Kunibert Raffer

http://homepage.univie.ac.at/Kunibert.Raffer

Preferred or Not Preferred: Thoughts on Priority Structures of Creditors

Paper prepared for discussions at the 2nd Meeting of the

ILA SOVEREIGN INSOLVENCY STUDY GROUP

16 October 2009

Hosted by the Legal Department, International Monetary Fund

700 19th Street, N.W., Washington, D.C. 20431

© Kunibert Raffer 2009

Municipal insolvency laws customarily differentiate classes of creditors according to various yardsticks and for various reasons. Preferences are granted to certain claims (e.g., unpaid taxes, social security contributions). Collateralised claims, liens on specific assets are usual, as are preferences established by contracts rather than law. Differentiated creditor classes are therefore certainly one possibility for any sovereign insolvency model. The question whether some form of differentiation should be transposed to a model of international sovereign insolvency must be tackled.

First, one should explore whether there already exists legal preference for certain creditors in the case of sovereign debts or not. There would be a strong argument to incorporate the present legal status, arguably even for going further in any form of sovereign insolvency. On the other hand, without any legal preference so far, one would have to ask whether there should be any preference ranking rather than symmetric treatment of all creditors.

Since the very start of "debt management" by International Financial Institutions (IFIs) these institutions themselves have claimed to enjoy preferred creditor status. It was even alleged that the task of development financing could not be fulfilled without such unconditional preference. For quite some time – until HIPC I – multilateral claims were even absolutely exempt. Multilateral relief is of great importance, but has always been difficult due to IFI-claims that they would be preferred or even exempt creditors. Once debt reduction had become unavoidable, IFIs claimed that others would have to grant them or to grant them first. Over the years, this claim, strongly supported by the Paris Club, gained more and more credibility. Even after James Wolfensohn had broken the taboo by pushing for the introduction of HIPC, IFIs have remained privileged. Under HIPC, e.g., all other creditors are supposed to take haircuts first. Only if this would still be considered insufficient by the Bretton Woods Institutions (BWIs), their own and other IFIs' claims can be touched. This is an unfortunate example of judging in one's own cause, or in economic lingo moral hazard. It is the unjustified basis on which other (non-Paris-Club, and private) creditors have to accept larger haircuts in order to finance IFI-preference. This complicates solutions considerably and discriminates quite a few creditors illegally. Especially for the poorest Southern Countries (SCs) burdened by a relatively large share of multilateral debts, this has meant an important, additional difficulty. However, also in richer countries, such as Argentina, IFI-claims can be relatively substantial. The problem of whether there is or should be preference of any kind for IFIs is crucial.

There exists no legal base for preferred creditor status, and IFIs know it. One can even read it on their own homepages. No legal hindrance exists to reduce multilateral debts, no legal norm demanding preferred treatment. In fact, most IFIs are statutorily obliged to grant relief sooner than the private sector, but have simply refused to obey their statues. Furthermore this paper provides arguments indicating that subordination may be both legally and economically necessary. The main conclusion is thus that either there should be only one class of creditors or – if there is a differentiation - IFI-claims should be subordinated. Finally, a simple numerical example shows the different effects on *bona fide* private creditors that are discriminated by present debt management.

Considering the present discussion of changes on the role the IMF, however, there might be scope in pointing out that reformed IFIs might play quite a useful role as lenders in emergency, whose fresh money should well enjoy preferred status.

Preferred or Not Preferred - A Question IFI-Statutes Answer Clearly

Granting bilateral reductions, the Paris Club (which is legally non-existent) has demanded comparable losses from other creditors although without any legal base: This quite clearly recognises the principle of equal treatment, one of the cornerstones of any insolvency mechanism. However, the Paris Club has always insisted on preference for IFIs, thus *de facto* introducing a two-class-creditor model. Considering that Paris Club creditors decide themselves how much they want to "lose", a wholly unique creditor privilege at severest odds with the cornerstone of the Rule of Law, we may even speak of three classes, including the class that decides in their own cause, though on the basis of IFI-advice. Clearly no such procedure could be imagined in any municipal or decent sovereign insolvency proceedings.

