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May 26, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Note on an International Debt Adjustment Facility for Sovereign Debtors

Attached for consideration by the Executive Directors is a note on an international debt adjustment facility for sovereign debtors, which will be discussed in a seminar in late June on a date to be announced.

Mr. Gianviti (ext. 38329) or Mr. Morais (ext. 37788) is available to answer questions relating to this paper.

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Foreword to the Note on an International Debt Adjustment Facility for Sovereign Debtors

The purpose of the attached note is to identify and discuss the issues that would have to be resolved for achieving an orderly and comprehensive adjustment of a country's external debt. Drawing on relevant rules under national laws (which are not applicable to sovereign debtors), the note discusses the possible scope of an international debt adjustment facility, its operation, its mode of establishment, and its structure.

In terms of scope, the note discusses three main issues: whether such a facility should cover only sovereign debt obligations or also the liabilities of other public and private entities; assuming that the debt adjustment is initiated with respect to a sovereign debtor's external debt, whether it would be possible to prepare a comprehensive and viable debt adjustment plan without including domestic debt and bonds; and, in view of the concerns about moral hazard, what specific financial condition (payment default, insolvency, or illiquidity) would justify a triggering of the debt adjustment procedure.

In terms of operation, the note explains how initiation of a debt adjustment with such a facility could provide an automatic stay (standstill) on all legal actions against the sovereign debtor, facilitate prompt arrangement of interim financing for the debtor, permit the preparation of a debt adjustment plan based on a sound economic analysis of the country's problems, acceptance of the plan by all categories of creditors, and monitoring of the implementation of the plan.

Assuming that there is support for the establishment of such a facility, the note explains how this could be achieved by creating a separate organ of the Fund through an amendment to the Articles of Agreement or creating a new institution under a treaty.

Finally, the note discusses the possible structure of the facility, including the need for an independent judicial organ and the relationship between the Fund and the Facility.

By design, the attached note concentrates on the legal issues involved in such a facility. But there are other aspects to the topic that would need to be resolved satisfactorily before the facility described in this paper could be established. Three main issues are how the triggering and operation of a debt adjustment procedure would affect the economy of the debtor country, how to ensure that the procedure is compatible with the provision of the new financing that adjusting debtor countries require, and

how the existence of such a procedure would affect the international cost of capital.

On the first of these points, consideration will need to be given to the way domestic and foreign economic agents would react to the initiation of the procedure. This reaction would depend on the scope of the debt to be covered by the procedure (e.g., central government or wider public sector debt, debt held by nonresidents only or by residents as well, denominated in foreign currency only or also in domestic currency). It will be important to ensure that the market reaction to the announcement of a stay on the servicing of debt under this procedure will be less dramatic than under existing less orderly procedures. It will also be important to ensure that the existence of a stay will allow the debtor government to pursue desirable economic policies, which will increase the chances of a satisfactory resolution of its problems.

On the second point, existing procedures, such as the Paris Club and in some cases the London Club, provide ways to combine debt relief with the provision of new financing in support of the debtor's adjustment or development program. It would be important to ensure that the equitable adjustment of debt is combined with the provision of new money, involving appropriate burden-sharing.

On the third point, it is vital to be sure that putting in place such a procedure would not increase the international cost of capital to an unjustified extent. Such an increase might be justified to the extent it reflected the expectation of capital markets that there would be less injection of official money to help support countries in difficulties. But if the increase was because creditors thought they would in practice have less claim on the debtor's resources, it would be problematic. It should not be assumed, however, that debt adjustment procedures would necessarily result in payments from debtors of less value than under current arrangements; for one thing, it would be of value to creditors to have an arrangement that results in a more orderly adjustment and a quicker resumption of payments than the current procedures. To counteract any possible increase in the cost of capital, the facility should be structured and operate in such a way that creditors have the assurance that the debtor will, as a result of the procedure and under an internationally sanctioned plan, be in a better position to discharge its liabilities to them.

Note on an International Debt Adjustment Facility for Sovereign Debtors

In recent years, growing concern has been expressed about the absence of an orderly process for the adjustment of a country's external debt analogous to that available to private debtors under national laws. Because there is currently no single international legal framework for dealing with such cases, solutions are largely ad hoc in nature. In some cases, where a stay of payments and an orderly workout might be appropriate, the absence of an accepted legal framework presents countries with the stark choice between unilateral action such as a moratorium and the imposition of exchange controls, or severe--perhaps unsustainably severe--adjustment measures taken in an effort to continue servicing the debt. Often, as in the recent Mexican case, loans from international institutions and other governments may be needed to support the adjustment program and help maintain the freedom of capital flows. As the scale and speed of international capital flows increase, the need for official financing in such cases is likely to increase.

Some cases do result in negotiations, often after a country has defaulted on its payments. The solutions in these cases are generally based upon negotiations between sovereign debtors and representatives of different classes of creditors, such as the London and Paris Clubs, acting independently. While the details have differed from case to case, this process of voluntary negotiation has not always been orderly, except in the Paris Club. Sometimes, the unwillingness of one or a few private creditors to participate in a London Club arrangement has prevented or delayed the conclusion of an agreement that was acceptable to the debtor and the great majority of creditors. These problems will become more acute with the growing dispersion of creditors as a result of increasing reliance by sovereign borrowers on bond issues and other securitized financing.

Various proposals have, from time to time, been put forward for a comprehensive process of debt adjustment at the international level, which would draw on the experience under national laws. Such a process would be based on a sound economic and financial analysis of the country's problems, the formulation of a realistic plan for recovery, and a proper balancing of the interests of the debtor and its creditors in a spirit of cooperation.

In some proposals, reference has been made to Chapters 9 and 11 of the U.S. Bankruptcy Code (U.S. Code). 1/ Chapter 11, like the laws of many other countries, allows a debtor or a group of the debtor's creditors to file a petition for reorganization. However, this procedure does not apply to the federal government, states, or other national public entities.

1/ Title 11 of the United States Code (1988 & Supp. V 1993) (U.S.C.).

