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CAN A SOVEREIGN STATE DECLARE BANKRUPTCY?

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ABSTRACT

This article examines the issue of state bankruptcy. Since there is no uniform way to deal with the issue, attention is given to different practices and guidelines of courts' reasoning(s) on the matter. In order to answer the question of legality, as well as to confirm or disconfirm the hypothesis that sovereign state can declare bankruptcy, descriptive, analytical and comparative methods are used. The article provides a historical overview of state bankruptcies. The article also explores the existing judicial regulations, addresses the absence of international law containing a uniform or a codified bankruptcy law for states, and outlines the main principles applicable to the dispute resolution between an insolvent sovereign state and its creditors. In addition, the article analyzes the circumstances which allow states to suspend or repudiate the fulfilment of international obligations.

KEYWORDS

State, insolvency, bankruptcy, international law, insolvent state, suspension of obligation fulfilment, repudiation of obligation fulfilment

INTRODUCTION

Recently several European states (e.g. Greece, Latvia, Iceland) declared their inability to pay debts and warned the rest of Europe and the world of their potential bankruptcy. Contrary to the universally recognized regulation of insolvent corporations, and in some jurisdictions insolvent private persons, the issue of an insolvent sovereign state is not regulated. Unfortunately, we have no rule of law at the international level for regulating the insolvency and bankruptcy of the state.

The situations of uncertainty engendered by financial crises create many legal problems. There is little that is fair and open about unsustainable debt procedures today – usually, when a state is insolvent, disputes among the debtor and its creditors are resolved through an informal arrangement, where creditors act as judges, and representatives of the debtor countries simply accept or decline the offer advanced by the creditors. But often, because of the diversity of creditor interests and the absence of collective action clauses in all bond instruments, uncertainty is created among all participants as to how the restructuring process will unfold.

Moreover, in the absence of a special court that could under rule of law deal with sovereign state bankruptcy, problems arise with enforcing litigation and courts' decisions. Because of state immunity there is no enforcement mechanism for creditors to seize assets from an insolvent state. And certainly, there is no creditor controls on insolvent state – turnover managers cannot be dispatched to manage the state that has defaulted on its loans. Creditors cannot easily repossess the collateral that secures their debts. Creditors cannot apply legal mechanisms for transferring the assets to the creditors in the event of default. Crucially, when a state is insolvent, there is no bankruptcy ladder of priorities or equality clause. There is also no discharge of the debtor, and no retribution for delinquents which is repudiated due to unwillingness to pay and not due purely to inability. There is no forced disclosure except via voluntary statistics.

From a legal policy standpoint, this undefined situation creates a sense of lawlessness, which is incompatible with the concept of an international legal order. The significance of the problem of insolvent states in recent years forced academic proposals and debates at the international level on sovereign debt crisis resolution mechanisms, which are briefly discussed in this article.

The aim of this research is to affirm (or negate) the hypothesis that a sovereign state can declare bankruptcy. The article analyzes the current legal regulations, judicial practice and practices for resolving sovereign state solvency crisis. The analysis of the right to suspend or repudiate debt repayment on the basis of state insolvency is presented too. The article defines and analyzes judicial problems in the absence of rule of law.

1. CURRENT PRACTICES FOR RESOLVING SOVEREIGN STATE BANKRUPTCIES

In 2010 Greece warned about its possible bankruptcy; in 2009 Latvia essentially faced bankruptcy; in 2008 Iceland declared its inability to pay its debts. However insolvent countries are not a new phenomenon. Historically there have been many defaults on external debt. The medieval history of state insolvencies is one of wars, kings and ruined Italian bankers. For example, "France defaulted on its Sovereign debt eight times between 1500 and 1800, while Spain defaulted thirteen times between 1500 and 1900."[1] In the 19th century, most insolvencies involved defaults on international bond issues. Belligerents defaulted after World War I. Subsequently the Great Depression followed with debt crises and defaults in the 1930s. The British and French governments defaulted in the 1930s, considering the needs of their peoples more important than those legal obligations to creditors. In the 1980s most emerging countries defaulted. The Asian market collapsed in 1998, and then crises spread to Russia. In the beginning of 21st century Argentina and Ecuador became insolvent. These global crises were followed by debates and proposals for an international bankruptcy regime as an alternative for IMF bailouts.[2]

