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A good faith and relational contract approach

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Sovereign Debt and Holdout Disruption: A Good Faith and Relational Contract Approach

APRIL 2024

Francis D. Chukwu
University of Amsterdam Law School

Sovereign Debt and Holdout Disruption:
A Good Faith and Relational Contract Approach

ACADEMISCH PROEFSCHRIFT

ter verkrijging van de graad van doctor

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prof. dr. ir. P.P.C.C. Verbeek

ten overstaan van een door het College voor Promoties ingestelde commissie,

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For Ikenga

“A Desert Parable

You have decided to join 25 other people, all strangers to each other, on a bus tour of the broiling Mojave Desert. The ages of your fellow passengers range from 17 to 78.

50 miles into the desert and long out of cell phone range the bus breaks down. Behind the driver's seat is a single two liter bottle of water. It is the only potable liquid on the bus.

Immediately after the bus lurches to a halt, the 17 year old passenger wearing a varsity wrestling tee shirt grabs the bottle, drinks as much of its contents as he can hold and pours the rest over his sandaled feet (which had been uncomfortably heated by a stroll in the scorching sand).

Confronted with the prospect of many hours or even days on the stranded bus, your primary emotional reaction is:

> *a) Admiration, for the young lad's demonstration of decisiveness and initiative in seizing the water bottle. He was, after all, as much entitled to it as anyone else on the bus.*
> *b) Gratitude, for the boy's having demonstrated to the tour bus company how dangerous it can be to send a bus into the desert without adequate drinking water. His action delivered a sharp and salutary reprimand to the management of the bus company that will benefit all future passengers on all future tour buses.*
> *c) Regret, for not having signed up for the wrestling team when you were in high school.*
> *d) Outrage.”*

Lee Buchheit and Mitu Gulati (2021).

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Introduction

The Topic

On Monday December 19, 2022, Ghana suspended payments on most of its external debt.[1] With a balance of payment deficit of more than US$ 3.4 billion and a staggering 70 to 100 percent of its income going toward debt payments[2], the country's debt stock had simply become unsustainable, indeed unbearable. A week earlier, and with consultations with its creditors for a restructuring of its debt in parallel, the International Monetary Fund (IMF) announced a staff-level agreement (i.e., a preliminary agreement subject to IMF management and board approval) to extend a US$ 3 billion loan to Ghana under a structured program expected to return the country to debt sustainability in the near future.[3] As at June 2023, Pakistan remained in a critical state of debt unsustainability, dire economic straits, and in talks with the IMF over a loan expected to be in the region of US$ 1.2 billion under a structured program (much like Ghana's) aimed at debt sustainability.[4]

Ghana and Pakistan are not alone. Emerging markets across the world appear to be emerging from the Covid-19 pandemic with a serious debt strain and most needing some form of debt restructuring or other form of debt relief.[5] Like Ghana, Pakistan, and several emerging markets today, countries historically struggle with unsustainable debt at some time and most in unpredictable repeat cycles. Countries borrow for variegated reasons: to fund budget deficits, repay existing debt, finance wars, implement or augment social programs, fund infrastructure and other development needs, etc. Indeed, countries do not only borrow when in want, they also borrow (sometimes more) when in plenty, as a means of taking economic growth to even greater heights. Debt unsustainability may be a result of poor fiscal, financial, or monetary policies, or could also be the result of spillovers of international financial and/or monetary systemic shocks, domestic or global conflicts (wars) or pandemics (e.g., Covid-19), that may defy even the best designed fiscal, financial, or monetary policies.

A persistent cycle of debt and deficit has, thus, crept into the international economic system. This, brought home, means that several countries now and then find themselves in a position of unsustainable debt, often attended by stalled economic growth or outright recession; hence a need to manage the debt. In most cases, the typical (and historically best) way of dealing with an unsustainable sovereign debt burden is to restructure the debt. Suffice to say, therefore, that unsustainable sovereign debt and sovereign debt restructuring have become somewhat

[1] Christian Akorlie and Cooper Inveen, *Ghana to default on most external debt as economic crisis worsens*, REUTERS, December 20, 2022.
[2] *Id.*
[3] *IMF Reaches Staff-Level Agreement on a $3 billion, three years Extended Credit Facility with Ghana*, IMF, December 12, 2022.
[4] Gibran Naiyyar Peshimam and Ariba Shahid, *Pakistan working on possible restructure of debt with bilateral lenders, finance minister says*, REUTERS, June 10, 2023.
[5] Martin Wolff, *We must tackle the looming global debt crisis before it's too late*, FINANCIAL TIMES, January 17, 2023.

permanent features of the global political economy. Just about any country, especially from the emerging market economies, may have to restructure its debt at some time in the future.

