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# SOLUTIONS FOR DEVELOPING-COUNTRY EXTERNAL DEBT: INSOLVENCY OR FORGIVENESS?

*Agasha Mugasha**

*The rich rule over the poor, and the borrower is servant to the lender.*
Proverbs 22:7[1]

## I. INTRODUCTION

DEVELOPING-country external debt is an economic, social, and political issue. The debt weighs heavily on the shoulders of the debtor nations, crippling their domestic social and economic programs, as well as preventing them from participating effectively in international activities such as trade. Individuals and families in these countries are deprived of even the most basic elements of living. The debt problem also affects the rich/creditor nations as developing countries with stagnating or crippled economies cannot be effective trading partners. Furthermore, the social and economic strife caused by the crippling debt has a domino knock-down effect on the richer nations.

The debt problem has been around continuously for over thirty years.[2] Countries that have faced debt crises at different periods are geographically widespread: from Mexico and Argentina; Poland and Romania; Morocco, Tunisia, and Nigeria; Philippines and Indonesia; to Uganda,

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1. *Proverbs* 22:7 (New International Version).
2. The expression "debt crisis" is commonly associated with countries that have heavy to moderate indebtedness, the large majority of which are largely in Africa, Asia and, Latin America. This article is based on the narrower meaning of the expression. In broader terms, the same expression encompasses a large number of international and national financial crises, the most notable of which were the international financial crisis that occurred in the Southern Cone in the late 1970s; the third world debt crisis of the early 1980s; the savings and loan debt crisis in the United States in the late 1980s; India's balance of payments crisis in 1991; the ERM crisis in 1992; the Mexican crisis of 1994-95 and the crisis that followed in Latin America; the East Asian financial crisis of 1997; the Russian meltdown in 1998-99; the collapse of the Real in Brazil and its follow up in Latin America in 1998-99; the Turkish crisis in 2000; the Iraqi debt problem of 2004; and the Argentinian debt problem of 2004. *See* Daniel Bradlow & Ruxandra Burdescue, *At the Mercy of Vultures: Sovereign Creditors in Courts, in* AD HONOREM ION DOGARU: STUDII JURIDICE ALESE 189 (Rumania 2005).

Tanzania, and Mozambique. Creditors fall into different categories, but what binds them together is the global impact of the debt crisis. The creditors include multilateral agencies and bilateral lenders/official creditors, both of whom provide an additional particular type of credit, which is aid in the form of a concession.[3] The debts of multi-lateral agencies, such as the IMF (International Monetary Fund) and IBRD (International Bank for Reconstruction and Development, part of the World Bank) are, in case of default, renegotiated through the IMF, while the debts bilateral lenders/official creditors are, in case of default, renegotiated through the Paris Club. The third type of lender consists of private commercial lenders whose debt, in case of default, is renegotiated through the London Club. An altogether different type of financing is the investment in bonds, equities, or other securities; this type of funding brings its own particular and significant problems because it is amenable to swift capital flight, the creditors are geographically dispersed, and sometimes the creditors are anonymous. It has been known to present significant problems because of the speed at which the securities can be sold or withdrawn. Thus, the debt crisis is a global phenomenon even though it usually associated with Latin America and to a lesser extent Africa. Furthermore, the crisis affects the global financial system; that is the commercial banks as lenders, governments (as borrowers and lenders), and multi-lateral financial institutions as lenders and overseers of the global economy.

The borrowed funds have been utilized for various projects over the years, depending on both the needs of the borrower nations and on the prevailing development philosophy at any particular time in Washington and London. Early post-independence (1950s-1960s) multilateral agency loans emphasized the development of infrastructure, for example roads, dams, schools, and hospitals. The next phase focused on the development of export markets and import substitution. At the turn of the 21st century the loans have emphasized capacity building in democratization, governance, and the rule of law. Most recently, loans have predominantly focused on universal primary education, health, gender equality, and environmental sustainability.[4] Some of these aims do not directly or immediately give rise to export earnings to offset the payment of interest

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3. This is sometimes misleadingly referred to as foreign direct investment. Foreign direct investment (FDI) is actually a contrasting financing method, consisting of investment in productive foreign assets such as equipment, structures, and organizations.
4. The loans reflect the broader agenda of the Millennium Development Goals of: (1) eradication of extreme poverty and hunger; (2) achieving universal primary education; (3) promotion of gender equality and the empowerment of women; (4) reduction of child mortality; (5) improving maternal health; (6) combating HIV/AIDS, malaria, and other diseases; (7) ensuring environmental sustainability; and (8) developing a global partnership for development. *See, e.g.*, U.N. Millennium Project, http://unmillenniumproject.org (last visited Oct. 15, 2007); Africa and the Millennium Development Goals 2007 Update, U.N. Department of Public Information, Document No. DPI/2458 June 2007, http://www.un.org/millenniumgoals/docs/MDGafrica07.pdf.

and repayment of the loan, and for that reason these aims could be considered non-self replenishing.

At different periods in history there has been emphasis on particular types of debt. For instance, while international syndicated loans were popular in the 1970s, foreign direct lending and private investment have been more commonplace in recent years. In addition, a number of factors prevented the debtor nations from repaying the loans. For these reasons, it is not possible to discuss accurately all debt—even for the same country—because of the different permutations involved.

There were many causes of the debt crisis. Some causes were directly attributable to the debtor countries—and they explain why there is some resistance for debt forgiveness—while other causes are not. The crisis arose from excessive borrowing, inefficient and ill-thought-out economic policies, and corruption within debtor governments.[5] The creditor nations too shared part of the blame. There was excessive lending by private banks awash with petrodollars and eager to recycle them. Industrialized nations were also eager to lend during the Cold War in order to secure the political allegiance of corrupt and totalitarian regimes.[6] It was (and still remains) the case that a good percentage of the borrowed funds either did not leave the bank accounts in the creditor nations or in any event ended up in those same accounts.

The debt was also worsened by the fluctuations of the international economy. The two oil shocks from1973-1974 and 1979-1980, the decline in the prices for copper and coffee in the 1980s and 1990s, the tightening of monetary policy in the United States which drove up interest rates in the 1980s, and occasional recessions in the global economy, which reduced demand for exports from developing countries, all contributed to the debt crisis.

Many solutions have been suggested over the last twenty or so years; and if the problem were simple, it would have been resolved by now. For this reason, this article focuses on the more recent suggestions involving the majority of debtor nations. It only mentions earlier alternatives to provide a fuller context.

The proposed solutions to the debt problem fall into opposing categories: those which offer creditors some hope of recovering their funds, ensuring that the creditors' investments produce the expected return, and those which give priority to the interests of the debtor nations by calling for the debt to be cancelled. The economic and social implications of the various options will be discussed below, along with the legal principles upon which they might be based.

5. Chantal Thomas, *International Debt Forgiveness and Global Poverty Reduction*, 27 FORDHAM URB. L.J. 1711, 1714 (2000).

6. *Id.*; RUMU SARKAR, DEVELOPMENT LAW AND INTERNATIONAL FINANCE 93-98 (J. J. Norton ed., Kluwer Law Int'l 1999).

### A. Common Myths

The search for solutions to the debt problem often encounters common myths, both in favor of and against developing countries. One such myth is to say that developing countries, particularly those in Africa, are "basket cases" or "lost causes". In reality, some developing countries are now well-managed and can benefit from debt relief. Of the remainder, many are now better managed, both economically and politically, than they were a decade or so ago. This is largely due to the adjustment programs imposed by the IMF as part of the conditions for external borrowing and debt relief,[7] and the positive effects of globalization and international development. Globalization has led to increased awareness on the part of the citizens of the world and increased demands for accountability in political and economic governance. Due to increased interaction at all political levels right up to the United Nations, leaders worldwide are now, more than ever, accountable or under pressure to account for their actions.

