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Debtor-States and an International Bankruptcy Court: The IMF Creditor Problem

Michael T. Hilgers*

Bankruptcy can happen to any person or organization. It can happen to small businesses, corporations, and multinational conglomerates; even sovereign states are not immune from financial default. Contemporary business bankruptcies are arenas for creditors and debtors to handle their negotiations in a systematic manner under national laws in national courts. Yet when a sovereign state defaults on its debts, there is no equivalent forum to adjudicate the disputes between creditors and the state. The increasing numbers of creditors of debtor-countries make creditor refusals to consent to debt restructuring, also known as creditor-holdouts, increasingly likely. In academic circles there have been several proposed remedies to the creditor-holdout problem; these include a judicially-imposed limit on remedies¹ and the staying of collective actions against a sovereign,² proposals that are designed to force creditors into good faith negotiations. The most prominent, far-reaching, and controversial proposal is an international bankruptcy court (“IBC”) that has the power to supervise and enforce negotiations between a nation and its creditors.

The idea of an IBC is not new; the idea of universalism, or “one law, one court,” has enticed academics for years.³ However, until the recent International Monetary Fund (“IMF”) proposal to create an IBC, there had been no effort to turn the abstract into reality. Though the IMF action is welcomed, it is

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¹ Samuel E. Goldman, Comment, *Mavericks in the Market: The Emerging Problem of Hold-Outs in Sovereign Debt Restructuring*, 5 UCLA J Intl L & Foreign Aff 159, 165, 176–84 (2000) (proposing a regime where bankruptcy cases with high damages are dismissed with leave to amend).

² Philip J. Power, Note, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings*, 64 Fordham L Rev 2701, 2763–68 (1996) (arguing that basic protections of the US Bankruptcy Code should be extended to future negotiations between sovereign and creditor).

³ See Frederick Tung, *Is International Bankruptcy Possible?*, 23 Mich J Intl L 31, 34–35 (2001).

imperfect.⁴ Some flaws are minor, while others are inherent to the IMF itself and are incurable regardless of the specific plan. A fundamental flaw in the proposal is the IMF Creditor Problem: the IMF cannot be an objective and unbiased arbiter in cases where it has a substantial financial interest as a creditor.

This Development uses US law as a guide to analyze the problems of having the IMF as both a creditor and international arbiter of sovereign bankruptcies. Part I provides a brief background of sovereign bankruptcies, global capital markets, and the IMF. Part II illustrates the effectiveness of the US system, and how the application of the US Code could efficiently handle some problems inherent in an IMF-based bankruptcy proceeding. Part III deals with the IMF Creditor Problem. The Development does not argue normatively whether an IBC in the abstract should exist. And though it specifically analyzes the unique problem of an IMF-run court, the initial conclusions of Part II apply equally to any IBC effort.

I. GLOBAL CAPITAL MARKETS, SOVEREIGN BANKRUPTCIES, AND THE IMF

Foreign states' borrowing trends have evolved over the last sixty years. At the beginning of that period, countries would borrow primarily from the IMF.⁵ Even though the IMF had access to billions of dollars, two conditions pushed borrowing countries away from the IMF. First, the pool of money did not keep pace with inflation in the 1960s.⁶ Second, the IMF tied the loans to numerous economic conditions that were designed to improve the economic situation, but were often difficult to meet.

The difficult conditions imposed by the IMF led borrowing countries to search for alternative sources of funding. These countries found that the more flexible commercial banks—at the time flush with money from OPEC deposits in the 1970s—were better able to fuel their financial appetite.⁷ Unfortunately, in many countries economic conditions only worsened; as a consequence, such countries were forced to take out more loans simply to pay off the interest on

⁴ The IMF proposes to base its court on US Chapter 11 bankruptcy laws. For initial details on the IMF plan, see Anne Krueger, *International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring*, Address before the American Enterprise Institute (Nov 26, 2001), available online at <<http://www.imf.org/external/np/speeches/2001/112601.htm>> (visited Mar 30, 2003).

