

SOME THOUGHTS ON AN INSOLVENCY PROCEDURE FOR COUNTRIES by Prof. Dr. Christoph G. Paulus, Berlin¹

A. Outline of the Problem

The events of September 11th, 2001 have disclosed a coherence which Germany's Foreign Minister *Fischer* described as follows: "If we do not take care of the world's problems, then the problems will come to us." This sentence implies the recognition of that the approximately 200 nations on this earth form something like a global village – a village with no possibility of escape. In view of this conclusion, the question arises whether the living together in this village is regulated by adequate rules, i.e. such rules that are suitable for future use. The answer to this question is potentially of a fundamental significance which cannot be currently assessed. This is, however, not true for the area which is going to be set forth in this article – the debt crisis² of the world's poorest countries (especially those in the Third World). The problems here have already been well-known for a long time. Debtors, creditors as well as international organizations, such as e.g. the International Monetary Fund (IMF)³, the World Bank and non-governmental organizations have been intensively searching for solutions.

The fact that this crisis is a so-called common-pool-problem which means that a country's existing financial resources are not sufficient to satisfy all creditors, was already realized (and for some long known already then) in the mid 1980s on the occasion of the Mexico crisis. It was also recognized that there were similarities to the so-called insolvency law which forms part of that law which governs the relationship between individuals (private law).⁴ However, it took some time until it was realized (and even then not by everybody⁵) that even in cases of governmental sovereigns, the term 'insolvency' instead of merely 'temporary illiquidity' was applicable.

If this fact is established, it is a decisive step towards a more or less direct comparability or even transferability of the rules of civil law to the debt problem of countries. For, the starting point that a debtor cannot satisfy his creditor at all (or not fully) because of his illiquidity is a social phenomenon which has been solved by the means of insolvency law in different manners for the past milleniums. Consequently, the obvious thing to do is to examine whether these rules of civil law are suitable for solving the debt crisis of a country which, to be sure, is different in fact and in law. In this context, one has to depart from the – up to now – predominant principle (stated, e.g., in sec. 12 (1) no. 1 of the German Insolvency Code: henceforth: InsO) that a state has to be excluded from insolvency.

The desire to introduce a procedure at the level of the community of nations has increased especially during the past weeks and months (whether this is due to the events of 09/11/2001 is an open question).⁶ This politically motivated insight is supplemented by the fact known from its counterpart in private law that such a procedure has a disciplinary effect on all participants if it is transparent, foreseeable, efficient and equitable. Its sole existence creates incentives to come to a mutually agreed solution already in the preceding negotiations. The interests of the individual creditors are combined and a solution which is advantageous for the entirety of creditors is created instead of paying respect to individual interests. Thereby such a procedure canalizes the tension resulting from the inability to pay and leads to more fairness among one another.

Although the following goes beyond the legal problem which is the only aspect to be set forth in this article, it should at least be indicated that the handling of the debt crisis as up to the present has created a common-pool-problem of a totally different dimension: The mentioned inability to pay of an increasing number of countries has not only led to a deterioration of living conditions of the population concerned and therefore increased the gap between poor and rich but it has also forced many indebted countries to reduce their natural resources in a manner that is – from a global perspective – uneconomic⁷ and creates irreversible facts. One must only think about the demolition of the rain forest and its consequences for the world's climatic conditions.⁸

I. The Handling of Crises as up to the Present

The debt crises that occurred until now were generally solved by ad-hoc-solutions, such as the HIPC-initiative of the IMF.⁹ Thus, the establishment of an authority was prevented which acquires well-founded experience and has expertise in the relevant field and which thereby creates a base for a procedure which is characterized by constitutionality (*Rechtsstaatlichkeit*) and continuity.

This is, however, not true for institutions like the Paris Club (established in 1954) or the London Club.¹⁰ Both institutions undoubtedly dispose of the above mentioned expertise and the corresponding continuity. Yet both institutions do not – just like the World Bank and the International Monetary Fund (IMF) – fulfil the requirements of a constitutional procedure which have been explicitly laid down especially by the creditor countries. Since these institutions themselves are creditors, they cannot at the same time, be the final deciding authority in the procedure – may it also be in the form of a loosely integrated judicial board.¹¹ Emphasis is on the word "final"; the principles of constitutionality require that in case an agreement cannot be reached, a neutral authority decide on the basis of a transparent procedure. It has to be emphasized that the requirement of transparency is considered to be one of the most important criteria for efficiency by the IMF and the World Bank in the context of the worldwide

reforms and modernization of insolvency laws which both of these institutions have intensively supported.¹²

II. Scepticisms against a New Procedure

The creation of an independent procedure would have several advantages compared to the current system of handling debt crises. These advantages will be illustrated in the following passages. Hence, it is sufficient for the moment to point out one single, but absolutely essential advantage:¹³ the disciplinary effect that a procedure has on all participants when they meet – as this is the case already nowadays – in the Paris or London Club. This effect results from the bare existence of such a procedure, especially since it is governed by a neutral authority. In the context of the insolvency procedure under private law, the disciplinary effect is sometimes described like this: “Peace through deterrence.” Even if this sounds a little martial, this sentence elucidates that an insolvency procedure or a procedure for the settlement of debts can already have fulfilled its task without having been, *de facto*, applied at all.

As already mentioned above, I will repeatedly come back to this. At this point, it shall be analyzed in how far possible counter-arguments are sound.

1. Sovereignty

Some people argue that the insolvency procedure applied in private law does not fit to serve as a model because there is no liquidation of nations and they refer to that a judicial execution against countries is not possible.¹⁴ This fundamental objection is based on wrong premises which will be set out *infra*, sub B.

