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In 1970, the International Monetary Fund articulated a policy dealing with the circumstances under which the Fund will extend financial assistance to a member country that at the time has payment arrears to its other creditors. This article reviews the history of this "lending into arrears" policy and its adaptation over the years to the changing nature of sovereign borrowing and debt management practices. The article agues that the LIA policy, as it is being implemented in 2007, has slipped its original philosophical moorings and may eventually draw the IMF Executive Board into playing a referee function in future sovereign debt workouts.

I. Introduction

The International Monetary Fund's ("IMF" or the "Fund") lending into arrears policy ("LIA"),[1] as it is being implemented in 2007 (some eighteen years after its debut), may be a perfectly sensible measure to protect the IMF's own lending into a distressed situation. Or it may be a pretext for the IMF to assert a degree of supervision over the methods by which sovereign debtors reach settlements with their private sector creditors. Or it may be both. Therein rests the problem. No one, the IMF least of all, seems prepared to articulate the definitive rationale and objective of the LIA policy. This makes a critical analysis of the policy, whether attempted by the IMF Executive Board, sovereign debtors, or private lenders, very difficult. This article has three objectives: (1) to trace the evolution of LIA since its inauguration in 1989 in light of the historical events that have shaped its adaptation (if one views LIA in a benignant light) or its corruption (if one does not) since 1989; (2) to analyze the competing rationales for the policy; and (3) to offer some thoughts on how to promote the virtue of candor in the LIA debate, even if the virtue of wisdom remains elusive.

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1. "Lending into arrears" describes the circumstances in which the IMF will be prepared to extend financial assistance to a member country that has accumulated overdue amounts to other creditors.

II. Evolution of a Policy

The IMF's policy regarding sovereign arrears to private creditors has ebbed and flowed in response to the significant changes in the international capital markets over the last few decades. In this section of the paper, we trace this evolution and consider the legal basis of the policy.

A. The 1970 Formulation

The IMF's arrears policy was first articulated in a decision adopted by the IMF's Executive Board in 1970.[2] The policy was generally intolerant of arrears, ostensibly because

2. Decision No. 3153-(70-95), adopted 26 October, 1970, available in *Selected Decisions*, Seventeenth Issue, International Monetary Fund, Washington DC, 1992, pp. 359-36. *See also* http://www.imf.org/external/pubs/ft/sd/index.asp?decision=3153-(70/95)_2 and http://www.imf.org/external/pubs/ft/sd/index.asp?decision=3153-(70/95).

Decision No. 3153-(70/95) (emphasis added) reads as follows:

1. Undue delays in the availability or use of exchange for current international transactions that result from a governmental limitation give rise to payments arrears and are payments restrictions under Article VIII, Section 2(a), and Article XIV, Section 2. The limitation may be formalized, as for instance compulsory waiting periods for exchange, or informal or *ad hoc*.
2. The need for the Fund to define its policy on payments arrears is emphasized by the fact that restrictions resulting in payments arrears arising from informal or *ad hoc* measures do particular harm to a country's international financial relationships because of the uncertainty they generate. This uncertainty is particularly harmful to the smooth functioning of the international payments system and has pronounced adverse effects on the creditworthiness of the debtor country which may extend beyond the period of the existence of the restrictions.
3. In the light of these considerations, it is believed that the Fund should aim in consultation reports at a more systematic treatment of restrictions on payments and transfers for current international transactions that produce payments arrears. In all cases where payments arrears arise from a governmental limitation on, or interference with, the availability of foreign exchange at the time a payment for a current international transaction falls due, or with the timely transfer of the proceeds of such transactions, the payments arrears should be treated in the consultation papers as evidence of a payments restriction requiring approval in Article VIII or Article XIV consultation decisions. The staff, in the consultation discussions, will have to establish whether payments arrears exist by ascertaining whether there has been a substantial delay beyond that usually required for ascertaining the bona fides of exchange applications or the time that can be regarded as normally required for the administrative processing of applications for exchange. If payments arrears exist and approval of the restriction giving rise to them is requested by the member, the member should be expected to submit a satisfactory program for their elimination. Approval if given should be only for a temporary period and generally with a fixed terminal date. Because of the difficulty in surveillance, approval should be wherever feasible in terms of the level of arrears outstanding. The program for the elimination of the payments arrears should provide for a maximum permissible delay to which a payment or transfer could be subjected, together with a phased reduction in the outstanding level.
4. Fund financial assistance to members having payments arrears should be granted on the basis of performance criteria or policies with respect to the treatment of arrears similar to the criteria or policies described in the preceding paragraph for the approval of the payments restrictions. *In general, the understandings should provide for the elimination of the payments arrears within the period of the stand-by arrangement.* Such understandings should be based on the concept of a given level of payments arrears and should be reflected in the performance criteria included in stand-by arrangements in the higher credit tranches. To support the policies designed to deal with arrears the letter of intent should include a statement that there would be no imposition of new restrictions or increase in the level of delayed payments. Where Fund financial assistance is being provided, but only through the first credit tranche, the adoption of a viable program directed toward the elimination of

they damage the member country's international financial relationships and perceived creditworthiness. The principal focus of the 1970 decision, however, was on arrears that accumulate as a consequence of foreign exchange restrictions imposed by the member country, not arrears caused by outright defaults by the member on its debts owed to private or bilateral creditors.