Note worthy is to mention that the idea of applying bankruptcy principles to sovereign states is not new and goes back to Adam Smith[3] in 1776, who wrote:

> When it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor.[4]

The proper functioning of fair insolvency procedure depending on the full ability of parties to defend their legal interests is a widely discussed issue (mostly in academic level and by International Monetary Fund). However, the current legal situation of insolvent states and their creditors is very indefinite. There are no legal norms or even framework defining what rights and duties the insolvent state and its

[1] Bianca De Paoli, et al., "Costs of Sovereign Default." *Financial Stability Paper* no. 1 (Bank of England, 2006) // http://www.bankofengland.co.uk/publications/fsr/fs_paper01.pdf (accessed February 03, 2009).
[2] The author of the best known proposal is Anne O. Krueger (the first deputy managing director of the IMF).
[3] Adam Smith (1723 06 16 – 1790 07 17) was a Scottish moral philosopher and a pioneer of political economy.
[4] Adam Smith, "Of the Revenue of the Sovereign or Commonwealth (book five). Chapter III of Public Debts" (1776) // http://www.adamsmith.org/smith/won-b5-c3-ss7.htm (accessed March 07, 2009).

citizens have against its creditors and vice versa. And consequences of state insolvency are intimidating – "countries that lack reserves to cover their maturing foreign-currency debts are vulnerable to a run".[5] When a state is insolvent and operates in financial crisis, the banking system collapses and people lose their savings. There is inflation; interest rates and unemployment grow rapidly; the local currency depreciates; and local creditors have incentives to liquidate.

Despite that, there is no international statutory law that governs the procedures. "Current practices and procedures for dealing with Sovereign liquidity crises have evolved over the past few decades in a pragmatic and flexible manner."[6] Problems of insolvent states have been resolved through case by case application of a few broadly accepted general principles and left to evolutionary development. Most of the arrangements are informal even though the national authorities and the multilateral institutions are involved.

2. GENERAL LEGAL PRINCIPLES DEALING WITH SOVEREIGN STATE BANKRUPTCY

The basic function of any bankruptcy procedure is the resolution of a conflict between two fundamental legal principles:

> The right of creditors to interest and repayments collides and the principle recognized generally (not only in the case of loans) by all civilized legal systems that no one must be forced to fulfil contracts if that leads to inhumane distress, endangers one's life or health, or violates human dignity.[7]

"International law contains neither a uniform nor a codified bankruptcy law of states."[8] So, states refusal to pay on the basis of its insolvency under current judicial regulation would be determined as violation of *pacta sunt servanda* rule. Under the Resolution *Responsibility of States for Internationally Wrongful Acts*[9], such breach of international obligation is characterized as an internationally wrongful act. It is not an international agreement. It leads neither to customary-law application nor to legally binding application for another reason, but may serve as an indication of a legal conviction as is necessary to form customary law. Ultimately, it is now generally recognized in legal literature and in the view of

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[5] Nouriel Roubini and Brad Setser, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies* (Institute of International Economics, 2004), p.16.
[6] Amita Batra, "Sovereign Debt Restructuring," Indian Council for Research on International Economic Relations, 2002: 11 // http://www.icrier.org/pdf/OP02SovDebt.pdf (accessed March 01, 2009).
[7] Kunibert Raffer, "Solving Sovereign Debt Overhang by Internationalizing Chapter 9 Procedures," University of Klagenfurt, 2002 // http://www.jahrbuch2002.studien-von-zeitfragen.net/Weltfinanz/RAFFER_1/raffer_12.HTM (accessed March 05, 2009).
[8] *German bondholders v. Republic of Argentina*, German case: 2 BvM 1-5/03, 1, 2/06 (2007 03 08).
[9] *Responsibility of States for Internationally Wrongful Acts*, Resolution 56/83 of the United Nations (2002 01 28): art. 2.

international courts and tribunals that Articles on State Responsibility constitutes applicable customary international law.

However, in order to determine whether a state's refusal to pay its debts due to pure inability to pay contradicts the law, circumstances precluding wrongfulness must be evaluated. The Resolution *Responsibility of States for Internationally Wrongful Acts* enumerates circumstances precluding wrongfulness: distress, necessity, and compliance with peremptory norms. But, in order to defend on one of the above mentioned bases precluding wrongfulness, the debtor must prove the causational link between payment of debt and these circumstances. This is very difficult to do.

