The Ultimate Sovereign Debt Showdown: Russia & Ukraine likely to battle it out in court!

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Eurocrisis in the Press

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By Kanad Bagchi

Against the backdrop of acute political instability, civil war, the loss of Crimea, and a debilitating state of public finances, Ukraine remarkably secured a debt restructuring deal with its international bondholders on 27th August 2015, potentially augmenting its case for a $40bn bailout from the International Monetary Fund. The restructuring package envisaged a principal reduction of around 20% of the total $18bn debt outstanding along with a debt rescheduling arrangement until 2019. The deal has been vociferously hailed as a 'significant milestone' and one, which is likely to restore the 'debt sustainability' of the Ukrainian government. Amidst a cohort of international financial institutions, including Franklin Templeton, BTG Pactual, Rowe Price et al, agreeing to the haircut, Russia, which holds $3bn worth of those US dollar dominated bonds (just 'bonds' hereafter), refused to participate in the negotiations and insisted on being repaid in full. Both countries, having dilly-dallied for weeks since the initial restructuring deal, are now considering to resolve their dispute over the debt in a London court. In this regard, the bond agreements are governed by English law and are subjected to the jurisdiction of British Courts. Political skirmishes aside, this post considers some of the intricate questions connected with sovereign debt enforcement in general and speculates on the likely set of legal issues arising out of the present dispute in particular.

One of the main sticking points of the present controversy relates to the nature and scope of the bonds that were issued by the Ukrainian government, and in particular whether these count as official or private debt. The distinction is important for two specific reasons. First, Russia can validly insist on restructuring of official debt under the umbrella of the Paris Club, as opposed to the recently agreed private creditor-debtor arrangement. Second, legal defenses available to Ukraine in a debt enforcement action by Russia would vary substantially depending on the form and substance of the bonds and whether these are categorized as official or private debt.

Bilateral State Loan or Private Debt?

If the matter reaches the English courts, a ruling on the status of the debt becomes imperative. For starters, the Russian government acquired the entire 3 billion worth of Ukrainian government issued bonds, as a partial fulfillment of a previously agreed loan disbursement to the erstwhile government of Ukraine under President Viktor

Yanukovych. Reports suggest that an artificially low interest rate of 5% was agreed on the bonds, when the market, admittedly was demanding far higher rates. In addition to that, a debt acceleration clause giving Russia the option of immediately reclaiming the entirety of the funds, in the event of Ukraine's debt to GDP ratio exceeding 60%, posits an unusually compromising financing arrangement, further confounding the distinction between private and official debt. In the author's opinion, the peculiarities of the transaction highlight the fact that the bond issue and its purchase was both creditor specific and materially distinct, in as much as the Russian initiative lacked a purely commercial motive and a profit rationale. Such unconventional issues of securities add a strategic, if not a completely official flavor to the transaction, thereby admitting a characterization of the bonds as official sector debt, regardless of its form. That said, the present indeterminacy has nonetheless stimulated an intensely polarized debate amongst academics and practitioners alike and one hopes that a court decision will infuse more clarity and coherence on an issue, which is both novel and unprecedented. (For a fuller exposition of the debate, see here and here).

Can Ukraine Validly Resist Debt Enforcement by Russia Assuming that Debt is 'Official'?

In the author's opinion the answer to that question is, partially yes!

Undoubtedly, Ukraine will have to rely on the rather porous concept of 'odious debt' under public international law, which, though having a lineage dating back to the 19th century, continues to be the subject of academic disagreement and lacking precedents. One of the most authoritative expositions of the doctrine of odious debt was enunciated by Alexander Sack back in 1929, which has held ground ever since. According to Sack, for a government to repudiate/relinquish existing debt, it has to first prove that the debt undertaken by the former government was in clear contradiction to the interest of the people of that state, and second, that its creditors were aware of the odious purpose of the debt. He further adds that, once the government has sufficiently discharged its burden, it falls upon the creditor to show that the funds advanced were not utilized for extraneous purposes. In this manner, the odious debt doctrine represents an exception to the international law obligation on states to honor bilateral official debt.

In light of the above, if the bonds are classified as official sector debt, the current Ukrainian regime has to substantiate that the debt incurred by President Yanukovych bears no nexus with any discernible public purpose or state interest. In this regard, various news reports suggest (here, here and here) that Yanukovych had aggrandized his personal wealth from the billions that were lent to him by Russia before finally fleeing the country in the wee moments of a popular uprising against his rule. Moreover, voices across Ukraine's opposition parties seem to imply that the upfront bond purchase was akin to a 'bride' to Yanukovych in an attempt, to stray him away from a possible alliance with the European Union. In addition to that, speculation is rife that Russia was not merely a passive spectator to the then Ukrainian government's crackdown on the uprising against President Yanukovych, but was actively complicit. Acts of collusion between Yanukovych and Putin have been alleged along with financial and strategic assistance from the Russian side. It is reasonable to argue that any debts incurred by Yanukovych for the purposes of crushing the rebellion in Kiev would qualify as 'hostile debts' under international law, relieving the current Ukrainian regime from any repayment obligations.