The 1970 decision of the IMF Board enjoined the IMF staff to scold member countries during their annual Article IV consultations if those countries had allowed arrears to accumulate. The decision also warned that a member country burdened by arrears that sought financial assistance from the IMF would be expected to eliminate those arrears within the period of the stand-by arrangement and to foreswear accumulating any new arrears in the future. Thus, the IMF's policy at this stage *did* contemplate lending into arrears, as long as the member committed to eliminate those arrears by a "fixed terminal date".

The principal legal basis of this 1970 decision is found in Article V Section 3(a) of the IMF's Articles of Agreement, which requires the IMF to establish "adequate safeguards" for the use of its resources to support effective balance of payments adjustment, and Articles VIII and XIV, relating to payment restrictions imposed by IMF members. IMF lending to a member country with arrears was considered inconsistent with the "adequate safeguards" required by the IMF's Articles, particularly when the arrears were accumulated to finance an ill-advised exchange rate policy. Indeed, the origins of the no-arrears policy can be traced back further. The disruptive balance of payment practices by some countries in the inter-war period led the drafters of the IMF Articles of Agreement to state that one of the purposes of the institution, as defined in Article I(v), is:

> To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures *destructive of national or international prosperity*.[3]

B. The 1980 Formulation

In 1980, the IMF's Board signaled that it was prepared to show even greater tolerance toward arrears in the context of IMF-supported stabilization programs.[4] The 1980 Board decision reads, in pertinent part, as follows:

> It might not be feasible in the early stages of the program to go beyond an understanding that the member would try to avoid any further increase in outstanding arrears . . . . The Fund's policies on payments arrears are also concerned with their treatment in the context of stabilization programs supported by use of the Fund's resources. In these programs, member countries are expected to take steps to reduce and eventually eliminate payments arrears relating to capital transactions as well as to payments and transfers for current international transactions. In formulating policy

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the payments arrears should be an important factor in considering whether the country was making reasonable efforts to redress its international financial situation.

3. IMF Articles of Agreement, art. I(v) (emphasis added).

4. Arrears to Creditors and Debt Strategy, *Review of Fund Policies and Procedure on Payments Arrears Executive Board Meeting 80/154*, Oct. 17, 1980, *available at* http://www.imf.org/external/pubs/ft/sd/index.asp?decision=EBM/80/154.

> guidelines in these programs, the staff will continue to be guided by the approach set forth in the Executive Board decision of 1970 (Decision No. 3153-(70/95)). This approach will also be followed with respect to payments arrears arising from default. The technique chosen by a member to reduce outstanding arrears will reflect its institutional arrangements, as well as the magnitude of the arrears and the severity of the balance of payments problem. When payments arrears are large in relation to a member's available foreign exchange resources, it may not be possible to aim at the elimination of the arrears within the program period. Special arrangements may be needed for the renegotiation of outstanding debt obligations when debt problems are particularly severe. Depending on the member's circumstances and the length of the program, it may not be possible, in the early stages of a program, to reach an understanding with the member that goes beyond requiring the avoidance of any further increase in arrears.[5]

The 1980 formulation, therefore, introduced two new elements. First, it expressly jettisoned the strict requirement of the 1970 decision that all arrears must be cleared within the period of a stand-by arrangement. Second, for the first time, the policy referred to the possible need for "special arrangements" in severe cases that would eliminate the arrears through the renegotiation of the member country's outstanding debts. Nothing in the 1980 formulation, however, sought to prescribe how those negotiations should be conducted.

C. LIA in the Global Debt Crisis of the 1980s

The global debt crisis that began in 1982, the infamous "lost decade" of Latin America, profoundly reshaped both the role of the IMF, which was an institution in search of a mission following the abandonment of the par value regime, and the design of some of the IMF's policies, notably the LIA policy. The IMF played a key role in the sovereign debt workouts of the 1980s, influencing the behavior of private creditors (which were, at that point, almost exclusively commercial banks) as well as debtor governments.

During this period, the IMF's involvement in the sovereign debt restructuring process sought to vindicate three principles that the Fund held dear. The first was the traditional articles-mandated requirement to safeguard IMF resources.[6] Faced with a debt crisis of potentially catastrophic dimensions, the risks to the IMF's own credit advances to the twenty or twenty-five countries caught up in the process could no longer be viewed as remote or speculative. A number of member countries had massively over-borrowed from commercial banks in the late 1970s. Even the interest component of these loans became unsustainable as U.S. dollar interest rates skyrocketed to more than 20 percent per annum in the 1981-82 period. Without robust protections, therefore, fresh money advanced by the IMF could easily have been swallowed up in partial interest payments to existing creditors, leaving the IMF to join the queue of unhappy lenders holding defaulted loans.