Debtor protection is an essential feature of bankruptcy. "Human rights and human dignity of debtors are given priority over unconditional repayment."[10] The prioritization of the payment obligation and creditor's interests to get their assets in neglecting the needs of insolvent Sovereign are unjust. It contradicts the *ius cogens* of human rights. Also, it cannot be denied that enforcement of insolvent state payment obligations would risk an interruption of elementary state functions and increase the possibility of violations of human rights. Such pressure is unjust and unacceptable insofar as no equally essential interests were also at stake on the creditor's side. So, if the protection of fundamental rights of people of insolvent state are at stake, then the state has a right to repudiate or impose a temporal standstill on the fulfilment of its financial obligation.

When a sovereign state is insolvent, there is no bankruptcy ladder of priorities or equality clause. A priority structure is beyond debtor discretion – "sovereignty uniquely empowers a government to choose the order of repayment among its creditors based on its political imperatives, financing needs, reputation concerns, or any other considerations".[11] A formal insolvency regime typically sets out, in general terms, how different types of claims on a distressed private company will be treated in a restructuring and the order of payment in the event of liquidation. Internationally recognized bankruptcy law principles (which are as well entrenched in Lithuanian Republic corporate bankruptcy law and Lithuanian Republic corporate restructuring law[12]) usually indicates that employers and taxes get paid ahead of most private debts. Different kinds of debts may have different levels of priority—

[10] Federico Sturznegger and Jeromin Zettelmeyer, "Has the Legal Threat to Sovereign Debt Restructuring Become Real?" Harvard University, International Monetary Fund, 2006: 10 // http://profesores.utdt.edu/~fsturzen/legal.pdf (accessed March 04, 2009).
[11] Anna Gelpern, "Building a Better Seating Charted for Sovereign Restructurings," *Emory Law Journal* Vol. 53 (2004) // http://papers.ssrn.com/sol3/papers.cfm?abstract_id=902026# (accessed February 25, 2009).
[12] *Lietuvos Respublikos įmonių bankroto įstatymas* (Law on the Bankruptcy of Companies of the Republic of Lithuania), Official Gazette (2001, no. 31-1010): art. 3; *Lietuvos Respublikos įmonių restruktūrizavimo įstatymas* (Law on the Restructuring of Companies of the Republic of Lithuania), Official Gazette (2001, no. 31-1012): art. 14.

for example, debts backed by collateral are treated better than unsecured debts.[13] These rules tell a firm's creditors where their claims stand in order.

In contrast, no formal rules of priority lay out how different types of claims on a distressed state will be treated.[14] A court also has no power to force a state government to respect any rules of priority. Different creditors will argue that their claims should be given priority – so, the relative standing of various claims on a sovereign government is often ambiguous. Since insolvent state usually is unable to grant absolute priority[15] to many – if any – creditors, the debate is usually focused over relative priority.[16] Despite the present legal vacuum of bankruptcy framework for sovereign states, under Paris Club debt revision procedures there is a generally recognized, though unwritten rule that the International Monetary Fund gets money from the country debtor first. "Most sovereigns do respect a number of informal rules, avoiding total chaos. The priority traditionally granted to creditors like the IMF, the World Bank, and other multilateral development banks is almost always respected."[17]

However, these informal rules leave a lot of controversy – should domestic creditors be treated better or worse than external creditors, or should private external creditors have priority over other governments. As been stated by Anna Gelpern, a transparent, enforceable priority system for sovereign debt could reduce the risk of involuntary subordination, the attraction of lending to over indebted governments, and make restructuring less messy.[18]

"The extraordinary aspect of State bankruptcy is that it operates in a legal vacuum without a bankruptcy law."[19] To summarize all of the above-mentioned judicial problems, it is assumed in this paper that the absence of state bankruptcy regulation causes problems for both creditor and debtor, and the creation of a bankruptcy procedure is needed to eliminate this judicial gap.

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[13] Law on the Bankruptcy of Companies of the Republic of Lithuania, *supra* note 12: art. 33-34; Law on the Restructuring of Companies of the Republic of Lithuania, *supra* note 12: art. 14.

