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I. INTRODUCTION

Adam Smith recommended sovereign insolvency as "always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor."1 Christopher G. Oechsli published a detailed proposal of how to adapt Chapter 11, Title 11 of the US Code,2 well before August 1982,3 the date considered by many as the official beginning of the debt crisis. After Mexico's default, repeated suggestions to emulate Chapter 11 for sovereign debtors met stiff opposition, especially from International Financial Institutions ("IFIs") such as the International Monetary Fund ("IMF"). Their formalistic counterargument was that Chapter 11 did not address the problem of sovereignty. In defense, I proposed an international version of Chapter 94 in a paper presented at a conference at Zagreb University in 1987.5 In November 2001, the IMF suddenly presented its "new approach,"6 emulating Chapter 11 for sovereigns.

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Presently, four proposals are on the table: Collective Action Clauses ("CACs"), voluntary Codes of Good Conduct for debt renegotiation proposed both by the Banque de France, and (less elaborated) by the Institute of International Finance, and two models of sovereign insolvency.\(^7\) The first two proposals and insolvency models do not preclude each other. By helping creditors to organize, enabling them to act more quickly and efficiently, CACs are a useful component of any insolvency. The proper functioning of fair procedures depends on the full ability of parties to defend their legal and economic interests. Rules such as those elaborated by the Banque de France may help defuse crises. By contrast, the two insolvency proposals contradict each other fundamentally.\(^8\)

For details of my proposal—termed the Fair Transparent Arbitration Process ("FTAP") by many nongovernmental organizations ("NGOs")—to adapt Chapter 9, Title 11 of the US Code, I refer to other publications.\(^9\) Highlighting its irreconcilable differences vis-à-vis the IMF’s Sovereign Debt Restructuring Mechanism ("SDRM"), this paper discusses five issues of specific interest to jurists: impartial decisionmaking, the necessity to emulate Chapter 9, human rights and debtor protection, why equal treatment of creditors is mandatory, and an optional element to allow smoother negotiations and to stabilize capital markets.

II. IMPARTIAL DECISIONMAKING

With good reason, any decent legal system demands an impartial and uninterested entity to be vested with the authority to make certain decisions. It is the courts, rather than creditors or debtors, which must have this power. The very foundation of the Rule of Law demands that one must not be judge in one’s own cause. So far, international public creditors have been judge, jury,

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\(^8\) See id for a few similarities, such as verifying claims, which the International Monetary Fund ("IMF") also considers useful.

experts, bailiff, and occasionally even the debtor’s lawyer all in one, mocking the very foundation of any legal system.

The SDRM would continue this malpractice, conferring judicial authority on the IMF—both a creditor in its own right and an IFI that is dominated by a creditor voting majority. The Sovereign Debt Dispute Resolution Forum (“SDDRF”) is an IMF organ without authority to challenge the Executive Board’s decisions. The Board would, inter alia, decide on the adequacy of member’s policies and debt sustainability, thus presenting the plan and determining debt reductions. Formally, the SDRM exempts all multilateral claims; but lower sustainability levels, which mean higher losses for discriminated creditors, protect the viability of multilateral debt service. Smaller reductions might put it at risk. The IMF has an economic interest in “erring on the safe side,” by demanding relatively larger reductions from others to protect itself. Legal exemptions do not affect economic logic—this legal right is only enforceable if debtors have sufficient money. Higher losses of other creditors make problem-free debt service to IFIs more likely. The IMF would decide in its own cause.

Itself subject to the IMF Board’s decision, the SDDRF would hold substantial powers over private creditors and the debtor. It could recognize or void any claim in full or in part. It could practically wipe out claims, which is the ultimate authority over creditors.

