



## Debt Sanctions Can Help Ukraine and Fill a Gap in the International Financial System

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The escalating crisis in Ukraine has prompted the United States and Europe to impose the toughest economic sanctions against Russia since the end of the Cold War and to prepare for even tougher ones should the situation grow worse. At the same time, the continued instability and military conflict in eastern Ukraine, where rebels supported by Russia are accused of shooting down Malaysian Airline Flight 17, are straining Ukrainian finances. Despite a generous international support package, the government faces shrinking revenues, rising costs, and a spike in foreign debt payments over the next two years.<sup>1</sup>

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lent former Ukrainian president Viktor Yanukovich in a failed attempt to keep him in power late last year. Ukraine would then have the option to walk away from this debt without the usual legal and market consequences of repudiation. Such debt sanctions would reinforce the financial, energy, and trade sanctions under way, and by themselves would represent an appropriately targeted response to the conflict. They would be in line with international law and legislative precedent in the United Kingdom and Europe, most recently used for Iraq and the poorest countries—and would, uniquely among sanctions tools, offer financial relief for Ukraine.

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This Policy Brief outlines Ukraine's debt difficulties and the steps necessary to combine sanctions with debt relief. Although Ukraine could unilaterally repudiate some of its debt to Russia as illegitimate, the new government would then be vulnerable to lawsuits and would damage its market reputation. An act of the British parliament taking away creditor remedies for default on this debt would send a message that the courts and capital markets in the United Kingdom have no part in Russia's strategy in Ukraine. It would reduce Russia's capacity to disrupt Ukraine's finances and its influence on any future debt negotiations. Russia would also find it hard to sell unenforceable bonds to commercial buyers. Ukraine could gain up to \$3 billion with no legal or reputational fallout but would retain the option to pay some or all of the debt or renegotiate it as part of a political settlement, where it would have more bargaining power.

1. Steven Mufson, "Ukraine Will Need Billions of Dollars in New Aid This Year, Economists Say," *Washington Post*, July 22, 2014.

## UKRAINE'S DEBT PROBLEMS

Many of Ukraine's problems precede the ouster of President Yanukovich in February 2014, but many are also the direct consequence of the political crisis. Ukraine reported its public debt stock at just over \$73 billion at the end of 2013, including \$13 billion in state guarantees for Naftogaz (the state gas monopoly), the state infrastructure fund, and others.<sup>2</sup> According to the International Monetary Fund (IMF), this debt was slightly above 40 percent of Ukraine's GDP at the time. Continued deterioration, transition-related turmoil, and multilateral loans for the new government could push debt to over 63 percent of GDP by 2015 (IMF 2014). This is moderate by international

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standards; however, Ukraine has had a history of poor economic performance since the breakup of the former Soviet Union and has had trouble managing even moderate levels of debt. The government last restructured its debt in 2000, when it was less than 60 percent of GDP (Federico Sturzenegger and Jeromin Zettelmeyer 2007). Naftogaz restructured in 2009, adding more bond guarantees to the government's debt burden (Udaibir S. Das, Michael G. Papaioannou, and Christoph Trebesch 2012).

The IMF approved a \$17 billion program for Ukraine in late April 2014. At the time, IMF staff concluded that government debt was "sustainable with high probability" despite risks from capital flight, shaky banks, and a fragile currency. This conclusion was significant because under IMF policies, if the Fund lends more than twice the amount of a member country's quota in one year, it must determine that its debt is sustainable with high probability in the medium term (IMF 2012, 2013). If not, the IMF can ask the country to restructure its debt to protect the program and Fund resources. Ukraine has not had to restructure yet despite the fact that it would receive 800 percent of its IMF quota.

The IMF's assessment was qualified, subject to the "uncertainties that come from geopolitics."<sup>3</sup> These uncertainties have

2. See the Ukraine Bond Prospectus, February 17, 2014, available at [http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20\(3\).pdf](http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20(3).pdf) (accessed on August 11, 2014).

3. Ian Talley, "IMF Approves \$17 Billion Emergency Aid for Ukraine's Economy," *Wall Street Journal*, April 30, 2014, <http://online.wsj.com/news/>

multiplied. Escalating conflict makes it harder for Ukraine to manage a near-term spike in debt payments, which it cannot make without donor assistance. At the start of 2014, it expected to pay over \$10 billion in principal and \$3.5 billion in interest to foreign creditors before the end of 2015, and nearly \$21 billion more before the end of 2020 (table 1). Friendly governments and multilateral organizations have committed over \$30 billion (table 2), which was considered ample in April to guarantee debt repayments and meet other foreign currency needs through 2014. The economic program assumed a return to the capital markets in 2015 and 2016.