The second myth is that developing countries are the only victims of the negative effects of international finance or international trade and globalization. In reality, all countries of the world suffer the negative effects of globalization from time to time. From fishermen and farmers to investment bankers and stockbrokers, the global economy presents challenges to everybody. What differentiates developing countries is that their already fragile economic systems are more easily destabilized by negative changes in the global economy.

The third myth is to argue that the only way to solve the debt crisis is for the debtor nations to pay off all their debt. This is neither essential, nor particularly desirable because debt, per se, is not bad, nor is the use of debt to finance growth. Debt has many advantages, for example, it can fund projects where current revenues are insufficient or unavailable. The ultimate goal should be debt sustainability rather than debt elimination: not necessarily when a country has repaid all its external debt, but rather when that country is able to service its external debt without the need to compromise important domestic policies or endure prolonged austerity measures on its part or that of the creditors.[8]

7. For discussion of IMF conditionality, see International Monetary Fund, Articles of Agreement, art. V, § 3(a) (as amended Nov. 11, 1992) [hereinafter IMF]; Joseph Gold, Conditionality (Pamphlet Series No. 31, International Monetary Fund 1979); Manuel Guitian, Fund Conditionality: Evolution of Principles and Practices (Pamphlet Series No. 38, International Monetary Fund 1981); and for more recent discussion, see Legal & Policy Dev. & Review Dept., Int'l Monetary Fund, Guidelines on Conditionality (International Monetary Fund 2002), http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.pdf.
8. Roger E. Shields, Aspects of Current International Debt Problems: Is the Problem of Insolvency or Illiquidity? 6 (American Enterprise Institute for Public Policy Research 1985).

## II. CONVENTIONAL DEBTOR-CREDITOR RELATIONS

### A. Debt and Debt Collection

When credit is provided, a debtor-creditor relationship is created whereby the creditor earns the right to repayment. There is an obligation on the debtor to repay, and a right for the creditor to enforce payment. Debt normally earns interest, which is the charge for using someone else's funds. Alternatively, it can be seen as remuneration for the lender. Under municipal law, a debtor who refuses to pay will be subject to one of the alternative methods for debt collection. The first alternative consists of contractual remedies that become operative when the debtor is unable to pay, but has made a prior arrangement with the creditor whereby the creditor will take possession of an item belonging to the debtor if the debtor fails to pay. A slight variation of this alternative could be that the debtor will offer something of value to the creditor that the creditor will accept in exchange for his or her debt. So, while no formal agreement was made, the creditor will accept something in exchange for the release of the debt. The second alternative includes court remedies such as levying execution or garnishee proceedings. But these situations usually apply only when the debtor refuses to pay. If the debtor is simply unable to pay, the appropriate debt collection process is bankruptcy or insolvency proceedings. Another practical alternative, which is not exactly a debt collection remedy, is the renegotiation of the loan whereby the parties agree on a new contractual framework for the repayment of the same loan.

### B. Insolvency

Insolvency occurs when one is unable to pay one's debts as they become due from one's own money.[9] This leads to "cash-flow" or "commercial" insolvency. A temporary lack of liquidity, as opposed to an endemic shortage of working capital, does not amount to insolvency.[10] There is a difference between debtors who can pay their debts there and then (or within a short period of time) and those who need some time to raise the money. Debtors who need extra time are not solvent.[11] But the debtor's financial position is not limited to his or her cash resources. The courts will also take into account money that the debtor can raise within a relatively short time depending on the nature of the business and the amount of the debts.[12] Ultimately, the circumstances of each person's entire financial position are taken into account in determining whether or

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9. M & R Jones Shoplifting Co. v. Nat'l Bank of A/asia Ltd. (1983) 68 F.L.R. 282, 285. *See generally* ANDREW R. KEAY & PETER WALTON, INSOLVENCY LAW: CORPORATE AND PERSONAL 15-19 (Pearson Educ. 2003); IAN F. FLETCHER, THE LAW OF INSOLVENCY ¶¶ 1-001—1-011 (Sweet & Maxwell Ltd. 2002).
10. Expo Int'l Party Ltd. v. Chant (1979) 4 A.C.L.R. 679; Bank of Australasia v. Hall (1907) 4 C.L.R. 1514, 1543; In re Timbatec Party Ltd. (1974) 24 F.L.R. 30, 37.
11. In re Whitgift Nominees Party. Ltd. (1983) 68 F.L.R. 258; In re Noye, Deputy Comm'r of Taxation Ctr. Exp. (1956) 18 A.B.C. 77.
12. Sandell v. Porter (1966) 115 C.L.R. 666.

not there is insolvency, including cash resources and what the debtor can raise by pledging its assets.[13]

Historically, the main objective of bankruptcy/insolvency law was to provide for an orderly distribution of the debtor's assets by way of payment to creditors on a *pari passu* or pro-rata basis. This objective remains of paramount importance today, even though some jurisdictions, most notably the United States, places higher emphasis on the rehabilitation of the debtor. In essence, bankruptcy law is a legal process of debt collection that emphasizes collective action, where the debtor is unable to pay their debts.[14] The law reconciles the opposing interests[15] of creditors and the insolvent debtor by setting up elaborate legal regimes; namely, bankruptcy (for individuals and partnerships) and the liquidation of companies.[16] The law also provides for extra-curial regimes; namely, deeds of assignment, composition scheme, and deeds of arrangement.[17]

There are three main objectives of bankruptcy law: the protection of creditors, the protection of the debtor, and benefiting the community as a whole. The relative importance of these objectives varies from one jurisdiction to another, with English law emphasizing the first objective while United States law emphasizes the second one.

### *1. Protect Creditors*

First, bankruptcy law protects creditors as a group by preserving the debtor's assets and distributing them ratably. Bankruptcy stops any conduct that would be detrimental to the ratable distribution. Thus, the proceedings are essentially collective, and their aim is to distribute the estate in the most economical and expeditious manner. In order to achieve these aims, the proceedings are compulsory-neither the debtor nor the creditor can sidestep the bankruptcy proceedings. Secondly, bankruptcy law protects creditors from one another. It does this by avoiding the conflict of competing for specific assets, and avoiding the high cost of monitoring what everybody else is doing.

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13. Hymix Concrete Party. v. Garrity (1977) 13 A.L.R. 321.
14. When people or businesses borrow money, they may fail to repay the money. This can occur for different reasons: mismanagement or bad planning, recession, high interest rates, unexpected tort liability, bad luck, or primary industries factors such as drought or flood.
15. Policy makers must address at least three questions: (1) Can we assume/ trust that the debtor has declared all his/her property?; (2) Should we place limits on what property is available for distribution among creditors?; and (3) How do we resolve conflicting rights among different creditors when there are insufficient assets to fulfill all of the debts?
16. "Insolvency" is a broader expression that includes both bankruptcy and liquidation. Depending on the context, "insolvency" could mean exactly the same thing as "bankruptcy" or "liquidation."
17. In some cases these schemes are backed by court orders or other interventions to make them work.

### 2. *Protect the Debtor*

From the moment the bankruptcy proceedings commence, actions against the debtor are stayed. This ensures that the debtor is free from the pressure of creditors. Furthermore, bankruptcies are normally discharged after a reasonable period, varying between one and five years in the United States. A bankrupt individual who has been unfortunate, but not dishonest should be discharged, given a fresh start, and a resumption of normal status.

### 3. *Benefits to the Community*

Bankruptcy law provides that a debtor against whom a bankruptcy order is made has limited commercial dealings so that the bankrupt cannot defraud others. The second benefit is that a discharged bankrupt is integrated back in the community, thus recycling entrepreneurial skills. Thirdly, the protection of the debtor's estate preserves venture capital and jobs.

The success of the law in addressing debtor-creditor relations is measured by asking specifically: (1) Is the procedure efficient, without unnecessary cost and time-consuming procedures?; and (2) Does the procedure prevent exploitation by whoever may be so minded?

