

Sovereign Debt Crises as Threats to the Peace: Restructuring under Chapter VII of the UN Charter?

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Abstract

Sovereign debt crises might significantly decrease the level of socio-economic rights enjoyment for the population in the affected state. According to recent data, they even increase the risk of civil unrest. However, the resolution of sovereign debt crises is compromised by legal obstacles which result from the absence of a statutory, obligatory bankruptcy procedure for states. On the one hand, creditors might refuse to accept an exchange of their debt instrument in the frame of a workout and choose to litigate against the state. On the other hand, states might worsen their situation by unnecessarily delaying inevitable workouts. This article explores whether and to what extent the powers UN Security Council could be deployed in order to mitigate these problems. This requires a reconsideration of the concept of peace in Article 39 UN Charter. The article concludes that, at the request of the International Monetary Fund (IMF), the Security Council might put a stay on the enforcement of creditors' claims or order workout negotiations.

A. Introduction

“Right behind the German tank / drive the trucks of Dresdner Bank”¹. This is how a saying went in Germany during the Second World War. As cynical as it may have been, there was some truth in it. Arguably, sovereign debt constrains played a role in the outbreak of the Second World War. In recent years, more and more data has become available which reveals a correlation between sovereign debt crises and the outbreak of civil wars. Hence, excessive debt seems to be a potential threat to peace, if peace is understood in a negative sense as the absence of armed conflict. Moreover, excessive debt might reduce the ability of the State to provide basic services to its population such as health and education. This might threaten peace as understood in a more positive sense, such as the enjoyment of basic socio-economic rights. To safeguard peace in a negative and positive understanding, debt crises require timely, efficient and fair debt workouts, including possible debt relief, in order to stabilize the financial situation of the affected State (B.).

¹ Original: “Nach dem ersten deutschen Tank kommt sofort die Dresdner Bank” (transl. by the author).

However, several factors might delay such workouts. They result from the informal and voluntary character of the international legal framework for sovereign debt workouts. First, private creditors may opt to sue the State for the full amount of the debt. Indeed, so-called vulture funds have repeatedly initiated court proceedings in order to reclaim the nominal value of bonds purchased at much lower market prices. This disrupts indebted countries' efforts to restructure their debt and achieve a timely settlement. Second, the indebted State might miss the opportunity to avoid a debt crisis or mitigate its effects by a workout at an early stage. Since workouts usually entail adjustment measures, they are costly for the government of the indebted State. This might lead to unnecessary delays which increase a potential threat to the peace in both its negative and positive meaning (C.).

International organizations, and in particular the United Nations Security Council, are charged with the maintenance of peace and security. Ultimately, the correlation between sovereign debt crises and threats to the peace raises the question of whether and to what extent international organizations have the power to take action in sovereign debt crises. This article proposes that the powers of the UN Security Council should be used in order to overcome the mentioned lacunae in the legal framework before a situation aggravates and leads to the outbreak of civil unrest or compromises the realization of socio-economic rights. The proposal entails some intricate legal questions. First, conflicts of competence might arise between the Security Council and the IMF. The Security Council should not develop its own debt policy, but work in close cooperation with the IMF. Second, this proposal requires a reconsideration of the concept of peace stipulated in Article 39 of the UN Charter, the threshold for the power of the Security Council to adopt binding resolutions. Third, the rights of sovereign debtors need to be respected. They should not find themselves in a less favorable situation than in a "normal" debt workout. Otherwise, States might find their measures implementing a Security Council Resolution restructuring sovereign debt challenged before domestic courts (D.).

B. Correlations between Sovereign Debt Crises, Armed Conflict, and the Realization of Socio-Economic Rights

A growing literature claims that there is an intrinsic connection between situations of economic distress, in particular sovereign debt crises, and the likelihood of domestic or international armed conflict. Timothy

Mason has argued that, although Nazi Germany had been determined to wage war on its neighbouring States at some point in any case, economic and fiscal constraints were crucial for the timing of the Second World War. Germany's pre-war economy was organized around massive government expenditures on rearmament and infrastructure that required price and wage controls and piled up huge deficits, which led to a "flight into war"² in order to squeeze the occupied territories economically.³

While Nazi Germany is certainly an extreme case which cannot (and should not) be compared with contemporary armed conflicts, data about recent conflicts unfolds a certain propensity of economic crises to trigger civil wars. A recent study by the UN Development Programme reveals a significant negative correlation between declines in Gross Domestic Product (GDP) and the outbreak of civil wars.⁴ Although most of the literature focuses on economic conditions in general,⁵ or the availability of natural resources and their likelihood to lead to civil unrest,⁶ Chapman *et al.* have studied the impact of the financial situation of governments on civil unrest. Analyzing government bond spreads and government credit ratings for 19 countries, and government credit ratings in an additional set of 41 countries, they observe a negative correlation between exogenous shocks on a country's creditworthiness or weak domestic economic performance, and the outbreak of internal violence. Thus, maintaining access to foreign capital

² T. Mason, 'The Primacy of Politics. Politics and Economics in National Socialist Germany', in S. Woolf (ed.), *The Nature of Fascism* (1968), 165-195. This view is not uncontroversial, see T. Mason & R. Overy, 'Debate: Germany, 'Domestic Crisis' and War in 1939', 122 *Past and Present* (1989) 1, 205-221. In any case, with the beginning of the war, Germany suspended payments on external debt. K. Reinhart & K. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (2009), 96 (table 6.4) list Germany as defaulting in 1939.

³ On the latter aspect G. Aly, *Hitlers Volksstaat. Raub, Rassenkrieg und nationaler Sozialismus*, 2nd ed. (2006).

⁴ N. Kim & P. Conceição, 'The Economic Crisis, Violent Conflict, and Human Development', *UNDP/ODS Working Paper* (2009); see also E. Miguel, S. Satyanath & E. Sergenti, 'Economic Shocks and Civil Conflict: An Instrumental Variables Approach', 112 *Journal of Political Economy* (2004) 4, 725-753.

⁵ E.g. V. Koubi, 'War and Economic Performance', 42 *Journal of Peace Research* (2005) 1, 67-82.