However, since the launch of the program, Ukraine's economy has deteriorated despite unprecedented reforms. Security spending rose, capital flight exceeded projections, energy payments slowed, and revenue collections in the east plummeted.<sup>4</sup> IMF head Christine Lagarde joined a chorus of officials and observers in predicting that Ukraine could need billions of dollars in additional support if conflict did not abate soon. There was new talk of a debt restructuring.<sup>5</sup>

Making up for the economic damage will require extraordinary political effort even in the best case scenario.<sup>6</sup> Crimea, now seized by Russia, represented less than 5 percent of Ukraine's GDP, and fiscal transfers to it were a drain on the central government's budget. According to the IMF, eastern Ukraine represented more than 20 percent of GDP in 2013, including about 30 percent of industrial production and 28 percent of exports. If the violence in the east subsides quickly, it is still unlikely to volunteer revenue transfers to Kiev.

Ukraine's long-standing dependence on energy imports has been a major factor in its debt difficulties. The IMF estimates Ukraine's gas imports at \$36.5 billion for 2011–13, nearly all from Russia. When the two countries were on good terms, Ukraine got a discount on its gas bills. After Yanukovich fled, Russia raised the price from \$269 to \$485 per 1,000 cubic meters. Russia cut off the supply in June 2014 and has since claimed over \$5 billion in arrears.<sup>7</sup> Ukraine disputes the figure and has been scrambling to find alternative energy sources. The

articles/SB10001424052702303948104579534140466543308 (accessed on August 11, 2014).

4. "IMF Announces Staff Level Agreement with Ukraine on First Review under the Stand-By Arrangement," IMF Press Release 14/351, July 18, 2014, <https://www.imf.org/external/np/sec/pr/2014/pr14351.htm> (accessed on August 11, 2014).

5. Ian Talley, "Ukraine Holds Talks with Creditors about Possible Debt Restructuring," *Wall Street Journal*, June 19, 2014.

6. Anders Åslund, "How to Amend the Ukrainian Constitution," July 7, 2014, <http://blogs.piie.com/realtime/?p=4380> (accessed on August 13, 2014).

7. "Ukraine's Gas Arrears Reach over \$5.3 Billion—Gazprom," *RIA Novosti*, July 8, 2014, <http://en.ria.ru/russia/20140708/190843192/Ukraines-Gas-Arrears-Reach-53-Billion--Gazprom.html> (accessed on August 11, 2014).

**Table 1 Ukrainian public external debt service** (millions of US dollars)

	2014	2015	2016	2017	2018	2019	2020
Interest	1,607.40	1,912.20	1,790.80	896.70	596.30	588.90	580.30
Principal	4,267.50	5,815.70	8,759.10	4,335.80	559.30	519.50	2,054.90
Total	5,874.90	7,727.90	10,549.90	5,232.50	1,155.60	1,108.40	2,635.20

Source: Ministry of Finance of Ukraine, Ukraine Bond Prospectus, February 17, 2014, [http://www.centralbank.gov.ua/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20\(3\).pdf](http://www.centralbank.gov.ua/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20(3).pdf).

**Table 2 Donor pledges to Ukraine**

Donor	Pledged for 2014–16 (billions of US dollars)
International Monetary Fund	17.1
European Commission	2.9
European Bank for Reconstruction and Development, European Investment Bank	8.1
World Bank	3.9
United States	1.0
Total	33.0

Source: International Monetary Fund.

two countries lodged competing arbitration claims with the Stockholm Chamber of Commerce: Russia demanding arrears and Ukraine claiming overpayment and seeking a fair price determination.<sup>8</sup> The IMF expects gas payments to consume about \$10 billion a year, a cost that could rise because of fluctuations in the energy and foreign exchange markets. A Naftogaz bond payment of \$1.6 billion due in September 2014 adds pressure on foreign exchange reserves.

## A CASE FOR DEBT SANCTIONS

The case for debt sanctions rests partly on the same factors that support trade and financial sanctions imposed so far but also on others unique to Ukraine's debt to Russia. The United States and the European Union imposed trade and financial sanctions in response to Russia's annexation of Crimea—after a referendum rife with fraud and intimidation—and later to its stepped-up support for militant separatists in eastern Ukraine. The objective was to put pressure on key decision makers in Russia by cutting off the flow of money, goods, and services between Russia and the West. Refusing to enforce a \$3 billion

8. Gazprom officials have also threatened to file claims for an additional \$18 billion under "take-or-pay" terms in the contracts with Naftogaz; Ukraine wants these terms invalidated. "Gazprom Could File \$18Bln Gas Debt Claim Against Ukraine in Stockholm," *Moscow Times*, June 17, 2014, <http://www.themoscowtimes.com/article/502057.html> (accessed on August 11, 2014).

debt contract does this and more. To the extent such a refusal diverts money from Russia, it delivers aid to Ukraine. It also recognizes that debt contracts can be used as political weapons and pushes back.

