RUSSIAN DEBT RESTRUCTURING

OVERVIEW, STRUCTURE OF DEBT, LESSONS OF DEFAULT, SEIZURE PROBLEMS AND THE IMF SDRM PROPOSAL

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Introduction

The problem of sovereign debt has attracted much attention recently. By 2001, the total long-term less-developed countries debt stood at almost US $ 1.5 trillion. The recent sovereign debt crisis in Argentina has demonstrated that the debt burden of some countries reached unsustainable levels.

There are three main approaches to resolving sovereign debt crises and protection of creditors' rights. The first approach is to protect creditors' rights by means of litigation in foreign and domestic courts. The second approach was proposed in the G-10 report[1], which recommended wider use of collective actions clauses (CAC) in sovereign bond issues. Finally, the International Monetary Fund (the IMF) proposed in 2001 to establish a supranational bankruptcy mechanism called the Sovereign Debt Restructuring Mechanism (SDRM). I will explore all these approaches in my paper in the light of a Russian debt restructuring experience.

The experience of Russian sovereign debt restructuring presents an interesting case for study. The scale and the intensity of this process in the past decade were remarkable. After the collapse of the Soviet Union, the Russian Federation assumed sole responsibility for the external debt of the former USSR of $100 billion. This level of debt was too heavy for a transitional Russian economy that needed in further financial injections. The combination of a fall in output coupled with the fiscal costs associated with the transition made the scheduled debt service a significant burden. For ten years between 1991 and 2001 Russia reached six multilateral debt rescheduling agreements

[1] THE G-10 WORKING GROUP REPORT ON CONTRACTUAL CLAUSES (September 26, 2002), *at* http://www.bis.org/publ/gten08.pdf.

with official creditors, held five formal debt relief and principal deferment negotiations with commercial creditors[2] and passed through the financial crisis of 1998-99. The Russian default of 1998-99 was the first default of a major sovereign borrower since the 1980s. Beginning from late 2001 Russia graduated from reschedulings and started making its debt repayments regularly. Owing to high oil prices and the stable economic situation, Russia's gross reserves have reached the highest level in its history of $88 billion[3]. Russia was awarded first ever in its history an investment rating by Moody's Investment Service rating agency in October 2003. The Minister of Finance has recently announced that Russia will return to international capital markets and issue Eurobonds in 2005.

This paper presents the first comprehensive research of Russian debt restructuring process for the period of 1991-2004. In Part I, I will explore the problem of succession of the Soviet debt, the background of Russian debt restructuring process in the nineties, the structure of Russian debt and the default of 1998. I will focus mainly on sovereign debt instruments related to external debt such as Russian Eurobonds. I discuss the agreements with the Paris and London clubs of creditors because of their importance for the restructuring process. I also discuss restructuring of domestic bonds because their significant part was held by non-residents. In Part II, I will discuss the peculiar features of the Russian default of 1998-99 and its lessons. Part III discusses seizure and execution problems in MinFin III domestic litigation and Noga international litigation. I will also pay attention to Russian asset-protection tactics. Part IV analyzes the IMF SDRM proposal in the light of the Russian default of 1998.

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[2] The World Bank, *Global Development Finance 2000* 141, 148, 161 (2000).
[3] *See* The Central Bank of Russia, *Gold and Currency Reserves of the Russian Federation* (13 February 2004) *at* http://www.cbr.ru/print.asp?file=/statistics/credit_statistics/inter_res_04.htm.

Part I: Russian Debt Restructuring: History and Debt Structure

1.1 Overview

Since the demise of the Soviet Union on December 26, 1991 and Russia's declaration of independence, more than twelve years have passed. Russia's debt was significant and still remains so to this day. New Russia's credit history can be divided notionally in four equal periods:

Table 1: The Overview of Russian debt restructuring process

1992-1994	Process of succession of the debt. Russia succeeded the entire Soviet debt of about $100 billion. External debt exceeded 50% of GDP. Verification of claims. Negotiations with Paris and London club of creditors. Irregular debt payments. Deferral of payments and roll-overs. Simple rescheduling at par. New Russian borrowings
1995-1998	Complex agreements with Paris (1996) and London (1997) clubs of creditors. Active borrowings in domestic and international capital markets: massive issue of domestic ruble-denominated short-term treasury bonds (GKO and OFZ), first Eurobonds issue in 1996
1998-2000	Financial crisis, default of August 17 on domestic bonds and Soviet-era debts including Paris and London club obligations. Restructuring of domestic bonds. Agreement with the IMF. New agreements with Paris and London clubs of creditors
2001-present	Russia graduated from reschedulings, all payments are made in time, gross reserves reached US $85 billion, Moody's international rating agency awarded Russia first ever in its history investment rating on October 8, 2003. New Eurobonds issue planned for 2005

1.2 Succession of Soviet debt

My overview of the Russian debt begins from 1991, when the Soviet Union collapsed and defaulted on its debt. The creditors of the Soviet Union, mainly industrialized countries (Paris Club) and commercial banks (London Club) were

reluctant to provide new credits to Russia because they were concerned about who was responsible for the outstanding obligations of the former USSR.

Table 2: Succession of the Soviet Debt[4]

Data	Agreement	Comments
October 28, 1991	Memorandum of Understanding between the 8 former Soviet republics and the G-7	Only 8 out of the 15 former Soviet republics signed the agreement according to which they undertook joint and several responsibility for the Soviet debts.
November 21, 1991	G-7 offered a financial package of US $24 billion	It included the deferral of amortization payments falling due through end-1992. Russia received US $ 13.6 billion in cash.
December 4, 1991	Interstate Agreement on the Succession of External Debts and Assets of the USSR	Signed by 8 former Soviet republics. Russia's share of the debt of the Soviet Union determined at **61,34%**. The Interstate Council for Supervision for Debt Service and Use of Assets created. The Vnesheconombank was authorized as the Debt Manager. But soon it became clear that this Agreement was not functioning as only Russia had made payments abroad.
December 1991	The London Club of creditors roll-overs	Russia was granted multiple three-months roll-overs.
January 4, 1992	The Paris Club of Creditors deferrals	Formalized G-7's Proposal of November 21, 1991.
1992-1994	Russia concluded nine zero-options agreements	Byelorussia, Turkmenistan, Kyrgyzstan (summer 1992) Uzbekistan, Armenia, Moldova, Tajikistan (November 1992), Kazakhstan (September 1993),Ukraine (November 1992, December 1994). Russia would assume the responsibility for servicing the external debt of the former Soviet Union in exchange for the other states agreeing to transfer their share of the external claims to the former Soviet Union[5]

[4] I relied on ALEKSANDER SHOKHIN, VNESHNIĬ DOLG ROSSII [*External Debt of Russia*] 7-19 (Poligran 1997); Alejandro Santos, *Debt Crisis in Russia: The Road from Default to Sustainability, in* RUSSIA REBOUNDS 154, 156-157 (David Owen et al. eds., IMF 2003).

[5] Santos, *supra* note 4.

October 9, 1992	Bishkek Agreement	Leaders of the CIS countries decided to abandon the multiparty mechanism for Soviet debt and assets management
April 2, 1993	Declaration of the Government of Russia	Russia declared itself responsible for the entire debt of the former Soviet Union

On October 28, 1991, the G-7 and 8 out of the 15 former Soviet republics signed the Memorandum of Understanding between under which the republics undertook joint and several responsibility for the Soviet debts. This Memorandum was formalized in the Interstate Agreement on the Succession of External Debts and Assets of the USSR of December 4, 1992 (hereinafter the "Interstate Agreement") that was based on the principles contemplated by the 1983 Vienna Convention on Succession of States with respect to State Property, Archives and Debts (hereinafter the "1983 Vienna Convention") even though neither the Soviet Union nor most republics did not ratified it.

Under Article 41 of the 1983 Vienna Convention when a predecessor state dissolves and ceases to exist and the parties of its territory form two or more states, then, unless the successor states otherwise agree, an equitable proportion of the state debt of the predecessor state shall pass to each successor state taking into account all relevant circumstances.

But in 1992 it became clear that the Interstate Agreement was not functioning as only Russia made payments abroad and the agreement was abandoned in October 1992. Instead, the succession of the Soviet debt was formalized in nine "zero option" agreements concluded between Russia and eight former Soviet republics in 1992-93[6]. Under these agreements Russia would assume the responsibility for servicing the

[6] These include Byelorussia, Turkmenistan, Kyrgyzstan, Uzbekistan, Armenia, Moldova, Tajikistan, Kazakhstan and Ukraine. It should be noted that as of May 2004 Ukraine has not yet ratified the zero-option agreement with Russia and still claims its share of the Soviet property abroad. See Aleksander Bekker, *800 million for Friendship,* VEDOMOSTI, May 19, 2004.

external debt of the former Soviet Union in exchange for the other states agreeing to transfer their share of the external claims to the former Soviet Union.[7] The Russian Government in a statement dated April 2, 1993 declared itself responsible for the entire debt of the former Soviet Union of about $100 billion and acquired about US $7.5 billion of usable (gross) reserves and significant claims on a large number of developing countries.[8]

A number of factors made Russia's ability to service its debts problematic from the very beginning. They include the rapid decline in industrial output, inefficient fiscal policy, high interest rates. By these reasons the burden of the Soviet debt inherited by the Russian Federation was probably too heavy for a transition Russian economy to carry. One of the motivations for the agreement [to succeed all Soviet liabilities] was that a package of financial aid [to Russia] was being held up because creditors did not wish to provide additional funds to the region without clarification on who would ultimately be responsible for repaying the outstanding debts.[9]

Instead of choosing a Brady-like operation the Russian debt strategy at earlier stages was based on simple rescheduling at par. Alejandro Santos from the IMF argues that it would have been much more transparent to agree up front on a reasonable amount for Russia to repay on the Soviet-era debts. [10]

In the Interstate Agreement, Russia's share in the debt of the Soviet Union was determined at 61%. So it would probably have been reasonable for the new Russian leadership to negotiate a haircut of at least 39% on the Soviet debts or a ten or fifteen

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[7] Santos, *supra* note 4, at 156.
[8] *Id.*
[9] *Id.*
[10] *Id.*

year moratorium for payments on the Soviet debts. Both variants have historical precedents. Germany made the last payment on its World War I debt in 2001, i.e. 83 years after the Treaty of Versailles was concluded in October 1918.[11] Post World War II Germany received a 77% writeoff.[12]

Wood writes that if the state loses territory, its economic ability to service its foreign debt may be reduced.[13]. Russia assumed sole responsibility for the Soviet debt but even now Russia's GDP[14] is just a quarter of the 1989 Soviet GDP of US $1.3 trillion. Arguably, it made performance of the Soviet external loan contracts something radically different from that which was in the contemplation of the USSR and its creditors at the time they entered into the contract that might have been used to discharge Soviet external loan contracts by operation of the doctrine of frustration.

But as Santos notes, there was no political appetite to provide massive write-off of debts to a superpower nor for the former superpower to ask … it was politically expedient to the West to have the leverage on the direction of policies in Russia.[15]

1.3 Structure of Russian Debt

Table 3: Structure of Russian debt[16]

Type of Debt	Date	Contracting Party	Governing Law	Currency	Volume/stock*(billion)	Defaulted in 1998-99	Comments
Soviet-Era	Before	USSR			U$		

[11] SHOKHIN, *supra* note 4, at 41.
[12] *Argentina to Open New Talks with Creditors*, THE WALL STREET JOURNAL, March 11, 2004.
[13] PHILIP R. WOOD, PROJECT FINANCE, SUBORDINATED DEBT AND STATE LOANS 179 (Sweet & Maxwell 1995).
[14] As of 2003, Russia's GDP was US $346.5 billion. *See* The World Bank, *Russia Country Brief*, *at* http://www.worldbank.org.ru/ECA/Russia.nsf/0/9AFC2FEABF55CE7985256CB6006C353B?Opendocument.
[15] Santos, *supra* note 4, at 155. In contrast, in 1997 Russia even settled pre-1917 debts of Tsarist Russia to France by paying US $200 million to the ancestors of French bondholders.
[16] This table was prepared on the basis of multiple sources.

Debt	1/1/92				100		
Paris Club debt	Before 1/1/92	USSR		Diff. Curr.	US $40	Yes	Debt to official creditors
London Club debt	Before 1/1/92	Vnesheconombank		Diff. Curr.	US $30	Yes	Debt to commercial banks (loans)
• PRIN	1997	Vnesheconombank	English law	US $	US $22.2	Yes	principal bonds
							Issued under the 1997 London Club agreement
• IAN	1997	Vnesheconombank	English law	US $	US $6.8	Yes	
							interest-arrears notes
MinFin (Taiga or OVGVZ) bonds of 1-5 series	1993	Russian Federation	Russian law	US $	US $7.88	Yes, only on 3 series principal	Issued to compensate holders of foreign currency accounts with the Vnesheconombank
Russia-Era Debt	After 1/1/92	Russian Federation	US $40 billion in 2004				
GKO	1993-98	Russian Federation	Russian law	RUR	RUR**272[17]	Yes	short-term zero-coupon treasury bonds
OFZ	1995-present	Russian Federation	Russian law	RUR	RUR[18] 163	Yes	mid-term variable coupon bonds
MinFin 6-7 series	1996	Russian Federation	Russian law	US $	US $3.5	No	Maturity 10 & 15 years
Eurobonds	1996-98	Russian Federation	English law	US $, DM**, ITL**	US $16	No	
Eurobonds	2000	Russian Federation	English law	US $	US $21.5	No	Issued under the 2000 London Club agreement.
IMF	1992-	Russian	-	USD	US	No	As of April 1,

[17] As of 1/1/1998, US $ 45 billion at the July 1998 exchange rate or US $ 10 billion at the December 1998 exchange rate.
[18] As of 1/1/1998, US $ 27 billion at the July 1998 exchange rate or US $ 6 billion at the December 1998 exchange rate.
* Some instruments or their series were paid in full or restructured. For instance, restructured: GKO, some OFZs, MinFin 3, PRINs & IANs. Paid: MinFin 4, Eurobond 1,5,6. The outstanding stock of GKO bonds currently is insignificant (about RUR 2.72 bln).
** RUR – Russian ruble; DM – German mark; ITL – Italian lira.

