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Debts, Human Rights, and the Rule of Law: Advocating a Fair and Efficient Sovereign Insolvency

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Court decisions against Argentina, and the recent Resolution of the UN's General Assembly (GA) forcefully recalled a well-known glaring gap in the international financial architecture and the limits of the contractual approach. Demanding debt reductions, the newly elected Greek government raised again the issue of insolvency. So far, official claims have been reduced quietly already, while stating that official haircuts would be impossible, e.g., by lowering interest rates, deferring debt service or cancelling the EFSF guarantee fee.

The UN-Resolution demanded the elaboration of 'a multilateral legal framework for sovereign debt restructuring processes' (GA 2014). Regretting the absence of appropriate mechanisms, the Human Rights Council spoke of the 'unjust nature of the current system, which directly affects the enjoyment of human rights in debtor States' (HRC 2014, p.3). If debtor states can no longer finance their obligations under human rights law, people are denied basic human rights. Unlike under any civilized municipal law, debtor protection continues to be refused to the poorest by those creditor governments safeguarding debtor protection at home. All domestic legal systems have established insolvency as the only economically efficient and fair solution. Historical record and the fact that no one wants to abolish it, prove this solution right.

Already Adam Smith (1776/1979, p.930) saw the need for 'a fair, open, and avowed bankruptcy' of states, being 'both least dishonourable to the debtor, and least hurtful to the creditor'. Many proposals to follow Smith's advice were made around 1982 (Rogoff and Zettelmeyer 2002), all shunned by official creditors. While legal systems have evolved since the days of debt prisons and debt slavery, the generally acknowledged first best solution to debt problems continues to be refused to people in debtor countries. Clumsy attempts to emulate parts of insolvency (e.g. the Paris Club's 'comparable treatment'), skirting full proceedings exist. Predictably, success is limited.

Official lending has usually prolonged and worsened crises, postponing and increasing eventually unavoidable haircuts. Greece is one extreme example: 'rescue operations' increased debts from about 120% of GDP to roughly 175%. The illegal and economically absurd bailout of speculators rather than Greece has already afflicted would-be 'rescuers' themselves. A quick haircut, as proposed early on, also by people from the financial sector, would have contained losses (not least of the budgets of those illegally bailing-out speculators) and spared the Greek unnecessary hardship. In most jurisdictions penal law sanctions delaying insolvency, precisely because it makes things worse for all.

Argentina is another example of problems created because official creditors prevented the first best solution. Her unilateral debt reduction was an emergency solution, necessary because proper proceedings were unavailable, a second best solution or optimization under restrictions. Fair and Rule-of-Law-based insolvency proceedings would definitely have been better. More and more countries have resorted to unilateral actions. Ecuador put pressure on creditors via her debt audit commission, receiving a large reduction after quite an unpleasant debate. Enumerating several examples, Richards (2010) identified a clear trend toward unilateral exchange offers as a technique for restructuring sovereign debt. When Congo (Brazzaville) - after a series of restructurings in which creditors were either completely bypassed or slighted after initial overtures for dialogue – responded favorably to promoting a negotiated solution over unilateral exchange offers, he called this 'a ray of sunshine cutting through the shadow cast by the cases of Ecuador and Argentina.' (*ibid*., p.298) Without a fair solution, debtor countries had to become more assertive. Iceland refused to socialize the debt of her private banks, resisted considerable pressures, exited from the crisis quickly and is meanwhile called a success by the IMF (2011). Fair insolvency proceedings are no longer uniquely of interest to debtors, but increasingly also to the private sector.

The GA did not specify details. It is therefore necessary to draw attention to the essential and indispensable features of any procedure one can rightly call insolvency, all the more so, as proposals definitely not meeting these minimum requirements have been propagated as such.

