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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 regained momentum—applying the principles of domestic insolvency proceedings to sovereign states. Anne Krueger's (2001a, 2001b) speeches proposing to 'mimic' 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 that took the whole stonewall with it. Eventually, this economically sensible idea gained street credibility in Wall Street. The taboo of discussing insolvency was finally overcome.

Anne Krueger's speech in November 2001 followed several statements in favour of sovereign insolvency. The Secretary of the US Treasury, Paul O'Neill, was the first influential politician to publicly confirm the usefulness of an international insolvency procedure for sovereign governments. His idea was seconded by the British Chancellor of the Exchequer, Gordon Brown, and the Canadian Finance Minister, Paul Martin, a little later. Andy Haldane and Mark Kruger, employees of the Bank of England and the Bank of Canada, respectively, proposed 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' (2001: 13). Like Anne Krueger did later, the authors refuted many 'objections' to their proposal that have also been made against sovereign insolvency, but stopped short of proposing an independent arbitration panel.

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Haldane and Kruger acknowledged '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 enjoyed support beyond that of its authors. This change of mind within important G-7 countries certainly affected the change of attitude within the IMF as 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: 38) by the UN 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 was definitely not 'A New Approach to Sovereign Restructuring' as the titles of both her papers claim—Adam Smith was the first to propose this in 1776. Sovereign insolvency was propagated in the 1980s by UNCTAD and several individuals (cf. Raffer 2001a). It is welcome nonetheless, 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 on 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 the reason why the idea cannot be implemented quickly, or, why does it have 'no implications for our current negotiations with member countries—Argentina and Turkey, for example' (Krueger 2001a: 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 to be necessary.

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

Not proposing any specific procedures, Krueger's speech differed from the explicit call made by some G-7 finance ministers for an international Chapter 11. She did not rule out Chapter 9, although the *IMF Newsletter* of 10 December 2001 spoke of Chapter 11 (p. 1: 'modelled on

corporate insolvency'), and, most probably, she too thought of Chapter 11. The difference between the two is fundamentally important.

Chapter 9 is the only procedure protecting governmental powers, and is thus applicable to sovereign states. §904, titled 'Limitation on Jurisdiction and Powers of Court' states with utmost 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 will these 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.

Chapter 9 was introduced during the Great Depression, 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 in 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 all except 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, for example, 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 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 over the negotiations and, if necessary, decide also on sustainability, on the basis of the evidence brought forward. 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 acts as judge for their own cause. However, she proposed too much influence for the IMF by demanding that the Fund have the power to approve standstills, determine sustainability, and judge the debtor's economic policies. If granted these powers, the IMF will continue to act as judge for its own cause and there is a very great risk that little will change. Debt reductions under creditor domination (and with a leading role for 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 the 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 IMF's record, including enthusiastic praise of Argentina's or Indonesia's policies virtually until the crash, does not support Krueger's assertions of the Fund'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, that 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 the right to file. Independent arbitration panels, and not creditors such as the IMF, must endorse standstills immediately on being formed. Any creditor practically exercising the right to determine whether a debtor is allowed to file—for example, by consenting to it (Krueger 2001a: 5)—would decide on its own claims.

If it is needed for political reasons, one might agree to filing the demand at the IMF, as proposed by Ann Pettifor. However, in that case—as she emphasizes as well—the Fund must not be allowed to do more than simply serving as the 'post office' where the demand is deposited. The demand must be immediately passed on to an independent entity, and the IMF's consent should not be necessary. All further moves, including the organizational 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 demanded, as mandating a process often also means mandating the outcome.

As proposed by Krueger (2001b: 4), the 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 sustainability—the independent 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). The point is not so much that the IMF's record in this respect has been unsatisfactory. The point is that no creditor must be allowed to determine the outcome. If the IMF is 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: 7), the creditor will continue to determine the outcome and to dominate the debtor. As all creditors participate in the FTAP and have access to all the information brought forward, they will be able to see for 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.

What is important is that the debtor should 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 currently used as an argument to explain why it will take a number of years for insolvency-type mechanisms to be implemented. Anne Krueger (2001b: 3; see also: 2001a) argued that it will be necessary to change the laws of all countries, because otherwise vulture funds can 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 proposed that the necessary changes be enshrined into the IMF's Articles of Agreement. This, according to her, 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, Ann Krueger’s argument is nevertheless flawed. There is an easy solution for both presently existing and future contracts (cf. Raffer 2002).

Presently Existing Claims

Existing contracts can be changed only 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 and 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 change their laws governing sovereign immunities by inserting one short sentence, the problem of vulture funds will be solved for almost all cases. The sentence could, for example, read: ‘Starting international insolvency pro-

cedures renders void all waivers of immunity relating to this case.' This could be inserted for instance, in Part I, Chapter 33 of the UK State Immunity Act 1978. More elegant formulations than mine are, of course, welcome. If those few 'exotic' places such as Frankfurt, whose laws are occasionally agreed on, followed suit, the solution would be watertight. Even if a vulture chose to sue outside the stipulated jurisdiction its law would apply, not allowing any lawsuit in the matter. Although the rather unlikely case of existing contracts stipulating, say, Nauruan or Monaco laws—which may, for the sake of argument (I have not the faintest idea about these legal systems), allow lawsuits in such cases—cannot be excluded, this seems unlikely to be a frequent concern.

