

A LEGAL ORDER FOR INSOLVENCIES OF STATES

Christoph G. Paulus*

A. The starting point

The present Argentinian crisis is commonly seen¹ as the initiation for the creation of a new legal field – a field the existence of which appeared until recently as generally unthinkable of, which, however, in these days due to the efforts especially of the International Monetary Fund (IMF) is gaining more and more shape: namely a state insolvency law or, as the IMF calls it, Sovereign Debt Restructuring Mechanism (SDRM). To be sure, the topic as such is far from being new or just modern:² It is, e.g., just 100 years ago that the Argentinian Secretary of State, Luis Drago, formed the Doctrine that public debts give no justification for military intervention, let alone for occupation of American soil by European powers.³ He had done so in sight of just that – i.a. Germany had shortly before intervened in Venezuela because of unpaid debts.

Well, the danger of a military intervention appears nowadays neglectable; but the danger of an economic “bleeding out” exists. This cannot really be wanted in a global village of roughly 200 “inhabitants” which are – to a lesser or higher degree – mutually dependant on each other. A recent German experience is telling insofar: For the first time ever here, the new Insolvency Code (from 1999) contains a rule granting discharge to a debtor after the closing of an insolvency proceeding.⁴ The political reason for introducing this elsewhere time-honored legal instrument had to do with the fall of the wall: after this event, the inhabitants of the former GDR were, so to speak, overrun by sales-persons from the west, which, quite successfully, applied their aggressive sales methods – methods, known to most people in the west but unknown then to those from the east. The consequence of this “boom” was that roughly two years later an overproportionally high number of household was overindebted; this number was even so big that – for political reasons – something had to be done, namely the introduction of the said discharge rule!

Accordingly, what is true for a people of 80 million inhabitants should also contain some lessons for the global village with some 200 “inhabitants”: In both cases the transformation of the debt restructuring mechanism into a legal instrument guarantees transparency and predictability that alleviates the living together – an advantage which, incidentally, is always connected with the legalization (“Verrechtlichung”) of something that has been so far political:

* Christoph G. Paulus is professor of law at the Humboldt University at Berlin. He is member of the International Insolvency Institute. This article is based on talks presented at the Institute for Comparative Law at the University „La Sapienza“ in Rome, at the University of Buenos Aires and at the Fordham University in New York. The author is indebted to invaluable comments from Professors Christian Tomuschat and Christian Pestalozza (both Berlin) and Jay Westbrook (Austin/Texas).

¹ Whether this estimation is correct or not, is open to doubts, cf. *Paulus*, Staatliche Schuldenregulierung: Verfahren und mögliche Inhalte, BMZ-spezial Nr. 38, 2002, (= www.bmz.de/infotehk/fachinformationen/spezial/spezial038/index.html), as well as *idem*, Some Thoughts on an Insolvency Proceeding for Countries, American Journal of Comparative Law (forthcoming).

² See, e.g., *Politis*, Les emprunts d'états, 1894; *Dieno*, Il fallimento degli Stati e il diritto internazionale, 1898; or *Manes*, Staatsbankrotte – wirtschaftliche und rechtliche Betrachtungen, 3. ed., 1922

³ For this so called “Dragodoctrine” see *Pohl* in: Stier-Somlo/Elster (Hg.) Handwörterbuch der Rechtswissenschaft, 1926 – 1937, sub v. „Dragodoktrin und Porterkonvention“.

⁴ To be more precise: a discharge is granted under certain conditions, one of them being that the debtor transfers most part of his or her income for six years after the commencement of the proceeding. For details, cf. Paulus, Germany: Lessons to Learn from the Implementation of a New Insolvency Code, 17 Connecticut Journal of International Law 90 (2001).

What until then was a question of an ex post-discretion becomes by means of legalization a certainty which, accordingly, allows ex ante planning and adjustment.⁵

Therefore, it means a grand step forward that now an insolvency proceeding for bankrupt sovereigns is about to emerge as a separate field of law. This is due to the speech of Anne Krueger from the IMF that she had given in late November 2001 in Washington. There, she not only put emphasis on the necessity of such step but also came up at the same time with a concrete proposal for a respective proceeding.⁶ Irrespective of the great merits of this initiative, however, it is to be said that this proposal suffered from a number of deficiencies, seen from a rule of law perspective (cf. *infra* sub E I). The following remarks attempt to demonstrate how – in contrast to the IMF proposal – a proceeding can be designed in a way that the fundamental requirements of the rule of law are respected (*infra* sub F); requirements that, incidentally, outside the present topic are again and again recommended (or even requested to be applied) by i.a. the IMF to its member states. In order to clarify the underlying understanding of my own proposal, it appears to be appropriate to give some preliminary methodological and explanatory remarks; they shall “pave” the way to the said end (*infra* B through D).