Rather, Chapter 9 is more relevant in that it allows a municipality 1/ to file a petition for the adjustment of its debts. Chapter 9 differs from Chapter 11 in a number of significant ways: (i) the municipality must be insolvent in order to file a petition, 2/ (ii) only the municipality (and not its creditors) may file a petition, 3/ (iii) only the municipality may file a plan for the adjustment of its debts, 4/ (iv) unless the debtor consents or the plan so provides, the court may not interfere with any of the municipality's political or governmental powers, property or revenues, or use or enjoyment of any income-producing property, 5/ and (v) a Chapter 9 case may not be converted into a liquidation case. 6/ Under either Chapter 9 or 11, the legal effect of the filing of a petition is the "automatic stay" or suspension of debt collection and lien enforcement by creditors so that the debtor can continue to operate its business or affairs and prepare a plan without interference or threats of legal action. 7/

Although Chapter 11 and even more so Chapter 9 suggest interesting approaches, the issues raised by the indebtedness of sovereign debtors are too specific to be addressed only by an extension of the principles of these provisions. The mere fact that these provisions do not apply to the federal government or even to the individual states of the United States demonstrates the difficulty of such an extension. However, there may be situations where both sovereign debtors and their creditors would find it advantageous to resort to some type of legally binding debt adjustment procedure under a new international legal framework. On the basis of this assumption, this note examines the objectives of an international debt adjustment facility ("Facility") for sovereign debtors and the key elements of such a Facility. Its main purpose is to draw attention to issues that would need to be settled and difficulties that would need to be overcome before a Facility could be established.

1/ "Municipality" is defined as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40). Chapter 9 filings to date have been made largely by public agencies and instrumentalities, and to a lesser extent by political subdivisions such as cities and other local governments.

2/ 11 U.S.C. § 109(c). For municipalities, "insolvent" is defined as a "financial condition such that the municipality is (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due": 11 U.S.C. § 101(32)(C).

3/ 11 U.S.C. § 303.

4/ 11 U.S.C. § 941. Cf. 11 U.S.C. § 1121, which provides that, under certain circumstances, the trustee, a creditors' committee, or a creditor may file a plan.

5/ 11 U.S.C. § 904.

6/ Cf. 11 U.S.C. § 1112, which provides for conversion of a debt reorganization case (Chapter 11) into a liquidation case (Chapter 7).

7/ 11 U.S.C. §§ 362, 901, and 922.

I. Objectives of the Facility

In support of a proposal for a debt adjustment facility, it is generally emphasized that, in contrast with collective procedures that are in place for the orderly reorganization of private debtors' liabilities or adjustment of a municipality's debts, there are no equivalent procedures for adjustment of a country's external liabilities.

As straightforward as it may seem, this assertion contains several ambiguities, which derive essentially from (i) the dual meaning of the word "country", (ii) the concept of "external debt", and (iii) the purposes of a "debt adjustment procedure".

A. Meaning of "Country"

The word "country" may be used with two different meanings. In a legal sense, it refers to a sovereign state, which is a legal entity and a subject of international law. In an economic sense, it refers not only to the state but also to all the other agents (public and private sectors) of a country's economy.

There are a number of important differences between the state and the other agents of a country's economy. A state has specific powers and responsibilities and is protected by its sovereign immunities. Even though immunities may be waived, and do not apply to commercial activities of governments, it would be difficult, without resorting to coercion, to deprive a state of its basic governmental powers and responsibilities. Therefore, a debt adjustment procedure for a sovereign state could not be governed by the same rules as those that apply to private entities or to individuals, or even to local governments.

One possible rationale for taking the broader "economic" approach is that a sovereign state's payment default on its external debt is often due to insufficient foreign exchange in the country's economy. This lack of foreign exchange will also affect the discharge of other agents' external debts if they are payable in foreign exchange. If the broader definition is preferred, the concept of debt adjustment takes a totally different meaning. It involves not only the state's external debt but also the external debt of the public and private sectors. The task here would be huge and complex. A debt adjustment process covering all external liabilities of a given economy could lead to a situation where (i) the debtors' external liabilities would be reduced while their domestic liabilities continued to be serviced and otherwise remained unaffected, and (ii) debtors that are fully solvent could be relieved of part of their external liabilities because, taken collectively, the country did not have enough foreign exchange to meet all the liabilities of its economic agents.

In view of the complexity and difficulties that would be created by including all liabilities of the public and private sectors, it will be assumed that the word "country" is used to refer only to the state (the "sovereign debtor").

B. Concept of "External Debt"

External debt is usually understood as debt of a resident to a nonresident. However, under certain syndicated loan agreements, claims of domestic lenders are deemed to be external debt together with those of foreign lenders, usually because they are all payable in foreign exchange.

The reasons for singling out external debt may be diverse. Traditionally, foreign creditors may invoke the diplomatic protection of their national governments and, in some cases, the foreign creditors are themselves foreign governments or their public entities. This legal argument may be a sufficient justification for a special treatment of external debt. However, an economic reason has also been put forward, which is that external debt is either payable in foreign exchange or, if paid in local currency, convertible into foreign exchange. Therefore, the specific feature of external debt is that its discharge will directly or indirectly reduce the country's foreign exchange assets, and nonpayment of these debts is usually due to a shortage of foreign exchange.

The liberalization of exchange controls, including those on capital transactions, has contributed to the growing scale and speed of international capital transactions, and thus to the scale of potential crises. It also implies that domestic creditors have access to the international capital markets, and that a government's "external debt" may be partly held by local creditors. For this and other reasons, even if external debt is seen as the main problem that would justify the initiation of the adjustment procedures, there is justification once the procedures have been initiated to take into account all the aspects of the sovereign debtor's fiscal situation, including its domestic liabilities, in order to establish a viable debt adjustment plan.

While it is easy to define a shortage of foreign exchange when the exchange rate is fixed, that criterion is less clear when the exchange rate is freely flexible and determined by the market. Even in such circumstances, however, an economic shock or a change in market sentiment may drive the exchange rate to a point where there appears to be no viable way of continuing to service the external debt.