Apart from this argument, the sovereignty of countries is often mentioned as an obstacle why rules derived from civil law cannot be applied to the context of countries.

a) Transformation of the Concept of Sovereignty

This objection will not be explained in detail in this article. It is sufficient to indicate that the concept of sovereignty that has been developed by *Bodin* in the 17th century and that has been the foundation for international law ever since has been questioned latest since the Nuremberg Trials:¹⁵ Suffice it to refer to the formation of international criminal law which takes care of individuals¹⁶ like *Milosevic* or *Pinochet*.¹⁷ Reference can also be made to the question whether a group of terrorists that is not bound to a certain nation can wage war against a certain country within the meaning of international law.¹⁸ Because of the development of the notion of sovereignty towards its dissolution,¹⁹ it is highly doubtful whether the mere allusion to sovereignty can call in question the introduction of a procedure for the settlement of debts which is of highest interest for especially the debtor countries themselves. The counter-argument is of even lesser importance in view of the proceedings before the Paris or London Club which are at least equally infringing the principle of sovereignty as the procedure which is discussed here.²⁰

b) Chapter 9-Procedure

In addition, an examination of the US-American insolvency law shows that an insolvency procedure can be initiated against municipalities without violation of the principle of sovereignty. The chapter 9-procedure is a well-acknowledged legal institution which includes all creditors and in which the sovereign debtor still has full capacity to act. The procedure is a variant of the general reorganization (or in German: plan-)procedure, chapter 11, which has been adapted to suit the characteristics of the specific debtor.²¹ It is probably the most highly developed approach of dealing with sovereign municipalities in insolvency law.²² There have been cases in US-American bankruptcy law ever since 1934. A large number of cases – especially New York City’s inability to pay in 1975 – have contributed to a further development of this procedure which has been adapted to practical requirements. Details will be presented in the passage dealing with the proposal for a new procedure.

2. A Procedure Is Not the Solution of the Problem, It Only Offers a Structure

If debtor countries (or other institutions) are of the opinion that a procedure for the settlement of debts offers a method of automatically obtaining a discharge from the residual debt, their attention should be drawn to following limitation: The present proposal for the procedure does not contain any detailed explanation with regard to the material substance.²³ Its main goal is more modest: It should serve as a primary step which shall be applied before dealing with substantive problems. Thereby procedural justice²⁴ (*Verfahrensgerechtigkeit*) shall be achieved for the negotiations in the context of debt management. Hence, a base should be created from which a process can be initiated according to which contents are desirable, available and possible to enact.²⁵ Consequently, the establishment of such a procedure does not imply that the debtor is automatically discharged from his existing debts. Such

discharge is not impossible but it is dependent on the approval of the majority of creditors.

B. Terminology and Content of Modern Insolvency Law

I. The Comprehensive Concept of “Insolvency”

Outside the circle of experts of insolvency law and outside the United States of America, bankruptcies and going bust normally evoke associations that have entirely negative connotations and have made the “flaw of bankruptcy” an object of literary discourse.²⁶ From this perspective, it is fully understandable that a procedure for the settlement of debts which is based on the model of insolvency law is regarded sceptically or is even rejected.

However, there has been evolution in this context. The ideal of a “fresh start” which is obvious in the USA for a long time (see *infra*, B III 3) and which results from the country’s history of the origin, is also being adopted in other countries and is reflected linguistically by the application of the word “insolvency” instead of “bankruptcy”.²⁷ This development has been substantially supported and advanced by the IMF²⁸ and the World Bank²⁹ in the field of private law especially during the past few years as these institutions realized – in the context of the East Asia crisis – that, globally seen, effective insolvency laws are absolutely indispensable for global markets to function.³⁰ This implies a change of values because insolvency is not any more cursed with the “flaw of bankruptcy” but is considered a part of the economic ups and downs and is treated accordingly.

In the non-governmental field there were mainly two strings of development which contributed to the fact that modern insolvency law is not any more solely concerned with the liquidation of the debtor’s estate which was, for millenniums, the only way of satisfying creditors. This goal is nowadays being achieved alternatively and sometimes even exclusively by a different means: The re-integration of the debtor into the market with the support of the creditors.

- The first string of development was initiated by the US-American legislation (chapter 11-procedure). It corresponds with the emergence of a post-industrial service society (Dienstleistungsgesellschaft) in the western hemisphere. Here, debtors generally do not have any estate which can be eradicated. The worth of their corporation consists of values which can hardly be sold or legally evaluated and which are therefore more or less intensely bound to their person (know how, good will, connections, clientele). In these constellations it is quite useless for the creditors to strive for a liquidation of such assets. The existing goods can be materialized by far more effectively if the debtor is given the possibility to (re-)invest these assets in the market and optimize them.³¹

- The second string of development is the economic development of the so-called transition countries which have moved from governmental control to the system of free enterprise. If one wanted to apply the western standard of insolvency law to these countries, practically all firms and corporations would be forced into insolvency. In order to prevent such an unbearable result which would lead to a systematic breakdown, conditions need to be created under which the debtor is able to re-enter the market and is not driven out of it.

II. The Plan Proceeding

The alternative way for creditors to be satisfied is to “help the debtor to his feet” instead of resorting to liquidation of his or her assets; for the debtor is the one who best can realize their value. This process is called “*Planverfahren*” (plan proceeding) in Germany and is defined at length in sec. 217 ff. InsO. In simple terms, it deals with the following:

1. Description

The plan proceeding is a regular insolvency procedure. Its opening leads to the so-called *automatic stay*, i.e. the debtor is protected from creditors’ actions, as he is, at the same time, not allowed to take any actions which could affect the creditors’ position to their disadvantage. A plan for the reorganization of the debtor (which might possibly have to fulfil certain minimum requirements concerning the satisfaction of the creditors) is worked out and presented. This plan is discussed and put to the vote in a given – and therefore transparent – procedure. In contrast to the usual out of court restoration efforts, which are dependent on unanimous acceptance a majority vote suffices. In order to facilitate the procedure and reduce its complexity the creditors can be put together in groups whereby the formation of such groups is done under the aspect of functionality. The plan is considered approved if the majority (either of the voting creditors or, additionally, of the sum of the claims) within each group agrees to it. This result is binding for all creditors.