⁵ For a thorough recounting of global borrowing practices, see Theodore Allegaert, *Recalcitrant Creditors Against Debtor Nations, or How to Play Darts*, 6 *Minn J Global Trade* 429, 433–43 (1997).

⁶ *Id.* at 434.

⁷ *Id.*

old loans. These new loans were called “bridge loans.”⁸ However, this method of payment could not be sustained, and the perceived solution was use of the so-called “Brady Bills”: US-backed Treasury bonds sold to the public.⁹ Because Brady Bills made securitized sovereign debt available as Treasury bonds, they opened up the sovereign financing to a larger pool of investors. Throughout each phase of the global lending transformation, from the IMF to banks to US investors, both the volume and diversity of investors have increased. The most recent evolution of lending, global bonds, follows this trend.¹⁰ While providing more financial stability for debtor-states, global bonds also increase and diversify the creditors of the state more than any previous form of borrowing. However, as a result, debtor states are more likely to experience creditor-holdout problems.

Creditor-holdouts are “one of the primary barriers to orderly sovereign debt restructurings and, hence, one of the sources of global financial instability.”¹¹ Typically, when a country defaults, the debtor-state and its private creditors negotiate a debt restructuring. The restructuring eases the state’s short-term financial burden; in return, the creditors get higher interest rates and higher payouts. Executing a restructuring plan between a sovereign state and its creditors usually requires a unanimous vote from the creditors.¹² While many, indeed most, creditors have an incentive to restructure, not all do.¹³ As the number of creditors increases, through global bonds and the like, the probability of a creditor-holdout increases. Exacerbating this situation is the possibility that creditors may sue in US courts to recover from the debtor states.¹⁴ Because the possibility of a lawsuit is a realistic threat to a restructuring, the leverage it creates can embolden creditors to stall for better terms or bolt completely and sue for repayment. It is this power of creditors—to hold up the many for the concern of a few—that the IBC is designed to contain. To do so, the IBC would need jurisdiction over all of the parties, the authority to order or oversee negotiations, and the power to have its rulings bind the parties.

⁸ See Jessica W. Miller, Comment, *Solving the Latin American Sovereign Debt Crisis*, 22 U Pa J Intl Econ L 677, 681–82 (2001).

⁹ Id at 685–87.

¹⁰ Id at 687–88.

¹¹ G. Mitu Gulati and Kenneth N. Klee, *Sovereign Piracy*, 56 Bus Law 635, 637–38 (2001).

¹² Goldman, 5 UCLA J Intl L & Foreign Aff at 164 (cited in note 1).

¹³ See Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 Cornell L Rev 956, 960–61 (2000) (“One or more creditors may hold out, hoping that the need to reach an agreement will induce other parties to buy out their claims or pay them a premium.”).

¹⁴ Goldman, 5 UCLA J Intl L & Foreign Aff at 197 (cited in note 1).

The IMF is an organization created in part to “provide temporary financial assistance to countries to help ease balance of payments adjustment.”¹⁵ The IMF is essentially a savings and loan for sovereign states.¹⁶ The organization is made up of 184 countries, each of which contributes (in varying degrees) to the operating pool of money that the IMF uses for its bailouts.¹⁷

These bailouts are unique and generally not as flexible as bank loans, and therefore are not as desirable. IMF disbursements are tied to the fulfillment of certain macroeconomic conditions designed to solve the immediate debt problem, as well as lay the groundwork for economic stability.¹⁸ These conditions are typically difficult to meet, and some commentators maintain that in some cases the conditions imposed by the IMF have actually worsened the economic situation of the debtor country.¹⁹ Moreover, the IMF relies on intermittent funds from its member-states, making it difficult for the IMF to effectuate timely and effective disposals of large sums to debtor countries.²⁰ As a result, the IMF is a less than ideal lender. In spite of these shortcomings and the decreasing reliance on the IMF, it is still a multi-billion dollar player on the global borrowing scene.²¹ The IMF’s strength as a worldwide financing organization, coupled with its preexisting institutional infrastructure, makes it a ready candidate to establish an IBC.

