: New Data from Debt Service Watch', Briefing, 11 October 2023, Development Finance International et al.
[2] World Bank (2022) *International Debt Report 2022*, Washington DC: World Bank.

Despite the differences in profiles between bilateral official and private creditors, the legal instruments employed in their lending are largely similar, consisting of contracts governed by private law in domestic legal jurisdictions. Official bilateral lending involves mostly loan-based agreements while private lending include syndicated bank loans, other forms of commercial lending, and bonds and these different types of debt are governed by the laws of major legal jurisdictions, notably England and Wales and New York. The diversification of creditors has meant greater diversity and complexity in the contract terms and conditions and the structuring of the loan agreements, including the emergence of new and hybrid creditors that combine both official and commercial institutional features and lending terms and conditions.[3]

The shifts in the sovereign debt markets are making it increasingly challenging for sovereigns facing debt distress to effectively restructure their debt through traditional frameworks. This difficulty arises from the complexities in reaching a consensus among an increasingly diversified creditor base. Past experience with the Heavily Indebted Poor Countries (HIPC) Initiative and recent experience with the G20 Common Framework for Debt Treatments Beyond the DSSI (Common Framework)[4] and the Debt Service Suspension Initiative (DSSI)[5], illustrate that without legally binding debt standstills and/or cancellations, private creditors are less likely to participate fully and support multilateral debt relief initiatives. Additionally, the diversification of the official bilateral creditor base introduces new challenges in achieving consensus on official debt restructuring terms under traditionally recognised Paris Club comparability of treatment principles.[6]

The current debt relief mechanisms present a classic free-rider problem, where some creditors may opt not to engage in the initiative, hoping to benefit from concessions made by others. This creates a strong incentive for otherwise cooperative creditors to refuse participation in multilateral debt relief initiatives, thereby undermining the effectiveness of the arrangement as a whole. This issue is not financially neutral for the UK government, as public finance intended to support official debt relief and other financial flows to indebted countries, including concessional official development assistance (ODA), could end up being redirected to other creditors as debt repayments or service.

If current debt relief mechanisms are not complemented by statutory standstills and restructurings for sovereign debt, English courts could end up enforcing the claims of private creditors who are free riding on official debt relief initiatives, including the Common Framework and DSSI, funded by UK taxpayers. This could lead to a situation similar to what transpired to some countries in which speculative investors who purchased distressed debt of HIPCs on secondary markets were able to litigate to recover the full-face value at a later date.[7] This prompted the enactment of the UK's Debt Relief (Developing Countries) Act 2010 (2010 Act) to prevent creditors of beneficiary countries from recovering a debt amount in excess of that consistent with the HIPC Initiative.[8]

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[3] See Horn, S et al (2021), 'China's Overseas Lending' (2021), *Journal of International Economics*, Vol 132; Gelpern, A et al (2021), 'How China Lends: A Rare Look into 100 Debt Contracts with Foreign Governments', Aid Data et al, Policy Report, 31 March 2021.
[4] The Common Framework is an agreement of the G20 and Paris Club countries to coordinate and cooperate on debt treatments for up to 73 low-income countries that were eligible for the Debt Service Suspension Initiative. Only four countries – Chad, Ethiopia, Ghana and Zambia – have applied to the initiative and only Chad has concluded an agreement with its creditors since the initiative was launched in 2020.
[5] The DSSI was a scheme in place from May 2020 to December 2021 which enabled 73 LICs to request suspension of their debt service to official creditors. See World Bank (2022), 'Debt Service Suspension Initiative: Q&As', 10 March 2022.
[6] Buchheit, L and Gulati, M (2023), '*Enforcing Comparable Treatment in Sovereign Debt Workouts*' (2023) Capital Markets Law Journal, Vol 18, No 1.
[7] See Waibel, M (2007), 'Elusive Certainty: Implications of Donegal vs Zambia', International Financial Law Review, pp 31-4.
[8] HM Government (2011), 'Explanatory Memorandum to the Debt Relief (Developing Countries) Act 2010 (Permanent Effect) Order 2011'.