2. The English “London Approach”

This somewhat condensed outline shows that a court or a neutral authority does not necessarily need to be involved in the performance of a plan proceeding.³² Accordingly, the English banks, under the lead and authority

of the Bank of England, have developed the so-called “London Approach” which implies a similar mechanism for out-of-court-settlements for enterprises that are on the edge of insolvency: According to that, when banks learn about crisis indicators of their debtor enterprises, they are supposed not to start immediately with the realization of their securities which would lead the enterprises even further into insolvency. On the contrary, they should refrain from such actions and rather try to search for solutions together with the debtor and other creditors (banks, suppliers, etc.) in order to stabilize the debtor’s situation.

3. A Worldwide “London Approach”

It deserves attention that there are currently efforts to globalize this method, i.e. to have it applied not only by the English banks.³³ The so-called Lenders’ Group of *INSOL International* (an association of international insolvency practitioners) has agreed to a code of conduct which comprises eight principles.³⁴ It shall be recommended as a standard for the conduct of all large creditors towards their debtors who are serious financial difficulties. Even if the success of these efforts is questionable as there is no common superior authority, the approach as such is instructive – especially because the banks have made clear that as far as private law enterprises are concerned, they are willing to take responsibility for the restoration of financially weak enterprises. If these recommendations are adopted, the sanction for a conduct which infringes the code would be a kind of outlawry within the banking community – this would possibly have a more disciplinary effect than any legal measure.³⁵

III. Model Function of the Regulatory Mechanism of Private Law

Transferred to the context of the regulation of governmental debts, it can be concluded from these conceptual clarifications that the private law insolvency proceeding can certainly have a model function. For, according to the new understanding, the proceeding does certainly not imply a removal from the community of nations and therefore a liquidation³⁶ (which is naturally not to be discussed); to the contrary, it provides for the integration into this community. Hence, it is necessary to take a look at which peculiarities or advantages have led to the creation of an insolvency law under private law – at least as far as this is important for the present context. At this point, one has to recall that institutions like the IMF and the World Bank have realized the fundamental importance of insolvency law under private law for the global economic system only very recently and that they have designed standards for more modern and more efficient insolvency laws.

1. The Disciplinary Effect

As already mentioned above, a decisive reason for the creation of insolvency law is the disciplinary effect that it has on the participants. This is usually emphasized for the debtor,³⁷ but it is equally true for the creditors.³⁸ If the law offers a procedural model for the “worst-case-scenario”, there is always a sort of border line which serves as a reference point for both parties during the out of court restoration efforts. Moreover, this implies the application of a fundamental constitutional principle: If a unanimous solution is not possible, the case is not any more regulated bi- or multilaterally but with the help of a neutral authority. This strengthens the negotiation basis for all participants.

2. Majority Rule instead of Unanimity

While the preliminary negotiations require unanimity to achieve a legally binding agreement, which adds difficulty to these restoration efforts, the insolvency procedure only requires a howsoever constituted majority. This is one of the essential disciplinary effects for dissenting creditors (“troublemakers”).³⁹ This simplification is achieved by the fact that insolvency law is binding (*ius cogens*) and unites all creditors in a compulsory community (“Zwangsgemeinschaft”) which prevents them – whether they like it or not and whether they are aware of it or not – from taking proceedings against the debtor individually.⁴⁰ As this procedure wants to solve a financial crisis, not only the debtor but also the creditors lose a part of their rights. They also have to make a contribution for the sake of overcoming the debtor’s crisis. This is essential in order to have a solution that can be considered fair and constitutional. Here, indeed, is probably the crucial problem when implementing a governmental procedure for the settlement of debts.⁴¹

3. Objectives of Insolvency Law

The objectives of the insolvency laws are by no means uniform. While in Germany the satisfaction of the creditors is predominant, the US-American insolvency law focuses on the so-called “fresh start”, i.e. the possibility for the debtor to start again. In France, the idea that insolvency law is to be designed to save as many jobs as possible (even if this is at the expense of the creditors) is prevalent to a certain degree while in Argentina the primary

objective is to preserve enterprises as far as possible. In Italy, there is a procedure which aims even quite directly at the return of governmentally granted loans

According to the objective of a given insolvency law the importance of the diverging interests varies. Therefore, the aim of the insolvency law in question should be clear from the very beginning. Hence, regarding a possible proceeding for debt management, it is helpful (if not indispensable) to decide right at the beginning whether this procedure should focus on the satisfaction of the creditor, the improvement of a country's economic productivity or, e.g., on the improvement of the living conditions of the country's population.⁴²

C. Proposal for the Procedure

The preceding comments have shown that it is very well possible to create a governmental procedure for debt management using elements from the existing private law insolvency.⁴³ Again, it is to be emphasized that a plan proceeding does not result in the liquidation of the debtor's estate. Especially the US-American chapter 9-procedure (which can serve insofar as a model) demonstrates that such a procedure does not have to lead to the waiver of sovereign rights and interests.

Having this in mind, the following proceeding appears to be feasible:

I. Opening

1. Neutral Authority

a) Selection

Prohibition of collision of Interests: The worldwide demanded and emphatically recommended rule of law principle does require that the procedure for debt management be governed not alone by the parties involved. A neutral third person must at least be the last resort.⁴⁴ Only if this requirement is fulfilled, the procedure will have those advantages which result from a comparison with the insolvency procedure under private law. This fundamental deduction leads directly to the conclusion that neither the International Monetary Fund nor the World Bank will be suitable as such an authority. For, both these institutions are too much representatives of the creditors (even if this were true only from the debtors' perspective) because they themselves are in fact also creditors.⁴⁵

This opinion is not changed either by the IMF's recent proposal to introduce an institutionalized procedure.⁴⁶ According to that, the initiation of this procedure should be dependent on the IMF's consent. Looking at this approach from a constitutional viewpoint, it is, however, not acceptable because, in the end, it is again a creditor (may he also be benevolent) who decides whether the debtor can take the procedure or not.⁴⁷ The rules of fair trial demand that this autonomy (or sovereignty) be left at the debtor and that he alone be able to initiate the procedure. The interests of the creditor are adequately protected as the debtor's motion is subject to an abuse control.