Decisions by some creditors to extend *de facto* preferential status to IFIs and to put pressure on others to accept this decision differ fundamentally from a legal right of being exempt, even though the private sector has often acquiesced. The Paris Club may well decide not to demand the same haircut from any other group of creditors, multilateral or not. Nevertheless, there exists no legal obligation to grant such treatment, nor any legal or ethical obligation of other creditors to accept it. The fact that Paris Club creditors exercise pressure on some creditors to "grant" comparable relief but not on others, makes one question whether the Club's intentions are really based on emulating fair insolvency procedures and whether it wants to apply the Rule of Law. It also leads to questioning whether comparable reductions

granted under pressure are legally valid. HM Treasury (2009, p.22) admits having taken "vigorous action" against creditors exercising their rights, stating "There is evidence that the measures taken by the UK Government and international bodies to limit non-co-operative creditor activity have had some success, as described in the previous section. However, these methods cannot prevent creditors intent on pursuing their claims through the courts from doing so." (*ibid*., p.19) HM Treasury openly admits that demanding full repayment "is the creditor's legal right" (*ibid.*, p.5), that "creditors retain their legal rights to enforce claims against the country concerned" (*ibid*., p.14), as well as that – while government policy supports the full adoption of HIPC Initiative terms by all creditors – "this is not legally binding" (*ibid*. p.25). In spite of clearly stating that hold-out creditors only exercise their legal rights, HM Treasury even considers overturning judgments, to "make legislation apply to those qualifying HIPC debts on which judgment has already been obtained but not fully enforced, preventing the enforcement of those judgments". One could not speak more clearly in favour of what the US constitution prohibits as a "taking" or European constitutions forbid as expropriation. This makes it all the more inexplicable why those exercising their rights are branded "vultures". Clearly, the non-existence of sovereign insolvency procedures creates problems that could not exist within a fair insolvency regime.

It can be shown that the status of preferred creditor is alien to the statutes of all IFIs. The impression quite successfully created over decades that multilateral claims are entitled to preferential treatment is absolutely unfounded. In fact, IFIs have undone their founders' intention of subordinating IFI-claims in order to foster development financing and to reassure private flows, *de facto* reversing it into its opposite. Also, there is no hindrance for IFIs to undergo legal procedures, either in courts of law or in procedures of arbitration. They can fully participate in any insolvency proceeding.

- *The IMF*

The IMF knows that it enjoys no legal or contractual preferred creditor status, as one can read on its very own homepage (Boughton 2001, p.820¸ same page at IMF-homepage www.imf.org/external/pubs/ft/history/2001/ch16.pdf). Around 1988, when problems with SCs unable to service their debts to the IMF in time could no longer be ignored, preferring the IMF was discussed. It was tried to find arguments in favour of preference. But ultimately the fact that the IMF had no legal or contractual status as a preferred creditor could not be denied. Supporting their institution's drive for preference, its "Executive Directors stressed

the . . . need . . . in practice . . . to treat the Fund as a preferred creditor." In September 1988, the Interim Committee endorsed this position and "urged all members, *within the limits of their laws*, to treat the Fund as a preferred creditor." (*ibid*, p.821, emphasis added). The qualification "within the limits of their laws" shows that even this IMF-organ could not bring itself to demand unconditional preferred creditor status for the Fund from its own members. The Committee accepted that national laws may forbid any such treatment. In contrast to the impression IFIs (and especially the IMF) try to create, there is no legal hindrance to treating it like any other creditor. If its founders had thought preference a necessary condition for the IMF to fulfil its tasks as an international public institution, they would have granted it. Historically, they did the very opposite, initially clearly subordinating its claims. Since 1944 there would have been ample time to grant preference by an amendment if IMF member states had actually wished so.

Before the Second Amendment, the IMF's Articles of Agreement "contained a provision suggesting that others would have preference on the Fund" (Martha 1990, p.825). The author refers to Schedule B, paragraph 3 on the calculation of monetary reserves on which repurchase obligations were based. It seems logical that the exclusion of holdings "transferred or set aside for repayments of loans during the subsequent year" was done "to give preference in repayment to lenders other than the Fund." He argues that the intention of deleting this calculation and with it Schedule B, paragraph 3 from the statutes by the Second Amendment "was not to repudiate the underlying thought that it was beneficial to encourage bank lending by giving banks and others a preference in repayment" (*ibid*., p.814).

One has to concur with Martha (1990, p.814) that "general international law contains no compulsory standard of conduct requiring the preferential treatment of any external creditor, including the Fund" (*ibid.*, p.825), as well as that the IMF's statute interpreted on the basis of all available evidence contains "a presumption against a preferred creditor status". His conclusion is corroborated by the statutes of Multilateral Development Banks (MDBs), as well as by the IMF's attempt to gain legal preferred creditor status via the SDRM.

However, at present the IMF has no explicit statutory obligation to grant debt relief if its members are in trouble. Also, the subordination contained in Schedule B, paragraph 3 was deleted. Even if one chose not to agree with Martha, two facts cannot be denied:

a) the IMF's founders subordinated its claims to others, no doubt because of the Fund's public policy tasks of fostering international trade and safeguarding current transactions; quite logically, payments to the private sector were given explicit preference

b) even nowadays, its Articles of Agreement contain no wording whatsoever that could be stretched to construe preferred creditor status. While IMF-friendly argumentation may possibly challenge Martha on still existing or assumed subordination, it cannot claim any preference.