As a significant portion of debts owed by DEEs to both commercial and official bilateral creditors is governed by English law, this situation has important legal and political implications for the UK. The UK holds a unique position in offering effective mechanisms to address sovereign debt distress, ensuring equitable treatment to creditors and fostering global economic growth and development.

2. Domestic Legal Responses to Deal with Creditor Participation in Debt Relief Initiatives

Given that English law governs a substantial portion of the debt owed by DEEs to private and official bilateral creditors[9], the UK is strategically placed to address some of the shortcomings of the international sovereign debt architecture through domestic legal policy responses.

We propose two key legislative initiatives for the consideration of the UK Parliament to mitigate the sovereign debt crises facing DEEs, especially LICs. These initiatives are designed to encourage a more effective negotiation process among creditors and to establish a more coordinated and equitable approach to debt restructuring processes, thereby contributing to global efforts to resolve sovereign debt crises in a manner that supports sustainable development.

Legislative Proposal I: Enforcing Comparable Treatment in Sovereign Debt Restructurings

This proposed legislation addresses the challenge of enforcing the principle of comparable treatment in debt restructurings, which has historically been difficult to implement. By making this principle binding on sovereign debt obligations governed by English law, the legislation would ensure that the maximum recoverable amount of any qualifying debt by a debtor country is proportionate to the debt relief granted by official creditors under the terms of official debt relief initiatives or frameworks.

The proposed legislation would build upon the Debt Relief (Developing Countries) Act 2010, extending its mechanisms to debt treatments under the Common Framework and other arrangements specified by the Secretary of State. It would limit the recoverable amount on any qualifying debt to the level which the creditor could reclaim, assuming it provided the expected level of debt relief under a specified debt treatment. Furthermore, it would adjust the value of judgments and arbitral awards relating to debts covered by the proposed legislation to mirror the applicable debt treatment.

To support these measures, the proposed legislation would mandate a creditor to turn over any payments received from a debtor country in excess of the amount they ought to have received under the relevant debt treatment. This measure aims to prevent the misallocation of debt relief resources—often derived from ODA funding—towards servicing debts to creditors who did not partake in the debt relief effort.

Comparability of Treatment

The proposed legislation would reflect the Paris Club's principle of comparability of treatment as a baseline. In accordance with this principle, the debtor country undertakes to seek from non-multilateral creditors, particularly other official bilateral creditor countries not affiliated with the Paris Club, and private creditors (including banks, bondholders, and suppliers), a treatment on terms comparable to those outlined in the Agreed Minutes of the relevant debt treatment[10].

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[9] Debt Justice (formerly Jubilee Debt Campaign or JDC) estimates that 90 percent of bond debt owed by countries eligible for the DSSI (which includes all countries eligible for the Common Framework) are governed by English law. See JDC, 2020, 'The UK's Role in Supporting the G20 Debt Suspension', May 2020.
[10] See Paris Club (undated), 'The Six Principles'.

The 2010 Act included a provision to support this principle but the application of comparability of treatment has evolved since then. In practice, Paris Club creditors adopt a comprehensive approach in assessing a debtor's adherence to the comparability of treatment requirement, considering for each creditor type, changes in nominal debt service, net present value, and the duration of the restructured debt. Like the 2010 Act, the proposed legislation would seek to encourage not only the debtor, but now also the creditor, to engage with comparable debt relief. This includes both debt relief in the typical scenario of an insolvency crisis, where debt reduction is applied, but also in a liquidity crisis, where the focus shifts from reducing principal debt to modifying debt service terms (primarily affecting interest payments).

In instances where a debtor extends comparable terms to a creditor who subsequently initiates litigation in the UK, the debtor may request a UK court to stay the proceedings. Consistent with existing English case law[11], such a stay would be contemplated if evidence suggests that the creditor is acting against its genuine economic interests, driven by ulterior and improper motives such as state aggression, fraud, or trafficking in litigation.

The legislation can accommodate the adaptation of comparability of treatment standards to reflect evolving interpretations. The legislation would provide for the Secretary of State to specify alternative comparability of treatment standards to reflect debt treatment-specific agreements on the meaning of such treatment from time to time.