My international version of Chapter 9 respects the foundation of the Rule of Law: impartial decision making. As national courts in debtor or creditor countries might not be totally beyond political influence, I propose international arbitration. Following established international law practice, each side (creditors and the debtor) nominates one or two persons, who in turn elect one more person to achieve an odd number. While institutionalized, neutral entities are technically feasible, ad hoc panels are preferable. Assuming that new cases will be rare once the present backlog has been handled, any standing institution would be severely underemployed. Also, arbitration panels established by creditors and the debtor for each case might be more acceptable as parties


Understandably, creditors insist on stipulating jurisdictions outside debtor countries. However, courts in creditor countries might be problematic too. In 1984, the US Court of Appeals for the Second Circuit granted US insolvency protection to Costa Rica, based in part on the assumption that this was consistent with US policy. Allied Bank International v Banco Credito Agricola de Cartago, 566 F Supp 1440, 1443-44 (SDNY 1983). The Second Circuit reheard the matter in Allied Bank International v Banco Credito Agricola de Cartago, 757 F2d 516 (2d Cir 1985), and reversed itself when the executive branch, as amicus curiae, clarified that supporting Costa Rica was not US policy. This reversal was in spite of the Court’s own legal arguments and what it had called “principles recognized by all civilized nations.” UN Conference on Trade and Development, Trade and Development Report, 1986 at 142, UN Sales No E.86.II.D.5 (1986); Rafter, Internationalizing US Chapter 9 Insolvency at 401 (cited in note 9).
have more say. Like the SDDRF, these panels could recognize or void individual claims. This arrangement confers the same ultimate authority on them as the SDDRF is to be granted, but not more. My transparent procedure protects bona fide creditors.

I propose adapting the essential features, but not all of the specifics, of domestic Chapter 9 to form the basis of international arbitration procedures. Specific procedural decisions could be made by the panel on this basis when needed. Eventually, a body of procedural rules—a kind of procedural common law—would emerge from these decisions.

In strict analogy to domestic Chapter 9, the population affected by the solution would have the right to be heard—a right exercised, of course, by representation. Therefore I proposed: “[e]xactly like in Rule 2018, this could be done by trade unions or employees’ associations.” Furthermore, international organizations, such as the United Nations International Children’s Emergency Fund (“UNICEF”), “Catholic NGOs, similar organizations of other creeds (especially in countries with non-Christian majorities), NGOs without religious background . . . and—last but by no means least—grass-roots organizations of the poor” would also qualify. Rogoff and Zettelmeyer seriously misrepresent this proposal: “trade unions, NGOs or churches could function as arbitrators speaking on behalf of the citizens in the debtor countries.” A right to be heard does not make someone a panel member or a judge in national courts.

Rejected as utopian when first proposed, participation officially became part of the Enhanced Highly Indebted Poor Countries Initiative (“HIPC II”). Civil society is to participate in designing poverty reduction strategies. Obviously, participation is possible; furthermore, one cannot keep people from expressing their views. In Argentina, for instance, civil society “participated” in the streets by banging pots. Formal representation seems a better way of voicing opinions.

The arbitration panel could sit anywhere, including the debtor or neighboring countries, which would make participation by organizations representing the population easier. I have never demanded that it “be headquartered in a neutral country that is neither an active international lender
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nor borrower." 15 Few such countries exist. This error probably stems from a misinterpretation of the following passage: “The reason why no court, whether located in a creditor or debtor country, should chair the procedures is self-evident: its impartiality is not guaranteed.” 16 This remark refers to courts of law, not courts of arbitration. Language apart, the illustrating example of Allied Bank International 17 does definitely not involve a court of arbitration.

Filing for insolvency protection would trigger a stay. The panel must endorse or reject this stay immediately upon being formed. It must reject the debtor’s demand if unfounded, denying this debtor any advantage from starting the procedure. Initially, the IMF suggested that it should be given the right to endorse the stay triggered by the debtor’s demand for insolvency relief. It later tried to assuage private sector resistance with several variants, including one allowing litigation by dissenting creditors, but preventing any pecuniary advantage by deducting any amount recovered by litigation from the sum such creditors would finally be entitled to receive as a result of insolvency proceedings. 18 Reduced to a nudum ius, the right to litigation would become meaningless—in fact, a practical joke: “Assuming that this creditor would have to pay his/her legal fees (s)he would be worse off than by not litigating.” 19

The panel should verify claims, just as domestic courts routinely do. This proposal, 20 initially classified as impracticable and utopian by the IMF’s staff, is now part of Krueger’s “new approach.” 21 This gives hope that basic legal principles, such as checking whether those signing loan contracts on behalf of debtors actually have the authority to do so, might eventually be applied to developing countries.