B. METHOD TO APPROACH THE NEW TASK

I. Method

There exists an almost archaic but, nevertheless, striking example for how jurists approach a new task – be that the „juridification“ of a new world like cyberspace, the drafting of a new contract or statute, or the creation of a new field of law like the legal proceduralisation of the insolvency of states: Around the year 450 B.C., when Rome was shaken by ongoing social unrest, a 10 men committee was ordered by the patricians to draft and enact a legal code for the city.⁷ This was a new task since, so far, Rome had enacted only a few laws dealing with singular questions; what now was at stake was an all encompassing piece of legislation. These ten men did not sit down in order to discuss details like what needs to be regulated and how and in which sequence, etc. Instead, they started a journey to Greece searching for potential models and studying the codes which existed there. Only after their return and based on what they had learned from these models they started with their actual legislation draft. This story is paradigmatic – i.a. because it makes clear that there is much reason to such method: It leaves it unnecessary to constantly re-invent the wheel. On the other hand, one has to be very careful in adapting such pre-existing models to the new surrounding; there is certainly the danger that the new construct sticks too much to the old rules.

Having this method and especially its advantages and its dangers in mind, the here proposed proceeding shall be developed.

II. Comparable facts and situations

It was recognized already in the mid-80ies (especially when Mexico started to tumble) that the international debt crises were based on a „common pool“-problem; i.e. a situation in which a sovereign state’s existing financial resources did not suffice to satisfy all its creditors.

⁵ Informative *Haltern* in: *Der Staat* 2001, 243 ff.

⁶ A New Approach To Sovereign Debt Restructuring (IMF 2002 b); International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring (IMF 2001), www.imf.org/external/np/speeches/2001/112601.htm; The Evolution of Emerging Market Capital Flows: Why We Need to Look Again at Sovereign Debt Restructuring (IMF 2002 a), www.imf.org/external/np/speeches/2002/012102.htm. See also A. Krueger, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, www.imf.org/external/np/speeches/2002/040102HTM (2002 c).

⁷ Cf. *Paulus*, Verbindungslinien zwischen altem und neuem Recht in: Schermaier/Rainer /Winkel (ed), *Iurisprudentia universalis*, Festschrift Mayer-Maly, 2002, 563 ff.

In addition, it was noticed – at least by some⁸ – that this situation had similarities with the one which also existed with respect to private law entities (natural and legal persons) and which is dealt with there by the insolvency laws. Nevertheless, it took still some time until it became widely accepted that states, too, might become unable to repay their debts as they become due, which is the prevalent definition for being insolvent.

Once, this „discovery“ is made, a decisive step is made towards a more or less direct comparability (or even transferability) of the private law rules with (to) the debt problems of sovereign states. Since this phenomenon – a debtor has become unable to satisfy its creditors – has been regulated for virtually millenia by various insolvency laws that have developed numerous reactions in order to deal with such a situation. Therefore, it stands to reason to examine whether or not (and if so to which degree) these existing rules are apt to manage also a sovereign debt crisis, which, admittedly, takes place in a far more complex legal as well as factual surrounding.

III. Disciplining effect

It is well known from the private insolvency law that it can have a tremendous disciplining influence on all participating parties especially at out-of-court negotiations⁹ – provided that this law is transparent, efficient, and equitable. The same effect is desirable for the financial interactions on the state level as well; lending and borrowing here should be no less risky than in the private law sector. This leads to an additional argument for the introduction of an insolvency proceeding for bankrupt sovereigns: The mere existence of such (transparent, effective, and equitable) proceeding creates incentives to consent to an out-of-court solution. Since in front of the background of an insolvency proceeding, dissenting participants must be aware that once the proceeding has been opened they can be outvoted due to the majority requirement which replaces the unanimity requirement outside the proceeding. Moreover, the interests of all the creditors get bundled – with the consequence that more advantageous solutions can be found for the creditors as a group instead of each individual creditor's search for his own advantage.

Out-of-court negotiations do already exist as a debt restructuring mechanism for sovereigns; they are widely known as Paris Club or London Club respectively.¹⁰ The present author's proposal of an institutionalised insolvency proceeding does not encompass the recommendation that these “institutions” should be abolished. However, negotiations there would lose their “last instance”-flair and accordingly their definitivity since the next step can always be the commencement of an insolvency proceeding. The fact that the influence of those Clubs diminishes is all the more justified since there is a trend to be observed that essential parts of the public debts does result from state bonds. Therefore, the majority of creditors of an insol-

⁸ Meessen, Die insolvenzrechtliche Option in der internationalen Schuldenkrise, Zeitschrift für Rechtsvergleichung 1990, p. 255 seq.; Raffer, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18 (2), 1990, 301 ff.; *idem.*, Vor- und Nachteile eines Internationalen Insolvenzrechts, in Dabrowski/Eschenburg/Gabriel (ed.), Lösungsstrategien zur Überwindung der internationalen Schuldenkrise, 2000, esp. p. 226 ff.

⁹ International Monetary Fund – Legal Department, Orderly and Effective Insolvency Procedures – Key Issues, 1999 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.“

¹⁰ In the Paris Club the public creditors meet for debt restructuring negotiations and in the London Club the banks.

vent state are more often than not individuals¹¹; they are anyway not organized in a “Club” like the states and the banks.

C. OBJECTIONS AGAINST THE COMPARABILITY WITH THE PRIVATE LAW PENDANT

I. Sovereignty

Apart from the fundamental – but nevertheless mistaken – objection that there can never be a liquidation of states and that therefore any parallelism with the private insolvency law is to be excluded right away (for this see *infra* at ...), quite often the concept of sovereignty is brought up as a counter argument against an insolvency proceeding for states.

