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The Bankruptcy of Nations: An Idea Whose Time Has Come

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2009, 43(3) The International Lawyer, 1189-1216
abridged version republished as
“The Bankruptcy of Nations: Let the Law Reflect Reality,

A bankruptcy regime is a central part of each national financial system. Yet no regime exists for insolvent sovereigns. As a result too much capital flows into poor countries in good times and is often repaid at the expense of the basic human rights of the poor in these countries in bad times. This paper examines the case for a sovereign insolvency regime, and considers Chapter 9 of the US Bankruptcy Code as a model for such a regime.

The most charismatic and influential banker of the 1970s, Citicorp Chairman, the late Walter Wriston, famously declared that “countries never go bankrupt”.¹ His argument was that

“LDCs (less developed countries) don’t go bankrupt ... the infrastructure doesn’t go away, the productivity of the people doesn’t go away, the natural resources don’t go away. And so their assets always exceed their liabilities, which is the technical reason for bankruptcy. And that's very different from a company.”²

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Here speaks a man who clearly spent very little time outside the North-East of the United States. Infrastructure, if a country has it, can go away – Latin America’s crumbled throughout the 1980s as funding to maintain it simply was not available after the debt crisis of 1982.\(^3\) A people’s productivity, if it exists, can go away, as educational systems fall apart or a disease such as HIV/AIDS ravages the nation’s human capital. Natural resources, if they exist in meaningful amounts, can decline in value, or the nation can lose the capacity to harvest, extract or export them.

Furthermore, whether assets exceeds liabilities is a poor test for national bankruptcy – most of a nation’s assets are not saleable. The normal legal test, that an entity cannot service its debts as they fall due, also happens to be the right test to apply to a nation. As a nation can only print its own currency, and as poor countries invariably can only borrow abroad in other nation’s currencies,\(^4\) sovereign debtors can be unable to service their foreign-currency denominated debts as they fall due.

Wriston’s reasoning was utterly fallacious. But it served to justify a flood of loans to Latin American and African nations in the 1970s and early 1980s, and is still quoted regularly.\(^5\)

Countries do go bankrupt, and creditors can go bankrupt lending to them. Argentina was bankrupt in 2002. Much of Latin America and sub-Saharan Africa was bankrupt in 1982 and Indonesia was bankrupt in 1998. Many African countries are today.

Adam Smith, the father of economics, identified the clear need for a sovereign bankruptcy regime in his seminal work over 200 years ago, when he wrote:

“\(\text{Whenever it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor.}\)\(^6\)"


Horst Kohler, when Managing Director of the International Monetary Fund in 2002, spoke to the same problem as Adam Smith, when he said, “[T]he present arrangements for resolving sovereign debt crises are not sufficiently transparent or predictable, and … they impose unnecessary costs on debtors, creditors, and the system as a whole.”

Faced with a nation in crisis, the IMF simply has too few policy options at its disposal. The Fund can continue lending or stop lending to the debtor. Those are its options. If the nation’s problems are caused by an unsustainable debt burden, more debt will only make matters worse. Yet if the Fund stops lending, the debtor will usually be forced to default, terminating or at least destabilising capital flows not only to the debtor but usually also to its region or market segment. For instance, when Mexico struck problems in late 1994 the resulting ‘Tequila Crisis’ temporarily limited capital flows severely not only to all of Latin America, but to all emerging markets nations. So the IMF is faced with a very difficult choice in deciding to cut off a nation’s access to funding.

Yet today there is still no machinery or rules in place to facilitate or regulate sovereign bankruptcy. The IMF’s response to this paucity of options was to propose a Sovereign Debt Restructuring Mechanism, an inadequate response for reasons that will be considered. Adam Smith was right in advocating, when necessary, a “fair, open, and avowed bankruptcy” as the best course for both debtors and creditors.

Of course, when Adam Smith and contemporary authors write of sovereign bankruptcy they mean something quite different from corporate or personal bankruptcy. A sovereign nation cannot go out of business, the way a corporation can, and its assets cannot all be liquidated so that the proceeds can be distributed among creditors. Sovereign bankruptcy would involve a stay of execution by creditors while the procedure was in process, and would result in the determination of an amount of debt relief that would, after it had been effected, leave the debtor able to continue to service its remaining debts and afford to its people their basic human rights.

The term sovereign bankruptcy is therefore used, in the literature, as a short-hand for a formal procedure conducted according to rules that would result in some level of mandated debt relief. It is difficult to imagine any situation in which all of the debt would be cancelled. Indeed, sovereign bankruptcy should lead to much the same type of result as the long, protracted rescheduling negotiations which are currently the norm, viz. the debt would be cancelled in part and the balance rescheduled. The differences are that the level of cancellation might be higher, as the power of debtors in the current negotiated solutions is not great, and that the outcome would be determined by an independent

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8 The Fund cannot mandate a restructuring of the debt, that has to be an initiative of the commercial bank creditors and/or the sovereign debtor.
forum, not by the parties, and according to prescribed rules. In short the process should be fairer, swifter and more certain than that which prevails today.

Walter Wriston was correct in only one sense when he said countries cannot go bankrupt. Bankruptcy is a legal construct. Without a court to administer bankruptcy, and rules to govern it, an entity cannot be bankrupt, simply broke. In this narrow technical sense only, until we have an international sovereign bankruptcy regime, administered by a court or arbitral tribunal, nations can only be broke, not bankrupt. This article explores why, when countries are broke, they need to be able to declare bankruptcy, just as can companies and individuals, and how a sovereign bankruptcy regime will benefit creditors and debtors alike.

**Sovereign Debt Crises in Modern Times – A Primer**

Any analysis of sovereign debt crises in modern times must start in 1973. OPEC had discovered the delights of being a cartel -- the price of oil quadrupled, almost overnight. Banks accelerated their lending to developing countries to ‘smooth out the oil price shock’, i.e. to allow developing countries to keep buying oil without having to tighten their belts and depress economic growth. The OPEC nations deposited their oil receipts in the banks. And the developed nations had a choice of two options to afford the oil – they could earn more or spend less. As with individuals, spending less is rarely an attractive option. So the nations chose to earn more, or, in their context, export more. To do so they needed other nations to have money to buy their exports. This they ensured by encouraging their banks to lend more to developing countries in a process Philip Wellons termed, “passing the buck”.

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It was a neat trick. All other things being equal, the oil price rise would have plunged Europe and North America into recession. But all other things were not equal -- the governments of Britain, France, Germany and the US formulated a plan to increase their exports and avoid a recession by encouraging lending to their principal markets -- and the plan worked. More capital flowed south and the increased imports it funded staved off recession in the developed countries.\(^\text{13}\)

The developed nations enjoyed strong economic growth. The OPEC nations enjoyed ever-increasing credits with the world’s major banks; and the developing nations “enjoyed” ever-increasing debits with the world’s major banks.

It couldn’t last. The Chairman of Chase Manhattan Bank, David Rockefeller, said so, on the front page of the Wall Street Journal, in June 1974:

> “Channelling massive flows of oil dollars from dollar-rich to dollar-poor countries once seemed easily manageable. But now it looks more troublesome ... My own view ... is that the process of recycling through the banking system may already be close to the end for some countries, and in general it is doubtful this technique can bridge the [payments] gap for more than a year or at the most 18 months.”\(^\text{14}\)

However, Rockefeller’s warnings fell on deaf ears. Bankers preferred to listen to Walter Wriston.\(^\text{15}\) Wriston’s assurance that countries can’t go bankrupt influenced more lending decisions than any analysis by a credit committee and any warning by a Rockefeller.

Wriston’s approach was more profitable, in the short to medium term, than Rockefeller’s, and so the capital kept flowing south, for another eight long years, until August 1982, when Mexico announced it could no longer service its debts.

Mexico’s insolvency triggered a cessation of capital flows to all of Latin America and Africa which, in turn, plunged the two continents into crisis. And this debt crisis, as managed under the structural adjustment programs the IMF imposed on the debtor nations, exacted a horrifying human toll.\(^\text{16}\) According to UNICEF, over 500,000 children up to

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\(^\text{13}\) Ibid.

