Kunibert RAFFER

What's Good for the United States Must be Good for the World:

Advocating an International Chapter 9 Insolvency*

"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 dishonourable to the debtor, and least hurtful to the creditor."

Adam Smith, *Wealth of Nations*, 1776

"It is now well known that countries politically incapable of meeting their liabilities need some sort of bankruptcy procedure that ensures that all creditors share the losses."

The Financial Times, 30 July 1992

I.

The fiction that all sovereign debt can and will eventually be repaid long upheld by the North and multilateral institutions where Northern votes enjoy clear majorities, is finally crumbling away, although *The Financial Times* might still be a bit prematurely optimistic as well as too little aware of economic constraints.

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Economically, the problem of foreign debt cannot be solved without a substantial reduction of debts. The important question is thus how, not whether the burden will be reduced. Undoubtedly, the solution should be fair, economically sound, likely to restore development prospects in the South, and it should abolish those market imperfections in international credit markets that have contributed to if not produced the present crisis. The solution must be based on economic exigencies and fairness - not on political *ad hoc* decisions and favouritism.

A method of achieving these goals is the internationalisation of insolvency procedures, or an "avowed bankruptcy" to use Adam Smith's words. This proposal was already made during the first years of the debt crisis, and has repeatedly been advocated during the 1980s, among others by Nobel Laureate Lawrence Klein, and by UNCTAD in 1986. The model propagated was the reorganisation of a business firm, or - in legal terms - Chapter 11 of Title 11 (Bankruptcy) of the United States Code.

While economically feasible, international reorganisation pursuant to Chapter 11 or similar laws in other countries do not address the important problem of sovereignty. The proposal has therefore been attacked with the technical argument that differences between firms and sovereign states render Chapter 11 (or similar laws of other countries) inapplicable. This technical subterfuge can be answered by proposing the internationalisation of Chapter 9 of Title 11, the U.S. insolvency law.

Chapter 9, a procedure not well known outside the US, solves a problem unique to insolvent public borrowers: intrusion into the debtor's governmental power from without. It regulates the insolvency of so-called *municipalities*, protecting the municipality`s governmental powers. Designed and successfully applied within the U.S. for decades as a solution to the problems of official debtors there is no reason why it should not be applied to sovereign debtors. Like all good insolvency laws it combines the need for a general framework with the flexibility necessary to deal fairly with individual debtors. Under its umbrella many proposals made so far can be accommodated, such as interest capping, securitisation, counterpart funds, buy-backs, debt-for-nature (or equity, charity) swaps, or the ECA's proposals incorporated in the *African Framework*.

The idea of an international Chapter 9, originally advocated in 1987, has been discussed and presented in more detail elsewhere[*]. This brief presentation confines itself to sketching its essential elements, referring interested readers to the cited publications.

II.

A municipality, is defined by section 101 (34), 11, United States Code Annotated (USCA) as a "political subdivision or public agency or instrumentality of a State". A municipality filing a petition must

- be insolvent or unable to meet its debts as they mature
- desire to effect a plan to adjust such debts
- have either obtained the agreement of the majority of each class of creditors affected, or have attempted to work out a plan without success, be unable to negotiate with creditors because this is impracticable, or reasonably believe that a creditor may attempt to gain preference (§109(c), 11, USCA).

A petition filed results in an automatic stay of enforcements of claims against the debtor. In a Chapter 9 proceeding U.S. laws protect not only governmental powers of the debtor, but individuals affected by the plan as well as the interests of creditors.

The composition plan should be fair, equitable, and feasible. Furthermore, to be confirmed the plan also has to be in the best interest of creditors. Fairness is tested by whether creditors

[*] Kunibert Raffer, "Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face" *World Development*, 18/2 (February) 1990, pp.301-312; and: "Internationalising US Chapter 9 Insolvency: Economic Problems in Need of Legal Conceptualisation", in: S.R. CHOWDHURY, E. DENTERS, P.J.I.M. de WAART (eds), *The Right to Development in International Law*, Kluwer/ Martinus Nijhoff, Dordrecht, pp.397-410, 1992.

actually get what they can *reasonably* expect under the circumstances. In practice these amounts are similar to Chapter 11 cases. Approval of the plan is denied if the municipality has the means to honour all its obligations.

A municipality is not expected to stop providing basic social services essential to the health, safety and welfare of its inhabitants in order to pay its creditors. The US Supreme Court rejected the idea that a city has unlimited taxing power stating that a city cannot be taken over and operated for the benefit of its creditors. Tax increases that would depress the standard of living of the municipality's population below the minimum guaranteed to private debtors are clearly illegal. Feasible tax increases have actually been much lower.