Some clarifications are needed. Initially the Fund was to help member countries to overcome short-term dollar/gold-parity problems by unconditional short-term drawings. Acting as an emergency source of finance providing short-term liquidity on a comparatively small scale without any strings attached would have justified preferred, even unconditional repayment. Nevertheless, its founders subordinated the Fund's claims.

While no preferred creditor status was enshrined in its statutes, the possibility to waive its immunity was. Art. IX.3 of the IMF's Articles of Agreement granted it total immunity "except to the extent that it expressly waives its immunity for the purpose of any proceedings or by the terms of any contract". Obviously, this immunity is explained by the fact that conditionality was not originally foreseen. It would be difficult to perceive any need for legal procedures and redress in the case of an emergency helper unconditionally giving money. Nevertheless, its founders did not wish to exclude proper legal dispute settlement totally, but inserted this option. Payments such as "criminal debts" (drawings routinely allowing dictators to embezzle funds) might be one logically possible case in which waiving might have been seen as necessary. Evidently, its founders wanted to subject the Fund fully to the Rule of Law.

When conditionality became enshrined in the IMF's statutes in 1969, the appropriate change regarding immunity was not made for whichever reason, although its founders would doubtlessly have stipulated the possibility of legal redress as in the case of the IBRD if they had approved conditional drawing. Compared with other IFIs, especially the IBRD and IDA this seems an error that can be explained by historical events, the Fund's initial role as a helper without conditionality, and arguably by a new approach to membership rights once

Europeans were no longer the Fund's usual clients. Unfortunately, the initial intent was blurred when conditionality was introduced, rather than making the IMF financially accountable as indicated by economic reason, done in the case of the IBRD at Bretton Woods, and legally and ethically proper.

Be that as it may, the IMF may not only submit to arbitration or courts, but contractual clauses stipulating this are expressly allowed. Nothing in its statutes prevents the IMF from applying proper legal standards. On the contrary, the existence of this waiver may be seen as an encouragement to do so if and when appropriate. The IMF could be party in any insolvency court or insolvency proceeding by arbitration. No right to preference of any kind exists. The loan loss reserves the IMF has established – officially called precautionary reserves – allow haircuts from an economic point of view. These reserves have been paid for by its clients via a higher spread. There is no reason why these reserves should not be used for their unique purpose, to cover losses.

- *IBRD and IDA*

No article of the Bank's or IDA's statutes can be stretched to justify preference. By contrast, their Articles of Agreement still contain obligations that prove the founders' intention to subordinate these claims. Apparently, developmental tasks are the reason, quite as public interest in the global economic framework was in the case of the IMF. The statutes of the International Bank for Reconstruction and Development (IBRD, the first institution in the so-called "World Bank Group"), not only recognise default as a fact of life. They contain obligations of the IBRD beyond those of a "normal" creditor.

Article IV, Section 4 of the IBRD's statutes speaks of a "relaxation of conditions of payment" in order to "modify the terms of amortization or extend the life of the loan". The IBRD's statutes go even further. At "its discretion" the Bank may also accept "service payments on the loan in the member's currency for periods not to exceed three years". In this case repurchasing of the member's currency "on appropriate terms" is stipulated. This may be extremely useful if a country has a short-term scarcity of foreign exchange, and is likely or foreseeably able to pay in foreign currencies later. Art. IV.4.c.i thus provides a valuable way to defuse short-term (illiquidity) problems that might otherwise trigger default, protracted debt problems, and losses suffered by other creditors.

Article IV.4.c confers a right onto members suffering "from an acute exchange stringency" (*viz*. threatening default) to ask for relief. It stipulates:

> If a member suffers from an acute exchange stringency, so that the service of any loan contracted by that member or guaranteed by it or by one of its agencies cannot be provided in the stipulated manner, the member concerned may apply to the Bank for a relaxation of the conditions of payment. … (ii): The Bank may modify the terms of amortization or extend the life of the loan, or both.

Article IV.4.c specifically demands taking both the Bank's and *such member's interests* into account. One notices that no conditions are stipulated for such relief, except the member's urgent need for help. Similarly, IDA's Article V.3 demands to take decisions on relief "in the light of all relevant circumstances, including the financial and economic situation and prospects of the member concerned".

The country has the right to ask for relief. The IBRD may – but need not – grant it, but has to take the country's interest into account. The Bank does not have to grant relief whenever asked. Nevertheless, Art.IV.4.c certainly constitutes a general obligation to grant relief when and where appropriate, an obligation hardly reconcilable with the purported preferred creditor status, and the Bank's behaviour in the past. Other creditors, most clearly the private sector, have no such obligation. They may eventually lose money, and they may grant relief by renegotiation, but they have no obligation to grant relief, let alone take the debtor's interest into account.