	1998	Federation			$19.3		2004 $5.1 billion
World Bank	1992-1998	Russian Federation	-	USD	US $5.1	No	As of April 1, 2004 - $6.3 billion
Official & commercial debts	1992-1998	Russian Federation	-	USD	US $7.6	No	As of April 1, 2004 - $4.9 billion

1.3.1 Soviet-Era Debt

1. Paris Club Debt and its Restructuring

The Paris Club consists of Western governments that have lent money to developing nations and have agreed not to accept restructuring terms less favorable than those offered to the London Club. In 1998 the Paris Club debt stood at about $40 billion. Russia received Paris Club reschedulings in 1993, 1994, 1995, 1996 and 1999.

Table 4: Paris Club Reschedulings[19]

Date of the Treatment	Type of the Treatment	Amounts treated	Status of the Treatment
August 01, 1999	Ad-Hoc	$8.113 billion	active
April 29, 1996	Ad-Hoc	$40.160 billion	active
June 03, 1995	Ad-Hoc	$6.421 billion	fully repaid
June 04, 1994	Ad-Hoc	$7.100 billion	fully repaid
April 02, 1993	Ad-Hoc	$15 billion	fully repaid

All agreements contained a comparability of treatment provision.[20] Such provision included in the 1999 agreement provides that the Government of the Russian Federation commits itself not to accord any external creditors conditions of repayment

[19] This table is based on The Paris Club, *Russian Federation, List of the debt treatments, at* http://www.clubdeparis.org/en/countries/countries.php?PAY_ISO_ID=RU&submit=ok.
[20] *Id.*

for comparable credits more favorable than those accorded to the Participating Creditor Countries.[21]

Judge Pauley of the U.S. District Court for the Southern District of New York in the case of *Compagnie Noga d'Importation et d'Exportation S.A. v Russian Federation*[22] quoted the Statement of the Russian Deputy Minister of Finance Sergei Kolotukhin:

> These undertakings apply to cover debts irrespective of whether they were originally contracted by the Russian Government or on behalf of the former Soviet authorities.

A goodwill clause was included in the 1999 agreement whereby official creditors expressed their readiness to further consider the situation of the Soviet-era obligations at a later stage once conditions were established for the implementation of a more ambitious economic reform program but this clause has not been triggered yet:

> At the end of 2000 there was an exchange of letters between the [Russian] ministry of finance and the Paris Club secretariat which clearly demonstrated how far apart the two sides were. The Russian position continued to be that a comprehensive restructuring was required as envisaged in the agreed minute to the 1999 Paris Club agreement whereas the Paris Club secretariat insisted that Russia had graduated from reschedulings and that full payments should start immediately… Once Russian policymakers realized that virtually no room existed to garner further debt relief, Russia accelerated payments and by mid-2001, Russia had cleared almost all arrears owed to the Paris Club of creditors.[23]
>
> The Paris Club debt stood at US $42 billion in January 2004.[24]

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[21] The Paris Club, *Russian Federation Debt Treatment – August 1, 1999 - Comparability of treatment provision, at* http://www.clubdeparis.org/en/countries/countries.php?CONTINENT_ID=&DETAIL_DETTE_PAGE=4&IDENTIFIANT=89&PAY_ISO_ID=RU.

[22] *Compagnie Noga d'Importation et d'Exportation S.A. v Russian Federation* 00 Civ. 0632 (WHP)2002 U.S. Dist. LEXIS 17749 (SDNY 2002).

[23] *Id.*

[24] *See* The Central Bank of Russia, *External debt of Russia*, *at* http://www.cbr.ru/statistics/credit_statistics/print.asp?file=debt.htm.

2. London Club Debt and its Restructuring

The London Club represents more than 600 Western banks. Some of them made loans to the Vnesheconombank of the USSR (the VEB). The VEB was an original party to loan agreements concluded between the USSR and the members of the London Club prior to 1991.The VEB defaulted on these loans in 1992. After almost six years of negotiations and partial payments of interest and various payment deferrals the London Club debt was formally rescheduled for the first time in late 1997. By that time, the Russian debt to the London Club stood at about $30 billion. The second restructuring deal was concluded in 2000.

Table 5: London Club Reschedulings[25]

Agreement	Type of debt	Issuer	Governing law	Stock. (US $ billion)	Maturity (yrs)	Comments
1997	PRIN (principal bonds)	Vneshecon ombank	English law	22.2	25	The deal included up-front cash payments of US $3 bln. Russia defaulted on PRINs in December 1998 and on IANs in June 1999
	IAN (interest arrears notes)	Vneshecon ombank	English law	6.8	20	
2000	Eurobonds	Russian Federation	English law	18.3	30	The deal included a reduction in the face value of the bonds of $10.5 bln; a reduction in present value terms of $2.5 bln; up-front cash payments of $ 0.5 bln.
	Eurobonds (past-due interest)	Russian Federation	English law	2.8	10	

Under the 1997 Agreement the Soviet debt to the London Club was securitized. The Vnesheconombank - a state bank for foreign economic affairs of the former Soviet Union, issued PRIN (principal) and IAN (interest arrears) notes governed by English law.

[25] This table is based on FITCH RATINGS, SOVEREIGN REPORT: RUSSIA (London August 31, 2000); DEUTSCHE BANK GLOBAL MARKETS RESEARCH, RUSSIA LONDON CLUB RESTRUCTURING (London July 20, 2000) 3.

Russia defaulted on PRINs and IANs in 1998-99. If the creditors went to the court they would have to ask the court to lift the veil of the VEB because this institution was bankrupt since 1991. Piercing the VEB's veil would not be an easy task since the VEB is technically an instrumentality of a non-existent state i.e. the sole shareholder of the VEB is still the former Soviet Union. The VEB was heavily indebted when the Soviet Union defaulted on its obligations so the Russian Government could not reorganize it because of its huge debts. The VEB has never been incorporated and never got a banking license in modern Russia. It got a special status and operated on the basis of its Charter and decrees issued by the Presidium of Supreme Council of Russia (a predecessor of the modern Russian Federal Parliament) and the President.[26] If the English or any other court lifted the veil it would have to impose the liability on the Soviet Union. Because the USSR ceased to exist in December 1991 the court would have to go further to conclude that the VEB debts should be imposed on Russia as a legitimate successor of the USSR. However, such scenario would be problematic because the VEB was subordinated to the Central Bank of Russia by a decree of the Supreme Council in 1992. It made piercing of the VEB veil impossible under US law and arguably under English law as well. Under US law, a government instrumentality loses its separate juridical status and becomes the alter-ego or agent of its parent government when the government exercises extensive control over the instrumentality's daily operations and abuses the corporate form.[27] The English Court of Appeal held in

[26] Decrees of the Supreme Council of the Russian Federation No. 3875-1 of November 12, 1992, No. 2172-1 of January 13, 1992; Decree of the President of the Russian Federation No 2261of December 22, 1993.
[27] *First National City Bank v. Banco Para El Comercio Exterior de Cuba* 462 U.S. 611 (1983)

Trendtex Trading Corporation Ltd v Central Bank of Nigeria[28] that a Nigerian Central Bank is not a department of a foreign state. The VEB's direct supervisor - the Central Bank of Russia is an independent from the Russian Government entity[29] so it would be difficult if not impossible to prove that the VEB is an alter ego of the Russian Government or the Russian Federation. And even if the court would have decided that Russia should be responsible for the VEB's debts the creditors would have to find and attach Russian assets that is not a simple task as it will be shown in Chapter III. Not surprisingly that the London club as a coherent group of creditors not having a big collective action problem whose members have businesses in Russia, which could be endangered by a dispute with the Russian government, preferred to restructure defaulted PRINs and IANs.

Under a new deal concluded in 2000, the London Club debt was exchanged to Eurobonds issued by the Russian Federation (hereinafter also "2010 and 2030 Eurobonds") subject to English law. The price that the creditors paid for this upgrade in the seniority of debt was its reduction which amounted in total to US $13.5 billion. In return, creditors have secured a commitment from the Russian government that the new sovereign Eurobonds will in all respects rank pari passu with present and future unsecured and unsubordinated obligations of the Russian Federation.[30] The terms of issue of 2010 and 2030 Eurobonds provide that any new Eurobond issue will include an "expanded cross acceleration" clauses that will treat failure to honor the terms of the 2010 and 2030 Eurobonds as an event of default allowing bondholders to demand immediate and full repayment. Until US $1 billion of new Eurobonds have been issued

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[28] *Trendtex Trading Corporation Ltd v Central Bank of Nigeria* [1977] QB 529 (Eng. C.A.).
[29] See in more detail Part III of this paper.
[30] FITCH, *supra* note 25, at 21.

with the expanded cross acceleration clauses, holders of 1996-98 and new issue Russian Eurobonds will have "repurchase rights" (effectively a put option) that can be used to demand full and immediate repayment in the event of acceleration of the 2010/2030 Eurobonds.[31] Noteworthy, these Eurobonds trade at a small discount over Eurobonds issued voluntarily by the Russian Federation.[32]

3 Paris and London club agreements as models for negotiations with other group of creditors

Russia sought to regularize its debt with all creditors groups using the Paris and London club agreements as frameworks for the negotiations with other groups of creditors. The Russian strategy to offer "virtual" Paris Club deals for official creditors and "virtual" London Club deals for commercial creditors is based on the Paris Club principle of comparable treatment among creditors. This strategy has been largely successful. Thus, in 2001 agreements in principle were reached with the Forum of Trade Creditor Group Representatives (consisted of uninsured suppliers of the former USSR) and with the International Bank for Economic Cooperation and the International Investment Bank (which were the multilateral financial institutions of the former COMECON trading bloc). These agreements replicated the 2000 London Club deal that included reduction of debt and exchange to Russian Eurobonds.

> Foreign Trade Organization Debt
> In August 1998 the stock of foreign trade organization debt stood at about $4 billion … [Under the 2001 agreement] the transaction was effected through an exchange offer … substantially as if the participating creditors were "late joining creditors" under the 1997 rescheduling concluded with

[31] *Id.*
[32] SANTOS, *supra* note 4, at 178.

> the London Club of creditors of the former Soviet Union.[33] A formal bond exchange offer was made available to foreign trade organization (FTO) creditors in November 2002. Only holders of verified debt was were eligible. The first tranche of the exchange was successfully finalized though participation was low (just over $1 billion). FTO creditors ultimately receive a package similar to the London Club creditors including Eurobonds that mature in 2030, Eurobonds that mature in 2010 and some cash payments.[34]
>
> International Bank for Economic Cooperation/International Investment Bank Debt
> Both IBEC and IIB became inoperative shortly after the dissolution of the Soviet Union. The Russian Ministry of Finance reached an agreement in principle with IBEC and IIB and their creditors represented by Lloyds TSB bank in September 2001. On March 9, 2004 the Ministry of Finance of the Russian Federation announced that 100 per cent of eligible creditors had participated in the Ministry's offer to exchange Eurobonds for former USSR debt owed by the Vnesheconombank to the IBEC and IIB.[35]
>
> It seems that at least one creditor refused to join the FTO deal.[36] The Russian

Deputy Minister of Finance Sergei Kolotukhin witnessed in his statement that

> Since 1992 all of the Russian Government's creditors – with the exception of Noga – have cooperated with the Government in reconciling the amount of debts owed.[37]

It should be noted that the Noga's case is not typical in the sense that this creditor managed to obtain an arbitral award and it was one of rare cases when the Russian government waived its immunity in a loan agreement.

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[33] *See* Press Release, Ministry of Finance of the Russian Federation, *at* http://www.minfin.ru/ex_debt/prr.htm
[34] SANTOS, *supra* note 4, at 179.
[35] *Ministry of Finance of the Russian Federation Announces Results of the IBEC/IIB Exchange Offer at* http://www.minfin.ru/ex_debt/728_exdebt.htm.
[36] Statement of Sergei Kolotukhin at 2, *Noga supra* note 22.
[37] *Id*. at 2.