\(^\text{14}\) Quoted in C. Stabler, “Mideast Oil Money Proves Burdensome”, The Wall Street Journal, June 6, 1974, at 1 & 29. Of course, other bankers were of a different view.

\(^\text{15}\) And who, incidentally, was quoted as disagreeing with Rockefeller, in the same article, saying, “The Great Crisis ... ain’t going to happen”. And Wriston enjoyed a higher reputation in the market than Rockefeller!

the age of five years were dying each year in sub-Saharan African and Latin America in the late 1980s directly due to the effects of the debt crisis and its management.\textsuperscript{17} A partial solution to the debt crisis was crafted in the early-to-mid 1990s for much of Latin America under the Brady Plan, but the debt crisis has never really been resolved for much of sub-Saharan Africa. Accordingly, one can extrapolate the mortality identified by UNICEF over many years in that blighted part of the world.

From this potted history of the debt crisis of the 1980s two important points can be gleaned:

1. The creditors were prepared to keep extending credit, far beyond reasonable levels, because the absence of a bankruptcy mechanism meant they expected to be repaid by the debtor nations increasing taxes and reducing social services to their people.

2. The debtors were prepared to keep borrowing, far beyond reasonable levels, because of the short time frames of politicians, and the need at all costs to avert a recession so as to be able to win the next election, as well as the effect, in many cases, of bribes paid by creditors to individual politicians and technocrats.

3. The creditor nation governments encouraged this excessive extension of credit because it served their short-term interest in avoiding a recession.

After the debt crisis broke in 1982, the international banks required that all loans, corporate and sovereign, be brought under the sovereign guarantee as a way of facilitating rescheduling negotiations. This it did. It also improved the security of the banks, dramatically. The largest banks held the highest proportion of loans to the less creditworthy private sector. Unsurprisingly, these were the same banks that had insisted on the sovereign guarantee, in their role as members of the steering committees directing the rescheduling negotiations.\textsuperscript{18} The largest banks had engineered the socialisation of irrecoverable debts owed by private sector borrowers and the IMF facilitated, and at times directed, the process.

The East Asian economic crisis was a different type of crisis. The debt crisis of 1982 had been a crisis of excessive indebtedness fuelling excessive consumption. The fiscal and monetary policy settings of the East Asian countries were reasonable, and indeed prudent. In the words of Laurence Meyer, a member of the Board of Governors of the US Federal Reserve System,

\begin{itemize}
\item note 5, at 237; Silva-Herzog, \textit{The Costs for Latin America’s Development in Latin America’s Debt Crisis – Adjusting to the Past or Planning for the Future?} 35 (Pastor ed., 1987).
\item Buckley, op cit n 2 at 43.
\end{itemize}
“By conventional standards, the monetary and fiscal policies of the developing Asian economies prior to the crisis were largely disciplined and appropriate. ... consumer price inflation ... was relatively subdued [and] fiscal policy also appears to have been disciplined ... Therefore, another important lesson of the Asian crisis is that sound macroeconomic policies alone do not preclude crises.”\(^\text{19}\)

This latter crisis was the result of a number of factors including (i) fixed exchange rates, tied to an appreciating U.S. dollar when the currency of the countries’ principal competitor, Japan, was depreciating; (ii) weaknesses in the local financial sectors and their prudential regulation so that local banks were able to borrow heavily abroad and re lend the proceeds domestically without hedging the foreign exchange risks (i.e. relying utterly on the peg of the local currency to the Dollar to hold); (iii) crony capitalism which further eroded the effectiveness of prudential regulation; (iv) excessive capital inflows facilitated by premature liberalisation of local financial sectors; and (v) a region-wide loss of confidence.\(^\text{20}\)

In East Asia in 1997 the great majority of the debt was to the private sector. But this did not stop the taxpayer from eventually bearing it. The IMF-led bailouts, invariably described as bailouts of Indonesia or Thailand or Korea, were, in fact, long-term loans to these countries that had to be used to repay the short-term creditors. These loans thus became debts of the nation and the bail-outs were primarily of the creditors.\(^\text{21}\)

The consequences of the Asian economic crisis for the poor of the region were harsh. In Malaysia, Korea, Indonesia, Thailand and the Philippines, over 10 million people dropped below the poverty line from 1996 to 1998.\(^\text{22}\)

Early this decade Argentina plunged into a severe crisis. The years from 1991 to 1998 had been a prosperous time in Argentina as foreign capital flowed in, Argentina’s economy performed strongly and inflation was under control.\(^\text{23}\) In these years, Argentina significantly improved its banking system, more than doubled its exports, increased infrastructure investment through privatisations and otherwise privatised a broad range of

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\(^{23}\) GDP per capita increased an exceptional 44% between 1991 and 1998: Miguel Kiguel, “Structural Reforms in Argentina: Success or Failure?”, *Comparative Economic Studies*, XLIV No. 2 (Summer 2002) 83 at 84; percentage calculated from Figure 1. There was a brief hiatus in the growth during 1995 in response to the Tequila effect: the contagion from Mexico’s crisis in late 1994 and early 1995: id at 94-95.
industries, experienced significant growth in oil and mineral production and achieved record levels of agricultural and industrial output.24 Argentina was a darling of financial markets and of the IMF and was toasted as “the best case of ‘responsible leadership’ in the developing world”.25

Nonetheless at the end of 1998 Argentina entered a severe recession. The timing was dictated in part by the 1997 Asian economic crisis and the August 1998 Russian crisis severely restricting capital flows to emerging markets economies and in part by the chilling impact of its increasingly over-valued currency on Argentine export competitiveness.

Notwithstanding the years of prodigious growth in the 1990s, by decade’s end Argentina was experiencing the worst economic crisis in its history26 and possibly the worst peacetime economic crisis in world history.27 How did this happen? The principal causes are threefold: the peso-dollar peg; massive inflows of foreign capital facilitated by the almost complete liberalisation of Argentina’s capital account;28 and the corruption that is endemic in Argentine society.29

The peso-dollar peg had effectively stabilised inflation. However the peg led to a progressive overvaluation of the peso that stifled exports and promoted imports.

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24 Kiguel, supra n 1 at 100-101. This is not to suggest that many of the privatisations were not deeply problematic. It is always a profound challenge to realise appropriate prices for the privatisation of major businesses and assets in emerging markets nations for the range of potential purchasers is not wide and because of the risk of very favourable prices for well-connected purchasers. The scrupulous and rigorous public accountability procedures that would mitigate against the latter risk are rarely present. There is much to suggest that many of the privatisations of the 1990s in Argentina were at a deep undervalue.


26 Kiguel, supra n 1 at 83; Martin Crutsinger, “IMF Grants Argentina Debt Extension”, Associated Press Online, 09/05/02.

27 Duncan Green, “Let Latin America find its own path”, The Guardian, August 5, 2002. On one estimate total domestic financial assets shrunk from US$126.8 bn in March 2001 to US$41.5 bn in March 2002. If this is correct it is one the most massive destructions of wealth anywhere in the world in the past thirty years. See Business Monitor International, Economic Outlook, Argentina Quarterly Forecast Report, 2002.


29 A minor factor that contributed to the crisis was the privatisation of Argentina’s social security system in 1994. This meant the nation could no longer count social security revenues as revenues, and had to move them off the budget. This led to substantial budget deficits that would not have existed under the former system of accounting for these revenues. To remain compliant with IMF targets, Argentina then had to reduce public expenditure to reduce its deficit which in turn contributed to the downturn. See Larry Rohter, “Giving Argentina the Cinderella Treatment”, The New York Times, August 11, 2002, section 4, p 14, col 1, citing Professor Joseph Stiglitz.
The capital inflows, in typical Latin American fashion, were used to finance budget and current account deficits.\(^{30}\) Argentina thrived in the 1990s on borrowed money.\(^{31}\) Borrowing to finance budget deficits is particularly problematic because this use of the funds will not generate the foreign exchange to service or repay the debt.