Ukraine has strong moral, economic, and political arguments against repaying its debt to Russia, but default could expose it to legal and reputational risks it can ill afford. To minimize these risks, it makes sense to target a single, especially problematic \$3 billion bond and to back Ukraine's decision with imprimatur from the West.

## Unusual Bonds

The focus on the \$3 billion bond also makes sense in light of the origins of the current crisis.

Viktor Yanukovich was elected president in 2010. He was driven from office in February 2014, after months of popular protests, which erupted when he rejected the Association Agreement with the European Union under pressure from Russia in November 2013. He reacted to the protests with a violent crackdown and then escaped to Russia in February. Russia has since annexed Crimea, supplied Russian-speaking separatists, and massed troops on Ukraine's eastern border.

In December 2013, at the height of the protests against Yanukovich, Russian president Vladimir Putin offered Ukraine a \$15 billion aid package and a deep discount on gas imports. The first \$3 billion installment was released on Christmas Eve in exchange for Ukrainian government bonds due in December 2015. The package has since been suspended, but the \$3 billion debt remains.

This debt is different from Ukraine's other debt to Russia and unusual by international standards, because its substance does not match its form. As a result, Russia gains an advantage over all of Ukraine's other creditors.

According to its bond prospectus at the end of 2013, Ukraine's nearly \$30 billion in direct foreign debt included over \$17 billion in bonds issued abroad (including the \$3 billion to Russia from December 2013), a tiny smattering of loans from commercial banks, over \$9 billion from international financial

institutions such as the IMF, and \$911 million in loans from foreign governments. The last figure includes \$704 million owed to Russia that had been serviced from Russia's lease payments on the Crimean port of Sevastopol, revenue now lost to Ukraine since annexation. In addition, the government has guaranteed \$8 billion in foreign debts of state-owned firms like Naftogaz to private, multilateral, and bilateral government creditors.

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bond contract.**

Each of these categories of debt is treated differently under the prevailing customs for sovereign debt restructuring. For example, governments do not normally sue one another to collect their debts in national courts. If it were treated as foreign aid, the \$3 billion lent in December would be renegotiated in the Paris Club, a forum of government creditors that has met at the French finance ministry since 1956.<sup>9</sup> On the other hand, bonds are normally restructured by exchanging them for new bonds or amended by creditor vote with the threat of lawsuits looming in the background. Private creditors have increasingly resorted to lawsuits to put pressure on sovereign debtors (Julian Schumacher, Christoph Trebesch, and Henrik Enderlein 2014).

The different approaches reflect the distinct roles, motives, and legal rights of the creditors in a world where there is no comprehensive bankruptcy law to bring all creditors together. The Paris Club represents the mix of economic, policy, and political constraints of its member governments. Debt contracts and the associated legal remedies form the basis of loan and bond restructurings. The different categories of debt are loosely linked so that some debts do not get repaid at the expense of the rest. However, it is hard to prevent such free-riding without a bankruptcy law. Instead of bankruptcy, sovereign debt restructuring has historically relied on a mix of custom, self-interest, and power.

Russia's \$3 billion debt contract is an anomaly because it straddles categories. In substance, it is foreign aid that normally would not trade in the markets, would not be enforced in a national court, and would be restructured in the Paris Club. It is more than three times Ukraine's total other debt to the

Paris Club reported at the start of 2014. In form, the \$3 billion is a private bond contract, listed on the Irish Stock Exchange, governed by English law and enforceable in English courts—indistinguishable in most ways from Ukraine's other bonds. It represents by far the largest foreign bond payment Ukraine is scheduled to make during the IMF program.