The problem of governmental power is solved by § 904. The jurisdiction of the court depends on the debtor's volition and cannot be extended beyond it. The court may not interfere with the choices of a municipality as to what services and benefits it will provide to its inhabitants.

A plan can only be confirmed by the court if it embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle.

The openess and publicity of the bargaining process are of particular interest. People affected by the plan have the opportunity to voice their arguments, be they employees of the municipality or "special taxpayers" - i.e. special in the sense that they are expected to pay more. They have the right to be heard in all matters arising in a Chapter 9 case and to object to the confirmation of the plan. Representing the debtor's employees labour unions and employees' associations have the right to be heard on the economic soundness of a plan affecting their interests. Furthermore the court can permit *any* interested entity to intervene.

The plan's feasibility is defined by whether the debtor emerges from reorganisation with reasonable prospects of financial stability and economic viability, including sufficiency of capital structures. The viability of the reorganised debtor is the touchstone, which includes the ability to service debts agreed on in the plan.

III.

As the problem of governmental powers is solved by Chapter 9 it can easily be adapted to sovereign debts.

Because impartiality of national courts, whether in a creditor or a debtor country, cannot be guaranteed a neutral court of arbitration must be established to allow absolutely fair and equitable international Chapter 9 proceedings, devoid of overreaching, however subtle. As is usual practice in international law each side should nominate the same number of persons, who, in turn, elect one further member to achieve an uneven number. One of the arbitrators is elected as chairperson.

Like a court in a domestic Chapter 9 case arbitrators would have the task of mediating between debtors and creditors, chairing and supporting negotiations by advice, providing adequate possibilities to be heard for those affected by the plan, and - if necessary - deciding what should be done. Agreements between debtor and creditors would need their confirmation, in analogy to § 943. They would have to take particular care that a minimum of human dignity of the poor is safeguarded - in analogy to the protection enjoyed by a municipality's inhabitants.

Exactly like in domestic Chapter 9 cases employees of the debtor would be represented by trade unions or employees' associations. In contrast to "special taxpayers affected by the plan" the affected population would, of course, have to be represented by organisations speaking on their behalf. Grass-roots organisations of the poor, NGOs or international organisations such as UNICEF or the World Council of Churches could fulfil this task. The possibility of describing the expected impacts on the poor publicly would certainly have mitigating effects. Publicity of negotiations, like public sessions of domestic courts, would help guarantee a fair and equitable bargain, openly arrived at.

It is important to stress that an international Chapter 9 would not at all need a new international organisation, nor a costly bureaucracy. Theoretically not even an international treaty establishing international insolvency proceedings ratified by all (or the most relevant) creditor nations would be needed as long as all (or the most relevant) creditors are determined to solve the problem. Practically, though, an international treaty would certainly be helpful.

Two spectacular cases of *de facto* composition after World War II prove the point that no such treaty is required: the London Agreement with Germany and the Indonesian solution of 1969. Both reduced the debts of these countries measured in present values roughly by half. Both were, by the way, politically motivated, similar to the recent cases of Poland and Egypt. Whatever the motives, though, these two cases prove that international insolvency works, even without the legal basis of international proceedings.

Both creditors and debtors employ qualified personnel managing reschedulings or other debt related issues. In an international Chapter 9 these people would simply do what they have done so far, negotiating and arguing their points before the arbitrators instead of among themselves.

Creditors, debtors and organisations representing the population would have to argue, prove and document their points. Arbitrators would only have to decide if and when debtors and creditors cannot reach an agreement or if representing organisations show that an agreement is likely to put too heavy a burden on the poor.

The costs of the arbitrators, whose number should ideally be five or less, would have to be covered. A very small secretariat, giving them the necessary, minimal organisational support, would be needed. Since all the arguments and figures would have to be prepared and presented by the interested parties this support and hence its costs would be relatively low. Such costs, though, have to be covered in any case of international arbitration.

The court of arbitrators would not become a permanent institution. Once the task of starting a workable composition plan is achieved, it can be dissolved. If further disagreements should develop later on the same persons (or, if necessary, other arbitrators) could reconvene again to solve this (these) issue(s).

The general framework of an international Chapter 9 could easily accomodate a wide range of proposals. Nevertheless it seems useful to list a few essential issues.

- Assessment of Debts:

All claims have to be verified loan-by-loan at the beginning, as routinely done in any domestic insolvency. This would include verifying whether financial obligations had been incurred by people authorised to do so according to the debtors country's law at the time of signing. Only people authorised to sign on behalf of a firm can legally bind this firm and banks do check authorisation not to lose their money. All OECD governments have rules which must be followed closely to bind the country. This same general principle valid for legal entities in the North must be applied equally strictly in the South.