While the SDRM confers more power on the IMF, arbitration panels established by the parties would dramatically reduce the IMF’s importance. Unsurprisingly, the IMF has tried to argue against ad hoc panels. 22 Starting from the verification of claims, the IMF worries, “to be recognized for participation in

16 Raffer, 18 World Development at 304–05 (cited in note 5). See also note 10.
17 Allied Bank International, 757 F2d at 516.
20 Raffer, 18 World Development at 309 (cited in note 5).
22 Id at 63.
decision-making . . . the selection of a panel would have to follow, not precede, the verification process. But then who would resolve disputes arising from verification if there was [sic] no panel already in place?  

The answer is simple: all registering creditors nominate their one or two arbitrators, who speedily determine the recognition of claims. Recognized creditors could either confirm nominees or replace them. In theory, replacement could be necessary if so many claims are excluded that different arbitrators would have been nominated. This, however, while possible, seems unlikely to occur frequently. As creditors are known and organized, endorsing or replacing could be done quickly. Creditors whose claims are dismissed are a party with the same right as other creditors to nominate arbitrators to judge their case. There is no reason why creditors whose claims are finally not recognized should not enjoy the same legal protection as those whose claims are.

To back up its weak point, the IMF adds that creditors might each wish to appoint their own arbitrators, thereby making the case unmanageable. This “could distort the balance of power between the debtor- and creditor-selected arbitrators.” Echoing Rogoff’s and Zettelmeyer’s misperception, the IMF sees nominees not as impartial arbitrators but as representing and defending group interests. If so, anyone would, of course, demand their own “defenders” or lawyers. Unsurprisingly, this problem never emerged whenever private creditors and sovereigns agreed on arbitration. Compared with the IMF’s SDDRF, where everyone must accept the IMF’s dictate, my proposal confers more rights on both parties.

Sustainability would not be determined by the IMF, but would instead emerge from transparent negotiations between creditors and the debtor, with representatives of the affected population presenting their arguments. For decades, overly optimistic IFI forecasts have inflicted damages on member countries, rendering strategies based on such forecasts—especially proposed debt reductions—useless. Debt sustainability analysis highlights the inefficiency of IFI programs. Levels of sustainability emerging from this process can be expected to be better and more appropriate because all data and arguments can be presented.

23 Id.
24 Id.
Arbitrators would mediate between debtors and creditors, chair and support negotiations with advice, provide adequate possibilities to exercise the right to be heard, and, if necessary, decide the matter. As all facts would be presented by both parties and the representatives of the population during a transparent procedure, decisions would be unlikely to affect substantial sums of money, but would rather resolve deadlocks. Agreements between debtor and creditors would need the panel’s confirmation, in analogy to Section 943.  

III. Chapter 9

Initially not mentioning any specific Chapter, Krueger favors Chapter 11, the very model that the IMF staff had attacked as unsuitable for sovereigns. Krueger briefly refers once to Chapter 9 as being “In many respects ... of greater relevance in the sovereign context because it applies to an entity that carries out governmental functions.” Pointing out differences from the corporate model, she resumes: “All of these features could be appropriately integrated into a sovereign debt restructuring mechanism.” Important differences between municipalities and sovereigns, however, would have implications on the SDRM’s design:

Chapter 9 legislation acknowledges—and does not impair—the power of the state within which the municipality exists to continue to control the exercise of the powers of the municipality, including expenditures. This lack of independence of municipalities is one of the reasons why many countries have not adopted insolvency legislation to address problems of financial distress confronted by local governments.

This must be doubted on historical grounds. European governments seem to operate on the doubtful premise that public authority cannot go bankrupt, which makes special proceedings unnecessary. The point that municipalities are subject to control by states is presented in a misleading way. It seems that Krueger’s point is based on 11 USC § 903, entitled “Reservation of State power to control municipalities”:

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

26 11 USC § 943.
28 Id at 12-13.
29 Id at 13.
30 Id at 14.
(1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and

(2) a judgement entered under such a law may not bind a creditor that does not consent to such composition.