C. Purposes of a "Debt Adjustment Procedure"

A debt adjustment procedure under national laws usually consists of three stages: a suspension of individual actions for the enforcement of claims; a negotiation process, under judicial supervision, which may lead to a plan providing in particular for debt adjustment (e.g., lengthening of maturities, and reduction of interest rates and/or principal); and an implementation of the plan.

Although it is generally recognized that the existing informal arrangements for sovereign debt adjustment do not adequately cover stages two and three, it has sometimes been stated that the Fund already has the

power, under its Articles of Agreement, to achieve the equivalent of stage one, that is, a mandatory stay of enforcement actions. The relevant provision, Article VIII, Section 2(*b*), first sentence, provides:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

Under a liberal interpretation, which has been accepted by some courts (e.g., in France and, until recently, Germany), this provision would prevent the enforcement of contractual claims whose discharge has been prohibited by a member of the Fund in accordance with the provisions of the Articles, that is, either with Fund approval if this restriction is subject to approval under Article VIII, Section 2(*a*) (payments and transfers for current international transactions) or without the need for Fund approval if the measure is not an exchange restriction or is imposed under Article XIV (transitional arrangements) or under Article VI, Section 3 (capital movements). However, this interpretation has not been accepted in a number of jurisdictions that are major financial centers: the United States, the United Kingdom and, more recently, Germany (which now excludes the application of Article VIII, Section 2(*b*) to capital movements). The restrictive interpretation adopted in the United States and the United Kingdom has in fact made this provision irrelevant for the issue under consideration.

A possible remedy would be for the Fund to adopt an authoritative interpretation of this provision, which would then be binding in all jurisdictions. However, even assuming that the liberal interpretation prevails, another difficulty would have to be overcome, which is that, by definition, a government cannot restrict itself. Article VIII, Section 2(*b*) applies to exchange controls, not to defaults as such. A possible solution would be for the debtor government to discharge its debt in local currency into a blocked account. This could be regarded as a restriction, which, if it were consistent with the Articles, would give rise to the application of Article VIII, Section 2(*b*), since the restriction would be imposed after payment on the payee, who would be prevented from converting the proceeds of the payment into foreign exchange. Nevertheless, a possible objection would be that, if the contract provided for a payment abroad or in a foreign currency, the so-called payment into a blocked account would not be regarded as having discharged the government's liability; it would be a case of default, not a restriction, and Article VIII, Section 2(*b*) would not apply.

In any case, Article VIII, Section 2(*b*) could not by itself be a substitute for a debt adjustment procedure because its only effect is to delay enforcement of the contract; the substance of the debt is not altered. At best, this provision could only be a temporary remedy, a moratorium, giving the debtor some time to negotiate with its creditors.

II. Key Elements of the Facility

A. Mode of Establishment

There are two possible approaches to establishing the Facility: consensual and mandatory.

Under the consensual approach, the Fund could establish the Facility under Article V, Section 2*(b)*, which authorizes it "to perform financial and technical services", if requested to do so. Thus, for example, the Fund may agree to perform specific financial services or carry out technical services by providing advice, mediation, or good offices. This approach would allow the Fund to assist a sovereign debtor in negotiating an alleviation of its foreign debt service, but only with consenting creditors. However, the "free riders" would remain free to enforce their claims, 1/ which would put the consenting creditors at a disadvantage and may dissuade them from subjecting their claims to the Facility. There would still be no mechanism for binding all creditors to a debt adjustment plan agreed to by a majority. Without either a freeze on the right to enforce claims or a mechanism to enforce a negotiated debt adjustment plan among creditors, no orderly procedures for negotiations could be established.

The mandatory approach would require the creation of international treaty obligations, which would, either directly or through specific enactments, become part of the domestic law of participating states. The principal consequence of this approach is that the Facility would apply to all creditors attempting to enforce their claims within the territories of any of the signatory states.

Under this mandatory approach, the initial question to consider is whether the task of sovereign debt adjustment could or should be handled by an existing organ, such as the Executive Board of the Fund, or by a separate organ or institution. The task of the Facility would be a very technical and specialized one calling for economic, financial, and legal expertise: it would involve undertaking a detailed analysis of the country's debt problems, resolution of disputes with respect to particular categories of debt, and decision-making of a judicial nature. Guided by the experience with past sovereign debt reschedulings, this process can be a very time-consuming and complex exercise which would significantly expand the Executive Board's already heavy responsibilities. Moreover, in domestic legal systems, debt adjustment procedures are normally administered by courts of law, which are independent both of parties and governments; since Executive Directors are elected or appointed by governments which may

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1/ As explained above, the enforcement of foreign creditors' claims could only be suspended through a unified interpretation of Article VIII, Section 2(*b*), in cases where the Fund would find that the enforcement of these claims would be contrary to exchange controls that are consistent with the Fund's Articles.

themselves be parties (as creditors or debtors) to certain cases, there could be a perception, particularly among private creditors, of a conflict of interest. Therefore, in order to clothe it with the status of an independent judicial organ, it is important that the Facility be established as a separate organ or institution. In this regard, three possible methods may be envisaged.

The first method would be to establish a separate organ of the Fund for the specific and limited purpose of facilitating debt adjustment by sovereign debtors. This could be done through an amendment to the Fund's Articles of Agreement. The organ, which would have a quasi-judicial or arbitral character, would be managed and operated independently from the Fund's regular operations. The Administrative Tribunal of the Fund provides an example of an independent judicial organ within the Fund.

A second method would be for the Fund (and possibly also the World Bank and the regional development banks) to establish an affiliate institution. There are some precedents within the World Bank Group for the establishment of affiliates for specialized purposes, notably the International Centre for Settlement of Investment Disputes (ICSID) and the Multilateral Investment Guarantee Agency (MIGA). The Executive Directors of the Bank, assisted by staff and, in the case of ICSID, also by a special Legal Committee composed of representatives of member states, formulated the international treaty establishing each new institution and presented it to member governments for their signature and ratification. This procedure may be more efficient than convening an international conference for the preparation of an international treaty. Another way of establishing an affiliate would be for the international financial institutions jointly to sponsor the establishment of a new international organization; a precedent for this is the Joint Vienna Institute.

