

Fragile States, Debt Authorization and Governance Rules Recent Interactions Between Public Debt and (Global) Constitutional Law

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CSIS

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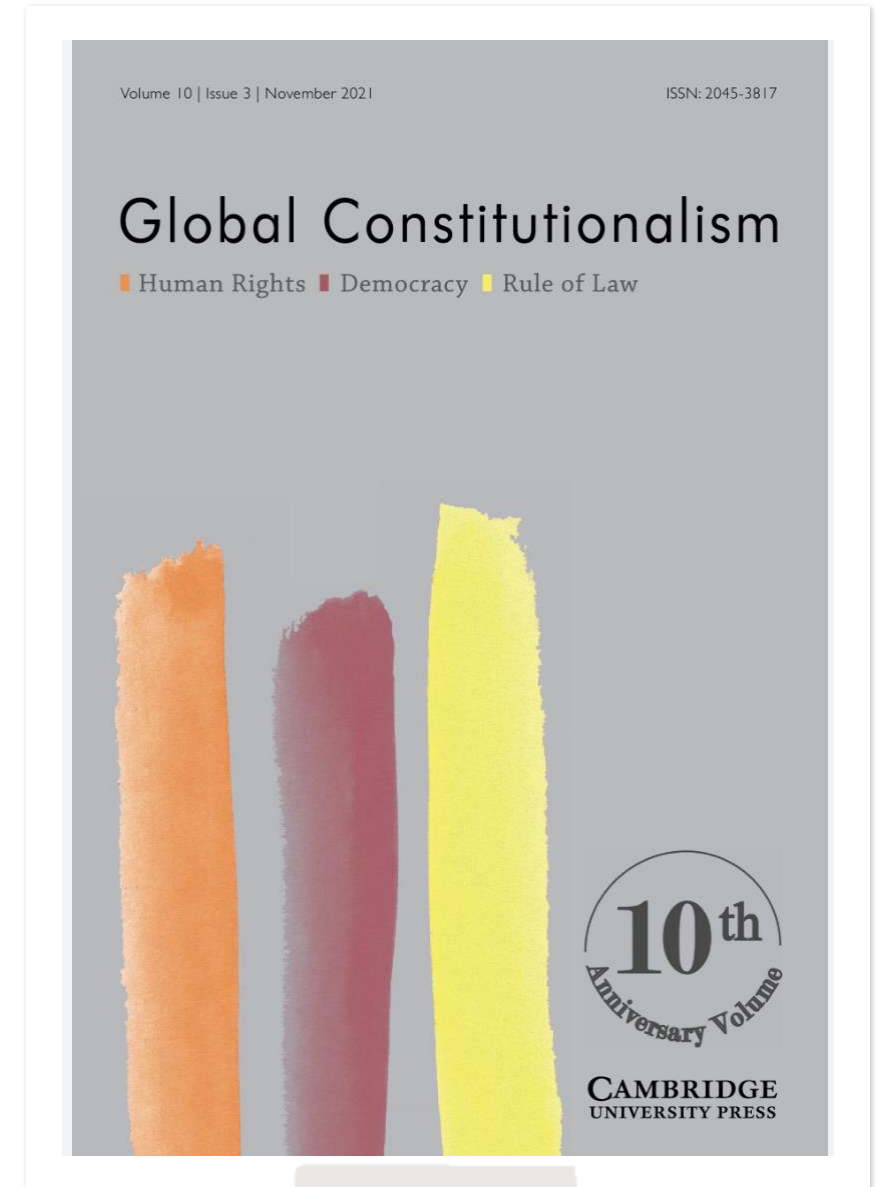
Summary

- (Global) Constitutional Law and Public Debt: A Gradual Interaction
- Fragile States (Or Why Institutions Matter)
- The Constitutional Validity of the External Debt
- Governance and SOEs: A New Alter Ego Wave?
- A Global South Constitutional Law Perspective
- Lessons and Next Steps



(Global) Constitutional Law and Public Debt: A Gradual Interaction

- Constitutional Law Governs several aspects of the public debt lifecycle:
 - Budgetary provisions within the checks and balances rule the public debt planning.
 - The use of the debt proceeds is also subject to checks and balances rules.
 - Compliance and fiscal controls review how the debt contracts were executed.
 - “Constitutional Governance”.
- The so-called Global South Constitutional Law provides an ambitious checks and balances system throughout the debt lifecycle.