1.3.2 New Russian Debt

1. Overview

In addition to old Soviet-era debt, Russia has built up significant amounts of new debt to finance its budget deficits. This has been done partly by issuing ruble-denominated treasury bonds known as GKOs and OFZs. In mid-1998, Russia's Treasury debt had reached around $70 billion, about one third of which was held by nonresident investors[38]. The GKOs are short-dated discount bonds. The OFZs are longer-dated coupon bonds. At the time of default Russia-era external debt amounted to some $60 billion about one-third of which was owed to the IMF one-third was in the form of Eurobonds and the remainder was owed to the World bank and other official creditors.[39] The stock of Russia-era debt declined to $39 billion by 2001.

2. Loans of International Financial Institutions (IMF)

Russia was granted a number of loans by the International Monetary Fund (IMF) and other international financial institutions during the last decade. At its height at the end of 1998 the debt to the IMF stood at $19.3 billion and the debt to the World Bank was $6.3 billion.

In an effort to prevent a coming crisis of August 1998 the IMF and the World Bank disbursed about US $ 5.5 billion in July – early August 1998.[40] But no IMF money was involved after Russia announced its default on August 17, 1998.[41]

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[38] *World Economic Outlook: Interim Assessment. World Economic and Financial Surveys* (The IMF 1998).
[39] SANTOS, *supra* note 4, at 171.
[40] Homi Kharas, Brian Pinto and Sergei Ulatov, *An Analysis of Russia's 1998 Meltdown: Fundamentals and Market Signals*, 1 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 3 (2001).
[41] Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?* 37 INT'L LAW. 103, 122 (2003).

A key component of the debt-resolution after the 1998 financial crisis was the negotiation of a new arrangement with the IMF in order to signal to the international community that a credible macroeconomic framework was in place to provide a basis for discussions with creditors.[42] Moreover, this leg of the strategy was key to unlocking an agreement with the Paris Club.[43] Negotiations with the IMF were suspended after the crisis began in late 1998 and continued until July 1999 when a new Stand-By Arrangement was approved by the IMF.

The IMF debt has been reduced to $5.1 billion by early 2004 in part reflecting repayments ahead of schedule.[44] It is expected that Russia will fully repay its debt to the IMF by early 2005.

3. Eurobonds

From November 1996 till July 1998 Russia issued nine Eurobonds of nominal value of $16 billion which were governed by English law. Eurobonds are denominated in various currencies, have pari passu, negative pledge and cross-acceleration clauses. Russia has never waived sovereign immunity in Eurobonds but it could not prevent the Russian assets abroad from attachments since the international consensus is that borrowings are commercial[45] (see e.g. the UK State Immunity Act 1978 s 3(3)(b)). Renegotiation of Eurobonds is difficult since they are widely held around the globe but not impossible. The first Russia-era Eurobonds placed in November 1996 was paid in full in November 2001.

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[42] SANTOS, *supra* note 4, at 168.
[43] *Id.*
[44] CBR, *supra* note 24.
[45] WOOD, *supra* note 13, at 107.

Russia did not default in 1998 on Eurobonds because of a number of reasons. Firstly, the service of Eurobond debt did not require much money in 1998 as the principal on the first issue was due in 2001. Secondly, under cross-acceleration clauses of the Russian Eurobonds the failure to make the final payment of principal in respect of any Russia-era public external debt (i.e. Eurobonds) which equals or exceeds US $75 million may constitute an event of default on other issues of Russian Eurobonds that would entitle more than 25% of their holders to declare them immediately due and payable. The default on the Soviet-era debt was expressly excluded as a cross-acceleration event. But because in 1998 the Eurobonds were the only form of the Russia-era public external indebtedness and the final payment of principal on the first Eurobond was due in 2001 the threat of cross-acceleration did not exist practically so this factor could have only a remote deterrent effect. Thirdly, the default on Eurobonds would put all Russian assets abroad under the risk of attachments. Fourthly, Russia's strategy throughout the 1990s was not to default on a Russia-era external debt and it would have been a big sacrifice to depart from this policy in 1998. Finally, Russia wanted to leave the door to international capital markets open as the default on Eurobonds could be followed by possible a long-term loss of access to international capital markets. Thus, the Fitch rating agency considers that if Russia defaults on its Eurobonds it may permanently lose access to international capital markets.[46] According to Horrigan, the default on such obligations would also effectively exclude Russia from world capital markets for the foreseeable future.[47] It seems that this strategy worked out and on March 30, 2004 the Russian Minister of Finance announced that Russia would issue new

[46] FITCH, *supra* note 25, at 21
[47] B Horrigan, *Debt Recovery by Foreign Investors in Post-Crisis Russia*, EUROPEAN BUSINESS JOURNAL 88 (1999).

Eurobonds in 2005[48] – seven years after the last voluntary Eurobonds issue in July 1998. The issue of Eurobonds will make sense only if Russia manages to refinance its debt at interest rates lower than on the existing debt because at this moment Russia is facing the problem of disposing huge currency reserves rather than raising addition funds in the capital markets.

4. Domestic Bonds

4.1. Domestic dollar-denominated bonds (MinFins)

In 1993, five dollar-denominated MinFin bonds (also know as Taiga bonds or by the Russian acronym OVGVZ which stands for Internal Government Hard Currency Bonds) were issued under Russian law to compensate holders of foreign currency accounts with the state-owned Vnesheconombank that were frozen in 1991. Many of these bonds were subsequently sold to foreigners. The MinFins are domestic debt issued under the jurisdiction of Russian law. MinFin bonds of 1-5 series were treated as a Soviet-era debt. Two additional MinFins of sixth and seventh series issued in 1996 were perceived to be a new Russia-era debt. The total stock of MinFin bonds amounted to $11.4 billion.

In May 1999, Russia defaulted on the MinFins 3 principal. In the letter of May 14, 1999 the Ministry of Finance announced that Minfin 3 restructuring would be carried out with regard for terms of restructuring of other categories of the Soviet debt. In November 1999, Russia announced a bond exchange to reschedule the MinFin series 3 bonds that was amended in January 2000. Investors were provided with the option of exchanging their defaulted bonds for combinations of new eight-year bonds similar to

[48] *See Russia intends to issue Eurobonds, at* http://www.minfin.ru/off_inf/756.htm

the MinFins (foreign currency-denominated with an interest rate of 3 percent) and four-year OFZs (ruble-denominated) bonds at an interest rate of 15 percent the first year and 10 percent thereafter. The Ministry of Finance continued to be the guarantor of the new bonds. The bulk of the MinFin series III has been successfully exchanged. Investors have preferred the foreign currency bond over the OFZ.[49] The MinFin of IV series was paid in full in May 2003.

A hold-out holder of a $100,000 MinFin III bond who disagreed with the terms of the exchange offer won the case in the Russian commercial courts in 2002 after three years of litigation[50] but the decision has yet to be enforced because of the limitations provided in the Federal Laws on Federal Budget for 2003 and 2004.

4.2. Domestic ruble-denominated Treasury bonds (GKOs & OFZs)

1. GKO

In attempt to develop domestic financial markets and to find alternative sources of financing for the budget, public bonds known by the Russian acronym of GKO were issued for the first time in May 1993.[51] GKOs were extremely liquid zero coupon treasury bonds denominated in rubles with maturities of up to one year sold at a discount and redeemed at par.[52] Foreign participation in the GKO market increased to about one-third of the market in mid-1998 that amounted to about $17 billion.[53] Those investors (who were mostly banks and non-residents) who invested in GKO were sometimes

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[49] SANTOS, *supra* note 4, at 180.
[50] *See* Federal Commercial (Arbitrazh) Court of Moscow District [FASMO] *OOO Rusatommet v Government & Ministry of Finance of the Russian Federation,* No КГ-А40/6804-02 of October 28, 2002 (RF).
[51] SANTOS, *supra* note 4, at 160.
[52] *Id.*
[53] *Id.* at 162.

earning interest rates exceeding 100% annually.[54] Arguably, those who gambled with these high-risk bonds knew that they were playing in casino.

2. OFZ[55]

OFZ were variable coupon treasury bonds denominated in rubles with longer maturities issued since 1995. The interest coupon was paid quarterly at a variable rate linked to short-term average CKO yields. The principal amount was paid as a bullet on maturity. A fixed-coupon OFZ (OFZ-PD) was introduced in 1997. These instruments were less liquid than the GKO and the size of their market more limited. The 1998 GKO default included a fair amount of these instruments too.

5. Default on Domestic Debt: Impact of Russian Moratoria and Exchange Control

1. Legality of Moratoria under Russian law

Some of GKOs/OFZs and MinFins bondholders pursued their claims through the Russian court system. Wood succinctly describes the problem that any creditor of a sovereign state faces in domestic courts: "a state is in charge of its own law-making machinery and can therefore change its laws unilaterally and compel its courts to give effect to the changes".[56] However, Wood notes that because a home government ultimately controls its courts and because no embarrassing foreign relations issues are involved, the right of action by a private citizen against his own government in domestic courts has been more quickly acknowledged than the impleading of foreign states.[57] This

[54] In 1995 an average nominal GKO yield adjusted by the inflation target for that year was 99%. The yield on GKO reached 144.9% on August 14, 1998 See Kharas et al., *supra* note 40 at 29.
[55] SANTOS, *supra* note 4, at 162 fn 6.
[56] WOOD, *supra* note 13, at 99.
[57] *Id.*

is also true for Russia –at least one MinFin III bondholder ultimately succeeded in Russian commercial courts after three years of litigation.[58]

1.1 The Crisis and Default of 1998

Prior to the financial crisis of 1998 Russia maintained for several years the strong ruble-dollar peg that eventually dried out the Central Bank currency reserves. The domestic debt was mostly short dated and, consequently, the Russian Government was frequently forced to raise new capital to make debt payments. On the revenue side, the Russian Government was having difficulty collecting taxes. More generally, the implementation of structural reforms to improve the economic strength of the country was proceeding poorly. Besides the deepening crisis in Asia, making matters worse, the prices of Russian commodities in particular, the price of Brent oil started to decline in October, 1997.[59]

In an effort to prevent a coming crisis and achieve a soft landing for the economy, a US $22.6 billion international financing package to support fiscal and structural reforms had been announced on July 13, 1998. The international financial institutions—the IMF and the World Bank—eventually disbursed only one-fourth of the total funds announced as part of the July package.[60]

In August, 1998 it became clear that the issue of Eurobonds and the IMF loans were not enough to establish sufficient liquidity for Russia, and there was a substantial outflow of capital from Russia.

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[58] See FASMO, *supra* note 50.
[59] DARRELL DUFFIE, LASSE HEJE PEDERSEN & KENNETH J. SINGLETON, MODELING SOVEREIGN YIELD SPREADS: A CASE STUDY OF RUSSIAN DEBT 4-5 (NBER paper, April 21, 2000).
[60] Kharas et al., *supra* note 40 at 3.

1.2 Acts on Moratoria on GKOs/OFZs

On August 17, 1998 in the Joint Statement of the Government of the Russian Federation and the Central Bank of the Russian Federation (CBR) the government declared that the government securities (GKOs and OFZs) with due dates through December 31, 1999, would be rescheduled into new securities.

The terms of GKO/OFZ restructuring were also determined in the following acts:

- Decree of the Government of the Russian Federation No 1007 of August 25 1998
- Decree of the President of the Russian Federation No 888 of 25 August 1998
- Decree No 1787-p of December 12, 1998 on novation of state securities
- Federal Law on Top-Priority Measures in the Field of Budget and Tax Policy[61]

Pursuant to Decree No 1007 of August 25, 1998,[62] the Ministry of Finance should pay on bonds in due time … by crediting money to special transit accounts of securities' holders from which the money may be reinvested at the discretion of an owner into new state securities. According to Decree No 1787-p of December 12, 1998[63], GKOs/OFZs should be exchanged with the owners' consent for newly issued bonds of federal loans with partial cash compensation (i.e. this decree provides the terms of "novation"[64]). None of these provisions suggests that the government defaulted on state securities and that the restructuring is compulsory.

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[61] Federal Law No 192-ФЗ of December 12, 1998 on Top-Priority Measures in the Field of Budget and Tax Policy.

[62] Decree of the Government of the Russian Federation No 1007 of August 25, 1998, On paying off state short-term non-coupon bonds and bonds of federal loans with permanent and variable coupon profit due till December 12, 1999 and issued into floatation before August 17, 1998

[63] Decree No 1787-p of December 12, 1998 on Novation on State Securities.

[64] Novation is a civil law doctrine. Black's Law dictionary describes novation as he act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party. BLACK'S LAW DICTIONARY (BA Garner ed 7th ed. 1999)

GKO bondholders made few attempts to pursue litigation in domestic courts[65] and it seems that none of them was successful. It partly can be explained by the success of the government in negotiating an agreement with GKO/OFZ bondholders:

> … despite initial criticism that its offer was one-sided and discriminated against foreign investors. The face value of domestic debt covered by the August 17, 1998, restructuring amounted to some $44 billion at the immediate precrisis exchange rate, of which 30 percent was held by nonresidents, who are estimated to have eventually received 5 cents on the dollar. The vast majority of creditors (over 99 percent by value) eventually signed on.[66]

Russian commercial courts dismissed the claims of GKO holders on the following grounds:

- The relations between the state and bondholders were governed by budget legislation, the funds for repayment of bonds were not provided in the budget, accordingly, the grounds for debt recovery on bonds were lacking.
- Despite of the impossibility of repaying the GKO debt 1999 the state did not refuse to honor its obligations on these securities in the future.
- The government acted within the scope of its authority by adopting decrees that provided restructuring of state debt on GKO.