The necessary features of any insolvency procedure are:

- *No creditor diktat*; equality of both parties, debtor and creditors; a neutral and independent entity without any self-interest must chair the proceedings. Unlike present practice or the proposed SDRM, creditors must not be allowed to be judge and party. Other arguments apart, economic efficiency prohibits deciding in one's own cause.
- *Debtor protection*; some resources must remain exempt to allow a humane existence and a fresh start
- *Best interest of all (not just some) creditors*; as recent cases have shown private creditors are increasingly discriminated against. Greece is arguably the worst case, where the private sector – lured into lending by absurdly low capital weights - alone had to suffer big haircuts.
- *Sovereignty* is an additional issue with sovereign debtors. It was used as a valid counterargument against proposals to adapt Chapter 11, Title 11 US Code to sovereigns after 1982. But there is an easy solution. The main and essential points of the special insolvency procedure for municipalities in the US (Chapter 9, Title 11, USC) can be easily applied to sovereigns as was shown in 1987 (Raffer 1989, 1990).

A solution to an overhang of sovereign debts is needed, differing markedly from debt relief creditors granted so far that usually prolonged and deepened crises. A proper mechanism to solve a sovereign debt overhang must comply with minimal economic, legal and humane requirements, and must be fair to all involved. Impartial decision-making and debtor protection are the two essential features of insolvency, both denied to debtor states nowadays, even though debtor protection is no longer totally absent. Impartial decisions are also denied to private creditors. This paper presents a model of sovereign insolvency fulfilling these conditions, the Raffer Proposal, also called FTAP (Fair Transparent Arbitration Process) by many NGOs advocating it. As it has been described in detail already (Raffer 1989, 1990, 2005, 2010), only its essential points are sketched against the background of recent evolutions.

Sovereignty, Equality of Parties, and Impartial Decisions

The difference between Chapter 11 and Chapter 9 is fundamentally important. Chapter 9 is the only procedure protecting governmental powers, and thus applicable to sovereigns. Section 904 ('Limitation on Jurisdiction and Powers of Court', Title 11 USC) states with outmost clarity that the court must not interfere with

(1) any of the political and governmental powers of the debtor
(2) any of the property or revenues of the debtor; or
(3) the debtor's use or enjoyment of any income-producing property.

The concept of sovereignty does not contain anything more than what section 904 protects. The court's jurisdiction cannot be extended beyond the debtor's volition, similar to the jurisdiction of international arbitrators. Unlike in other bankruptcy procedures, liquidation of the debtor or receivership are impossible. No trustee can be appointed (Section 926, avoiding powers, if seen as an exception, is very special and justified). Section 902(5) explicitly confirms: '"trustee", when used in a section that is made applicable in a case under this chapter ... means debtor'. Change of 'management' (removing elected officials) by courts or creditors is not possible, nor should it be in the case of sovereigns. Obviously, similar guarantees are absent from Chapter 11, where debtor-in-possession financing is not unusual too. Public interest in the functioning of the debtor safeguards a minimum of municipal activities under Chapter 9. Limits to tax increases exist. When creditors insisted on higher payments by the City of Asbury Park, the US Supreme Court clearly stated that a city cannot be taken over and operated for the benefit of its creditors.

Chapter 9 was passed during the Great Depression, precisely to avoid prolonged and inefficient negotiations and reschedulings, to allow quick, fair, and economically efficient solutions. Lawmakers rejected a first draft not barring intervention into the governmental sphere as unconstitutional. A new version containing §904 passed. Creditor interventions similar to those usual in Developing or Eurozone Countries nowadays were considered inacceptable. 'Debt management' as practiced internationally for decades was to be avoided. Technically, the essential features of Chapter 9 allow implementing an economically sensible, fair, efficient, and legally correct solution.

The formally powerful position of the debtor might make non-economists wonder whether Chapter 9 actually works. Over 500 cases within the US show it does. Needing a solution the debtor must make a proposal acceptable to creditors. As history has shown, sovereign debtors cannot be forced to comply by courts either. The situation is similar. Composition plans should be fair, equitable, and feasible. To be confirmed the plan has to be reasonable and also in the best interest of creditors. They must be provided the 'going concern value' of their claims. A plan can only be confirmed if it 'embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle' (cf Raffer 1990, p.302).