Given the need to reconcile the constitutional rights of Union and State, Section 903 simply states the obvious: that insolvency procedures cannot invalidate state laws, nor state rights regarding a “political subdivision or public agency or instrumentality of a State” deriving all its rights and powers from the state. Filing for bankruptcy does not void the Constitution or the law. Section 903 does not disturb constitutional arrangements. As laws on the subject of bankruptcy are constitutionally reserved to Congress, and as states are prohibited to pass laws impairing the obligation of contracts, states may only suggest methods of composition. If creditors agreed, then this might be useful. As the US Constitution does not apply elsewhere, US constitutional concerns might not explain the lack of municipal insolvency laws in other countries. Only post-communist Hungary adopted an insolvency law for public debtors upon the advice of private Western consultants.

Both corporations and municipalities are subject to national laws. If justified, Krueger’s reservation would therefore also hold against Chapter 11. Because national laws typically address nonsovereign actors, they could not be a source for international norms if Krueger were right. International treaties could not draw on the principles of national contractual laws that address nonsovereigns. In contrast to this view, national legal norms have always been considered a source for international law. Krueger’s short, and only, passage on municipal insolvency expresses an implicit dislike of Chapter 9. It is discussed so cursorily that neither legal sources nor academic literature on this topic is referred to. Chapter 9’s transparent, fair, and democratic nature is at odds with IMF perceptions.

Chapter 9 is the only insolvency procedure protecting governmental powers, which renders it applicable to sovereigns. Section 904, “Limitation on Jurisdiction and Powers of Court,” states:

31 11 USC § 903.
34 See Kupetz, 27 Urban L at 582 (cited in note 32).
36 Id, art I, § 10, cl 1.
37 Krueger, A New Approach at 12–13 (cited in note 6).
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. 38

The concept of sovereignty does not contain anything more than what Section 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. Unlike in other bankruptcy procedures, liquidation of the debtor or receivership is not possible. A trustee may not be appointed. 39 Section 902(5) explicitly confirms, "'trustee', when used in a section that is made applicable in a case under this chapter . . . means debtor." 40 Changes of "management" (for example, the removal of elected officials) by courts or creditors is impossible, and the same should hold for sovereign debtors. Only voters should have the power to remove elected politicians from office. If any regulatory or electoral approvals are necessary under other, nonbankruptcy laws for the execution of the provisions of the plan, Section 943(b)(6) mandates that such approval must be obtained before the court can confirm the plan 41—a point clearly adaptable to sovereigns. Similar provisions suitable for public entities are neither needed nor applicable within Chapter 11.

Public interest in the functioning of public debtors safeguards a minimum of municipal activities. US municipalities are allowed to maintain such basic social services that are essential to the health, safety, and welfare of their inhabitants. The affected population has a right to be heard. The procedure is as transparent as befits a public entity. US Chapter 9 provides viable solutions protecting the debtor's governmental sphere as well as the best interests of creditors. This is essential, for only a totally fair mechanism would be universally accepted, and rightly so.

38 11 USC § 904.
39 But see 11 USC § 926. "Avoiding powers," if considered an exception, is very special and justified.
40 11 USC § 902(5).
41 11 USC § 943(b)(6).

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IV. DEBTOR PROTECTION, HUMAN RIGHTS, AND THE ESSENCE OF INSOLVENCY

Impartial decisionmaking and debtor protection are the two essential features of insolvency, both denied to the globe’s poorest over decades. The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles: the right of creditors to interest and repayments versus the generally recognized principle, limited not just to lending, that no one should be forced to fulfil a contract if it leads to inhumane distress, endangers one’s life or health, or violates human dignity. Debtors should not be forced to starve themselves or their children to be able to pay.

Although claims are recognised as legitimate and legal, insolvency exempts resources from being seized by bona fide creditors. Debtors’ human rights and human dignity enjoy unconditional priority. Developing countries—more precisely, their inhabitants—are the only exception from this humane paradigm, because they are denied insolvency protection without any good economic or legal reason. One must recall that insolvency only deals with claims based on solid and proper legal foundations. Nevertheless, human dignity always takes preference over perfectly legal, morally sound, and legitimate claims.

Developing countries are the only debtors fully and absolutely at the mercy of (public) creditors even though debtor protection mechanisms could easily be implemented. People remain unprotected against policies that extract larger payments at severe cost to vulnerable groups, resulting in preventable harm such as increased rates of infant mortality. Over decades public creditors have forced these debtors to make sacrifices “which would not be acceptable in Canada and the United States.”42 Even during the era of debt slavery creditors could not simply grab and enslave insolvent debtors. The decision of a court was needed. Nowadays, sovereign debtors and their people do not even enjoy this flimsy legal protection: creditors can decide without needing any court’s approval. Creditors decide arbitrarily, with little economic success, as decades of “debt management” prove.