Some of Russia's reasons for dressing up foreign aid as market bonds may have been innocuous, others less so. First, it might have sped up the deal: The \$3 billion came from the Russian sovereign wealth fund, which has standing authority to invest in the market.<sup>10</sup> Second, Russia might have wanted the option to sell the debt quickly in the private capital markets. Third, and potentially more problematic for Ukraine, the bonds give Russia the power to trigger a cascade of defaults under Ukraine's other bonds and a large block of votes in any future bond restructuring. This is because all of the government's bonds are linked among themselves: When one bond defaults, the rest can do the same. While such "cross-default" links are common among bonds, they are unusual between bonds and foreign aid. The rationale is that private bondholders and government creditors have different motives and different relationships with the sovereign debtor. For example, a government creditor might give up profit for the sake of helping an ally or destabilizing an enemy's economy.

The \$3 billion bond contract also contains unusual terms that give Russia yet more power over Ukraine and more advantages over other creditors. Unlike all other Ukrainian bonds, this one promises to keep government and guaranteed debt under 60 percent of Ukraine's nominal GDP.<sup>11</sup> Ukraine could find itself in default simply because its economy collapses, say, thanks to losing territory, new trade barriers with Russia, or civil unrest. Paradoxically, the bond contract boosts Russia's power as a creditor when it chips away at the denominator of Ukraine's debt-to-GDP fraction. The debt-to-GDP term could also make it easier and more profitable for Russia to unload its investment in the market, since the buyer would get the right to demand payment ahead of all other creditors whose bonds do not have such a clause.

10. "Ukraine Debt: An Investor's Guide," Europe Emerging Markets Research, J.P. Morgan, March 27, 2014, pp. 11–12. The fund bought the debt in apparent contravention of its stated policy of investing in debt rated AA– or higher (International Forum on Sovereign Wealth Funds, Members Information, Russia, <http://www.ifswf.org/members-info.htm#rus> [accessed on April 21, 2014]). Ukraine's debt is rated CCC by Standard & Poor's; its highest rating in the past five years was B+.

11. See Ukraine Bond Prospectus, "Debt Ratio," p. 28, [http://www.central-bank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20\(3\).pdf](http://www.central-bank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/19034/Prospectus%20-%20Standalone%20(3).pdf) (accessed on August 11, 2014). The requirement mirrors Ukrainian budget law. The law can be amended by the Ukrainian parliament; the contract cannot.

9. See Club De Paris at <http://www.clubdeparis.org> (accessed on May 8, 2014). Russia has been a member since 1997 and has participated in the Club's Ukrainian debt restructurings before.

Russia also has the right to demand full repayment of its bonds ahead of schedule if Ukraine misses a payment to any other creditor “controlled or majority-owned” by Russia.<sup>12</sup> This term is also unique among Ukrainian bond contracts and may have been intended to put pressure on Ukraine to pay Gazprom. When Ukraine issued the bond in December 2013, Russia was already claiming arrears under energy supply contracts between Naftogaz and Gazprom; some but not all are disputed.<sup>13</sup> Depending on how the courts interpret this contract term, Russia may be able to trigger default on the bonds at will.<sup>14</sup>

The form and terms of the debt, combined with its two-year maturity, are consistent with Russia’s reported intent to keep Ukraine “on a short leash.”<sup>15</sup> Debt is deployed as an instrument of political control.

### Hostile Acts and Odious Debts

Unless Ukraine’s allies commit to helping repay its debt, Ukraine and its other creditors could easily find themselves negotiating a workout with a large bondholder that is annexing bits of its territory and fueling instability from within. The law has developed tools for cases where debt becomes an instrument of corruption and violent oppression; however, these tools are hard to apply and can backfire against the debtor. One such tool is the concept of “odious debt.”

The idea that the state should not be held responsible for debts incurred against the public interest can be traced back to 17th century foundational texts on international law (Robert Howse 2007, pp. 5–6). At the height of colonial expansion and gunboat diplomacy in the 19th and early 20th centuries, successor states occasionally refused to pay back the “war debts” that had financed military campaigns against them. “Hostile

12. See Ukraine Bond Prospectus, “Relevant Indebtedness,” p. 27, and “Events of Default-Indebtedness of Ukraine,” p. 31.

13. Ukraine claims that it does not owe the money because it never took delivery of the gas; it contests the “take-or-pay” promise. See Ukraine Bond Prospectus, p. 16.

14. At least two alternative readings would be more favorable to Ukraine. First, any arrears are likely owed by Naftogaz, not the government directly. However, the bond language appears to cover a broad range of guarantees and indemnities given by Ukraine. While the gas contracts between Russia and Ukraine are not public, Ukraine has frequently recapitalized Naftogaz to enable payments to Russia. Second, the notes are held by the Russian sovereign wealth fund, not Russia directly. The sovereign wealth fund is not the majority-owner of Gazprom. However, if the fund has no distinct legal personality from the Russian government, the clause would still cover Gazprom. If Russia sells all or part of its holdings, private buyers who do not own or control Gazprom may not be able to invoke the clause.