This objection shall not be discussed here in detail. A few remarks do suffice for the present purpose. The concept of sovereignty was developed by Bodin in the 17th century and played a prominent role in the following centuries – especially by laying the foundations for the public international law.¹² However, its isolated concentration on states was subjected to doubts for the first time at the Nürnberg Trials and has further been shaken by the evolution of an international criminal law, which deals with individual persons¹³ like *Milosevič* or *Pinochet*.¹⁴ Another example for the erosion of the traditional concept of sovereignty (and, additionally, the public international law) is the question raised by the US administration whether a terroristic organisation, which is not confined to a given territory, can fight a war according to the principles of public international law.¹⁵

These examples demonstrate that public international law is about to transcend the impermeability of states. The erosion of this fundamental pillar of sovereignty¹⁶ leaves the argument questionable that sovereignty should be an obstacle to introduce a debt restructuring proceeding, which is for the benefit of all parties involved. This is all the more so since the present day negotiations at the Paris Club or London Club imply an – at least – equally cut into the sovereignty concept as the here proposed proceeding would do. The same is to be said about the World Bank’s and the IMF’s conditionality,¹⁷ which tends to become sharper the closer the financial breakdown comes. Thus, the reference to the concept of sovereignty is not really

¹¹ In the case of Argentina, it is said that some 60 % of this state’s creditors are private bondholders (most of them are Argentinians).

¹² See, e.g., *Tomuschat*, *International Law: Ensuring the Survival of Mankind on the Eve of a New Century*, in: *Recueil des cours* 281 (1999), p. 161 seq.

¹³ For the increasing importance of the individual in the area of public international law see, e.g., *Randelzhofer*, *The Legal Position of the Individual under Present International Law*, in: *Randelzhofer/Tomuschat* (ed.), *State Responsibility and the Individual: Reparation in Instances of Grave Violations of Human Rights*, 1999, p. 231 seq.

¹⁴ About this see *Werle*, *Zeitschrift für die gesamten Strafrechtswissenschaften* 1996, p. 808 ff.; *idem*, *Juristenzeitung* 2001, p. 885 ff.

¹⁵ For this, e.g., *Tomuschat*, *Der 11. September und seine rechtlichen Konsequenzen*, *Europäische Grundrechtszeitschrift* 2001, 535 ff.

¹⁶ Cf. *Zürn*, *Sovereignty and Law in a Denationalised World*, in: *Appelbaum et al.* (ed.), *Rules and Networks – The Legal Culture of Global Business Transactions*, 2001, S. 41 ff.; *Fassbender*, “Souveränität” in: *Volger* (ed.), *Lexikon der Vereinten Nationen*, 2000; *idem*, *Commentary of Art. 2 Nr. 1 UN-Charta* fig. 3 seq., 45 seq., in: *Simma* (ed.), *The Charter of the United Nations: A Commentary*, 2. ed., 2002; *idem*, *Der Internationale Gerichtshof: Auf dem Weg zu einem „Weltinnenrecht“?*, *Aus Politik und Zeitgeschichte* vom 8.7.2002, B 27 – 28/2002, p. 32 seq.

¹⁷ About the relation of the conditionality of the IMF and the sovereignty of states cf. *Meessen*, *IMF Conditionality and State Sovereignty*, in: *Dicke* (ed.), *Foreign Debts in the Present and a New International Economic Order*, 1986, S. 117 ff.; *Weigeldt*, *Die Konditionalität des Internationalen Währungsfonds in ihrem Verhältnis zur Staatssouveränität und zu den Menschenrechten*, 1999. *Lowenfeld*, *The International Monetary System and the Erosion of Sovereignty*, 25 *Boston College International & Comparative Law Review*, 257 seq. (2002).

a valid counter argument against a proceeding that – after all – will be commenced only if the insolvent state itself pulls the trigger.

And finally: The US bankruptcy law itself makes sufficiently clear that a public entity like a municipality can go through an insolvency proceeding without being impaired in its sovereignty. The Chapter 9-proceeding is a striking example for a perfectly functioning insolvency proceeding: it includes all creditors and keeps the municipality running. I will come back to this example on various occasions in the following remarks.

II. No automatic discharge

Some potential debtor states might indulge the hope that introducing an insolvency proceeding means a quasi automatic discharge from the remaining debts. This assumption may be one of the reasons for the widespread distrust into this undertaking on the creditors' side. However, be it made clear: What is proposed here is a variation of a plan proceeding and, thereby, resembling chapter 9 or 11 proceeding of the US Bankruptcy Code. This means that a plan has to be drafted, which leads to a discharge only if this plan provides so and if the necessary majority of creditors gives its consent to such provision.