The third method would be for the Facility to be established as a separate international organization under a new international agreement, which all countries would be invited to sign and ratify. This approach, however, could be quite time-consuming.

The main difference between the first method and the other two is that an amendment of the Articles would bind all members, while a new treaty would leave individual countries free to participate or not. The former method would avoid the perception that certain countries intend to use the Facility as debtors, and that others have agreed that their rights as creditors may be impaired while those of other creditor countries would remain unaffected.

B. Structure and Composition

If the consensual approach is adopted and a special organ is established, the Fund would perform the functions of the Facility using its staff and resources.

If the mandatory approach is followed, two alternative structures could be envisaged. If a separate organ of the Fund were to be established, it could be an independent judicial organ of the Fund, like the Administrative Tribunal. 1/ If a separate affiliate or a new international organization were to be established, ICSID and MIGA are possible models. In this case, the Facility would be set up as a public international organization whose members would be sovereign states, both "debtor" states and "creditor" states (i.e., states in their capacity as official creditors or as "representatives" of private creditors). Like ICSID, the Facility should preferably be independent of the multilateral financing institutions and have a lean administrative structure, possibly headed by a Secretary-General; and the "arbitral" organ of the Facility should consist of prominent and internationally-respected persons with relevant economic, financial, and legal expertise.

Although private creditors cannot become members of a public international organization, their claims may constitute the bulk of external debt owed by a sovereign debtor. A way must be found to provide representation to such creditors. One possibility would be to set up a Creditors' Committee to serve in an advisory capacity to the Facility; the composition of the Committee would vary from case to case depending on the country, the composition of its debt, and the creditors involved. The Committee could then act as the channel of communication among the sovereign debtor, its creditors, and the Facility.

C. Eligible Debt

For any debt adjustment plan to be viable, all or most of the sovereign debtor's external obligations (including guarantees of other debtors' liabilities) would need to be brought under the purview of the Facility. Moreover, as explained below, consideration will have to be given to the inclusion of domestic liabilities.

A major problem would be the identification of all creditors; difficulties could arise particularly with respect to the holders of bearer bonds. It would be desirable, therefore, for the Facility to establish, with the assistance of the debtor, a registry of all creditors. 2/ Where necessary, notices could also be placed in newspapers around the world requiring all creditors of the sovereign debtor (including particularly the

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1/ The Administrative Tribunal, whose members are "officers of the Fund," adjudicates disputes between staff members and the organization; these members "shall be completely independent in the exercise of their duties" and "shall not receive any instructions or be subject to any constraint." (Statute of the Administrative Tribunal of the Fund, Article VIII)

2/ Under Chapter 9, the municipality prepares a list of creditors: if a creditor is on the list, it is then deemed to have filed a claim; if not, the creditor is required to file a claim: 11 U.S.C. §§ 501, 901, 924, and 925.

holders of bearer bonds) to register the sovereign debt obligations held by them with the Facility; failure of a creditor to register could result in its debt being extinguished. 1/ In addition to the identification of creditors, disputes on the existence and amounts of claims may arise in some cases and would have to be settled.

Rescheduling agreements in recent years have defined the "eligible debt" to be rescheduled. The term usually covers the external debt of the government, central bank, and other public sector institutions owed to commercial banks and other private financial institutions (which debt is currently the subject of London Club rescheduling) 2/ and to bilateral official creditors (which debt is subject now to Paris Club rescheduling). 3/ Debt owed to creditors in the London and Paris Clubs represent a significant portion of the external debt of many highly-indebted countries and, as such, should be included in any debt adjustment plan. Such inclusion would not necessarily preclude separate negotiations and conclusion of agreements by these creditors within the framework of a debt adjustment plan established by the Facility. In view of the experience in sovereign debt rescheduling acquired over the years by the London and Paris Clubs, it is important that their views be taken into account by the sovereign debtor and the Facility in the development and confirmation of the debt adjustment plan. The experience of the Paris Club, in particular, is noteworthy because it has demonstrated the capacity to operate flexibly and effectively in handling official debt in close association with Fund programs; and it has also provided increasing debt reduction to low-income countries and has rescheduled debt in a way that has encouraged the provision of new money. Accordingly, the Facility should establish detailed arrangements for closely coordinating its work with creditor groups such as the London and Paris Clubs. These arrangements should include provision for consultations and communications between the Facility, the debtor and the two Clubs in the preparation and finalization of the debt adjustment plan, and inclusion of cross-effectiveness provisions in the agreements of the creditors concerned with respect to acceptance of the plan.

1/ But see 11 U.S.C. § 944(c), which provides that debt held by creditors which had neither notice nor knowledge of the Chapter 9 case, is not extinguished when the plan is confirmed.

2/ Debts of private sector entities are normally excluded unless they are guaranteed by the government.

3/ Paris Club debt consists of both loans extended directly by official creditors, and loans extended by private creditors but guaranteed or insured by export credit agencies; in the case of the latter category, upon default and payment under the guarantees, the export credit agencies would take over the private loans through subrogation. Thus, the so-called "official debt" covered by the Paris Club frequently includes a significant element of debt initially owed to private creditors.

There are, however, a number of other categories of sovereign debt that could raise some problems, depending on their inclusion in or exclusion from any debt adjustment process.