Debt Service Suspension

The proposed legislation aims to encourage debtor countries to extend offers on comparable terms to creditors not engaged in a relevant debt treatment. It would enable debtor countries, having extended such an offer to a creditor, to request a stay of UK legal proceedings initiated by that creditor, particularly when the creditor lacks a genuine economic interest in pursuing such proceedings. This stay would be facilitated through a moratorium on enforcement ('debt standstill'), targeting creditors pursuing litigation for some ulterior purpose, such as in economic furtherance of war, fraud, or as part of unjustified and speculative litigation.

This standstill in no way releases the debtor country of its debt nor does it represent a waiver or act of forbearance by the creditor. On the commencement or continuance of court or arbitral proceedings, the debtor is entitled to apply to the court for a time-limited stay of proceedings which must be granted provided that the country has taken steps to acknowledge those proceedings. The stay of proceedings has the effect of stopping the expiry of any limitation period that would otherwise bar claims, thereby safeguarding creditor rights.

Eligible Debt Treatments

Currently, only LICs are eligible to apply for debt treatment under the Common Framework, which is identified as the qualifying debt treatment under the proposed legislation. However, as previously discussed, the proposed legislation can be expanded to encompass future multilateral and bilateral debt initiatives that fulfil predetermined criteria and are designated as eligible debt by the Secretary of State. By doing so, the proposal empowers the Secretary of State to identify debt treatments not currently covered by the Common Framework.

[11] *Re Virgin Active Holdings Ltd, Virgin Active Ltd and Virgin Active Health Clubs Ltd* [2021] EWHC 1246 (Ch).

The criteria for such identification are comparable to those of the Common Framework; however, granting the Secretary of State the authority to designate a debt relief arrangement as a qualified debt treatment facilitates swift action in response to any future economic crises. Where a designated debt treatment adopts alternative comparability of treatment criteria from those used by the Paris Club, the legislation would permit the Secretary of State to specify these alternative criteria as applicable to the designated debt treatment.

Legislative Proposal II: Extending the Eligibility for Application to Corporate Debt Restructuring Mechanisms to Sovereigns

The second proposed legislative initiative seeks to extend the eligibility for application of corporate debt restructuring mechanisms to sovereigns, offering a comprehensive and effective solution to the challenge of sovereign debt distress. Under UK legislation, companies facing financial may enter into a compromise or arrangement with their members or creditors (or any class of them) to restructure their financial obligations, including any type of debt[12]. This flexible solution could be extended to sovereigns by adapting the existing requirements of the UK legislation to their unique situation.

To be eligible for a corporate debt restructuring plan, the legislation outlines three criteria, adaptable for sovereign entities:

First, the company must be susceptible to being wound up under the Insolvency Act 1986, including unregistered foreign companies. An unregistered foreign company seeking to restructure its debt in the UK must have a sufficient connection with the English jurisdiction, and the restructuring plan should be likely to achieve its purpose. The courts consider that there is a sufficient connection with the English jurisdiction where the governing law or jurisdiction clauses (or both) of finance documents are English law.[13] Applied to sovereign debt, this requirement would enable sovereigns to propose a restructuring plan to any creditors whose contracts are governed by English law. Additionally, the courts evaluate whether the proposal is likely to achieve its purpose by considering whether the restructuring will be effective in practice in binding opposing creditors into a variation of their rights.[14] In the case of sovereign debt, the effectiveness of the restructuring would be significant as it would novate the obligations of the sovereign, making the previous debt unenforceable before English courts.

Second, the company must have encountered or be likely to encounter financial difficulties that are affecting or will or may affect its ability to carry on business as a going concern. Applied to sovereigns, this requirement offers a good basis for countries in debt distress or at high risk of debt distress as per the International Monetary Fund's Debt Sustainability Assessment to propose a debt restructuring plan to their creditors.

Third, there must be a proposed compromise or arrangement between the company and its creditors or any class thereof, and/or its members or any class thereof, aimed at eliminating, reducing, preventing, or mitigating the effect of any financial difficulties in question. Similarly, a legislative reform could enable sovereigns to propose a restructuring plan to one or more creditor classes to prevent or mitigate the effect of debt distress.