(Global) Constitutional Law and Public Debt: A Gradual Interaction

- No precise mechanism facilitates the interaction between Constitutional Governance and the Public Debt International Law Framework (external debt v. domestic debt).
- Building Governance was a task of development banks, not the IMF.
- The choice-of-law provisions immunize the domestic Constitutional Law.
- There is no multilateral public debt system that promotes constitutional governance.



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MAKING PUBLIC DEBT PUBLIC—ONGOING INITIATIVES AND REFORM OPTIONS

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following document(s) have been released and are included in this package:

- The **Staff Report** prepared by IMF staff and completed on June 22, 2023.

The report prepared by IMF staff has benefited from comments and suggestions by Executive Directors following the informal session on July 25, 2023. Such informal sessions are used to brief Executive Directors on policy issues and to receive feedback from them in preparation for a formal consideration at a future date. No decisions are taken at these informal sessions. The views expressed in this paper are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board.

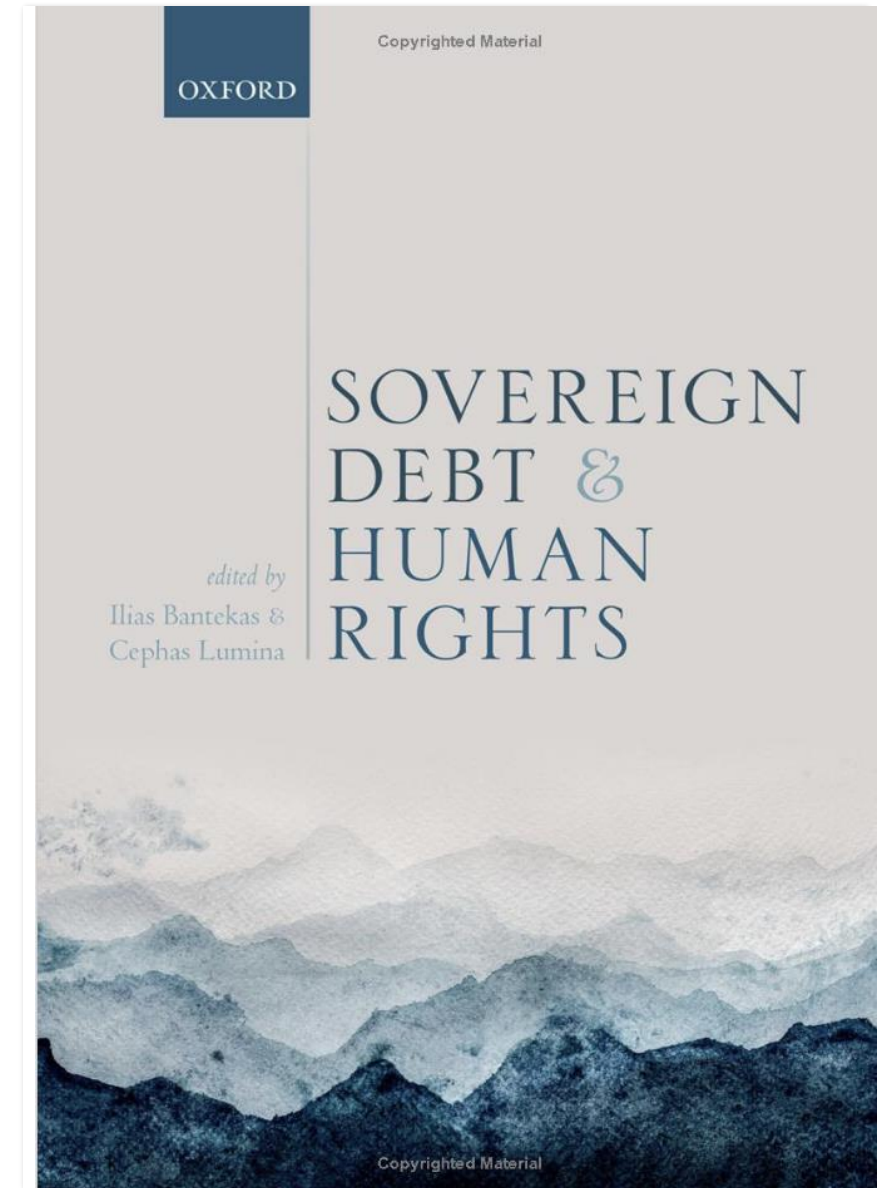
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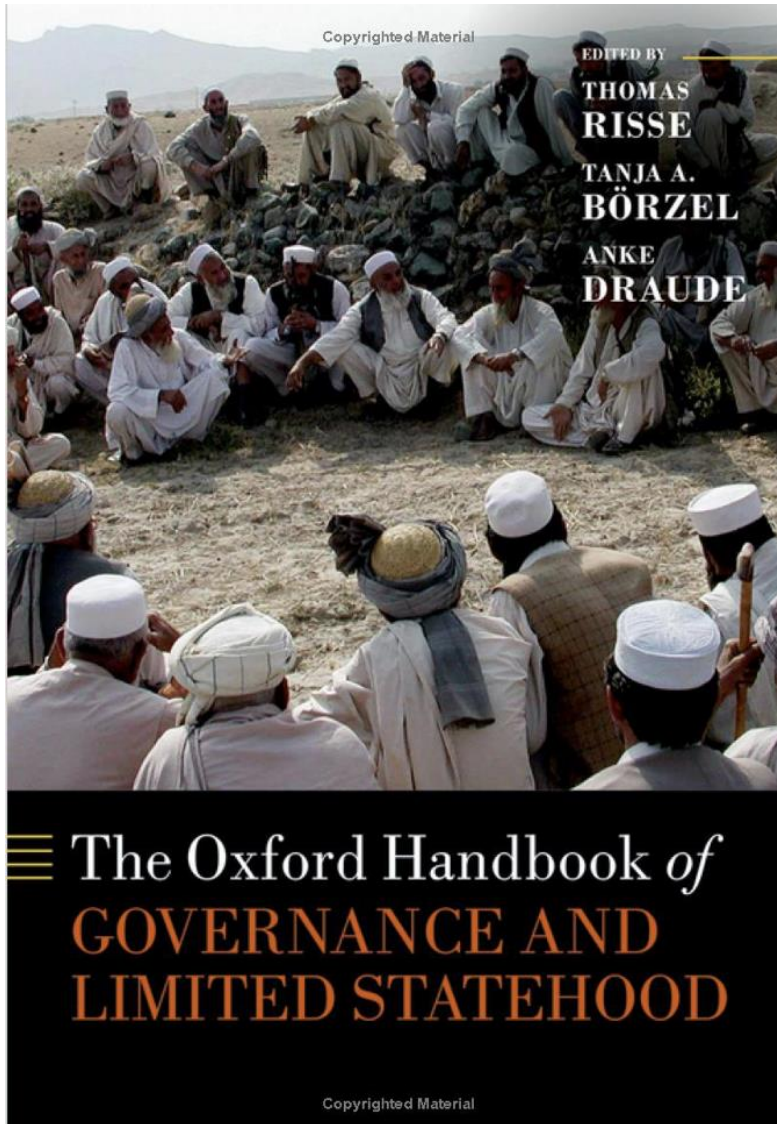
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(Global) Constitutional Law and Public Debt: A Gradual Interaction

