Fordham International Law Journal

Volume 12, *Issue* 1 1988 *Article* 1

Back to the Market: The Debt Problem in Legal Perspective

Karl M. Meessen*

*

Back to the Market: The Debt Problem in Legal Perspective

Karl M. Meessen

Abstract

This article argues that the debt problem can be attributed to the failure on the part of those who operated the huge market of recycled petro-dollars in the late 70s and early 80s. The author then discusses how reinforcement of a decentralized decision-making system depends on three factors; transparency, market entry, and confining state regulation.

ARTICLES

BACK TO THE MARKET: THE DEBT PROBLEM IN LEGAL PERSPECTIVE

*Karl M. Meessen**

The debt problem, which is now in its seventh year, has produced, and continues to produce, a considerable amount of legal work. It has required the drafting of ever more complex restructuring agreements between debtor states and a multitude of creditors. It has led to the design and implementation of new and ingenious links among the various groups of official creditors, commercial creditors, and international organizations such as the International Monetary Fund (the "IMF") and the World Bank, both trying to impose some conditionality on economic policies. It has also led to the development and adaptation of new financial instruments that respond to the needs of banks in handling sovereign debt.[1] These and many other aspects of the debt problem seem to escape any comprehensive theoretical assessment from a legal perspective. They indeed do escape unless the main characteristic is seen in that very diversity: the solution of the debt problem, it is submitted, no longer follows the ideal of an orderly government-sponsored general settlement, but is guided by the market model under conditions of mixed economies, that is, by decentralized decision-making by a multitude of private actors combined with a fair amount of government activity.

The outbreak of the debt crisis can be attributed to a market failure, or rather to a failure on the part of those who operated the huge market of recycled petro-dollars in the late 70s and early 80s. Neither the commercial lenders nor the sover-

---

* Dr. iur. (Bonn), Professor of Public Law, International Law, European Law, and International Economic Law at the University of Augsburg, Augsburg, Federal Republic of Germany; Professor of International Trade Law at the Graduate Institute of International Studies, Geneva, Switzerland.

1. For recent surveys, see Clark & Gianni, *Are There Solutions to the Debt Problem?*, INT'L FIN. L. REV., Sept. 1988, at 9; Corrigan, *A Balanced Approach to the LDC Debt Problem*, FED. RES. BANK N.Y. Q. REV., Spring 1988, at 1; Loehnis, *Prospects for International Lending and Reschedulings*, in PROSPECTS FOR INTERNATIONAL LENDING AND RESCHEDULINGS 1-1 (J. Norton ed. 1988).

eign borrowers were prepared to take note of the warning signals given off by the deteriorating prospects for economic growth. Yet, the expectation of growth was the only collateral used at the time to secure loans to developing countries. The moratorium that was unilaterally declared by Mexico in August 1982 should not have come as a surprise.

Today, the international finance and banking systems having survived, the debt crisis is no longer a crisis, but has become the ongoing problem of the overindebtedness of developing states. These debts have proved resistant to attempts at a global resolution. The latest call of the United Nations Conference on Trade and Development ("UNCTAD") for a general debt relief of thirty percent[2] was answered shortly thereafter. Concluding the joint annual meeting of the IMF and the World Bank that was held in Berlin in September 1988, the Fund's managing director pleaded with lenders and debtors to stick to the present "case-by-case" approach, and the president of the World Bank supported what he called a "pragmatic evolutionary approach."[3] In its most recent pronouncement, the World Bank recommends a "modified strategy" combining "voluntary debt reductions, sustained adjustment programs, enhanced catalytic roles by international financial institutions, and significant tax and regulatory changes by the industrial countries."[4]

If that accent on voluntary aspects, not only of debt reduction but also of other operations, can be interpreted as a presently prevailing trend of going "back to the market," then the focus of legal research should be shifted from examining restructuring procedures and developing corollary obligations of public international law to analyzing legal factors that facilitate market processes and thereby alleviate the continuing burden of governments. Such reinforcement of decentralized decision-making depends on a number of factors. Three of them will be discussed in the following sections.

2. Dullforce, *Creditors Urged to Assist Heavily Indebted Nations*, Fin. Times, Sept. 2, 1988, at 1, col. 7.

3. Stephens & Fidler, *IMF to Study Ways of Tackling Several Key Monetary Problems*, Fin. Times, Sept. 30, 1988, at 28, col. 3.