The courts avoided to evaluate the legality of the actual default on GKO bonds[67] and presumed the priority of financial (budget) legislation over civil legislation. The courts referred to provisions of Article 13 of the Federal Law on Peculiarities of Issue and Floatation of State and Municipal Securities that provides that methods, order and sources of funding of expenses relating to servicing obligations of the Russian

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[65] *See* e.g. Federal Commercial (Arbitrazh) Court of Moscow District [FASMO] No КГ-А40/172-00 of February 1, 2000.
[66] Kharas et al., *supra* note 40 at 43.
[67] *See* e.g. Federal Commercial (Arbitrazh) Court of Moscow District [FASMO] No КГ-А40/1678-00 of May 4, 2000.

Federation originated as a result of the issue of state and municipal securities are governed by the budget legislation of the Russian Federation.[68]

As it follows from the GKO court cases the most important provision of post-default legislation is Article 3 of the Federal Law on Top-Priority Measures in the Field of Budget and Tax Policy[69] (hereinafter also the Federal Law on Top-Priority Measures) that provides

> Repayment of state bonds … that are due through December 31, 1999 issued into floatation before August 17 1998 is made by way of crediting the moneys to special investment bank accounts … All operations in special investment bank account except crediting … suspended till the end of restructuring of state securities.

However, the courts did not provide any explanation why these two federal laws should have priority over another federal law - the Civil Code of the Russian Federation that does not allow unilateral breach of contract of a state loan by the state (Article 817.4 is specifically devoted to contract of a state loan). Later the Russian commercial courts held in MinFin III litigation that the provisions of the Civil Code apply to the relations between bondholders and the state as an issuer of bonds.

Despite of this apparent flow in the courts decisions in GKO litigation the default on GKO/OFZ bonds would likely sustain the scrutiny of the Constitutional Court of Russia because the rights of bondholders were restricted by a federal law, i.e by the Federal Law on Top-Priority Measures.

In the Judgment of June 9, 1992 the Constitutional Court of the Russian Federation assessed the refusal of the Government to pay on state checks and stressed

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[68] Federal Law of the Russian Federation No 136-ФЗ of July 29, 1998 on Peculiarities of Issue and Floatation of State and Municipal Securities.

[69] Federal Law of the Russian Federation of December 12, 1998 N 192-ФЗ on Top-Priority Measures in the Field of Budget and Tax Policy.

inadmissibility of unilateral change … of the terms of contractual obligations by the state concluding that such unilateral change infringes property rights of citizens, limits freedom of economic activity.[70] However, in its judgment of December 23, 1997 the Constitutional Court of the Russian Federation stated that the realization of individual rights and interests should not affect negatively upon providing with budget funds of rights and interests of all citizens, when the budget funds are insufficient to secure realization of constitutional rights of all citizens, and that the balance between the rights and legitimate interests of persons that are parties in property relations with the state and the interests of other citizens may be found in the form of a *federal law*.[71] In the light of these conclusions of the Constitutional Court the chances of the holders of defaulted Russian domestic state bonds to win their case in the Constitutional Court of Russia would be considered as low because their rights were limited by the federal law.

1.3 Acts on Moratoria on MinFin III

On May 14, 1999 the Ministry of Finance of Russia issued a letter in which it asked the holders of MinFin of III series not to produce bonds for payment until November 14, 1999, and informed that all submitted MinFin III would be returned back to their owners. The difference between the default on MinFin III bonds and the default on GKOs/OFZs was that the default on MinFin III was declared by a letter of the Ministry of Finance (though MinFins III were issued on the basis of a decree of the Government) whilst the restructuring of GKOs was provided by a federal law. On November 29, 1999 the Government issued the decree on novation of MinFins III[72].

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[70] The Constitutional Court of the Russian Federation No 7-П of June 9, 1992.
[71] The Constitutional Court of the Russian Federation No 21-П of December 23, 1997.
[72] Decree of the Government No 1306 of November 29, 1999 on Novation of Bonds of Domestic State Loan of Third Series.

In the first round of litigation, Russian commercial (arbitrazh) courts dismissed the claims of MinFin III holders on the same grounds used in the judgments in GKO cases presuming the priority of budget legislation over civil legislation[73]. However, the Supreme Commercial (Arbitrazh) Court of Russia in *Rusatommet v Russian Federation*[74]remanded the case to the trial court holding that the Civil Code provisions govern relations between the Ministry of Finance and bondholders and that Item 4 Article 817 of the Civil Code excludes the possibility of unilateral change of the conditions of a state loan from the side of the borrower. Earlier the Supreme Court of the Russian Federation in its judgment of August 28, 2001[75] came to a similar conclusion. The Supreme Commercial (Arbitrazh) Court ordered the trial court to evaluate the legality of MinFin III moratorium. It also held that the November 1999 exchange offer was not binding on MinFin bondholders. This conclusion of two Russian supreme courts is in full accord with international practice. Buchheit writes that an exchange offer does not [usually] bind non-participating holders. In other words, holders declining the offer are left with their old bonds and will continue to enjoy their full legal rights and remedies under those instruments.[76]

On October 28, 2002 the Federal Commercial (Arbitrazh) Court of Moscow District upheld the decision of an appellate court and ultimately decided the case in favor of a MinFin III holder referring in its decision extensively to the judgments of the

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[73] *See* Federal Commercial (Arbitrazh) Court of Moscow District [FASMO] КГ-А40/723-00 of March 16, 2000.
[74] The Supreme Commercial (Arbitrazh) Court of the Russian Federation [VAS] No 2453/00 of February 13, 2002.
[75] The Supreme Court of the Russian Federation [VS of the RF] No ГКПИ 2001-1159 of August 28, 2001.
[76] LEE C. BUCHHEIT, SOVEREIGN DEBTORS AND THEIR BONDHOLDERS 8 (UNITAR Training Programs on Foreign Economic Relations, Document No. 1, February 2000).

Supreme Commercial (Arbitrazh) Court and Supreme Court of the Russian Federation.[77] The Court held the Civil Code does not allow unilateral breach of contract, the restructuring (novation) is not mandatory and that the provisions of budget legislation may matter at the stage of a judgment's execution. Curiously enough, the court held that the decision on the introduction of legal or actual moratorium was not adopted so the refusal of a payment agent to pay on MinFin III bonds was not legitimate. The execution problems in MinFin III litigation will be considered in Part III.

2. International Litigation Perspectives

The fact that domestic bonds on which Russia defaulted in 1998-99 were issued subject to Russian law effectively "insulated" the Russian Federation from the perils of international litigation.

2.1 Article VIII, s 2(b) of the Bretton Woods Agreement

Sovereign debtors in trouble often invoke the defense of Article VIII, s 2(b) of the Bretton Woods Agreement. Under Article VIII, s 2(b) of the Bretton Woods Agreement establishing the IMF to which Russia is a signatory there is a provision for mutual recognition by the courts of IMF members of each others exchange controls applicable to 'exchange contracts' if the controls are consistent with the IMF agreement.[78] This provision states:

> 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.

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[77] FASMO, *supra* note 50.
[78] WOOD, *supra* note 13, at 154.

According to Wood this provision has had a limited reception by municipal court. For instance, English, American[79] and probably German[80] courts will not normally regard a loan contract as being within this provision in contrast to their Luxembourg and French counterparts[81].

US federal courts took the narrow view of "exchange contracts" in Article VIII, Section 2(b) so they interpret "exchange contracts" as contracts for the exchange of one currency against another or one means of payment against another. In *Libra Bank Ltd v Banco Nacional de Costa Rica*[82] Judge Motley of the U.S. District Court for the Eastern District of New York held that a contract to borrow United States currency, which requires repayment in United States currency, and which designates New York as the situs of repayment, is not an exchange contract within the meaning of Article VIII, section 2(b). Similarly, the English Court of Appeals held in *Wilson, Smithett & Cope Ltd v Terruzzi*[83] that exchange contracts within the Bretton Woods Agreement Art. VIII, s. 2 (b) refer to contracts for the exchange of the currency of one country for that of another.

It seems that if the holders of GKOs/OFZs filed lawsuits in American, English and German courts the Russian government could not probably use Article VIII, s 2(b) of the Bretton Woods Agreement as a straightforward defense of the default on GKOs/OFZs against bondholders' claims, but it might succeed in France and Luxembourg, whose courts take the broad view that Article VIII, s2(b) covers all

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[79] *See* e.g. *Libra Bank Ltd v Banco Nacional de Costa Rica,* 570 F Supp 870 (SDNY 1983) (loan not barred by Costa Rican exchange controls).
[80] Gerhard Wegen, *2(B) or not 2(B): Fifty Years of Questions - the Practical Implications of Article VIII Section 2(B*), 62 FORDHAM L. REV. 1931, 1938 (1994).
[81] WOOD, *supra* note 13, at 154.
[82] *See Libra Bank Ltd v Banco Nacional de Costa Rica,* 570 F Supp 870 (SDNY 1983).
[83] *Wilson, Smithett & Cope Ltd v Terruzzi* [1976] Q.B. 683 (Eng. CA).

contracts involving monetary elements. Nevertheless, Article VIII, s 2(b) could be still relevant in the case of a GKO/OFZ restructuring scheme under which all proceeds received by non-residents were deposited into S-accounts (special ruble-denominated accounts that are not freely convertible into foreign exchange or cash rubles).[84] These restrictions imposed by Russian exchange control obviously refer to contracts for the exchange of the currency of one country for that of another so the conditions established by *Libra Bank Ltd v Banco Nacional de Costa Rica* and *Wilson, Smithett & Cope Ltd v Terruzzi* could be met.

2.2 Act of State Doctrine

In the United States, courts have sometimes refused to enforce contracts that are contrary to the exchange control regulations of other countries not based on the language of Article VIII, s 2(b) of the Bretton Woods Agreement but on the act of state doctrine.[85] This is uncommon for the continental Europe, because continental European countries (e.g. Germany) do not recognize an act of state doctrine to the same extent as the United States.[86] Under the act of state doctrine, United States courts will not sit in judgment on the validity of the public acts of foreign sovereigns within their own territory.[87]

In *Western Banking v Turkiye Guaranti Bankasi*[88] the Court of Appeals of New York held that the act of state doctrine is not applicable to debts located outside the foreign state whose act is being raised as a defence. In *Libra Bank Ltd v Banco Nacional*

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[84] Ministry of Finance of the Russian Federation, *Summary of GKO/OFZ Refinancing Program for Non-Residents* (March 26, 1999), *at* http://www.minfin.ru/off_inf/112.htm.
[85] *See* e.g. *Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 566 F. Supp. 1440 (S.D.N.Y. 1983) (holding the act of state doctrine as meritorious in defending against a suit for a loan default), rev'd, 757 F.2d 516 (2d Cir.), cert. denied, 473 U.S. 934-35 (1985).
[86] Wegen, *supra* note 80, at 1938.
[87] *See* e.g. *Banco Nacional de Cuba v. Sabbatino,* 376 US 398 (1964*)*.
[88] *Western Banking v Turkiye Guaranti Bankasi* 456 NYS 2d 684 (1982).

de Costa Rica[89] Judge Motley of the U.S. District Court for the Eastern District of New York held that the act of state doctrine may only be used as a defense to preclude judicial inquiry where the act of the foreign sovereign occurs within its own territory. According to Wood, the English courts reach the same result by using different reasoning, i.e. that the discharge of a contract is governed by its proper law and, as the proper law was an external system of law, the contract was insulated from national exchange control.[90]

In order to invoke this defense the defendant needs to prove that the situs of debt was within its own territory. In the case of GKOs/OFZs and MinFins the situs of debt is probably Moscow, Russia. The matter is that GKOs/OFZs and MinFins were issued in the form of documentary securities with obligatory centralized deposit. Under the terms of issue of GKOs/OFZs the Central Bank of the Russian Federation (CBR) was designated as the main payment agent.[91] The Central Bank and the Vnesheconombank were payment agents under terms of MinFin bonds.[92] So the situs of GKO/OFZ and MinFin debts is probably Moscow i.e. - the place where the Central bank of Russia and the Vnesheconombank are situated and where the bondholders have actually been paid. Therefore, it seems that the Russian Government could invoke an act of state doctrine as defense in litigation in US courts.

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[89] See *Libra Bank Ltd v Banco Nacional de Costa Rica,* 570 F Supp 870 (SDNY 1983).
[90] Philip R. Wood, *Governing law, jurisdiction and immunity clauses* (London September 2002) 12 [on file with the author].
[91] Decree of the Government of the Russian Federation No 458 of May 15, 1995 on General Terms of Issue and Trade of bonds of federal loans.
[92] Decree of the Council of Ministers of the Russian Federation No 222of March 15, 1993 Terms of the issue of domestic state currency bond loan, Section 3.1. *See* also *at* http://www.veb.ru/index.asp?objectID=864&lang=eng.