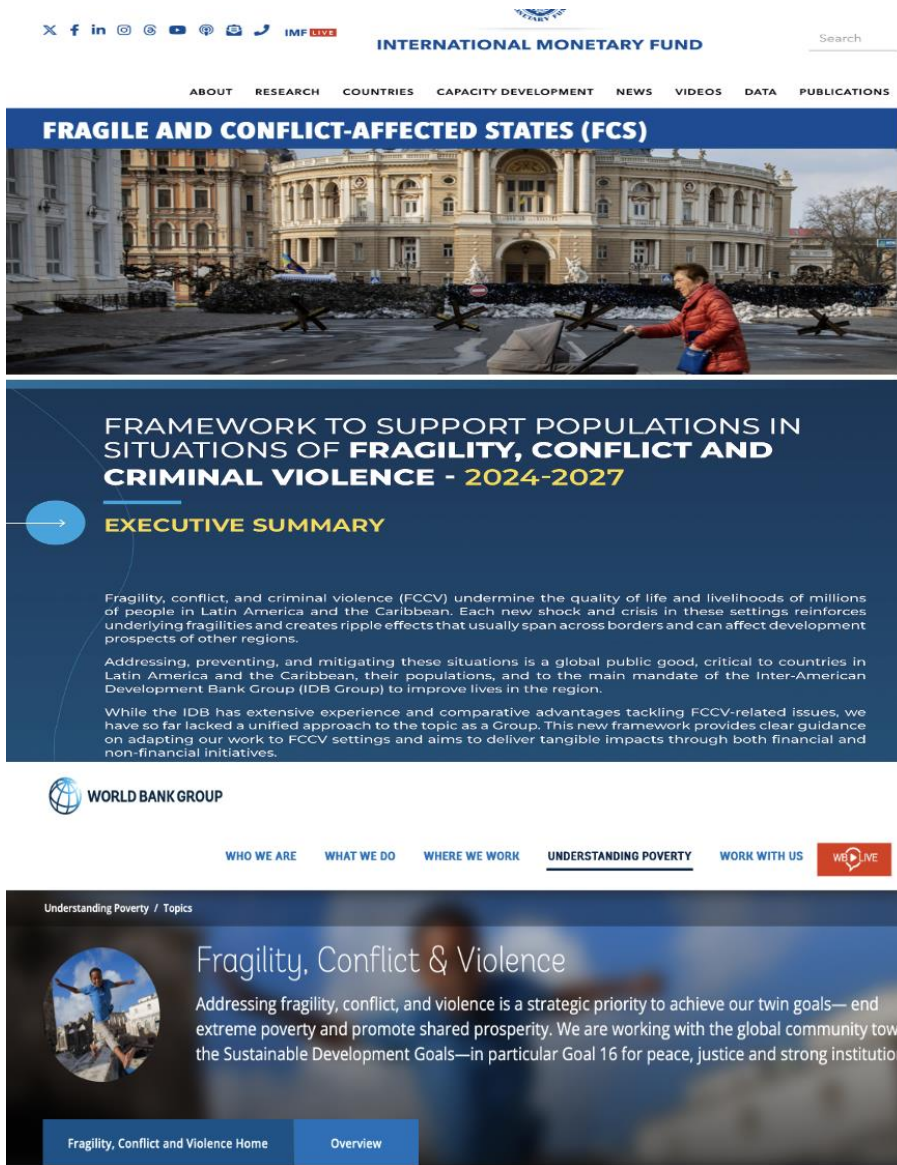
- Since the end of the 20th century, there has been a tendency toward “Global Constitutional Law”.
- First Tier: Increasing interest in promoting Constitutional Governance in the Global Space. Transparency, accountability, and good governance.
- Second Tier: The “extra-territorial” effect of human rights, particularly social and economic.
- International standards on public debt should be considered through the lens of Global Constitutional Law.