Criteria of Selection: The positive aspect about searching a suitable neutral third person is that the number of prospective persons should be kept quite small. The significance of this subject calls for the development of an expertise which is on the one hand highly important for the predictability of the procedure and on the other hand ensures that the procedure is accomplished – as a result of the gathered experience – with the highest possible competence. The smaller the number of prospective third persons, the better this objective can be achieved.

Compared to this primary requirement it is only of secondary importance how to determine this pool and where to establish it: One can either establish it in an institution (“institution solution”), e.g. the United Nations or one of their sub-organizations, or at the International Court of Justice⁴⁸ (or, respectively, a subdivision there which would have to be created there). From the legal point of view the latter is more reasonable. It is, however, also possible to organize the pool more openly and allow the parties to select – comparable to the usual arbitration procedure – each a preferred person who himself appoints a superior third person (“arbitration solution”). This approach leads to the difficulty to determine the members of the pool, i.e. the problem who should be authorized to select the pool.

The “arbitration solution” has the advantage of higher flexibility and possibly also higher acceptance because at least one of the deciding votes has been appointed by oneself. As opposed to this, the “institution solution” has the advantage of being more neutral and easier to determine.

b) Tasks

The (legal)⁴⁹ tasks of the neutral third person can be differently organized. Details will be shown in the following paragraphs. But if one wanted to typify the possible profiles of tasks, one could either follow the Anglo-American model of a judge who acts mainly as a controlling “supervisor” or its European counterpart (on the continent) who has had influence on the judgment ever since.

In the first case the neutral third person is limited to verify the existence of an opening reason (infra, C I 2),

to check the submitted plan mainly with regard to its realization and completeness (infra, C I 5 a), to question whether the proposal of the motion is abusive (infra, C I 5 b), to preside over the negotiations of the plan, to control whether the plan has been correctly materialized and approved (infra, C II 3) and finally to supervise the execution of the plan (infra, C III).

The more active variant of the neutral third person adds additional elements relating to the content to the above-mentioned description of tasks: the verification whether the substantive postulates of the plan are fulfilled (infra, C I 6), the realization of conceded rights of recovery (infra, C II 2), the competence to submit own proposals for a plan (infra, C II 3), etc. If the neutral third person is legally qualified (which would naturally be the case with a judge of the International Court of Justice or its subdivision), he could furthermore be assigned the task to verify the indicated debts with regard to their legality, i.e. to check, for example, whether the formal requirements etc. of the laws of the respective countries are fulfilled.⁵⁰

2. Opening Reasons

In light of a study which has been prepared by the academic commission of the BMZ⁵¹ it has to be indicated that so far the opening reasons for an insolvency proceeding has so far not been satisfactorily determined or legally defined. Nevertheless insolvency law has functioned well for millenniums. Hence, this difficulty is no counter-argument for the introduction of a procedure for the settlement of debts.

Overindebtedness as an opening reason raises, however, considerable difficulties already under private law.⁵² Therefore the adaptation of this reason to the here discussed context of countries is extraordinarily problematic. As a result one can only think about recurring to cessation of payment or illiquidity as opening reasons both of which are generally accepted reasons. These reasons are given if the debtor cannot fulfil his liabilities in full.⁵³ One could also consider in this context whether the so-called imminent illiquidity should be sufficient as opening reason. By initiating the procedure at an earlier point, the chances of speeding up the settlement of debts increase. Because at this time there are still more liquid assets than at a later time when they have been exhausted – due to the inability to pay – to a larger extent.⁵⁴

The problem of the opening reason, however, can be solved entirely differently – that is by means of abuse control which has to be carried out anyway by the neutral third person (see infra, 5 b). He makes a synopsis of all circumstances that have made the country file the petition and he decides whether this complies with the requirements of loyalty and good faith (*bona fides*).

3. Type of Procedure

The only possible type of procedure is the plan proceeding. Each thought about liquidation, judicial execution or whatever coercive measures is, as emphasized above, to be excluded from the very beginning. Therefore only a plan proceeding is possible. This has to be organized in such a way that the creditors and the debtor are brought together in order to discuss – under the supervision of a neutral third person – the plan for the management of debts which has been presented by the debtor.⁵⁵ Then the plan has to be put to the vote and to be decided upon.

4. Right to File a Motion

As far as this subject is concerned, the US-American chapter 9-procedure seems exemplary –it should be the exclusive right of the debtor country to file a petition and, thus to initiate the proceeding.⁵⁶ This is essential in order to maintain sovereignty because the admissibility of a petition filed by a creditor or even an institution would force the debtor country into a duty to act which is in the worst case not advisable or restrains the debtor country to act.

With regard to the aforementioned advantage of each insolvency procedure (infra, B III 1) that its sole existence has a disciplinary effect on all involved parties, the here presented proposal seems like a one-sided favoritism of the debtor. For if only the debtor country is given the possibility to initiate the procedure, it is thereby given a means of pressure which it can – in contrast to the creditor – always use, e.g. at the negotiations with the Paris or London Club. This imbalance is, however, indispensable because of the reasons mentioned above. Therefore, it has to be compensated – at least to a certain degree – by imposing higher demands upon the admissibility of the petition (see infra, C I 5) and perhaps also upon the minimum requirements with regard to the contents (see infra, C I 6).

5. Formal Requirements

a) Feasibility of the Plan

One of those compensating regulations in favor of the creditor which has already been mentioned above (supra,

C I 4); it is the introduction of certain requirements, the fulfillment of which has to be verified by the neutral third person. Probably the most important requirement is that along with the filing of the petition for the initiation of the proceeding a plan be submitted by the debtor country which contains solutions or proposals of how – according to its own opinion – its problems can be solved. Even if this plan will only be dealt with and discussed with the creditors after the proceeding has been instituted, the plan should be assessed at least roughly with regard to its feasibility at the beginning.⁵⁷ By this means it can and shall be prevented that the procedure is carelessly instituted, its sole purpose being to keep the creditors waiting without considering their interests.

b) No Abuse

Closely connected to the aforementioned argument is another requirement of admissibility– the examination whether the motion was filed with abusive intent. In order to evaluate this aspect, the neutral third person would have to be generally able to obtain the necessary informations from the International Monetary Fund as well as the World Bank (among others). It might be at this point that a petition is remitted if, e.g., a country files it in order to get discharged from its reparation obligations after a lost war; this would constitute a behaviour which is in contradiction to its former deeds (*venire contra factum proprium*). An exception could be made here possibly if the petition were filed by a government which is not identical with the one responsible for the war.