2.3 Exchange Controls

If the agreement is governed by the law of the jurisdiction of the borrower such law is susceptible to being changed by and for the benefit of the sovereign borrower. Under New York law the stipulated law is the law at the time of decision. In accordance with this principle, the New York Court of Appeals has applied foreign post-contract law to contracts governed by foreign law in several instances.[93] In *Mayer v Hungarian Commercial Bank of Pest*[94] Judge Galston of the U.S. District Court for the Eastern District of New York dismissed lawsuit of a holder of a Hungarian bond. The Hungarian Government in 1931 enacted legislation blocking the payment of foreign currency bonds abroad. Instead, the foreign bondholders were limited to claiming amounts due on their bonds in Hungary in Hungarian currency. A bondholder's claim in New York on Hungarian municipal bonds failed because the bonds were governed by Hungarian law.

In the English case of *Re Helbert Wagg & Co Ltd*[95] a German company carrying on business in Germany borrowed sterling payable in England from an English company under a contract governed by German law. By German exchange control legislation enacted subsequent to the making of the contract, the borrower was required to pay the amounts owing to the lender in German currency to a German government office and thereby was discharged under German law. Judge Upjohn of Chancery Division held that the liability was validly discharged under the governing law of the contract.

GKOs/OFZs and MinFins were issued subject to Russian law so U.S. and English courts would likely reject the claims of GKO/OFZ and MinFin bondholders.

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[93] M Gruson & R Reisner 'Governing-Law Clauses in International and Interstate Loan Agreements: New York's Approach' 1 U. OF ILLINOIS L REV. (1982).
[94] *Mayer v Hungarian Commercial Bank of Pest*, 21 F Supp 144 (EDNY 1937)
[95] *Re Helbert Wagg & Co Ltd* [1956] Ch 323 (Eng. Ch).

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The Russian default on domestic bonds was unlikely to be adjudicated by foreign courts and it sustained the scrutiny of domestic courts. The only exception was the default on dollar denominated domestic MinFin bonds of III series that in the view of Russian commercial courts was probably illegitimate.

Part II: Lessons of the Financial Crisis

2.1 Differentiated and Discriminatory Treatment of Creditors

A key element in the [Russian] external debt strategy was discrimination between a Soviet-era debt contracted before January 1, 1992 and a Russia-era debt contracted after this cut-off date.[96] During the Russian financial crisis of 1998-1999 the Russian government defaulted on all Soviet-era external debts including the Paris club obligations, London Club obligations under the 1997 agreement and domestic dollar-denominated MinFin bonds of III series. Russia also defaulted on its domestic debt. At the same time, the Russian government stayed current on Eurobonds and other external debt denominated in foreign currencies contracted by the Russian Federation. The only exception to this selective default strategy were interest payments made in May 1999 on MinFin bonds of 3-5 series that were perceived to be Soviet-era debt.[97]

Table 6: Russian Selective Default of 1998-99

Soviet-era debt (before 1 Jan 1992)		Russia-era debt (after 1 Jan 1992)	
Defaulted	**Not defaulted**	**Defaulted**	**Not defaulted**
Paris Club debt			Debt to official creditors
London club debt			Debt to commercial debtors
MinFin III principal	Interest on MinFins 3-5		Eurobonds
Trade debt of USSR		Domestic bonds	Interest on MinFins 6-7

The fact that Russia stayed current on its Eurobonds and a FX-denominated debt contracted by Russia since 1992 left some foreign observers perplexed to wonder what the motives were behind this selective default approach and discriminatory distinction between Russian and Soviet debt. One of the experts on the Russian economy Kasper

[96] SANTOS, *supra* note 4, at 171.
[97] A probable explanation of this phenomenon can be that payment of coupon profits on MinFins 4-5 did not require much money but default on them could have triggered cross acceleration clauses.

Bartholdy from a US investment banking firm CSFB provides the following explanation of this phenomenon:

> The argument that underlies the government's distinction between Soviet and Russian debt runs along the following lines… The [Russia's] government made a mistake in 1991-2, when it assumed responsibility for the Soviet Union's foreign debt … an undertaking which the country could ill afford. The responsibility for this debt really rests with the old Communist rulers of the Soviet Union and not with the new Russian Federation. The world at large should, therefore, allow the government to shirk responsibility for at least a part of this debt. A poor debt servicing record for this debt should not undermine the world's view of the overall creditworthiness.[98]

Bartoldy criticizes the government's distinction between Soviet and Russian debt arguing that the government's dominant decision criterion seems instead to have been to default on as wide an array of liabilities as possible, subject to overriding wish to stay on Eurobonds.[99] Indeed, the Russian government obviously defaulted on liabilities that were the least protected legally such as Soviet-era debts. It is submitted that Russia did not default on the public external debt contracted after 1992 mainly because of the concern not to loose the access to international capital markets in the foreseeable future.[100]

2.2 Unique Default on Domestic Debt

No major borrower country defaulted on its debt since the 1980s before the Russian default of 1998.[101] Scott writes that perhaps Russia was confident that its superpower status and earning prospectus permitted this.[102]

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[98] Kasper Bartoldy, *Debt Servicing. Russian style, in* THE WILD EAST: NEGOTIATING THE RUSSIAN FINANCIAL FRONTIER 125 (P Westin ed. Pearson Education 2001).
[99] *Id.*
[100] See above the section on Eurobonds.
[101] Hal S. Scott, *Emerging Market Debt, in* INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 25 (2004) [on file with the author].
[102] *Id*

Foreign economists observe that the Russian default on domestic debt in August 1998 was somewhat unique in modern history.

> The August 17, 1998, default was unprecedented, as it included a default on local currency-denominated debt instruments that at some point were perceived to be the "risk-free asset" in the economy. The government's decision to default initially on GKOs and OFZs (and only subsequently on most Soviet-era debt) was clearly controversial as *no country in modern history had defaulted on a bond that was denominated in its local currency and was subject to its local law.* In the past all countries facing the dilemma that Russia faced in August 1998 had chosen the option of eliminating their domestic currency debt problem by printing money, generating an extraordinary outburst of inflation … [103]

Among other reasons why Russia defaulted on domestic debt rather than to choose the way of inflation were named: the negative experience with high inflation of the early 1990s, the lack of private sector involvement[104], the perception that single-digit inflation in early 1998 was a major policy achievement, the bad recent East Asian experience with devaluation.[105] It seems that in the light the negative experience of the August 1998 default the Russian Government will likely try to avoid defaulting on domestic debt in the future.

2.3 No IMF bailout after the August 1998 Default

Before the financial crisis of August 1998 there was a perception among investors that the international community would not allow Russia's economic program to fail. Indeed the IMF and the World Bank provided about US$ 5.5 billion in July-early August 1998. But a "too big to fail" theory did not work out. Though in a number of cases the IMF bailed out private creditors during the crises in some Asian and Latin

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[103] SANTOS, *supra* note 4, at 166.
[104] *Id.*
[105] Kharas et al., *supra* note 40 at 3.

American countries it did not provide any money after the default of August 17, 1998[106] until a new arrangement was reached with Russia in July 1999. So now the investors are aware that the IMF may not bail them out in the case of another financial crisis as it happened after the Russian default in 1998 that reduces a moral hazard problem in future lending to Russia.

2.4 Collective action clause in domestic bonds?

The Russian default of 1998 on domestic bonds clearly demonstrated the need in a legal provision that would allow restructuring domestic debt without defaulting on it and breaching contractual obligations. English-style majority action clauses of Russian Eurobonds that allow changing payment terms of bonds by 75 % majority may be a good example to follow in domestic bonds.

Though, theoretically a sovereign may avoid the default on domestic bonds by printing money and causing inflation that will largely eliminate domestic debt such scenario is impossible if domestic bonds are denominated in foreign currency. For instance, Russia had a large stock of dollar-denominated MinFin bonds. In this case an English-style majority action clause may provide a legitimate way of restructuring bond debt without defaulting on it so such clauses should be adopted in all future Russian domestic bonds.

2.5 Holdout problem

The problem with exchange offers that have become a popular legal technique for carrying out sovereign bond restructurings is that they are not binding for non-

[106] Scott *supra* note 41 at 122.

participating holders that potentially can create the hold-out or free rider problem. Russia had a holdout problem only in restructuring of Minfin bonds of third series.

A holdout creditor in the MinFin III restructuring was a Russian law firm Rusatommet that purchased a MinFin III bond of the face value of US $100.000 (allegedly for no more than 20-40% of its face value[107]) in July 1999 - more than a month after Russia defaulted on MinFin bonds of third series. After the payment agent refused to pay on a bond Rusatommet filed suit in the Moscow commercial (arbitrazh) court. These facts may suggest that Rusatommet purchased a bond with the purpose to sue the Russian Government but that is not prohibited by Russian law. It does not have champerty provision similar to Section 489 of New York Judiciary Law that provides that

> No person … shall solicit, buy or take an assignment of, or be in any manner interested in buying or taking an assignment of a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon

However, the US case of Elliot v Peru demonstrated that champerty rule is useless against holdout creditors.

It should be noted that Rusatommet is not a vulture holdout creditor in traditional understanding since after more than five years passed litigation is still going on and, allegedly, the cost of litigation for Rusatommet exceeded the face value of a bond. Besides, the typical holdout strategy involves waiting until the conclusion of a restructuring agreement with other creditors. Rusatommet in contrast purchased a bond and initiated litigation practically right after the default.

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[107] It follows from MinFin prices charts provided in DUFFIE ET AL., *supra* note 57 at 8.

The practical consequence of this case may be that holders of Russian bonds in future will be inclined to reject to restructure debts and hold out when presented with exchange offers.

A Swiss firm Noga can be regarded as a kind of holdout trade creditor. All Russia's trade creditors (suppliers) except Noga agreed to reconcile debt on the term similar to the London Club restructuring deal. The concern of the Russian Government is that:

> … [Noga], however, is insisting on payment of the full face value of the debt the Tribunal determined that the Russian Government owes NOGA. Were the Government to pay NOGA today on such terms, clearly more favorable than the Government is paying its other similarly situated creditors, the delicate and complex restructuring plans achieved with its creditors could unravel ... [108]

2.6 Bondholders and Human Rights

In 1998 the Russian Parliament ratified the European Convention for the Protection of Human Rights and Fundamental Freedoms (hereinafter also the "Convention") that added the entire new dimension to Russian law.[109] The European Court of Human Rights was enabled to adjudicate claims of Russian natural and legal persons and its decisions are binding for the Russian Federation.

After Rusatommet – a holder of a MinFin III bond lost its case against the Russian Federation in the Federal Commercial Court of Moscow District it filed suit in the European Court of Human Rights ("the ECHR") on September 15, 2000.[110] Rusatommet in its petition alleged inter alia the violations of its human rights to:

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[108] Kolotukhin, *supra* note 36, at 2.
[109] Federal Law No 54-ФЗ of March 30, 1998.
[110] *Rusatommet Ltd. v. Russia* No 61651/00 of October 10, 2001 (ECHR).

- peaceful enjoyment of his possessions provided by Article 1 of Protocol 1 to the Convention.
- fair trial provided by Article 6 of the Convention.
- an effective remedy provided by Article 13 of the Convention.

It is hard to speculate on how the European Court of Human Rights would decide this case as the ECHR proceedings were stayed after the Russian court started reconsidering the Rusatommet case again. However, on November 30, 2000 the MinFin III exchange offer was closed by the Russian Government. Given the fact that Rusatommet failed before that time to win its case in Russian courts an absolute refusal to pay on a MinFin 3 bond belonged to Rusatommet could probably have been regarded by the European Court of Human Rights as an attempt to expropriate Rusatommet's property that may constitute infringement of its right to peaceful enjoyment of its possessions provided by Article 1 of Protocol 1 to the Convention that states that:

> Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

As it follows from the prompt reaction of the Russian Government it was not sure that this was not the case. On July 30, 2001 the Russian Government extended the MinFin III exchange offer indefinitely.

An interesting aspect of this case is a probable influence of the Rusatommet petition to the ECHR upon the dynamics of domestic litigation. Here is the chronology of the Government's actions after the European Court of Human Rights started its proceeding in the Rusatommet case:

Table 7: The influence of Rusatommet petition to the ECHR on domestic litigation

March 16, 2000	Rusatommet lost its case in the Federal commercial (arbitrazh) court of Moscow District

July 2000 - March 2001	The Supreme Commercial Court three times refused to reconsider the case on July 28, 2000, September 4, 2000 and March 2, 2001
Sept 15, 2000	Rusatommet filed suit in the European Court of Human Rights
June 5, 2001	The representative of the Russian Federation to the European Court of Human Rights sent a letter to the Chairman of the Government of Russia asking to prepare a memorandum on the Rusatommet case
June 16, 2001	The Russian Prime-Minister instructed the Ministry of Finance and Ministry of Justice with the participation of the Supreme Commercial Court of Russia to prepare a memorandum on the Rusatommet case
July 30, 2001	The Government extended the MinFin III exchange offer indefinitely
August 14, 2001	The Chairman of the Supreme Commercial Court of Russia brought a protest on the decision of Federal commercial court of Moscow District of March 16, 2000
February 13, 2002	The Presidium of the Supreme Commercial Court of Russia vacated and remanded the case to Moscow commercial court.
April 10, 2002	The Moscow Commercial court ruled in favor of Rusatommet against the Russian Federation

The dynamics of events after the filing of petition with the ECHR in the MinFin III litigation probably suggest that the petition to the ECHR helped the MinFin III holder to win its case in domestic courts.