Fragile States (Or Why Institutions Matter)



- After the end of the Cold War, new states without capacity were labeled as “failed states”.
- The concept evolved to focus on fragile states.
- The state fragility measures if the Government can effectively perform its duties.
- The areas that the Government cannot address are “areas of limited statehood” (ALS).



Fragile States (Or Why Institutions Matter)

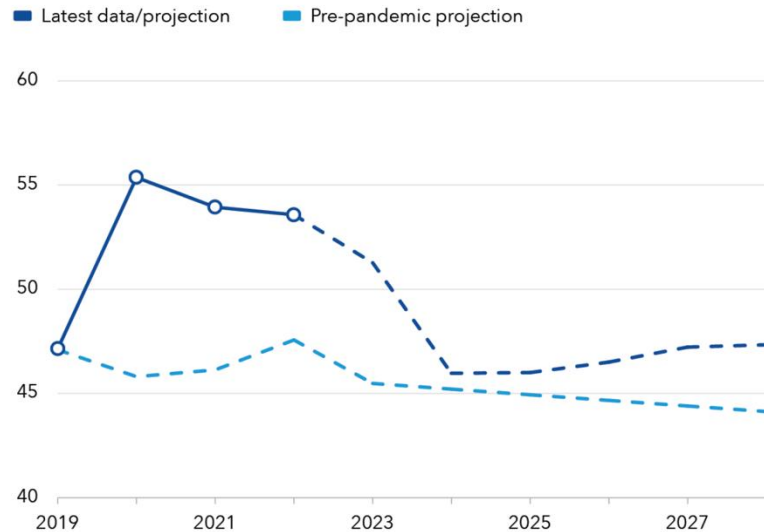
- State fragility can undermine the performance of formal institutions (Rule of Law *de iure*, Rule of Law *de facto*).
- World Bank (2011) and the IADB (2024) adopted policies to design special development programs in fragile states and conflict-affected situations.
- The IMF adopted its policy in 2023.
- The capability trap: neither the state nor the civil society can effectively perform their tasks (ALS).
- Macroeconomic instability and balance of payment problems are symptoms of state fragility. How to escape the capability trap?

Fragile States (Or Why Institutions Matter)

Growing burden

Debt levels in fragile and conflict-affected states rose sharply through the pandemic and are expected to remain elevated.

Gross government debt as a percent of GDP



Source: IMF, World Economic Outlook & IMF Estimates.