The first category is debt incurred with domestic creditors, denominated either in foreign or local currency. In the past, sovereign debt reschedulings have generally been limited to a country's external debt incurred primarily with nonresident creditors; the rationale for this practice was that the rescheduling was directed towards conserving scarce foreign exchange resources. However, in the light of both the significant growth in domestic public debt (sometimes payable in foreign currency) in the highly-indebted countries and the transferability of claims (bearer bonds, securitization of debt), and of proceeds from payments between residents and nonresidents, it is becoming increasingly clear that the external debt situation cannot be analyzed effectively in isolation from the domestic debt situation. 1/ First, a high level of domestic debt contributes to a country's fiscal deficit both directly and also by affecting the level of interest rates and thus affects the ability of the country to service its external debt; if the fiscal deficit is to be reduced, there is no reason in principle why domestic debt should be excluded from the debt adjustment process. Second, in the light of the growing internationalization of capital markets, the distinction between foreign currency and local currency debt obligations is becoming less relevant. Finally, exclusion of domestic debt would result in domestic creditors being given preference over foreign creditors. Given the objective of a debt adjustment, which is to provide relief to a financially distressed country, there appears to be a strong case for including domestic debt in any debt adjustment process. However, it has to be recognized that this would greatly enlarge the scope, and complicate the task, of the Facility.

The second category is debt owed to secured creditors. Under most national laws, secured creditors are included under a reorganization or debt adjustment plan. However, their claims have priority. 2/

The third category is debt evidenced by bonds. Some of the middle income sovereign debtors (e.g., Mexico and Venezuela) have issued various series of bonds, which were purchased by both large institutional and small private investors in the international bond markets; several of these bonds were issued in bearer form. Further, as a result primarily of the Brady debt reduction transactions, a very significant proportion of the external debt obligations of several of these debtors (e.g., Argentina, Brazil, Costa Rica, Philippines, Mexico, Uruguay, and Venezuela) is represented by bonds fully collateralized as to principal and partially as to interest.

1/ See Guidotti & Kumar, Domestic Public Debt of Externally Indebted Countries (IMF Occasional Paper 80, 1991).

2/ See 11 U.S.C. §§ 506 and 507.

Bonds have generally been kept out of rescheduling, 1/ and no institutional framework currently exists for consideration of debt adjustment in respect of bonds. However, any debt adjustment plan, if it is to be viable, must include bonds. Representatives of various classes of bondholders could be appointed, and bondholders who had registered their claims with the Facility would be permitted to vote on the adoption of a final debt adjustment plan.

The fourth category is short-term debt such as letters of credit, suppliers' credits, commercial paper and notes (which usually have a maturity of three to six months) and other contractual claims. The solution here, as in most previous reschedulings, could be to exclude all short-term debt (e.g., all debt with a maturity of less than one year). 2/ However, this might encourage the incurrence of short-term external liabilities by sovereign debtors, a potentially undesirable outcome.

The fifth and final category of debt is that owed to multilateral financial institutions such as the Fund, the World Bank, and the regional development banks (MFIs). On the one hand, as noted earlier, for any debt adjustment procedure to be truly effective, all or most of the debt of the sovereign debtor should be included. On the other hand, debt owed to MFIs has consistently been excluded from previous debt reschedulings for strong

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1/ In recent years, however, bonds of a number of countries have been rescheduled, e.g., Costa Rica (1985), Nigeria (1988), Guatemala (1989), and Panama (1994). There have also been several instances in the more distant past when sovereign bonds have been rescheduled on an ad hoc basis. In 1953, the London Agreement on Germany's External Debt included provisions for the reduction in principal and rescheduling of a number of bond issues, including the Young Loan of 1930. Other examples of bond rescheduling are those negotiated by the British Corporation of Foreign Bondholders (1868), which reached settlement on various bonds issued by national, state, and municipal governments of several foreign countries; the U.S. Foreign Bondholders Protective Council (1933), which did the same with several governments in Latin America and Europe that had defaulted on foreign dollar bonds they had issued; the Association Nationale des Porteurs Français de Valeurs Mobilières (1898); the Association Belge Pour La Défense des Détenteurs de Fonds Publics (1898); and the League of Nations Loans Committee (1930s) which assisted bondholders and defaulting debtor governments in reaching a settlement on various bonds issued by the latter. The British Corporation officially opposed writing down principal, but forgave interest arrears, made concessions on future interest payments, and allowed repurchases of defaulted bonds. The U.S. Council reached temporary and permanent settlements that provided for resumption of interest and amortization payments and, in certain cases, for a reduction of principal or interest.

2/ Short-term credits have, however, been rescheduled in a few cases, e.g., Zaire and Nigeria, where holders of letters of credit exchanged those claims for longer-term bonds.

policy reasons: first, these institutions make loans in circumstances under which other lenders would not participate, and second, a reduction in the value of debt to such institutions affects all members including the debtor. Furthermore, in the case of the World Bank, the policy against rescheduling is designed to protect its triple-A credit rating in the international bond markets, where it is the largest borrower. On balance, given these reasons, the debt to MFIs should be excluded from the purview of the Facility.

The above problems concerning the definition of "eligible debt" would need to be resolved at the outset as they are fundamental to the establishment and successful operation of the Facility.

D. Operating Procedures

The following procedures may be considered for the operation of the Facility in dealing with sovereign debtors:

1. Qualification for Access to Facility

The first question to consider with respect to the initiation of the debt adjustment process is what would be the specific situation that triggers or justifies initiation of the process.

Under some national laws, there are no filing restrictions based on the financial condition of private debtors. 1/ However, most other laws require that the debtor be either illiquid or insolvent. 2/ It would not be appropriate to base a petition of a sovereign government on accounting insolvency, meaning a situation where its liabilities exceeds its assets.

1/ Although Chapter 11 does not have a filing restriction based on financial condition, Chapter 9, which applies only to municipalities, does: 11 U.S.C. § 109(c). The U.K. law does not require a company debtor to be insolvent in order to file a petition for a company voluntary arrangement. However, for a court to make an administration order, a company must be, or be likely to become, "unable to pay its debts": Insolvency Act 1986, §§ 8(1)(a) and 123, 2 U.K. Stat. 1027 (1986) (hereinafter U.K. Act).