⁶ E.g. P. Collier & A. Hoeffler, 'Greed and Grievance in Civil War', 56 *Oxford Economic Papers* (2004) 4, 563-595.

seems crucial for conflict prevention.⁷ A case in point is Rwanda, which saw a tremendous increase in sovereign debt followed by harsh and probably belated austerity measures in the early 1990 which fuelled ethnic tensions until the outbreak of violence in 1994.⁸ In line with these findings, the 2009 European Report on Development reveals that the debt burden of fragile countries stands at 73.9% and that of non-fragile countries at 18.9% of GDP.⁹ Further, Azam as well as Addison and Murshed identify a lack of resources for redistribution as a main source of civil war.¹⁰

Certainly, domestic and international armed conflicts may have many causes, not all of which relate to economic or financial conditions. Fragile States with rich natural resources may have a low level of sovereign debt.¹¹ And high levels of sovereign debt might be more likely to trigger civil wars in States with pre-existing divides in society. For example, without a predisposition for ethnic tensions, genocide of such a scale would have been unlikely in Rwanda. But ethnic divisions alone do not explain the occurrence of internal conflicts, either. A model developed by Collier and Hoeffler and tested with data from conflicts in African countries between 1960 and 1992 reveals that a country's ethno-linguistic fractionalization does not significantly correlate with the likelihood of civil war, while per capita income does.¹²

Thus, contemporary research suggests that the situation that existed during the 19th century has been reversed: While debt crises formerly exposed a State to the risk of *foreign* intervention geared towards reclaiming debts, threats to the peace now originate from within the affected society. This might be the result of changed expectations about public welfare and

⁷ T. Chapman & E. Reinhardt, 'International Finance, Predatory States, and Civil Conflict' (29 October 2009) available at <http://userwww.service.emory.edu/~erein/research/finance-conflict.pdf> (last visited 2 May 2012).

⁸ H. Hintjens, 'Explaining the 1994 Genocide in Rwanda', 37 *Journal of Modern African Studies* (1999) 2, 256-8; M. Chossudovsky, 'Economic Genocide in Rwanda', 31 *Economic and Political Weekly* (1996) 15, 938-941.

⁹ G. Giovannetti *et al.*, 'Overcoming Fragility in Africa', European Report on Development (2009), 47.

¹⁰ J.-P. Azam, 'The Redistributive State and Conflicts in Africa', 38 *Journal of Peace Research* (2001) 4, 429-444; T. Addison & S. Murshed, 'Debt Relief and Civil War', 40 *Journal of Peace Research* (2003) 2, 159-176.

¹¹ Giovannetti *et al.*, *supra* note 9, 47.

¹² P. Collier & A. Hoeffler, 'On Economic Causes of Civil War', 50 *Oxford Economic Papers* (1998), 563-573.

increasing dependency on public services.¹³ Today, citizens expect their State to provide some essential welfare services. This seems to constitute a major source of legitimacy of the State as well as of peace.¹⁴ The rioting unfolding at the height of the Argentinean and Greek debt crises in 2001 and since 2010, respectively, demonstrates that such expectations of governmental public welfare are not unique to the developing world.

Short of civil wars and rioting, debt crises might entail dreadful consequences for socio-economic rights enjoyment. As the ongoing European sovereign debt crisis aptly demonstrates, there is a strong correlation between sovereign debt and GDP decline. Although successful workouts might have beneficial long-term effects for growth in the affected economies, they tend to lead to a sharp GDP decline during the first year.¹⁵ This is to some degree the result of austerity measures, such as layoffs in the civil service, cuts in government spending, and similar measures of contractarian fiscal policy which all contribute to GDP decline in the short term. In a certain sense, what is at work here is a reversed version of the Keynesian government expenditure multiplier.¹⁶ Further, according to the so-called “debt overhang hypothesis”, a high level of official debt decreases the rate of return of private investments because of increasing taxes and interest rates. This hypothesis emerged from observations in the aftermath of the sovereign debt crises of the 1980s, and, though not uncontroversial, has found affirmation in some studies.¹⁷ The result is a further decline in GDP. In the end, debt crises tend to lead to declines in economic output, whether through austerity programs or taxes. The ensuing reduction in government financial capacity threatens the enjoyment of socio-economic rights.¹⁸ The realization of education, health, and other basic social services

¹³ See M. Foucault, ‘Governmentality’, in G. Buchell & P. Miller (eds), *The Foucault Effect. Studies in Governmentality* (1991), 87-104.

¹⁴ Cf. F. Scharpf, *Regieren in Europa* (1999), 20-28.

¹⁵ E. Borenzstein & U. Panizza, ‘The Costs of Sovereign Default’, *IMF Working Paper* (2008) No. 238, 8.

¹⁶ J. Keynes, *The General Theory of Employment, Interest and Money* (1936), Book III, Chapter 10.

¹⁷ Defending the hypothesis: A. Deshpande, ‘The Debt Overhang and the Disincentive to Invest’, 52 *Journal of Development Economics* (1997), 169-187; against the hypothesis: B. Hofman & H. Reisen, ‘Debt Overhang, Liquidity Constraints and Adjustment Incentives’, *OECD Development Centre Working Paper* (1990) No. 32.

¹⁸ On the effects of austerity programs on socio-economic rights, see R. T. Hoffmann & M. Krajewski, ‘Staatsschuldenkrisen im Euro-Raum und die Austeritätsprogramme von IWF und EU’, 45 *Kritische Justiz* (2012) 1, 2, 10-13.

depends to a large extent on the financial capacity of the State. Cuts in spending on these issues tend to disproportionately affect the least well-off segments of society.¹⁹

Timely workouts seem to be crucial for the prevention of both internal conflicts and declines in the enjoyment of certain socio-economic rights enjoyment. Addison and Murshed emphasize the importance of prompt debt workouts in order to mitigate the risk for domestic conflict.²⁰ Other studies confirm that timely and effective restructurings which break the vicious circle of increasing sovereign debt and economic slowdown might reduce the likelihood of war.²¹ Timely resolutions of debt crises reduce uncertainty and prevent a situation where domestic creditors buy up more and more government bonds in order to prevent default, just to be hit even harder when default finally occurs.²² Also, the enjoyment of socio-economic rights enjoyment might benefit from timely workouts. For example, Greek government debt has experienced an almost exponential rise since 2008 with debt levels of 113% of GDP in 2008, of 129% in 2009, of 144.9% in 2010 and over 160% in 2011.²³ The later the workout, the greater the hurt is for the creditors *and* the remaining debt level.²⁴ Thus, one may expect early workouts to cause less severe austerity and lower decline in GDP.²⁵ The following section will therefore examine obstacles to timely debt workouts under the current legal framework for sovereign debt.

