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The Final Demise of Unfair Debtor Discrimination? - Comments on Ms Krueger's Speeches*

During the last few weeks of the year 2001 a fairly old proposal to solve the debt crisis of Southern countries has regained momentum – applying the principles of domestic insolvency proceedings to sovereign states. Anne Krueger's (2001a, 2001b) recent speeches proposing to "mimick" domestic insolvency laws are a very useful contribution to the issue of debt management. Her first speech in Washington seems to have been the one falling stone taking the whole stonewall with it. Eventually this economically sensible idea has gained street credibility in Wall Street. The taboo of discussing insolvency is finally overcome.

Anne Krueger's speech in November 2001 followed several statements in favour of sovereign insolvency. The Secretary the US Treasury, Paul O'Neill, was the first influential politician publicly confirming the usefulness of an international insolvency procedure for sovereign governments. This idea was seconded by the British Chancellor of the Exchequer, Gordon Brown, and the Canadian Finance Minister, Paul Martin, a bit later. In a recent paper two employees of the Bank of England and the Bank of Canada, Andy Haldane and Mark Kruger (2001, p.13), propose a standstill arguing that sovereign debtors need the safe harbour which bankruptcy law provides in a corporate context: "Everyone accepts this as an important part of the capital market mechanism; it supports, not supplants, market forces. The same is true in an international context, where standstill guidelines can serve as surrogate bankruptcy law." Like Anne Krueger later, the authors refute many "objections" against their proposal that have also been made against sovereign insolvency, but stop short of proposing an independent arbitration panel.

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The authors "acknowledge the substantial input and involvement of Paul Jenkins, Deputy Governor, Bank of Canada and Mervyn King, Deputy Governor, Bank of England" (*ibid*.). These two gentlemen also wrote the Foreword. One may thus presume that this proposal enjoys support beyond that of its authors. This change of mind within important G7 countries has certainly affected the change of attitude within the IMF expressed by Anne Krueger. One may expect the call for a "debt arbitration process to balance the interests of creditors and sovereign debtors and introduce greater discipline into their relations" (Annan 2000, p.38) by the UN's Secretary General to meet less reservations now than it did in the year 2000.

As already shown above her useful proposal of emulating domestic insolvency proceedings is definitely not "A New Approach to Sovereign Restructuring" as the titles of both her papers claim - Adam Smith was the very first to propose this in 1776. Sovereign insolvency was propagated in the 1980s by UNCTAD and several individuals (cf. Raffer 2001a). It is welcome none the less, and it might, of course, be "new" to the IMF. It is a long needed advance in "debt management" for which the Fund deserves credit. However, her papers remain somewhat vague in several points and raise a few questions:

- Which domestic insolvency law should be "mimicked", or form the base (Chapter 9 or Chapter 11)?
- Who is to decide, especially when important matters come up, or to chair the process?
- Are rogue creditors are reason why the idea cannot be implemented quickly - or, why it has "no implications for our current negotiations with member countries - Argentina and Turkey, for example" (Krueger 2001a,p.2)?
- Which loans are to be included, i.e. what about multilateral debts?
- Which countries should benefit from the new mechanism?
- Fresh money lent during the process.

Finally, a brief remark on delays and their damaging effects seems indicated.

Which Domestic Insolvency Procedure? - Chapter 9 *vs.* Chapter 11?

Not proposing any specific procedures Krueger's speech differed from some G7 finance ministers explicitly calling for an international Chapter 11. She does not rule out Chapter 9, although the *IMF-Newsletter* of 10 December 2001 speaks of Chapter 11 (p.1: "modelled on corporate insolvency"), and she most probably thought of Chapter 11 too. The difference between the two variants is fundamentally important.

Chapter 9 is the only procedure protecting governmental powers, and thus applicable to sovereigns. §904 titled "Limitation on Jurisdiction and Powers of Court" states with outmost clarity:

> “Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with -
> (1) any of the political and governmental powers of the debtor
> (2) any of the property or revenues of the debtor; or
> (3) the debtor's use or enjoyment of any income-producing property.”