This indicates that the Bank's founders wanted to subordinate the IBRD's claims, maybe formulating so clearly because no sovereign insolvency procedure existed. Evidently, IBRD-claims are meant to rank behind other claims under certain circumstances. Interpreting Art.IV.4.c in favour of preference as much a logically possible, one could probably challenge the presumption of intended subordination, but even in this case, one could not do more than claim that the statutes put the IBRD on an equal footing with other creditors. Even this biased interpretation would result in the very opposite of preference. The often heard "argument" that relief for multilateral debts cannot be granted or would make development finance inoperable, was not shared by the IBRD's and IDA's founders formulating their respective

Articles of Agreement. Steadfastly denying debt relief, claiming to be a preferred creditor, forcing member countries not to avail themselves of their statutory right is definitely at severest odds with statutory duties, and good governance.

Art.IV.7 clearly formulates: “In cases of default on loans made, participated in, or guaranteed by the Bank: (a) The Bank shall make such arrangements as may be feasible to adjust the obligations under the loans, including arrangements under or analogous to those provided in Section 4 (c) of this Article.” As the Section 4.c explicitly allows debt relief, it would be difficult to argue that the obligations to be adjusted exclude the debtor’s obligations to the IBRD. Such absolute clarity has become absent in latter statutes. Non-multilateral creditors may proceed in the same way, but they are not obliged to do so.

Checks of the IBRD, *inter alia* by Canada's auditor-general, concluded that it has no preferred status. Under pressure from private business the IBRD even waived the negative pledge clause in its loans in 1993. (Caufield 1998, p.323) If it had been *de jure* preferred there would have been neither need nor scope for such clause, nor for pressure to waive it, as legal norms always prevail. It is one rare occasion where private creditors asserted their rights *vis-à-vis* IFIs. By waiving this right, the IBRD acknowledged that its claims should not be treated in the same way as private claims, but should be subordinated to them, in line with their founders’ intentions.

The IBRD’s founders understandably wanted lending to be subject to some market discipline – as also proved by clauses allowing the IBRD to be sued or allowing members legal redress via arbitration, designing mechanisms that would allow the Bank to shoulder its fair share of the risks involved – another clear sign that no preference in treatment was and is wished as these clauses are part of the presently valid statutes.

Compared with the IBRD, IDA’s Articles of Agreement are somewhat vague. Pursuant to Article V.3, titled “Modifications of Terms of Financing,” IDA may “agree to a relaxation or other modification of the terms on which any of its financing shall have been provided.” In the case of maturities of thirty-five, forty, or even twenty years with ten year grace periods and “no interest charge” (IDA prefers to call its 0.75% interest rate a service charge, probably in line with Islamic Banking principles) this leaves little realistic alternatives but outright reductions. Repayment periods of 125 years, including 65 years of grace as suggested by the

IBRD’s *Global Development Finance 2000* – of course, more years in the case of IDA - or a "'bullet' option" with an interest rate of 0.0001% or less over an unspecified but rather long period seem too ridiculous to be earnestly considered.

Like the IBRD, IDA has to take “the financial and economic situation and prospects of the member concerned” into account. IDA is a fund fed by periodic replenishments and re-flows. Economically, reducing re-flows is immediately possible without endangering the fund. The argument that amortisations are needed to refill IDA, which would preclude debt relief, is definitely no longer valid at all since IDA started to distribute grants. Like cancelled IDA-debts, grants do not create re-flows. If grant-financing does not endanger the functioning of IDA, debt relief cannot do so either. The common problem of debt relief persists, of course. Unless reductions are financed additionally, loanable funds decrease. Real lending capacity has to be assessed on a "net base", though. Programme credits just granted to allow re-flows “on time”, merely substituting (over)due credits by new ones, must not be counted. They are not really new lending.

While these two IFIs are already held by their statutes to avoid default by relaxing their terms, their Articles of Agreement are absolutely clear as regards default itself. Article IV.6 of the IBRD’s Articles of Agreement demands a special reserve to cover what Article IV.7 calls “Methods of Meeting Liabilities of the Bank in Case of Defaults.” Detailed rules on how to proceed follow. Not acting as stipulated, the Bank and IDA have inflicted gravest damage on members under duress, SCs forced to turn to them for help because of acute foreign exchange stringency. As the Bank is only allowed to lend either to members or to other borrowers if member states fully guarantee repayment (Article III.4), the logical conclusion is that default of member states was definitely considered a possible, and maybe even an occasionally necessary, solution. In accordance with its statutes, the IBRD has charged its members spreads in order to finance these reserves, in breach of its statutory obligations it has refused to use them.