A special variant of the abuse control would be an additional requirement of admissibility: to allow a motion from the debtor country only if such a motion has not been filed within a certain period of time – 2, 5, 7, 10 years etc. In this way, an inflationary use of this new instrument could be controlled.

6. Substantive Requirements

The aforementioned requirements of admissibility only refer to more or less formal criteria. They can naturally be extended by further, more substantial requirements. There is a big variety regarding the contents of these requirements. Possible standards can be extracted from the requirements which are demanded by the World Bank and the International Monetary Fund on the basis of their conditionality^{58, 59}. If one were of the opinion that such minimum requirements are desirable one has to think about which aims one wants to achieve with the insolvency proceeding which is being proposed here (cp. B III 3). For, it makes sense that the substantive minimum requirements are in conformity with these aims – not to mention that such minimum requirements must certainly not infringe the sovereignty rights and obligations of the debtor country.

In view of the fact that the proposed procedure can only be a plan proceeding which tries to help the debt-burdened country to take part again actively in economic life, the country has to be given the minimum means of subsistence (however this may be defined) also for the phase during which the plan is executed. Otherwise the proceeding would be a “still-birth” from the beginning because it would already not be politically justifiable for the debtor country’s population. This cannot be of interest for the donating countries either.

7. Effects

a) General Effects

Once the petition is filed, the debtor must immediately be protected from creditors’ attachment. Not only is this mechanism – the “automatic stay” – characteristic of insolvency procedures under private law, but it also has to be introduced in the envisaged procedure for the management of state debts. Only with the help of this mechanism the intended advantages of this procedure, i.e. the disciplinary effect and especially the systematic and transparent way of bringing about a consent, can be achieved. However, one should consider whether this “stay” should be limited in time in order speed up the proceedings.

The problems resulting from the “automatic stay” will be illustrated in connection with the formation of a compulsory community (infra, C II 1). However, it has to be mentioned already here that the putting through of such a “stop” is difficult with regard to all creditors – be they public or private – because it cannot be sanctioned in the same way by domestic law as its pendant under private law. But the aforementioned “London Approach” shows nevertheless that practically the same effect can be achieved by way of “voluntary” submission – in that case the voluntariness is ensured by the superior authority of the Bank of England. In this context, however, a comparable effect is probably not even possible by means of an international obligation which is not binding for private creditors. At the most, this effect can be achieved if the banking world comes to a corresponding agreement which threatens possible offenders of the “automatic stay” with outlawry or the flaw of illoyalty. As already shown, especially banks seek exactly this effect for usual insolvencies of enterprises, i.e. those under private law (supra, B II 3). In consideration of this, it is not only applicable for debtors under private law, but *a fortiori* also for countries – especially if one bears in mind the above-mentioned situation of the world where few more than 200 members must try to find a *modus vivendi* which is necessary to survive together.

Obviously, the “automatic stay” on the creditors’ side must have a corresponding counter-part on the debtor country’s side: the prohibition of the debtor country to take actions which could affect the creditors’ position to their disadvantage.⁶⁰ It is the task of the neutral third person to control this and he should be able to have access to the information basis of the IMF and the World Bank. The observance of this task of the debtor can be indirectly enforced by repealing the proceeding in case of violation and thereby letting the consequences ensue which will be described later (infra, C II 3).

b) Subsequent Creditors

The effect that has just been illustrated is, however (and self-evidently), not applicable to such creditors who have granted the debtor country new credit after the procedure was instituted. Such new credit, which is generally indispensable for the feasibility of the plan, could only be obtained in highly exceptional cases if it was not privileged compared to the existing claims in the procedure for the settlement of debts.

II. Procedure

1. Compulsory Community

a) Lack of Competence

It has already been mentioned that probably the greatest difficulty in adapting the rules of private insolvency law to a governmental proceeding for the settlement of debts is that all creditors existing at the time of the institution of the procedure⁶¹ must be included – another difficulty is how to achieve this result. While the national legislation can create – by virtue of its constitutional competence – a compulsory community (that includes governmental as well as private and domestic as well as foreign creditors), such an institution is missing in the context in question. This deficit is supplemented by the difficulty to bring the public and the private creditors under one heading.

b) Practical Remedies

The search for a solution of this problem has led to the employment of so-called “collective action clauses” in certain contracts. This signifies, as a result, the voluntary subjection of one party to certain majority decisions. Just recently the Executive Board of the IMF said the following in this context:

„... Directors noted the useful role that voluntary collective action clauses in bond contracts could play in the orderly resolution of crises, and agreed that their explicit introduction in bond documentation would provide a degree of predictability to the restructuring process.”⁶²

Another variant that is also based on contractual consent are the so-called “exit consents”.⁶³ They contain a waiver of unanimity for certain modifications of debt administration and therefore put indirectly pressure on the creditors to consent to changes on their own initiative.⁶⁴

Accordingly one can state that intensive efforts are currently made to find a mechanism that unites the creditors in a position in which they have to necessarily act together even if this is not in the form of a compulsory community under private law. Even if this endeavour has not yet been completely successful, one has to point out once again the aforementioned efforts to achieve a global uniformity of creditors in the field of insolvencies of enterprises under private law. Because this indicates on the one hand that the banks (and other creditors) are willing to assume macro-economic responsibility and on the other hand that uniformity can also be achieved by non-legal sanctions as for example by way of outlawry by the peers.

c) Formation of Groups

As far as a “communitization” of all creditors (which should be achieved now or in near future) is concerned, i.e. especially the inclusion of all bond holders, enormous legal problems are piling up. In the abstract, either duress or an incentive are possible means. The latter, i.e. an incentive, can be made in the form of exchange offers – as has been the case in Ecuador and Pakistan.⁶⁵ The success of such a procedure depends on whether the creditors “fall” for it.⁶⁶ If not, a possibility to sanction is missing as far as it is not contractually agreed to. Duress is out of the question as long as the national legislation does not introduce a mutual precept of respect. Whether such a precept is possible and – above all – whether it would be binding for foreign creditors, is more than doubtful.