Finally, corruption played its insidious role in rendering Argentina’s economy profoundly inefficient by increasing transaction costs and by diverting capital flows from their intended destination into the private accounts of politicians, senior civil servants and leaders of industry.\(^{32}\)

The recession deepened into a severe crisis in late 2001 when the IMF refused to extend further credit to the nation, believing its economic programs to be unsustainable. Commercial lenders followed this lead, Argentina was denied access to capital and defaulted on its external debt of some US$ 132 billion. The government was forced to float the peso, and it sunk. The government also implemented ‘assymmetric pesofication’ under which dollar-denominated bank loans and deposits were redenominated in pesos. Banks were required to convert their assets (such as loans) into pesos at a one-for-one rate and their liabilities (such as deposits) into pesos at a rate of 1.4 to 1. This generated massive losses for the banking system. The government then sought to compensate the banks for these losses by a massive issue of government bonds of necessarily doubtful value.\(^{33}\)

Thus the ultimate burden fell on the public purse by way of the government bonds issued to compensate the banks for their pesofication losses. In the words of Pedro Pou, the President of the Central Bank of Argentina until mid-2001, “The government has transferred about 40% of private debt to workers … We are experiencing a mega-redistribution of wealth and income unprecedented in the history of the capitalist world.”\(^{34}\)

The living standards of over one-half of the Argentine people fell below the poverty line and over a third could not afford basic food.\(^{35}\) Children were fainting in class from hunger, regularly. Adults were rioting and breaking into supermarkets, regularly, in search of food. UNICEF Argentina was concerned that stunted growth and reduced

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\(^{30}\) Kiguel, *supra* n 1 at 101.  
\(^{31}\) Rojas-Suarez, *supra* n 23 at 10.  
\(^{34}\) As cited in Gaudin, ibid.  
mental capacities would be the long-term consequence of this economic crisis for millions of the nation’s children.\textsuperscript{36}

An effective sovereign bankruptcy regime could have ameliorated a substantial amount of this human suffering in Africa, Latin America generally, Asia and Argentina. Effective bankruptcy regimes bring many benefits at the national level, and would do so at the global sovereign level.

The Benefits of Bankruptcy Regimes Generally

At the national level, the principal purposes of a personal bankruptcy system are generally enunciated as being to divide the assets of an insolvent debtor fairly and rateably between its creditors, and to allow an insolvent debtor the opportunity to make a fresh start free from the burden of accumulated debt (provided the debtor has not engaged in dishonest or otherwise improper financial conduct).\textsuperscript{37} Sir Roy Goode has identified four objectives of corporate insolvency law: restoring the company to profitable trading, maximising returns to creditors, providing a fair and equitable system for the ranking of claims and identifying the causes of company failures and imposing sanctions for culpable management.\textsuperscript{38} All of the other literature on the topic is in similar terms.\textsuperscript{39}

What is missing from the literature is the notion that an effective insolvency regime will improve dramatically the allocation of credit within an economy, and thus make the economy more stable. This I have termed the ‘systemic’ aspect of bankruptcy – for without a bankruptcy regime, any economy will, as a system, be unstable.

The fairness aspects of bankruptcy are important. Internationally their absence has cost millions of lives. However, notwithstanding this appalling mortality, the systemic

\textsuperscript{36} Arie, supra n 3.

\textsuperscript{37} This is how the purposes of bankruptcy law are expressed in the leading Australian text, \textit{Lewis Australian Bankruptcy Law}, (Dennis Rose QC (ed.), Sydney: The Law Book Company Limited, 1994) at 1. Oddly enough, the purposes of insolvency laws often receive scant attention in the literature. The classic Australian text on liquidation, \textit{McPherson The Law of Company Liquidation} (J O’Donovan, Sydney: The Law Book Company Limited) is utterly silent as to the purposes of liquidation as is the classic English text, \textit{The Law of Insolvency}, op cit n 8.


\textsuperscript{39} The latest edition of the classic Australian text on liquidation, \textit{McPherson The Law of Company Liquidation}, (Keay A (ed), 4th ed, The Law Book Company Limited) enunciates purposes in much the same terms as Sir Roy Goode, and Ian Fletcher’s classic English text, \textit{The Law of Insolvency} (Sweet & Maxwell, London, 1996) is silent on the issue. The most thorough Australian analysis of the principles that should underpin and guide a modern insolvency law is to be found in the Australian Law Reform Commission Report, \textit{General Insolvency Inquiry}, (ALRC 45, Canberra: AGPS, 1988). That report identified nine principles that should govern any insolvency regime (corporate or personal) but did not address the systemic benefits of such a regime. Likewise, Finch’s excellent book, \textit{Corporate Insolvency Law: Perspectives and Principles} (Cambridge University Press, 2002) does not investigate the credit-allocation effects of an insolvency regime, although she touches on some related matters in chapter 4, and specifically at 143-44.
advantages of a bankruptcy system are arguably as, or even more, important at the international level. This is because the more immediate risk of loss under a global bankruptcy regime would tend to moderate capital flows to developing countries. An effective global sovereign bankruptcy regime in the 1970s would have led to far less capital flowing south. The real prospect of massive loan losses would have sharpened banker’s minds. When a Rockefeller said these loans were unsustainable, bankers would have listened, for if he was right they were set to lose billions.

These systemic advantages can help to ensure that the capital flows are more appropriate to the needs and capacities to repay of debtors. Financial crises would thus be less frequent and less severe because crises are so often the result of excessive inflows in preceding years. Furthermore, in the event of a crisis, the workout would proceed more rapidly and efficiently and thus the workout costs to creditors and debtors would be reduced.

We take this systemic effect of bankruptcy for granted in domestic systems. If a bank makes a poor credit decision domestically and lends to a borrower who subsequently becomes insolvent, absent security, most of the money will be lost. Without the prospect of sovereign bankruptcy, lenders do not bear the full implication of poor lending decisions internationally and thus excessive extensions of credit are likely. When nations have unsustainable debts, they typically must repay them, as there is no alternative, save a highly destabilising default that may deny the nation access to commercial capital for years. The debts are serviced through higher taxes and lower social services in countries that are already poor -- countries in which lower social services translate into malnutrition, inadequate housing and health care, unsafe water, etc. The debts of effectively bankrupt nations are repaid at the expense of the most basic human rights of their own citizens. We still have something very like debtors’ prisons for highly indebted nations. The Latin American nations are still struggling to service the debt that was incurred in the 1970s in the debt crisis. That debt has been restructured, reduced, and transformed into Brady bonds, but the bonds are still some fifteen to twenty years away from being fully repaid, and in the interim must be serviced, along with much of the debt incurred since the 1970s. Debt is a lifetime sentence for poor countries. The countries wages, in the form of foreign exchange earned from exports, are effectively garnished for 30, and sometimes up to 45, years!

Given these are the human consequences of sovereign insolvency, and given the founder of economics as we know it could see so clearly that from time to time it would be

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necessary for nations to declare themselves bankrupt, why has there never been put in place any means for a country to do so?

**Why Is There No Global Sovereign Bankruptcy Regime?**

The answer to why there is no global sovereign bankruptcy regime has five elements:

1. The lack, before the 1980s, of an overarching need for a sovereign bankruptcy regime.
2. The profound difficulties of creating international institutions and gaining widespread implementation of treaties.
3. The inability to compel participation in such a regime.
4. The perceived interests of the creditors.
5. The short term interests of debtors.

Each element will be considered.

**Absence of an Overarching Need, Until Relatively Recently, for a Sovereign Bankruptcy Regime**

Significant international financial crises are becoming far more frequent, and more severe, as the growing interconnectedness of markets means that national crises, that once would have been limited to that one country, now routinely spread throughout their region, and often to the other emerging markets of the world.

In the ‘good old days’, developing countries had financial crises intermittently and there was simply no pressing need for a supranational institution to deal with them – the crises were insufficiently frequent to warrant it and were often quite limited in their geographic spread. Yet, the proliferation of crises in the past thirty years means today that, for the first time in history, any such institution would, if it were to exist, be consistently busy.

There are reasons for this recent proliferation of crises. The principal one is the convergence of financial markets under globalisation. Until the 1970s most national financial systems functioned as relatively self-contained units: savings within an economy funded investment within that economy. The internationalisation of finance since that time has meant ever-increasing capital flows, particularly portfolio capital flows, between nations. Contempory capital flows swiftly into developing nations

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41 See the quote referenced by n 6.