2.7 Is Elliot Scenario possible?

In June 2000, Elliott Associates, L.P., a New York-based hedge fund, obtained a federal court judgment against the Republic of Peru and a Peruvian public sector bank.[111] The underlying claim arose pursuant to a 1983 New York law-governed letter agreement and guarantee of Peru containing a pari passu clause. Elliott knew that Peru

[111] *Elliott Assocs., L.P. v. Banco de la Nacion*, No. 96 Civ. 7916 (SDNY 2000).

was obliged to make a payment in September 2000 to bondholder accounts maintained with the Euroclear System in Belgium and the Depository Trust Company ("DTC") in the United States. On September 26, 2000, the Belgian Court of Appeals granted Elliott's motion to block Peru's Brady Bond payment. In its decision, the Court construed a pari passu clause of Peru bonds as saying that the debt must be repaid pro rata among all creditors. Shortly thereafter the case was settled, with Peru paying Elliott virtually everything Elliott had been seeking. This construction proposed by the Belgian Court of Appeals of a boiler-plate pari passu clearly contradicts a traditional explanation for the appearance of pari passu covenants in sovereign credit instruments. For instance, Wood writes that

> In the case of a sovereign state, . . . [t]he clause is primarily intended to prevent the earmarking of revenues of the government or the allocation of its foreign currency reserves to a single creditor and generally is directed against legal measures which have the effect of preferring one set of creditors over the other or discriminating between creditors."[112]

Belgian[113] and US courts[114] moved to follow the decision of the Belgian Court of Appeals in a number of cases but the English courts took a more traditional approach and rejected the claims of holdout creditors.[115] However, in the recent decision of March 19, 2004 the Belgian Court of Appeals in Brussels in *Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A*[116] significantly reduced the practical significance of the *Elliot v Peru* case by finding that there was no basis for any injunction against

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[112] PHILIP R. WOOD, *LAW AND PRACTICE OF INTERNATIONAL FINANCE* 156 (London 1980).
[113] *See Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A.,* Public Hearing of Summary Proceedings of Thursday, September 11, 2003.
[114] *See* e.g. *Red Mountain Fin., Inc. v. Democratic Republic of Congo and Nat'l Bank of Congo* CV 00-0164 R (C.D. Cal. May 29, 2001).
[115] *See Kensington Int'l Ltd. v. Republic of the* Congo (2002) No. 1088, at 6:13-16 (Commercial Ct. 16 April 2003). (judgment of Mr. Justice Tomlinson) (characterizing J. Cresswell as finding motion for injunctive relief "novel and unprecedented" and denying injunctive relief).
[116] *See Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A*., Court 9 of the Brussels Court of Appeals, 19 March 2004 N 2003/KR/334.

Euroclear, which was not a party to the contract. This decision should prevent similar holdout creditors from interfering with payments of debt through Euroclear in the future.[117]

As the interpretation of a pari passu clause is still unsettled in some major jurisdictions the question is if the *Elliot v Peru* scenario can be repeated with Russian debts? Pari passu clauses are contained only in two debt instruments issued by the Russian Federation – Eurobonds and dollar-denominated domestic MinFin bonds. Russia never defaulted on its Eurobonds but it defaulted on MinFins III. Theoretically, insurgent MinFin bondholders could have followed the way of Elliot but it seemed to be an unlikely scenario as MinFins are governed by Russian law and, accordingly, as the experience of 1999 default on these bonds demonstrated the Russian government may unilaterally change the terms of their issue, for instance, by removing a pari passu clause at all. Besides, because of the recent decision of the Belgian Court of Appeals in *Republic of Nicaragua v. LNC Investments and Euroclear Bank S.A*. the Elliot v Peru route may loose its appeal for holdout creditors.

2.8 Collective Action Problem

I found at least three examples when Russia faced a collective action problem. The first example is the MinFin III restructuring. In 2001 at least 10% of MinFin bondholders did not submit their bonds for exchange though the MinFin III restructuring started three years earlier in November 1999.[118] This may be explained by the attempts of some MinFin III bondholders to pursue claims in Russian courts.

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[117] *Nicaragua Wins Key Decision in Battle With Hold-Out Creditors*, March 31, 2004, *at* http://www.cgsh.com/english/news/NewsDetail.aspx?id=1497.
[118] *See* OVGVZ, *at* http://www.minfin.ru/debt/ogvz.htm.

The second example is a swap of GKOs/OFZs for Eurobonds in mid-July 1998. In July 1998, in the face of mounting pressures in the domestic capital market, Russia tried to secure agreement on a voluntary market-based swap of ruble-denominated domestic instruments (GKOs and OFZs) for medium-term dollar denominated Eurobonds.[119] The authorities hoped that if the exchange attracted sufficiently high participation, and the credibility of the overall adjustment package had been accepted by the markets, domestic interest rates (which had exceeded 70 percent, in the context of the ruble being pegged to the U.S. dollar) would return to more normal levels, thereby contributing to a successful resolution of the crisis.[120] Participation in the exchange was $6.4 billion out of a total of $41 billion of eligible domestic debt. The swap was immediately perceived to be a failure.[121] A number of factors is likely to have contributed to the low participation in the exchange. First, reports and discussions with investors after the deal pointed to both a lack of incentives in the exchange (in particular, the government stressed its commitment to maintain payments on the old bonds), and a collective action problem. In this regard, some investors were understood to have held on to their GKOs and OFZs in the hope of benefiting from a decline in interest rates, which would have followed the successful completion of the deal. Second, a number of investors felt the deal was poorly marketed, while others did not agree that the deal would contribute significantly to debt sustainability. Third, there was a widespread

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[119] REVIEWING THE PROCESS FOR SOVEREIGN DEBT RESTRUCTURING WITHIN THE EXISTING LEGAL FRAMEWORK, 23 (IMF August 1, 2003), *at* http://www.imf.org/external/np/pdr/sdrm/2003/080103.htm.
[120] *Id.*
[121] SANTOS, *supra* note 4, at 164.

perception among investors that the international community would not allow Russia's economic program to fail (a moral hazard problem). [122]

Third example is a failed amendment of the bond contract of PRINs and IANs notes issued under the 1997 agreement with the London Club of creditors. Within a year Russia was back in arrears to the London Club. After the interest payment on PRINs in December 1998 was missed. Russia tried to amend the bond contract but the critical mass of 95% was not reached and Russia missed the next scheduled payments (June 1999 and December 1999) on both PRINs and IANs. Here is the main problem was probably a high threshold of 95% needed to amend payment terms.

This examples witness that diverse and diffuse bondholders' community creates problems of coordination and collective action.

2.9 Reputation and Access to International Capital Markets

Why do countries ever repay their debts? A traditional answer was that countries repay in order to preserve a reputation for repayment, and so retain the ability to borrow in the future.[123] In 1989 Bulow and Rogoff in their paper have shown that

> [A] sufficient condition for reputations to fail to enforce repayment is that countries in default have access to a rich set of deposit contracts. Intuitively, when expected future repayments are large, a country can default, invest the resources saved in deposit contracts, and enjoy a higher level of consumption thereafter.[124]

The Russian post-default experience probably confirms the last assertion as Russia is able to return to international capital markets seven years later after the default, by issuing Eurobonds in 2005 owing to the strong economic position. In 2003 Russia's

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[122] REVIEWING THE PROCESS FOR SDRM, *supra* note 119.
[123] J Eaton & M Gersovitz, *Debt with Potential Repudiation,* 48 REV. OF ECONOMIC STUDIES 289 (1981).
[124] J Bulow & K Rogoff, *Sovereign Debt: Is to Forgive to Forget?* AMERICAN ECONOMIC REV 43 (1989).

gold and foreign currency reserves soared by US $29.2 billion,[125] now they exceed US $100 billion. It is doubtful if Russia could return to international capital markets so quickly if it defaulted on its Eurobonds in 1998. It seems that what really matters for investors is the current economic performance of a prospective debtor rather than its credit history.

2.10 Protection of Retail Investors

One interesting feature of the 1998 Russian financial crisis is that retail investors did not suffer much directly as a result of the default on domestic bonds. They rather suffered indirectly as bank depositors when large Russian commercial banks collapsed. The matter is that holders of Russian domestic bonds were mainly professional investors: Russian banks and non-residents. It happened partly owing to the fact that the minimum denomination of most GKO bonds was relatively high - about 100.000 rubles or about US $16.5 thousand at pre-crisis exchange rates. That made GKO unavailable for most retail investors as the average monthly salary in Russia in 1998 was about $100.

The protection of retail investors is a big issue these days. For instance, millions of retail investors hold much of Argentina's private debt, including 450,000 Italians, 35,000 Japanese, and 150,000 Germans and Central Europeans.[126] Recently, Argentina's government offered 75% haircut on its private debt. It means that all these retail investors will receive just 25 cents on the dollar that would be a substantial blow to their

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[125] *Study: Russia No. 3 Borrower in Developing World*, THE MOSCOW TIMES, April 27, 2004 at 7.
[126] M Moffett, *Argentina's Plan to Fix Financial Mess Leaves Small Creditors in Lurch,* THE WALL STREET JOURNAL EUROPE, January 14, 2004.

financial well-being. This example shows the necessity of introducing of additional protections for this category of investors.

In contrast, professional investors do not need such protections as they are capable of protecting their own interests. They may spend millions dollars for litigation as Elliot Associates or Noga or just pulled money out of countries at the first sign of distress. For instance, the recent research shows that mutual funds tend to make substantial withdrawals one month before the crisis.[127]

Foreign retail investors do not buy foreign domestic bonds but they buy Eurobonds issued under law of New York, England or their own jurisdictions. The Russian 1998 default experience suggests that the high minimum denomination of bonds may make such securities unavailable for an average retail investor. Currently in order to facilitate transfers by the investors, the terms of [bond] loans are usually set out in securities, each of which is in a relatively small amount, e.g. $1,000.[128] So New York and England as the most popular jurisdictions for issue of sovereign Eurobonds[129] should probably prohibit the issue of Eurobonds with a face value of less than $100.000 by a sovereign issuer whose credit rating is less than A.

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[127] A PANIC PRONE PACK? THE BEHAVIOR OF EMERGING MARKET MUTUAL FUNDS (IMF Working paper 00/198, December 2000).
[128] PHILIP R. WOOD, INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION 9 (Sweet&Maxwell 1995).
[129] COLLECTIVE ACTION CLAUSES: RECENT DEVELOPMENTS AND ISSUES 16 (The IMF March 25, 2003), *at* http://www.imf.org/external/np/psi/2003/032503.pdf.

Part III: Seizure and Execution Problems in Domestic and International Litigation.

Obtaining a judgment is one thing, enforcing it is another.[130]
PR Wood

3.1 Blocking execution against domestic assets: Execution problems in MinFin III litigation

The Rusatommet litigation presents an interesting case of domestic bondholder litigation against the Russian Government in Russian commercial courts. Rusatommet - a MinFin III bond holder managed to win the case against the Russian Government April 2002 after three years of litigation. Later that judgment was upheld by the higher instances of Russian commercial courts.[131] This case is remarkable first of all for the Russian court system as it was the first ever case in the modern Russian history when a bondholder won his case in domestic courts against the state. This case tested maturity and independence of the Russian court system and proved that investors can protect their rights in domestic courts.

However, the legal battle is far from over as Rusatommet is still unable to enforce the judgment. On May 12, 2003 the Service of Court Bailiffs closed execution proceedings. Rusatommet tried to challenge inaction of the Service of Court Bailiffs. The trial court ruled in favour of Rusatommet but the appellate court reversed and the Federal commercial court of Moscow District on February 6, 2004 upheld the judgment

[130] Wood, *supra* note 13, at 113.
[131] See FASMO, *supra* note, at 50.

of the appellate court.[132] The courts referred to Article 122 of the Federal Law on the Federal Budget for 2003 that provides that execution of judgments against the Russian Federation is not within the authority of the Service of Court Bailiffs. The plaintiff appealed to the Supreme commercial (arbitrazh) court of Russia.

This kind of obstacle for execution of a judgment against a sovereign locally is not novel in international practice. Wood notes that all countries have a provision that creditors can sue their home country but they can never attach public assets locally as the creditors have to rely upon a political decision to pay such creditors:

> Most of a state's assets are inviolable from legal process ... *A state can pass legislation, binding on its courts, immunizing domestic asset from execution, and many have done so*.[133]

For example, § 882a of the German Civil Procedure Code provides that:

> (1) Execution of a money claim against the Federal Republic of Germany or against a federal state, as far as not property rights are executed, can only commence four weeks after the creditor has indicated his intention of execution to the authority which represents the debtor, and, if execution shall take place against assets held by another authority, to the responsible Minister of Finance. Receipt of the indication has to be confirmed on demand of the creditor. …
> (2) Execution is not admissable against things which are indispensable to fulfilling the tasks of public interest of the debtor or against things the disposal of which is against the public interest.