15. Kathrin Hille, “Ukraine bailout could derail Putin’s drive to boost Russian economy,” *Financial Times*, December 18, 2013, <http://www.ft.com/intl/cms/s/0/3b3db13c-67e3-11e3-a905-00144feabd0.html#axzz313qckLHW> (accessed on August 11, 2014).

debts,” incurred to suppress insurrections, were sometimes disavowed when the rulers departed. States could also refuse to repay money borrowed and stolen by dictators where creditors had full knowledge of their intent (Lee Buchheit, Mitu Gulati, and Robert Thompson 2006). A Russian jurist writing in Paris in the 1920s wove the various strands of precedent together into the evocative term odious debt (Alexander N. Sack 1927, as cited in Sarah Ludington and Mitu Gulati 2008).

Similar ideas are part of domestic law in many countries (Howse 2007, Matthias Goldmann 2013). Fraud, duress, lack of authority, bad faith, and abusive behavior by creditors can all block debt collection (Buchheit, Gulati, and Thompson 2006; Parker Hood 2012). In bankruptcy, when creditors cause harm to the debtor, try to gain unfair advantage over other creditors, or misrepresent the nature of their claims, judges can deny their claims, take away their votes, or send them to the back of the debt collection line (Adam Feibelman 2007, Anna Gelpern 2007).

If Ukraine chose to invoke odious debt, it might say that borrowing by the Yanukovich government was against the public interest. He stands accused of stealing tens of billions of dollars in public funds throughout his tenure to support a lavish lifestyle,<sup>16</sup> including a private zoo with \$10,000 name plates for the animals.<sup>17</sup> The fact that his security forces shot at unarmed demonstrators in February 2014 bolsters the case.

However, this strategy would be risky for Ukraine because few courts have explicitly endorsed odious debt. Even commentators who agree that some debt should go unpaid as odious disagree on the most basic questions of application: What debt qualifies as odious—money for missiles, all borrowing by dictators, corrupt or wasteful spending? In this debate, the fact that Yanukovich was elected, that he is described as more corrupt than violent, and that not all debt proceeds were stolen or used to buy bullets to shoot at the people, could hamper Ukraine’s defense.

Unsettled law and preemptive concessions by creditors might help explain why, despite examples of repudiation of illegitimate debt in the 19th and early 20th centuries, the contemporary sovereign restructuring experience is conspicuously lacking in odious debt claims. Since 1997, 19 countries have restructured bonds, all but one based on economic necessity. Even post-apartheid South Africa and post-Saddam Iraq specifi-

16. “Ukraine’s Stolen Assets: A Long, Hard Slog,” *Economist*, March 5, 2014, <http://www.economist.com/blogs/easternapproaches/2014/03/ukraine-s-stolen-assets> (accessed on August 11, 2014).

17. “Asset Recovery Workers on the Case of Ukrainian Kleptocrats,” *National Public Radio*, March 6, 2014, <http://www.npr.org/2014/03/06/286646514/asset-recovery-workers-on-the-case-of-ukrainian-kleptocrats> (accessed on August 11, 2014).

cally refused to invoke odious debt.<sup>18</sup> Political considerations remained between the lines. The sole exception is Ecuador, which launched a unilateral bond buyback offer in 2008, threatening default because a presidential audit commission “found significant indications of illegality and illegitimacy.”<sup>19</sup> These claims were controversial, but most creditors accepted Ecuador’s terms, which delivered nearly 70 percent debt relief. Ecuador returned to the capital markets five years later.<sup>20</sup>

**Ukraine could refuse to pay the bonds and invoke odious debt. This strategy is fraught with legal, political, and market risks, all of which would play into Russia’s hands.**

Ecuador’s example of threatening unilateral repudiation could be risky for Ukraine because it depends on donor funding and cannot afford to stay out of the market for five years. Wealthy governments have balked at endorsing a broad reading of odious debt that gives sovereign debtors the right to repudiate, because much of their own lending would be at risk.<sup>21</sup> They prefer to make it easier for debtors to get relief on economic grounds.

In sum, Ukraine has two options for dealing with its debt. First, it can treat the debt to Russia as just another claim on the fruits of domestic reforms and foreign largesse. While it can pay, Ukraine must hope that Russia does not use its favorable bond contract terms to trigger a cascade of defaults simply to destabilize its finances. If it ever needs debt relief, Ukraine must hope that Russia would not try to use its bonds to block agreement or to get preferential treatment. This has been Ukraine’s strategy so far.