¹⁹ M. Dowell-Jones & D. Kinley, 'Minding the Gap: Global Finance and Human Rights', 25 *Ethics and International Affairs* (2011) 183, 190-193; instructive on the dependency of human rights enjoyment on economic preconditions is the capabilities approach, see A. Sen, 'Human Rights and Capabilities', 6 *Journal of Human Development* (2005) 2, 151-166.

²⁰ Addison & Murshed, *supra* note 10.

²¹ Kim & Conceição, *supra* note 4, 9.

²² Borenzstein & Panizza, *supra* note 15, 20.

²³ Data retrieved from Eurostat, available at <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsieb090&plugin=1> and http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-23042012-AP/EN/2-23042012-AP-EN.PDF (last visited 2 May 2012).

²⁴ D. Benjamin & M. Wright, 'Recovery Before Redemption: A Theory of Delays in Sovereign Debt Renegotiations', Centre for Applied Macroeconomic Analysis Working Paper (2009) 15.

²⁵ This idea underlies the call for prompt restructurings in Principle 15 of the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing (January 2012) available at http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf (last visited 2 May 2012).

C. Sovereign Debt Restructurings and Holdouts

I. The International Legal Framework for Sovereign Debt Workouts

Currently, there is no comprehensive, obligatory international mechanism for sovereign debt workouts.²⁶ At the beginning of this century, the IMF proposed a comprehensive Sovereign Debt Restructuring Mechanism which would have included an automatic stay of all claims, those of private as well as those of public creditors, as well as procedures for the negotiation of workout plans subject to the approval of a qualified majority of creditors. However, the project failed because of the reluctance of the United States to change the current system in which every creditor fights for herself.²⁷ Therefore, sovereign debt restructuring continues to be dominated by voluntary, informal ad-hoc arrangements: Among others, the Paris Club arranges workouts of bilateral government debt, while the London Club provides a venue for commercial banks and their sovereign debtors. The International Monetary Fund (IMF) provides various lending facilities for countries facing different needs.²⁸ Other arrangements like the Heavily Indebted Poor Countries Initiative (HIPC) make debt relief dependent upon *ex-ante* conditionalities, i.e. the fulfilment of multilaterally agreed policy reform plans.²⁹ Thus, defaulting States have no legal guarantee to get a timely, efficient, fair, and sustainable workout in case of an acute crisis. Similarly, no creditor or international institution could oblige a State to implement adjustments when default has occurred or seems unavoidable. The voluntary, consensual nature of debt workouts is the root cause of both creditor and debtor holdouts, which may delay necessary workouts (II. and III.).

²⁶ The existing frameworks are incomplete and need to be further developed, cf. A. v. Bogdandy & M. Goldmann, 'Sovereign Debt Restructurings as Exercises of International Public Authority: Towards a Decentralized Sovereign Insolvency Law', in C. Esposito & J. Bohoslavsky, *Responsible Sovereign Financing: The Search for common Principles* (2012), forthcoming.

²⁷ J. Kämmerer, 'State Bankruptcy', in R. Wolfrum (ed.), *Max Planck Encyclopedia of Public International Law* (2009), margin notes 17-19.

²⁸ Cf. <http://www.imf.org/external/about/lending.htm> (last visited 29 April 2012).

²⁹ For a detailed analysis of this regime see L. Guder, *The Administration of Debt Relief by the International Financial Institutions – A Legal Reconstruction of the HIPC Initiative* (2009), 131-190.

II. The Problem of Private Creditor Holdout Litigation

Not every private creditor has an interest in holdout litigation. Indeed, commercial banks usually have an interest in continuing their sovereign lending business. The syndicated loans which they often extend to sovereign borrowers are multiparty agreements. Commercial banks which do not agree to workouts affecting such loans but sue the defaulting State for the full amount of their debt might be excluded from the next deal by their peers. In terms of game theory, they participate in a repeated, highly transparent prisoner's dilemma, which mitigates the incentive to free ride.³⁰

However, other investors play different games, which increase their incentive to free ride. Vulture funds usually do not participate in repeated games. They only search for singular occasions to earn exceptional returns at high risks. Usually, they buy sovereign debt at huge discounts from the nominal value. Instead of agreeing to a workout plan, they sue the debtor State for the nominal amount plus interest.³¹ This might trigger, intensify or prolong a debt crisis and cause the above-mentioned consequences. The case of Zambia is illustrative of this. In 1979, Romania borrowed Zambia 15 million USD for agricultural equipment. More than 20 years later, Zambia saw itself unable to service this debt. It negotiated a settlement with Romania that would have reduced the outstanding debt to 3 million USD. However, Romania sold the loan to a vulture fund before the conclusion of the settlement. The fund sued Zambia in English courts for 40 million USD for the full amount of the debt plus costs. The court recognized Zambia's liability in principle.³² Payment of this amount would have eliminated the positive effects of official debt relief and might have compromised

³⁰ G. Norman & J. Trachtman, 'The Customary International Law Game', 99 *American Journal of International Law* (2005) 3, 541, 558-560.

³¹ H. Scott, 'A Bankruptcy Procedure for Sovereign Debtors', 37 *The International Lawyer* (2003) 1, 103, 116-117.

³² *Donegal International Ltd. v. Republic of Zambia et al.*, 15 February 2007, [2007] EWHC 197 (Comm.); M. Waibel, 'Elusive Certainty – Implications of *Donegal v. Zambia*', rightly points out that it would have come worse for Zambia had the High Court recognized not only its liability in principle, but also the plaintiff's entitlement to full damages. The Court's imprecise findings regarding the amount of damages due might have incentivized the parties to settle at a relatively low sum compared to other holdout litigation, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1566490 (last visited 2 May 2012).

Zambia's social services.³³ The parties eventually settled for 15.5 million USD.