The Problem

However, for several reasons including the reality that there is no sovereign bankruptcy mechanism for sovereign borrowers, such as exists for corporate borrowers under domestic legal systems, successful restructuring of sovereign debt requires cooperation and coordination amongst the sovereign and its creditors. Hence, when certain creditors refuse participation in the restructuring of sovereign debt, the result could range from a long-drawn litigation and poorly managed debt restructuring process to a derailment of the sovereign debt restructuring exercise and disorderly debt default with painful consequences for the sovereign, its creditors, and the international community. The situation is particularly exacerbated where those holdouts are of the stock that approach sovereign debt restructuring with an a priori intention to refuse participation in the restructuring and no intention of cooperation with the sovereign debtor, other creditors and other stakeholders through the restructuring process, while seeking to use litigation (and in recent times arbitration) to obtain maximum recovery for their debt outside of the restructuring process and to the detriment of the sovereign creditor, the participating creditors, and at a real risk of a failure of the restructuring process (the "holdout creditor" or "holdout", as used in this thesis). The problem of holdout disruption of sovereign debt restructuring is therefore a critical challenge to successful restructuring of unsustainable sovereign debt.

The Enquiry

This thesis seeks answers to the problem of holdout disruption of sovereign debt restructuring ("holdout disruption" as used in this thesis) by exploring a contract law theory of sovereign debt, i.e., whether sovereign debts are relational contracts, and the legal implications of such a relational character. This, then, is the central research question of this thesis: are sovereign debt contracts relational contracts? Following from this research question arise two sub-research questions connected to the main research question. If sovereign debt contracts are relational contracts: (i) is a duty of good faith implied by law in sovereign debt contracts; and (if the duty of good faith is implied by law in sovereign debt contracts), (ii) how may a relational contract approach to sovereign debt help combat holdout disruption, given the duty of good faith implied by law in relational contracts? The enquiry in this thesis explores these questions under English and New York laws. The reason for selecting English and New York laws is twofold. First, most sovereign debt contracts are contracted under either English or New York law; secondly, most holdout disruption litigation is undertaken in the courts of New York, with enforcement typically sought in New York or other United States courts, English courts, and sometimes in the courts of Continental Europe.

The Research Methodology and Plan

Is Holdout Disruption Really a Problem?

To contextualize the enquiry, this thesis will first critically examine the concept of holdout disruption with a view to showing how it poses a problem to sovereign debt restructuring. This task is undertaken at sub-Chapters 1.4 and 1.5 of this thesis (after a brief introduction to the subject of sovereign debt and necessary foundational sovereign debt and sovereign debt restructuring concepts). The aim of Chapter 1 of this thesis is therefore two-fold: first, to highlight the meaning of sovereign debt generally and as used in this thesis in the context of holdout disruption and to explain the meaning of holdout disruption generally and as used in this thesis; and secondly, to address the question why holdout disruption is a problem worthy of attention both from the legal academia and other stakeholders. Sub-Chapter 1.5 uses the *NML v. Argentina*[6] litigation as an illustrative case study of the holdout disruption problem.

If Holdout Disruption is a Problem, What Contemporary Solutions are there for It and Do These Solutions Fall Short of Addressing the Problem?

Once it is determined that holdout disruption is a problem and poses a challenge to sovereign debt restructuring, it would be necessary to examine what, if any, are the contemporary solutions to holdout disruption and why they fall short of adequately addressing the problem. I undertake this task in Chapter 2 of this thesis where current approaches to sovereign debt restructuring: the so-called statutory and contractual approaches, are critically analyzed. Chapter 2 also critically examines Collective Action Clauses (CACs) as the contemporary tool of choice for combating holdout disruption, exploring their potential strengths and drawbacks.

Where Does this Thesis Seek Answers?

Having determined that holdout disruption poses a problem to sovereign debt restructuring, and that CACs do not adequately address the problem, this thesis seeks remedies to holdout disruption from a contract law theory of sovereign debt: that sovereign debts are relational contracts (i.e., that sovereign debts possess the attributes of relational contracts as such relational contracts are recognized by law under English and New York laws). And an enquiry whether holdout disruption could be a violation of the duty of good faith as a legal consequence of such relational contracts under English and New York laws. This enquiry on the contract law theory of sovereign debt contracts provokes the central research question of this thesis.

Are Sovereign Debt Contracts Relational Contracts?