The concept of sovereignty does not contain anything more than what §904 protects. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. A municipality cannot go into receivership. Unlike in other bankruptcy procedures no trustee can be appointed. §902(5) explicitly confirms: "'trustee', when used in a section that is made applicable in a case under this chapter ... means debtor”. In plain English this means that a US municipality cannot go into receivership and its elected officials cannot be removed from office by the court. Liquidation of the debtor and change of "management" (i.e. removing politicians in charge) by courts or creditors are not possible in the case of municipalities - nor should this be possible in the case of sovereigns. Similar guarantees are of course absent from Chapter 11: firms are not sovereign, thus there is no sovereignty to protect. There are no similar restrictions on courts, and receivers are appointed in Chapter 11 cases. For insolvent corporations this makes sense.

During the Great Depression Chapter 9 was introduced precisely to avoid prolonged and inefficient negotiations and reschedulings, to allow quick, fair, and economically efficient solutions for overindebted US municipalities. A first draft by municipalities that did not bar creditor intervention into the governmental sphere was rejected by lawmakers as unconstitutional. Creditor interventions such as those usual in Developing Countries nowadays were considered unacceptable. Only a new version containing §904 was allowed to pass. Therefore countries are well advised to demand the emulation of Chapter 9, which gives the debtor a much stronger position. There is no reason why countries should be treated worse than US municipalities. It is fundamental that sovereignty be respected - this is possible and guaranteed if Chapter 9 is the model.

Pursuant to Chapter 9 the debtor's population has a right to be heard in the proceedings, This right would have to be exercised by representation in sovereign cases. Chapter 9 guarantees an appropriate form of debtor protection - a human right presently granted to anyone but the globe's poorest. US municipalities are allowed to maintain basic social services essential to the health, safety and welfare of their inhabitants. Officially the principle of participation is already part of present debt management for HIPCs, where civil society is to participate in designing poverty reduction strategies. Thus it is not totally new. In Argentina, e.g., civil society "participates" in the streets by banging pots. Formal representation seems a better way than that. While not all governments will eagerly embrace this idea, these representatives of the population may often be a welcome help for debtor governments arguing for a humane treatment of their people - as humane as the treatment granted to inhabitants of municipalities.

Who Decides?

Independent arbitrators nominated by creditors and the debtor must preside negotiations and if necessary decide on the basis of the evidence brought forward, also on sustainability. Like the advocates of a Chapter 9 based Fair and Transparent Arbitration Process (FTAP) Krueger clearly stated that the IMF - itself a creditor - should not adjudicate disputes. This is helpful and correct. The very essence of the Rule of Law demands that no one must be judge in their own cause. However, she proposes too much influence for the IMF by demanding that the Fund have the power to approve standstills, to determine sustainability, and judge the debtor's economic policies. If granted these powers the IMF would continue to judge in its own cause and there is a very great risk that little changes. Debt reductions under creditor domination (and with a leading role of the IMF) have not delivered sustainable recovery, because too little was granted too late. The most likely outcome of this new process under IMF influence would be some re-make of Miyazawa/Brady schemes that - although positive to the extent that they reduced debt burdens – have been unable to solve the debt problem so far.

The Fund's record, including enthusiastic praise of Argentina's or Indonesia's policies virtually until the crash, does not support Krueger's assertions of the IMF's qualities. Nor does the speed with which the IMF distances itself from former "model-pupils" immediately after a crisis starts, suddenly claiming that these previously cheered policies are totally inefficient, the debtor country’s politicians are absolutely corrupt or both.

Insolvent sovereigns could "file" for Chapter 9 insolvency protection or FTAP by depositing their demand at the UN. This should automatically trigger a standstill. Clearly, only governments have a right to file. Independent arbitration panels must endorse standstills immediately on being formed, not any creditor such as the IMF. Any creditor practically exercising the right to determine whether a debtor is allowed to file - e.g. by consenting to it (Krueger 2001a, p.5) - would decide on its own claims.

If that need be for political reasons, one might agree to filing the demand at the IMF - as proposed by Ann Pettifor. However in that case - as she emphasises as well - the Fund must not be allowed to do more than simply serving as the "post bag" where the demand is deposited. But it must be immediately passed on to an independent entity, and the IMF's consent must not be necessary. Any further move, including all organisational work to establish the panel must be in the hands of a neutral, disinterested party, such as the UN. The Fund must not mandate the process, as Krueger demands, as mandating a process often means also mandating the outcome.