- Socialised Debts:

Quite a few governments were forced by banks to assume retroactively losses from private lending initially done without any government involvement. The reason for such actions is simple: private debtors can go bankrupt, official debtors are not allowed to do so by the North. This is one clear illustration that the lack of international insolvency is a market imperfection. It should also be noted that such increases in the debt burden of debtor countries based on rather unorthodox legal foundations have not met audible protest by

International Financial Institutions (IFIs), although they made debt management much more difficult. These socialisations of private losses must be declared null and void.

- Symmetrical Treatment of Creditors:

An important distinction is made between commercial banks, bilateral governmental loans, and IFIs. The Brady Initiative, e.g., only calls on commercial banks to take losses by reducing their claims, but not on IFIs. The understandable selfinterest of any creditor apart, there exists no objective reason for preferential treatment of this class of creditors.

Multilateral lenders charge interests below the debtor's market rate. Even for normal IFI-lending which is called "development finance" as it is too tough to qualify as Official Development Assistance according to the DAC definition, this is a valid point for preferential treatment. This point is all the more valid for concessional flows.

There is, however, another difference between IFIs and banks. Commercial banks did lend aggressively but have usually not interfered with their clients' economic policy while multilaterals have strongly influenced the use of loans and exerted massive influence on their debtors' economies. In the case of the IMF the Group of 24 critisised the proliferation of performance criteria extending quite often down to microeconomic variables such as prices for specific products. The IBRD has been proud of the detailed monitoring of its projects for decades. Only in the most recent past this pride has not been voiced quite as perceptibly.

Put briefly: IFIs take economic decisions but refuse to participate in the risks involved. They insist on full repayment, even if damages caused by their staffs occur, which have to be paid by the borrower. A new loan might be given to correct the damages done by the first, as e.g. in Brazil's Polonoreste case, leaving the debtor with more debts and the IFI with more interest income. *Time* of 12 December 1988 reported that $ 240 million had been loaned, which finally caused considerable environmental damages. Bank officials admitted that they had erred - then 200 million $ were lent to control the damage done by the first loan. Brazil's IBRD debts increased by 440 million $.

Or, to give one other example: the Republic of Trinidad and Tobago documented grave irregularities and deficiencies in the IMF's assessment of its economy, which created the impression of economic mismanagement. After the IMF became aware of these substantial errors corrections were not published in spite of their importance to the country. According to a mimeoed document by the Ministry of Finance and the Economy of Trinidad & Tobago on the *Trinidad and Tobago Government's Relationship with the International Monetary Fund 1988* (dated January 1989) the country's own expert (K. Levitt) advised them not to "pick a fight" with the IMF, because of the government's need for the IMF's "seal of approval" to reschedule their debts.

These examples must not be misunderstood as blaming these institutions for making mistakes. A certain amount of mistakes will, alas, unavoidably be made by any operating firm or institution. These examples show another, more disturbing point: in the case of the IFIs decision making is not only delinked from financial responsibilities, their errors may even cause financial gains. This is a system absurdly at odds with the Western market system. At a time when riskless decision making by bureaucrats is abolished in the East, there is no reason why it should be preserved in the West. It is the most basic precondition for the functioning of the market mechanism that economic decisions must be accompanied by (co)responsibility: whoever takes economic decisions must also carry financial risks. If this link is severed - as it was in the Centrally Planned Economies of the former East - efficiency is severely disturbed. Bringing the market mechanism to multilateral institutions is therefore advisable. The striking contrast between free-market recommendations given by IFIs and their own protection from market forces must be abolished. Introducing the market mechanism would doubtlessly allow IFIs to benefit from its considerable benefits as much as their clients.

Naturally, it would be difficult if not impossible to determine the appropriate financial share of an IFI in one single project or programme that went wrong. In the case of an insolvent country, though, there exists an easy and simple solution to link decisions and risks: like any other creditor IFIs should lose part of their claims. In countries where IFI involvement is high and which have oriented their policies according to IFI "advice" for some time, this solution is particularly justified and appropriate.

The IBRD argues that its own excellent rating as a borrower would suffer if not all their loans were repaid to the last cent. If that were true all commercial banks would have unbelievably low ratings as a certain amount of lost loans is simply part of the costs of running a bank.

The fact that inverse transfers from debtor countries to IFIs have been observed, turning IFIs into net receivers rather than net funders, provides another strong argument for symmetric debt reduction.

In the case of Indonesia Hermann J. Abs advocated convincingly and forcefully that all creditors must be treated equally. It is a matter of fairness to debtors as well as to other creditors. Considering all circumstances mulitlateral institutions must not be treated more favourably than other creditors. Debt reduction must be uniform, the same percentage must be deducted from all debts.