An *ad hoc* panel of arbitrators nominated by both parties plus one further person elected by nominees should play the role of domestic courts, a traditional method in international law. This arbitration model was granted to Germany by creditors, including Greece and Ireland, in 1953 (Raffer 1989, p.60): Rule of Law and arbitration instead of Troika and arbitrary creditor diktat. As several problematic court cases have illustrated, courts in creditor countries may not always be a good solution. Arbitrators would mediate between debtors and creditors, chair and support negotiations with advice, provide adequate possibilities to exercise the right to be heard, and, if necessary, decide. As all facts would be presented by both parties and the representatives of the population (s. below) during a transparent procedure, decisions would be unlikely to affect substantial sums of money, but would rather resolve deadlocks. Agreements between debtor and creditors would need the panel's confirmation. Ideally, arbitrators would just rubberstamp plans agreed by creditors and the debtor.

Institutionalized arbitration is, of course, technically also feasible. But *ad ho*c panels give more say to the parties and do not need the long process of negotiating and ratifying a treaty. Acceptance by the main, important countries suffices, admittedly a big problem in practice.

Arbitration has become quite popular. The WTO and many bilateral investment treaties now including debts use it. ICSID has widened the concept of investment to include debts, arguably in a problematic way. There is no longer any logical reason why arbitration should not be used in a sovereign insolvency procedure, as it was foreseen in Germany's *de facto* case.

Protecting Debtors and Democracy

Human rights and human dignity enjoy unconditional priority, even though insolvency only deals with claims based on solid and proper legal foundations. All insolvency laws guarantee insolvent debtors humane standards of living, and usually a 'fresh start', exempting resources that could be seized by *bona fide* creditors. Debtors - unless they are countries in distress - cannot be forced to starve their children in order to be able to pay more. Debtor protection, one main principle of all civilized insolvency laws, had remained largely absent internationally. Due to massive pressure by NGOs, HIPC II finally acknowledged the principle of debtor protection, not necessarily always fully honoured by practice, but with visible improvements. An official anti-poverty focus was established, anti-poverty programmes were introduced for the first time. The MDRI confirmed this.

Multilateral debt reductions were seen as a necessary condition for reaching the MDGs, goals accepted by virtually all countries. Fully financing the MDGs can thus be interpreted as a form of debtor protection, although it differs from the protection enjoyed by domestic debtors. Even fully reaching those MDGs directly affecting poor people's lives does not yet satisfy the standard set by human rights and within countries. Not all Goals and Targets even aim at eliminating inacceptable living conditions. MDG 1 is a particularly good example. In spite of its wording ('Eradicate extreme poverty and hunger') Goal 1 only intends to halve the proportion of the extremely poor (Target 1) and the proportion of people suffering from hunger. There remain people who go hungry or live under unspeakable conditions.

In virtually all poor debtor countries poverty existed before the debt crisis. With some justification, creditors can argue that a sovereign insolvency mechanism cannot resolve all development problems of a country that already existed before and independently of debt problems, in other words substitute development policy.

In search for an international standard the MDGs thus offer a solution. Determining debtor protection, the MDGs prove useful and predestined to serve as the measuring rod. They are an internationally accepted standard capable of preventing excessive debt service from constituting an obstacle to the realization of human rights. Resources necessary to finance the MDGs should be exempt, although the MDGs ensure, strictly speaking, less than standard debtor protection as with other debtors.

The MDGs have been accepted by virtually all countries. Creditor governments, too, promised to 'spare no effort' to free people from 'the abject and dehumanizing conditions of extreme poverty', and 'committed' themselves to realizing the right to development for everyone as well as to 'freeing the entire human race from want.' If that is a true statement rather than a political truth, important creditor governments cannot but enthusiastically embrace the MDGs as an acceptable debtor protection standard. The proof of the pudding is always in the eating. The MDGs may continue to be useful as a yardstick after 2015, if no other goals protecting the poor in a similar way would be accepted.