2/ For example, the French law provides that proceedings may be initiated where it is "impossible" for the debtor "to pay its debts from available assets," and where there has been a "cessation of payments" to creditors: *Loi no. 85-98 du 25 janvier 1985 relative au redressement et à la liquidation judiciaires des entreprises*, Art. 3 (hereinafter French Law No. 85-98). The Italian law is quite similar to the French: Royal Decree No. 267 of March 16, 1942, Art. 5, *Gazetta Officiale*, No. 81 (April 6, 1942) (hereinafter Italian Law No. 267). The new German statute requires illiquidity, imminent illiquidity, or, in some cases, insolvency: *Insolvenzordnung vom 5. Oktober* 1994, §§ 17-19, *Bundesgesetzblatt I S.* 2866 (hereinafter German Statute).

The U.S. Code, unique among the laws of the major national jurisdictions, allows one type of public debtor, municipalities, to file a petition for debt adjustment. 1/ Chapter 9 provides that the municipality must be "insolvent", which is defined as a financial condition such that the municipality is generally not paying, or is unable to pay, its debts as they become due. 2/ This definition seems to refer to a condition of illiquidity, i.e., a problem of cash flow, 3/ rather than insolvency proper (which denotes an excess of liabilities over assets). 4/ Since sovereign debtors have the power to generate assets through taxation, the test of insolvency (as it is generally understood) would seem inappropriate. Recourse to the Facility by a sovereign debtor should preferably be based on its actual or prospective inability to service external debts as they become due, i.e., illiquidity.

2. Right to Petition Facility

The next question is: who should have the right to petition the Facility for debt adjustment?

Most national laws permit the debtor or a group of its creditors to file a petition initiating a proceeding. 5/ However, under Chapter 9, only the municipality may file a petition for debt adjustment. 6/ In the case of sovereign debtors, the latter voluntary approach would be the preferred and primary method of initiating a debt adjustment procedure. The sovereign debtor is in the best position to know its economic and financial situation and, therefore, also able to foresee any future debt servicing difficulties.

1/ Municipalities are unique among governmental entities in this respect; neither state governments nor the federal government may file a petition under the U.S. Code: 11 U.S.C. §§ 109(c)(1) and 101(40).

2/ 11 U.S.C. § 101(32)(C).

3/ In the case of In re City of Bridgeport, 129 B.R. 332 (Bankr. D. Conn., 1991), the court dismissed a Chapter 9 petition filed by the City of Bridgeport on the ground that the city was not insolvent. The court stated that "Chapter 9 offers a solution to chronic economic distress caused by costs and revenues spiraling in opposite directions, but Chapter 9 is not available to a city simply because it is financially distressed." Ibid. at 336. The court declared that, to be insolvent, "a city must prove that it will be unable to pay its debts as they become due in its current fiscal year or, based on an adopted budget, in its next fiscal year." Ibid. at 338.

4/ See 11 U.S.C. § 101(32)(A) and (B).

5/ See 11 U.S.C. §§ 109, 301, and 303; French Law No. 85-98, Art. 4; U.K. Act, § 9. In France, the court also may initiate proceedings *ex officio* or at the request of the state: French Law No. 85-98, Art. 4.

6/ 11 U.S.C. § 303.

To address the concerns of private creditors, consideration may be given to the possibility of permitting governments of "creditor countries" (either as creditors in their own right or in the exercise of their diplomatic protection of national creditors) to petition the Facility for a sovereign debt adjustment. If this is considered appropriate, the right to petition should be limited to situations where the sovereign debtors' inability to service its external debt has been evidenced by actual cases of debt service payment default.

Consideration may also be given to the possibility of authorizing the Managing Director of the Fund to notify the Facility of a situation in which, in his opinion, the sovereign creditor should have filed a petition, in which case the process could be initiated *ex officio* by the Facility. The Managing Director's initiative would be preceded by appropriate consultations, in particular with the sovereign debtor and the governments of major creditor countries.

Under each of the above three methods of accessing the Facility, the final determination as to whether initiation of the debt adjustment process meets the required conditions will be made by the decision-making organ of the Facility. Under the first two possibilities, it may also be worth considering whether the Managing Director of the Fund should be consulted prior to the filing of a petition with a view to ensuring that there is a *prima facie* case for such a petition.

3. Automatic Stay

Sovereign debtors usually own or maintain property and other assets, including bank accounts, in several foreign countries. In order to ensure a smooth debt adjustment process and the equal treatment of all creditors, it is essential that there be no rush of creditors to courts around the world to obtain judgments against, or attach the assets of, the sovereign debtor concerned. Therefore, the constituent document establishing the Facility (which could be an amendment to the Fund's Articles or a new treaty) could provide that once the debt adjustment process has been initiated, an "automatic stay" comes into effect immediately, which has the effect of restraining all creditors (secured and unsecured) from commencing or continuing all lawsuits for debt collection or enforcement of liens or judgments. In addition, the constituent document establishing the Facility could prohibit the debtor from making any payments to particular creditors.

Under many national laws, the filing of a petition results in the suspension of any debt collection action or lien perfection by creditors. 1/ As noted earlier, it is this stay of legal actions that allows an orderly process of negotiations to take place. Either as a direct effect of the constituent document establishing the Facility or through specific enactment, this provision would have to become part of the law of the signatory states, and domestic courts would thus have to enforce this provision. 2/

The period of time during which an automatic stay continues varies among jurisdictions, but the actual number of days typical in the case of a private sector debtor might not be appropriate for a sovereign debtor, whose affairs are considerably more complex. Given the wide diversity of potential users of the Facility, and the complexity of their cases, it might be appropriate to make the length of a stay discretionary. Therefore, a limited period of time (up to six months), but subject to a limited number of subsequent extensions (e.g., two extensions of up to three months each) might be envisaged.

4. Interim Financing

The debtor may require additional financing during the period of the automatic stay, and during which a plan is developed and approved. In many countries, certain lenders develop a specialization in providing such interim financing to companies in reorganization proceedings. Such lenders are likely to provide financing only if they receive preferential status for their loans, perhaps in the form of a security interest. In order to facilitate this process, the constituent document establishing the Facility could provide that the security interest for such interim financing is exempt from the application of the automatic stay.