At the other extreme, Ukraine could refuse to pay the bonds and invoke odious debt. This strategy is fraught with

legal, political, and market risks, all of which would play into Russia’s hands.

The proposal in this Policy Brief would give Ukraine and its allies a third option: a sanctions law that would reduce Russia’s influence over Ukraine’s debt and its ability to profit from selling the debt in the market, while shielding Ukraine from the legal and reputational consequences of not paying Russia.

**PROPOSAL AND PRECEDENT**

To create this third option, the UK parliament could enact a debt sanctions law making Ukraine’s \$3 billion bond issued to Russia on December 24, 2013, unenforceable as against public policy under English law. Neither Russia, nor anyone who buys the bond from Russia, could sue or arbitrate to collect the debt in the United Kingdom. Russia would have a right without a remedy. Ukraine would retain the option to pay the \$3 billion as part of a political settlement but would negotiate from a much stronger bargaining position. Negotiation and working through the Paris Club would become Russia’s best collection strategy.

A more ambitious version of the law could leave the target debt designation to the UK Foreign and Commonwealth Office (FCO) or HM Treasury. This would reflect a broader policy of debt sanctions and would require designation criteria in different countries and circumstances. Such a law could draw on contract sanctions and odious debt scholarship, but its design details go beyond the scope of this Policy Brief.

Like most sanctions, debt sanctions could have a sunset provision. It could be a certain date when the law would expire unless renewed or a set of conditions reflecting de-escalation between Russia and Ukraine. This stands in contrast to odious debt, which is tainted forever by the circumstances of its inception. It cannot become unodious simply because the dictator repented midway through the loan term.

The basic design of the debt sanctions proposal builds on recent innovations in debt restructuring and sanctions policy. It contains elements of recent European and UK measures to shield Iraq and heavily indebted poor countries, contract sanctions proposals from the Center for Global Development Working Group on the Prevention of Odious Debt (2010), and the contract sanctions consultation document issued earlier this year by the FCO.<sup>22</sup> None of these measures by themselves would solve Ukraine’s debt problem with Russia. Debt sanctions would fill a gap in the system.

18. See Center for Global Development Working Group on the Prevention of Odious Debt 2010; Ali Allawi, “Why Iraq’s Debt Deal Makes Sense,” *Euromoney*, September 2005, p. 213.

19. Republic of Ecuador, “Letter from the Finance Minister,” *Noteholder Circular*, April 20, 2009, pp. i-iv, <http://blogs.reuters.com/felix-salmon/files/2009/04/noteholder-circular-goe-bond-offer.pdf> (accessed on August 11, 2014).

20. Ecuador’s allegations of illegitimacy ran the gamut from unauthorized signatures to interest rate hikes by the US Federal Reserve; they were and continue to be contested. See Arturo C. Porzecanski 2010; Center for Global Development Working Group on the Prevention of Odious Debt 2010, p. 7; and Das, Papaioannou, and Trebesch 2012, table 5, p. 37.

21. While the United States might have been happy in 2003 to support Iraq’s repudiation of Saddam Hussein’s debt on the grounds that he was a murderous tyrant, US officials did not welcome Vietnam’s refusal in 1993 to repay military debt thinly disguised as agricultural credits in 1971 (Marian Nash 1997).

22. UK Foreign and Commonwealth Office, *Contract Sanctions: A Consultation* (February 14, 2014).

### Precedent: Iraq and Heavily Indebted Poor Countries

This would not be the first time that the world's leading financial powers shielded countries from their creditors. In May 2003, the UN Security Council passed resolution 1483, which made Iraqi oil and gas assets immune from seizure by private creditors, who held \$100 billion in legacy debt from Saddam Hussein. The United States and the European Union, among others, implemented and extended the resolution in their legal systems,<sup>23</sup> which greatly strengthened Iraq's negotiating position and reduced the appeal of invoking odious debt. In the end, Iraq secured over 80 percent debt relief. Unlike the shield for Iraq, the sanctions proposed here would not require a UN Security Council resolution, since the only debt in question is governed by English law, subject to the jurisdiction of English courts or arbitration in London. Russia's veto in the Security Council would not be an obstacle.

In 2010, the UK Debt Relief (Developing Countries) Act 2010 blocked private creditors from collecting more than government creditors from heavily indebted poor countries (HIPC) under court judgments and arbitral awards.<sup>24</sup> The law was a response to creditor lawsuits against Zambia and Liberia, where creditors collected outsized judgments from very poor countries that were eligible for 90 percent debt relief under multilateral initiatives. The law applies to sovereign debt contracted before its initial enactment on June 8, 2010. Unlike the 2010 law, refusing to enforce Russia's \$3 billion claim against Ukraine would free up resources for private creditors—not limit their recovery.