Exempting resources under the title of debtor protection can only be justified if they are used as intended. Concerns about the proper use of resources are not unfounded. But the solution is simple: a transparently managed fund43


43 Ann Pettifor, Concordats for Debt Cancellation: Making Debt Relief Work Twice—First, as Money to the Poor; Second, For Empowering the Poor, New Economics Foundation, Jubilee Research (June 2001), available online at <http://www.jubileeplus.org/opinion/Ann_concordats_debt_cancellation.htm> (visited Mar 27, 2005).
financed by the debtor in domestic currency. Within my model it would statutorily have to use its resources for antipoverty measures and financing a fresh start of the debtor economy. The management of such funds could be monitored by international boards or advisory councils consisting of members nominated by debtors, creditors, and NGOs. As this fund is a legal entity of its own, checks and discussions of its projects would not concern the government’s budget, which is an important part of a country’s sovereignty. Aid could be channeled through the fund, changing its character of money set apart from the ordinary budget towards a normal fund for the poor.

In analogy to domestic Chapter 9 this fund would finance basic social services essential to the health, safety, and welfare of inhabitants. While this idea had been severely attacked when first presented as part of a sovereign Chapter 9, HIPC II officially incorporates antipoverty measures. Although actual positive pro-poor effects lag perceptibly behind official declarations, the principle is accepted. Once again, the SDRM rolls progress back.

V. APPLYING FUNDAMENTAL LEGAL PRINCIPLES TO IFIs: TREATING ALL CREDITORS EQUALLY

Insolvency laws usually include preferential treatment of certain types of claims. Treating all creditors equally is not a procedural necessity. This important feature of my sovereign insolvency model is based on specific economic and legal reasons; on the necessity to establish the equivalent of national liability and tort laws; on jurisprudence as the *ars boni et aequi*; and on fairness to other creditors, who like debtors have to pick up part of the bill of IFI failures. As the so-called Brady Initiatives that reduced private sector claims for some Middle-Income Countries showed, even generous reductions by one class of creditors alone are insufficient to regain viability. The losses private creditors had to accept have not benefited debtors under the present system of unjustifiable IFI privileges.

At present, IFIs are not preferred creditors, as one can even read on their own homepages, but they do enjoy de facto privileges. The SDRM would legalize this practice, changing present legal status and statutes of IFIs in their favor. The IMF has never mentioned this change. Surreptitiously, the SDRM would secure for the IMF the coveted legally preferred creditor status it lacks.

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44 See Raffer, *International Debts: A Crisis for Whom?* at 59 (cited in note 5); Raffer, 18 World Development at 305–06 (cited in note 5).

Checks of the International Bank for Reconstruction and Development ("IBRD"), by, among others, Canada’s Auditor General, concluded that it had no preferred status. Under pressure from private business, it even waived the negative pledge clause in its loans in 1993. If the IBRD had de jure preference, there would have been neither the need for such clause, nor for pressure to waive it.

Rather than stipulating any preference, the IBRD’s Articles of Agreement contain the legal obligation to grant debt relief if and when needed. Article IV, section 6 obliges it to build up a special reserve providing for what article IV, section 7, “Methods of Meeting Liabilities of the Bank in Case of Defaults,” demands. Detailed rules are stipulated how to proceed. As the IBRD is only allowed to lend to members or with repayment fully guaranteed by member states, this logically applies to sovereign default.

All multilateral development banks mirror the IBRD’s statutes. Unlike private creditors, they all are statutorily obliged to reduce debts in case of default, but in practice they prefer to breach their statutes and not to grant debt relief. This is done both to the detriment of debtor member states and of other creditors, who have to accept much larger haircuts than legally necessary. The European Bank for Reconstruction and Development writes off losses and submits to arbitration in the way also foreseen for the IBRD. Obviously, multilateral development banks, if properly managed, can survive obeying their statutes. The IMF’s economic interest in legalizing the present unlawful discrimination of other creditors is immediately clear. It is one of the SDRM’s elements that make it an extremely self-serving proposal.