II. THE US CODE AND CONFLICTS OF INTEREST

A successful bankruptcy proceeding requires an unbiased and objective arbiter. Objectivity not only ensures a fair and reasoned proceeding for the negotiating parties, but also preserves the credibility and respectability of the bankruptcy system as a whole. A judicial stake in the outcome creates a conflict of interest that impedes objectivity. The US system has effectively overcome this obstacle with a relatively simple system for the identification and remediation of potential problems. In most instances, as this Part shows, the IMF could have similar success in eliminating conflicts of interest by following a similar system. While an IMF-based bankruptcy may have an increased potential to generate

¹⁵ *About the IMF*, available online at <<http://www.imf.org/external/about.htm>> (visited Mar 30, 2003).

¹⁶ For general information about the IMF, see id.

¹⁷ See *The IMF at a Glance*, available online at <<http://www.imf.org/external/np/exr/facts/glance.htm>> (visited Mar 30, 2003).

¹⁸ See Schwarcz, 85 Cornell L Rev at 963 (cited in note 13) (noting that two possible requirements the IMF may impose are a domestic balanced budget and devaluation of local currency).

¹⁹ See, for example, Jeffrey D. Sachs, *50 Years On: IMF, Reform Thyself*, Wall St J A14 (July 21, 1994).

²⁰ Schwarcz, 85 Cornell L Rev at 967 (cited in note 13).

²¹ Id at 962 (noting a recent \$42 billion IMF loan package to Brazil).

conflicts of interest, this Part demonstrates that this is not an altogether alarming problem.

In the US, a judge must disqualify himself from bankruptcy proceedings where the judge knows that “he ... has a financial [or other substantial] interest in the subject matter in controversy or in a party to the proceeding”²² The first step is identifying a conflict of interest. In a typical case, with one or two parties on each side, this is done fairly quickly because a jurist “can simply compare his families’ [sic] holdings with the names on the caption to the complaint.”²³ However this process necessarily becomes more difficult with multiple parties, particularly in class actions, due to the increased identification costs of searching through thousands of class members for a possible conflict. Moreover, class actions bring a greater probability of large substitution costs.²⁴ A judge may not certify a class until the case is well underway, and the class members may not be determined until long after that. At that point, substitution would be especially costly in terms of apprising a new judge of the nuances of the case.²⁵

An IMF-based proceeding, because of the large number of creditors, facially implicates this class-action identification problem. However, knowing the creditors in advance eliminates the substitution-cost concerns of having to remove the judge after the case is well underway. The situation reduces itself to a simple, albeit somewhat costly, administrative matter of matching up parties with the judge to find any potential conflicts. If used in the IMF context, we should not expect the costs to diverge significantly from those in the US context, making the US Code a valuable model for identification of conflicts in an IMF system.

Under the US Code, identified interests are per se violations of the statute, and require immediate removal of the judge from the case.²⁶ Generally, per se rules over-enforce, requiring a judge with a technical conflict of interest to recuse herself even if she is not actually biased. Those costs are typically negligible; an unbiased, though disqualified, judge will not hurt the system, as long as there are sufficient jurists available and the judge is not replaced with a biased one. An additional problem with a per se rule is that it could lead to a disruptive disqualification if many judges have similar conflicts. Because of the large number and varied backgrounds of American bankruptcy judges, the types of interests that could disqualify a judge—for example, stock ownership or familial ties—are not uniform across the judiciary. For example, not all judges

²² 28 USC § 455(b)(4) (2000).

²³ *In re Cement and Concrete Antitrust Litigation*, 515 F Supp 1076, 1080 (D Ariz 1981).