As described by Krueger (2001b, p.4) restructuring terms should indeed emerge from negotiations between creditors and the debtor. But if so there is no place for anyone, including the IMF, to judge what sustainability is like - the panel, too, could just confirm the agreement reached. Sustainability must exclusively be confirmed or judged by the independent panel established by creditors and the debtor on the basis of evidence tabled during the procedure (for details see Raffer 2001a, or: http://mailbox.univie.ac.at/~rafferk5). It is not so much the point that the IMF's record in this respect has been underwhelming. The point is that no creditor must be allowed to determine the outcome. If the IMF would be the "channel through which the international community can reach a judgement on the sustainability of a country's debt and of its economic policies" (Krueger 2001a, p.7) the creditor side would continue to determine the outcome and to dominate the debtor. As all creditors participate in the FTAP, having access to all information brought forward, they will be able to see themselves that/whether the solution is sustainable. If they think not, they can argue this point during the FTAP. There is no need for any single creditor to endorse the outcome.

The important point is that the debtor would be a party with equal standing, not dominated by any creditor. I think this is necessary both to enable the debtor to defend its legitimate interests and to reach a sustainable solution. The experience with creditor domination so far strongly supports this view.

Delays because of the Problem of Rogue Creditors and Shopping for Jurisdictions

The problem of vulture funds is presently used as an argument, why it would take some more years before insolvency-type mechanisms can be implemented. Anne Krueger (2001b p.3; see also: 2001a) argued that it would be necessary to change the laws of all countries, because otherwise vulture funds could always pick a country where they can enforce their claims successfully:

> "If these principles were to be established and enforced, it is clear that they would need the force of law in any country where enforcement might be sought. In practice this means that they must have the force of law universally. Otherwise creditors will shop around for jurisdictions in which they have the best chance of enforcing their claims."

To do so she proposes that the necessary changes should be enshrined into the IMF's Articles of Agreement. This - she argues - would be easier than the "heroic task" of getting every country to amend its domestic bankruptcy law.

While the IMF's help in solving problems of international overindebtedness is certainly welcome, her argument is nevertheless flawed. There is an easy solution both for presently existing and future contracts (cf. Raffer 2002).

- *Presently Existing Claims*

Existing contracts can only be changed if all creditors agree. Vulture funds holding claims will certainly not do so, as this is precisely the reason why they can hold out against the debtor and all other creditors. But vultures in turn are also bound by these existing contracts, including by those clauses stipulating which law applies in the case of disputes. About half the loan agreements are governed by New York, almost half by British law - facts that cannot be changed without unanimous consent either. Vultures, therefore, cannot shop around.

Logically this means that if the US and the UK changed their laws governing sovereign immunities by inserting one short sentence the problem of vulture funds would be solved for almost all cases. This sentence could. e.g., be: "Starting international insolvency procedures voids all waivers of immunity relating to this case." In the UK State Immunity Act 1978, Chapter 33, this could e.g. be inserted in Part I. More elegant formulations than mine would, of course, be welcome. If those few "exotic" places such as Frankfurt followed, whose laws are occasionally agreed on, the solution would be water-tight. Even if vultures chose to sue outside the stipulated jurisdiction its law would apply, not allowing any lawsuit in this matter. Although the rather unlikely case of existing contracts stipulating, say, Nauruan or Monaco laws - which for the sake of the argument (I have not the faintest idea about these legal systems) might allow lawsuits in such cases - cannot be excluded, this seems unlikely to be a frequent concern.