Although loudly and wrongly asserting preferred creditor status and their incapability of reducing claims, the IMF and all multilateral development banks have built up large loan loss provisions. Based on a 2002 decision to reach SDR 10 billion, the IMF’s “precautionary balances” had risen to about SDR 6 billion (8.5 percent of credit outstanding) as of the end of October 2003. Other IFIs’ provisions ranged from slightly above 20 percent (IBRD) to over 30 percent.
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All have charged their clients the costs of losses but refuse to grant reductions, claiming that they cannot finance this already prefinanced relief.

Finally, the SDRM would undo progress achieved under the Highly Indebted Poor Countries Initiative ("HIPC"), which broke the taboo of multilateral debt reductions—a great merit of James Wolfensohn. Although still unduly preferred, IFIs are not exempt under HIPC—unlike under the SDRM.

Overwhelming evidence, even by IFIs themselves, shows that IFIs force policies on debtors thus taking far-reaching decisions. Equal treatment would expose them appropriately to the risks involved, while preference for IFIs would be inequitable and unfair. However, even if IFIs only provided consultancy services like other consultants, there is no reason why the liability and financial accountability standards of consultants should not apply. IFIs do not deny that they give advice as part and parcel of services paid for by clients. The IBRD even calls itself the knowledge bank.

If consultants fail to respect professional standards or to work properly, they can be taken to court. If governments or their agents create damage by negligence, by failing to exercise their duty of care, by not obeying professional standards or acting unlawfully, governments can be sued by individuals. As a general principle, victims have a right to compensation. IFIs, however, can inflict damage with impunity, and doing so may even allow them financial gain. Developing countries and the poor remain unprotected against negligent or willful damage. Worse still, errors and negligent damage tend to increase the importance and income of IFIs. Damages caused by one negligent project or adjustment program call for a new loan to repair them, thus multiplying IFI income—"IFI-flops securing IFI-jobs." Institutions such as the IMF are economically rewarded for not applying due diligence. Such perverse outcomes are economically unjustifiable, mocking the understanding of law as *ars boni et aequi*.


54 Id at 158 (cited in note 53).
Joseph Stiglitz heard about an incident that illustrates the break from normal legal practice: an IMF country team had copied large parts of the text for one country’s report into another country’s report, even leaving the original country’s name in a few places.\(^5^5\) Jurists would hardly doubt how to classify the behavior of consultants selling an analysis of corporation A’s problems to corporation B after changing names, making B believe that it was receiving tailor-made advice for its problems.

Two more examples may suffice to demonstrate the difference between private market actors and IFIs. In 2003, a German court ordered a bank to compensate a client whom it had advised to buy Argentine bonds as high yielding yet safe investments.\(^5^6\) The court followed the plaintiff’s argument that the bank did not explain Argentina’s well-known difficulties adequately, ordering the bank fully to indemnify the client because of its advice. A British couple borrowing money from Lloyds successfully sued the bank because its manager had advised and encouraged them to renovate and sell a house at a profit. The High Court ruled that as the manager had gone beyond mere lending by giving specific advice, he should have clearly pointed out risks and advised the couple against the project. Lloyds had to pay damages when prices in the property market fell and the couple suffered a loss.\(^5^7\) The point is not whether courts found in favor of plaintiffs or defendants, but that legal redress is possible. Indeed, the principle is firmly established in all OECD countries that anyone suffering or alleging to suffer damage due to another’s fault or because of failures to observe a purely equitable duty must be able to seek redress.

No multilateral debt problem would exist if normal accountability, liability standards, and tort laws applied to Southern debtors. But IFI clients have to pay for their consultants’ negligence, which increases unpayable debts. The establishment of the IMF’s Independent Evaluation Office (“IEO”) or the IBRD’s Inspection Panel, are commendable steps in the right direction, but they do not change the underlying problem. While officially recognizing fault, they do not provide real relief: they do not provide financial redress. Simply thumbing through their internal publications provides many examples of unmet due diligence.