42 In 1970 the capital that moved around the globe to support trade in goods and services far exceeded that which moved to support direct and portfolio investment. More recently capital flows have outweighed trade flows by a factor of over 60 to one: P. Sutherland, *Managing the International Economy in an Age of Globalisation*, The 1998 Per Jacobsson Lecture, the annual meeting of the IMF and the World Bank (Oct., 1998). By institutional investors, I am referring to mutual funds, pension funds, and other managers of other people’s money.
when prospects look good and there is a surplus of liquidity in the developed world, and as swiftly out of those nations when storm clouds gather there, or prospects in the developed nations’ markets look better. In the memorable phrase of Professor Michael Pettis, our contemporary international financial system, particularly as it relates to developing nations, is “The Volatility Machine”.

**Difficulties of Creating International Institutions**

History teaches us to never underestimate the difficulty of establishing an international institution. Witness the abortive history of the International Trade Organisation. The ITO was to be the third Bretton Woods institution, to accompany the IMF and the World Bank. These three institutions were the brainchildren of John Maynard Keynes and Harry Dexter White – the Englishman and American charged with shaping the international economic architecture after World War II (whose proposals were adopted at the Bretton Woods conference). Keynes and White had fresh in their minds the experience of the Great Depression that had dominated most of the inter-war years. They foresaw the need for a regime of fixed exchange rates to promote international trade, a monetary fund to assist with the implementation and operation of that regime, a development bank to assist with rebuilding Europe after the war and then to aid the development of poor countries, and a trade organisation to ensure the liberalisation and promotion of international trade. The IMF and World Bank came into existence, but due to subsequent US opposition the International Trade Organisation was never formed, and only the treaty it was to administer, the General Agreement on Tariffs and Trade, was implemented.

The scale of accomplishment in establishing the IMF and World Bank should itself not be undervalued. It took a global cataclysm, preceded by the Great Depression, to summon the political will to make those ideas reality. And it took years of failure by the U.S. and E.U. in the 1980s to extend the international trade regime to intellectual property rights and services to persuade them of the need for an international trade organisation, and to allow the ITO to come into being, fifty years late, as the World Trade Organisation.

Indeed, fifty years was also roughly the gestation time for the International Criminal Court that came into being in The Hague in 2002. The Nuremburg War Crimes Tribunal was an ad hoc international criminal court formed for the purpose of trying the Nazi war criminals of WWII, and at that time the need for a standing court was recognised and articulated. The realisation of that idea took 56 years. An international sovereign bankruptcy regime may have saved millions of lives in the 1980s, and so the need for it

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was critical, but the idea wasn’t seriously considered until the mid-1990s. In a much-cited speech in 1995, Jeffrey Sachs argued that “IMF practices should be reorganized such that the IMF plays a role far more like an international bankruptcy court and far less like the lender of last resort to member governments”. Let us hope history is not a firm guide to the gestation periods of such organisations, and we don’t have to wait until 2050 for a sovereign bankruptcy regime.

The Inability to Compel Participation in Such a Regime

Any particular regime will favour some groups over others and compelling the participation of those likely to be disadvantaged will always be a problem. This is a direct consequence of the absence of an international court with jurisdiction over such issues.

Perceived Interests of Creditors

We don’t have a global sovereign bankruptcy regime because the creditors believe its absence works in their favour. The banks have argued vociferously against a bankruptcy regime internationally when they accept, and indeed welcome, them nationally. Why? In the words of William Rhodes, Senior Vice-Chairman of Citibank,

“the existence of a formal bankruptcy mechanism, whether invoked or not, would cause uncertainty in the markets, deter potential lenders and investors, and drive up the countries’ borrowing costs”.

This is nonsense. National bankruptcy regimes greatly enhance certainty and this serves generally to attract lenders and investors and thus diminish borrowing costs and there is

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no reason it would be any different internationally.\textsuperscript{48} On the other hand, there is no formal structure for the resolution of sovereign debt crises and each crisis typically casts a pall for many years on debtor country prospects and bank profits. Debtor countries suffer with no new capital and ever increasing debt loads and banks suffer as in most cases they have to keep advancing new funds for years to enable the debtors to keep paying interest.\textsuperscript{49}

William Rhodes is the world’s most experienced banker in sovereign debt restructurings. He speaks as he does, presumably, because banks like the present arrangement under which, when a crisis hits, the poor in developing countries are consigned to the debtors’ prisons of poverty, ill-health and ignorance\textsuperscript{50} so that the loans made by the banks can be repaid.

The major international commercial banks appear unable to learn the lessons of history or appreciate the benefits to themselves of a more enlightened approach.

The debt crisis of 1982 was resolved in part by the Brady Plan of the early 1990s under which the loans were converted into bonds with principal or interest discounted by 35%. History has proven that the debt relief in the Plan was necessary to allow Latin American economies to grow again and restore capital flows to the region. The Plan also gave the banks readily tradable bonds, rather than illiquid loans, that permitted many banks to sell their exposure to investors comfortable with risk, and free up their own capital to move on and undertake new business. The Brady Plan proved to be a huge boon to banks, yet at the time they resisted it strongly, and only agreed to it under enormous pressure from their own national banking regulators.\textsuperscript{51}

The banks were wrong to oppose the Brady Plan -- in hindsight it benefited the banks more than the borrowers -- and in opposing a global sovereign bankruptcy regime, the banks have got it wrong, again.


\textsuperscript{50} In developmental terms, virtually everyone agrees that the 1980s was a lost decade in Latin America due to the Debt Crisis. (Even Anne Krueger agrees: see Krueger, op cit n 27). No progress was made between 1982 and 1989 on debt relief or meaningful ways forward for debtor nations, and so the continent’s poor went hungry, its young poor went uneducated, and its infrastructure crumbled, as nations continued to service an overwhelming debt burden (usually through new loans which simply increased the total indebtedness). The debt gridlock of the 1980s was in no one’s long-term interests but damaged the debtors far more than the creditors. See C Marichal, A Century of Debt Crises in Latin America (1989) at 237; and Buckley, ibid n 22 at 34-36.

The fact that credit costs may well be higher with a sovereign bankruptcy regime in place will not work to the detriment of creditors, because the benefits of less severe crises should outweigh the detriment of a lower volume of lending. Whether higher credit costs will, on balance, negatively affect debtors is considered below.

The other reason creditors prefer the status quo is that in a system without rules, power rules. While a sovereign bankruptcy regime would make the international financial system more stable and thus benefit banks and borrowers alike, it also represents a step towards limiting the power of the international banks and thus is a step onto a slope that, from their perspective, appears slippery.52

The Short-term Interests of Debtors.

Any sovereign bankruptcy regime is likely to increase the cost of credit within debtor countries, as creditors will factor in the enhanced prospect of losses in calculating interest rates. As Hal Scott has written, “While this may be good for sovereigns in the longer term, they would prefer not to take the medicine and continue to enjoy subsidized borrowing rates due to bailout expectations.”

In 2002 the Argentine and Brazilian governments were reportedly opposed to the IMF’s SDRM proposal because they feared it would raise their cost of financing in international markets.53

The politicians in debtor countries, like all politicians everywhere, are focussed primarily on retaining power at the next election – improving the sovereign balance sheet in ways likely to pay off substantially in six to ten years time, especially when this entails costs today, rarely sits high on the agenda.

Many writers have advocated the establishment of a global bankruptcy regime as a way of allocating losses more fairly between lenders and borrowers and of improving the efficiency of the system.54 So what would a global sovereign bankruptcy regime entail?

A Global Sovereign Bankruptcy Regime

The comprehensive approach would be to establish a standing sovereign bankruptcy court. A more achievable approach, at least in the near term, would be to establish an ad hoc tribunal for each case. In either case, the body would need to apply an agreed set of rules


and procedure. A court would need to be implemented by a treaty between nations, and its establishment, rules and regulations would require many years of planning and negotiations. An ad hoc arbitral tribunal could be established quickly if implemented by agreement between the creditors and a nation in difficulty, although of course, for the reasons considered above, creditor agreement is unlikely. The ad hoc tribunal could be formed by the creditors appointing two members to the tribunal, the debtor nation likewise appointing two members, and the four members then jointly appointing a fifth, to serve as their presiding member.