Chapter 9 knows two instruments to protect debtors:

- exempting a minimum of resources needed to allow debtors to go on functioning, and to provide essential services to its inhabitants

- the right to be heard of the affected population. If electoral approval is necessary under nonbankruptcy law to carry out provisions of the plan it must be obtained before confirmation of the plan pursuant to §943(b)(6).

US municipalities must be allowed to go on functioning and to provide essential services to their inhabitants (presently, Bill H. R. 870 wants to extend Chapter 9 protection to Puerto Rico). Resources necessary to assure this are exempt. This principle must be applied to sovereign countries. Resources necessary to finance minimum standards of basic health, primary education etc. must be exempt. Eventually, anti-poverty measures under HIPC II have formally recognized this principle. Private creditors have always been aware that some money simply cannot be collected due to public resistance against social expenditure cuts. The SDRM, by contrast, fell back behind this minimum standard, not mentioning any kind of debtor protection at all. In Greece people have to die in hospitals because necessary medication can no longer be bought due to the Troika's decisions. The absence of sovereign insolvency protection allowed forcing Greece against the law to shoulder the costs of rescue programs Germany or France would have had to finance for their banks if Art. 125, the 'no bailout clause', would not have been violated. ATTAC (no year) showed that 'at least 77.12%' of 'rescue' funds went to the financial sector. According to the *Washington Post* (January 28, 2015) only 11% went to Greece's government. Greece suffers from this illegal activity of other member states, paying for banks and speculators, something a sovereign insolvency procedure would prohibit. Finally, the private sector (not necessarily each private creditor) suffered larger losses.

Of course, no insolvent debtor can just go on as before, saving and economizing are unavoidable. The question is uniquely which services are exempt, or have to be assured, though on reduced levels.

As Iceland proved, protecting the population is possible and adjustment pains can be cushioned (Bohoslavsky 2014). The IMF (2011) put it very aptly in a nutshell: 'Iceland set an example by managing to preserve, and even strengthen, its welfare state during the crisis.' In stark contrast to the standard IMF-recipe, Iceland introduced capital controls, did not tighten her fiscal policy during first year of the program, had referenda in order to determine whether the debts incurred by her three liberalized and deregulated banks should be paid in full by taxpayers. The people decided against. Iceland returned to capital markets in 2011. Differences to orthodox 'debt management' are obvious.

According Kentikelenis *et al* (2014) the weakness of regional health systems were one 'major reason' why Ebola spread so rapidly. IMF conditionalities requiring spending cuts had eroded health care systems over the years. The IMF denies this, pointing at increases in health spending 'from 2010 to 2013' (Gupta 2014), apparently effects of HIPC II. Without any doubt stronger health systems would have reduced Ebola's international impact. This illustrates that no debtor protection in debtor countries can create international externalities. Apart from diseases, too strict austerity is also likely to affect migration flows.

Stiglitz *et al* (2015) pointed out: 'Any framework for sovereign debt restructuring has to take account of the primacy of the functions of the state, its obligations to its citizens, and the "social contract" the state has with its citizens.'

Participation of the municipality's inhabitants is guaranteed: in domestic Chapter 9 cases the affected population has a right to be heard. Internationally, this would have to be exercised by representation. Trade unions, entrepreneurial associations, religious (Christian, Muslim etc.) or non-religious NGOs, or international organizations such as

UNICEF could represent the debtor country's population, presenting arguments and data before the panel. Affected people would thus have the right to defend their interests, to present estimates and arguments, to show why or whether certain basic services are necessary. The openness and transparency usual within the US should become the norm of sovereign insolvency.

Besides preserving essential services to the population my proposal gives the affected population and vulnerable groups a right to be heard. It gives voice to those who have been denied participation and have therefore often ‘participated’ rioting in the streets. HIPC II already practices NGO-participation. Transparency and NGO-participation in debt issues are meanwhile facts. I propose to apply the same legal and economic standards to all debtors, to guarantee equal treatment of indebted people everywhere, irrespective of nationality or color of one’s skin. There is no logical reason why someone living in an insolvent US municipality is treated in a more humane way than people living in another public debtor, such as Greece.