## III. THE NATURE OF THE DEBT PROBLEM

In the 1980s, the debtor nations were unable to pay their external debt and either refused to pay at all or postponed payment. This applied to either interest, principal, or foreign denominated debt, and was achieved by either unilateral declarations of postponement (moratoria) or rescheduling. In the wake of these developments, it was realized that there was no central authority or forum to oversee an orderly resolution to the crisis; for example, a global bankruptcy system. This role was eventually assumed by the IMF, which acted as a lender of last resort. In more recent years, the problem has been that the debt is unsustainable for the large majority of the least developed countries. That is to say, servicing external debt (payments of interest and repayments of principal) consumes such a high percentage of the countries' resources that other domestic economic and social programs are put in jeopardy.

An important consideration in recent discourse about sovereign debt is the type of creditors. The earlier sovereign debt, or pre-1980 debt, was predominantly held by commercial banks and bilateral lenders. Largely as a result of the Brady Plan, whereby commercial bank debt was exchanged for bonds,[18] and partly also because new debt was contracted by

18. The Brady Plan was the more successful of two plans-the other being the Baker Plan-for reducing sovereign debt by converting it from commercial bank loans to widely-held bonds. The Brady Plan was instituted in 1989 and has been expanded since. *See* TRADE ASS'N FOR EMERGING MARKETS, THE BRADY PLAN, http://www.emta.org/emarkets/brady.html (last visited Nov. 9, 2007); LEX RIEFFEL, RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 149-77

way of international bonds, the creditors to many sovereign states today consist of bondholders. The poorest of countries, though, still rely on bilateral lenders and multilateral agencies. The difference in the type of creditors as well as the debtors foreshadows the reality that the solutions to the debt crisis necessarily have to be different.

## IV. SOLUTIONS TO THE DEBT PROBLEM

The international community has created, or attempted to create, several solutions for the debt crisis. Some of these are designed to balance the economic interests of the creditors and debtors by ensuring that the creditors ultimately get full repayment, while the debtor obtains some concessions, for example, more time within which to pay. Other options are designed to clear the debt as soon as possible.

### A. Debt Re-framing

The solutions categorized as "debt-framing" give the debtor some breathing space, but the debt itself substantially remains and may even become bigger. They include debt restructuring, trading in debt (the secondary market in debt), and debt-for-equity swaps.

#### *1. Debt Restructuring and Debt Rescheduling*

Debt restructuring (and rescheduling) is a solution that has already been implemented for a great many developing countries. Generally, it involves the renegotiation and modification of the contractual terms of the loan to enhance the borrower's chances of full payment of the loan. The borrower obtains concessions, such as extensions or a write-off of part of the debt. Furthermore, the orderly management of the debt is generally beneficial to both sides because it may prevent the debtor from falling into deeper economic chaos. But the interest on the loan continues to accrue at a rate equal to or greater than the bank's average cost of funds at the date of restructuring. Restructuring usually involves the consolidation of many debt contracts into just a few, with the accompanying standardization of their clauses, and a reduction in the number of debtors, so that the debts of many corporations became instead the debt of the central bank with the sovereign's guarantee.[19] In the past,[20] restructuring was accompanied by rescheduling, in which new commercial bank loans and new IMF loans were granted together with postponement of capital repayments and arrangements for longer maturities for existing

(Brookings Inst. Press 2003); *see generally*, R.P. Buckley, Emerging Markets Debt: An Analysis of the Secondary Market (Kluwer 1999).

19. Butterworth's Business and Law Dictionary (LexisNexis 2d ed. 2002).

20. The dynamics of rescheduling have changed significantly because of the change in the creditors' profile. The earlier creditors to sovereign borrowers tended to be commercial banks, which were relatively few and were interested in long-term relationships with the debtor nations; while today's creditors tend to be numerous and geographically dispersed bond holders. Bondholders are much more difficult to coordinate than commercial banks. *See* Bradlow, *supra* note 2, at 190.

commercial bank loans.[21]

This possible solution is in practice merely an adjournment of virtually unchanged obligations. True, it allows the debtor country to survive a crisis and to live to see another day of debt servicing after the default or potential default that brought the rescheduling about, but given the enormity of the debt burden on most developing countries, this method appears to circumvent the real problem and provide only a temporary solution. In any event, the restructuring exercise may be frustrated if a creditor or a group of creditors refuse to join in or institutes court action against the sovereign. While it is true that the there are some legislative measures[22] and some market practices such as the "collective action clauses"[23] to discourage the recalcitrant creditors from going it alone,[24] rescheduling remains to a large extent a voluntary exercise that does not guarantee a positive outcome for the debtor. When dissenting creditors have insisted on their contractual rights and sued the sovereign debtors, the courts have in nearly all cases upheld the terms of the contract and found in favor of the creditors.[25]

With the benefit of hindsight, rescheduling can more appropriately be viewed as having done the necessary groundwork for an efficient secondary market[26] since many debts with different characteristics were streamlined into fairly standardized financial instruments capable of being widely traded. Rescheduling was a necessary facilitation of trade in these "instruments," because it made them readily exchangeable as if they were commodities, due to the similarity of their terms.[27] That view would therefore characterize rescheduling as the mainstay of a different proposed solution, rather than an answer to the debt problem in its own right.

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21. Ross P. Buckley, *Rescheduling as the Groundwork for Secondary Markets in Sovereign Debt*, 26 DENV. J. INT'L L. & POL'Y 299, 301 (1998). For rescheduling under the Paris Club, see Alexis Rieffel, *The Role of the Paris Club in Managing Debt Problems*, *in* ESSAYS IN INTERNATIONAL FINANCE NO. 161 (Princeton Univ. 1985); UNITAR/DFM, NEGOTIATION OF FINANCIAL TRANSACTIONS, LESSON 13: THE PARIS CLUB (UNITAR/DFM Online Course, 2005), http://www.unitar.org/dfm. For rescheduling under the London Club, see UNITAR/DFM, NEGOTIATION OF FINANCIAL TRANSACTIONS, LESSON 15: RENEGOTIATIONS WITH COMMERCIAL CREDITORS: THE LONDON CLUB (UNITAR/DFM Online Course, 2005) http://www.unitar.org/dfm.
22. In particular, Italy and Belgium have enacted legislation to facilitate restructuring and protect investors.
23. Collective Action Clauses (CACs) permit a supermajority of creditors, say 85 percent to agree to a modification of the terms of the instrument and therefore mean that the minority can be overridden by the majority. *See, e.g.*, Lee C. Buchheit & Elizabeth Karpinski, *Belize's Innovations*, 22 BUTTERWORTH'S J. INT'L BANKING & FIN. L. 5 (2007).
24. *See, e.g.*, Naoki Ishikawa, *Towards the Holy Grail of Orderly Sovereign Debt Restructuring Part I: The Use of CACs in Sovereign Debt Financing*, 22 BUTTERWORTH'S J. INT'L BANKING & FIN. L. 333 (2007).
25. See the court cases discussed *infra*.
26. Buckley, *Rescheduling*, *supra* note 21, at 308.
27. *Id.* at 309.