As Krueger (2001a, p.4) points out, it is not absolutely clear whether Elliott's strategy would "survive legal challenge in future cases". But in the case of Peru the vulture fund was able to get its way. Apparently the threat of raising troubles was sufficiently great to make the country pay. This doubt is supported by a relevant US court case, allowing the *prima facie* assumption that a change of laws might not even be necessary. In 1984 the US Court of Appeals for the Second Circuit in New York granted US insolvency protection to Costa Rica. The court recalled a Canadian precedent, drew analogies to US laws, quoted § 901(a), stating that Costa Rica's actions were "*consistent with the law* and the policy of the United States" and

> in entire harmony with the *spirit of bankruptcy laws* the binding force of which ... is *recognised by all civilised nations* ... Under these circumstances *the true spirit of international comity requires that schemes of this character*, legalized at home, *should be recognized in other countries*.
>
> (UNCTAD 1986, p.142, emph. mine)

After a rehearing in 1985, however, the court reversed itself. The executive branch had joined the litigation as *amicus curiae* making it clear that they supported the IMF rather than principles which should be recognised by all civilised nations according to the court. Therefore a simple change in the administration's policy - accepting those principles - appears to be sufficient to allow debtor insolvency protection of US law to be applied to sovereign debtors. To be perfectly sure this would have to be checked by specialised lawyers familiar with these US laws, but this case provides a reason to believe that a change of present laws would not even be necessary. O'Neill's recent support of international insolvency gives reason for hope. As the US would have to support any scheme of international debt arbitration the difference between a change of laws by inserting one small sentence and mere support by the administration might possibly not be of great practical importance.

- Future Contracts

Future contracts can include either any or all of the useful changes that have been proposed so far, such as collective action clauses, or agree on arbitration instead of waivers of immunity, as preferred by Brazil (cf. Rocha 1999, pp.91f). Some contracts between countries and private creditors already stipulate arbitration - it is not something entirely new. But one could also agree on a traditional waiver of immunity combined with a clause stating that no creditor is allowed to sue during international Chapter 9 insolvency proceedings. This would put vultures out of business. Recent contracts by Canada and the UK incorporating new clauses regarding creditor actions into debt contracts are a useful and commendable way of breaking the ice.

The only question remaining is whether creditors are likely to shop around for jurisdictions where waivers of immunity are not voided by international debt arbitration, or whether they prefer contracts without any clauses eliminating the vulture problem. Logically, this seems unlikely. At the time of lending and signing vultures will not be present. It makes little economic sense to lend money at 100, watching it fall from its nominal value to, say, 20 in order to sue then to get 100. *Bona fide* creditors have a legitimate interest in not creating trouble for themselves, including the risk of getting less because of vultures. Payments to vultures always are against the interest of *bona fide* creditors, be it because they get less than they otherwise would, because this money cannot be used to finance recovery, which would have negative effects on future creditworthiness of the debtor, or simply because of the trouble created by disruptive interference. Their legitimate and understandable interest in having the possibility of redress against alleged breaches of contract by the debtor would be served by arbitration and/or appropriate clauses in new contracts, including causes prohibiting lawsuits during international insolvency proceedings before a neutral panel. While irrational behaviour can never be totally excluded, it seems not unlikely that the experience with vulture funds may make *bona fide* creditors prepared or even eager to avoid such problems in the future. Examples from the past such as sharing or negative pledge clauses in syndicated lending corroborate the conclusion that normal - i.e. *bona fide* - creditors have an interest in orderly and fair work outs rather than in grab races. Creditors interested in long term relations with a country even more so.

Krueger wrongly states that it would take years to implement her proposal or FTAPs to argue that present cases cannot be dealt with. The examples of Germany's debt reduction in 1953, Indonesia's after 1969, or Poland's after the demise of communism disprove this opinion. Any further delay would impose those unnecessary costs Krueger rightly deplores. Arbitration is a traditional means of international law, highly popular at present in all cases except when it comes to protect the poorest in indebted countries. *Ad hoc* panels could be formed immediately if important official creditors agree. Present cases such as Argentina should already benefit from FTAP. This argument of hers does not justify further delays. On the contrary, to limit unnecessary sufferings the solution has thus to be implemented at once, i.e. already in the case of Argentina.

Which Debts? The Problem of Multilateral Debts

Krueger's (2001b, p.4) argument that the IMF be treated with preference is flawed. The IMF's record, especially but not only during the Asian crisis, shows that it does not avoid disorderly adjustment, nor does it discourage countries from policies that "would do unnecessary harm to themselves" as Anne Krueger puts it. This formulation implies that “Developing Countries” are unlikely to know what is good for them – they need a stern governess for their own good. The encouragement and support for Argentina's exchange rate policy is but one further illustration of this point.

