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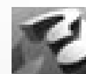
International Insolvency/Arbitration:

Arguments and Counterarguments



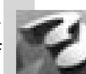
Insolvency is for firms; for countries it is not applicable, as countries are sovereign

If one considers the common perception of corporate or individual insolvency, this is legally right. But that is precisely, why US Chapter 9 is proposed as a model. Chapter 9 has been designed and implemented in order to deal with the specific opportunities and constraints debtors with governmental powers are facing. All its principles can and should be applied internationally.

"International law knows no bailiff" – arbitration can not be enforced

Right - there is none. But this is so in ALL cases, including those which are unrelated to debt. Still arbitration works fairly well in international disputes and as a settling mechanism in the framework of international treaties like the WTO. In all these cases absence of formal enforcement is of no concern. The same is true for existing agreements on debt, e.g. with the Paris Club. Agreements between countries and their creditors cannot be enforced in the same way as treaties between individuals within a country. The only reason sovereign countries have to honour international agreements like those over debt payments is that they consider the gains – political, as well as economic - to be grater than the losses they would incur by running into conflict with those they have seen at the negotiation table. Regarding this fundamental weakness of international relations an arbitration procedure is formally neither better nor worse than the existing creditor-dominated procedures. In practice, the fact that agreements have been reached with broader participation of all parties involved, tends to rather bring about better and more sustainable results (see below) Any way: nobody proposes to do away with the Paris and London Clubs for being unable to invade non-complying sovereign debtors.

Paris Club rulings in fact happen to be disregarded by individual creditors or debtors. One reason for this is that usually only a selection of a country's sovereign creditors is involved in working out the PC arrangement – normally the OECD countries which also happen to be members of the Paris Club. Other creditor nations, be them Emerging Economies or HIPCs themselves often see no reason to grant relief to a debtor because an agreement has been set up in which they have had no influence. This is even more the case for private creditors, whom PC members try to involve through „equal treatment clauses"; these rule that a private creditor has to grant the debtor comparable terms to those agreed upon by the PC. Especially at times where private flows to the South are up to nine times the volume of public flows, private creditors tend to accept this kind of tutelage even less. In contrast, an agreement that has been worked out with the participation of all parties involved has a much better chance to be honoured by all stakeholders.



Countries will never receive any new loans after an insolvency/arbitration procedure; they will effectively exclude themselves from capital markets.

If that were true, no reorganised company could ever get any new loans - which is manifestly wrong, as daily experience shows. It is also wrong for sovereign borrowers: Indonesia got a reduction of its debts in a de facto insolvency in 1969. In the mid-1970s it had the Pertamina crisis because the public sector had again been able to overborrow.

Moreover, investors make their decisions first of all by considering the probability of repayment in the future. The debtors track record regarding the servicing of past loan contracts is one, but by far not the most important aspect they take into account.

On the other hand, they logically see future repayment prospects improved, once they can be sure that the debtor will not have to use parts of the hard currency they bring in, for servicing old failed or unprofitable investments.

A new international bureaucracy would have to be created in order to deal with insolvency procedures.

It is important to stress that an international Chapter 9 would not at all need a new international organisation, nor a costly bureau cracy. Arbitration panels are temporary. Once the task of starting a workable composition plan is achieved, the panel can be dissolved. If further disagreements should develop later on the same persons (or, if necessary, other arbitrators) could reconvene again to solve them. Theoretically not even an international treaty establishing international insolvency proceedings ratified by all (or the most relevant) creditor nations would be needed as long as all (or the most relevant) creditors are determined to solve the problem. Practically, though, an international treaty would certainly be helpful.

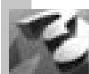
What about the technical personnel necessary for an arbitration? Both creditors and debtors employ qualified personnel managing reschedulings or other debt related issues. In an international Chapter 9 procedure these people would simply do what they have done so far: negotiate and argue their points. But now they would do so before the arbitrators instead of among themselves. As the panel comprises 3 or 5 arbitrators plus people perhaps the same number of secretarial and technical staff per case, one can hardly speak of a huge international bureaucracy, even considering that there will be quite a few cases due to the backlog accumulated. In the case of the WTO (which has permanent staff) this concern about new bureaucracies was not voiced at all.

Countries will tend to borrow irresponsibly, once they do not face the uncomfortable perspective of having to see the Paris Club in case of default.

Under an arbitration procedure debtors would still face extensive investigation into their assets as well as into their past lending and governance practices. This would take place under public surveillance which would enforce rather more than less discipline on debtor governments and civil servants.

However, the disciplinary effect of existing mechanisms has been extremely one-sided. In reality bad borrowing necessarily implies bad lending and this in turn presupposes that there is a bad lender. The need for enforcing discipline not only on the borrowing, but also on the lending side has never been taken into account in existing frameworks.

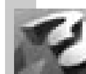
History reveals that the deterring effect of existing mechanisms against bad borrowing has been minimal in the past. Corrupt and oppressive rulers hardly consider long-term repayment or renegotiation aspects when taking out loans for their immediate needs. In contrast again, creditors who in the seventies have handed out "petro-" and "metrodollars" in large amounts without asking questions, had rather thought twice, had they faced questions directed to them in case of a future defaults.



Instead of inventing completely new mechanisms, one should better improve the existing ones. In fact HIPC is already taking a lot of the insolvency/arbitration elements on board.

This assertion is quite far off the reality of HIPC. Out of the four basic principles of an international insolvency procedure, HIPC contains only trace elements of one: There is no independent decision making, no hearing of all stakeholders before a decision on debt relief is made, and the procedure – though it is so pretended occasionally – is not comprehensive (see above). The only element of an insolvency procedure, which HIPC has a certain right to claim it honours, is the protection of the basic needs of an indebted country. However, the definitions of "debt sustainability" which have been applied through the scheme's history are so unrealistically high that particular countries even paid more after they were "relieved" from their debt burden than before.

This obvious failure is not haphazard. It mirrors the fundamental defect that a sustainable solution in a conflict can simply not be achieved if one of the two parties is judge in its own cause. Therefore a "reformed Paris Club" would be no solution. A creditors' cartel can in the best of all cases act benevolently towards a debtor. It can never do justice. This is why impartiality is one of the key elements of the rule of law.



We never did it that way...

Not totally right. When Indonesia was at the brink of default in 1969 and the Paris Club was lacking the instruments and procedures to relieve the country of some unbearable payments, but at the same time had a strong interest to stabilise the military dictatorship in a strategically important corner of the world , they did not lack imagination like they obvously do today. The PC contracted an experienced banker to work out a compromise which was coherent (even including the Soviet Union, which happened to be an important creditor to Indonesia) and acceptable to everyone. The "mediator" came up with a solution which actually neglected all existing principles of the Paris Club. In the end he was able to convince all parties to accept a nearly total write-off of interest on past claims. Though this "mediation" was not an arbitration in the strict sense of the word, it contained a lot of its basic elements, and highlighted the superiority of negotiated solutions over those enforced by creditors.

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