The two principal models generally considered as the basis for any sovereign bankruptcy regime are Chapters 9 and 11 of the US Bankruptcy Code. Chapter 9 is entitled “Adjustment of Debts of a Municipality”. Chapter 11 is succinctly entitled “Reorganization” and is available to allow corporations or partnerships to seek to trade their way out of bankruptcy, under the supervision of a court.

Under a Chapter 9 model, the decision upon whether to file for sovereign bankruptcy protection would be the debtors. In domestic law the decision is likewise taken by the debtor, but subject to two limitations: (i) the State must specifically authorise that debtor to file for bankruptcy, and (ii) the debtor must establish that creditors holding a majority of claims have also agreed to this course of action, or that such agreement has been sought in good faith and was not able to be gained. There is no state or other entity senior to a national sovereign in the way that a State of the United States of America is senior to its municipal governments or other entities; and of course the second limb of this requirement of Chapter 9 could be incorporated into any set of sovereign bankruptcy rules.

This capacity to initiate bankruptcy proceedings should not be an incentive to go bankrupt. It is not an incentive in domestic practice within nations, and debtor nations generally seek to avoid default at all costs. In the words of Nouriel Roubini, “Governments try to

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55 Presently, no court has jurisdiction over disputes between a sovereign state and citizens (such as banks or bondholders) of another sovereign state – the International Court of Justice deals only with disputes between sovereign states: Michelle White, “Sovereigns in Distress: Do They Need Bankruptcy?” Brookings Paper on Economic Activity, 1:2002 at 21. Arbitral tribunals, such as those under the auspices of the International Centre for the Settlement of Investment Disputes (ICSID), do deal with such disputes, but are, of course, not courts. For more on ICSID, see RP Buckley, "Now We Have Come to the 'ICSID' Party: Are Its Awards Final and Enforceable?" (1992) 14 Sydney Law Review 358.


58 USC 109 (c) (2)

59 USC 109 (c) (5)
avoid, as much, and as long as possible, defaults as they are politically, socially and economically costly." The norm is for even very poor nations to continue to service their debt at the expense of the most basic human rights of their people.

A Chapter 9 Model for a Global Sovereign Bankruptcy Regime

Chapter 11 proceedings are far more well known than Chapter 9 proceedings and perhaps for this reason, commentators often consider Chapter 11 when looking for a precedent for a sovereign bankruptcy regime. However, while a sovereign is not a "political subdivision or public agency or instrumentality of a State" (the definition of municipality in the Bankruptcy Code) it is closer to a local government than it is to the corporations the subject of Chapter 11, and, more importantly, the issues that arise in the bankruptcy of a nation are closer to those of a local government than a corporation. For these reasons, Chapter 9 is the best place to start, and a close examination of its provisions and implementation in practice suggest it is the best precedent available for a sovereign bankruptcy regime.

While Chapter 9 is not well known, there have, nonetheless, been about 500 proceedings brought under Chapter 9 in its history, including 172 Chapter 9 reorganizations filed between 1988 and 2005 “the vast majority by small government agencies like municipal utilities, school districts or entities established for a single project such as a hospital or convention centre.”

Chapter 9 was first enacted in 1934 during the Great Depression and the legislation was amended extensively in 1978, and again in 1988 and 1994, to give it greater efficacy. The only major county to reorganise under Chapter 9 in its modern, post-1978 form, has been Orange County.

Chapter 9 has worked effectively and efficiently in the bankruptcy of local municipalities within the U.S., and has the standing of being a functional U.S. law. In the words of the distinguished economist, Kenneth Rogoff, “Chapter 9 of the U.S. bankruptcy code … has proven relatively effective.”


64 Jeweller at CRS-4.

The other major proposal by civil society to address this problem, the idea of a Fair and Transparent Arbitration Process, is basically a Chapter 9 style proceeding facilitated by an arbitral tribunal rather than a court. The difference is largely inconsequential.66 What matters is the fairness and efficacy of the rules and the independence of the tribunal, not the tribunal’s form as a court or arbitral tribunal, and nor the form of proceedings as a court case or an arbitration.

The principal requirements for a municipality to be eligible to file for bankruptcy protection under Chapter 9, that are relevant to a sovereign, are that it must: (a) be insolvent,67 (b) desires to effect a plan to adjust its debts,68 and (c) either (i) obtain the agreement of creditors holding a majority in amount of the claims in each class that the debtor intends to impair under its proposed plan, or (ii) negotiate in good faith with its creditors and fail to obtain such an agreement, or (iii) establish negotiation is impracticable.69

A municipality is defined by Chapter 9 to be insolvent when it is in a financial condition such that (a) it is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (b) it is unable to pay its debts as they become due.70

Immediately a petition is filed, there is an automatic stay on all collection actions against the debtor.71

Chapter 9 permits objections to the petition for bankruptcy. Objections typically relate to whether the negotiations with creditors were conducted in good faith or whether the petition was filed in good faith. If the court determines these good faith requirements were not met, its remedy is to dismiss the petition, which returns all parties to the status quo ante.72 A court may also dismiss a petition for lack of prosecution, unreasonable delay, failure to propose a plan within the time the court has stipulated, material default under a plan and other causes.73

Claims have to be proved, and the court will fix a time within which this must be done. If a claim appears on the list filed by the debtor it is deemed proved unless the debt is listed as disputed, contingent on unliquidated.74 Accordingly, creditors only need to file for claims neglected or disputed in some way by the debtor. In the international context,

67 11 U.S.C. s 109 (c)(3)
68 11 U.S.C. s 109 (c)(4)
69 11 U.S.C. s 109 (c)(5).
72 11 U.S.C. s 921(c).
73 11 USC s 930.
74 11 U.S.C. s 925.
unless the relevant sovereign bankruptcy rules so prohibit, this stage of proving the debts
would give rise to an opportunity for debtor nations to allege debts are odious or
illegitimate. Odious debt has been aptly described as “a wobbly old doctrine of
international law”. The idea is that sovereign debt is odious if (1) it is incurred for a
purpose that does not benefit the people of the debtor nation, and (2) it is incurred without
the consent of the people. The reasoning is that the debt is that of the regime which
incurred it, but not of the people, and hence it should fall with the fall of the regime.

While a detailed exploration of the notion of odious debt, or the broader notion of
illegitimate debt, is beyond the scope of this paper, the fact that such proceedings could
provide an opportunity for such allegations to be explored and tested is, in itself, a reason
for the major banks to oppose such a development or, alternatively, a reason to so draft
the rules governing the procedure as to exclude, or limit narrowly, the scope for the
debtor to argue that certain debts are unenforceable due to being odious or illegitimate.

Perhaps the most important section of Chapter 9 from the point of view of its applicability
to sovereigns is section 904, which provides that:

    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 or 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 debtor can therefore go about its day-to-day activities and borrow money without
recourse to the court. These restrictions were required to ensure the constitutionality of
Chapter 9 in the U.S. but they work equally well to preserve the sovereignty of a
sovereign debtor.

In a Chapter 9 case there is no property of the estate and no estate to administer, and so
the court cannot interfere with the debtor's use of its property or revenues. The only

77 See sections 364 and 901(a) of 11 USC.
Cameron Water Improvement District No. 1, 298 US 513 (1936) (which held the first version of
Chapter 9 unconstitutional because it infringed on sovereign powers) and the later case of Bekins v.
United States, 304 US 27 (1938) (which upheld the constitutionality of the revised enactment).
79 See the definition of property of the estate in U.S.C. § 902(1).
exception is in the very limited case in which the debtor refuses to pursue a cause of action to set aside a voidable payment – under section 926 “the court may appoint a trustee to pursue such cause of action.”