*2. The Secondary Market in Developing Country Debt*

The secondary market in developing country debt is the market for a states' indebtedness, in which the debts of a country (or of many debtors in a country) are sold and bought.[28] The sale-purchase transaction is usually at a heavily discounted price and this indeed is the main attraction for the purchaser of sovereign debt. The market provides the opportunity for commercial banks or other creditors to rid themselves of bad debt at some (albeit small) return, whilst speculators are afforded the opportunity to take a chance on the repayment capabilities of the sovereign nations by whom the debts are owed, or on the expectations of the market in this regard.[29] The courts have specifically endorsed such transactions in distressed debt even when they were entered into at a significant discount and with a view to commencing litigation almost immediately. An English court has held that "an assignment of a mere right to litigation is bad, . . . but an assignment of property is valid, even though that property may be incapable of being recovered without litigation."[30] Debtor nations, on the other hand, are left in the same position as they were before the sale of their debts, if not in a worse state, due to the likely nature of their new creditors. The latter will, by definition, wish to make a profit by reselling their "investments," or worse still, by litigating, or more usually threatening litigation in accordance with their strict legal rights under the agreements,[31] in order to enforce their returns. Many creditors have successfully litigated against sovereign debtors on the basis of the loan interests obtained in the secondary market. The common starting point by the courts was that the sovereign debtor was not immune from suit because it had engaged in a commercial transaction,[32] and thus the foreign state and its central bank were generally amenable to the jurisdiction of the courts (for example in England or New York). Furthermore, the property of the foreign state or its central bank may be the subject of execution proceedings if immunity has been waived as far as enforcement is concerned.[33]

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28. More broadly, the secondary loan market is one where the owner of an interest in a loan can deal in that loan by trading it or in any other way transacting in the loan interest. *See* AGASHA MUGASHA, THE LAW OF MULTI-BANK FINANCING: SYNDICATED LOANS AND THE SECONDARY LOAN MARKET (Oxford Univ. Press 2007); THE HANDBOOK OF LOAN SYNDICATIONS AND TRADING (Allison Taylor & Alicia Sansone eds., McGraw-Hill 2006).
29. Theodore Allegaert, *Recalcitrant Creditors Against Debtor Nations, or How to Play Darts*, 6 MINN. J. GLOBAL TRADE 429, 429-30 (1997). *See also* RUMU SARKAR, DEVELOPMENT LAW AND INTERNATIONAL FINANCE 113 (Kluwer 1999).
30. Camdex Int'l Ltd. v. Bank of Zambia, [1998] Q.B. 22, 40 (CA.).
31. Allegaert, *supra* note 29, at 430.
32. In the United States, see Republic of Argentina v. Weltover, Inc., 504 U.S. 607 (1992).
33. Under English law, the State Immunity Act of 1978 precludes recovery against a sovereign debtor. The immunity is lost, however, if the dispute involves any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation or if immunity has been expressly waived in respect of the transaction concerned (section 3(3)). A similar, but not identical position is provided for in the United States in the Foreign Sovereign Immunities Act 1976. *See also* Charles Proctor, *Sovereign Debt*

The dangers of court action by purchasers of sovereign debt in the secondary market are very real as illustrated by the *Dart*[34] case. The Dart family bought up so much Brazilian debt that within a year they owned the fourth largest share of such indebtedness, having bought it on the secondary market for discounts of 60 percent or more. In 1993, when Brazil requested its creditors to allow it to convert approximately one-third of its debt, including the Dart family holdings, into bonds at much less than face value, the Darts refused in an attempt to "free ride" on the backs of the other creditors and achieve for themselves a much better deal than the commercial banks and the finance ministry, without causing the negotiations to collapse. If this "hijacking" of the process was not enough, the family sued a year later, the first possible day on which they were permitted to do this,[35] claiming accelerated repayment of both the principal and the interest. The court denied the request to accelerate the principal, but did not dismiss the right to have the $60 million in overdue interest paid. The parties eventually settled and Brazil agreed to pay $25 million in cash and $52.3 million in bonds, with the practical effect that the court's decision clearly worked in Dart's favor. Clearly, this type of profiteering is an unpleasant consequence of what would otherwise be an ingenious idea. It must surely render the scheme worse than useless from the debtor countries' point of view, as there is the likelihood of them being required to pay more of their debts sooner than if their debts had never been restructured in the first place.[36] But the advantages of the secondary market for the original-party-come-seller of debt are overwhelming.[37] This is clearly a solution for creditors but not for debtors.[38]

Such lawsuits are common worldwide. There is some remarkable similarity in the profile and action on the part of the creditors, and some fair amount of predictability on the part of the courts in England and the United States. Concerning the creditors' profile, the purchase of the debt has typically been a financial institution such as a vulture fund, hedge fund, or trust that specializes in trading distressed debt. The new creditor proceeded to institute court action[39] and, after successful litigation, sought to enforce the judgment debt against the property of the debtor. For example, in *Kensington International Ltd. v. Republic of Congo*,[40]

*Restructuring and the Courts–Some Recent Developments*, Part 1, BUTTERWORTH'S J. INT'L BANKING & FIN. L. 379 (2003).

34. CIBC Bank & Trust Company (Cayman) Ltd. v. Banco Central do Brasil, 886 F. Supp. 1105, 1106 (S.D.N.Y. 1995).

35. CIBC sued on behalf of the family as the holder of record of the debt.

36. Allegaert, *supra* note 29, at 446-47.

37. *Id.* at 443-44.

38. *Id.* The secondary market has other advantages that are not relevant here. Most importantly, it provides liquidity for the financial markets and makes loans more available. Lenders can commit to loans with the knowledge that the loans can be sold if it should become necessary.

39. *See, e.g.*, Argo Fund Ltd. v. Essar Steel Ltd., [2006] E.W.C.A. 241 (Civ.).

40. Kensington Int'l Ltd. v. Republic of the Congo, [2006] 2 B.C.L.C. 296 (Q.B.). The judgment debt was $121,365,437.70; and interest was accruing at a daily rate of $22,008.23.

Kensington was the judgment creditor to the sovereign government and it had obtained its creditor status by way of assignment of four loan agreements. The creditor successfully enforced its judgment by obtaining a third party order, whereby the court permitted the creditor to attach the proceeds of two consignments of oil that the court held to belong to the debtor nation. In *Camdex International Ltd. v. Bank of Zambia*,[41] the vulture fund obtained the sovereign debt by assignment, reduced it into a judgment debt, and proceeded to seek enforcement by freezing the debtor's assets. When the creditor failed to enforce the judgment in that way, it sought to enforce by way of a garnishee order.[42] Similar action on the part of the creditor was seen in *Cardinal Finance Investments Corp. v. Central Bank of Yemen*,[43] where a fund acquired promissory notes at significant discount and sought summary judgment for the face value of the notes. In *Donegal International Ltd. v. Zambia*,[44] the original creditor to Zambia was Romania, which then assigned its interest to the claiming fund. Zambia resisted the claim on many grounds, including the allegation, which was upheld by the court, that the claimant had improperly sought and obtained information about the sovereign borrower and that the debtor was required to pay a penal interest rate.

These cases in the English courts were mirrored by cases in United States courts such as *CIBC Bank and Trust Company (Cayman) Ltd. v. Banco Central do Brasil*,[45] *Elliott Associates v. Banco de La Nacion*,[46] *Salah Turkmani v. Republic of Bolivia*,[47] and *EM Ltd. v. Republic of Argentina*.[48] Of course, each case was decided on its merits and the decisions are different. But one can make safe generalizations when comparing and contrasting the two jurisdictions. First, the debtor always failed whenever it raised the defense relating to sovereign immunity. Secondly, the courts in the United States and England adopted a common position that the debtor who failed to pay its debts on time was liable to the creditor regardless of the reason for the failure to pay and the consequences the debtor might face. The general approach of the English courts differed from that generally followed in the United States when it came to the policy considerations that apply to a sovereign debtor

41. *Camdex*, [1998] Q.B. at 22 (Civ.).
42. Camdex Int'l Ltd. v. Bank of Zambia, [1997] C.L.C. 714 (Civ.).
43. Cardinal Fin. Inv. Corp. v. Cent. Bank of Yemen, [2001] Lloyd's Rep. Bank 1 (Civ.) (denying Central Bank of Yemen's motion for dismissal of claim brought by Cardinal for breach of contract).
44. Donegal Int'l Ltd. v. Zambia, [2007] 1 Lloyd's Rep. 397 (Q.B.).
45. *CIBC Bank*, 886 F. Supp. at 1105 (S.D.N.Y. 1995).
46. Elliot Assocs., L.P. v. Banco de la Nacion, 194 F.3d 363 (2d Cir. 1999). The same facts of this case gave rise to litigation in Belgium in which the court adopted a novel interpretation of the *pari passu* clause. *See* Elliott Assocs. L.P., General Docket No. 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, Sept. 26, 2000). That interpretation was overturned in Republic of Nicaragua v. LNC Invs. & Euroclear Bank, S.A., No. 2003/KR/334 (Court of Appeals of Brussels, 9th Chamber, Mar. 19, 2004).
47. Turkmani v. Republic of Bolivia, 193 F. Supp. 2d 165 (D.D.C. 2002).
48. EM Ltd. v. Republic of Argentina, 2003 U.S. Dist. Lexis 15975 (S.D.N.Y. 2003).