By contrast, other creditors, especially the private sector, have no similar obligations. Logically, this supports the view that these multilateral institutions are meant to grant relief well before others in order to avoid liquidity problems, and their statutes legally subordinate their claims. The task of fostering development would explain this decision of their founders. Using the possibilities allowed, even suggested by their statutes and obviously intended by

their founders would doubtlessly have defused quite a few crises, and saved other creditors a lot of money.

- *The Inter-American Development Bank*

Mirroring the statutes of the IBRD or IDA, the IDB is also statutorily obliged to help avoid payment crises or defaults. Art.VII.3.a stipulates: "The Bank, in the event of actual or threatened default on loans made or guaranteed by the Bank using its ordinary capital resources shall take such action as it deems appropriate with respect to modifying the terms of the loan, other than the currency of repayment".

In case that default cannot be avoided in spite of such measures (assuming the Bank had followed its obligation), the Agreement Establishing the Inter-American Development Bank provides for "Methods of Meeting Liabilities of the Bank in Case of Defaults" (Article VII, Section 3) in the case of debtor default (Art.III.13). Pursuant to Art.VII.3.b charges should first be made "against the special reserve provided for in Article III, Section 13". This reserve consists of the charges to borrowers specifically cashed to establish it. If insufficient, "to the extent necessary and at the discretion of the Bank" it should be charged "against the other reserves, surplus, and funds corresponding to the capital paid in for ordinary capital shares." Quite logically, the special reserve has to be held in "liquid form". Finally – worst coming to worst – "the Bank may call upon the members to pay an appropriate amount of their callable ordinary capital subscriptions".

Once again mirroring the IBRD, the IDB is not immune. It can be sued (Art XI.3). "Property and assets of the Bank shall … be immune from all forms of seizure, attachment or execution before the delivery of final judgment against the Bank". Once again "members or persons acting for or deriving claims from members" are barred. However, and unfortunately from a legal point of view, independent arbitration is restricted to countries no longer members or countries already having decided to leave the Bank. Otherwise: "Any question of interpretation of the provisions of this Agreement arising between any member and the Bank or between any members of the Bank shall be submitted to the Board of Executive Directors for decision." The Board of Governors acts as a second level. Its decision is final. Deplorably, this is not independent decision making – however the contracting parties stipulated it this way.

- *The Asian Development Bank*

The Agreement Establishing the Asian Development Bank similarly demands a special reserve to meet liabilities in the case of default (Article 17). Article 18 gives the detailed description of how to proceed. The ADB "shall take such action as it deems appropriate with respect to modifying the terms of the loan, other than the currency of repayment" (Art.18.1). One notices an important change: threatened or imminent default is not mentioned. Unlike the MDBs mentioned above, the ADB has no obligation or mandate to try to prevent the outbreak of a crisis. But it must react appropriately once a member actually defaults.

The procedure mirrors the MDBs mentioned above. Losses have to be charged first against the special reserve, then "other reserves, surplus and capital available to the Bank" is to be used. Finally, uncalled subscribed callable capital has to be called. Part of its income is to be used for reserves (Art. 40).

The Bank may be sued, although Art.50 already limits this possibility to "cases arising out of or in connection with the exercise of its powers to borrow money, to guarantee obligations, or to buy and sell or underwrite the sale of securities". However, it "may waive any of the privileges, immunities and exemptions conferred under this Chapter in any case or instance, in such manner and upon such conditions as it may determine to be appropriate in the best interests of the Bank" (Art.50.1). The qualification has to be noted: not legal principles, equity considerations, fairness, or legally proper behaviour, but the Bank's best interest determine such decision. Its property and assets are immune from all forms of seizure, attachment or execution before the delivery of final judgment.

Arbitration is restricted to former members (including members "on the way out"). Art.60 and Art.61 mirror the IDB: first the Board of Directors, then the Board of Governors is to decide on "Any question of interpretation or application of the provisions of this Agreement arising between any member and the Bank, or between two or more members of the Bank".

This seems to mirror a tendency towards reducing adequate legal relief for members suffering damages and towards reducing the clear obligations expressed of earlier statutes. This can be observed especially well in the case of the African Development Bank.