The central (or main) research question of this thesis – are sovereign debt contracts relational contracts – is explored and answered at Chapter 4 of this thesis. But, before answering the main research question in Chapter 4, Chapter 3 of this thesis discusses the relational contract theory as formulated and popularized by Ian Macneil, and introduces the concept of a relational contract approach as used in this thesis – which is an approach to relational contracts focusing on the attributes of relational contracts as recognized under English and New York laws (the recognition

[6] *NML Capital Limited & Another v. The Republic of* Argentina, 2005 WL 743086 (SDNY 2005).

themselves being based on the relationship(s) between or among the parties and the character of the contract as informed by its overall context) but not wedded to the theoretical relational spectrum underpinnings or limited to the theoretical assumptions of Ian Macneil's concept of relational contract theory. To answer the main research question, the characters of sovereign debt contracts as recognized in law and practice, including the tests for relational character of commercial contract laid out by the English High Court in *Alan Bates v. Post Office Limited (No.3)*[7] are all considered along with relevant academic works on the characteristics of relational contracts.

Is the Duty of Good Faith Implied by Law in Relational Contracts?

While the duty of good faith under English law imposes a duty on contract parties "… to act honestly and with fidelity to the bargain, not to act dishonestly and not to act to undermine the bargain struck or the substance of the contractual benefit bargained for, and to act reasonably and with fair dealing having regard to the interests of the parties … and to the provisions, aims and purposes of the contract, objectively ascertained"[8], is that duty implied in relational contracts, and what is the legal consequence(s) if so implied? The requirement of the duty of good faith under New York law is similar to that under English law. The duty of good faith under New York law imposes a duty on contract parties to avoid actions that will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract[9], and is violated when any promises which a reasonable person in the position of the promisee would be justified in understanding were included in the contract, and which are not inconsistent with the terms of the contract, is breached[10]. Again, is this duty implied in relational contracts under New York law, and what is the legal consequence if so implied? Chapter 5 of this thesis explores the duty of good faith under both English and New York law, with a view to answering the first sub-research question: is the duty of good faith implied by law in relational contracts under English and New York laws, and what legal consequence(s) follow from such recognition? The discussions critically examine the debate whether or not the duty of good faith is implied by law in relational contracts as a class or species of contracts, in the light of the decision of the English High Court in *Yam Seng Pte Limited v. International Trade Corporation Limited*[11] and subsequent English precedents on the issue of good faith in relational contracts. The Chapter also critically examines the state of the law on the recognition of relational contracts under New York law (where jurisprudence on the topic has been thinner relative to English jurisprudence), with a view to understanding whether New York law recognizes or would recognize relational contracts and enforces or would enforce them as such under New York law.

If Sovereign Debt Contracts are Relational Contracts; and the Duty of Good Faith is Implied by Law in Relational Contracts, how would an Application of the Duty of Good Faith Help Combat Holdout Disruption?

[7] [2019] EWHC 606 (QB).
[8] [2018] EWHC 333 (Comm) [175].
[9] *Kirke La Shelle Co. v. Armstrong Co.*, 263 NY 79, 87 (1933).
[10] *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 98 N.Y.2d 144; 773 N.E.2d 496; 746 N.Y.S.2d 131 (2002) at 153.
[11] [2013] EWHC 111 (QB).

If sovereign debt contracts are relational contracts, then under English law, the duty of good faith would be applicable to sovereign debt contracts as relational contracts. Under New York law, the duty of good faith is also implied by law first in all contracts to which the Uniform Commercial Code (UCC) applies, and secondly under the common law applicable to all contracts in New York law. The duty of good faith could therefore be invoked against holdout disruption under both English and New York laws. But what exactly does a duty of good faith require the parties to do or refrain from doing – so that one may determine whether the duty of good faith has been violated? This is the pith of the second sub-research question of this thesis. To answer this question Chapter 6 of this thesis analyzes the contents of the duty of good faith under both English and New York laws, as distilled from the most authoritative case laws in both jurisdictions, showing for each content of the duty of good faith what the law requires or prohibits and how the duty of good faith is violated in each case by holdout disruption. Chapter 6 of this thesis also explores the role of the relational contract approach in the enterprise of this thesis – as a background for the application of the duty of good faith under English law and as a guide to the nature of good faith conduct required of the parties under New York law where the duty of good faith is already implied by law.

Additionally, and for purposes of the discourse on holdout disruption, the Chapter also explores (at sub-Chapter 6.7) the law on third party beneficiary under English and New York laws, pursuant to which the sovereign debtor, as a third party to certain creditor coordination agreements among its creditors, may be able to enforce express or implied obligations of good faith in intercreditor coordination agreements against holdouts.