The Russian Ministry of Finance apparently managed to lobby the insertion of a provision in the Federal Law on the Federal Budget for 2003 that effectively blocked execution of a judgment obtained by Rusatommet. Article 122 of the Federal Law on Federal Budget for 2003 was reproduced in the Federal Law on the Federal Budget for 2004. According to Article 135 of the Federal Law on the Federal Budget for 2004,

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[132] See Federal Commercial (Arbitrazh) Court of Moscow District [FASMO] No КГ-А40/96-04 of February 4, 2004 *OOO Rusatommet v Service of Court Baliffs & Ministry of Finance of the Russian Federatio*.
[133] WOOD, *supra* note 13, at 154.

execution of judgments against the Russian Federation is not carried out by the Service of Courts Bailiffs.[134]

It seems that if Rusatommet's files a petition to the Constitutional Court of Russia it might have some chances for success as absolute blocking of a court's judgment may constitute an infringement of a constitutional right to judicial protection of its rights and freedoms provided by Article 46.1 of the Russian Constitution and a right to an effective remedy provided by Article 13 of the European Convention for the Protection of Human Rights. However, if the Constitutional Court decides that this provision contradicts the Constitution and repeals it or the Federal Law on the Federal Budget for 2005 does not contain such provision it is far from clear how much time will it take the Service of Courts Bailiffs to enforce the judgment as the queue of domestic debtors of the Russian Federation is long and budget funds allocated every year for satisfaction of the claims against the Russian Federation are insufficient.

This case (though an appeal to the Supreme Commercial (Arbitrazh) Court of Russia is pending) clearly demonstrates that the Russian state can successfully immunize domestic assets from execution.

3.2 Seizure problems in Noga litigation

1. Loan Agreements

Noga is a Swiss corporation – a commercial creditor of the Russian Government that concluded a loan agreement ("oil-for-goods" deal) with the Russian Government in 1991. This agreement included a waiver of sovereign immunity (the Russian Government and Russia as rule never waives sovereign immunity), an arbitration clause

[134] Federal Law No 186-ФЗ of December 23, 2003 on the Federal Budget for 2004.

and was governed by Swiss law. The fact that the party to the loan contract was the Russian Government but not the Russian Federation precluded Noga from levying execution on Russian assets abroad.

The Russian Government has made repeated offers to Noga to join in the restructurings on the same terms as similarly situated creditors. Instead, Noga has pursued payment of the full face value of the arbitration awards.

Noga obtained three arbitral awards of about US $52 million in 1997 and 2000 from the Arbitration Institute of the Stockholm Chamber of Commerce and tried to enforce them in some countries including the United States. Russia alleged that the amount of the claims (including arbitral awards and court judgments) in favor of Russian entities against Noga relating to transactions under the loan agreements was roughly equal to the amount owed by the Government to Noga under the arbitral awards (approximately $50 million including interest through 1997) and that these claims were assigned or could have readily been assigned to the Russian government.[135]

2. US Litigation

Judge Pauley of the US District Court for the Southern District of New York held in *Compagnie Noga d'Importation et d'Exportation S.A. v Russian Federation* [136] that the arbitration award could not be confirmed against the Russian Federation because it had objected to the arbitration and ultimately, the Swedish arbitrators had issued their awards only against the *Russian Government*. The US district court ruled that the Russian Federation properly pled the set-off as an affirmative defense and that Noga could enforce just two judgments of Swedish courts against the Russian Federation of

[135] Kolotukhin, *supra* note 36, at 2.
[136] *Noga, supra* note 22.

about US $31.000 (attorney fees) that were subject to set-off. It seems that despite the leverage afforded by obtained arbitral awards, it will not be easy for Noga to enforce these awards since they were entered against the Russian Government because this significantly narrowed the amount of assets available for seizure. The fact that Noga could not attach any assets for seven years confirms this assertion.

3. Attachment Attempts in USA

In the USA, Noga sought to attach Russian Government assets such as grain shipped on the Mississippi and Ohio Rivers, substantial sums on deposit in New York banks and highly enriched uranium located at the United States Department of Energy's uranium processing centre near Paducah, Kentucky. The Russian Government's ownership of the uranium assets arises from an agreement between the United States and the Russian Government concerning the disposition of highly enriched uranium extracted from nuclear weapons dated February, 18 1993. To prevent seizure of the uranium and other assets related to the HEU Agreement, President Clinton blocked their attachment by Executive Order[137]. In July 2001, President Bush extended this order. In addition, the Russian Air Force cancelled a commemorative transpolar flight of two fighter jets to Vancouver in July 2002 because of the fear of attachment by Noga.[138]

As the Noga's attempts to enforce the arbitral awards in the United States failed it could not attach Russian assets in the USA.

4. Attachments in Europe

Noga made a number attempts to seize Russian assets in many European countries that I summarized them in the table below. These attachments have raised

[137] Exec. Order No. 131519, 65 Fed. Reg. 39279-39280 (June 21, 2000).
[138] James J. Napoli, *Soviet Aviator's Son Honors Transpolar Trip*, PORTLAND OREGONIAN June 21, 2002.

many diplomatic antagonisms.

Table 8: Noga's attachment attempts against Russian assets in Europe[139]

Country	Year	Target /Asset	Owner of asset	Comment
United Kingdom	2002	For the first time since 1988, there were no Russian planes at the Farnborough air show because of the fear of attachment by Noga		
Germany	2002	No Russian planes at the Berlin air show.		
France	June 2002	The Russian Air Force canceled a flying demonstration devoted to the World War II cooperation between the Soviet and French Air Forces		
France	June 22, 2001	Russian Su-30MKK and MiG-AT jet fighters	Sukhoi and MIG design bureaus, a state-owned Komsomolsk-on-Amur aviation plant (KnAAPA)	Noga tried to seize two Russian jet fighters at the international air show in Le Bourget. The court of the French town of Bobigny threw out Noga's lawsuit against the organizers of the show on July 2, 2003 and imposed a fine of 6,000 euros on Noga. On April 7, 2004 Noga dropped appeals in the French courts
Switzerland	October 1, 2001	CHF5 million bail bond	Bail bond was paid by the Russian authorities	The Swiss Federal Court reaffirmed a lower court ruling that a CHF 5 million bail bond posted on behalf of Pavel Borodin (a former property manager of the Russian president) was immune from sequestration (no evidence that the bail bond was paid by the Russian government)
Belgium	2000	Russian Art Treasures exhibition	Russian state museum	The Royal Museum of Art and History in Belgium was forced to abandon a show of Russian Art Treasures when it could not gain legal guarantees against the seizure of the art
France	Fall 2000	Russian President Vladimir Putin's plane	State airline "Russia"', Administration of the President of the Russian Federation	On August 7, 2000 lawyers representing a Swiss company threatened that they would demand the seizure of Russian President Vladimir Putin's plane when he visits France in October as part of their battle to recover alleged debts. In the autumn of the same year France reportedly issued a presidential decree to prevent the seizure of the Russian president's personal aircraft at Orly.

[139] This table is based on multiple sources. I also used M. WRIGHT, REPUTATIONS AND SOVEREIGN DEBT (Stanford University Department of Economics, September 2001), *at* http://sccie.ucsc.edu/documents/AIEC/2002/wrightpaper.pdf.

The Netherlands	August 16, 2000	Tall sailing ships Mir, Sedov and Kruzenshtern	State Technical University of Murmansk (Sedov), Sankt-Peterburg state maritime academy (Mir), Baltic state academy of fishing fleet (Kruzenshtern)	To pre-empt further action on this front, foreign governments sought immunity from seizure for Russian ships. The Harlen district court in ruled that the Russian tall sailing ships Mir, Sedov and Kruzenshtern were immune from seizure.
France	July 13, 2000	The world's largest tall ship Sedov	State Technical University of Murmansk	Sedov was impounded in the port of Brest at the Brest boating festival international sea festival Brest-2000. Both the ships owners and the French state prosecutor argued that the university was not liable for Russian state debts. A court of appeal agreed on 24 July and ordered Noga to pay US $71,000 in damages to the ship's owners, and US $35,000 to the festival organizers. A last minute appeal by Noga against the release of the ship failed when the appeal order was not filed correctly.
France	May 2000	Bank accounts	Russia's embassy and consulate general in Paris	On 10 August 2000, a Paris judge ruled that the suit had no legal basis and ordered Noga to pay FF 30,000 (more than US $4,000 in damages). The appeal had been supported by the French government. The court cases turned on the argument of the Russian government that, under international law. - Central Bank assets were immune from attachment for Russian State debts. This had been the finding of the court in Luxembourg. - Russian embassy property is protected under the Vienna convention.
France	May 2000	US $63 million in bank accounts	Central Bank of Russia and almost 70 Russian government agencies and companies in which the Russian state had a stake.	
Luxembourg	2000	US $650 million		
Luxembourg/ Switzerland	1993	US $279 million in 30 bank accounts	The Central Bank, the Government, Russian organizations and agencies	In 1996, these accounts were mainly unfrozen because the Central Bank was not party to the contracts. The Luxembourg accounts were unfrozen in 1996, but there is some doubt as to when (and if) Switzerland accounts were ever unfrozen.

3.3 Asset protection tactics

Wood writes that where the foreign debt is owed by a separate state entity as opposed to the state itself, the state has a greater freedom in readjusting their obligations and greater protection against foreign creditor remedies.[140] In many cases the execution on Russian assets proved to be difficult or impossible because of sovereign immunity or because the owner or lender was not the Russian Federation but some other entity such as:

- the Vnesheconombank (see above the section on the London Club debt)
- the Government of the Russian Federation (see *Compagnie Noga d'Importation et d'Exportation S.A. v Russian Federation*[141]*)*
- The Central Bank of Russia
- state entities
- commercial companies (e.g. Fimaco)
- embassy or consulate (which enjoys diplomatic immunity)

1. State Entities' Liability

According to Wood the assets of a state entity, such as an airline or central bank are not available to satisfy the obligations of the state.[142] This concept works perfectly in France, USA (but not probably in Switzerland). The only US case where the veil of incorporation was lifted is *First National City Bank v Banco Para el Commercio Exterior*[143]where the US Supreme Court held that veil could be pierced if the state entity is a mere agent of the government or if the corporate form was abused to work fraud or injustice. In *Carige v Banco Nacional de Cuba* involving the transfer of assets from an old Cuban central bank to a new Banco Central de Cuba, the English Chancery Division

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[140] WOOD, *supra* note 13, at 155.
[141] *Noga, supra* note 22.
[142] WOOD, *supra* note 13, at 156.
[143] *First National City Bank v Banco Para el Commercio Exterior* 462 US 611 (1983).

held that the creditor failed in its plea that the switch was a fraudulent preference designed to prejudice creditors.[144] Noga failed in many cases to attach Russian assets because the courts held that those assets belonged to state enterprises that were not liable on the Russian government obligations.

2. Immunity of central banks

Immunity statutes of many countries including USA and UK have specially immunized central bank property in the absence of an express waiver.[145] Section 14(4) of the UK State Immunity Act 1978 provides that where a central bank is a separate entity has the same advantages as a state … e.g. immunization from injunctions, the enforcement of judgments and arbitration awards against its property without its consent or prior agreement. The English Court of Appeal held in *Trendtex Trading Corporation Ltd v Central Bank of Nigeria*[146] that a Nigerian Central Bank is not a department of a foreign state. Section 1611(b)(1) of the US Foreign Sovereign Immunities Act of 1976 contemplates that property of a central bank or monetary authority held for its own account is immune in the absence of an explicit waiver.

According to Article 1 of the Federal Law on the Central Bank of the Russian Federation[147] the Central Bank is a legal entity that performs functions and authorities provided by the Constitution of the Russian Federation and the present Federal Law independently from other federal bodies of state power. Accordingly, it is likely that the Central Bank of Russia will enjoy sovereign immunity in the USA and UK as well as in most European countries.

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[144] *Banca Carige Spa Cassa Di Risparmio Di Genova E Imperia v Banco Nacional De Cuba and Another* [2001] 1 WLR 2039 (Eng. Ch).
[145] WOOD, *supra* note 13, at 117.
[146] *Trendtex Trading Corporation Ltd v Central Bank of Nigeria* [1977] QB 529 (Eng. CA).
[147] Federal Law No 86-ФЗ of July 27, 2002 on the Central Bank of the Russian Federation.

As it probably follows from the Noga attachment saga, central bank accounts are the most attractive targets for creditors of the sovereigns. From the policy point of view it is unlikely that in future the United Kingdom or the United States would strip foreign central banks of their immunity as it may prevent central banks of developing countries from depositing their reserves in these countries. On the other side, for instance, the Central Bank of Russia holds substantial part of its currency reserves in US government bonds. If USA abandon sovereign immunity for central banks, developing countries would probably have to reinvest their reserves in European bonds or bonds of other regions that would undermine the market for US T-bonds.