- *The African Development Bank*

The case of the African Development Bank (AfDB) is slightly different. The first version of the Agreement establishing the AfDB, dated 4 August 1963, contained the arrangements known from other MDBs. Article 22 even foresaw reserves to cover special funds. The Agreement's present version (after the last revision of July 2002) eventually became available after some years on the AfDB's homepage. Article 22 ("Methods of Meeting Liabilities on Borrowings for Special Funds") still refers to "any reserve established for this purpose" (i.e. meeting liabilities) as the first step. The text of Article 20 ("Special Reserve") was completely deleted (its heading remained), possibly in reaction to the Bank's downgrading from triple-A by Standard & Poor's in the 1990s, and its reform. At that time African members were certainly not in a position to oppose Northern requests. Art. 19 – "Commission and Fees" - was deleted as well. This is the article where the use of some income to build up reserves is usually stipulated. Naturally, the AfDB, too, has built up loan loss reserves.

Article 21 (Ordinary Operations) still stipulates what should be done in the case of default by borrowers. But referring to calling capital early on, rather than to using reserves first, could be intended as a disciplining measure on borrowing members. Article 21 and the history of the statutes do not support the argument that unconditional full repayment is always expected. It also contradicts any assumption of preference. Although the AfDB claims in its "Investor Presentation" to be a preferred creditor, its statutes do not confer this status on it.

Art. 52 on judicial proceedings mirrors Art.50 of the statutes of the ADB. The Board of Directors may waive immunity "in cases where its action would in its opinion further the interests of the Bank." (Art.59) Arbitration is only foreseen for former members or "a member upon the termination of the operations of the Bank".

However, its *General Conditions Applicable to the African Development Bank Loan Agreements and Guarantee Agreements (Non Sovereign Entities)*, Section 10.04 "any controversy between the parties to the Loan Agreement and the Guarantee Agreement and any claim by a party against the other party arising under the Loan Agreement and the Guarantee Agreement" not settled amicably my be submitted to arbitration. Section 10.04 of the *General Conditions* for "Sovereign Entities" repeats this verbally.

- *The European Bank for Reconstruction and Development*

The European Bank for Reconstruction and Development writes off losses and submits to arbitration (also foreseen for the IBRD) - which proves that MDBs, if properly managed, can survive financial accountability and market risk. Its clientele, however, does not comprise SCs.

The Agreement Establishing the European Bank for Reconstruction and Development also determines that commissions and fees received “shall be set aside as a special reserve which shall be kept for meeting the losses of the Bank in accordance with Article 17 of this Agreement” (Art.16) If the Board of Directors determines the size of the special reserve to be adequate, all or part of this money may contribute to the Bank’s income. As any private firm, the Bank is held to maintain a reasonable diversification of its investments. In the case of arrears or default, the EBRD “the Bank shall take such action as it deems appropriate. The Bank shall maintain appropriate provisions against possible losses.” (Art 17.1).

Its statutes once again restrict arbitration to former members (Art.58). But Art.4 of its Headquarters Agreement clearly stipulates cases where immunity does not apply: if waived in “any particular case or in any written document”, regarding borrowing or underwriting, “in respect of the enforcement of an arbitration award made against the Bank as a result of an express submission to arbitration”, and regarding “any counter-claim directly connected with court proceedings initiated by the Bank“. Upon the delivery of final judgment against the Bank its property and assets are no longer immune. Art.10.2 prohibits the use of the EBRD’s ordinary capital resources to cover losses from special operations and for Special Funds.

General Legal Principles Favouring Non-Preference

It is a general and powerful principle of law that someone unlawfully inflicting damage must not be allowed to benefit from their own unlawful action. Courts normally refuse to enforce a claim based on the claimant’s own illegal or immoral conduct or transactions (*ex turpi causa non oritur actio*).

Presently, IFI lending differs. Suffice two examples. Over decades the IBRD had continued lending to Suharto`s Indonesia, knowing that a third or at least a quarter of all loans would disappear. Indonesia after Suharto had to repay these debts too including interests and fees, in spite of the IBRD’s role. The IMF’s own Independent Evaluation Office documented that the

Fund lent to Argentina, clearly knowing that "the program offered no solution", viewing it "as deeply flawed". Argentina had more debts, a higher debt service, and bigger problems, the IMF a higher income stream.

Demands for full repayment of loans that knowingly damaged the borrower has been "supported" by the claim to enjoy preferred creditor status. Remedial action is urgently called for. Either existing mechanisms allowing taking IFIs to court or submitting to arbitration must be used to determine damages (the IMF would have to waive immunity), compensation is paid, and IFIs are then treated like any other creditor, or IFI-claims must be subordinated.

Granting drawings – even when fully knowing that this would deteriorate the situation – the IMF granted "abusive credit". This is a concept in particular familiar to French, Belgian, and Italian jurisprudence. Juan Pablo Bohoslavsky (2006) surveyed laws and judicial practice in eight countries establishing creditor liabilities for loose lending in order to extract common principles from national, domestic laws to transform the theory of the responsibility for abusive granting of credit into a general principle of international law. He argues that such "abusive credits" should also have consequences in international law, and thus be made applicable to cases of sovereign insolvency. This concept holds lenders liable for damages inflicted on other creditors by lending with disregard for the most basic principles of risk evaluation, thus hiding the debtor's real situation and postponing the already insolvent borrower's crash, thereby increasing other creditors' losses. Bohoslavsky suggests subordinating abusive credits.