The closest parallel that one can draw from history is perhaps the Tinoco arbitration between Great Britain and Costa Rica in 1923. Costa Rica refused to honor debts incurred by Federico Tinoco (the then dictator) to the Royal Bank of Canada ("bank"), arguing that the debts were incurred for Tinoco's personal gratification, without any tangible benefit to state purposes. It was also argued that the bank was aware of the odious purpose of the debt, in as much as it was common knowledge that Tinoco was preparing to flee the country in the immediate future. The bank having subsequently failed to discharge its burden of proving otherwise, the arbitral panel ruled that Costa Rica's repudiation of all previous regime contracts was valid under international law and that it was under no obligation to repay any previously incurred debt to the bank. The present case bears very close resemblance to the Tinoco case, yet it remains to be seen how much credence a court would lend to an international ruling passed over

a century ago. Further, it should be emphasized that it is exceedingly difficult, if not impossible to prove the 'odious' purpose of debt on the one hand, and creditor's knowledge of the same, on the other. Except for remarkably straightforward cases, establishing that the creditor was aware or ought to have been aware of the nature and purpose of the funds advanced usually requires political and historical enquiry rather than legal reasoning. For such purposes, neither the Tinoco case nor international law in general, provides any definitive rules on the burden of proof that should be applied in such cases.

What if the Debt are Classified as 'Private' Debts?

As a general rule, there exists no international law obligation on states to honor debt owed to private creditors in the same manner that States are obligated with respect to State aid/loan, except where there is a claim for expropriation or unjust/discriminatory treatment. As the Tinoco arbitration illustrates, the doctrine of odious debts can be invoked as a defense against private creditors as long as the successor government has not materially gained from such debt. Therefore, any proof of unjust enrichment against the successor government would automatically prevent the latter from relying on the doctrine.

That said however, a second stage of the enquiry with respect to debt obligations against private creditors concerns the extent to which the bond agreement falls within the scope of international and domestic law. In the present case, English law governs the terms of the bond agreement and hence an enquiry as to the rules under English law of contract becomes imperative. Although, there is yet no precedent under English law with respect to sovereign debt claims against private creditors, there certainly exists an entire body of case law on freedom of contracts and its exceptions thereof. The doctrine of odious debts can represent a carefully crafted exception to the concept of freedom of contract rendering the debt agreement unenforceable.

Conclusion

In numerous ways, the present situation is both extraordinary and unparalleled. The scarcity of established international rules on debt classification and enforcement looms over Ukraine in its most recent struggle with Russia. Although, the government of Ukraine can validly invoke the doctrine of 'odious debt' to relinquish its obligation under the bond contract, much depends on the court's evaluation of the facts leading up to the loan agreement and the subsequent application of the funds. Due to a near absence of consensus under international law as to the limits and continuity of the doctrine of odious debts, it is the author's best guess that a court is likely to take the private debt approach and appraise the present claim as a traditional freedom of contract issue under English law. Therefore, much circumspection has to be exercised by Ukraine in advancing an argument that posits the doctrine of odious debts as an exception to the freedom of contract. Notwithstanding the above, a legal showdown between Russia and Ukraine in British courts is likely to be both highly politicized and long drawn, especially with respect to questions involving Russia's continued role in the Ukrainian conflict. Though under English Evidence law the court can summon parties to produce any evidence which it deems appropriate in connection with the case, it remains to be seen whether a court would be willing to exercise that prerogative, and if so how and to what extent Russia will comply with English procedural and evidentiary law.

Despite having secured a momentous restructuring deal with most of its creditors, Ukraine stands to become entangled in a legal squabble, and possibly remain outside the bounds of IMF's lending policies. Given that Ukraine's economy has been beset with low output and an almost unending recession, it is imperative that Ukraine receives the support of the IMF irrespective of the formal classification of the debt. In this regard, it is encouraging to see a broad consensus emerging in the IMF regarding a possible change in its lending criteria such that Ukraine is not prevented from accessing funds as a result of missed payments to Russia. For this we will have to wait until the end of November, when the IMF board is expected to adopt the changes as suggested. The present controversy and its political tangents aside, the case is likely to receive tremendous scrutiny from both sovereign debt academics and practitioners alike, in anticipation of whether a court can bridge the gap between geopolitics and the international law of sovereign debt.

Note: This article gives the views of the author, and not the position of the Euro Crisis in the Press blog, nor of the London School of Economics.

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