3. Use of Shell Companies

The seizures led the Central Bank of Russia to establish the Financial Management Co., or FIMACO, an offshore shell company in the British Channel Islands of Jersey and Guernsey to hold its gold and foreign currency reserves.[148] A representative of Noga's management alleged that the FIMACO was used to conceal the assets of Russia's assets from its creditors such as Noga.[149] At the IMF's behest, PricewaterhouseCoopers (PWC) was commissioned by Russia's central bank to investigate the relationship between the Russian central bank and its Channel Islands offshoot, Financial Management Company Limited and PWC did not find any misuse of funds. Mr. Michel Camdessus, then the Managing Director of the IMF wrote in his letter to Le Monde that the IMF "did know that part of the reserves of the Central Bank of Russia was held in foreign subsidiaries, which is not an illegal practice".[150]

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[148] THE MOSCOW TIMES, July 15, 2000.
[149] See *at* http://samvak.tripod.com/pp157.html.
[150] The IMF, Russia and *Le Monde,* The Letter of Mr. Michel Camdessus, the Managing Director of the IMF to Le Monde *at* http://www.imf.org/external/np/vc/1999/081999.htm.

It is interesting that a grand parenting ownership structure was used as the FIMACO was majority-owned by Eurobank, the Central Bank's Paris-based daughter company. So the FIMACO scheme was triple proof from attachments by Russia's creditors.

The most likely explanation of the use of FIMACO is that though the Central Bank enjoys statutory immunity in most countries, this shell company was probably used to prevent temporary disruptive attachments such those that took place in Switzerland and Luxembourg in 1993 and 2000 (even though those attempts were unsuccessful, unfreezing of the CBR assets demanded some time and efforts).

4. Diplomatic accounts

Diplomatic accounts are not protected by the 1961 Vienna Convention on Diplomatic Relations, but may be by customary law.[151] For instance, UK law regards moneys in diplomatic accounts as governmental (see *Alcom v Columbia*[152]). The US deimmunised the whole of an embassy bank account even which was partly for commercial purpose (see *Birch Shipping Corp v Tanzania*[153]). By these reasons the attempts of Noga to attach diplomatic accounts in many European countries were unsuccessful.

5. State-Owned Ships

As it was mentioned above Noga tried to seize a tall ship belonged to a Russian technical university. Article 3 of the Brussels Convention for the Unification of certain rules concerning the Immunity of State-Owned Ships of 1926 specifically provides that state-owned and non-commercial ships shall not be subject to seizure, arrest or detention

[151] WOOD, *supra* note 13, at 116.
[152] *Alcom v Columbia* [1984] 2 All ER 6 (Eng. HL).
[153] *Birch Shipping Corp v Tanzania* 507 F Supp 311 (DDC 1980).

by any legal process, nor to any proceedings in rem.

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These cases probably witness that Russia adheres to the chosen debt strategy and send a clear signal over the markets that holdouts will not be tolerated. Russia quite effectively protects its assets. MinFin III and Noga litigation showed that litigation is not probably a particularly attractive route for most creditors seeking repayment by a sovereign - in part because of *difficulty identifying assets that could realistically be seized to enforce a judgment.* Apart from diplomatic antagonisms accompanying the attempts to seizure of sovereign assets, litigation is usually very expensive and time-consuming and, accordingly, is available to large extent only to large and scrappy value creditors.

Part IV: The IMF SDRM proposal in the light of the Russia's post-1998 Default Experience

In 2000 the IMF proposed a new approach to sovereign debt restructuring called Sovereign Debt Restructuring Mechanism (SDRM). The Chapter 11 of US Bankruptcy Code model has provided the intellectual origins of the SDRM.

The principal features of the SDRM are:[154]

- Majority restructuring— agreement approved by a qualified majority of creditors binding on all creditors that are subject to the restructuring.
- Hotchpot rule — any amounts recovered by a creditor through litigation would be deducted from its residual claim under an approved restructuring agreement[155].
- Priority financing—a specified amount of new financing will be excluded from the restructuring, if supported by a qualified majority of creditors.

To make these features operational, the framework would also require independent arrangements for the verification of creditors' claims, the resolution of disputes, and the supervision of voting.

The IMF SDRM proposal addresses the problems of holdout creditors, collective action, discrimination among private creditors and execution problems that Russia and its creditors faced during the 1998-99 crisis. But do Russia and their creditors need this kind of supranational bankruptcy mechanism whose efficiency is not clear and whose implementation will demand investment and effort? As Scott notes there is the issue of what benefit the SDRM would provide to a sovereign that it could not achieve acting on

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[154] PROPOSALS FOR A SOVEREIGN DEBT RESTRUCTURING MECHANISM (The IMF, January 2003*), at* http://www.imf.org/external/np/exr/facts/sdrm.htm#qa.

[155] The hotchpot rule was devised in nineteenth century English bankruptcy law. See THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS 37 (The IMF, November 27, 2002), *at* http://www.imf.org/external/np/pdr/sdrm/2002/112702.htm.

its own outside of the SDRM.[156] My opinion is that there is no need of the SDRM in the case of Russia.

The main problem was discrimination between Soviet-era and Russia-era debts. The analysis of post-1998 default restructuring shows that Russia and its creditors undertook a number of steps to prevent discrimination among the different categories of Russia's creditors in the future.

Table 6: Measures undertaken to prevent discrimination among creditors

Category of defaulted debt	**Measures negotiated by creditors to prevent discrimination in the future**
Paris Club 1996 agreement obligations	The 1999 Agreement includes a comparability of treatment provision that reads: > 1. In order to secure comparable treatment of debts due to external public or private creditors, the Government of the Russian Federation commits itself to seek from its external creditors … rescheduling or refinancing arrangements on terms comparable to those set forth in the present Agreed Minute for credits of comparable maturity ***making sure to avoid inequality between different categories of creditor***s.[157] This clause is quite broad and may arguably be extended to Russia-era debt contracted after 1992.
London Club 1997 agreement obligations	Under the 2000 Agreement PRINs and IANs issued in 1997 by the Vnesheconombank were exchanged for new Eurobonds issued by the Russian Federation governed by English law which contain cross-acceleration clauses to the previous stock of Russian Eurobonds. If Russia defaults on these Eurobonds principal all other Russian Eurobonds may become due immediately if more of 25% their holders decide so.
Trade debt of the former USSR	Under the 2001 FTO deal this debt is to be exchanged to Russian Eurobonds.

The measures undertaken by the Paris and London clubs of creditors cannot prevent the default in the future as they rely on the borrower's compliance. But the

[156] Scott, *supra* note 101, at 56.
[157] The Paris Club, *supra* note at 21.

SDRM cannot prevent sovereign defaults either as the main purpose of this mechanism is to make defaults less painful and more orderly.

These measures do not address the problem of discrimination of holders of domestic debt (e.g. GKO holders) but the IMF proposal excludes domestic debt either from the SDRM.[158]

A wider use of collective action clauses as a practical alternative to the SDRM was recommended in the Report of the G- 10 Working Group on Contractual Clauses[159]. English-style majority action clauses of Russian Eurobonds may successfully address the problems of collective action and holdout creditors. All Russian sovereign Eurobonds were issued subject to English law and their majority action clause permits the change of payment terms with the consent of 75% supermajority of bondholders.[160] So majority creditors may block any attempt of holdout creditors to disrupt restructuring. However, the deficiency of the collective action clause solution is the problem of aggregation across several bond issues.

The problem of creditor moral hazard (i.e. decreasing market discipline on sovereign borrowing) and creditor discrimination between Soviet-era and Russia-era debts in the case of Russia in my opinion may be resolved by modification of the terms of Russian Eurobonds. Their terms expressly excludes the default on the Soviet-era debt as an event of default for the purposes of their cross-acceleration clauses – only the default on the Russia-era public external debt contracted after 1992 may under some circumstances trigger cross-acceleration provisions of Russian Eurobonds. If the exclusion of the Soviet-era debt as a "cross-acceleration event" is removed, I think it

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[158] IMF SDRM Design, *supra* note 155, at 22.
[159] G-10 REPORT, *supra* note 1.
[160] Article 12 of Terms and Conditions of Russian Eurobonds.

would increase the borrowing discipline of a Russian state and there will be no objective reason for Russia to differ between Russian and Soviet debts in the case of serious financial difficulties. It is important that such modification will not require an alteration of the current terms of Russian Eurobonds. It is enough to issue just one Eurobond with a modified cross-acceleration clause to provide a bridge between a Soviet-era debt and Eurobonds. Such operation is going to be done with regard to the London Club debt (which is a Soviet-era debt) under the 2000 London Club agreement in a new issue of Eurobonds exceeding US $1 billion. The Eurobonds issued under the 2000 London Club agreement include a condition that any new Eurobond issue will include an "Expanded cross acceleration clauses" which will treat failure to honor the terms of Eurobonds issued under the 2000 London club agreement as an event of default allowing bondholders to demand immediate and full repayment.

In addition, the moral hazard problem in respect of lending to Russia is mitigated by the fact that after the Russian default of 1998 the investors are now aware that the IMF may not bail them out in the case of a financial crisis.

An essential feature of the SDRM would be the establishment of a dispute resolution forum (ad hoc court) — the proposed Sovereign Debt Dispute Resolution Forum (SDDRF). But will Russia be willing to submit itself to a supranational judicial body? Our opinion is that it is unlikely (though a number of agreements with foreign commercial creditors include arbitration clauses). The matter is that the Russian leadership was always quite sensitive in the issues regarding a surrender of even a small portion of its sovereignty. Russia did not join the Rome Statute of the International Criminal Court. What is more specifically the MinFin III and Noga litigation demonstrated that the Russian government may be embarrassed by creditors' attempts to

bring the case to a foreign court. For instance, after a MinFin III bondholder brought his action in the European Court of Human Rights the Russian commercial courts made a complete U-turn and decided the case in favor of the plaintiff. As the IMF thinks that the sovereign would only seek to activate the mechanism when it had formed a judgment that the features of the SDRM would enhance its capacity to restructure its debt rapidly and in a manner that limits economic dislocation, the SDRM could not be activated without the sovereign's request.[161] By the reasons explained above we doubt that if the SDRM is ever adopted, the Russian government will ever activate the SDRM even if it faces a severe financial crisis.

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My conclusion in Russia's specific context is that Russia and its creditors probably do not need the SDRM because the 1999 Paris Club agreement and the 2000 London Club agreement sufficiently address the problem of discrimination between Soviet-era and Russia-era debts. The modification of cross-acceleration provisions of Russian Eurobonds by inclusion of a default on all Soviet-era debts as a cross-default event may help to prevent a possible unequal treatment of Soviet-era and Russia-era debts in the future and mitigate a moral hazard problem. English-style majority action clauses contained in all Russian Eurobonds and the adoption of such clause in all domestic bonds may to a significant extent resolve collective action and holdout problems.

[161] IMF SDRM Design, *supra* note 155, at 7.

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Annex 1: External Debt of the Russian Federation 1998-2004 (Russia' debt to non-residents, in billion US dollars, based on the Central Bank of Russia data)

	January 1, 1998	January 1, 1999	January 1, 2000	January 1, 2001	January 1, 2002	January 1, 2003	January 1, 2004
Total (including debts of private entities)	179,9	187,8	177,8	160,5	149,0	153,2	182,1
Bodies of State Government	133,5	138,3	132,8	117,2	104,2	97,7	99,2
Federal bodies of Government	132,3	135,9	130,7	116,0	103,2	96,7	97,9
New Russia's debt	39,3	38,0	34,2	49,5	41,9	41,0	39,8
Loans of international financial organizations	5,2	6,6	6,9	7,0	7,0	6,8	6,6
World Bank	5,1	6,3	6,7	6,8	6,7	6,6	6,3
others	0,2	0,2	0,2	0,2	0,2	0,2	0,3
Other loans (including loans of states-members of the Paris Club of creditors)	7,6	9,7	9,8	8,4	6,3	5,7	4,9
Securities in foreign currency	6,5	14,1	12,1	30,7	26,9	26,7	26,8
Eurobonds	4,5	9,5	8,9	8,0	7,1	7,1	5,7
Eurobonds issued as result of GKO restructuring (swap) (July 1998.)	0,0	2,7	2,2	1,4	1,4	1,4	2,0
Eurobonds issued as result of the London Club 2000 restructuring	0,0	0,0	0,0	20,5	17,4	16,3	16,8
MinFins - VI u VII series & OGVZ 1999.	2,0	1,3	0,6	0,7	1,0	1,8	2,4
OGNZ	0,0	0,6	0,4	0,0	0,0		
Securities in Russian rubles (GKO-OFZ)	17,8	5,8	3,6	1,6	0,6	0,5	0,1
Other indebtedness	2,2	1,9	1,8	1,8	1,2	1,3	1,4
Debt of the former USSR	93,0	97,9	96,5	66,5	61,2	55,7	58,1
Loans of official creditors –the Paris Club of creditors members	37,6	40,0	38,7	39,0	36,3	39,2	42,7
Loans of the London club of creditors members	28,1	29,6	30,6	0,0	0,0		
Indebtedness to former socialist countries	14,9	14,8	14,7	14,6	11,5	4,2	3,6
MinFins - III, IV, V series	3,2	2,5	1,8	1,2	1,7	2,2	1,4
Other indebtedness	9,1	11,0	10,8	11,7	11,7	10,2	10,4
Bodies of monetary and credit regulation	13,5	19,5	15,7	12,0	9,7	7,5	7,8
Loans	13,2	19,3	15,6	11,7	9,5	7,3	7,5
IMF	13,2	19,3	15,2	11,6	7,4	6,5	5,1
Others	0,0	0,0	0,4	0,1	2,1	0,8	2,4