Chapter 7 of this thesis complements Chapter 6 in exploring how the duty of good faith, as applied in relational contracts under English and New York laws, could help combat holdout disruption. Chapter 7 critically analyzes three contextual applications of the duty of good faith in the sovereign debt and holdout disruption context:

- firstly, counterparty duty of good faith (i.e., between the sovereign debtor and its creditors),
- secondly, intercreditor duty of good faith (i.e., among the sovereign creditors themselves, but which the sovereign debtor may also be able to enforce against a holdout if the doctrine of third-party beneficiary applies to it), and
- finally, good faith in transfer/assignment of sovereign debt (i.e., concerning the assignment or transfer of sovereign debt subject to a restructuring exercise to a holdout),

in each case with a view to demonstrating how the duty of good faith (i) exists and (ii) could be enforced, drawing from both academic opinion (where available) and analogous cases in the corporate debt context.

Under each contextual application of holdout disruption (i.e., counterparty duty of good faith, intercreditor duty of good faith, and assignment/transfer of sovereign debt), Chapter 7 further uses select case law precedents of holdout disruption decided under New York law (where the

vast majority of holdout disruption cases are decided) with a view to demonstrating how, though good faith was not pleaded against the holdout in these cases, an application of the duty of good faith could have helped combat the holdout disruption and helped the sovereign debt restructuring exercise succeed.

It is necessary to note here that the restructuring of sovereign debt is part of the performance of the sovereign debt contract. The act of refusal to participate in the restructuring therefore relates to contract performance, hence an allegation of breach of the duty of good faith against holdouts by reason of such refusal relates to good faith in performance. In practice, a sovereign debtor with a debt sustainability problem contacts its creditors (typically with the help or under the auspices of key multilateral institutions, particularly the IMF, which help to design a debt restructuring framework to bring the country back to debt sustainability), prepares a debt restructuring proposal, and commences discussions and negotiations with its creditor pool on the restructuring of the debt. The creditors would meet any number of times and consider the restructuring proposal before accepting or rejecting it, and, if accepted, then accepting new debt instruments pursuant to the restructured debt. At all such material times in the course of the debt restructuring exercise the sovereign debt contract is at performance stage and the good faith duties in consideration at all such times (particularly the duty to collaborate in good faith in the restructuring exercise) are good faith in the course of performance. To elucidate on this point, of course a holdout may opt out of the restructuring exercise and decide to pursue actions for payment on its debt which, if not paid by the sovereign debtor, may constitute a breach of contract; but even in such holdout scenario, the duty of good faith, if pleaded by the sovereign debtor against the holdout in the enforcement action, would relate to the holdout's refusal to participate in the restructuring exercise i.e., in the course of contract performance. However, since the UCC (Section 1-304 (2003)) already implies the duty of good faith in performance and enforcement (i.e., default scenario) alike, an action or omission potentially in breach of the duty of good faith relating to enforcement would still be within the scope of the application of the duty of good faith under New York law.[12] English case law, however, does not yet appear to make any distinction between good faith in performance and enforcement, particularly as it relates to relational contracts, hence the clarification made here is of relevance more to English than New York law.

Relevance of Good Faith in Continental Europe?

Although the duty of good faith is discussed in this thesis based on English and New York laws, sub-Chapter 5.3 of this thesis briefly comments on a potential application of the duty of good faith in Continental European jurisdictions as a plausibly even more potent doctrine in combating holdout disruption, based on how the duty is interpreted and applied in these jurisdictions.

[12] New York case law does not also draw any distinctions between the requirements or elements of the duty of good faith in performance relative to enforcement. What the law requires of the parties remain the same in either case.

***

Some of the text in this thesis, particularly at Chapters 1 and 2 and sub-Chapter 3.1, draw on my 2016 SSRN working paper titled "Sovereign Debt Restructuring: A Contract Theory Perspective".[13]

***

Sources referenced in this thesis include those in original languages other than English. For sources in original languages other than English, I have used official (i.e., governmental or institutional), publisher's, or author's English versions (where available) or translations from online translation tools.

[13] Francis Chukwu, Sovereign Debt Restructuring: A Contract Theory Perspective (June 27, 2016). Society of International Economic Law (SIEL), Fifth Biennial Global Conference, Available at SSRN: https://ssrn.com/abstract=2800924 or http://dx.doi.org/10.2139/ssrn.2800924.