The proposal for a proceeding which is made here can reduce the problem in so far as the private bond holders can be – in case groups are formed – bounf together within one group. This would be consistent with permissible and factual criteria of division as for example the classification of other private or public creditors. Hence, the bond holders would only have a single vote as a group when the plan is put to the vote.

2. Avoidability

The aforementioned chapter 9-procedure has one special feature which is common to practically all insolvency laws on this earth: the avoidability of transfers and transactions which the debtor had undertaken before the procedure was instituted and which – after the opening of the proceeding – prove to be disadvantageous for the entirety of the creditors who are involved. Naturally not all transactions can be affected by this retroactive rescission but only those which have certain negative features: a prevalent standard for this is on the one hand the preferential treatment of individual creditors and on the other hand the intention to discriminate the creditors collectively with the transaction in question.⁶⁷

If certain payments can be reclaimed when the procedure is instituted, this alone already implies a certain disciplinary effect for especially pressing creditors. If they collect their claims selfishly and even with force, they must expect that exactly this performance of the debtor will be reclaimed in the procedure that will be subsequently instituted. This causes – according to the efficiency of the actual realization of such a reclaim possibility – possibly a more or less intense pressure to act conformably already in the pre-procedural stages of debt management, i.e. in such stages where negotiations are made without the participation of a neutral third person – comparable to the Paris or London Club.

If this option that has been well-established in the private law insolvency proceeding for millenniums is transferable to the governmental procedure for the management of debts, the additional question arises whose transactions should be rescinded: only those of the government or also those of the reigning person who has used money which was meant for the government privately. If a private yacht is bought, the question is easy to answer. The situation is more complicated if the issue at stake is a prestige object which is of no use for the population, e.g. the air terminal in no-man's-land, etc. These particular problems should, however, not deter from generally introducing the option of contestation. For it is, as has been shown, an important step with the help of which the here proposed proceeding would not even have to be applied at all *in praxi*.

3. Consent

Naturally the plan requires the consent of the creditors. It is, however, not clear which creditors are referred to in this context. In any case, all public and private foreign creditors have to be included. Because of reasons of fairness it is then also indicated to include domestic banks as well. Whether, beyond that, domestic private creditors are to be included, should be decided individually by the neutral third person. One could fundamentally support the inclusion although exceptions should be made in reasonable cases.

In contrast to the non-procedural negotiations, e.g. in the Paris or London Club, the requirement of unanimity for the consent of the plan is not feasible. The subsequent question what kind of majorities should be necessary in order to pass the plan depends on which priorities one sets. A majority between 51 and 99 % is thinkable whereby one can further differentiate according to the amount of the claims (“sum”) and the number of creditors (“heads”) or one can classify the creditors in groups for voting (supra, B II 1).

The consequence of if an agreement is not reached is – depending on the powers of the neutral third person – either negotiations about a new plan or the failure of the proceeding. The latter is an acceptable consequence (although it should be avoided if possible) as the agreement only fails if the required majority is not obtained. Thereby it is impossible that one (or some few) creditors negotiate in such a way that they persistently and continually abide by their “nay”. He or they must be prepared to be crammed down in the proceeding. The more the required majority for the approval of the plan is reduced towards 51 %, the bigger the risk is for such creditors. On the other hand, the mere possibility that the plan fails entails that the debtor is well advised to create a plan which has realistically chances to get approved by a majority of creditors.

Whether the required majority is reached and the plan is approved, shall be determined by the neutral third person by means of a formal verification.

III. Realization of the Plan

Each plan must naturally contain a proposal or show a method to which extent and in which time the debts should be paid. If the plan is approved by the creditors and verified by the neutral third person, the question arises whether the realization of the plan should be entirely the debtor country's responsibility or whether there should not be at least a partial supervision or control by the neutral third person who is already familiar with the facts. In any case, the discipline to observe the objectives of the plan is ensured by such a control. It could even be fortified by introducing a sanction that the plan becomes void in case of certain deficiencies or non-compliance. In that case the burden of debt would jump back to its original amount without the debtor having the possibility to re-file a petition for such proceeding (see supra, C I 5 b).

D. Summary

A governmental procedure for the settlement of debts could be organized in such a way that a plan proceeding can be carried out only if the debtor country files such a motion. The plan is to be submitted to a neutral third person who has to be selected from a possibly small pool in order to develop expertise as soon and as intensively as possible. An “automatic stay” ensues from the submission of the plan, i.e. the debtor is exempt from creditors’ attachment and the debtor is hindered from performing any transactions to the disadvantage of the creditors. The plan must fulfil certain requirements which refer to formal aspects but possibly also to the contents.

If the plan is not consistent with these requirements, it is rejected by the neutral third person and the debtor country is again in the procedural stage in which it has been so far – in the negotiations with the Paris or London Club although one cannot appeal to a superior authority. If the plan is, however, in accordance with the imposed requirements, the plan proceeding is instituted at the same time, i.e. the examination and discussion of the proposal under the supervision of the neutral third person. The plan is then approved if the required majority is reached and the neutral third person has verified that the procedural rules have been observed. It is worth considering whether the estate which shall be distributed can or should not be increased by introducing a right of avoidability.

APPENDIX

The Principles of the Lenders’ Group

FIRST PRINCIPLE: Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a “Standstill Period”) to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor’s financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

SECOND PRINCIPLE: During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.