D. TERMINOLOGY AND CONTENTS OF THE MODERN INSOLVENCY LAW

I. Insolvency law in a modern Sense

Outside the US and outside the narrow circle of insolvency experts bankruptcies and insolvencies usually lead immediately to negative ramifications. The “flaw of bankruptcy” is a still very vivid and powerful feeling in most areas of the world so that there is a further reason for a general objection against introducing an insolvency proceeding for states. But this is, of course, unjustified. Things here have developed; liquidation is no more the only option for dealing with a debtor's bankruptcy. Reorganisation is now the alternative. What is almost self understood within the US due to its historical “foundation myth” of a fresh start becomes nowadays outside the US slowly but more and more known. This move towards providing a possibility to reorganise a debtor instead of liquidating its assets is pushed heavily by the IMF¹⁸ and the World Bank.¹⁹ These institutions have realized at the so called East Asia crisis in the mid-90ies that the existence of an effective and orderly insolvency procedure is indispensable for the well functioning of global economies.²⁰ Therefore, these institutions try to get countries adapting modern insolvency laws – containing both alternatives: liquidation as well as reorganisation. This development will finally lead to a change of values by overcoming the “flaw of bankruptcy” – or at least diminishing its exclusive influence.

What is known in the US as “Chapter 11-proceeding” will be called in what follows “plan proceeding”, thereby using the German terminology of what is the equivalent to Chapter 11. Suffice it, to mention briefly the peculiarities of this proceeding: It is a regular insolvency proceeding the commencement of which leads to an automatic stay. Within this proceeding, a plan is to be drafted of how the debtor shall be reorganized. Under certain circumstances, this plan might need to entail some minimum requirements as to the satisfaction of the creditors. This draft will then be discussed and voted on in an orderly procedure. The necessity of unanimity is replaced by a majority vote. In order to reduce the complexity of such proceeding, there might be the possibility to bring the creditors into certain groups. The voting on the plan

¹⁸ Cf. International Monetary Fund (as fn 10).

¹⁹ For this, see World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, 2001.

²⁰ More elaborate Paulus, Der Internationale Währungsfond und das internationale Insolvenzrecht, IPRax 1999, p. 148 seq.

is mediated here in that the creditors are voting within their groups and that the final consent to the plan depends on the number of consenting groups.

II. Consequences for the further discussion

Transferring that what has so far been said about the private insolvency law and its recent development to the present context of state insolvencies shows that this existing example can work as a model – at least to a certain degree. Since goal of the new field of law can never be the insolvent state's expelling from the community of the other states (i.e. liquidation) but, to the very contrary, only the inclusion into this community. And this is what, indeed, modern insolvency laws do provide for.

E. PROPOSALS OF THE IMF AND THE USA

I. IMF

It has already been mentioned that it is Anne Krueger's merit that the present topic has got such a worldwide attention.²¹ Until her abovementioned speech in late 2001 the discussion about an insolvency proceeding for bankrupt states was almost exclusively reserved for non-governmental organisations and churches.

Initially, the IMF had the idea that even filing a petition for commencement of the proceeding should be dependent on this institution's approval; this had meanwhile been given up. Nevertheless, the most up-to-date proposal, for the time being, still keeps a central role for the IMF within the proceeding. Thus, the trigger criterion shall be the unsustainability of debts – a qualification, which is to be made by the IMF; whether or not an automatic stay enters into force shall be dependent on the approval of either the creditors or the IMF; the acceptance of a plan shall be subject to this institution's consent; etc.

The essential problem of this proposal is that the IMF itself usually is a creditor itself of those countries that are bankrupt or are about to become. Seen from a rule of law-perspective, it is more than problematic that a creditor shall be the necessary economic and financial advisor, both before and after the commencement of the proceeding, who, moreover, controls the admission thereto. Apart from that, a further serious problem with the IMF's central role in such proceeding stems from the fact that this institution is far from being independent and autonomous. It is a well known fact that it consists of members which are contributing "membership-fees" in differing amounts. Therefore, the IMF proposal is, at least in the eyes of outstanding parties, afflicted with the stain of a collusion of interests.

II. USA

What is here said to be the proposal of the US is possibly just an idea of Under Secretary of the Treasury for international Affairs, John Taylor. He at least negates the advantage of an full-fledged insolvency proceeding; instead, he wants to achieve similar results by means of changes of existing contracts. This refers to contract clauses that do exist already for a while and that are quite popular in the context of bond issuances, e.g. „collective action clauses“ or „exit consents“ or „pari passu clauses“.²² They have in common that they try to achieve on a contractual basis what is hereafter (F I) called "enforced community". This result, however, is hard to achieve – if at all.²³ Leaving apart non-contractual debts, changes of existing contracts presuppose consensus which can be achieved either through pressure or incentive. A state,

²¹ See also Bundespräsident Rau in his speech from May 13, 2002 about globalisation: www.bundespraesident.de at „Reden und Zitate“.

²² References for that at *Paulus*, American Journal of Comparative Law (sub ...).

²³ Argentina, e.g., has issued 88 different types of bonds and they are subjected under 5 different jurisdictions.

which is a potential future candidate for an insolvency situation and which is probably in desperate need of money from the general capital market, is more likely than not to increase the attractiveness of its bonds by waiving such restricting clauses.