Today, at least five legal developments facilitate holdout litigation by private creditors, which has become a frequent phenomenon.³⁴ First, much sovereign debt today is in the form of bonds, not syndicated loans. While developed economies have long had a preference for treasury bonds, developing and emerging economies have been issuing bonds in particular since the inception of the Brady plan in the late 1980s.³⁵ This plan allowed them to exchange their non-performing loans into bonds backed by American or German government securities. As exchange-traded securities, bonds have more liquidity than syndicated loans and therefore became an attractive investment for different groups of investors.³⁶ The other side of the coin is that the relationship between sovereign debtors and their bondholders is more bilateral. Without syndicates, there is no group pressure or potential sanctioning power to prevent individual debtors from free riding and undermining a workout.³⁷ But even without vulture funds, bonds increase the practical difficulties of organizing consensual workouts because of the sheer number of creditors.³⁸

Second, sovereign immunities are usually inapplicable to modern sovereign debt instruments. Virtually all of them contain provisions waiving jurisdictional immunities.³⁹ In addition, debt instruments are considered to be commercial transactions (*acta iure gestionis*), to which jurisdictional immunities no longer apply under customary international law.⁴⁰

³³ Oxfam, 'Oxfam and Jubilee call for action as Vulture swoops on Zambia's cash' (15 February 2007) available at <http://www.oxfam.org/en/node/128> (last visited 2 May 2012).

³⁴ For an overview of notable cases see U. Panizza, *et al*, 'The Economics and Law of Sovereign Debt and Default', 47 *Journal of Economic Literature* (2009) 3, 651, 655-659.

³⁵ J. Fisch & C. Gentile, 'Vultures or Vanguard? The Role of Litigation in Sovereign Debt Restructuring', 53 *Emory Law Journal* (2004) Special Edition, 1043, 1063ff.

³⁶ *Id.*, 1067. The table in Scott, *supra* note 28, 104, shows a massive move from loans to bonds in the sovereign debt of developing and emerging economies during the 1990s.

³⁷ Scott, *supra* note 31, 115.

³⁸ M. White, 'Sovereigns in Distress: Do They Need Bankruptcy?' *Brookings Papers on Economic Activity* (2002) 1, 287, 305-306.

³⁹ M. Waibel, *Sovereign Defaults before International Courts and Tribunals* (2011), 157; *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

⁴⁰ P.-T. Stoll, 'State Immunity', in R. Wolfrum (ed.), *Max Planck Encyclopedia of Public International Law* (2011), marginal notes 6 and 22.

Third, some vulture funds succeeded in enforcing their contractual rights. A particularly infamous example is the case of *Elliott Associates v. Republic of Peru*. Elliott had bought Peruvian loans at a discount price and refused to agree to exchange them into bonds as part of a restructuring agreement. It was granted the full amount by a US court. The court did not consider it abusive to buy debt with the intention to sue for payment.⁴¹ A Belgian court allowed *Elliott* to enforce the US judgment by intercepting Peru's interest payments destined for creditors which had accepted the exchange offer when the funds were channeled through Belgium for settlement.⁴² Another vulture fund which sought enforcement of claims arising from defaulted Argentinean bonds recently succeeded in obtaining attachments to Argentina's reversionary interest in US and German government securities pledged as collateral to Brady bonds. The securities are to be returned to Argentina by the Federal Reserve Bank of New York as part of a negotiated debt restructuring.⁴³

Fourth, international investment dispute settlement opens up new avenues for holdout litigation and effective enforcement. The International Center for the Settlement of Investment Disputes (ICSID) offers a new avenue for holdout litigation. Most bilateral investment treaties are applicable to sovereign debt instruments.⁴⁴ The avalanche of cases filed against Argentina since 2001 provides ample evidence of the interest of investors to seek awards for which sovereign immunity from enforcement might not create an insurmountable obstacle.⁴⁵ Although some of the plaintiffs are retail investors which might have lost their fortune by Argentina's unilateral default, not a few of them belong to the group of "usual suspects".

Fifth, although the aforementioned developments illustrate that, from the creditors' point of view, sovereign debt is increasingly becoming "normal debt" for which no special rules apply, the legal situation of debtor States has not kept pace with this development. Sovereign debtors have

⁴¹ *Elliott Associates, L.P. v. Banco de la Nacion and The Republic of Peru*, 194 F.3d 363 (US Court of Appeals, 2nd Circuit, 1999).

⁴² Fisch & Gentile, *supra* note 32, 1086; L. Buchheit & J. Pam, 'The *Pari Passu* Clause in Sovereign Debt Instruments', 53 *Emory Law Journal* (2004) Special Edition, 869.

⁴³ *Capital Ventures International v. Republic of Argentina*, 652 F.3d 266 (US Court of Appeals, 2nd Circuit, 2011).

⁴⁴ K. Gallagher, 'The New Vulture Culture: Sovereign Debt Restructuring and Trade and Investment Treaties', IDEAs Working Paper (2011) 2.

⁴⁵ Waibel, *supra* note 36, 318-319.

insufficient remedies available in order to fend off suits in courts. First, the defense of necessity is recognized by most courts as a possible defense in a suit by private creditors against sovereign debtors.⁴⁶ However, it may not be invoked in case the sovereign debtor has contributed to the situation of necessity; a condition which has received diverging interpretations by different tribunals.⁴⁷ Also, the defense may only be invoked as long as the state of necessity endures. Once it ceases, for example with the progressive implementation of a workout plan, free riders might litigate again.⁴⁸ Second, collective action clauses, which have become highly popular since the rejection of the IMF proposal for a sovereign debt restructuring mechanism, prevent individual investors from suing defaulting sovereign debtors unless 25% of all holders of the respective bond agree, and facilitate restructurings by majority votes of only 75% or 85%. However, large vulture funds may be in a position to buy sufficiently large amounts in order to sue or prevent restructurings, since the percentages of votes required for such moves refer only to the holders of one particular bond, not to the holders of all outstanding bonds.⁴⁹ Third, one might argue that there is at least an emerging general principle of law obliging domestic and international tribunals to stay attachments and other enforcement proceedings up to the conclusion of restructuring negotiations.⁵⁰ While such stay enjoys universal recognition in domestic insolvency law,⁵¹ some courts have applied this rule in sovereign default cases as well.⁵² Courts which at present do not stay

⁴⁶ But see the decision of the German Federal Constitutional Court in its judgment of 8 May 2007, cases 2 BvM 1/03 *et al.*, BVerfGE 118, 124. For a critical analysis see S. Schill, 'Der völkerrechtliche Staatsnotstand in der Entscheidung des BVerfG zu Argentinischen Staatsanleihen – Anachronismus oder Avantgarde?' 68 *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* (2008), 45-67.