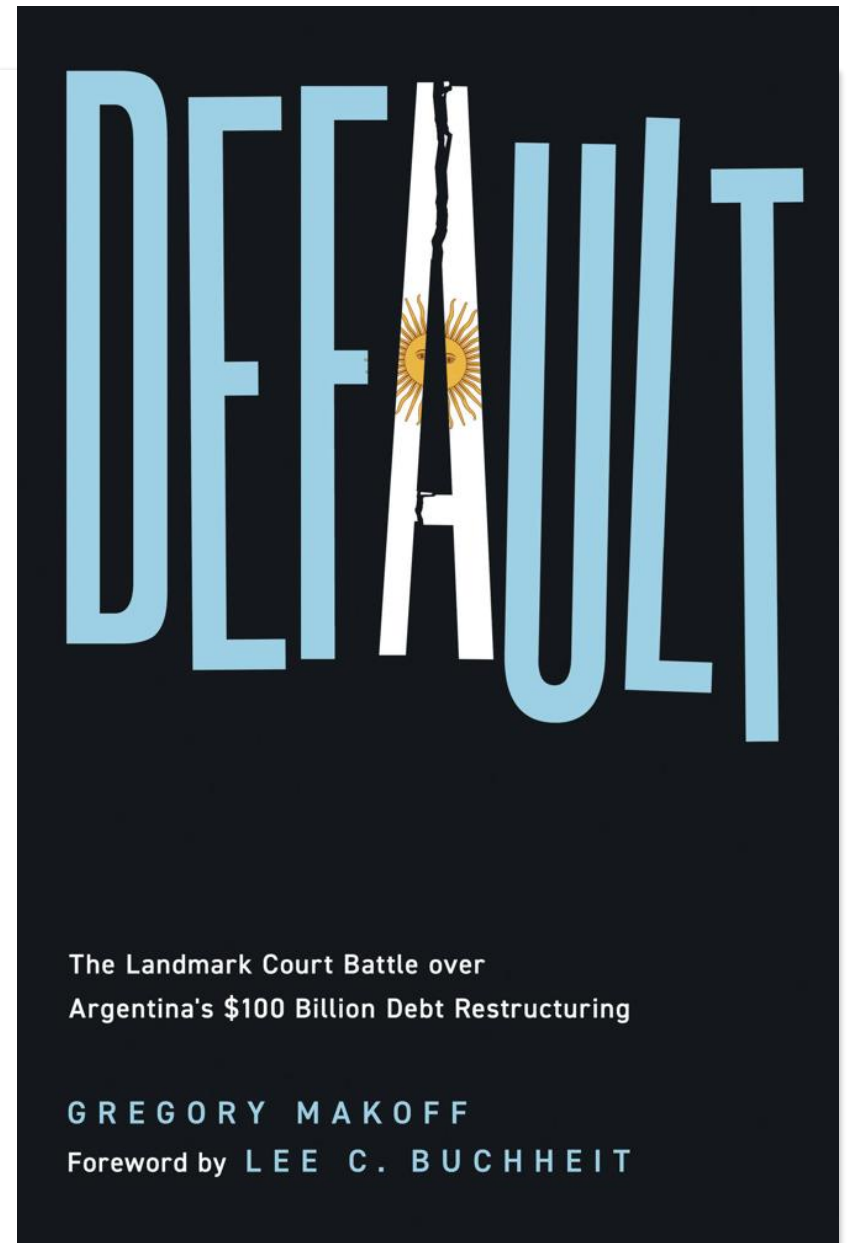
Note: Analysis of 39 economies classified as fragile or conflict-affected according to the IMF's FY24 FCS list.

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- Narrowing down the ALS to fulfill the IMF mandates:
- Understanding how informal institutions work.
- Looking beyond the institutional design: *De facto* rule of law (the example of SWF)
- A Bottom-Up Strategy: Building capability: statistical services, banking supervision, financial intelligence, civil society engagement.
- Identifying the root cause: Good governance throughout the public debt lifecycle. A Global Constitutional Law Perspective.