The IEO’s evaluation of the IMF’s role in Argentina uncovered many clear cases of, at best, grave negligence. The September 2001 “program was also based on policies that were either known to be counterproductive . . . or that had proved to be “ineffective and unsustainable everywhere they had been tried.” The IEO’s critique is further damning because it is based not on perfect hindsight but rather on views “expressed by FAD [the IMF’s Fiscal Affairs Department] at the time.” Another “critical error” was the lack of “a clearer understanding of an exit strategy in case the chosen strategy did not work.” The Board supported “a program that Directors viewed as deeply flawed” mainly because “no one has proposed a different strategy that, risk adjusted, promises a less costly alternative.” The “. . . September 2001 augmentation suffered from a number of weaknesses in program design, which were evident at the time. If the debt were indeed unsustainable, as by then well recognized by IMF staff, the program offered no solution to that problem.” The IMF “failed to use the best analytical tools, “ and “[a]vailable analytical tools were not used to explore potential vulnerabilities in sufficient depth.” The IMF was consistently unduly “optimistic” in its forecasts, as this and other reports document. This small choice may suffice to show that if the IMF were a consultancy firm and Argentina were its client, Argentina would easily win damage compensation. But the IMF is not a consultant. Argentina has to pay for programs the IMF implemented, knowing according to the IEO that these very programs contributed to her ruin. The IMF gets more interest income from a damaged Argentina than if it had successfully intervened and solved Argentina’s problems. One cannot help but concur with the statement of the Argentine Governor: “Recognizing errors is, however, just the first step in a healthy self-criticism exercise. The second step is bearing responsibility for failures, namely sharing the burden of redressing their consequences.”

59 Id at 91.
60 Id at 91, n 97.
61 Id at 75.
62 Id at 81.
63 Id at 89.
64 Id at 109.
65 Id at 110.
Internal evaluations of other cases found the same problems. A small choice of formulations may suffice to prove this: "excessively optimistic,"68 "failure to take account of the key factors,"69 "risks that were not sufficiently explored," "available data were not adequately utilized,"70 "structural weaknesses" whose "seriousness" was not "fully analyzed or stressed in surveillance reports,"71 not informing clients about dangers the IMF had recognized,72 "overpromising what the IMF can deliver,"73 or the need for "greater results orientation."74

The IEO is frequently quite explicit when it comes to IMF failures. Its analysis of Asia nevertheless fails to mention that at least one official IFI document explicitly warned that liberalizing capital accounts would lead to catastrophe in Asia. In 1999, the IBRD acknowledged having known "the relevant institutional lessons" since the early 1990s.75 An audit report by its Operations Evaluation Department on Chile's experience with precipitate capital account liberalization warned expressly that proper sequencing and institution building were mandatory to avoid damage. The risks of quick capital account liberalization had been recognized years before the crash, and the unfolding of the Asian crisis when these countries liberalized in the Chilean way could be watched like a movie whose script is known. But instead of pointing out these risks and warning Asian countries, IFIs encouraged their Asian members to carry on policies leading them straight into a crash.

Equal treatment of all creditors would be a first, yet important step76 to create disincentives for such behavior and to overcome the present victim-pays, guilty-party-gains principle. In the light of the IEO's findings, one may even

69 Id at 26.
70 Id at 17.
71 Id at 17.
72 Id at 26.
74 The recommendation to "[s]hift the emphasis . . . from the production of documents to the development of sound domestic policy formulation and implementation processes" recalls IFI publications from over a decade ago suggesting no perceptible change. Id at 7. See Raffer, International Financial Institutions and Accountability (cited in note 53).
76 See Raffer, International Financial Institutions and Accountability (cited in note 53); Raffer, 18 Ethics & Intl Aff at 61 (cited in note 50) (regarding redress in the case of IFI projects).
argue that it is too soft on IFIs and that other creditors should enjoy preference over IFIs. The SDRM attempts to bar even equal treatment, and to preserve the present legally, morally, and economically perverted arrangement.

**VI. STABILIZING INTERNATIONAL CAPITAL MARKETS**

I have repeatedly advocated optional features for eliminating legal risk and stabilizing markets, especially focusing on provisioning. Eliminating avoidable problems is advantageous to both creditors and debtors.

Because continental European banks had appropriate loan loss provisions, they were much less affected by the 1982 crisis than US and Japanese banks. Tax deductible loan loss provisioning had encouraged the former to recognize economic reality. Sufficient provisions would have allowed them to realize losses immediately if needed, while US banks had claims vis-à-vis some large countries so high that losses might have wiped out their equity.