THIRD PRINCIPLE: During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

FOURTH PRINCIPLE: The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

FIFTH PRINCIPLE: During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

SIXTH PRINCIPLE: Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

SEVENTH PRINCIPLE: Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

EIGHTH PRINCIPLE: If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

(Footnotes)

- ¹ This article is based on a study which the author has worked out on behalf of the “*Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung*” (Federal Ministry for Economic Cooperation and Development). He is indebted to Mr. Ritesh Rajani, Berlin, who translated the German manuscript into English.
- ² This word has been established as a fixed term during the past decades. See only *Dabrowski/Eschenburg/Gabriel*, Lösungsstrategien zur Überwindung der internationalen Schuldenkrise (omnibus volume), 2000, pp. 213 ff.
- ³ At last *Anne Krueger*, IMF, in her speech on 11/26/2001: International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, www.imf.org/external/np/speeches/2001112601.HTM. According to that, the solution of debt crises which has so far been mainly political should be transformed into a procedure and thereby be given a legal ground. The consequences of this approach are illustrated in *Haltern*, Die Rule of Law zwischen Theorie und Praxis, Der Staat 2001 (40), pp. 243 ff.
- ⁴ *Meesen*, Die insolvenzrechtliche Option in der internationalen Schuldenkrise, ZfRVergl 1990, pp. 255 ff.; *Raffer*, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18 (2), 1990, pp. 301 ff.; *Raffer*, Vor- und Nachteile eines Internationalen Insolvenzrechts, in *Dabrowski/Eschenburg/Gabriel* (supra, note 2), especially pp. 226 ff. Informative: *Knieper*, Nationale Souveränität, 1991, pp. 130 ff.
- ⁵ See only *Pieper*, Völkerrechtliche Aspekte eines Internationalen Insolvenzrechts, in: *Dabrowski/Eschenburg/Gabriel* (supra, note 2), pp. 246 f.
- ⁶ See *Krueger* (supra, note 3); BMZ spezial no. 14, Internationale Insolvenzregelungen für Entwicklungsländer, May 2000, pp. 11 ff.; UNCTAD, Trade Development Report, 2001, p. 68.
- ⁷ *Oberndörfer*, Schutz der tropischen Regenwälder durch Entschuldung, 1989.
- ⁸ There are several other examples in the omnibus volume of *Dabrowski/Eschenburg/Gabriel* (supra, note 2).
- ⁹ BMZ spezial (supra, note 6), p. 11 ff. This is, however, not true for *Schwarz*, Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach, 85 Cornell Law Review, pp. 956 ff. (2000): He makes a draft for an international agreement.
- ¹⁰ In the Paris Club, public creditors meet to regulate questions relating to debts, whereas in the London Club the banks meet for this purpose.
- ¹¹ For the contradicting view: See International Monetary Fund, A New Approach to Sovereign Debt Restructuring: Preliminary Considerations, 2001, p. 13.
- ¹² International Monetary Fund-Legal Department, Orderly and Effective Insolvency Procedures – Key Issues, 1999, p. 6; World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, 2001, pp. 25 f.
- ¹³ See also *infra*, B III 1
- ¹⁴ In this context, in Germany reference is often made to sec. 882 a of the Civil Procedure Code (Zivilprozessordnung = ZPO) according to which the judicial execution against legal persons under public law depends on several precautions.
- ¹⁵ *Tomuschat*, International Law: Ensuring the Survival of Mankind on the Eve of a New Century, 2001, pp. 161 ff.; *Knieper* (supra, note 4), pp. 58 ff.
- ¹⁶ The increasing significance of the individual in international law is illustrated in *Randelzhofer*, The Legal Position of the Individual under Present International Law, in: *Randelzhofer/Tomuschat* (pub.), State Responsibility and the Individual: Reparation in Instances of Grave Violations of Human Rights, 1999, pp. 231 ff.
- ¹⁷ Instructive: *Werle*, Menschenrechtsschutz durch Völkerstrafrecht, ZStW 1997, pp. 808 ff.
- ¹⁸ For this, see e.g. *Tomuschat*, Der 11. September 2001 und seine rechtliche Konsequenzen, EuGRZ 2001, pp. 535 ff.
- ¹⁹ See *Knieper*, supra (note 4), *passim*.
- ²⁰ For the relationship between the IMF’s Conditionality and the governmental sovereignty: *Meesen*, IMF Conditionality and State Sovereignty, in: *Dicke* (ed.), Foreign Debts in the Present and a New International Economic Order, 1986, pp. 117 ff.; *Denters*, Law and Policy of IMF Conditionality, 1996; *Weigeldt*, Die Konditionalität des Internationalen Währungsfonds in ihrem Verhältnis zur Staatssouveränität und zu den Menschenrechten, 1999.
- ²¹ See *infra*, B II.
- ²² The procedure is illustrated in, e.g., *Kopelman*, Municipal Bankruptcy: The Worst-Case Scenario, 34 Oct. Boston Bar Journal, 9 (1990); *McConnell/Picker*, When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy, Practising Law Institute – Commercial Law and Practice Course Handbook Series, March 1995, (713 PLI/Comm 35). The German state laws do not directly deal with this topic because of the legislative premise that municipalities cannot become insolvent. It can, however, be concluded that in the case of an impending inability to pay the “*Rechtsaufsichtsbehörde*” (agency of supervisory control) can intervene and dismiss the municipal “sovereign”, cf. sec. 128 Brandenburg Gemeindeordnung (GemO); sec. 114 Bayerische GemO; sec. 124 Baden-Württembergische GemO; sec. 132 Niedersächsische GemO; sec. 117 Sächsische GemO.
- ²³ See, however, *infra* C I 6.
- ²⁴ For an instructive explanation of procedural justice, refer to *Bierbrauer/Gottwald/Birnbreier-Stahlberger* (pub.), Verfahrensgerechtig-

keit, 1995.

²⁵ Whether the proposed procedure should be legally binding or only of appealing character to cooperate shall not be decided at this point in order not to block any creative impulses. Even if the binding force of such a procedure is desirable due to reasons of predictability and legal certainty, the procedure of the Paris or London Club shows that continuity can also be guaranteed without laying down these rules in the framework of international law.