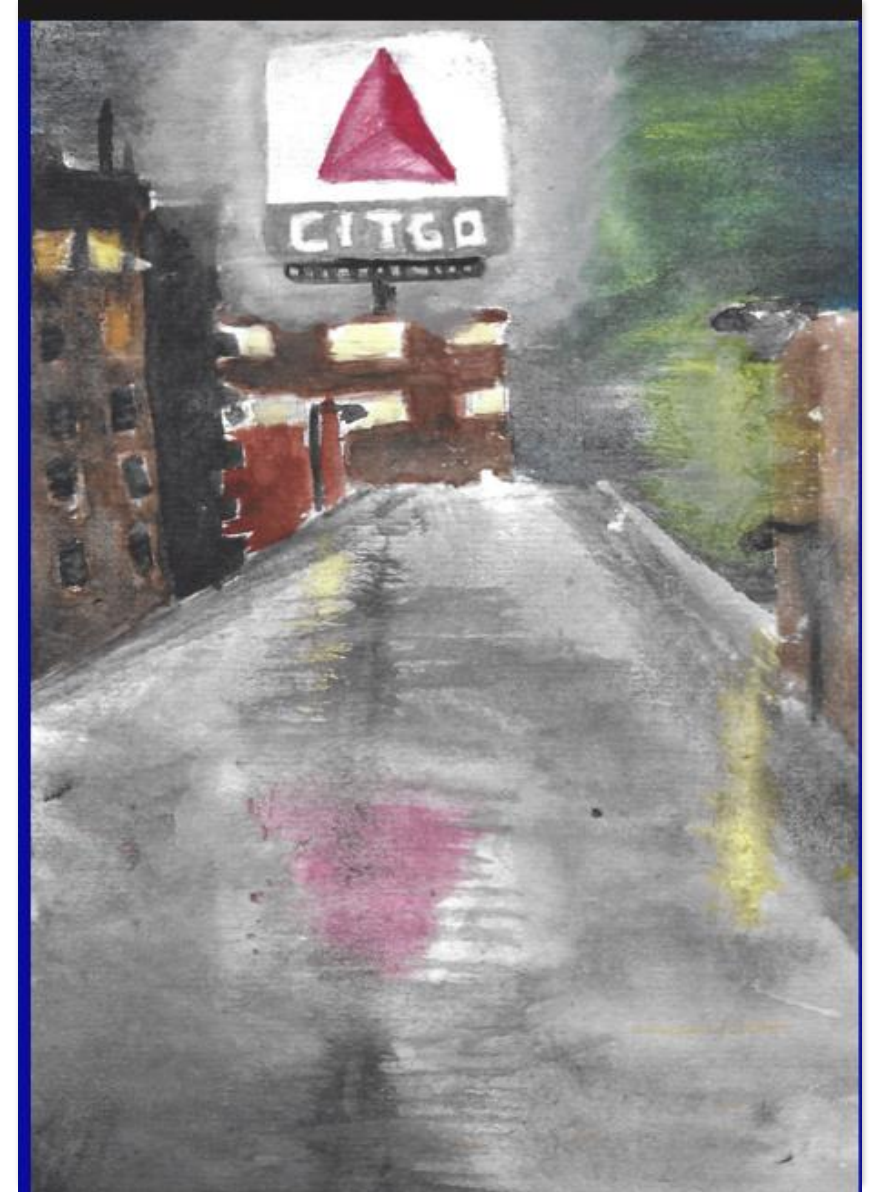
The Constitutional Validity of the External Debt

- The choice of law provisions (NY and English Law) protects bondholders from the borrower's institutional risks.
- External debt is “immunized” from the domestic Constitutional Law.
- Some lessons for Argentina: The “Lock Law” and its ineffectiveness of Domestic Law.
- The reduced effect of the act of state doctrine and the comity principle: the *Allied Bank* case.



The Constitutional Validity of the External Debt: PDVSA 2020s

- In 2016, the Venezuelan National Oil Company issued notes due in 2020, with the collateral over 50,1% of shares of Citgo, its most valuable foreign affiliate.
- The National Assembly exercised its constitutional powers to deny PDVSA's authorization to pledge the shares. Nevertheless, PDVSA signed the indenture and pledge agreements.
- Those agreements established the exclusive applicability of the New York Law, with no reference to the domestic law.
- Is the validity of the Notes ruled by the Venezuela Constitution?