⁴⁷ See only C. Binder 'Changed Circumstances in Investment Law: Interfaces between the Law of Treaties and the Law of State Responsibility with a Special Focus on the Argentine Crisis', in C. Binder *et al.* (eds.), *International Investment Law for the 21st Century* (2009), 608-630.

⁴⁸ M. Waibel, 'Two Worlds of Necessity in ICSID Arbitration: *CMS* and *LG&E*', 20 *Leiden Journal of International Law* (2007) 3, 637.

⁴⁹ Gallagher, *supra* note 44, 12; Fisch & Gentile, *supra* note 32, 1094-1095.

⁵⁰ We make this point in *v. Bogdandy & Goldmann supra* note 23.

⁵¹ International Law Association, 'State Insolvency: Options for the Way Forward', Report of the Sovereign Insolvency Study Group, The Hague Conference (2010), 23.

⁵² Supreme Court of New York, *Crédit français, S.A. v. Sociedad financiera de Comercio, C.A.*, 128 Misc.2d 564 (1985); US Court of Appeals, Second Circuit, *EM Ltd. v. Argentina*, Summary Order, 05-1525-cv, 13 May 2005 (this decision lacks precedential value).

proceedings in order to protect workout negotiations might be more willing to do so if all creditors had the right to participate in workout negotiations in the Paris and London Clubs and similar venues. But as long as this does not change, it might be necessary to have more effective legal remedies available against holdout litigation which triggers, deepens or prolongs a debt crisis with all its consequences. Anne Krueger described the risk of holdouts as one of the reasons why sovereign debtors delay restructurings longer than it is healthy for their economy.⁵³ Since States provide essential public services to billions of people every day, they should not be prevented from necessary, timely, and efficient restructurings by formally legal, but morally questionable creditor holdouts.

III. The Problem of Debtor Holdouts

Unlike bankruptcy proceedings under domestic law, negotiations about sovereign debt workouts require the consent of the debtor State. This facilitates debtor holdouts. Governments of heavily indebted States have a number of incentives to avoid negotiations about workouts at an early point in time, before they actually have to suspend payments on their outstanding debt. There is no free lunch in debt workouts. They almost invariably require adjustment programs, whether in the form of IMF conditionalities or in other aspects. As a consequence, the government of the debtor State will have to implement policy reforms which might create hardship for parts of the population or economy at least in the short run. They might have to cut back public services or lay off public employees and will face restricted access to international capital markets for a considerable period of time.⁵⁴ In addition, an impending workout might lead to capital flights from the defaulting State in anticipation of currency depreciation or higher inflation in order to deplete domestic debt (including private savings), or both. For these reasons, governments might be less inclined to tackle their debt problem at the earliest possible occasion and rather postpone it until after the next election. In the meantime, however, things might worsen, resulting in a much more dramatic debt crisis.

⁵³ A. Krueger, *A New Approach to Sovereign Debt Restructuring* (2002)

⁵⁴ C. Richmond & D. Dias, 'Duration of Capital Market Exclusion: An Empirical Investigation' (2009) available at <http://ssrn.com/abstract=1027844> (last visited 2 May 2012), report a median of 7 years until countries regain full access to capital markets. The period is shorter if natural disasters were the cause of default.

This incentive structure is not mere theory. Recent empirical research revealed the unwillingness of governments to default on sovereign debt as the main cause for delays in sovereign debt restructurings.⁵⁵ Other research which emphasizes positive effects of protracted debt negotiations does not necessarily contradict these results. It finds that delays in restructurings might allow a State to wait with the workout until the economy has regained strength and thereby mitigate the adverse effects of adjustment programs and the market reactions described above.⁵⁶ However, this presupposes that States still have sufficient resources in order to bridge the time between the first signs of a debt crisis and economic recovery. Economic recovery is difficult to forecast. In the worst case, a State might default at the height of a recession. By contrast, timely workouts might require less adjustment and cause less turbulence on the markets. Therefore, the present international legal framework for sovereign debt workouts appears to be insufficient in that it leaves it to the discretion of the debtor State to decide whether and when to restructure. This is another reason for looking into the possibility of Security Council action.

D. The UN Security Council: Sovereign Debt Crises as Threats to the Peace?

I. Security Council Action as Legal Assistance for the IMF

Certainly, the Security Council is not the first organization one might expect to resolve sovereign debt crises. The resolution of debt crises falls squarely within the powers of the IMF, which has the necessary competence, experience, and funds to intervene in most debt crises. However, the IMF lacks the competence to take decisions against creditor or debtor holdouts which bind all States. IMF lending facilities require the consent of the debtor State, and it would be difficult to use the proceeds to

⁵⁵ C. Trebesch, 'Delays in Sovereign Debt Restructuring. Should we really blame the creditors?' (2008) available at <http://www.cid.harvard.edu/Economia/papers/Rio%2008/Trebesch%202.pdf> (last visited 2 May 2012). Identifying democratic government as a factor contributing to debtor holdouts: H. Enderlein, *et al*, 'Sovereign Debt Disputes. Testing the role of politics and institutions in financial crisis resolution', *paper presented at the Political Economy of International Finance (PEIF) Conference in Claremont* (2008).

⁵⁶ R. Bi, 'Beneficial Delays in Debt Restructuring Negotiations'. *IMF Working Paper* (2008) No. 38.

pay holdout creditors. At least, this would have to be part of the loan agreement, and the IMF might be unwilling to use loans to pay back holdout creditors, since it usually claims the highest priority as a *de-facto* lender of last resort. It therefore seems worthwhile to think about other mechanisms in the present international legal order which might lend themselves to emergency actions against creditor or debtor holdouts.