²⁶ One must only think about *Tony Grünlich's* (maiden name: *Buddenbrock*) fate in *Thomas Mann's* novel. Cp. also *Paulus*, *Entwicklungslinien des Insolvenzrechts*, KTS 2000, p. 240. For illustrations about the ancient Roman Law – which is the direct historic root of the described flaw – cf. *Kroppenberg*, *Die Insolvenz im klassischen römischen Recht*, 2001, pp. 240 ff.

²⁷ The non-legal literature has so far applied the term “international insolvency law” in this context. From the legal point of view it has to be pointed out that this term is already used for such cases where the estate of a debtor (according to private law) is not situated in a single country, i.e. it refers to cases in which the insolvency procedure has a cross-border effect.

²⁸ See International Monetary Fund (supra, note 12).

²⁹ See World Bank (supra, note 12). An additional (comparative) “Technical Paper” will appear in 2002 by *Booth/Paulus/Rajak/Westbrook*.

³⁰ In detail: *Paulus*, *Der Internationale Währungsfond und das internationale Insolvenzrecht*, IPRax 1999, pp. 148 f.

³¹ Cp. *Paulus* (supra, note 26), p. 247; See also International Monetary Fund (supra, note 12), p. 14.

³² If “*Eigenverwaltung*” (debtor in possession) is ordered pursuant to sec. 270 ff. InsO, a “*Sachwalter*” (trustee) has merely a supervising function.

³³ Cp. INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts*, 2000.

³⁴ See Appendix.

³⁵ This was already realized by *Seneca* in *de beneficiis* V.21.1.

³⁶ See also *Schwarcz* (supra, note 9), pp. 958 f. with further references.

³⁷ E.g. International Monetary Fund (supra, note 12), p. 8.

³⁸ See e.g. World Bank (supra, note 12), p. 25 sub 70.

³⁹ International Monetary Fund (supra, note 12), p. 8: “... an effective insolvency law can provide a useful means of ensuring that private creditors contribute to the resolution of the crisis. For example, a rehabilitation procedure provides a way to impose a court-approved restructuring agreement over the objections of dissenting creditors.”

⁴⁰ Instructive: *Hänel*, *Gläubigerautonomie und das Insolvenzplanverfahren*, 2000.

⁴¹ See infra, C II 1.

⁴² See infra, C I 6 (further illustration of this requirement).

⁴³ For the adaptation into binding law under international law see *Pieper* (supra, note 5), pp. 251 f.

⁴⁴ Dissenting opinion: *Schwarcz* (supra, note 9), pp. 1018 ff.

⁴⁵ For the “moral hazard” problem which shall result from the function of the IMF as “lender of last resort”: *Schwarcz* (supra, note 9), pp. 961 ff.

⁴⁶ *Krueger* (supra, note 3).

⁴⁷ See also “The Economist” (12/08/2001): “When countries go bust”, p. 76.

⁴⁸ Regarding the problems of acceptance in the international community, see *Tomuschat* (supra, note 15), pp. 411 ff. UNCTAD (supra, note 6), p.68 speaks about the establishment of an International Bankruptcy Court. Dissenting: *Kreile*, *Deutschland und die Reform der internationalen Finanzarchitektur*, *Aus Politik und Zeitgeschichte* B 37-38/2000, p. 15.

⁴⁹ The actual influence of the deciding person can – according to its character and acceptance – go far beyond what is legally necessary.

⁵⁰ See *Frankenberg/Knieper*, *Rechtsprobleme der Überschuldung von Ländern der Dritten Welt*, RIW 1983, pp. 569 ff.

⁵¹ *BMZ spezial* (supra, note 6), pp. 3 ff.

⁵² Cp. only World Bank (supra, note 12), pp. 29 f.

⁵³ Regarding this “general cessation of payment test” see only International Monetary Fund (supra, note 12), pp. 21 f.

⁵⁴ *Schwarcz* (supra, note 9), pp. 981 ff., too, grants the debtor the exclusive right to file. He considers, however, the requirement of an opening reason counter-productive.

⁵⁵ For further explanation see infra, C I 4.

⁵⁶ See also The World Bank Group – Operations Policy and Strategy, *Poverty Reduction Strategy Papers – Internal Guidance Note*, January 21, 2000, p. 3.

⁵⁷ At this point it becomes evident that the aforementioned expertise of the neutral third person is particularly desirable.

⁵⁸ See *Weigeldt* (supra, note 20).

⁵⁹ Informative regarding Germany’s experience so far: *Pieske*, *Möglichkeiten und Grenzen der Entschuldung durch Gegenwertfonds*, in: *Dabrowski/Eschenburg/Gabriel* (supra, note 2), pp. 207 ff.

⁶⁰ Naturally it must be examined diligently which actions may not be restricted (as they are derived from incontestable principle of sovereignty) and which of them put the creditors at a disadvantage.

⁶¹ Therefore not the above-mentioned (supra, C I 7 b) new creditors. For these creditors the plan can and must have a special rule in favor of them.

⁶² International Monetary Fund, *Involving the Private Sector in the Resolution of Financial Crises – Restructuring International Sovereign Bonds*, 2001, p. VI.

⁶³ See especially *Buchheit/Mitu Gulati*, Exit Consents in Sovereign Bond Exchanges, 48 UCLA Law Review, pp. 59 ff. (2000).

⁶⁴ See especially for the “exit consents” that Ecuador has introduced: International Monetary Fund (supra, note 62), pp. 8, 11. *Ibid.*, p. 12 concerning the “pari passu clauses”.

⁶⁵ See International Monetary Fund (supra, note 62), pp. 8 ff.

⁶⁶ This could be directed if there were well-functioning secondary market for such bonds.

⁶⁷ This dualism sounds like the US-American conception for insolvency lawyers but it is also applicable to German law. Thereby the groups of cases are chiseled more precisely, cp. *Paulus*, Germany: Lessons to Learn from the Implementation of a New Insolvency Code, 17 Connecticut Journal of International Law pp. 89 ff., 93 ff. (2001).