[12] Part 26A of the Companies Act 2006.
[13] See for example, *Re Apcoa Parking Holdings GmbH and Others* [2014] EWHC 1867 (Ch); Re Drax Holdings Ltd [2003] EWHC 2743 (Ch).
[14] *Re Rodenstock GmbH* [2011] EWHC 1104 (Ch), at para 73.

To sanction a corporate restructuring plan, the approval of a 75 percent majority in value of each voting class is mandatory. This process, conducted within the court, necessitates the court's approval to convene meetings for voting on the proposal and to review the appropriateness of dividing creditors into classes for voting purposes.

Despite the majority requirement, the legislation contains a 'cross-class cram down' provision that allows the court to sanction the plan as binding, even if a dissenting group in a class of creditors or members results in the plan not being agreed by 75 percent in value of that class. This provision stops obstructive investors holding the debtor to ransom. However, it only applies where those creditors will be no worse off under the plan, and where another class of creditors that would have a 'genuine economic interest' in the debtor, even if the plan did not proceed, approves the plan.[15] This mechanism could be adapted to apply to circumstances where sovereigns have already agreed upon the terms of a restructuring with official creditors, such as the Common Framework.

3. Restructuring Mechanisms to Sovereigns Complementing Contractual Approaches

The legislative reforms proposed in this briefing aim to complement ongoing efforts to develop market-based and contractual approaches to managing sovereign debt crises in DEEs. While recognising the work the UK government is undertaking to encourage private sector involvement in multilateral debt relief initiatives, it is apparent that further actions are needed at multilateral and national levels to facilitate effective, timely and orderly sovereign debt restructuring processes.

Efficient debt restructuring becomes especially critical in the context of climate change, where heavily indebted countries often face severe climate impacts. These impacts, in turn, often exacerbate debt vulnerabilities.[18] Thus, the establishment of a statutory framework for debt restructuring is crucial. Such a framework should enable states facing debt distress to effectively renegotiate their financial obligations and create fiscal space, thus avoiding the current delays and uncertainties associated with restructuring processes. This approach would facilitate the allocation of resources towards critical issues, including climate change mitigation and adaptation.

We endorse the International Development Committee (IDC)'s recommendation that the UK government 'should consult on the introduction of legislation to compel or incentivise participation of private creditors in the Common Framework'[19] and have outlined some proposals for discussion and consultation above. While we acknowledge the UK government's concern that a legislative approach 'would be complex and could have unintended consequences' for developing countries' access to finance,[20] a broad-based consultation will allow for these challenges to be addressed with detailed and forensic technical input, enabling consideration of these approaches based on evidence.

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[15] See, eg, *Re Virgin Active Holdings Ltd, Virgin Active Ltd and Virgin Active Health Clubs Ltd* [2021] EWHC 1246 (Ch).
[16] UK Export Finance, 'UK Export Finance Launches New Debt Solution to Help Developing Countries with Climate Shocks', Press Release, 8 November 2022.
[17] Munevar, D (2021), 'Sleep Now in the Fire: Sovereign Bonds and the COVID-19 Debt Crisis', European Network on Debt and Development (Eurodad), 26 May 2021.
[18] Fresnillo, I (2020), 'A Tale of Two Emergencies: The Interplay of Sovereign Debt and Climate Crises in the Global South', Eurodad,17 December 2020.
[19] House of Commons International Development Committee (2023), 'Debt Relief in Low-Income Countries', Seventh Report of Session 2022-23, 28 February 2023, para 62.
[20] House of Commons IDC (2023), 'Debt Relief in Low-Income Countries: Government Response to the Committee's Seventh Report of Session 2022-23', Eighth Special Report of Session 2022–23, 8 June 2023, ix.

We support IDC Chair Sarah Champion's call for consultation on a legislative approach,[21] especially in the context of an emerging transnational movement to advance these proposals in other creditor jurisdictions, such as New York and Germany.

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[21] House of Commons IDC (2023), 'Debt Relief in Low-Income Countries: UK Government Must Bring the Fight to a Global Stage', 8 June 2023.

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