[14] Noteworthy is to mention that in some countries, certain public entities are subject to an insolvency regime. Municipalities in the United States, for example, are subject to Chapter 9 of the US Bankruptcy Code.

[15] *Absolute priority* means that claims at the top get paid in full, those in the middle get paid in part, and those at the bottom get nothing.

[16] *Relative priority* assures only those at the top of the priority structure better treatment than those at the bottom and nobody may get paid in full.

[17] Nouriel Roubini and Brad Setser, *supra* note 5, p. 250.

[18] Anna Gelpern, *supra* note 11: 4.

[19] Philip Wood, "State insolvency: bankruptcy without a bankruptcy law," (2009) // http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=49910&prefLangID=410 (accessed March 09, 2009).

3. ANALYSIS OF CIRCUMSTANCES ALLOWING STATES TO SUSPEND OR REPUDIATE INTERNATIONAL PUBLIC DEBT

3.1. GENERAL CONDITIONS WHEN A STATE CAN REPUDIATE

The state, whether it is insolvent or not, can abolish the fulfilment of financial obligations when a treaty provides the possibility to repudiate or restructure. Generally, "if the borrower and lender agree *ex ante* how to adjust payments in the event of negative shocks, there is no need to renegotiate the contracts *ex post*, when crisis occurs"[20].

Secondly, it may do that when the *creditor state gave its consent to non-fulfilment of the interest obligation.* Decision of the permanent Court of Arbitration of 11 November 1912 in the *Russian Indemnity* case between Russia and Turkey[21] is a good example.[22] The Permanent Court of Arbitration, to which the dispute was submitted, decided:

> The Imperial Ottoman Government was under an obligation to the Imperial Russian Government for the payment of moratory compensation as from 31 December 1890/12 January 1891, the date of receipt of a demand for payment that was explicit and in due form. However, inasmuch as the rights of the Imperial Russian Government under that demand for payment had in fact been extinguished as a result of the subsequent waiver by its Ambassador in Constantinople, the Imperial Ottoman Government is now under no obligation to pay interest to it according to the dates on which payment of the indemnity was effected.[23]

The Court found that Russia's consent was lawful, although it would otherwise have constituted a breach of an international obligation incumbent on Turkey.

Thirdly, a state can abolish the fulfilment of its financial obligations when the *debt contract was illegitimate.* There are certain debts which are not expected to be repaid because the debt itself is "against the law or not sanctioned by law, unfair,

[20] Nouriel Roubini and Brad Setser, *supra* note 5: p.83.
[21] *Russia v. Turkey*, Permanent Court of Arbitration case: Russian Claim for Interest on Indemnities (1912 11 11).
[22] Facts of the case in brief: Under the Treaty among States (of 27 January 1879), Turkey was required to pay an indemnity to Russia in reparation for damage suffered by the latter during the Russo-Turkish war. Since Turkey was not in a position to make immediate payment of the entire amount, it spread the payment over a period of more than 20 years, until 1902. In 1891, the Russian Government made a formal demand to the Ottoman Government for payment of the principal plus interest, but when the subsequent installments were paid, the creditor Government made no reservation as to interest and did not apply any part of the amounts received to interest. It was only in 1902, upon completion of the payments, that Russia demanded the payment of moratory interest, which the Ottoman Government refused to make.
[23] *Russia v. Turkey*, *supra* note 21.

improper or objectionable, or infringes some public policy".[24] It is assumed that "illegitimate debt consists of loans which were improperly granted and are thus the liability of the lender and are not to be repaid."[25] The doctrine of odious debts was universally recognized after the United States seizure of Cuba from Spain in 1898 when Spain demanded that the United States has to pay Cuba's debts, and the United States refused, on the grounds that the debt had been "imposed upon the people of Cuba without their consent and by force of arms".[26] The concept of odious debt was also recognized in 1998 by the British House of Commons International Development Committee when it wrote that "the bulk of Rwanda's external debt was incurred by the genocidal regime which preceded the current administration."[27] An outstanding arbitration ruling was also given by United States Supreme Court Chief Justice Taft in 1923. The case was about a Costa Rican dictator, Frederico Tinoco, who was "overthrown and the new government renounced to repay loans made by the Royal Bank of Canada to the Tinoco government"[28]. The renouncement was made on the grounds that it was not a state's debt, but a personal debt of F. Tinaco. Judge Taft ruled in favour of the Costa Rican government and pointed out that "the bank knew that this money was to be used by the retiring president, F. Tinoco, for his personal support".[29] A preeminent ruling was made by Federal Judge Dr Jorge Ballesteros in Argentina's debt case. In 1976 – 1983 when military junta was in power in Argentina, foreign debt rose from $8 billion to $46 billion. In 2000 Federal Judge Dr Jorge Ballesteros ruled that the debt contracted during the dictatorship was illegal and illegitimate.