Further participation by parliaments or the electorate could easily be integrated. The debtor government can choose to leave the task of nominating panel members either to the parliament or the people. Voters could, e.g., elect arbitrators from a roster on which experts reaching a minimum of supporting signatures by voters would be listed. One arbitrator might be chosen by parliament, the other by voters. The parliament might establish a special committee to handle insolvency, including members of the cabinet, as proposed in a bill drafted on the initiative of Argentine Congressman Mario Cafiero. This bill would have established a Comisión Representativa del Estado Nacional. Consisting of members from both Houses and the executive power, it was to nominate panel members and represent Argentina during the proceedings. Solutions to sovereign debt problems need not destroy democracy – as the EU does at present. Sovereign insolvency proceedings would have been much better for anyone than Argentina’s unilateral action, necessary because insolvency was unavailable.

Compared with HIPC II debtor participation has declined again. Those really affected by adjustment have no voice at all, referenda (if considered) are prevented both in debtor countries (as in Greece) and in countries whose taxpayers are to finance bail-outs, covering losses of their own banks. The democratic sovereign is gagged. This problem goes beyond debt, destroying the very essence of democracy. ‘Democratic processes must entail open dialogue and broadly active civic engagement, and it requires that individuals have a voice in the decisions that affect them, including economic decisions’, as Stiglitz (2000, p.20) put it. These ‘people, who would inevitably face much of the costs of the mistaken policy’ are ‘not even invited to sit in on the discussions; and I often felt myself to be the lone voice in these discussions suggesting that basic democratic principles recommended that not only should their voice be heard, but they should actually have a seat at the table.’ (*ibid*., p.1) US Chapter 9 shows how this problem can be solved.

Creditors have, of course, the right to demand selling some of the debtor’s assets to reduce their losses. This is part and parcel of any insolvency case, fair and justified. Quick fire sales under enormous pressure and within a stipulated short time-frame as presently requested from Greece are not. They are likely to yield unfairly low prices (as illustrated by euro-countries) damaging both *bona fide* creditors and the debtor, though allowing some lucky (or well connected) few to get these assets on the cheap.

Fair and Equal Treatment of All Creditors

The last point of my proposal is fair and equal treatment of **all** creditors. Multilateral debts must no longer enjoy illegal preference. All creditors must be treated equally, in line with the statutes of multilaterals. So far, the private sector has been forced to bear most or all losses. Official creditors, even when and if delaying haircuts by their actions, thus increasing damages, have enjoyed economically undue and illegal preference. This is patently unfair, economically wrong, and must stop. Especially the poorest countries must get meaningful multilateral haircuts. Particularly problematic and a grave violation of the Rule of Law is any form of *ex post* seniority. The IMF (2012, p.54) put this new discrimination of private creditors in a nutshell: 'the ECB's exemption from the Greek PSI reflected a net expected transfer of value from private sovereign bond holders to the ECB.' Economically, this is vulture behavior.

All debts of the sovereign, domestic and foreign must be included in one, single procedure. Erce (2014, p.23) showed that discriminating domestic creditors, or 'IMF-sanctioned heterogeneous treatment of sovereign creditors can have negative effects on growth'. Including domestic claims may thus be in the purely economic interest of foreign creditors.

Insolvency laws usually allow preferential treatment of certain types of claims. Ladders of priority are plain vanilla. Treating all creditors equally is not a procedural necessity, but in my model all creditors are to be treated equally. Except creditors lending during the procedure to keep the country afloat - whether public or private - all private and public creditors must get the same haircut. This avoids unfair burden sharing. Demanding that those official creditors aggravating damages by illegal lending must not enjoy preference is extremely justified and indispensable. One may even demand subordination of insolvency delaying public lending. Greece illustrates this most clearly: a quick haircut early on would have cost the private sector less.

Equal haircuts, arguably subordination of abusive public credit, is therefore an important feature of my sovereign insolvency model, which is based on specific economic, legal, and ethical reasons: on the necessity to establish the equivalent of national liability and tort laws, and on fairness to *bona fide* creditors, who like debtors would have to pick up part of the bill of failures by official lenders.