Except in this very narrow instance, there is no power in Chapter 9 proceedings to appoint a trustee in bankruptcy or a receiver. This is appropriate, for the elected government of the municipality (or sovereign nation) must be allowed to continue to govern.80

There is also a ‘cramdown’ procedure, in American parlance. Acceptance of a class of creditors to a proposed plan is required if the plan impairs the claim of the class. However, when there is more than one class of creditors the claims of which are impaired by the plan, the court may confirm the plan if at least one impaired class accepts the plan and the plan does not discriminate unfairly and is fair and equitable as between classes of creditors.81 There is a requirement that the plan be in the "best interests of creditors and is feasible" but this provision means something different under Chapter 9 than the similar wording under Chapter 11. Under Chapter 11, a plan is said to be in the "best interest of creditors" if creditors would receive as much under the plan as they would if the debtor were liquidated.83 Liquidation of municipalities (or sovereign nations) is not possible. So, in the Chapter 9 cases, for a plan to be in the "best interests of creditors" and “be feasible” has generally been interpreted to mean that it must be better than the other alternatives available to the creditors. As the alternative to Chapter 9 is dismissal of the case, leaving every creditor to fend for itself, the "best interests of creditors" test is usually interpreted to mean the municipality must use reasonable efforts to repay its creditors, not that it devote every available resource to the task.84

The bankruptcy court under Chapter 9 is not as actively engaged in managing the case as in Chapter 11 proceedings. In Chapter 9 the court’s role revolves more around approving the petition, confirming the plan of debt adjustment and ensuring implementation of the plan.85 This, again, is highly suitable to the situation of sovereign debtors. It would hardly be appropriate for a court or arbitral tribunal to be instructing a nation in the conduct of its affairs in the way that Chapter 11 bankruptcy judges regularly intervene in the affairs of corporations trading under Chapter 11 protection.

While there are differences between local governments and national governments there are many similarities between these levels of government, especially when one is a large

80 Kunibert Raffer has noted that the inability to appoint a receiver of a nation has often been raised in debates in Germany as a reason an international bankruptcy regime was unworkable: K Raffer, debt overhang, note 56.
81 11 U.S.C. ss 1129(a)(10) and 1129(b).
82 9 U.S.C. s 943(b)(7)
85 US courts, ibid.
and formerly prosperous county in Southern California. In December 1994, Orange County filed for protection under Chapter 9, as a result of massive losses from the inappropriate use of derivatives in managing its (and other counties’) investments, and emerged from bankruptcy in February 2000.  

In the words of a Congressional Research Service report for Congress,

“the Code itself, as applied by the bankruptcy court, appears to have been sufficiently flexible to accommodate the operational needs of the County and the interests of its creditors. … the bankruptcy forum appears to have provided an appropriate and efficient judicial mechanism for its resolution. The County qua municipality remained in control of its ‘political’ affairs, that is, the operation of government and the provision of public services, while the County qua debtor was free to pursue both litigation and negotiated settlement with its creditors.”

In the national context, the intervention of the IMF in national Finance Ministries and the imposition of austerity policies, invariably prevents the country from providing appropriate public services. Most debtor nations in crisis are prevented by the IMF from running budget deficits sufficient to pay teachers or health care workers or provide the most basic social services to their citizens, despite considerable evidence that overly restrictive fiscal settings are not conducive to economic growth in developing countries.

In short, what worked for Orange County would work far, far better than our current arrangements for the poorer nations of the world. This should not be surprising, as adjudication under a predetermined set of rules by an independent forum should produce a fairer and more certain and predictable outcome than the utterly unregulated negotiations that resolve these issues today. Developing nations, and the international financial system, would both be best served by a carefully crafted set of bankruptcy rules, modelled on Chapter 9 of the US Bankruptcy Law, and applied and enforced by independent tribunals.

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86 Jeweller, at CRS-10.
87 Ibid.
89 In the words of the Center for Global Development, “The evidence suggests that IMF-supported fiscal programs have often been too conservative or risk-averse. In particular, the IMF has not done enough to explore more expansionary, but still feasible, options for higher public spending”: Center for Global Development, “Does the IMF Constrain Health Spending in Poor Countries? Evidence and an Agenda for Action”, available at http://www.cgdev.org/content/publications/detail/14103, accessed on August 20, 2007. See also Ross P Buckley and Jonathon Baker, “IMF Policies and Health in Sub-Saharan Africa”, in Global Health Governance: Crisis, Institutions and Political Economy, forthcoming, Adrian Kay and Owain Williams (Eds), London: Palgrave Macmillan, 2008.
Benefits of a Global Sovereign Bankruptcy Regime

So what advantages would a global bankruptcy regime with a highly developed, formal system of rules bring? Five come to mind.

1. The unconscionable delays that occasion most sovereign debt workouts would be shortened, to the benefit of creditors and debtors.

2. The appalling human suffering, and the state mandated infringements of basic human rights, that have accompanied IMF Structural Adjustment Programs and Poverty Reduction Strategy Papers, would be dramatically ameliorated by the debt relief granted to sovereign debtors and by removing the IMF from the Ministries of Finance of the debtor nations.90

3. Capital flows to less credit worthy developing countries would be ameliorated by the prospect of national insolvency. Reckless lending and reckless borrowing would be constrained, and costs of credit higher91 -- and all of this would be a good thing.

4. The international financial system would be far more stable as capital would flow within it only after far more careful credit decisions than is now the case. This greater stability would benefit both creditors and debtors. In short, capital would tend to flow between economies more as it does today within economies (where the prospect of debtor bankruptcy plays its cautionary role).

5. Creditor moral hazard would be greatly reduced. As the need for international rescue packages (primarily facilitated by the IMF) would be greatly reduced92 so would the attendant moral hazard -- these packages invariably require that the funds provided be spent on discharging debt then due, and thus the packages bail out the creditors who advanced short-term debt, the most destabilising form of debt for a nation.

6. Debtor moral hazard should remain largely unaffected. As discussed previously, nations are usually very slow to default on their loans. Indeed, in the view of Anne Krueger and other experts,93 nations usually postpone the day of reckoning and fail to seek restructurings of their indebtedness when timely and required, so that when the crisis comes it is far more severe and destabilising to the system than if the nation had sought a restructuring and some debt relief earlier. There is no reason to expect that the existence of a sovereign bankruptcy regime would reduce the commitment nations typically display to servicing their foreign debt at all costs.

90 See text accompanying ns 35 & 36.
92 Id at 103.
93 See quote from Anne Krueger at note 104.
Early this decade, as alternatives to such a bankruptcy regime, the major banks and banking industry associations proposed the mandatory inclusion of collective action clauses (CACs) in all sovereign bond documentation and the IMF proposed its Sovereign Debt Restructuring Mechanism initiative. Each will be briefly considered.

**Collective Action Clauses**

Collective action clauses are clauses in debt documentation by which creditors agree in advance to accept the determination of a majority of them, usually a super-majority of 75% of creditors, as to any variation of the terms of the debt. This removes many of the collective action problems inherent in bond debt, in which the bonds may be held by hundreds or thousands of creditors. It prevents the rogue creditor, in which small creditors may refuse to participate in a general restructuring, and then sue for repayment in the full, original terms, after the great majority of creditors have accepted rescheduled terms.\(^{94}\) It makes a debt workout with bonds more workable.

For many years, bonds issued under U.K. law typically had such clauses in them, and those issued under New York law did not. The same sovereign issuers issued in both markets. Research showed that CACs tended to lower the borrowing cost for more credit-worthy issuers and raise it for less credit-worthy issuers.\(^{95}\) Presumably the more credit-worthy benefit from being able to take advantage of a more orderly restructuring process should it ever become necessary, whereas for less creditworthy issuers, any provision that makes a rescheduling easier is resisted.\(^{96}\)

In 2002 the US and other G-10 nations were keen to see CACs included in all sovereign bond contracts as an alternative to the SDRM approach of the IMF, and in the years since CACs have become standard inclusions in bond documentation. Today they are the norm in bonds issued under New York law,\(^{97}\) just as they always have been in bonds issued under English law. CACs do assist in debt restructurings, but do not remove the need for a bankruptcy regime,\(^{98}\) for two reasons:

1. CACs facilitate reschedulings, but do not, in and of themselves, afford debt relief when only debt relief will give a nation a sustainable debt burden and enable it to

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\(^{96}\) Eichengreen & Mody, ibid.


\(^{98}\) White, op cit n 26.
honour most of the human rights of its people. If a nation’s debt burden is unsustainable, the provision of further official finance by the IMF and the World Bank merely worsens its situation. The solution “is less debt, not more”.