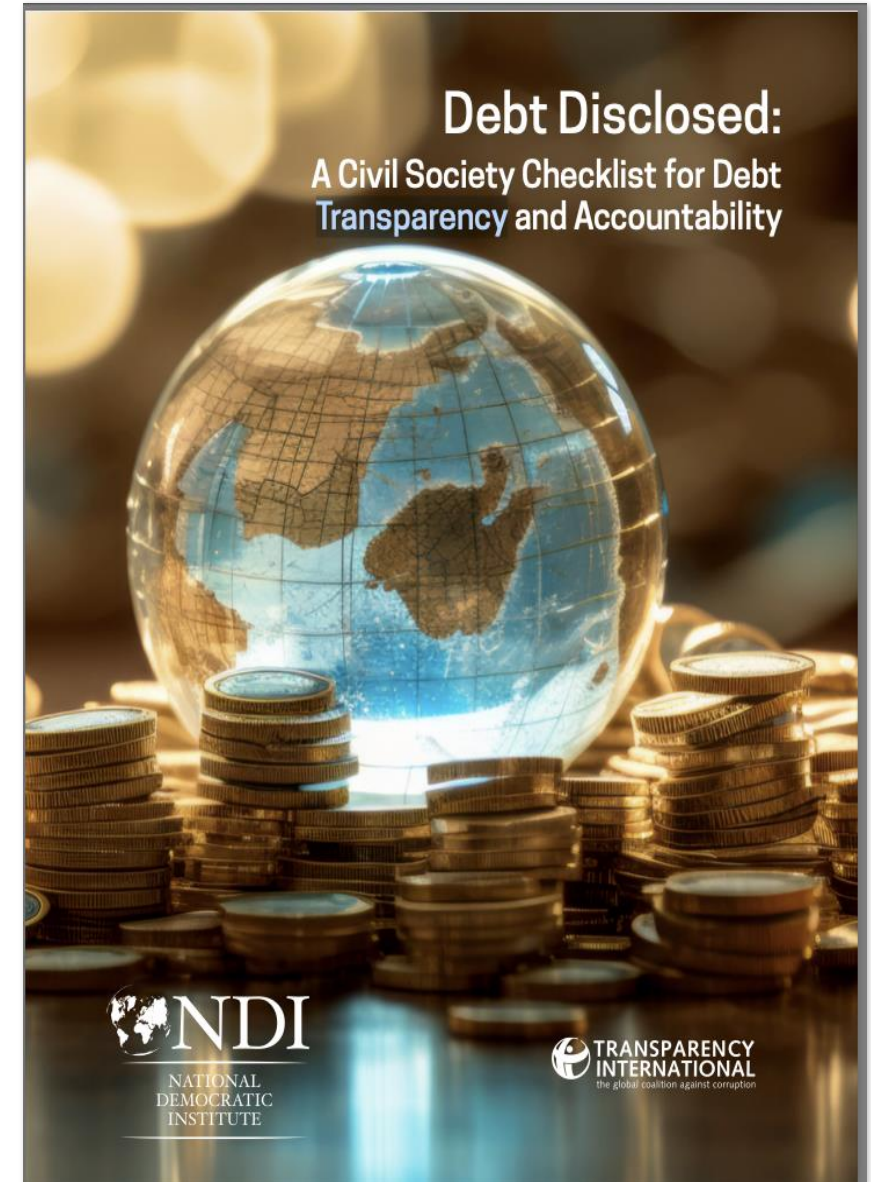
The Constitutional Validity of the External Debt: PSVSA 2020s

- The interpretation of the SDNY (2020): the choice of law provision excludes the application of the Constitutional Law.
- The interpretation of the Second Circuit (2022): Section 8-110 (a) (1) of the NY UCC presents doubts: “The local law of the issuer's jurisdiction governs the validity of a security.”
- The NY Courts of Appeal (2024): The Constitutional Law determines whether the issuers were duly authorized. A narrow scope but a powerful one.
- The Second Circuit granted the appeal and remanded to the SDNY, which will rule on the validity issue based on the Venezuelan Constitutional Law.



The Constitutional Validity of the External Debt: PSVSA 2020s

- The scope of the Constitutional Law is narrow: constitutional provisions that determine if the issuer is duly authorized.
- Should human rights and transparency provisions be considered part of the validity criteria?
- The domestic statutory framework does not determine the validity of bonds.
- From the odious debt to the unconstitutional (invalid) debt.
- Promoting increased interaction between external debt and Constitutional Law.



INTERNATIONAL MONETARY FUND

The Legal Foundations of Public Debt Transparency: Aligning the Law with Good Practices

Karla Vasquez, Kika Alex-Okoh, Alissa Ashcroft, Alessandro Gullo, Olya Kroytor, Yan Liu, Mia Pineda, and Ron Snipeliski

WP/24/29

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2024
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WORKING PAPER

Governance and SOEs: A New Alter Ego Wave?

- **Alter Ego First Round:** Bancec and the Argentina Saga: Only extensive political control over the foreign instrumentality allows the declaration of an alter ego relation.
- **Alter Ego Second Round:** The Venezuela Saga (2018-2019) and PDVSA (D. Del and 3rd Cir): *“If the relationship between Venezuela and PDVSA cannot satisfy the Supreme Court’s extensive requirement, we know nothing that can”*.
- The “extensive control” test was based on gross deviations from good governance standards.

Governance and SOEs: A New Alter Ego Wave?