General principles of law and fundamental economics clearly underline the case against preference. Applying presently valid legal norms is mandatory. Economically, this would finally abolish a patently and perverse incentive system in favour of the mechanisms that are the basis of the success of market economies.

Fresh Money from IFIs: Justifying Preference

Any money loaned during (to keep the debtor afloat) or after a sovereign insolvency must be exempt, not subject to reductions. Such loans must, of course, have unconditional seniority. It must not be lumped with previous claim, or as A. Krueger pointed out, have "some kind of preferred creditor status". This is usual practice in all municipal insolvency procedures. Should the IMF provide these resources without conditionality – as initially stipulated at

Bretton Woods – this money should enjoy preference. This would, of course, be a qualitative difference to IMF lending so far. Such emergency lending would serve a very useful role – especially so in the framework of an international insolvency solution. Helping everyone by providing finance in a situation of duress without undue interference into debtor economies provides a public good.

The present discussion on re-orienting the IMF after the US Crisis justifies hopes that such re-orientation might be in the cards. If the IMF – or any other IFI - fulfils the role of financing debtor countries during sovereign insolvency procedures this - only this - money would naturally have to be exempt. To the extent the IMF or other IFIs pose conditions, they would also have to accept liability, tort law and submitting to legal redress. However, a process of relaxing conditions is quite perceptible with the IMF right now. Returning to the role under Bretton Woods is, of course, quite impossible: exchange rates are no longer fixed. However, the new financial architecture poses new threats and challenges for which appropriate institutions are needed. Emergency finance allowing countries in distress to avoid a crash or to negotiate a crisis better, is certainly a task in essence similar to the idea behind the arrangements at Bretton Woods. IFIs, especially the IMF if we judge from its mandate, could again provide a much needed international public service. In a way, this would be a homecoming as well as great support in stabilising international financial relations. Such new flows would have to enjoy preference.

All Kinds of Debts and their Economic Effects – An Illustration

A quite simple numerical example may serve in order to illustrate the effects of preferences on the distribution of losses among all creditors. Table 1 shows the effects of unfounded claims (classified as odious, illegitimate or in whichever way), unpayable debts, and preferred creditors. Let us assume that country A has total debts of 100, but is only able to service a debt stock of 50 (50 is unpayable), and that A actually gets insolvency protection, no doubt a heroic assumption still when it comes to SCs. To simplify we only consider a one-off debt stock reduction.

If all debts have to be honoured and no creditor is preferred, the haircut would be 50. With 40 null and void, A's remaining debt stock is 60, of which 10 still have to go in order to align A's capacity to pay to debt service due. Economically, this would not matter for A: 50 would go one way or another, although based on very different legal titles. But for A's creditors

Table 1: Haircuts of *Bona Fide* Creditors under Different Assumptions

Differentiation of Creditors	*Haircuts of Private Creditors*
None	
No preference, all debts fully recognised	50%
Claims amounting to 40 null & void§	16.67%
IFIs Exempt	
All other debts fully recognised	83.33%
40 null & void, 40 (IFIs) exempt	50%
IFIs Treated Lawfully	
40 plus 10 of IFI claims null & void	0%
40 plus all IFI claims null & void*	0%

§ including any form of impaired claims that economically results in recognised claims ultimately being less than nominal claims initially demanded

*in this extreme case, debtor country still has the money left that would be needed to service 30

the results differ strongly. In the former case every creditor would receive half their claims. In the latter case, those whose claims are voided would receive nothing, while recognised creditors would receive 83.33%. As economic facts eventually assert themselves – what cannot be paid goes unpaid – denying debtors the Rule of Law has considerable effects on creditors, both unduly discriminated *bona fide* creditors, and unduly protected ones. Official creditors allowing or supporting violations of the Rule of Law cause substantial negative effects for *bona fide* creditors.

Treating perfectly legal and legitimate debts like debts lacking such solid foundation inflicts grave injustice. Classifying and differentiating debts may thus be seen as more in the interest of *bona fide* creditors, even though the application of universally recognised legal principles would have avoided substantial damage to debtor countries and their peoples. In an insolvency procedure respecting existing legal principles, private *bona fide* creditors would recover more than under present public creditor domination. Disregarding the Rule of Law, official creditors presently cause substantial negative effects for *bona fide* creditors.