F. OWN PROPOSAL FOR A PROCEEDING

The preceding remarks have made sufficiently clear that a sovereign debt restructuring mechanism indeed can be modelled after the reorganisation scheme of the private insolvency law – at least to a certain degree. Starting from that premise, the following procedure appears to be feasible:

I. Creation of an „enforced community“

Seen from a legal perspective, the most intrinsic problem for introducing a state insolvency proceeding is the question of how all creditors can be pulled within. It is probably the most peculiar and most important property of any insolvency law that it is granted the power to include all existing creditors into its proceedings – no matter whether or not these creditors want it, know about the proceeding, or whether they are domestic persons or foreigners. German scholarship calls this phenomenon “Zwangsgemeinschaft” which might be translated as “enforced community”. On first sight, it appears as if there were no authority that could – on a global scale – create a similar enforced community in case of a state insolvency. Therefore, the IMF has in mind to overcome this obstacle by means of changing its statutes; the US treasury wants to achieve comparable results through changing existing and future contract clauses.

However, there is a third possibility, which is maybe easier (at least in political terms) to realize than the other ones. It results quasi automatically from the following considerations: Be it repeated that it is worldwide unanimously accepted that a national legislator has the power to create the said enforced community by enacting an insolvency law for its private law entities, thereby binding the respective state itself (prominently its tax authorities) and even foreign states if they happen to have, e.g., a tax claim against the bankrupt. This shows, that it is also accepted throughout that both the domestic state and foreign states are without any objection seen to be subject to the private law enforcing mechanism. Having realized this almost banal but nevertheless surprising truism, the second consideration goes without saying: The said national legislator has, additionally, the generally accepted power to enact an insolvency law that deals with the break-down of certain public entities such as municipalities. Thus, if, e.g., a city like New York would go bankrupt, nobody would utter any doubts about the legitimacy of the then to be commenced chapter 9 proceeding in which the US legislator provides for an enforced community.

Having lined up these two considerations, the third arises as a logical consequence: why should it not also be possible for a national legislator to enact a law which deals with the insolvency of this state and which, thereby, forces all existing creditors into such community? When this legislator is permitted to bind private persons, banks, and even foreign states into the participation of insolvency proceedings of its subordinates why should this possibility evade in case of the insolvency proceeding of just this state? There is no legal reason why this approach of enacting a “state insolvency law” should not work out to get the effect of an enforced community. However, there is an obvious practical problem – namely that it is more than likely that such state will draft a law which lacks the common standards of fairness towards the creditors. States not unlike private debtors tend, once a crisis has arisen, to forget or at least neglect their own responsibility for the present situation; instead, they more often than not start to blame their creditors and to hold them responsible for this crisis.

This problem, as serious as it is, can be solved quite easily. What needs to be prevented is that each national legislator drafts its own national “state insolvency law”, thereby creating as many different laws as there are states on this globe. The solution for this is that a global institution like the UNO²⁴ drafts a model law, which is sufficiently precise in its details so that the individual deviations from this model after its enactment in the various states remain tolerable. Since UNCITRAL, as a major sub-organisation of the UN, has already extensive experience with drafting model laws in the sector of insolvency law this would be the institution of first choice for this task. Once such model law for state insolvencies exists, it could be transformed into national legislation quite rapidly: not only that the typical creditor countries could make the initial step and, thereby, giving a good example; but also those states which are likely candidates for such insolvency proceeding could be urged by means of the IMF’s or the World Bank’s conditionality to take it over into their national legislation. This mechanism would guarantee a quick spreading of that law since usually these states ask for credit at these institutions once they are in a crisis.

II. Opening

All what follows is actually nothing else than just the potential contents of the abovementioned model law. It goes without saying that this article does by far not cover all issues that need to be addressed in such law. What is intended is rather to add some additional ideas to the already ongoing discussion and, thereby, to highlight some possible improvements.

The most important issue of the proceduralization appears to be that the parties involved are under the control and guidance of a neutral third party – not unlike the quite common concept outside the US of a trustee who surveils a debtor in possession.²⁵ It is a mandate of fairness that there is such third party which is objective and neutral and which has the definite saying about the sequence of procedural steps. Absent of such control mechanism, a proceeding of the here proposed kind would run the risk of its devaluation because the parties might tend to fall back into their former power structures. This, however, is exactly what an insolvency proceeding is designed for to prevent and to exclude. Having said this it becomes clear that here is another reason why the IMF or the World Bank necessarily has to be excluded from any major role within the here proposed proceeding; these institutions are usually creditors and as such they are in a conflict of interests (and be it just in the eyes of the debtor states).²⁶

1. Neutral Instance

As to the search for such a qualified neutral third party, it should be clarified right at the outset that the circle of potential candidates should be kept small. In sight of the magnitude and importance of the tasks, it appears to be indispensable that these persons develop as quickly as possible an expertise; this is crucial not only for a competent mastering of the tasks connected with any proceeding but leads also to its higher transparency. It is clear that this goal is better achieved the smaller the group of these candidates is.

A further and less important question is where the pool of these potential neutral third parties should be institutionalised. This could be, e.g., the International Court of Justice²⁷ (even though the neutral third party does not play the role of something like a judge; this person

²⁴ IMF and World Bank are to be excluded since they are generally creditors.

²⁵ Cf. IMF (fn 9), p. ...

²⁶ About the „moral hazard“-problem in connection with the IMF’s role of „lender of last resort“, cf. *Schwarzc*, *Sovereign Debt Restructuring: A Bankruptcy Reorganisation Approach*, 85 *Cornell Law Review*, 961 seq. (2000).