### Analogue: Prospective Contract Sanctions

A law targeting Ukraine's debt to Russia would build on the debt and contract sanctions proposals advanced by academic and civil society commentators and the FCO. These earlier proposals also deny contract enforcement instead of blocking assets and activities like traditional sanctions. However, they would not work for Ukraine because they deal with future contracts, while Ukraine's problem is existing debt. This is why the law proposed here is retrospective, like traditional sanctions and the laws for Iraq and the poorest countries.<sup>25</sup>

23. See Council Common Position (EC) No. 2003/495/CFSP of July 7, 2003, Art. 2, 2003 OJ (L 169) 1. This order expired on June 30, 2011. See Council Decision 2011/100/CFSP of February 14, 2011, 2011 OJ (L 41) 1. See also Executive Order No. 13303, 68 Federal Register 31931 (May 22, 2003).

24. See Debt Relief (Developing Countries) Act 2010 at <http://www.legislation.gov.uk/ukpga/2010/22/contents> (accessed on August 11, 2014).

25. See *Donegal Int'l Ltd v. Zambia*, [2007] EWHC (Comm) 197, [2007] 1 Lloyd's Rep (Eng); and Thomas Laryea 2010. The lawsuit against Zambia originated with an agricultural credit from Romania that would have been restructured in the Paris Club. The original credit was unenforceable in English

courts. Romania sold the loan to a private investor, who convinced Zambian officials to turn it into an enforceable contract under English law.

Seema Jayachandran and Michael Kremer (2006) have adapted legal theories of odious debt for prospective financial sanctions. A multilateral body would label a regime as odious while it is still in power and thereby relieve its successors from the legal obligation to repay. Potential creditors would know that their contracts may not be honored, odious regimes would lose market access, and the international community would express its disapproval of the regime up front, reducing bias and the appearance of victor's justice.<sup>26</sup> The Center for Global Development Working Group on the Prevention of Odious Debt has taken the academic analysis beyond odious debt and odious regimes: It proposes multilateral compacts to make commercial contracts entered into by repressive or corrupt regimes "nontransferable" to their successors.<sup>27</sup> FCO put forward a version of this contract sanctions proposal as a consultation paper in February 2014.

Like most of the writing on odious debt, these contract sanctions deal with the problem of state succession. An evil ruler signs contracts that burden future generations long after the ruler is deposed. The problem to be solved, regime odiousness, is visible to the international community when the contract is made. In contrast, the case against repaying \$3 billion to Russia has become more compelling since the inception of the contract, with the annexation of Crimea and support for Ukrainian separatists. Also, potentially oppressive contract terms, like the debt-to-GDP covenant, were unknown and hard to specify before the disclosure was posted on the Irish Stock Exchange.<sup>28</sup> These are all problems distinct from the sins of the Yanukovich government in December 2013.

### Objections and Counters: Tools for a Messy World

There is a gap in the international financial architecture. Today's fragmented sovereign debt restructuring regime seeks to deliver economic relief but has no space for questions of political legitimacy. At the other extreme, traditional sanctions impose economic pain for political payoff; economic benefit is not part of the equation. The debt sanctions proposed here bridge this gap. They address two important problems that no other policy tool does: the use of debt contracts for political control and hostile acts by a creditor government against the debtor. In

26. Jayachandran and Kremer (2006) also argued that loan sanctions are more efficient than trade sanctions in the long term.

27. See Center for Global Development Working Group on the Prevention of Odious Debt 2010. The CGD Working Group proposal focused in particular on debt and extractive industry contracts.

28. These terms are unusual in sovereign bond practice and were not known before they were posted on the Irish Stock Exchange website in December 2013.

addition, debt sanctions can deliver badly needed financing for Ukraine. Nevertheless, they are open to objections.

First, the most common criticism of contract sanctions also applies to debt sanctions: They interfere with contracts. This criticism misunderstands both debt contracts and traditional sanctions. Debt contracts are routinely invalidated by the courts, rewritten in bankruptcy, and blocked by traditional sanctions. Traditional sanctions by definition interfere

**Debt sanctions lack the moral clarity of forward-looking multilateral contract sanctions and of the more traditional visions of odious debt.... Nevertheless, they would fill an institutional gap in international finance, put pressure on Russia, and help Ukraine.**

with contracts when they forbid delivery of goods or money transfers. Once Ukraine's allies have decided to use sanctions against Russia, they have committed to breaking contracts for political ends, unless they design sanctions specifically to exclude existing contracts.<sup>29</sup> Debt sanctions are more limited than traditional trade and financial sanctions because they do not prohibit the underlying activity but simply refuse court enforcement.