In summary, a state can refuse to pay when the debt contract was illegitimate, a creditor explicitly or implicitly gave its consent to non-fulfilment of the obligation, or parties from the beginning agreed how payments will be adjusted in case of insolvency. This is applicable whether a state is insolvent or not.

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[24] Joseph Hanlon, "Defining Illegitimate Debt and Linking its Cancellation to Economic Justice," Open University (2002): 5 // http://www.odiousdebts.org/odiousdebts/publications/DefiningIllegitimateDebt.pdf (accessed March 28, 2009).
[25] Joseph Hanlon, "Illegitimate Loans: Lenders, not Borrowers Are Responsible," *Third World Quarterly* Vol. 27, No. 2 (2006): 219-220 // http://www.open.ac.uk/personalpages/j.hanlon/3WQ_illegitimate_debt.pdf (accessed March 28, 2009).
[26] *Ibid*.
[27] Susanne Soederberg, "The Transnational Debt Architecture and Emerging Markets: The Politics of Discipline and Punish," *Third World Quarterly* 26(6) (2005) // http://www.allacademic.com/meta/p_mla_apa_research_citation/0/7/3/0/6/p73064_index.html (accessed March 05, 2009).
[28] Joseph Hanlon, *supra* note 25.
[29] *Ibid.*

3.2. ANALYSIS OF CIRCUMSTANCES WHICH SHOULD PRECLUDE WRONGFULNESS IN CASE OF STATE BANKRUPTCY

State of necessity

State of necessity is a general legal principle which sets the boundaries of the enforceability of claims– in particular with regard to the protection of life and health of the people of an insolvent state. "Invocation of state necessity is recognized in customary international law in those legal relationships which are exclusively subject to international law."[30] In the case of non-fulfilment of international obligation, a sovereign state can claim that its conduct was not wrongful because adopted in situation of economic necessity. "As necessity is a defence of last resort, it would be necessary to establish that the debtor state exhausted all other possibilities to avert the economic crisis and to protect the social rights of its people before it could succeed with the defence."[31] In Article 25 of State Responsibility, a state of necessity is described as a grave and imminent peril for an essential interest of the state could not otherwise be avoided and the defence is only available where the state did not contribute to the situation of necessity it finds itself in.[32]

"A defense of economic necessity was invoked by Argentina when it defended itself in court proceedings brought by bondholders in Germany to enforce payment on Argentinean bonds that had been in default."[33] Argentina relied on its inability to pay because of economic crisis. The arguments raised by Argentina were that economic necessity is a recognized defense in public international law and is directly applicable to the relationship between the Argentinean state and its private German creditors.[34] In the view of the Republic of Argentina,

> Necessity was said to apply if major state interests were at risk. It was not possible to objectively define these interests in a manner that would be universally valid, but it was not necessary for the existence of the state itself to be at stake in order to justify necessity. State insolvency was said to be a vital interest that was worthy of protection. If a state was insolvent, the ability to perform all state purposes was said to be impaired. It was said to follow from international jurisprudence and doctrine that a state could also invoke state necessity if it were in dire economic and financial straits.[35]

Moreover,

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[30] *German Bondholders v. Republic of Argentina*, *supra* note 8.
[31] Sabine Michalowski, "Sovereign Debt and Social Rights-Legal Reflections on a Difficult Relationship," *Human Rights Law Review* 8:1 (2008) // http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1159234# (accessed March 14, 2009).
[32] *Responsibility of States for Internationally Wrongful Acts*, *supra* note 9: art. 25(2) (b).
[33] Sabine Michalowski, *supra* note 31.
[34] *Ibid*.
[35] *German Bondholders v. Republic of Argentina*, *supra* note 8.