2. The essential problems facing sovereign debt workouts are not collective action problems among creditors, although these are significant. For instance, the workout for the Debt Crisis took from 1983 to 1994, and yet this workout faced far fewer collective action problems than any comparable workout would today, for the debts in question were loans by a relatively small number of banks, not bonds held by many creditors. The banks were highly susceptible to the moral suasion of their respective central banks, and it was this pressure, and this pressure only, that eventually led to the Brady Plan and some relief for debtors – but a decade too late for most debtors! Collective action problems are only a small part of the problem. The US push for CACs implicitly assumed they were most of the problem, presumably so as to not have to deal with the real issues.

The problem with CACs is not that they won’t help, as they are, but that they are not a solution for the sovereign insolvency problem. CACs were developed as an alternative to the IMF’s Sovereign Debt Restructuring Mechanism (SDRM) proposal, which the U.S. initially supported but subsequently squashed. So what did the IMF propose?

The IMF Proposal: The Sovereign Debt Restructuring Mechanism

The SDRM was first proposed in a signal speech by Anne Krueger, First Deputy Managing Director of the IMF in November, 2001. The IMF’s proposed scheme, initially received some favourable comment from the U.S. administration, but the

100 Buckley, op cit n 2.
administration soon became a major critic of the proposal, and in light of these criticisms the IMF revised the initiative considerably.

The IMF developed its SDRM proposal to address two problems it had identified. The first is the absence of “adequate incentives for orderly and timely restructuring of unsustainable sovereign debts”.102 The general consensus is that developing country debtor governments tend to postpone initiating a restructuring of their debt until far later than is optimal from the perspective of their creditors and their own citizens.103

In the words of Anne Krueger,

“Like a patient with a toothache avoiding a trip to the dentist, a debtor country will all too often delay a necessary restructuring until the last possible moment, draining its reserves and increasing the eventual cost of restoring sustainability. Creditors suffer too, as the fear that some may be unfairly favored in a disorderly workout depresses the value of claims on the secondary market and, at worst, may block agreement on a necessary restructuring. All this can leave the international community with the unpalatable choice of accepting a disruptive and potentially contagious unilateral default, or bailing out private creditors and thereby contributing to moral hazard.”104

This tendency to be late to restructure is strongly supported by the prospect and actuality of IMF rescue packages.105

The second problem is that without a bankruptcy type mechanism the only choices available when a nation is in serious financial trouble are a default (which is highly disruptive to the debtor and potentially destabilising for the entire international financial system) or a bailout of the private creditors thereby, in Anne Krueger’s words, “contributing to moral hazard”.106

102 Krueger I, ibid.


104 Krueger II, op cit n 26.

105 Eichengreen, ibid.

The IMF’s proposal as developed, and later modified, had four principal elements:107

1. Majority restructuring so as to circumvent the collective action problems that are particularly prevalent with bond financing and to remove the free-riding and rogue creditor problems.

2. Deterrence of disruptive litigation – by providing for any amounts recovered to be deducted from any eventual residual claims.

3. Protection of creditor interests by a restraint on the debtor paying non-priority creditors and by an IMF assurance of good economic conduct by the debtor to give the creditors an assurance the debtor will pursue policies that protect asset values and restore growth.

4. Seniority for new lending, so as to attract it to the country.

The SDRM would also have involved the appointment of a Sovereign Debt Dispute Resolution Forum, which is described as independent even though its members would be nominated and endorsed by the Fund. The Forum would have power to decide disputes between creditors and between creditors and debtors. However its role falls far short of that of a bankruptcy tribunal and the SDRM falls far short of the bankruptcy regimes that are an essential part of all national economic systems.108 Specifically there were seven problems with the SDRM initiative:

1. Because the SDRM was not a bankruptcy regime, it could never have insisted on debt relief for debtors, even when debt relief was required for a nation’s economic viability.109

2. The determination of whether a nation qualified for debt restructuring was to be made not by the Sovereign Debt Dispute Resolution Forum, as one would expect, but by the IMF.

3. The determination of a nation’s level of debt sustainability, from which the necessary amount of debt reduction would follow as a matter of logic, was to be made not by the Sovereign Debt Dispute Resolution Forum, as one would expect, but by the IMF.110


109 Notwithstanding newspaper headlines such as “IMF plan would let countries declare bankruptcy”, by Martin Crutsinger, Sydney Morning Herald, Sept 30, 2002, 8, col 3; the SDRM, by the IMF’s own admission, was not a bankruptcy regime and never intended to be one.

110 K Raffer, “The IMF’s SDRM – Another Form of Simply Disastrous Rescheduling Management?”, forthcoming C Jochnick & F Preston (eds), Sovereign Debts at the Crossroads
4. The IMF would have discharged these two critical functions while compromised by its status as a major creditor of the debtor (as virtually every country requiring debt restructuring has debts to the Fund), and presumably with one eye upon the recoverability of its own loans. That one should never be a judge in one’s own cause is a fundamental principle of due process and natural justice that the SDRM proposal ignored. In Hal Scott’s words, “the IMF is not impartial. Allowing the IMF to operate the SDRM mechanism would be like putting a class of secured creditors, rather than a court, in charge of a corporate reorganization.”

5. The SDRM was to apply only to commercial bank debt, not Paris Club, IMF and World Bank debt. This meant that even considerable debt reductions by commercial creditors may have been insufficient to return debtor nations to viability as the overall debt burden on the nation would be insufficiently reduced. Any effective response to the problem of sovereign insolvency needs to apply to all debts of a sovereign.

6. In response to U.S. criticism, the stay on enforcement of claims that featured in the initially proposed form of the SDRM, and is a part of virtually all domestic bankruptcy regimes was dropped and replaced by the less effective “Hotchpot rule” under which any amounts recovered by a creditor are deducted from the creditor’s eventual entitlements. In the words of Charles Tabb, “In no way is hotchpot a substitute for a stay”.

7. The laws and rules that the Forum would have applied were never drafted – so the IMF was in effect requesting support for a process the details of which were unknown and incredibly important.

Perhaps unsurprisingly, given it was a creation of the IMF, the SDRM would have entrenched the IMF in its role of international debt and economic crisis policeman by establishing a legal basis for that role – a role it has conspicuously failed to discharge well ever since it took it on in late 1982. Under IMF structural adjustment programs the

112 Official inter-governmental loans are rescheduled through a process known as the Paris Club.
114 Comments of Professor Charles Tabb on an earlier version of this paper, e-mail to the author of April 19, 2008, copy on file with author.
1980s were a lost decade in Latin America and Africa. The IMF’s initial policy prescription of budgetary austerity for the nations most affected by the Asian economic crisis in 1997 was wrong, as the Chief Economist of the World Bank identified at the time and as the Fund itself subsequently tacitly admitted by endorsing expansionary policy settings in those nations. Argentina was a model IMF pupil in the decade up to its catastrophic meltdown in late 2001 – a meltdown that was the direct result of IMF-endorsed policies.\(^{116}\)

It appears the U.S. opposed the SDRM partly because it represented an expansion in IMF powers,\(^{117}\) and, partly, and perhaps more so, because the major banks opposed the idea. At the Spring Meeting of the Fund in 2003, the Fund’s governing body nixed the idea.\(^{118}\)

The SDRM proposal sought to make the current debt restructuring process more efficient without addressing any of the inequities of the present system. In the IMF’s words, “We are not proposing a bankruptcy mechanism for countries, but simply a mechanism to facilitate debt workout negotiations between a debtor and its creditors”.\(^{119}\)

Yet a bankruptcy mechanism is precisely what is needed. One purpose of a rules-based system is to redress power imbalances by the application of fair and just rules – to replace the law of the jungle under which the most powerful wins, with the rule of law under which justice should out. The SDRM failed this test. In seeking to render the current system more efficient it sought to do entrench and enhance the power of the Fund itself, and the creditors, without offering any improvements over the current system for the debtors.