in financial difficulty. English courts were more sensitive to the fact that they were dealing with sovereign states and treaded warily where the debtor had an arguable case.[49] In exercising their discretion to grant or refuse remedies, English courts took into account the public functions of a sovereign state and its legal system, and declined to enforce against assets that were of little value to the creditor but which could be important to the debtor nation in the context of its national economy.[50] It could as well be that, from this sample of cases, United States courts are more amenable to the interests of the creditor as far as *enforcement* of a judgment is concerned, while English courts are more amenable to the interests of the debtor. It bears emphasis, however, that both jurisdictions are united on the premise that debts must be paid; in any case, many borrowers might not have the choice as to forum where an action against them might be instituted.

Other variations of debt re-framing have been tried or could be suggested, such as securitization,[51] or eradication of the interest on the debts, but all of these options require the debtor countries to continue to pay enormous sums of its currency reserves,[52] which by definition they can ill afford. These solutions are consistent, however, with the sovereign states' fulfillment of their obligations under the agreements (at any rate the agreements as amended), and the commercial interests of the creditors. There is also considerable debate about whether such arrangements, especially in the case of the heightened threat of litigation, might encourage states in difficulty to seek the help of the IMF at an earlier stage[53] and whether this might or might not[54] be helpful to the country's long-term economic health since IMF help comes complete with "austerity measures" that the country must implement[55] that may promote stability.

### 3. *Debt-for-Equity Swaps*

The concept of a debt-for-equity swap is that upon buying their own debt that has already been sold on the secondary market. Developing countries' governments exchange the debt with the offer to investors of equity interests in nationalized industries or local currency bonds.[56] In other instances the debt is exchanged straight for full or par-ownership of

49. *See, e.g.*, *Donegal* [2007] 1 Lloyd's Rep. at 397; *Cardinal* [2001] Lloyd's Rep. Bank 1; *Camdex*, [1998] Q.B. at 22.
50. *See* Proctor, *supra* note 33, part 3.
51. SARKAR, *supra* note 6, at 116-17; Ruth Rosauer, Note, *Emerging Market Debt Instruments Play Siren Song for Pension Plans*, 7 MINN. J. GLOBAL TRADE 211, 220-21 (1998).
52. *See* Allegaert, *supra* note 29, 437.
53. *Id.* at 436.
54. Dan Taylor, *The International Monetary Fund: Wallet Sore to the West or Savior to the Global Financial Crisis?* 8 CURRENTS: INT'L TRADE L.J. 79, 80 (1999).
55. Allegaert, *supra* note 29, 467.
56. SARKAR, *supra* note 6, at 114; Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 328-29 (1995); *see generally* Daniel H. Cole, *Debt-Equity Conversions, Debt-for Nature Swaps, and the Continuing World Debt Crisis*, 30 COLUM. J. TRANSNAT'L L. 57 (1992).

a state enterprise or interest in a state enterprise. The mutual hope is that such companies or instruments can generate a return to satisfy the creditors, whilst developing country governments are freed from paying interest on their debt burden.[57] This appears to be a wonderful idea, although there is still a high risk involved for investors, and repayments are still being collected from the greater government purse. Additionally, investors have not always relished the conditions upon which such equity is offered, either in terms of the discounts being operated, or the restrictions on investments.[58]

Debt-for-nature swaps are another variation of this type of policy, in which debtor countries' environmental co-operation is bought on the secondary debt market.[59] It is submitted that this is not altogether a satisfactory solution to the debt problem both because it "excuses" creditor countries from their environments obligations and because it only exchanges the debtor state's economic burden for a performance obligation that is likely to be at least as costly, particularly for underdeveloped industries whose current running costs their owners can ill afford.

The weakness in all of the above-mentioned schemes is that in attempting to balance the creditors' interests with those of the debtors, the latter are still required to pay hard currency they simply cannot afford. This is not to ignore the fact that the debtors contracted the debt in the first instance and utilized it, but is to acknowledge the debilitating effect of excessive debt. The choice is simple: either the creditors continue to require recompense for their extension of credit and therefore the debtor countries continue to suffer, or the debt will have to be terminated either through insolvency or forgiveness. The following section discusses the arguments in favor of, and against insolvency and debt forgiveness.

### B. Sovereign Insolvency

It has been suggested that an international bankruptcy forum be established, to which a debtor nation in serious financial crisis could submit its monetary affairs and deal with all its creditors in an orderly fashion. It must be emphasized at the outset that most of the proposals used the word "bankruptcy" in the broader sense more commonly associated with the United States, which is different from the meaning associated with English law. The proposals essentially put forward a legal framework for a restructuring mechanism. The use of the word "bankruptcy," however, made the proposals repugnant to a great many debtor countries because of the meaning associated with the word outside the United States. "Bankruptcy" under English law and countries that follow the same legal

57. Sean M. Neal, Note, *Bringing Developing Nations on Board the Climate Change Protocol: Using Debt-for-Nature Swaps to Implement the Clean Development Mechanism*, 11 GEO. INT'L ENVTL. L. REV. 163, 170 (1998).

58. *See* Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Dept Trading From 1989 to 1993*, 21 FORDHAM INT'L L.J. 1802, 1832-33 (1998).

59. Neal, *supra* note 57, at 170.

tradition is pervading and has far-reaching consequences that make the bankrupt a "third-class" citizen. Bankruptcy carries much more stigma in other jurisdictions than it does in the United States, and the proposals made a very unwelcome entry on terminology alone.

Following this terminological clarification, it becomes evident that much of the discourse has focused on creating the most effective procedures and methods for renegotiating and rescheduling sovereign debt. A particular problem that occupies the minds of the commentators and that is sought to be resolved is that of hold-out creditors who refuse to join in the renegotiation. The various proposals therefore focus on ensuring that all creditors support or are bound by the renegotiation effort. Some of the proposals argue for the use of market-oriented methods, whereby the parties would provide in their contracts for what would happen if the debt were to be renegotiated and whereby the courts would enforce such contracts.[60] Other proposals would favor the use of a statute-like procedure along the lines of bankruptcy legislation.[61] A different permutation was added in 2004 in relation to Iraq's sovereign debt whereby the U.N. Security Council passed a resolution that effectively prevented creditors from attaching Iraq's assets (mainly oil revenues) when the country had more debts than funds.

First and most notably, the proposal for an International Bankruptcy Agency was made at the Group of Seven (G7) Summit in Halifax, Canada in June 1995 in the wake of the Mexican financial crisis earlier that year.[62] Mexico faced capital flight in January 1995; foreign investors suddenly realized that Mexico had an external debt of $29 billion falling due in 1995, but the central bank had reserves of only $6 billion. The creditors anticipating a default refused to roll-over (extend) their debt, and either demanded repayment or withdrew their money. These actions brought Mexico to the brink of default. Eventually the United States government organized a rescue package of $50 billion, largely by arm-twisting several institutions into cooperation,[63] but the episode led to the realization that there was a vacuum in international financial management, where investors could relocate capital with extraordinary speed, thus making a debtor nation vulnerable to capital movement that may sometimes be speculative or irrational.

The idea of an international bankruptcy forum/agency, meaning an institution to coordinate restructuring, has been supported in a case such as Mexico's where there was speculative creditor panic and the debtor na-

60. *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, Note, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317 (2002).

61. Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV 956, 966 (2000) (see the IMF proposal).