> A State cannot, for example, be expected to close its schools and universities and its courts, to disband its police force and to neglect its public services to such an extent as to expose its community to chaos and anarchy merely to provide the money wherewith to meet its moneylenders, foreign or national.[36]

The obligation of a government to ensure the functioning of its essential public services must take precedence over an obligation to pay its debts.

The question of economic necessity as a defense in international law was referred to Federal Constitutional Court of Germany. On the 8th of May, 2007, the Court ruled that "no general rule of international law is ascertainable which entitles a state to temporarily refuse to meet private-law payment claims due towards private individuals by invoking state necessity declared because of inability to pay."[37] In a certain case, the German Constitutional Court discussed the existence and scope of economic necessity in international law. The majority of the Court reasoned that while customary international law recognized the principle of economic necessity as a defense between states, neither a rule of customary international law nor a general principle of international law could be established that would allow a state to rely on economic necessity in its dealings with private creditors. However, it is still an open question as to whether the defense of state of necessity can be enforced in disputes among a sovereign state creditor and a sovereign state debtor.

The conclusion, it must be emphasized that necessity is a temporary defense. It is assumed in this paper that necessity should be an admissible plea when dealing with an insolvent state. But it should have certain limitations which have not been fixed with sufficient clarity. Once the necessity no longer exists, the state should have to repay the debt. In such a manner legitimate expectations of creditors would not be infringed, and dishonest debtor states would be prevented from unjust enrichment.

When a state can repay debt only at the expense of neglecting the basic social needs of their people

Debt repayment obligations of many developing countries often exceed their economic possibilities.[38] From a legal perspective, debtor states might have a right,

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[36] This statement, submitted by the government of South Africa to the Preparatory Committee of the 1930 Hague Conference for the Codification of International Law.
[37] *German Bondholders v. Republic of Argentina*, *supra* note 8.
[38] In order to analyze the debt obligation correctly, the question how countries are repaying the debt must be asked. Practically most loans are in the currencies of industrialized countries, and under IMF and World Bank structural adjustment policies, countries were forced to devalue substantially. For example, Mozambique devaluation was so rapid that between 1986 and 1990 the interest rate in local currency was 123%.

or even be under an obligation, not to repay their debt where they can only do so at the expense of neglecting the basic social needs of their people.

Legal analysis begins here with international human rights documents: The Universal Declaration of Human Rights, the International Covenant on Economic, Social and Cultural Rights, and national Conventions. At the international level social rights of a human have been widely protected. Article 25 of The Universal Declaration of Human Rights grants the right to an adequate standard of living, "including food, clothing, housing and medical care and necessary social services", as well as the right to social benefits in cases of need, Article 22 – "the economic, social and cultural rights indispensable for his dignity and the free development of his personality", Article 26 – and "the right to education".[39] International Covenant on Economic, Social and Cultural Rights guarantees the right to social security (Article 9); to social protection (Article 10); to an adequate standard of living and to food (Article 11); to the highest attainable standard of health (Article 12), and right to education (Article 13).[40] In many states, similar rights are also guaranteed by their national constitutions. However, in order to claim that due fulfilment of financial obligations is related to violation of social rights, the effects and causation link must be proved, which is often difficult to do.

There is a view that the creditor state must take responsibility, because loans made to developing countries did enrich them. If fulfilment of financial obligation forces the movement of funds from securing basic social needs or citizen to pay the debt for rich country, the fulfilment of such obligation could be deemed due "unreasonableness and therefore invalidity or unconstitutionality, which the State would have the burden to rebut"[41]. However, another view is that debt owned by the debtor is the creditor's property and by contractual obligation it must be repaid. It has been argued that "states that assume international obligations must be expected to meet those and defend them against demands to adopt policies that would violate their international obligations"[42].