The present situation encourages 'overoptimism' of those determining haircuts (cf. Guzman 2014, pp.35ff; Raffer 2010, pp.204ff). More realistic forecasts would demand larger reductions and more losses of the public sector. Delaying is thus the 'optimal' strategy of governments hoping that later on another, new government might have to tackle this problem and acknowledge losses that already occurred long before it came to power. The preparedness to stretch Greece's amortization period seems explained by the fact that present political decision makers will be retired when the impossibility of repayment finally has to be recognized. Other cabinets will officially have to take losses of the past veiled over years and the blame for what was basically not their fault. Equal treatment would provide a strong disincentive.

Snail-speed Progress

Although opposition is still quite strong, changes to the better exist, deplorably slow progress at snail speed since the first proposals of sovereign insolvency around 1982.

No one would still defend illusory approaches such as the 'Baker Plan' or the 'Venice Terms' (all must and can be repaid plus interest), except the EU. The need for debt reduction is no longer debated. Even in the case of Greece, where this illusion has been kept alive longest, the tide seems to be turning. Changes in terms and conditions constitute an official sector haircut on the sly.

Recognizing unpayable debts, CACs and comparable treatment are trying to substitute proper insolvency proceedings. Some countries have passed laws against professional hold-outs, aka 'vulture funds'. The problems created by the absence of Adam Smith's first best solution, a glaring gap in the international financial architecture, have become quite obvious. The GA's call for a sovereign insolvency mechanism is an evolution obviously propelled by Argentina's litigation and debatable decisions by a federal judge, who continued to be unfamiliar with essential facts after presiding for over a decade (see *New York Times,* July 24, 2014).

Recalling the objections against my proposal during the 80s, most forcefully made by IFI-staff, one notes movements, especially so after Krueger's proposal. Krueger (2001) recognized the necessity of an orderly framework, pointing out that this reduces restructuring costs, echoing Raffer (1989). Like touched by Harry Potter's wand, the IMF immediately turned from a fierce enemy to an ardent advocate of sovereign insolvency. Nevertheless, its SDRM is no insolvency mechanism: the IMF's Executive Board would have continued to determine haircuts and debtors' policies (cf Raffer 2005, p.365), and only the private sector would have had to take losses, both in stark contrast to the first proposal to arbitrate (Raffer 1989) shaped after and inspired by Germany's London Agreement.

Verification (Raffer 1990, p.309) often called impossible before in discussions with IMF-staff, was eventually demanded by the IMF (2002, p.68). 'Agreements between debtor and creditors would need the confirmation of the arbitrator, in analogy to Section 943' (Raffer 1990, p.305; similarly Krueger 2002, p.7). Krueger (2001, cf. Raffer 1990) proposed stays or standstills, even though the IMF (e.g. 2002, p.33ff) backtracked under criticism, modifying Krueger's bolder proposal. Arbitration was proposed, though only for private creditors, possibly for bilateral but not for multilateral creditors (e.g. IMF 2002, pp.56ff). But this body would not have been allowed to decide the two really important issues.

Debt arbitration has become quite popular meanwhile. Creditors use ICSID and BITs to sue debtor nations. Only when it comes to fair and efficient solutions of sovereign debt distress, arbitration is shunned by the same governments eagerly pushing it anywhere else. In 2005, however, the Norwegian Government explicitly expressed the intention to support arbitration on illegitimate debts.

HIPC I already recognized the need for multilateral debt reduction, a great merit of Wolfensohn's, breaking this taboo. Nevertheless, undue preference is still granted to IFIs instead of treating them in accordance with their own statutes. Finally the MDRI demanded substantial cuts of some multilateral debts to provide additional support to reaching the MDGs. This can be interpreted as a form of debtor protection: money that could be paid to creditors is used to finance social expenditures. The principle of debtor protection has already been accepted by HIPC II, with visible results.

Summing up, one may say: change is painfully slow, but it exists. More speed is urgently needed.

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