4. World Bank, Bank News Release No. 89/S17 (Dec. 19, 1988).

I. *TRANSPARENCY*

The sanctity of private contracts in view of debtor-state intervention was correctly confirmed by the final outcome of *Allied Bank International v. Banco Credito Agricola de Cartago*.[5] In that case, Costa Rica had made servicing of a hard currency debt subject to the approval of the Central Bank of Costa Rica, which was first refused, then later granted subject to a new restructuring agreement. That restructuring agreement, however, was accepted by all creditor banks except one, Fidelity Union Trust Company of New Jersey, which was represented by Allied as the agent of the syndicate. The District Court for the Southern District of New York denied Allied's motion for summary judgment on act-of-state grounds;[6] the Court of Appeals for the Second Circuit originally affirmed that decision,[7] yet under the principle of comity.[8] Only after the U.S. government intervened, a rehearing was granted and the former order was reversed:[9] neither the act-of-state doctrine nor comity principles were considered to demand recognition of the Costa Rican foreign exchange restrictions and of the restructuring agreement reflecting those restrictions. The authoritative confirmation of private contracting, however, failed to make the debt enforceable. The plaintiff, in fact, was never paid according to the original terms of the contract and eventually decided to sign the restructuring agreement as well.[10] Nevertheless, the decision in *Allied* has an important side effect that may not have attracted much attention so far: it provides for some transparency in the debt market. In the primary market, as between creditors and debtors, the nominal terms of the agreement are confirmed as a starting point for negotiations on restructuring sovereign debts. The conduct of such negotiations, heavily burdened by involuntary lending of fresh money, may not live up to the textbook model of a properly function-

5. 757 F.2d 516 (2d Cir.), *cert. dismissed* 473 U.S. 934 (1985).

6. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440 (S.D.N.Y. 1983), *rev'd*, 757 F.2d 516 (2d Cir. 1985).

7. This 1984 decision appears in 23 I.L.M. 742 (1984). The decision was subsequently vacated on rehearing by 757 F.2d 516 (2d Cir. 1985).

8. 23 I.L.M. at 747.

9. 757 F.2d at 523.

10. *See* Mudge, *Country Debt Restructure: Continuing Legal Concerns*, in PROSPECTS FOR INTERNATIONAL LENDING AND RESCHEDULING, *supra* note 1, at 18-4.

ing market. Yet transparency reaches the secondary market as well, and there it seems to be of critical importance: how could it be imagined that one is successfully trading claims against sovereign debtors if the nominal value of those claims is at the disposal of the debtor state? From that perspective it seems counterproductive to see the Committee on International Monetary Law of the International Law Association derive from international treaty law a "state of necessity" defense to be applied to contractual relations between commercial creditors and debtor states.[11] What does "state of necessity" mean in public international law? What precedent permits the use of such a notion within the national law applicable to the contract that is relevant in the particular case? Fortunately, the state of necessity defense, as unhelpful as it is regarding the transparency of the debt markets, would usually also be unwarranted under the proper law of contracts, which, to be sure, would have to be identified and examined in each particular case.

II. *MARKET ENTRY*

The debt problem will have been solved once entry into the primary debt market is attractive again. After years of absence from the capital market, Venezuela now seems back to raising new funds, that is, funds in addition to those needed for restructuring purposes.[12] Chile also claims to be approaching a similar standard of creditworthiness.[13] For the time being, however, the priority in most cases is still with allowing entry into the secondary market. The attractiveness of the secondary market to new entrants, of course, depends on the availability of negotiable assets. To produce them, creditor syndicates must grant to their members some measure of independent action. Under the menu approach, included in restructuring agreements are a variety of options, such as exit bonds, which at a certain price allow an escape from the formal

11. *See* Comm. on Int'l Monetary Law, Int'l Law Ass'n, Committee Report paras. 16-25 (Aug. 1988); considerably watered down in Int'l Law Ass'n, International Monetary Law Resolution paras. 4-11 (Aug. 1988) (both report and resolution to be published in INT'L LAW ASS'N, REPORT OF THE 63RD CONFERENCE (1988)).