The IMF's increased role in international capital markets since 1982 contrasts sharply with a total lack of financial accountability. Enjoying *de facto* "preferred creditor status" International Financial Institutions (IFIs) may and often do gain institutionally and financially from crises, as well as from their own errors and failures, even if they cause damages by grave negligence. Another loan may be granted to repair damages done by the first loan, increasing the IFI's income stream (Raffer 1993). This is a severe moral hazard problem and an economically totally perverted incentive system. While private creditors are supposed to grant debt reductions, feeling the sting of the market mechanism, IFIs increase their exposure, knowing that they will be protected. Meanwhile, they have started the absurdity of giving loans for debt reduction.

Multilateral institutions have (co)determined debtor policies. The market mechanism demands that they be financially accountable for their actions. The "World Bank's" Articles of Agreement foresee debt reductions. In poor countries with large shares of multilateral claims reducing these is necessary for sustainability.

To increase IFI-efficiency and to improve their role in capital markets, market incentives must be brought to bear. The international public sector must become financially accountable for their own errors in the same way consultants are liable to pay damage compensation if/when negligence on their part causes damage or OECD-governments are if they create damages by negligence or violating laws. By contrast, the IMF has been allowed to violate its own statutes with impunity by not allowing its members to exercise their membership right of controlling capital flows. Finally, the present privileged position of international public creditors discriminates unfairly against private creditors suffering avoidable losses because of IFI privileges when countries are unable to service their debts. Sufficiently large reductions by one class of creditors only are more difficult to get, which puts the debtor country at a disadvantage. A mechanism to correct present inefficiencies is urgently needed.

One must fully and literally concur with Krueger(2001a, p.6) that no creditors should be treated more favourably than others. All countries *de facto* insolvent and all kinds of debts must be included in this procedure. As a matter of fairness to other creditors and the debtor present multilateral debts must be treated like any other loans. With standards regarding Southern debtors and IFIs comparable to those of private consultancy there would be no multilateral debt problem in quite a few countries. Particularly the poorest countries need an end of the unwarranted preference for multilateral institutions, which basic market economics also demand.

Which Countries?

Although Krueger (2001a) did not mention a specific group of countries, she obviously had "emerging markets" in her mind. The dismal record of debt management so far but also the Rule of Law suggests that any country be given this option.

Eventually offering various debt reduction schemes creditors recognised long ago that full repayment is unrealistic. But the problem has dragged on, obstructing development. Insufficient reductions have burdened debtor economies. This is both evident for HIPCs, and for "emerging markets" such as Argentina. If Argentina's debt problem during the 1980s had been solved early on, putting the country onto a sustainable basis again, there would be no present crisis.

The first HIPC Initiative's officially declared objective was reaching overall debt sustainability by co-ordinated action, allowing countries to exit from continuous rescheduling. It is meanwhile clear that HIPC II will not deliver its goal either. Change is necessary.

Referring to Chapter 9 and the arbitration mechanism contained in its international variant UNCTAD (1998, p.91) demanded in its Chapter on Sub-Saharan Africa (*ibid.*, p.130)

> "Nevertheless it is possible to establish the key insolvency principles and apply them within the existing international framework. The application of these principles would dictate an immediate write-off of all unpayable debts in SSA [= Sub-Sahara Africa] determined on an independent assessment of debt sustainability."

For both country groups basically the same problem emerges: creditor caused delay has created costs, very much as Krueger points out, that could have been avoided by quick and appropriate action. Debt management by creditors has not delivered, but usually worsened the situation. For both groups the problem is a debt overhang and determining which reductions are necessary for a fresh start. Both groups thus need a fair, transparent, and efficient mechanism. The basic fundament of the Rule of Law that one must not be judge in one's own cause makes it mandatory that debt management by official creditors be replaced, even more so in the case of poor countries, whose policies were largely (co)determined by IFIs, not least the IMF.

The Role of the IMF

The IMF could offer technical help in solving problems that might come up, such as steps to avoid disruptive interference by vulture funds. It could help co-ordinate bondholders or lend money necessary to keep the country going during FTAP, but only without any conditionality attached, as initially foreseen at Bretton Woods. This could be seen as adapting its initially agreed on function to the present world economy. Naturally, its rights as a creditor with regard to presently existing claims would guarantee the IMF full participation in the proceedings, but not any role as a debt manager, only as one of many creditors. Finally, the IMF could encourage countries to go down the road indicated by the Fund now. After opposing this very mechanism for decades this would be helpful in avoiding further damage.