²⁴ *Id.*

²⁵ *Id.* (“To switch judges in mid-stream not only wastes judicial time and energy, but can constitute a substantial administrative burden.”).

²⁶ *Id.*

own Citibank stock, nor are all judges married to a Bank of America Vice President. Applying the removal statute per se in the US therefore does not cause a system-wide disqualification; as a result, the overall cost of such a regime is negligible. The alternative, a “reasonableness” test, would eliminate fewer unbiased jurists but would cost more to implement.²⁷

Now consider the composition of an IMF court, and assume that American citizens make up a significant number of its judges. The major parties involved in IMF bankruptcy proceedings, such as large banks, governments, and the IMF itself, will presumably want IMF judges to be knowledgeable about international investment. At the margin it would be more likely that an IMF judge would have a connection to a typical creditor of a debtor-state (for example, a large financial institution) than a US judge, who is simply needed for his knowledge of bankruptcy, not other investment-related fields.²⁸ Further, it is quite unlikely that the IMF would have more judges than the US bankruptcy system.²⁹ The combination of these factors makes it not only more likely that a judge sitting on the IBC would be disqualified, but that the damage done from each judge who is removed would increase. Here, then, the per se application makes it more likely that there would be a shortage of judges, which could limit the effectiveness of the IMF court and possibly under-represent certain nations’ interests.

While this dynamic may be more problematic in the IBC context than in the US situation, there are relatively painless solutions available. One is to increase the number of judges and rotate them based on the case at hand. Given that creditors are known from the outset, it should not be too difficult to create an objective panel of judges. The system could simply screen each potential judge for familial ties and include a divestiture or opt-out regime for any interest in financial institutions. Considering the likely caseload of an IBC, taking these

²⁷ For the proposition that such reasonableness (rule of reason) tests are more costly than a per se rule, see Gail F. Levine, *B2Bs, E-Commerce & the All-or-Nothing Deal*, 28 Rutgers Comp & Tech L J 383, 427 (2002) (“[R]eviewing all-or-nothing cases under the rule of reason and not the per se standard will likely add administrative costs.”).

²⁸ See Raymond N. Hulser, Comment, *The Rejection of Collective Bargaining Agreements in Chapter 11 Reorganizations: The Need for Informed Judicial Decisions*, 134 U Pa L Rev 1235, 1243–44 (1986) (arguing that bankruptcy judges’ technical expertise for handling reorganizations does not necessarily extend to other fields).

²⁹ By statute, there are just over three hundred authorized federal bankruptcy judgeships in the United States. 28 USC § 152(a)(2) (1994). In the first quarter of 1997, there were more than 300,000 bankruptcy filings in the United States. Administrative Office of the US Courts, *Record Level Filings Warrant Creation of New Bankruptcy Judgeships* (June 19, 1997), available online at <http://www.uscourts.gov/Press_Releases/bkhrpr.htm> (visited Feb 27, 2003). Because at the international level there were far fewer bankruptcy actions in the 1980s and 90s, see Schwarcz, 85 Cornell L Rev at 958 (cited in note 13), it is a safe assumption that an IBC would require less judgeships than the US system.

precautions should allow full application of the American system to an IMF court.

III. THE IMF CREDITOR PROBLEM

The biggest concern, and most difficult to overcome, is the IMF Creditor Problem. The billions of dollars that the IMF gives out are not gifts. They are loans, and as such they make the IMF a direct creditor of sovereign states. The IMF Creditor Problem has two parts. The first is obvious—how can the IMF claim impartiality in a proceeding where it has billions of dollars at stake? Notwithstanding the shareholder “ownership” of the IMF, the IMF and its bureaucrats have direct financial and political interests in recouping the IMF’s loans. The second part of the problem deals specifically with the conditions attached to IMF loans, and how the IMF is trapped between internal consistency and sound economic policy.