The proponents of this view also note that a foreign creditor (who is not bound by legal or moral obligation) "is forced to assume the bill for the protection of the social rights of the people of the debtor state"[43]. Moreover, "it has been argued that to enable debtor states to avoid debt repayment by relying on their social rights obligations would be tantamount to an unjustified forced transfer of

[39] *The Universal Declaration of Human Rights*, adopted by the United Nations (1948): art. 22.
[40] *International Covenant on Economic, Social and Cultural Rights,* entered in force 1979 01 03 (1966, Geneva): art. 13.
[41] Sabine Michalowski, *supra* note 31.
[42] *Ibid*.
[43] *Ibid*.

resources."[44] Opponents of this view claim that the creditor state is not forced to pay the bill of protecting social rights of debtor state, he just is expected to accept that the "debt will not be repaid at the expense of the protection of the core of social rights of the people in the debtor country"[45]. Sabine Michalowski gives a good comparison with bankruptcy procedures for private persons in national laws: "over-indebted individuals would be deprived of the means to satisfy their basic needs if they were forced to repay their debts"[46]. Additionally, rights to basic social needs of the people of the debtor state cannot be abolished due to the inability of representatives of the debtor state to withstand the pressure of a usually economically and politically more powerful state or corrupt representative.

A remarkable example is the Argentinean Zero Deficit Act which was enacted in July 2001, when Argentina was already in a very grave economic and social situation.

> This statute introduced a policy according to which every month the effective tax income would first be used to service the interests of the debt, and the remaining balance would then be dedicated to other public expenditures. It empowered the executive to reduce, inter alia, pensions and the salaries of public employees if public spending exceeded the State's assets.[47]

The statute was nullified as unconstitutional by the Supreme Court. This was partly based on considerations that resemble economic and social rights protection. The same view was expressed by judge of German Constitutional Court Lübbe-Wolff in his dissenting opinion in the case of German bondholder's against Argentina. He noted that,

> As far as financial obligations of the state are concerned, certain fundamental tasks and obligations of the state, in particular those on which the life and health of its citizens directly depend, deserve usually to be given priority over the timely satisfaction of the interests of creditors, that is unless on the other side equally essential interests come into play.[48]

The examples just provided demonstrate that social rights-based arguments are convincing and can make difference in practice in the future. However, it must be agreed that, notwithstanding the fact that above cited opinions were persuasive, there is no legal practice in recognizing the violation of fundamental rights of citizens of insolvent debtor state as a condition allowing to terminate or to suspend the financial obligations of the state. However, it should be, because otherwise the

[44] *Ibid*., relying on Tooze, "Aligning States Economic Policies with Human Rights Obligations: The CESCR's Quest for Consistency," *Human Rights Law Review* 2 (2002): 229.
[45] *Ibid*.
[46] *Ibid*.
[47] Joseph Hanlon, *supra* note 24.
[48] *German Bondholders v. Republic of Argentina*, *supra* note 8.

fundamental rights of people of insolvent states are violated. Finally, it is emphasized in this paper that under current legal regulation there is no legal norm permitting the sovereign state to repudiate or suspend the fulfillment of international obligations on the basis of insolvency. And as analysis has shown the case practice is also contradictory. Even so academic debates in the legal and economic literature argue that it must be a basis, because it would be useful for both sides – debtor and creditor. Academics call for an open, fair international insolvency procedure for sovereign states, and emphasize that "under any insolvency procedure … human rights and human dignity of debtors are given priority over unconditional repayment".[49]

CONCLUSIONS

According to the analyzed material, the following conclusions can be made:

- The historical analysis showed that bankruptcy of the sovereign state is not a new matter – some countries have even defaulted on their external debt several times.
- Human rights are given priority over unconditional repayment. If the debtor state proves circumstances which preclude wrongfulness and shows the direct link between fulfillment of financial obligation and violation of human rights, then this should be the basis to abolish or temporarily suspend debt payment. The obligations imposed on states cannot be greater than those imposed on an insolvent private individual.
- State of necessity should be an admissible plea when dealing with an insolvent sovereign; but it should have certain limitations which have not been fixed with sufficient clearness. Once the necessity no longer exists, the state should have to repay the debt. In such a manner legitimate expectations of creditors would not be infringed, and dishonest debtor states would be prevented from unjust enrichment.

A sovereign state cannot legally declare its bankruptcy but only can suspend or repudiate the international debt obligations. Analysis of existing controversial case practice showed that in certain circumstances violation of fundamental rights of citizens of the insolvent debtor state could be the condition allowing the termination or temporary suspension of international financial obligations.

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[49] University of Vienna Professor Kunibert Raffer, quoted in: Kris Millegan, "Paris Club is not an Institution, It's a Non-Institution" (2003) // http://www.mail-archive.com/ctrl@listserv.aol.com/msg109744.html (accessed February 15, 2009).

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