Fresh Money

Any money loaned during or after FTAP to keep the debtor afloat must be exempt, not subject to reductions. It must not be lumped with previous claim, but enjoy seniority, or - to use Krueger's (2001a, p.6) words "some kind of preferred creditor status". In contrast to present multilateral debts, there is an objective reason and a necessity to grant preference - as in all domestic insolvency laws. If the IMF fulfils the role of financing the debtor country during sovereign insolvency procedures this - and only this - money would serve a useful role, which - if it need be - could be seen as providing a public good, like Anne Krueger does.

Regarding new inflows of money after and because of sovereign insolvency Krueger (2001a, p.6) points out that the presence of a formal mechanism

> "could reduce the overall volume of capital flowing into the emerging markets. But that would not be a bad thing if it meant that creditors and debtors were assessing risk more appropriately. Sound lending and borrowing decisions would in turn make it less likely that countries would find themselves overindebted to begin with."

One has to concur. It is not the quantity of money that is relevant for economic development, but the use it is put to. As the increase in debt stocks since 1982 shows traditional debt management has largely been a Ponzi scheme - new loans were given to repay old ones more or less in time, or arrears were capitalised as “new loans”. This made debtors less and less able to repay fully. The debt overhang grew and the situation became more precarious. Logically, interest rates therefore shoot up. Argentina is again a good example. Forced to borrow at 20 per cent interest and more just to honour her obligations "in time" is explicable as a desperation strategy as long as new money is available at ruinously high interest rates and short time, and no insolvency protection for sovereigns exists. But it is clearly not a sustainable solution. If the country were not forced by circumstances to borrow these sums the volume of loans would shrink – doubtlessly an improvement for the country.

On the other hand, once the country succeeds with a fresh economic start due to and after a Chapter 9 based FTAP, new investment opportunities will arise and long term investment will again be available at normal interest rates. Investors decide on the basis of economic stability and expected profits. The Deputy Governor of the Bank of England, David Clementi, saw no empirical evidence of “any discernible negative long-term effect of a country’s prior debt servicing record on the terms and volume of its borrowing."(UN 2000, p.19). However, one may well assume that a fair and orderly workout will be judged better by long term investors immediately after the process than disorderly losses. The process is thus both in the debtor's and the creditor's interest, as Krueger correctly emphasises, unless one thinks of vulture funds.

Delays and Damages

Krueger rightly point out that delays cause costs, and that avoiding such damages is one reason for sovereign insolvency procedures. One has to concur fully with Anne Krueger (2001a, p.8):

> "For debtor countries, the new approach would clearly reduce the costs of restructuring and would encourage countries to go down that road earlier than they do now. This is not a bad thing. At the moment too many countries with insurmountable debt problems wait too long, imposing unnecessary costs on themselves, and on the international community that has to help pick up the pieces."

As someone having advocated sovereign insolvency for over 15 years, repeatedly drawing attention to this kind of damage, I might recall that countries were not allowed by creditors to choose that road. Especially opposition by the IMF was one important reason why this was so. This also makes one ask whether the IMF really financed a public good as Krueger (2001b, p.4) argues to justify preferential treatment or rather a public bad. The unnecessary costs Krueger rightly mentions and deplores are caused by creditors dominating international "debt management" absolutely – they are creditor caused damages (cf. e.g. Raffer 2001a, 2001b, p.4). Therefore it is good to have the Fund finally "on board". The IMF could now help avoiding further unnecessary costs by advocating an international Chapter 9.

Present cases such as Argentina should already benefit from FTAP – this follows logically from Krueger's own convincing argument that delays cause unnecessary costs.

Conclusion

This paper has argued that there is a strong and convincing case to demand one specific type of insolvency appropriate for sovereign debtors, a process based on the principles of the US Chapter 9. It further showed that no creditor must be allowed to exert decision power, whether openly or in a hidden way. Finally, it shows that both the FTAP mechanism and Anne Krueger's proposal can be applied immediately.

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