In contrast to the IMF, the Security Council not only has the necessary powers to take binding decisions pursuant to Chapter VII of the UN Charter.⁵⁷ For example, in order to mitigate the effects of creditor holdouts, the Security Council could oblige States to implement appropriate legislative or administrative acts in order to reach a stay of ordinary and enforcement proceedings against a particular State up to the conclusion of ongoing negotiations. The Council could also impose a stay on the execution of ICSID awards. By virtue of Article 103 of the UN Charter, this decision would take precedence over the obligation of States arising under the ICSID Convention. In case of debtor holdouts, the Security Council could oblige a defaulting State to negotiate a debt workout with its creditors and impose a procedural framework for such negotiations as well as minimum substantive requirements such as respect for essential socio-economic rights. Ordering emergency payments might be difficult to achieve since the Security Council itself does not dispose of the necessary financial resources. In addition, ordering other States or the IMF to bail out a defaulting State would put a premium on creditor holdouts or delay necessary adjustments.⁵⁸ Obliging a State to implement a specific adjustment program without negotiations or other means of participation might only be justified in cases of extreme urgency, as it conflicts with the idea of ownership which guides IMF conditionalities in order to ensure their acceptance by the defaulting State and its population.⁵⁹ In addition, short of such intrusive measures, the mere threat of Security Council action might induce debtor States and their creditors to agree on timely and sustainable solutions. But such highly intrusive measures might not be necessary. International financial markets would probably stop lending to a State as soon as the Security Council orders it to negotiate a workout and thereby effectively force it into such negotiations. This might render claims arising

⁵⁷ Cf. Art. 25 Charter of the United Nations.

⁵⁸ Cf., however, J. Kämmerer 'Der Staatsbankrott aus völkerrechtlicher Sicht', 65 *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht* (2005), 651, 660-662.

⁵⁹ Cf. IMF, Guideline on Conditionality (2002), para. 3.

from new credit agreements concluded after this point unenforceable before domestic or international tribunals.

While the UN Security Council has the legal powers to take the necessary action against creditor and debtor holdouts, it certainly cannot compete with the IMF regarding the institutional knowledge and experience in matters of sovereign debt crises. It would not be advisable for the UN to double the work of the IMF. Therefore, the UN Security Council might follow a policy of cooperation with the IMF and only act upon the request of the latter. In domestic legal orders as well as in international relations, such a relationship is known as legal assistance. Such assistance usually requires both organizations to have the competence *ratione materiae* to deal with the respective situation.⁶⁰ Thus, it needs to be established under what conditions debt crises might constitute a threat to the peace as required by Article 39 of the UN Charter.

II. The Concept of Peace in Article 39 UN Charter

According to Article 39 of the UN Charter, any use of the Security Council's Chapter VII powers requires at least the existence of a threat to the peace. Although the Security Council enjoys broad discretion in the interpretation of these notions, it needs to respect the limits imposed by this and other Charter provisions, not only as a matter of the rule of law, but also because its resolutions might be challenged before the International Court of Justice⁶¹ or the European Court of Justice, as the Kadi case has shown.⁶² This raises the question whether and when a sovereign debt crisis might amount to a threat to the peace. Does this threshold necessarily require a high likelihood of serious civil unrest or widespread violence? Or is an impending disruption of essential welfare services or massive depreciation of the level of fulfillment of socio-economic rights sufficient to establish the existence a threat to the peace as armed violence?

⁶⁰ H. Damian, 'Mutual Legal Assistance in Administrative Matters', in R. Wolfrum (ed.), *Max Planck Encyclopedia of Public International Law* (2009), margin note 3.

⁶¹ Implicitly, the ICJ assigned itself such powers of review in its Order on Provisional Measures in the *Lockerbie Case (Libyan Arab Jamahiriya v. United Kingdom)*, ICJ Reports 1992, 3, para. 40

⁶² In Kadi, the ECJ only examined the European Regulation implementing a Security Council Resolution, see Cases C-402/05 P and C-415/05 P, *Kadi and Al Barakaat v. Council*, [ECJ 3 September 2008].

Obviously, the answer hinges on the understanding of the concept of peace in Article 39 of the UN Charter. According to a narrow, negative reading, peace is tantamount to the absence of armed force. In a broader, more positive understanding, however, peace means the availability of a minimum level of what John Rawls called “primary goods”, i.e. basic civil rights and socio-economic conditions which enable a life in self-determination.⁶³ Historically, being immediately under the impression of the Second World War, the drafters of the UN Charter had a negative concept of peace in mind, although some delegates pleaded for a more positive one.⁶⁴ The positive concept of peace gained popularity only in peace research during the 1960s based on the idea that armed force represents only one particular State on a scale ranging from complete worldwide solidarity to the complete absence thereof.⁶⁵ The text of Article 39 does not contain any particular clues. At least, it does not militate against a broad concept of peace. A systematic interpretation in the context of other provisions reveals support for both the narrow and the broad concept of peace. Article 1(2) of the Charter can be understood as stipulating a broad concept of peace. It speaks of “universal peace”, which is not reduced to the absence of war, but seen to comprise “friendly relations” among equal States and the principle of self-determination. Both these elements somewhat exceed the negative concept of peace. The practice of the UN General Assembly confirms the broader meaning of Article 1(2).⁶⁶ By contrast, Article 2(4) of the Charter, the duty to refrain from the “threat or use of force”, is generally understood as implying a negative concept of peace only. This reading is corroborated by the preamble and Article 44, the other Charter provisions which all contain the term “force” supplemented by the predicate “armed”.⁶⁷ Since the content of these two provisions is closely connected with the issues addressed in Article 2(4), inferring an *argumentum e contrario* from the omission of the predicate “armed” in Article 2(4) seems inappropriate.

⁶³ J. Rawls, *A Theory of Justice* (1971), Section 15.

⁶⁴ See C. Tomuschat, ‘Obligations Arising for States Without or Against Their Will’, 241 *Recueil des Cours* (1994) 199, 335-336.

⁶⁵ J. Galtung, ‘Editorial’, 1 *Journal of Peace Research* (1964) 1, 1-4; J. Galtung, ‘Violence, Peace, and Peace Research’, 6 *Journal of Peace Research* (1969) 3, 167-191.

⁶⁶ R. Wolfrum, ‘Article 1’, in B. Simma (ed.), *The Charter of the United Nations. Commentary*, vol. 1, 2nd ed. (2002), margin note 9.

⁶⁷ A. Randelzhofer, ‘Article 2(4)’, in B. Simma (ed.), *The Charter of the United Nations. Commentary*, vol. 1, 2nd ed. (2002), margin notes 16-18.