- Capital Flight:

Measures against capital flight should be supported by both creditor and debtor countries. In analogy to domestic laws the international Chapter 9 should provide the possibility of overruling banking secrecy to recover money obtained by criminal activities, e.g. embezzlement, in the first place.

- Economic Adjustment:

Economic reform in problem debtor countries is doubtlessly necessary, but the burden of adjusting should not be shifted entirely on them. Debt service payments have to be brought in line with the debtor's capacity to earn foreign exchange. Regarding creditor countries a trade-off between more repayments and less protectionism or higher debt reduction and a higher level of protectionism is necessary.

Doubtlessly there exists a need for reform within debtor countries. These reforms, monitored by the council of arbitrators, should adjust the debtor to the real international environment, not to a textbook illusion of "free markets". Realistic strategies have to drop the IFIs' predilection for one-sided liberalisation by those countries that can be forced to do so. Import substitution on a substantial scale is necessary, while existing export possibilities should be used. Economic diversification must be part and parcel of this kind of adjustment. A policy mix between intervention and market forces is necessary.

Import substitution should be encouraged where economically viable to form the basis of future economic diversification. Monitoring by the arbitrators, agreed upon in the plan, could help to overcome the problem of petrifying protection. Protection should allow domestic industries to compete with imports, and should be reduced as domestic industries become more efficient. Military spending, which was so long the sacred cow of "structural adjustment", must not be safe from budgetary cuts.

- Protecting the Poor:

Considerable knowledge how to target social expenditures on those needing support exists. Redirecting expenditures in favour of basic services, using less expensive yet efficient drugs, employing basic health workers or "barefoot doctors" are possibilities. Good results can be achieved with limited financial resources. These resources, however, must be exempted from debt service.

- Issues Regarding Commercial Banks:

Contractual constraints for individual bargains between debtors and banks, such as *negative pledge* and *sharing clauses*, serve the same purpose as a Chapter 9 proceeding: to prevent unfair preferential treatment of one or some creditors.

With an international Chapter 9 these clauses would therefore no longer be necessary because all creditors would be treated fairly and equally. This solves the free rider problem - i.e. creditors not granting reductions gaining at the expense of those reducing their claims - which may result in a deadlock where all banks refuse debt reductions. Insolvency procedures covering all creditors can avoid this outcome. The free rider argument also strengthens the case for symmetrical treatment of all creditors.

Insufficient provisions against sovereign risks, widely quoted as a hindrance to debt reduction in the 1980s have ceased to be a problem. By now all banks have sufficiently provided against Third World risk to absorb relatively large debt reductions, i.e. to recognise in their books what has been reality for some years.

Nevertheless, a proposal made by Alfred Herrhausen in 1989 could be taken up if needed when international insolvency is introduced: banks can increase their provisions during a period of not more than five years, during which interest rates on already existing debts are substantially reduced (with exceptions such as trade financing). After this period claims are reduced at once or in stages.

Although not a necessary part of an international Chapter 9 the question of tax deductibility of loan loss reserves should be touched upon briefly. Economically, provisions are simply a means of bringing nominal values of claims in line with their real depreciated values. The theoretical alternative of actually writing claims down to their factual values is rather impractical, not least because debtors might be encouraged not to honour already written off obligations. As long as the amount of reserves is identical to the actual loss in value suffered by loans, tax free provisioning simply serves as a means to bring official and taxable income in line with actual, economic income. Under these circumstances tax deductibility does not mean any costs to the budget, but taxing provisions means taxing illusory profits.

If provisions exceed actual losses banks get an interest free loan, which would cause annual costs to the budget equal to this difference times the appropriate tax rate times the interest rate at which the government itself can borrow. As such a loan is extended until provisions are used or resolved, postponing a solution to the debt crisis costs taxpayers' money. It can be argued, however, that under the assumption of a sufficiently well functioning regulatory framework only no or negligibly small differences between provisions and reductions in values and thus costs to the budget are possible. The latter might be outweighed by greater stability, as loan loss reserves perform an important stabilising function in financial markets. Adopting the principle of tax deductibility prevalent on the Continent could therefore increase the stability of international financial markets.

An international Chapter 9 would have the advantage that banks would never again presume that sovereign debtors will always repay. If it had existed during the 1970s enormous misallocations of funds could have been avoided and the debt burden would certainly be much smaller. Its existence might even have prevented the debt crisis.

IV.

Economic history, not least the history of present creditors, teaches us that debt reduction is economically unavoidable at last. It only remains to be asked how long it will take and how much human suffering decision makers are prepared to allow before debtor countries' obligations are finally brought in line with their capacity to pay.