²⁷ About the problematic acceptability within the international community of states see, e.g., *Tomuschat* (fn 13), p. 411 seq.

does not decide on legal issues, it is only guiding the parties through the proceeding) or the UN and maybe even UNCITRAL as the drafting institution of the model law.

2. Reason for opening

It is another intricate problem under which condition a state should be permitted to file a petition for the here proposed proceeding. A “borrowing” from the private law example of an overindebtedness is to be excluded since even in that context this trigger is hardly ever provable.²⁸ Whereas the IMF prefers to refer to the unsustainability of debts, one could also think of referring to the inability to pay the debts as they fall due – the traditional definition of insolvency. If this appeared to be acceptable one could go even a step further and think about the criterion of an imminent inability to pay; because this would lead to an earlier opening of these proceedings and would, thereby, alleviate the prospects of the debt recovery.

However, it might be that the problem of defining an appropriate trigger criterion can be solved by a simple control of abuse, which has to be performed anyway by the neutral third party, cf. *infra* at 5. This person takes into account all available data about the reason why the respective state believes to be insolvent and, thus, a potential candidate for the here proposed proceeding. This examination would have close resemblances to what is known in the private law counterpart as *bona fide* filing.

3. Type of proceeding

One can not even think of any alternative other than a reorganisation or plan proceeding as the only appropriate type of proceeding. Be it repeated that any idea of liquidation or enforcement law is to be excluded right from the outset. Thus, if the only option is a plan proceeding, the sequence of events is – simply put – that the creditors are put together with the debtor on “one table” and that they discuss about, vote on and decide about a plan that has initially been drafted by the debtor.

4. Right to file

With respect to this issue, the US model of the chapter 9-proceeding appears to be paradigmatic – i.e. the exclusive right to file a petition is with the debtor state alone. In earlier days exercising this right was dependent of the consent of the majority of the creditors. This rule, however, proved to be an unsurmountable hurdle for the commencement of the proceeding (and was, therefore, later on changed) when in the mid-70ies the city of New York was broke and tried to file a petition.²⁹ But it is not only this example that suggests to have the sole filing right with the debtor state; if anywhere, it is here, too, a question of the concept of sovereignty: If the filing of a petition were dependent on the consent of a creditor (or a majority of them) or if a petition could even be filed by a creditor, the debtor state would be pressed into a corset of actions, which, in the worst case, would be unnecessary or, in other cases, would at least make its policy subject to intense foreign influence.

To be sure, if this exclusivity of the filing right is accepted, one has to consider the following consequence. It has been said *supra*, that in the field of private law the sheer existence of an insolvency law has, dependent of course on its efficiency, a more or less disciplining influence; since both sides are given the possibility to pull the trigger, so to speak. Under these auspices, the present proposal appears to be a unilateral favoritism for the debtor state. Since it is this party alone that has the power to commence the proceeding, it is only this side which has at

²⁸ See just World Bank (fn. 19), p. 29 seq.

²⁹ See also The World Bank Group – Operations Policy and Strategy, Poverty Reduction Strategy Papers – Internal Guidance Note, January 21, 2000, p. 3.

the “out of court”-negotiations (i.e. the negotiations at the Paris or London Club) the bargaining power to “step out” and to file a petition. The creditors do not have this power and, therefore, have no counter bargaining power. However, not only that US the chapter 9-proceeding amply demonstrates that this peculiarity of an insolvency proceeding is obviously bearable; it is also for the reasons mentioned above that this feature of a sole filing right should be kept. But, as a matter of fact, there has to be some compensation in order to protect the interests of the creditors. This could be done by at least to means: firstly, strict requirements as to the admissibility of the petition and, secondly, certain minimum requirements as to the contents of a plan (for both see below).

5. Formal requirements

As just mentioned, such a compensating regulation would be that certain requirements must be fulfilled; otherwise the petition would be rejected as inadmissible. The examination has to be done by the neutral third party. The most important of these requirements is that the filing state has a plan added to its petition; a plan that explains in detail how the filing state thinks or envisages how its reorganisation or debt restructuring shall be performed. Even though this plan will be discussed, possibly altered, and voted on only after the commencement of the proceeding by the creditors, it should be examined already at this point by the said third party – at least in a superficial manner and to the end to check whether or not this plan appears to be realistic.³⁰ This control is necessary in order to prevent potential debtor states to file a petition just in order to get out of the abovementioned “out of court-negotiations” or to annoy the creditors or even to take their interests not serious enough.

The latter example implies that the neutral third party’s examination includes a checking whether or not the filing was done bona fide. To be in the position to do such examination, the third party certainly is dependent also on additional information from the IMF and the World Bank respectively. However, this will certainly not always be sufficient as the following example demonstrates: Shall the filing be mala fide if the debtor state initiates the here proposed proceeding just because it wants to get rid of (all or) parts of its payment obligations resulting from a war, thus, especially from reparation duties?³¹ As a rule of thumb, the answer will be “yes” since such a petition is in flagrant contradiction to the previous acts of this state (*venire contra factum proprium*). However, exceptions from this rule might be imaginable if, e.g., an administration different from the one that had started the war (or that had agreed on those reparations) files the petition. Thus, it is highly difficult to give a clear “yes” or “no” answer to such question. Additionally, it should be noted that the flexibility of the plan allows to spot the plan just on such debts of the state which exist beyond those reparation obligations and that these shall be fulfilled in toto.