Second and related, UK efforts to protect Ukraine's market reputation could backfire against the United Kingdom. A leading financial center cannot disregard contracts willy-nilly and stay leading for long. This is not an argument against debt sanctions but for using them rarely and choosing targets carefully. When sanctions are narrowly crafted (for example, targeting a single unusual debt owed by Ukraine), the benefits of the vast London market would continue to outweigh fear of sanctions for most debtors and creditors. Nevertheless, the United Kingdom would benefit from multilateralizing the initiative.

Another related argument is that unilateral debt sanctions could be circumvented. For example, Russia or someone who buys the bonds from Russia could try to sue outside the United Kingdom. This would not detract from the proposed sanctions. Ukraine would have little to fear from such a lawsuit if the judgment is uncollectable in the United Kingdom. Suing on English-law bonds in a jurisdiction friendly to Russia would

29. For example, recent EU trade sanctions are notable for carving out existing contracts to allow French and German equipment deliveries to Russia.

also hold no attraction for mainstream investors, reducing the market value of the bonds.

At the other end of the spectrum, some might press to expand the sanctions beyond the \$3 billion bond contract with Russia. Including Gazprom arrears and holdings of Ukraine's debt by Russian entities would deliver more relief to Ukraine and would send an even stronger message to Russia. Alternatively, repudiating all debt incurred under Yanukovich would discourage lending to corrupt leaders. Such expansive sanctions would be harder to justify and administer. The \$3 billion bond makes a good target because it is particularly objectionable in form and substance and because it is easy to identify. As they gain experience with debt sanctions, the United Kingdom and others could consider criteria for expansion—or decide to reserve the measure for the most egregious debts.

Another criticism would ask what makes speculative private investment betting on a donor bailout of Ukraine morally superior to Russia's bonds. Such investment may raise a burden-sharing problem but not necessarily one of illegitimacy and abuse. It can be solved in a conventional debt restructuring based on economic considerations without recourse to sanctions. In turn, debt sanctions are best suited to counter political abuse of debt contracts, which is not confined to government creditors but happens to be salient with Ukraine's debt to Russia.<sup>30</sup>

Finally, there is the awkwardness of a former imperial power unilaterally declaring other countries' contracts illegitimate. The United Kingdom and the United States have both used military force in the past to collect debts and influence weaker countries (Louis Perez and Deborah Weissman 2007). Is it legitimate for them to punish Russia for doing the same? This objection has no easy counter. Major financial jurisdictions necessarily project political power. Sanctions are a transparent way to do it. It would obviously be better if sanctions were multilateral, but changing English law is the most practical interim solution.

In sum, debt sanctions lack the moral clarity of forward-looking multilateral contract sanctions and of the more traditional visions of odious debt, where courts or audit commissions sift through a dictator's debts amid the rubble left behind.<sup>31</sup>

30. If governments were the only ones doing political lending, one could simply close national courts prospectively to their debt contracts and treat them as bets on the survival and prosperity of the borrowing government (Gelpern 2007). This would force debt negotiations into political fora and reduce private market interest in the debt. This approach is impractical in a world where central banks and reserve managers use sovereign bonds as policy instruments; it is also ineffective in a world where private financial firms can easily front for governments in most political lending.

31. Robert Howse and Ruti Teitel, "Debt, Dictatorship, and Democratization,"



Nevertheless, they would fill an institutional gap in international finance, put pressure on Russia, and help Ukraine.

## CONCLUSIONS

Sovereign governments cannot file for bankruptcy. There is no single court to decide which sovereign debts are good, which are abusive, and what to do about the in-between—nor to apportion assets and liabilities between Old and New Ukraine, as between Old and New Chrysler, should it come to this. Instead, there are contracts, customs, and institutions, which do a decent job of relieving a country's debt burdens after they become inefficiently high in the judgment of the IMF. In this patchwork, public and private creditors are supposed to occupy different corners and abide by different rules, lightly coordinated and occasionally adjusted to limit free-riding. Politics is

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*Project Syndicate*, April 4, 2011, <http://www.project-syndicate.org/commentary/debt--dictatorship--and-democratization> (accessed on August 11, 2014).

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