Subsequent practice such as the Friendly Relations Declaration confirms the narrow concept of peace in Article 2(4).⁶⁸

A purposive interpretation might corroborate a broader reading of Article 39, corresponding to Article 1(2) rather than to Article 2(4) of the Charter. The correlation between armed conflict and socio-economic factors makes long-term, sustainable prevention of armed conflict dependent upon the progressive attainment of socio-economic goals. This idea has found support in the practice of the United Nations. Initiated by a policy statement in 1992,⁶⁹ the Security Council recognized non-military issues such as socio-economic conditions as potential threats to the peace. In 2005, Secretary-General Kofi Annan's programmatic report "In larger freedom" stressed the importance of reducing poverty in order to achieve peace, thereby opting for a broad approach to the concept of peace under the UN Charter.⁷⁰ Also, the 2005 World Summit Outcome and the Geneva Declaration on Armed Violence and Development recognize the linkage between development and peace and security.⁷¹ What is more, the Council let deeds follow these words. Since the early 1990s, the Council has recognized new types of situations as constituting a threat to the peace, such as human rights violations, irrespective of their impact on other States, or the ousting of democratic governments.⁷² In light of this practice, it would not amount to a tremendous step for the Security Council to include in this list imminent debt crises which might cause a deep depreciation of the level of fulfillment of socio-economic rights or even armed conflicts.

Some point out that those far-reaching powers of the Security Council might lead to conflicts of competence with the other organs of the United

⁶⁸ GA Res. 2625 (XXV), 24 October 1970, first principle.

⁶⁹ Note by the President of the Security Council, UN Doc. S/23500/3, 31 January 1992.

⁷⁰ 'In larger freedom: towards development, security and human rights for all', Report of the Secretary-General, UN Doc. A/59/2005/ paras 12-17, 25-27, 106, 140-142, 21 March 2005.

⁷¹ GA Res. 60/1, 24 October 2005, para. 72; Geneva Declaration of 7 June 2006, <http://www.genevadeclaration.org/fileadmin/docs/Geneva-Declaration-Armed-Violence-Development-091020-EN.pdf>.

⁷² E.g. SC Res. 794, 3 December 1992; SC Res. 841, 16 June 1993; see Tomuschat *supra* note 64, 339 et seq.; Y. Dinstein, *War, Aggression, and Self-Defense*, 4th ed. (2005), 304; I. Österdahl, *Threat to the Peace: The Interpretation by the Security Council of Article 39 of the UN Charter* (1998), 85; J.A. Frowein & N. Krisch, 'Article 39', in B. Simma (ed.), *The Charter of the United Nations. Commentary*, vol. 1, 2nd ed. (2002), margin note 7.

Nations.⁷³ However, it does not appear that the Charter suggests a delimitation of powers between the Security Council and other organs along the lines of subject matters, but according to the urgency of the situation. Firstly, the Charter provides already for a considerable overlap of the powers of the Security Council and the General Assembly. Article 11 of the Charter gives the General Assembly the competence to deal with matters relating to peace and security. Second, Article 12(1) suggests that the relationship between the powers of the Security Council and the General Assembly is a temporal one, not one of different subject areas (“*While* the Security Council is exercising [...] the functions assigned to it [...], the General Assembly shall not make any recommendation[...]” – emphasis added). This provision might simply acknowledge the fact that the Security Council is better equipped to deal with emergencies, given the small number of members and the binding character of its resolutions. Conversely, the Security Council should indeed not touch upon general questions of economic and social policy (apparently the main concern of the advocates of a narrow concept of peace for Article 39) and adopt resolutions with legislative character. The UN Economic and Social Council or the General Assembly with its broader membership and committee structure might be better positioned for such tasks. Third, even in case of emergencies, the Security Council does not have the exclusive, but only the primary responsibility for peace and security (cf. Article 24 of the UN Charter). In fact, it often acts in parallel with other organs and agencies. For example, its resolutions often relate to issues which touch upon the powers of Specialized Agencies incorporated by the UN Economic and Social Council and the General Assembly pursuant to Article 63 of the Charter, such as questions of refugee and human rights protection. And the ICJ has accepted that the General Assembly remains seized with a matter and may even file a request for an Advisory Opinion while the Security Council is addressing it.⁷⁴ Finally, following the idea of the *effet utile*, one could argue that the empirical correlations between economic difficulties and armed conflict make it even more difficult to separate powers according to subject areas. Where and when should measures preventing threats to the peace begin if they are meant to be effective? Should the Security Council only intervene when a debt crisis has destabilized a State to the extent that a civil war is

⁷³ Cf. Frowein & Krisch, *supra* note 72, margin note 6.

⁷⁴ *Legal Consequences of the Construction of a Wall in the Occupied Palestinian Territory*, Advisory Opinion, ICJ Reports 2004, 136, para. 24.

about to break out? This would be imprudent given that earlier interventions may produce more sustainable solutions.

III. The Decision to Intervene and the Moral Hazard Dilemma

Having thus established that a sovereign debt crisis threatening the fulfillment of essential socio-economic rights might constitute a threat to the peace in and of itself, the Security Council needs to carefully consider the correct point of intervention. After all, not every creditor holdout triggers a sovereign debt crisis with serious consequences for the enjoyment of socio-economic rights or peace and security. If the Security Council were to make abundant use of its power to resolve sovereign debt crises, it might produce moral hazard. States might become careless about their debt level and rely on the Security Council to impose a stay on the actions of their creditors or rid them of some of their debt.

In order to keep the moral hazard problem under control, the Security Council should take into account the following three considerations. First, it might strive to make the determination of a sovereign debt crisis more objective. Thus far, there is no generally accepted standard. The Security Council could use macroeconomic indicators for such a determination, such as the ratio between the long-term growth of debt and the expected long-term per capita GDP growth based on historical data sets. Also, credit ratings and sovereign bond spreads for sovereign bonds are viable indicators for impending debt crises,⁷⁵ even though each of them has its own set of problems and should not be relied on exclusively. Economists have thought about indicators for predicting sovereign debt crises.⁷⁶ Since developed States with a history of stability might live with much higher debt/GDP ratios than developing States with a history of serial default,⁷⁷ one should

⁷⁵ On credit ratings: C. Reinhart, 'Default, Currency Crises, and Sovereign Credit Ratings', 16 *World Bank Economic Review* (2002) 151-170; on sovereign bond spreads: A. Pescatori & A. Sy, 'Are Debt Crises Adequately Defined?', 54 *IMF Staff Papers* (2007) 2, 306-337.