A special variant of the control of abuse would it be if the model law provides that a filing is to be rejected as inadmissible if a respective petition has been filed within a certain period of time prior to the present one. It depends on political considerations whether such period would be 2, 3, 5, 7 or ten years. This were another compensating feature in order to guarantee discipline on the debtor’s side. As a matter of fact, details here are intricate: should such barring from a new filing depend on just a prior filing, or should that petition at least have passed the initial control of the neutral third party, or shall the complete proceeding have been performed – successfully or not?

³⁰ This task underlines what has been said supra about the necessity for a neutral third party to develop expertise.

³¹ A remarkable example for such discharge is the Agreement on German External Debts, London 27th february, 1953. It has provided a substantial relief for Germany; cf. *Abs*, Entscheidungen 1949 – 1953: Die Entstehung des „Londoner Schuldenabkommens“, 1991.

6. Substantive requirements

The admissibility requirements just mentioned relate almost exclusively to formal criteria. They certainly can be complemented by further, more substantial requirements. Here, the possibilities are vast; to a certain degree, it might serve as an example what the IMF and the World Bank usually have states fulfill within the framework of their conditionality.³² But it should be noted, that one restriction of developing these substantive requirements must always be kept in mind: Since the here proposed proceeding can only be a reorganisation proceeding, i.e. a proceeding that attempts to free the debtor state from its debt trap and to help it back into the position of an active economy partner, it is indispensable to leave such state something like an existence minimum – however this shall be defined. Otherwise, the proceeding would never be initiated, and be it just for its unbearable inner political consequences. Thus, it can't be excluded that, e.g., new schools shall be built or old ones repaired, or that a certain minimum food supply is provided, etc.

7. Effects

Upon filing of the petition³³, there must be an immediate stop of all creditor actions. This automatic stay not only is an essential feature of all private law insolvency laws; it has also to be provided for in the present state insolvency proceeding. Since such stay is indispensable for introducing the abovementioned disciplining function and, moreover, for an orderly and transparent procedure in which a consent of all parties involved shall be achieved. When, thus, the question is not if there should be an automatic stay at all, it is one how long this should last. It should be not too long – e.g., 3 months – in order to have the disciplining function of the proceeding. A prolongation should be possible but dependent on either a majority vote of the creditors or(and) the consent of the neutral third party.

There cannot be any doubt that the model law must provide for a corresponding automatic stay on actions by the debtor state which have a detrimental effect³⁴ on the satisfaction of the creditors.³⁵ It is a further task of the neutral third party to control this forbearance duty of the debtor state, and it is here, again, on informations from, i.a., the IMF and the World Bank. If such control should not suffice, one could introduce the threat of a sanction: If the debtor state does not refrain from such actions, the petition becomes inadmissible or the opened proceeding becomes annulled – with the consequence, described supra at 5, that a new petition is barred for the next period of years.

Even though it is an evident truism, it should be noted for the sake of clarity that the automatic stay – as well as the inclusion into the enforced community – does not apply to those creditors that have granted fresh money or credit after the commencement of the proceeding. Not only that, legally, the enforced community binds generally only those creditors who exist at the time of the commencement of the proceeding; it is also, economically, unthinkable that anybody would provide the desperately needed fresh credit for a state reorganisation if it had not a preferred legal status as opposed to the the prior existing creditors.

³² Cf. *Weigeldt*.(fn. 17).

³³ It would be an alternative solution to have the automatic stay begin only when the neutral third party has already examined and approved the admissibility of the petition. In such a case, however, one probably would have to provide some preliminary protective measures.

³⁴ As a matter of fact, it needs detailed examination which acts do fall under the untouchable sovereignty and which one are to be judged as detrimental to he creditors.

³⁵ Thus, it is prudent that the IMF sees it as admissible if in this context states should be permitted to impose strict measures against capital flight,.IMF (fn 6: 2002 b, p. 35 ff.).

III. Procedure

Once the petition is, according to the decision of the neutral third party, in compliance with all the requirements as set out supra and the automatic stay has entered into force, the next step is the procedure as such. There, mainly two things are to be done: firstly, the verification of the creditors' right and, secondly, discussion and agreement about that contents of the plan that will be put to the final voting.

1. Creditors

It is by no means easy to decide about who should be an admitted creditor for the proceeding here in question. The answer to this question is easy when foreign states or banks are at stake. It becomes a littlebit more problematic when it comes to bondholders of the debtor state – be they consumers or banks, be they citizens of this state³⁶ or foreigners. But what if there is a citizen who has, e.g., a repayment claim against the tax authorities? Shall he be included into the proceeding? Additional problems arise when it comes to disputes about the legality of claims or their amount. In order to come here to a timely (if not speedy) solution, there should be the possibility to go to an arbitration court. It could be constituted in the usual manner: both sides are allowed to proposed a judge, and both so chosen judges agree on a third judge who is presiding this court.