62. *See* John H. Chun, Note, *"Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 FORDHAM L. REV. 2647, 2651-52 (1996). The G7 also proposed the establishment of an Emergency Financing Mechanism that would double the General Agreement to Borrow (the amount available at the IMF). This would essentially equip better the function of lender of last resort.

63. *Id.* at 2659-663.

tion suffered only a short-term liquidity crisis rather than a solvency crisis.[64] The bankruptcy forum would protect the debtor by stopping investors relocating their funds from a sovereign government that is facing a financial crisis. It would also mutually benefit the creditors and the debtor nation by facilitating an orderly re-negotiation of the debt. Furthermore, it would benefit the international financial system by minimizing contagion and maintaining confidence in the international financial system.[65]

Secondly, some commentators have suggested an insolvency procedure for debtor nations based the approach taken by private law towards debtors, and in recognition of the fact that many domestic systems of law provide for bankruptcy procedures that could be harmonized into a global procedure. It has been suggested that in all situations where the debtor cannot satisfy all creditors, even it if is a sovereign debtor, the so-called common-pool-problem arises.[66] Once the resistance to calling government sovereigns "insolvent" rather than "temporarily illiquid" has been overcome, and the predominant principle that a state cannot be made bankrupt, the private law rules on insolvency can be applied by comparison or directly to sovereign debtors.[67] The desirability of an insolvency procedure at the level of nations, it is argued, lies in the disciplinary effect it would have on all participants–debtors and creditors–because it would create an incentive for mutually agreed solutions.

Thirdly, some IMF officials, perhaps reflecting mainstream philosophy in recent years, actively considered the idea of sovereign insolvency along with the alternative of debt restructuring.[68] The idea, which was not new at all, arose from the realization that efforts to curb the debt crisis had

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64. *Id.* at 2659, 2691. Mexico did not have the cash at hand to redeem its obligations, but generally it had the resources to repay the debt.
65. *Id.* at 2676.
66. The problem of the common pool illustrates the advantages of cooperative action. Imagine a small lake filled with fish. Consider the following two scenarios: (a) if a single individual owns the lake, he will limit the amount of fishing. This is so that fish will be able to reproduce, and this will ensure that there will be fish in the future; (b) If no one person owns the lake, and a group of self-interested people use the lake for fishing, each will try to maximize the amount of fish caught. Even though everyone will realize that they would all benefit if they limited the amount of fishing, each one soon discovers that any self-imposed limits on fishing do not ensure that the fish would remain. Self-interest would dictate that each catches as much fish as possible, despite the interest of the group to preserve the fish. If there were a law regulating fishing, everyone would benefit.

    This supports the theory that creditors will be better off if they act as a group. The law of debt, whereby each creditor can pursue individual remedies, is modified to benefit all. Thus bankruptcy law steps in and forces the diverse creditors with competing interests to act collectively.

    There are some fallacies in the problem of the common pool. First, it assumes that each individual is self-interested; in fact, many are cooperative. Secondly, in practice creditors do not always rush to seize assets - sometimes they allow restructuring. *See generally* DOUGLAS G. BAIRD, THOMAS H. JACKSON & BARRY E. ADLER, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 22-24 (3d ed. 2001).
67. Christoph G. Paulus, *Some Thoughts on an Insolvency Procedure for Countries*, 50 AM. J. COMP. L. 531, 532 (2002).
68. *See also* Schwarcz, *supra* note 61, at 958-59.

hitherto been mainly political, but that they should be transformed into a workable procedure and thereby be given a legal grounding.[69] It was realized that the existing framework for negotiations was inefficient because it was solely contractual and required unanimity of all the creditors. The framework could thus be derailed by a party that did not agree to the direction of the negotiations and that created problems in practice.

The IMF favored and developed the Sovereign Debt Restructuring Mechanism (SDRM), which would consist of a procedure for sovereign debtors to submit to a designated institution or body. It was considered that both the institution and the procedure would be fairly easy to implement by treaty, which would be implemented perhaps by way of amendment to the IMF Articles of Agreement, and thus be binding on the international financial community. The mechanism would provide for a mandatory stay on enforcement procedures, majority decisions that would be binding on all creditors, and a "priority" incentive for creditors to keep credit lines open during the renegotiation.[70] The proposed restructuring mechanism was considered to have a greater likelihood of being effected than the alternative of relying on collective action clauses for the orderly restructuring of debt.[71] In order to be effective, collective action clauses would need to be enforceable in all the courts, which would require all the courts of the world to work to the same principle, or would need to be legislated for across all jurisdictions to avoid forum shopping.[72] Less creditworthy nations may also find it difficult to negotiate such clauses, and in any case the clauses would only apply to future obligations and thus take a long while to start before becoming effective.[73]

A bankruptcy regime in the form of the SDRM would have three factors to consider when a country is facing liquidity crisis and needs to renegotiate its debts with its creditors, in the face of the risk that creditors can relocate money worldwide with extraordinary speed: (1) the mechanism's ability to respond quickly and decisively to creditor panic; (2) the mechanism's ability to minimize moral hazard; and (3) the mechanism's ability to respond to multiple and simultaneous creditor panics.[74] The merit of the international bankruptcy regime recognizes that financial systems have evolved faster than institutional structures, and there is no international or mutually acceptable procedure to deal with capital flight.[75] And while domestic systems have protections for debtors and creditors, there

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69. Anne Krueger, First Deputy Managing Dir., Int'l Monetary Fund, Address at National Economics' Club Annual Members' Dinner: International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (Nov. 26, 2006) (transcript available at www.imf.org/external/np/speeches/2001112601.htm).
70. *See also* Proctor, *supra* note 33, part 3.
71. The proposal was not adopted but work continues on it. Private institutions attacked it because it did not restrict their contractual rights to enforce debts against sovereign lenders. It was also attacked by poorer nations because it would have made borrowing on the international markets more expensive for them.
72. *See* Krueger, *supra* note 69.
73. *See* Proctor, *supra* note 33.
74. Chun, *supra* note 62, at 2687-692.
75. *Id.* at 2668.

is no similar arrangement in the international context.[76]

One model that has been suggested for the international bankruptcy regime is chapter 9 of the U.S. Bankruptcy Code, which protects municipalities from creditor panics and averts economic chaos. In broad outline, if a sovereign debtor submitted to this bankruptcy procedure, it would get some breathing space to re-negotiate with its creditors and would be assured of cooperative action by all creditors.[77] This would be achieved through four key elements:[78] (1) the automatic stay;[79] (2) the post-petition creditor preference;[80] (3) the plan of readjustment;[81] and (4) the cram-down provision.[82] Chapter 9 of the U.S. Bankruptcy Code affords the municipalities procedural protections from impermissible interference by creditors, and parallel provisions would similarly protect sovereign debtors.[83] Municipalities are not subject to involuntary bankruptcy petitions and they have the exclusive right to file the plan of adjustment.[84] Unlike chapter 11, under which the court may appoint a