⁷⁶ E. Remolona *et al.*, 'A Ratings Based Approach to Measuring Sovereign Risk' (January 2007) available at <http://ssrn.com/abstract=963041> (last visited 2 May 2012), combine credit ratings and historic default rates; while P. Manasse *et al.*, 'Predicting Sovereign Debt Crises', *IMF Working Paper* (2003) No. 221, develop an early warning mechanism using past data about macroeconomic, fiscal and political indicators.

⁷⁷ K. Reinhart & K. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (2009), 21-33.

not apply these indicators too schematically, but with a view to the stage of development of the affected State. Ultimately, the determination of sovereign default will, and should, always be a value judgment. But standards and indicators might protect to some extent against decision-making which market participants will find arbitrary.

Second, without narrowing down the concept of peace at this stage, the Security Council should intervene only if there are additional structural conditions which increase the likelihood of a serious socio-economic crisis affecting large parts of the population, or of the emergence of civil unrest. For example, pre-existing situations of economic duress that would become unbearable in case of a holdout or belated default; ethnic, racial, religious or similar tensions might be indicative of a necessity to intervene.

Third, before taking any measures, the Security Council, relying on the expertise of the IMF, should be aware of their potential effects on the market and on market discipline. Any stay on judicial proceedings imposed by the Council might cut off the State concerned from international capital markets until a restructuring is completed. The Council should therefore ensure that international institutions like the IMF would be able to provide necessary funds for indispensable expenditures as long as the State concerned has no access to capital markets. Otherwise, the situation might turn from bad to worse. In the absence of market discipline, the Council should seek to corroborate IMF conditionalities in order to ensure that the State concerned spends the money prudently and is committed to structural reforms. For example, the Security Council could make stays of enforcement dependent upon certain additional requirements (e.g. full cooperation in negotiations about a workout, full transparency about the country's financial situation, external auditors, or other measures).

On the positive side, Security Council intervention in debt crises would reduce creditor moral hazard. If holdouts are not that easily available any more, creditors will think twice before they lend money to States with huge piles of sovereign debt and ailing economies. Some States could only accumulate large amounts of sovereign debt because private creditors were usually bailed out in the past. While the Brady plan led to some write-offs in the 1980s, the sovereign debt crises of the 1990s had no negative consequences for private creditors. The brunt was borne by the taxpayer.⁷⁸

⁷⁸ Scott *supra* note 31, 113-115.

Ultimately, the Security Council needs to balance all these risks and challenges. As a matter of prudence, it should always proceed in close coordination with the IMF, given its experience in sovereign debt matters as well as its funds. Also, it might enter into consultations with other international institutions such as the G20 or the Basel Committee in order to determine the consequences of a restructuring for financial markets.

IV. Limits: Constitutional and Human Rights of Creditors

Each Member State of the United Nations would have to find ways of complying with Security Council resolutions in these matters in accordance with its domestic law. Regarding stays on the execution of judgments, some legal orders already require the consent of the government before the authorities may enforce judgments against foreign sovereigns.⁷⁹ Other States would have to implement similar measures.

It is not unlikely that creditors affected by such Security Council resolutions would seek legal remedies before domestic and international courts. They might consider the decision of the Security Council, or the consent given by their government if it is a member of the Security Council, or the implementing measures, as acts amounting to an expropriation. Generally, insolvencies are not acts of expropriation: the creditor receives the actual value of its investment. It decreased in value not because of government intervention, but because the defaulting company (or private individual) did not do as well as expected. A similar logic could be applied to sovereign defaults. Certainly, creditor holdouts are an effective means of protection against unjustified, discretionary defaults.⁸⁰ However, if the Security Council determines that a workout is necessary, after an objective and hopefully transparent examination of the presence of a debt crisis, and after weighting all chances and risks, one can hardly say that creditors still need to be able to defect in order to protect themselves against arbitrary default. Their situation is not worse than it would be in case of a normal, everyday default of a private counterparty.

What is different from private counterparty defaults is, however, the fact that a State has no balance sheet. This makes it difficult to assess the remaining value of debt instrument in case of default or a debt crisis. It will

⁷⁹ A case in point is the *Distomo* judgment of the Greek Areopag against Germany; cf. the subsequent decision of the European Court of Human Rights, *Kalogeropoulou et al v. Greece and Germany*, ECHR (2002), Appl. No. 59021/00.

⁸⁰ Cf. Fisch & Gentili, *supra* note 35.

have to be determined procedurally in the course of workout negotiations. In order to ensure that domestic courts approve of Security Council measures, the Council should take the utmost care to ensure that the negotiations are conducted in a fair and equitable manner.⁸¹

E. Conclusion: The Security Council as the Second Best Solution

Admittedly, this paper suggests a rather intrusive approach to a problem which is in the first place “only” about money, and which not everyone might intuitively qualify as a security issue. Nevertheless, the potentially fatal effects of sovereign debt crises require a reservoir of adequate countermeasures. Governments and international institutions need to think of strategies for the prevention of civil unrest or severe depreciations of socio-economic rights. They should not wait until a multilateral resolution mechanism sees the light of day, which is unlikely to happen anytime soon. The existing legal infrastructure of the Security Council could be used in cases of emergency caused by holdouts, even though this would certainly not alleviate concerns regarding the legitimacy of the Security Council.⁸² Also, such measures will only work successfully if good care is taken of the moral hazard and constitutional implications which might result from them. Besides that, it should not be forgotten that any involvement of the Security Council is only apposite in emergencies. Naturally, it is better to avoid such emergencies in the first place and to keep government debt at a sustainable level.

⁸¹ Cf. UNCTAD Principles, *supra* note 25, Principle 15.

⁸² E.g. E. de Wet, ‘The Legitimacy of United Nations Security Council Decisions in the Fight against Terrorism and the Proliferation of weapons of Mass Destruction: Some Critical Remarks’, in R. Wolfrum & V. Röben (eds), *Legitimacy in International Law* (2008), 131-154.