12. Cohen, *Venezuela Launches $500m Floating Rate Note Issue*, Fin. Times, Dec. 16, 1988, at 6, col. 2.

13. Durr, *Debt Negotiator Resigns in Chile*, Fin. Times, Dec. 9, 1988, at 3, col. 5.

and informal constraints of syndication, especially with respect to providing fresh money in the future.[14] One will have to remember, however, that such creditor syndicates serve more than the private commercial interests of the lead banks. This point came up in *A.I. Credit Corp. v. Government of Jamaica*.[15] In that case, Continental Illinois Bank had assigned sovereign debt, as rescheduled in 1984, to the plaintiff, who did not become a party to later restructuring agreements in 1985 and 1987 with the same debtor state. In conformity with the letter and the spirit of the 1984 agreement, the plaintiff sued the government of Jamaica for debt outstanding under that agreement. In granting summary judgment for the plaintiff, the court was careful to note that none of the governmental agencies of Jamaica or other banks had sought to intervene. The background is explained in a footnote where the court mentions a letter of an IMF official to the Governor of the Bank of Jamaica confirming that the sharing and default provisions "could create problems for the implementation of the international debt strategy that is supported by member governments of the International Monetary Fund."[16] Indeed, independent action of a member of a syndicate, unless carefully prearranged by contractual commitments, undermines the functioning of the restructuring process. A sophisticated opening up of syndication agreements would, however, not only fuel secondary markets with the amount of negotiable instruments necessary to attract new entrants, but it might also enhance the manageability of renegotiations, since a wider array of commercial interests of creditor banks, partly resulting from differing legal regimes in the various home states, could be accommodated.

III. *CONFINING STATE REGULATION*

The debt markets will remain, perhaps to a greater extent than other markets, subject to state regulation. Foreign exchange law, banking law, securities law, and tax law are the principal instruments by which states are able to channel the flow of market processes. A wholesale call for deregulation

14. For a discussion of such instruments, see generally W. CLINE, MOBILIZING BANK LENDING TO DEBTOR COUNTRIES (1987); Buchheit, *The Changing Tactics of Sovereign Debt Restructuring*, INT'L FIN. L. REV., Nov. 1987, at 35.

15. 666 F. Supp. 629 (S.D.N.Y. 1987).

16. *Id.* at 633 n.5.

seems much too indiscriminate in view of what is at stake. To call for harmonization would always be welcome but hard to follow, as experience within the member states of the European Communities confirms. To reconsider the extraterritorial reach of domestic legislation, however, may be a point that deserves to be made. Some reconsideration in that respect is already under way. Regulation K on international banking recently was modified with an explicit reference to the debt problem,[17] and Regulation S on offshore securities transactions was proposed by the Securities and Exchange Commission on June 10, 1988.[18] If the market strategy is to gain momentum, especially if secondary markets are to become more significant, market access must be facilitated. Less regulated international markets have to be given room along with the more highly protected national markets. Such territorial confinement of state regulation is by no means prohibited by international law; it may even be mandatory under some principles and rules of international law, among them the principle of enlightened self-interest.[19] That principle, on the one hand, encourages assessment of the pros and cons of national regulation in a most pragmatic manner. The element of "enlightenment," on the other hand, demands that national self-interest be considered in the light of the values shared by the international community and in the light of countervailing interests of foreign states, such as those of debtor states. Regarding internationally shared values, the "one world" aspect of the debt problem should be remembered: creditors and debtors are equally interested in removing the obstacles to economic growth that seem to paralyze so many efforts. A reconsideration of the extraterritorial reach of banking and securities regulations could help enable secondary markets to redistribute risk among creditors and also provide for elements of voluntary debt relief, for example, by allowing buy-back operations.

17. 12 C.F.R. § 211.5(f) (1988).

18. Offshore Offers and Sales, Securities Act Release No. 6779, Fed. Sec. L. Rep. (CCH) ¶ 84,242 (June 17, 1988).

19. For an explanation of that principle and a general discussion of state jurisdiction, see generally Meessen, *Conflicts of Jurisdiction Under the New Restatement*, 50 LAW & CONTEMP. PROBS. 47 (1987).

EXAMINING DEBT-EQUITY SWAPS

Two informative articles that appear in this issue of the *Fordham International Law Journal* are devoted to discussing debt-equity swaps.[20] To explain those swap operations and their regulatory setting, both in debtor states and the home states of creditors, serves a useful purpose, all the more so since debt-equity swaps link market processes to the development of the real economy. Financial innovations may breathe life into the debt markets, but payment of interest and repayment of capital will in the last analysis have to be made from the proceeds of the real economy of debtor states. By their dual role of offering additional opportunities in the secondary market and attracting additional money in the form of direct foreign investment, debt-equity swaps could now, if inflationary pressures are brought under control, help to trigger the kind of growth that was expected in vain a decade ago.

20. Shepherd & Clock, *Regulatory Aspects of Developing Nation Debt-Equity Swaps*, 12 FORDHAM INT'L L.J. 43 (1988); Wallenstein & Silkenat, *Investment Funds and Debt-Equity Swaps: Broadening the Base of a New Financial Tool*, 12 FORDHAM INT'L L.J. 8 (1988).