2. Plan discussion

As a matter of fact, the plan that initially has to be presented by the insolvent state is subject to further changes. The abovementioned requirement to present a realistic and – generally – acceptable plan is not meant to concentrate the proceeding on this once and for all drafted plan but shall rather prove the seriousness of the petition and, thereby, serves to a certain degree as a further control against abuse of the proceeding. Thus, if it comes to negotiations within the proceeding, all terms of the initial plan are subject to discussion and potential changes. Therefore, it might turn out that, in the end of the proceeding, a plan is to be voted on that has nothing in common with the initial one.

For the sake of clarification: the contents of a plan should not be prescribed beyond that what has supra, sub ..., been said. Each plan can be as individual as each insolvency case: a plan might, thus, cover all creditors' claims or just parts of them or just a group of creditors; it might provide for complete or partial debt reduction or just for a moratorium; etc. All what can be said in general terms is that these contents should be as precise as possible in describing how the state shall be lead out of the crisis. This is necessary for the surveillance during the period of the plan fulfillment, cf. infra sub IV.

3. Avoidability

The abovementioned chapter 9-proceeding contains a feature that it has in common with virtually all existing insolvency laws on this globe – namely the avoidability of transactions, which have been performed before the commencement of the proceeding and which, within the proceeding, turn out to be detrimental for the collective satisfaction of the debtor's common creditors. As a matter of fact, not all such transactions can be subject to avoidability; they must, additionally, display certain peculiarities. A quite popular categorization for them is the differentiation between fraudulent transactions and preferential treatments.³⁷

³⁶ Cf. fn 11.

³⁷ For comparative insolvency lawyers, this bi-partition resembles the US American concept; however, it is applicable for the German law as well, even though this law subdivides the two parts in more detailed fragments, cf. *Paulus*, Germany: Lessons to Learn from the Implementation of a New Insolvency Code, 17 Connecticut Journal of International Law 89 seq. (2001).

Thus, if in case of the commencement of a proceeding certain transfers can be recovered this possibility alone implies a disciplining function for particularly urging creditors. Since they must be aware that they are more likely than not bound to return within the proceeding what they before have collected in an all to egoistic manner.³⁸ Depending on the efficiency of such recovery possibility, avoidability exercises a certain pressure on creditors and the debtor even before the commencement of a proceeding to act in conformity with the insolvency principle of equal treatment (*par condicio creditorum*).

Seen from this perspective, it is obvious that an avoidability option is to be wished also in the context of a sovereign debt restructuring mechanism. However, there were additional problems, which are particular for the present context and, which, therefore, would need special considerations. Suffice it to name just the question of whose transactions should be made recoverable; only those of “the state” or also those of rulers who, e.g., have used public resources for private purposes? The latter question is easy to answer if there is a purchase of a private yacht at stake; it becomes more difficult, however, if a prestigious but completely useless project such as a huge airport in the middle of nowhere is to be judged.³⁹ Nevertheless, problems like the one mentioned should not discourage from installing the avoidance option at all. Since it plays an important role for reducing the application of the here proposed proceeding in general.

4. Consent

As a matter of fact, the plan needs the creditors’ consent. However, unlike at the out of court-negotiations (e.g. at the Paris or London Clubs) within the here proposed proceeding such consent does not mean unanimity. Instead, a majority is sufficient. How this majority shall be defined, depends on various – more or less political – considerations: any figure between 51 % and 99 % can be thought of. The closer the figure comes to 99, the better are the chances for obstructing creditors; whereas in the opposite case, the debtor is better off. In any case, the said majority can certainly also be combined – e.g. not only that a certain percentage of (present) creditors has to agree but also that they represent a certain percentage of the whole debt amount, etc.

If a consent is not achieved, there might be two alternative escapes: either re-negotiations about an altered plan (with or without an extension of the automatic stay) or the definite failure of the proceeding. The latter alternative, even though it should possibly be avoided, does lead to the pre-proceeding situation of the debtor state. Thus, the former status quo re-enters into force; moreover, this state is barred from commencing a new proceeding for the next period of years according to what has been said supra, at II 5, about the only limited possibility to pull the insolvency trigger. This quite drastic sanction fulfills a disciplining function in that it forces the debtor state to come up with a plan proposal that can realistically be expected to achieve the necessary consent.

For the sake of clarity, it should be confirmed by the neutral third party whether or not the requisite majority has give its consent to the plan.

IV. Plan fulfillment

As a matter of fact, each plan must necessarily contain a description of how the debtor state is to be reorganized, especially how the debts and to which degree and within which time shall

³⁸ A common term in this context is „vulture funds“.

³⁹ To be sure, the avoidance power must never be used to the end to generally nullify politically unprudent decisions; the “march of folly” cannot be made revokable by means of this legal instrument.

be satisfied. Once, such plan has been accepted by the creditors and has been approved by the neutral third party its fulfillment can hardly be left to the sole responsibility of the debtor state. In this period – maybe even particularly in this period –, surveillance is indispensable, at least in a more than sporadic manner. Such control guarantees the necessary discipline of the debtor state to put into reality what is agreed upon within the plan. In addition, one could think of an even harsher incentive for sticking to the plan's commands; namely that in case of certain deficiencies in its realisation the plan becomes nullified. The consequence of this would be that all the debts “fall back” into its former shape and amount – and that the debtor state had no chance to file again a petition within the next years (see supra at II 5).