5. Preparation of Debt Adjustment Plan

Once the debt adjustment process has been initiated with the Facility, a debt adjustment plan would need to be prepared. Most national laws permit the court to appoint a third party to gather information concerning the

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1/ See 11 U.S.C. §§ 362, 901, and 922. In the United Kingdom, a stay arises upon the presentation of a petition for an administration order: U.K. Act, § 10(1)(c). In Italy, the filing of the petition for a preventative arrangement brings into force a stay: Italian Law No. 267, Art. 168. Cf. 2 German Statute, §§ 21(1) and 87-90 (providing authority for the court to prevent execution by a creditor prior to the opening of a proceeding and for a stay during a proceeding); French Law, Art. 47 (providing for a stay from the opening of a proceeding).

2/ As a practical matter, it would be most important that such a stay be enforceable in those jurisdictions most relevant to sovereign debt.

financial condition of the company. 1/ Many national laws also provide that the court or its appointee prepare the plan, 2/ while some provide that it is the debtor that prepares and presents to the creditors a plan. 3/ Under Chapter 9, it is exclusively the responsibility of the municipality to do so. 4/ In the context of sovereign debt adjustments, it may be more appropriate for the Facility first to undertake a study of the debtor state's financial situation, and then work with the debtor which will prepare its plan for debt adjustment in consultation with its creditors.

The first step would be to undertake a detailed study and analysis of the particular country's debt problems, which may vary from severe balance-of-payments difficulties calling for immediate action to structural, financial, fiscal, and transfer-of-resources problems requiring longer-term adjustment measures. This would involve: examination of the domestic economic situation of the country; assessment of the impact of external factors (e.g., export performance and prices/markets for its major commodities) on the developmental and financial problems of the country; review of the country's assets including those of state enterprises, and ownership of natural resources; estimates of short- and long-term capital requirements, and likely availability of funds; review of the country's external debt management policies, projected debt servicing requirements and measures adopted to avoid debt servicing difficulties; allocation of scarce resources to competing claimants for use of these resources (i.e., external debt servicing demands versus demands for funding of domestic programs); and examination of the need for the country to undertake specific adjustment measures.

In preparing its debt adjustment plan under the overall supervision of the Facility and with the assistance of the staff assigned to the Facility, the debtor would need to consult with its main creditors so as to ensure that the finally negotiated debt adjustment plan will be approved. As is required under most national laws, the debt adjustment plan should provide for fair and equitable treatment of the different classes of creditors, taking into account differences between unsecured and secured (or other preferred) creditors. It would likely propose appropriate concessionary arrangements designed to match the debtor's capacity to service the debt (e.g., extensions of loan maturities, reduction in interest rates, and partial or full write-off of arrears).

1/ See, e.g., 11 U.S.C. § 1104. French courts and English administrators have this authority: French Law No. 85-98, Arts. 46 et seq.; U.K. Act, §§ 21 and 22.

2/ See, e.g., 11 U.S.C. § 1121(*c*). In the United Kingdom, an administrator may devise a plan for administration: U.K. Act, § 23. A similar rule prevails under the German law: German Statute, § 218.

3/ See, e.g., 11 U.S.C. § 1121(*a*); U.K. Act, § 1(1); Italian Law No. 267, Arts. 124 and 160.

4/ 11 U.S.C. § 941.

The plan could also provide, if necessary, for additional financing from the same or other creditors to tide the sovereign debtor over while the debt adjustment plan is being implemented. There should be no obligation to provide such financing; rather, incentives should be offered, such as adequate security or preferred creditor status. To facilitate acceptance of the debt adjustment plan, it could also provide a "menu" of options to the creditors such as alternative participation instruments or partial securitization of new debt obligations, conversion of old debt obligations into new debt obligations, debt-equity conversion schemes, and possibly also exit bonds to permit dissenting banks to leave the syndicate. Finally, the debt adjustment plan could spell out the specific means for the implementation of the plan and, most importantly, provide for the monitoring of the implementation by the Facility, with the expert assistance of the Fund.

In terms of staff resources and expertise, the Facility is not likely to be equipped to undertake the complex task of studying and analyzing the country's debt problems. The Fund, with the possible assistance of the World Bank, would possess expert knowledge and understanding of these factors and would, therefore, be equipped to undertake such study and analysis as a service to the Facility.

Finally, while the debt adjustment plan is being prepared, approved, and implemented, due regard should be paid to the sovereign character of the debtor. For example, Chapter 9 forbids interference by the court (unless the debtor has earlier so agreed in a plan) with any of the municipality's political or governmental powers, property or revenues, or use or enjoyment of any income-producing property. 1/ It would be wise to include similar restrictions in the constituent document establishing the Facility.

6. Acceptance and Confirmation of Debt Adjustment Plan

After the sovereign debtor prepares the plan, it would have to be presented to its creditors for their approval. National laws differ as to the requirements for determining minimum acceptance by creditors. The constituent document establishing the Facility could require, similar to Chapter 9, that creditors be put into classes and that each class of creditors votes on the debt adjustment plan. 2/ In Chapter 9 cases, the plan designates the number of classes and which creditors are in each

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1/ 11 U.S.C. § 904.

2/ The U.K. law makes no reference to classes; it only requires that a majority of all creditors approve, providing that the interests of no creditor are unfairly prejudiced: U.K. Act, § 6(1); see also U.K. Act, § 24. In France, the court decides on its own whether creditors' interests have been considered adequately, but nonpreferred creditors must be treated pari passu: French Law No. 85-98, Arts. 61, 74, 76, and 78.

class. 1/ The constituent document establishing the Facility could provide for a limited number of classes, e.g. secured creditors, general unsecured creditors, and subordinated creditors. Following the U.S. approach, it could also provide that in order for the plan to be confirmed, the plan would have to be approved by a majority of creditors in each class representing at least two-thirds of the amount of all claims of such class. 2/ It could further provide that, in the event that one or more classes of creditors fail to approve the plan, the Facility may deem the plan approved if the plan does not discriminate unfairly and a majority of creditors, representing at least two-thirds of the total amount of debt owed to all creditors, have approved the plan.