Tax deductible provisions have often been misunderstood as a taxpayers' subsidy. Costs to taxpayers, and hence the benefits to banks, or other creditors (such as corporations outside the financial sector), have always been strongly exaggerated.

Loans still kept at 100 percent on the books have lower factual or real values once creditworthiness and economic standing of debtors have become doubtful, as the existence of secondary markets proves. From an economic and factual point of view money is actually lost before nominal claims are eventually adjusted downwards in the books. Recognizing diminished values of claims is just another way of stating that the sum of net assets, and thus the tax base, has declined. Reducing claims immediately to secondary market values would make this absolutely clear, but is patently unfeasible. Not least, it would encourage debtors not to honor their obligations in full.

To the extent that provisions reflect actual losses in the values of loans already suffered but not yet booked, they do not economically constitute taxable income. This would be the case if loan loss reserves set aside during one year are equivalent to the change in factual values during that year. Increasing reserves continuously in line with declining factual values would thus not really cost taxpayers a single cent. Should the economic outlook of the debtor improve,

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these reserves would, of course, have to be reduced accordingly to keep provisions in line with actual losses. A tax regime without tax deductibility of reserves taxes illusory profits existing only because of tax laws. The Treasury gets an interest-free loan as losses are shifted to the future. An economist can only wonder why banks in jurisdictions restricting or refusing tax deductibility have not protested against paying too much tax.

Because the real world is not an economist's comfortable blackboard, uncertainty will not allow a precise estimate of probabilities (and thus factual values) in practice. One may discuss whether reserves actually match losses already suffered. If reserves are larger banks get a loan by tax authorities equivalent to this difference between reserves and changes in the values of loans; if reserves are smaller this difference is taxed as illusory income. The respective amounts are:

$$[100(1 - p) - \text{reserves}] t_i g$$

where

\begin{align*}
\text{p} & = \text{repayment probability, hence} \\
100p & = \text{expected value,} \\
t & = \text{tax rate} \\
i_g & = \text{interest rate at which the Treasury itself borrows.}
\end{align*}

The first term in square brackets expresses actual losses. If set aside reserves are smaller than actual losses, the term in square brackets is simply illusory income taxed. If reserves are larger, this would be a temporary loan from the Treasury, which carries no interest in many countries. Such a loan would mean costs to taxpayers that are this difference times $t_i g$. At $t = 40$ percent and $i_g = 4$ percent, a difference of $100$ would result in costs of $1.60$ per year. Assuming that supervisory authorities keep loan loss reserves roughly in line with the decline in value of dubious loans, both costs to taxpayers and taxation of illusory profits will be very low or negligible. A substantial stabilizing effect can be obtained at no or minimal costs to taxpayers.

Economically, provisions have the important function of spreading losses over some years—losses which might otherwise ruin creditors if they had to absorb them in one year. Whether to have tax systems encouraging more prudential provisioning should not be decided without considering the alternatives. Continental Illinois or the case of the Savings and Loan institutions (with bailout costs at least two-hundred billion dollars) may suffice to show that extremely limited tax deductibility does not necessarily prevent costs to taxpayers. Bailouts cost money too, on top of the costs of the crises.
The introduction of my international Chapter 9 could be used to change the tax regime regarding provisioning where needed. This would perceptibly deescalate future debt crises, leaving creditors and debtors more leeway for negotiating their way out of the problem. Economically, it would also be fair to creditors.

VII. CONCLUSION

My proposal can be summarized very briefly: fundamental legal principles recognized and applied within our countries must also be respected when dealing with debtors from the South. Human rights, human dignity, and the protection by the Rule of Law must be enjoyed equally by all human beings, irrespective of passports. While the IMF’s SDRM is marred by unacceptable institutional self-interest rendering it inequitable and unfair to nearly anyone but the IMF, especially to private creditors and debtors, an international Chapter 9 offers a fair and equitable solution, and is in the best interest of bona fide creditors, debtor countries and the poor. Economic logic suggests that the IMF will continue lobbying for its SDRM at the next opportunity. Anyone affected, not least private creditors, would be well advised to explore alternatives to the SDRM, such as my proposal, that are fair to them.