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76. *Id.* at 2671.
77. The International Bankruptcy Agency would be in the nature of an arbitration forum, organized under the auspices of the IMF. As an arbitral tribunal, it would have the key advantages that its proceedings would generally be less contentious than court proceedings, and the parties can establish the procedural rules and regulations that would govern the reorganization. Parties would voluntarily submit to its jurisdiction, and the adoption of chapter 9 type of proceedings (*infra*) would ensure that there is no direct interference in the political and economic affairs of the debtor nation. *See id.* at 2676-79.
78. *Id.* at 2672.
79. The effect of an automatic stay provision is that, upon the filing of a bankruptcy petition, all creditors, and other parties in interest, are automatically prevented, for a period of thirty days, from commencing or continuing lawsuits and enforcing or collecting claims or judgments against the debtor. This prevents the creditors from harassing the debtor, and promotes orderly administration of the debtor's assets and also avoids their dissipation. *See id.* at 2674.
80. The post-petition creditor preference provisions facilitate the injection of new resources into the debtor so that it carries on business as usual. The provision permits the municipality/debtor to obtain unsecured credit by granting priority of repayment over all administrative expenses, unsecured creditors, and junior security interests already encumbering the property of the debtor. *See id.* at 2674-75.
81. A municipality/debtor is required to file a plan of adjustment of its debts, which may modify the rights of all creditors relating to repayment of principal, interest, or repayment method. The plan of adjustment is invariably negotiated between the municipality and creditors to find a mutually acceptable plan for adjusting the debt. *See id.* at 2675.
82. A cram-down provision prevents a small minority of creditors from wrecking a reorganization plan. For the reorganization to work, two requirements need to be met. First, a qualified majority of lenders must accept the plan of reorganization. This means that two-thirds of the amount of the claims that consist of one half of the number of creditors, approve or are not impaired by the plan. Second, the court must find that the plan "does not discriminate unfairly, and is fair and equitable" in relation to the dissenting and impaired class. The "unfair discrimination" requirement means that the debtor treats all classes of equal rank identically under the plan. The "fair and equitable" doctrine requires that senior creditors receive full payment before junior creditors receive payment. *See id.* at 2675-76.
83. Chapter 9 of the U.S. Bankruptcy Code is actually titled, "Adjustment of Debts of a Municipality."
84. Chapter 9, section 901 of the U.S. Bankruptcy Code applies section 301, thus making it clear that it is only the municipality that can initiate a plan of its own debt adjustment. There are no involuntary chapter 9 cases.

trustee to govern the debtor's affairs,[85] chapter 9 protects the rights of the state to control its political subdivisions[86] and the right of the municipal debtor to manage its governmental and spending priorities without judicial interference.[87]

Two alternative procedures have been suggested. The first is an institution-based procedure, for example the United Nations or any of its subdivisions, or the International Court of Justice, that could either act as a controlling supervisor of the bankruptcy procedure, following the Anglo-American model of a judge, or have a more invasive influence on the procedure, following the continental model of a judge.[88] The procedure would only be debtor-initiated and would put in place an automatic stay of proceedings against the debtor from the time the debtor submits to it.[89] The second alternative would be an arbitration procedure that has the flexibility usually associated with arbitration.

Without detracting from the strength of the arguments made in favor of a bankruptcy approach to developing country debt, proponents of the approach are concerned with the orderly management of the debt, which does not go to the core problem of reducing the debt. The proposals focus on establishing a legal framework for an effective restructuring mechanism. Some argued that since there are domestic laws regulating individuals and entities that are in financial difficulty, there could, and should, be an international body of law or procedure that handles a similar problem at the international level. Others focused on the desired result, for example stopping capital flight, and created a solution that would perhaps solve that problem but not many others. In terms of the value of the debt, the proposals seemed to offer little practical help beyond what was already available, for example through the London Club or Paris Club. The proposals were not carried through because a good proportion of the creditor community and the debtors did not support them. At the present time, most commentators, creditors, and debtors prefer the use of contractual negotiations for establishing the legal framework for debt renegotiation.

### C. Debt Forgiveness

The sheer size of developing country external debt in relation to the ability to service the debt, coupled with the cyclic nature of the debt led many individuals, groups, and governments to call for debt forgiveness in part or in full. One basis for this proposition is that less than half of the payments made by developing countries go towards retiring the principal debt because most of the payments go to payment of interest. Various

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85. U.S. Bankruptcy Code, 11 U.S.C. §§ 1104-06 (2000 & Supp. IV).
86. 11 U.S.C. § 903 (2000 & Supp. IV).
87. 11 U.S.C. § 904 (2000 & Supp. IV).
88. Paulus, *supra* note 67, at 542-43. The procedure would exclude the IMF and the World Bank because they are creditors.
89. *Id.* at 551.

arguments have been made in favor of debt forgiveness, which is also called debt relief, debt alleviation, debt remission, or cancellation of debt.

### 1. *Why Forgive the Debt?*

#### a. Moral Arguments

Forgiveness of debt is founded on the kinship of the human spirit–that there is a bond between all human beings that overrides material differences and inequalities.[90] This is more often articulated by religious groups, but the argument is not the exclusive domain of religious conviction. The fundamental tenets of international human rights law provide for the principle of universal human dignity, and "the belief that human solidarity requires action by all to ensure that the dignity of all is recognized and protected."[91]

In favor of developing countries, it has been further suggested, controversially, that the western creditors who seek to enforce their loan contracts against particular developing countries should refrain from doing so, in recognition of the fact that for centuries the colonial powers plundered the human and natural resources of these nations without ever offering compensation or restitution, which in any case would be impossible in the case of the slave trade, due to the infinite worth of each individual who was stolen. The question then becomes who are really the creditors and who the debtors?

Finally, there is another forceful argument that the developed nations lured developing nations into the debt trap by making easy credit available, and they now have a moral obligation to get them out.[92]

#### b. Economic Arguments

Debt reduction is in the interests of all countries in the world, particularly the western world. Developing countries that are free of debt will expand economically and will become more viable partners with whom the western countries can do business. Secondly, the debt burden directly deprives the people in the poor countries of the basic conditions of survival, later on prosperity. It thus ties up the human capital in these people, which largely remains untapped and unavailable to the development process. Thirdly, debt forgiveness would have a positive re-distributive effect of global resources. The resources capable of wiping out the entire debt of the developing nations would do more good to the global economy than it would if it were added to the wealth of the rich nations.[93] If the debt obligations are enforced, a great many people will continue to starve, or die of preventable diseases, or continue to lack a basic educa-

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90. Thomas, *supra* note 5, at 1713.
91. *Id.* at 1714.
92. *See* Jens J. Wilhelmsen, *Pushing for Debt Forgiveness*, FOR A CHANGE MAGAZINE, Aug. 1, 2000.
93. This is called the diminishing marginal utility of money. *See* Thomas, *supra* note 5, at 1715-16.

tion. If, on the other hand those debts are cancelled, the banks' and investors' profits are simply reduced, or at worst they will lose a substantial investment. The two are hardly comparable!

The last and perhaps weakest argument is the commercial banks' own contributory fault in continuing to lend to defaulting nations,[94] which should stop them from seeking to recover these "bad debts." It is submitted that this argument should fail, both because the debtor countries were equally at fault in continuing to borrow and, conversely, that in the face of the prevailing circumstances, both parties were justified in continuing the arrangement without closely scrutinizing the possible consequences.

c. Political Arguments

Perhaps the most compelling reason for debt forgiveness is that it is critical to ensuring political security and international peace. Severe poverty is often a source of political strife. Developing country external debt has the potential, if unchecked, to provoke instability and disorder of all kinds due to dissatisfaction with poverty on a massive scale.[95] Furthermore, "[t]he political legitimacy of the current order is undermined when the world's powers stand by and allow the world's poor to suffer and even to die. Conversely, the political legitimacy of the current order is reinforced when the world's powers join the world's poor in partnership."[96]

d. Legal Arguments

The legal arguments for debt forgiveness are premised on the idea that unsustainable debt is a challenge to the world order, and debt forgiveness is a critical component in securing international prosperity and international peace.[97] Debt and debt forgiveness are, thus, a challenge for international law. There are general principles of human dignity and self-determination that make a case for forgiveness. For instance, The Universal Declaration of Human Rights recognizes that the "inherent dignity . . . of all members of the human family is the foundation of freedom, justice and peace in the world."[98] Furthermore, article 1 of the International Covenant on Civil and Political Rights grants all people the right of self-determination which includes the right to "freely pursue their economic, social and cultural development,"[99] and states that "[i]n no case may a people be deprived of its own means of subsistence."[100]

94. *See, e.g.*, *id.* at 1714.
95. Buckley, *Facilitation*, *supra* note 58, at 1803; Thomas, *supra* note 5, at 1716 (adding that a population that is decimated and destabilized by disease is vulnerable to strife and unrest).
96. Thomas, *supra* note 5, at 1716.
97. *Id.* at 1717.
98. Universal Declaration of Human Rights, Preamble, G.A. Res. 217A (III), ¶ 1 (Dec. 10, 1948).
99. International Covenant on Civil and Political Rights, G.A. Res. 2200A (XXI), art. 1, ¶ 1 (Dec. 16, 1966).
100. *Id.* ¶ 2; *see also* Thomas, *supra* note 5, at 1717.

e. Against Forgiveness

It is also possible to find many arguments that stand in the way of debt forgiveness, but all of them pale into insignificance in comparison with the sheer human need caused by maintaining the debt obligations of developing countries. For example, two similar arguments would protest that the effect of canceling debt would destroy confidence in less developed countries' creditworthiness, or that it would destroy confidence in the secondary market in sovereign debt. It is evident, however, that in many cases, such confidence is only a chimera anyway.