Piercing the (Sovereign) Veil: The Role of Limited Liability in State-Owned Enterprises

W. Mark C. Weidemaier*

Sovereign nations own more than ten percent of the world's largest firms and use these ownership stakes to pursue economic, social, and political objectives unrelated to profit maximization. Sovereign nations also have unique powers and attributes that "ordinary" owners lack. Sovereigns do not need an owner's control rights to direct entity behavior; they have the power to regulate. Sovereigns do not need an owner's economic rights to extract value; they have the power to tax. And sovereigns do not need to hide behind the principle of limited liability, which protects owners of limited liability entities; they have sovereign immunity in both domestic and foreign courts.

Despite these fundamental differences, neither courts nor legal scholars have seriously examined whether organizational law should distinguish sovereigns from other owners. This Article takes up that question, focusing on the law of veil piercing as applied to corporations and other limited liability entities owned by sovereign states. Its first contribution is to demonstrate that the principle of limited liability does different work for sovereign states than for ordinary shareholders. That principle's primary function is to create a partition between the owner's assets and those belonging to the entity. Because the partition yields important economic benefits, veil piercing is reserved for exceptional cases. But foreign states do not need organizational law to realize these benefits. The law of foreign sovereign immunity already protects the state's assets in ways that mimic the protections of organizational law. By contrast, state-owned entities rely on organizational law for asset protection.

* Ralph M. Stockton Jr. Distinguished Professor, University of North Carolina School of Law. For comments on prior drafts, thanks to Martin Brinkley, John Conley, John Coyle, Tom Hazen, Mitu Gulati, Eisha Jain, Kim Krawiec, Rich Saver, Richard Squire, Deborah Weissman, and to participants at workshops and conferences at Brooklyn Law School, Duke Law School, the University of North Carolina School of Law, and Vanderbilt University School of Law. Thanks as well to Matt Gauthier for research assistance.

- **Alter Ego Third Round. The Venezuela Saga Continues (2023) and the Rubin factors:** Even ordinary economic controls could be considered as evidence of an alter ego relationship:
- Constitutional and statutory provisions rule the instrumentality.
- The central government's ownership and economic benefits.
- The central government appointment and removal powers.
- Economic policies adopted by the central government.
- Debt restructuring process of the central government and its instrumentalities.
- The alter ego factors are determined based on the historical governance relationship (there is not a rigid timeframe).



Governance and SOEs: A New Alter Ego Wave?

- Many SOEs and NOCs fulfill the 2023 expanded interpretation of the alter ego factors.
- Those factors can apply from the central government to the instrumentality and in a “reverse” fashion.
- Some interesting developments in the YPF case (SDNY).
- The new alter ego claims related to Venezuela (federal v. state law).
- How can the constitutional governance rules of SOEs and NOCs be redesigned, including the ESG standards?

THE GLOBAL SOUTH AND COMPARATIVE CONSTITUTIONAL LAW



*Edited by
Philipp Dann, Michael Riegner,
and Maxim Bönnemann*

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A Global South Constitutional Law Perspective

- The so-called Global South Constitutional Law provides an ambitious checks and balances system throughout the debt lifecycle.
- Transparency safeguards human rights at the international and domestic levels.
- Social and economic rights require efficiency and a result-based approach, particularly during a debt restructuring.
- Two parallel frameworks exist: the Global South Constitutional Law and the External Debt Framework.

Constitutional Law	External Public Debt
Public-policy oriented	Contract-oriented
Sophisticated checks and balances system	Sophisticate contract reduces checks and balances
High standards of transparency	Low standards of transparency
Confidentiality is exceptional	Confidentiality is conventional
Ample civil participation mechanisms	Reduced civil participations mechanisms
Unilateral actions	Bilateral actions (and collective problems)
Government is sovereign	Sovereign is waved
Civil procedure allows policy discussion	Debt litigation does not offer strong policy discussions.
Accountability is enforceable	No binding instruments to enforce accountability
Human right centered	Reduced scope of human rights.

External public debt could be an escape door for constitutional accountability.

Lessons and Next Steps

- The so-called Global South Constitutional Law ensures transparency and accountability in the public debt lifecycle as part of progressive checks and balances.
- Good constitutional design is not enough: state capacity and ALS may hinder the effectiveness of Constitutional Law, negatively impacting the governance of the debt lifecycle.
- Violations of the Constitution may determine the invalidity of external debt, regardless of the choice of law provisions. Transparency? Human rights?
- Constitutional governance and the alter ego relationship with SOEs and NOCs.
- Towards a Global Constitutional Law Agenda