First, because the IMF is a direct creditor of debtor-nations, the IMF is a particularly poor choice as an arbiter. A US judge cannot preside over a bankruptcy when he is a creditor in that same bankruptcy proceeding—neither should the IMF. At first blush this appears to be an apples and oranges comparison. Certainly it is true that if the United States is a creditor in a domestic case, then a US judge, with no other conflict of interest, could oversee the negotiations. Even though the judge is a US citizen and presumably has an interest in seeing the US be successful, for example, in claiming back taxes, we would not expect the judge to be removed solely because of that interest. Analogously then, even though the IMF as a body has a direct interest in the outcome, we can expect that an otherwise unbiased judge could handle the case. While perhaps technically true, in the reality of global lending, such a scenario would have a *perceived* conflict of interest that the US situation does not have. For example, suppose that Citibank is a major creditor of Argentina, and that a vice president of domestic operations at Citibank, who deals solely with small business loans in the US, is appointed to the IMF court because of her expertise in commercial matters. In almost all respects she would be an objective arbiter. Nevertheless, such a situation would not be perceived as objective—the conflict of interest of the organization supersedes any particular objectivity of the individual.

The second problem concerns the condition system of the IMF. If the IMF controls the bankruptcy proceedings and restructures the debt owed to it, will the original conditions that the IMF set still be operative? Making this question particularly problematic is that some commentators see IMF loan conditions as causing the poor macroeconomic situation that brought the

country to the court in the first place.³⁰ If the IMF bankruptcy court admits that the IMF bailouts were failures and alters the loan conditions accordingly, such a decision makes the IMF internally inconsistent. But if the IMF bankruptcy court maintains internal consistency by holding that the IMF loan conditions were legitimate and should be maintained, the underlying economic problems are possibly perpetuated and exacerbated. Though either choice damages the credibility the IMF needs to run a successful and legitimate IBC regime, it is more likely that the court would err on the side of enforcing loan conditions set by the IMF. If one IMF bureaucracy cannot see the ineffectiveness of these loan conditions, it cannot be that another IMF bureaucracy will arrive at a different result. The situation does not necessarily change even if one assumes that the IMF loan conditions are currently working. Even the most effective bureaucracies sometimes make mistakes, and past success in setting loan conditions is no guarantee of future success. It is a matter of when, not if, an IMF-backed IBC would have to right an IMF wrong. At that stage, as in the US system, an independent arbiter is necessary, and this is something that the IMF cannot provide.

IV. CONCLUSION

An IMF-based bankruptcy court would run into many difficulties. Some of these roadblocks, including concerns over conflicts of interest, can be remedied or circumvented by applying the US Code. The IMF Creditor Problem, however, is inherent in any IMF bankruptcy proposal and cannot be remedied. This structural reality may not be enough to stop the creation of such a court. If creditors, mostly from rich Western nations, want the stability of some form of international bankruptcy court, poorer countries may have little choice—accept the court or go without money. But if a court is to be created, it should not be under the auspices and oversight of the IMF. Fortunately, most investors (as well as debtor-states) currently oppose the creation of an IMF-backed court.³¹ Moreover, the US government has criticized the creation of a supranational bankruptcy court.³² Clearly, the IMF gives loans to sovereign nations with the expectation that those loans will be repaid, and rightly so. While creating a bankruptcy court within the IMF organizational structure might help it to recoup some of that money, it would ultimately be a futile attempt at solving sovereign bankruptcies.

³⁰ See, for example, Sachs, *50 Years On: IMF, Reform Thyself*, Wall St J at A14 (cited in note 19).

³¹ See, for example, Adam Lerrick and Allan H. Meltzer, *Sovereign Default: The Private Sector Can Resolve Bankruptcy Without a Formal Court*, in Carnegie Mellon Gailliot Center for Public Policy, *Quarterly Intl Econ Report* (Apr 2002), available online at <<http://www.house.gov/jec/imf/bank.pdf>> (visited Mar 30, 2003).

³² *Id.*