Finally, the Facility would confirm the debt adjustment plan as accepted by the sovereign debtor and its creditors. Then, the plan could be enforced against all creditors, including creditors who voted against the plan.

7. Implementation of Debt Adjustment Plan

Under most national laws, once a plan has been accepted, it applies, with certain limited exceptions, to all creditors, even those who dissented. 3/ As noted earlier, a major problem with the current mechanisms for debt adjustment is that, even if the banks' Steering Committee were inclined to reach agreement with a debtor on a debt adjustment plan (i.e., involving a variation in the relevant payment terms), such a plan would require the unanimous consent of the creditors. Given the somewhat different interests and objectives of syndicate banks in a debt crisis scenario, it would be virtually impossible or at least extremely difficult to obtain unanimous consent. In fact, a number of dissenting creditors have sued sovereign debtors (e.g., Jamaica and Costa Rica) for the enforcement of their rights under the terms of the original loan agreement notwithstanding the fact that the majority of creditors reached agreement with the debtor on a debt adjustment plan. Only if dissenting creditors can be bound by the agreement will the problem of "free riding" creditors be solved.

However, if the Facility is established by treaty (either through an amendment to the Fund's Articles or a separate treaty), the debt adjustment plan can be enforced through domestic law and domestic courts on dissenting creditors. As noted earlier, the debt adjustment plan could include

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1/ See 11 U.S.C. §§ 901 and 1123(a).

2/ 11 U.S.C. § 1126.

3/ See, e.g., 11 U.S.C. § 1141; U.K. Act, §§ 5 and 24; French Law No. 85-98, Art. 64. As noted earlier, under Chapter 9, creditors that had neither notice nor knowledge of the case are not bound by it: 11 U.S.C. § 944(c). In a company voluntary arrangement in the United Kingdom, those who had no notice or were unable to vote are not bound: U.K. Act, § 5(2)(b).

mechanisms, such as exit bonds, debt-equity conversion schemes, and buy-back arrangements, so as to permit dissenting creditors to leave the lending syndicate, if they so wish.

8. Monitoring Debtor's Performance under Debt Adjustment Plan

After the debt adjustment plan is confirmed by the Facility, the debtor's compliance with the plan would need to be monitored. Under national laws, the court oversees compliance with the plan. Because Chapter 9 applies to public entities, it is particularly relevant to the question of how much oversight the Facility might reasonably exert. Under Chapter 9, the court retains jurisdiction over the case for "such period of time as is necessary for the successful implementation of the plan" 1/, but closes the case "when the administration of the case has been completed." 2/ The case may be reopened "to administer assets, to accord relief to the debtor, or for other cause." 3/ Consequently, if the debtor fails to perform in accordance with the debt adjustment plan, 4/ the court may take steps to enforce the terms of the confirmed plan 5/ or may consider a proposal to modify the confirmed debt adjustment plan. 6/

The Facility could be given powers similar to those of a national court. However, enforcement of the creditors' claims under the terms of the plan (possibly by a Trustee acting on their behalf) would raise legal and practical issues, particularly with respect to assets located within the debtor's territories.

Under some sovereign loan agreements (through claw-back clauses), the creditors have the right to request a modification of the plan if the debtor's financial condition improves significantly within a specified period of time--e.g., one year--from the confirmation of the plan. Similarly, under the Facility, the debtor's performance of the terms of the debt adjustment plan would need to be monitored and subsequent adjustments in the plan could be envisaged. As suggested earlier, the task of monitoring the implementation of the plan could be delegated to the Fund. However, the authority to reopen the case and modify the debt adjustment plan would remain with the Facility.

1/ 11 U.S.C. § 945(a).
2/ 11 U.S.C. § 945(b).
3/ 11 U.S.C. §§ 350(b) and 901.
4/ Since 1960, defaults have occurred in at least seven cases: Collier on Bankruptcy 945.01 (1992) (citing Hearings on H.R. 31 and 32 before the Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee, 94th Cong., 1st Sess., ser. 27, pt. 2, at 697 (1975)).
5/ See Collier on Bankruptcy, supra, 945.01 (citing H.R. Rep. No. 94-686, 94th Cong., 1st Sess. 35 (1975)).
6/ 11 U.S.C. §§ 350(b) and 901. See also Collier on Bankruptcy, supra, 945.01, note 8.

9. Funding of Facility

The Facility would likely incur substantial costs in managing a debt adjustment process.

If the Facility is established as a separate organ of the Fund, the costs of the Facility would be borne by the Fund's administrative budget unless otherwise prescribed in the instrument governing the Facility. A distinction could be made between general overhead costs and operational costs related to actual cases. Since the latter would be substantial, consideration should be given to charging a fee to the sovereign debtor and the creditors, in a proportion to be determined.

If the Facility is established as a separate international organization, the permanent cost of maintaining the organization would require budgetary appropriations; 1/ additional costs generated by cases could be recovered from the parties.

10. Costs of Parties

The parties themselves would incur significant costs, including the fees of their respective lawyers. Under the London Club reschedulings, the entire expenses of the rescheduling (which run into several million dollars in view of the protracted nature of the negotiations and the number of parties involved), including the expenses of the creditors and their lawyers, are borne solely by the sovereign debtor. Under the Paris Club rescheduling, the expenses (which are much less) are borne by the governments concerned. Under the U.S. Code, the debtor is required to pay the creditors' costs (including the fees of their lawyers and accountants) if they have made a substantial contribution in the case. 2/

If the U.S. approach were to be followed, some formula for the sharing of expenses between the sovereign debtor and the creditors could be developed since the present system under private commercial bank rescheduling seems unduly burdensome on sovereign debtors given their already weak financial situation. A simple approach may be for each party to meet its own expenses.

Legal Department
May 25, 1995

1/ In the case of the Paris Club, a major part of the expenses--meeting rooms, Secretariat, etc.--are borne by the French Government.
2/ 11 U.S.C. § 503(b)(3) and (4).