The only remaining argument is the disappearance of all "sticks" and "carrots" from the IMF's pantry and the resultant freedom developing countries would have over their own economies and foreign investment rules. The former could well cause problems in the future, although it would restore a measure of these countries' sovereignty, with which they have the right to do as they see fit. It is also becoming increasingly obvious that foreign investment in developing country economies squeezes out local investment and enterprise, so that returning control over this matter is likely to benefit these fledgling economies.

Debt forgiveness is not easy to achieve, though, whether for the IMF or creditor governments, which must face the difficulties inherent in the public relations problems that would follow, especially if taxpayers' money were at stake.

*2. The Implementation of Debt Forgiveness*

The bulk of the external debt for the poorest of sovereign states is owed to official or multilateral creditors. Forgiveness of official debt would be done by unilateral government action of the creditor nation. Recently the United Kingdom has been at the forefront of these efforts, but many nations of the world have played their part as well. Groups of creditor states, for example the Paris Club or the G10, may agree on a common course of action, but ultimately the implementation of the decision lies with individual creditor nations.

Debt forgiveness may similarly be at the level of international financial institutions; for instance, the IMF through the Highly Indebted Poor Countries program. Such forgiveness would have to fall within the ambit of the constituting document, for instance the Articles of Agreement.

*3. Articles of Agreement of the IMF: The Purposes of the IMF*

In addition to the primordial purpose of promoting international monetary co-operation, the other purposes of the IMF, as listed in article I of the Articles of Agreement are as follows:

> (ii) To facilitate . . . balanced *growth* of international trade, and to contribute thereby to the promotion and maintenance of *high levels of employment and real income* and to the *development of the productive resources of all members* as primary objectives of economic policy.

> (iii) To promote exchange *stability*, to maintain orderly exchange arrangements . . .
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them . . . with opportunity to correct maladjustments in their balance of payments *without resorting to measures destructive of national . . . prosperity*.[101]

It is immediately apparent, that some of the IMF's fundamental principles can be used for debt relief. It is certainly true that there are other Fund objectives that conflict with the ones mentioned above,[102] and those whose outworking is more favorable to creditors have been allowed to take precedence. It has been authoritatively suggested by Sir Joseph Gold, however, that the articles should be interpreted by deciding "which purpose or purposes . . . are to be given decisive weight in order to increase the likelihood that over time all the purposes of the fund can be realized."[103]

## V. CONCLUSION

The expressions "sovereign insolvency" and "international bankruptcy" when used the context of sovereign debt really mean sovereign debt restructuring. To parties outside the United States, it is therefore terminologically incorrect to present the choice facing an illiquid sovereign debtor as that between "bankruptcy" and "forgiveness." The choice is really between restructuring and forgiveness. The use of the "bankruptcy" and "insolvency" terminology has caused animosity to the idea of restructuring among debtor nations because the two words attract unpleasant meaning in different legal cultures. Much of the debate about international insolvency or bankruptcy has ebbed because there is now a functional and generally acceptable legal framework for restructuring sovereign debt. While the legal framework is still in its infancy and for that reason it could be labeled as ad hoc, the majority of external debts are restructured on the basis of the contractual provisions inserted in the credit documents while other debts are restructured through the IMF, the Paris Club, and the London Club.

Many of the restructuring deals involve debt write- off as a practical business solution, which means that debt forgiveness and restructuring or the so-called "sovereign insolvency" are not mutually exclusive. In fact, forgiveness and restructuring are very compatible and can be utilized to great effect as long as the ultimate result is debt sustainability. It is not possible to make gold out of thin air and for that reason the loss must fall upon either the creditors or the debtors. The former may attempt to recoup some of their losses through discounting bonds in the secondary market, but a clear choice must be made between attempting to balance debtor and creditor interests, (which half satisfies the creditors, yet fails

101. IMF, *supra* note 7, cl. (ii), (iii) & (v) (emphasis added).
102. Allegaert, *supra* note 29, at 450-51.
103. *Id.* at 451.

completely to do away with the debtor's debt) and deciding to eradicate the debt problem at the creditors' expense. This paper concludes that the latter option is essential. The idea is also in the ascendancy in what is a life-and-death situation for so many millions of people. Ultimately, however, debt alleviation has to be funded by the richer nations; so it becomes a matter of balancing their domestic policies with debt alleviation. This underscores further realities, at least for official creditors.

First, there must be the double coincidence of the ability and willingness to forgive the debt. Granted that debt forgiveness means that creditor nations forego opportunities for their own people, public opinion oscillates whether or not to forgive debtor nations. The overwhelming sentiment in a particular creditor nation may favor forgiveness at a particular time and not another. Decision makers must get the timing right as far as the sentiments for debt forgiveness are concerned. Secondly, the debt can only be forgiven on certain conditions. In the past, this meant that debt forgiveness was usually conditional on meeting some economic tests and undertaking some further economic reforms. It was also a common requirement that the debtor nations embark on some corporate governance and democratization processes. These are reasonable conditions, if only for the debtor nations to be seen giving the assurance that they are doing their best in the economic and political management of their affairs. Finally, debt forgiveness fundamentally tilts geo-political power in favor of the creditor nations, if that were not the case already. The current debt crisis means that, technically, some countries are insolvent. Even though the nations of the world do not use that particular expression, debtor and creditor nations deal with one another with mutual appreciation of the fact. This increases the relative strength of the creditor nations in all spheres of life. This can be both a good and bad thing. For instance, it means that the debtor nations lose a certain amount of control over their own decisions. On the other hand, it means that there will be some external input to some major decisions.

The problem of unsustainable debt is part of the intractable wider problem of underdevelopment and poverty. The many part-solutions to the complex problem of underdevelopment and poverty also constitute part solutions to developing country external debt.[104] Solutions to the debt crisis, though, cannot be the same for all countries. Middle-income developing countries have a menu of options available to them, for example securitization, secondary markets, renegotiation that offers debt write-off, debt-for-equity schemes, and other variations. For the poorest

104. Some of the solutions agreed at the G8 Summit in Gleneagles in 2005, for facilitating development progress in Africa included: (1) a doubling of aid; (2) writing-off immediately substantial debts; (3) a commitment to end export subsidies; (4) substantial funding for many health initiatives; (5) reduction of conflict; (6) education; and (7) a requirement for developing countries to "decide, plan and sequence their economic policies to fit with their own development strategies, for which they should be accountable to their people." Policy Issues, G8 Gleneagles 2005, http://www.g8.gov.uk/servlet/Front?pagenam=openmarket/xcelerate/ (last visited Oct. 23, 2007).

countries, debt relief is the answer in the form of bilateral debt relief by individual countries or through the Paris Club, and multilateral debt relief (including the HIPC initiative). Even then, the debt relief would be only one in a range of approaches towards attaining debt sustainability. There is consensus at the present time that the development of trade in developing countries is the most effective approach towards increased prosperity for those countries and an essential step towards the attainment of the millennium development goals. In addition, the efforts at the better management of external debt also have a role to play tackling the problem of external debt.