In cases of sovereign insolvency, debt relief is often essential, for only debt relief may allow insolvent nations to grow and develop again. Under the SDRM, debt relief would


\(^{118}\) In the delicate language of such bodies, “The Committee welcomes the work of the IMF in developing a concrete proposal for a statutory sovereign debt restructuring mechanism (SDRM) and expresses its appreciation for the IMF management and staff's efforts. … The Committee, while recognizing that it is not feasible now to move forward to establish the SDRM, agrees that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises”, *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund*, Press Release No. 03/50 April 12, 2003; available at [http://www.imf.org/external/np/sec/pr/2003/pr0350.htm](http://www.imf.org/external/np/sec/pr/2003/pr0350.htm), accessed on April 23, 2003.

only be available if debtors were able to extract it from creditors by negotiation. How likely this is depends on the attitudes of creditors to debt relief.

Throughout the 1980s the creditor community resisted vigorously all calls for debt relief as a response to the Latin American and African debt crisis.\footnote{Bresser Pereira, LC. “Solving the Debt Crisis: Debt Relief and Adjustment”, Testimony before the House Committee on Banking, Finance and Urban Affairs on the hearing on the “Less Developed Country Debt Crisis”, Jan 5, 1989, 101st Congress, First Session, 330; and Buchheit, LC. “Debt restructuring-speak: ‘Senor, que pasa?’”, IFLR, March 1991, 10.} As Donald Regan said in the early 1980s, when Secretary of the U.S. Treasury:

“\textquoteleft I don\textquoteleft t think we should just let a nation off the hook because we are sympathetic to the fact that they are having difficulty. As debtors, I think they should be made to pay as much as they can bear without breaking them. You just can\textquoteleft t let your heart rule your head in these situations.\textquoteright”\footnote{As cited in WJ Quirk, “Will an Underdeveloped Countries Debtors’ Cartel Squeeze the Big Banks?”, (1983) 47 Business and Society Review 4 at 10.}

The first Brady Plan restructuring, for Mexico in 1989, was a slow process as hundreds of banks resisted it strenuously, principally because it contained an element of debt relief. Many banks were reportedly “disgusted” with the deal but in the end had to go along with it under intense pressure from their central bank regulators.\footnote{“Hurricane heading for Brady Plan” 794 IFR, Sept 23, 1989, 12; and “Commercial bankers say Brady Plan is a non-starter” 795 IFR, Sept 30, 1989, 8.} This has been the consistent stance of creditors to debt relief.

A revealing insight into creditor thinking in this regard can be gained from a letter from the Chief Executives of five financial market associations to Horst Kohler, then Managing Director of the IMF, expressing concerns over the IMF’s SDRM proposal.\footnote{Letter dated 6 February 2002 from the Securities Industry Association, Emerging Markets Traders Association, International Primary Market Association, International Securities Market Association and The Bond Market Association to Mr Horst Köhler <http://www.emta.org/ndevelop/imflettr.pdf>}

As the industry associations wrote,

\textquoteleft We disagree strongly with several of the key assumptions that were used by Ms Krueger as the basis for her proposal: (1) that there is a collective action problem preventing creditors as a group from reaching agreement on restructuring terms for countries that have an ‘unsustainable’ level of external debt; (2) that IMF assistance to debtor governments has the effect of ‘bailing out’ private creditors; and (3) that the proposed framework offering a debt country legal protection from creditors would be analogous to domestic bankruptcy procedures.\textquoteright”\footnote{Ibid.}

To deny the existence of collective action problems among bond creditors is a long bow to draw.\footnote{See Lee C Buchheit and G Mitu Gulati, “Sovereign Bonds and the Collective Will”, (2002) 51 Emory Law Journal 1317. Furthermore, any study of the resolution of the debt crisis in the 1980s
agreement of all to any change in the terms of the bond is exceptionally difficult, and the main reason CACs are a step forward.

To put the word ‘unsustainable’ in quotation marks so as to suggest that nations do not have unsustainable debts is unethical. The most impoverished nations today spend four times more repaying debt than on health, education, sanitation and other basic needs. Such debt can only be serviced at the direct expense of the human rights, and often the very lives, of millions of people and can only be considered sustainable by those whose moral compass has gone utterly awry.

To deny that IMF bailouts serve to bail out private creditors is, quite simply, outrageous. The IMF itself admits this is the consequence of the IMF organised loans to sovereign debtors in times of crisis – in fact, such a use of the funds is mandated by the terms of the loan. The financial industry associations assert that “private creditors have and undoubtedly will continue to experience substantial losses on their exposure to emerging market sovereign debtors who have experienced payment difficulties”. True, entirely true, so what? No one asserts that bailouts shield creditors from all losses. The problem is that bailouts protect creditors of short-term debt from much of the losses that a free market would impose upon them – thereby encouraging the type of debt that enhances volatility and reducing systemic stability, while also promoting moral hazard. Bailouts are an utterly unwarranted interference in the operations of the market, especially when they invariably result in the socialisation of private corporate debt.

The third objection of the financial industry associations has substance: the SDRM is not analogous to domestic bankruptcy procedures (and that is precisely the great weakness with it).

discloses substantial collective action problems – and this in the days when the debt was in the form of loans owed to relatively few banks, not in bonds and owed to a plethora of bondholders as is the case today.


These attitudes of commercial bankers to debt relief are mirrored in those of rich nations and the multilateral agencies they control. As Jeffrey Sachs has written, “The guiding principle of debt relief (on official debts) in the past 20 years has been to do the minimum possible to prevent outright disaster, but never enough to solve the debt crisis.”\footnote{Jeffrey D Sachs, “Resolving the Debt Crisis of Low-Income Countries”, Brookings Papers on Economic Activity, no. 1, 2002, pp. 257-86.}

For as long as creditors are adopting such positions, there will be little prospect of negotiated justice for debtor nations under any version of an SDRM – a proposal that leaves virtually all substantive issues to negotiation between creditors and debtors.\footnote{Hal S Scott, “Would a New Bankruptcy Regime Help?”, Brookings Paper on Economic Activity, 1:2002 at 6.}

Ultimately, the strongest argument for a sovereign bankruptcy regime, and against the SDRM, arises from the long-standing attitudes of creditors to debt relief.

**Conclusion**

The history of the past fifty years tells us that debtor nations usually continue to service their debts, even when they are broke and can do so only by borrowing ever more debt.\footnote{See Lee C Buchheit and G Mitu Gulati, “Sovereign Bonds and the Collective Will”, (2002) 51 Emory Law Journal 1317.}

Countries can always repay loans precisely because they can always increase taxes and reduce spending on health, education and nutrition – but at some point with poor countries such reductions in spending lead to utterly unconscionable hardship.

National bankruptcy regimes seek to ensure the maximum return to creditors while ensuring the debtors have food, housing and the capacity to work. Humane nations tolerate nothing less. We rejected debtors’ prisons centuries ago.\footnote{An excellent analysis of the history of the early common law remedies against debtors, including imprisonment for debt, can be found in Dennis Rose QC (ed.), Lewis Australian Bankruptcy Law, The Law Book Company Limited, 1994 at 7-10.}

The absence of an international bankruptcy regime means people starve, and live without adequate shelter, healthcare and education, while their country’s wealth goes to service loans. Yet national bankruptcy laws were introduced for this very reason: to ensure insolvent debtors could have adequate food and shelter. Why is it that what is unacceptable within any developed nation, is considered acceptable by the international financial community when it applies in other, poorer, borrowing countries?

The need for an effective global bankruptcy regime for nations will not go away. In the words of one commentator, “In the absence of a strong push for a … global bankruptcy court, the losses to overall global economic efficiency from emerging market crises of liquidity quickly becoming crises of solvency (resulting in unnecessarily destroyed domestic economies), are likely to mount.”\footnote{Leslie Elliott Armijo, “The Political Geography of World Financial Reform: Who Wants What and Why?”, in (2001) Vol 7 No 4 Global Governance (special issue on the New International Financial Architecture).}
The pressure from civil society for an effective global bankruptcy regime must be increased. Bankruptcy is an essential element of all domestic economic systems offering equity for debtors and creditors and systemic stability. As Adam Smith identified over 200 years ago, an effective bankruptcy regime is needed for sovereign states. It would ameliorate capital flows to debtor nations by making creditors price in the real risks of the credit, and provide major benefits in terms of fairness and systemic stability to the entire international financial system – benefits that will translate into fewer and less severe financial crises and into a massive reduction of unconscionable human suffering. Sovereign bankruptcy is an idea whose time has come. Extensive work is required to ensure it comes to pass.