As Krueger (2001a: 4) pointed 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 creating trouble 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, and 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 *recognized by all civilized 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: 142, emphasis mine)

After a re-hearing in 1985, however, the court reversed its decision. The executive branch had joined the litigation as *amicus curiae*, making it clear that they supported the IMF rather than principles which should be recognized by all civilized 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 absolutely sure, this would have to be checked by specialized lawyers familiar with these US laws, but this case provides reason to believe that a change in the present laws will not even be necessary. O'Neill's recent support of international insolvency gives reason for hope. As the US will have to support any scheme of international debt arbitration, the difference between a change in the laws by inserting one small sentence and mere support by the administration will possibly not be of great practical importance.

Future Contracts

Future contracts can include any or all of the useful changes that have been proposed so far, such as collective action clauses, or arbitration rather than waivers of immunity, as preferred by Brazil (cf. Rocha 1999: 91ff.). 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 made by Canada and the UK incorporating new clauses regarding creditor action into debt contracts are a useful and commendable way of breaking the ice.

The only remaining question is whether creditors are likely to shop around for jurisdictions where waivers of immunity are not rendered void by international debt arbitration, or whether they would prefer contracts without any clauses to eliminate the problem of vultures. 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 and watch it fall from its nominal value to, say, 20, in order then to sue 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 are always against the interest of *bona fide* creditors, whether it be because they get less than they otherwise would, for this money cannot be used to finance recovery, which would have negative effects on the 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 redressal against alleged breaches of contract by the debtor would be served by arbitration and/or appropriate clauses in new contracts, including clauses 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 stated 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 that Krueger herself rightly deplored. Arbitration is a traditional means of international law, highly popular at present in all cases except when it comes to protecting 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 suffering the solution has to be implemented at once, that is, already in the case of Argentina.

Which Debts? The Problem of Multilateral Debts

Krueger's (2001b: 4) argument that the IMF should 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 put it. This formulation implies that 'developing countries' are unlikely to know what is good for them—that they need a stern governess for their own good. The encouragement of 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 its 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 damage by grave negligence. Another loan may be granted to repair the damages done by the first loan, increasing the IFI's income stream (Raffer 1993). This is a severe moral hazard and an economically 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 as consultants are liable to pay damage compensation if/when negligence on their part causes damage, or as OECD-governments are liable if they create damage 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 to control capital flows. Finally, the present privileged position of international public creditors discriminates unfairly against private creditors who suffer avoidable losses because of IFI privileges when countries are unable to service their debts. Sufficiently large reductions by only one class of creditors are more difficult to get, which puts the debtor country at a disadvantage. A mechanism to correct the present inefficiencies is urgently needed.

One must fully and literally concur with Krueger(2001a: 6) that no creditor 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 loan. 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. The poorest countries particularly 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 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 recognized long ago that full repayment is unrealistic. But the problem has dragged on, obstructing development. Insufficient reductions have burdened debtor economies. This is evident for both HIPCs and for ‘emerging markets’ like Argentina. If Argentina's debt problem during the 1980s had been solved early on, putting the country on to a sustainable basis again, there would be no present crisis.

The first HIPC Initiative's officially declared objective was reaching overall debt sustainability by coordinated 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: 91) demanded in its chapter on Sub-Saharan Africa (ibid.: 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-Saharan 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 pointed out, that could have been avoided by quick and appropriate action. Debt management by creditors has not delivered, but has usually worsened the situation. For both groups, the problem is a debt overhang and determining what reductions are necessary for a fresh start. Both groups thus need a fair, transparent and efficient mechanism. The basic premise of the rule of law that one must not be a 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, and 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 coordinate bondholders or lend the money necessary to keep the country going during FTAP, but without any conditionality attached, as initially foreseen at Bretton Woods. This could be seen as adapting its initially agreed-upon 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 as a debt manager, only as one of many creditors. Finally, the IMF could encourage countries to go down the road now indicated by the Fund. Having opposed 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 from, not subject to reductions. It must not be lumped with previous claims, but enjoy seniority, or—to use Krueger's (2001a: 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, and, if it need be, it 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: 6) pointed 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 capitalized 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 shot up. Argentina is again a good example. Being 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 for a short time, and no insolvency protection exists for sovereigns. 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—doubtless spelling 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: 19). However, one may well assume that a fair and orderly work-out will be judged better by long-term in-

vestors immediately after the process than disorderly losses. The process is thus both in the debtor's and the creditor's interest, as Krueger correctly emphasized, unless one thinks of vulture funds.

Delays and Damages

Krueger rightly pointed out that delays cause costs, and that avoiding such damages is one reason for sovereign insolvency procedures: ‘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’ (2001a: 8).

As someone who has advocated sovereign insolvency for over fifteen years, repeatedly drawing attention to this kind of damage, I might recall that countries were not allowed by creditors to choose that road. 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: 4) argued, to justify preferential treatment, or rather a public bad. The unnecessary costs Krueger rightly mentioned and deplored are caused by creditors dominating international ‘debt management’ absolutely—they are creditor-caused damages (cf., for example, Raffer 2001a; 2001b: 4). Therefore it is good to have the Fund finally ‘on board’. The IMF can 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 a specific type of insolvency appropriate for sovereign debtors, a process based on the principles of the US Chapter 9. It further shows 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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