Quite noteworthy distributional effects are exacerbated by IFIs securing themselves privileged treatment as *de facto* preferred creditors, in breach of their own statutes. This undue privilege is especially problematic in the poorest countries where large percentages of sovereign debts are multilateral, and IFIs have influenced economic policies substantially. Official creditors have repeatedly attached conditionalities to debt relief that are not connected to economic necessities and have quite often worsened crises.

The haircut necessary for discriminated creditors to align capacity to pay and debt service would be 83.33% if IFIs were allowed to continue disobeying their statutes. If 40 were voided but no IFI-claims, a stock of 20 of non-IFI-debt would remain, but only 10 could be serviced (servicing capacity 50, IFI-stock 40). Treated "comparably" non-IFIs would lose half their face values, unless they chose to litigate. Under fair and equal treatment, they would only lose 16.67%. If they win, as likely at present, they lose nothing. Considering mathematics and IFI-statutes, even private creditors without "vulture-intentions" may be induced to litigate. Paying insurance against loan losses also remains more costly as long as IFIs remain unduly preferred. Instead of attacking "vultures" one should attack illegal and illegitimate IFI-behaviour and those governments supporting it. Undue treatment of IFI has cost the poor much more dearly than any sum recovered by "vultures". Inexplicably, this problem gets practically no attention.

Debt reductions are usually calculated in present value terms. It must thus be noted that the IBRD explained in its "How to do a Debt Sustainability Analysis for Low-Income Countries" of October 2006: "*For private external debt, the NPV is assumed to be identical to the nominal value of debt* (i.e. the nominal interest rate is assumed to be equal to the discount rate.)" Thus, any haircut agreed on in percentages of NPVs means higher reductions in terms of current dollars by the private sector. Also, shifting payments into the future does not reduce NPVs of the private sector – in contrast to public creditors, one further way of discriminating private creditors. Naturally, comparability of treatment as demanded by the Paris Club is based on NPVs. Once again, the public sector secures itself preferred treatment.

Conclusion

The founders of all IFIs usually stipulated an obligation to reduce or subordinate multilateral claims, no longer explicitly enshrined in the IMF's statutes, though. This obligation was more clearly pronounced earlier. Also, legal redress is more restricted in more recent statutes or

versions of statutes. But MDBs still have a statutory obligation to grant relief not a statutory privilege of preference. Their founders obviously meant MDBs to grant relief well before others. Their task of fostering development would explain this decision of their founders. Over the years MDBs have reversed this decision in violation of their own statutes. Unlike private creditors they all are statutorily obliged to reduce debts in case of default, but prefer breaching their statutes by not granting debt relief. This is done both to the detriment of debtor member states and of other creditors, who have to accept much larger haircuts than legally necessary. This undue privilege of preference is especially problematic in the case of the poorest countries where multilateral claims amount to substantial percentages of sovereign debts and IFIs have influenced economic policies considerably. In any case, no legal right to preference emerges. As the very existence of "vultures" proves no consensus to grant preference to IFIs exists either. *De facto* preference based on consensus does not exist.

Important multilateral development banks violate their own constitutions by not giving members in default relief as stipulated. The IBRD simply refuses to acknowledge default, even if countries have not paid anything for six or seven years (Caufield 1998, p.319). Claiming no default as long as such countries stay "in mutual respectful contact" (*ibid*.) with the Bank, the IBRD mocks any acceptable accounting rules.

Nevertheless, there is also scope for preference if and to the extent IFIs provide a public service, a public good others might be not be readily prepared to supply. Sufficient fresh money without undue conditions during an insolvency proceeding is such a task. Doing so would be in the interest of creditors, and debtors.

Bibliographical Annex

Bohoslavsky, Juan Pablo (2006) *Consecuencias jurídicas y económicas del crédito abusivo (Especial referencia al endeudamiento soberano),* European PhD Thesis, Faculty of Law, University of Salamanca.

Boughton, James M. (2001), *Silent Revolution: The International Monetary Fund 1979–1989*, Washington, DC: IMF; Chapter 16 also at www.imf.org/external/pubs/ft/history/2001/ch16.pdf (accessed 12 August 2009).

Caufield, Catherine (1998), *Masters of Illusion, The World Bank and the Poverty of Nations*, London: Pan.

HM Treasury (2009) "Ensuring effective debt relief for poor countries: a consultation on legislation", July.

Martha, Rutsel Silvestre, J. (1990) "Preferred Creditor Status under International Law: The Case of the International Monetary Fund", *International and Comparative Law Quarterly* **39**(4), pp 801ff.

Raffer, Kunibert (fc; planned: June 2010) *Debt Management for Development - Protection of the Poor and the Millennium Development Goals,* forthcoming at Edward Elgar, Cheltenham (UK)/ Northampton (US)