5. *Id.* (emphasis added).

6. For a discussion of the policies developed by the Fund over the years to safeguard its own resources, most notably with regard to its conditionality procedures, *see* Rosa Lastra, *Legal Foundations of International Monetary Stability*, 371-443 (Oxford University Press) (2006).

Second, the IMF became a fierce advocate of "burden sharing," the idea that all of the parties caught up in a sovereign debt crisis (the citizens of the debtor country, the creditors, and the international financial institutions (IFI)) must share the pain of the resulting workout in an equitable manner. Translated, this meant that the citizens had to accept an IMF adjustment program, the creditors had to restructure their loans (which meant sometimes lending new money), and the IFI's had to continue emergency lending.

Finally, the IMF wanted to garner widespread recognition by governments and other lenders of the IMF's "preferred creditor" status.[7] The IMF had long argued that it and the other IFI's, unlike commercial lenders, were prepared to advance funds into visibly distressed situations. This, the argument went, warranted an understanding that IFI creditors would be completely exempt from default and restructuring.

The IMF was not sure that all sovereign debtors and all private creditors had bought into this self-proclaimed "preferred creditor" status. After all, other types of lenders ranging from trade creditors to bondholders had in their day tried to peddle their own theories about why they should be exempted from sovereign debt restructurings. Had the IMF been entirely confident that its preferred creditor status would be respected, there would have been little need to worry about safeguarding IMF resources in a distressed situation or, for that matter, little need for a policy on lending into arrears. The preferred creditor status of IMF loans would ensure their timely repayment, regardless of the size of the defaults and arrears inflicted on other creditors, all of whom would, in this scenario, have accepted a de facto subordinated status.

In the early days of the global debt crisis, these factors induced the IMF to take a very firm stance on lending into arrears. Notwithstanding the limited tolerance of arrears found in the Board's pronouncements of 1970 and 1980, the IMF refused to lend money under its stabilization programs during the 1980s unless and until the debtor country had cleared its arrears with private creditors either through a rescheduling of overdue principal amounts or "new money" borrowings designed to refinance interest arrears, or both.

The practical effect of the IMF's policy of not lending to countries in payment arrears to their private creditors meant, of course, that sovereign debtors needed to agree on the terms of the restructuring offered by private creditors in order to access IMF resources. The debtor's program of economic reform was thus effectively held hostage to the commercial bank restructuring process.[8] For their part, the commercial banks' willingness or ability to negotiate these restructuring packages was heavily influenced by bank regulatory and supervisory requirements. This was particularly important in the United States since in order to continue to classify the loans as performing during the crisis, commercial banks needed to receive interest payments on a timely basis.[9]

By the end of the decade, the sovereign debt restructuring world had changed dramatically. On March 10, 1989, U.S. Treasury Secretary Nicholas Brady announced what would soon be dubbed the "Brady Initiative," a plan to induce commercial banks to write off a portion of their claims against sovereign borrowers in return for receiving liquid,

7. *See* Lee Buchheit, *Of Creditors, Preferred and Otherwise*, INT'L FIN. L. REV., June 1991, at 12.

8. *See* Anna Gelpern, *Policy Briefs in International Economics*, No. PB05-2, Institute for International Economics, Sept. 2005, at 9.

9. *See* Sean Hagan, Sovereign Debtors, Private Creditors and the IMF, INTERNATIONAL MONETARY AND FINANCIAL LAW UPON ENTERING THE NEW MILLENNIUM, at 329 (Norton ed.); Lee Buchheit, *Whatever Became of Old New Money?*, INT'L FIN. L. REV., Dec. 1990, at 11.

partially-collateralized bonds for the balance. In addition, commercial bank debt restructuring and new money packages became harder and harder to syndicate to the international banking community as the 1980s moved on. Some smaller banks and some regional banks flatly refused to participate in the later deals, dragging the restructuring process out over months or years.[10] Finally, a few countries, Argentina and Brazil being the most prominent, stopped paying interest on their commercial bank debt altogether. More precisely, they stopped borrowing "new money" from the bank lenders in order to remain current on interest payments to those same lenders.[11]

A strict adherence to the IMF's "no arrears" policy, therefore, would have rendered the IMF an increasingly irrelevant player in the sovereign debt workout process. If all IMF programs had to await the conclusion of the sovereign debtor's latest restructuring/new money package with its commercial creditors, there might soon be no IMF programs for these countries at all.

D. The Revolution of 1989

In May 1989, the IMF Executive Board concluded that its policy of not tolerating arrears provided creditors with excessive leverage over the sovereign debtors caught up in the debt crisis. As a result, the IMF again modified its arrears policy to tolerate temporary arrears to commercial banks, enabling the IMF to support adjustment programs even if no agreement had yet been reached between the debtor country and its bank creditors.[12] The Chairman's statement following the Executive Board meeting of May 23, 1989 (EBM/89/61) (the "1989 Summing Up") said:

> It is clearly the wish of the Board that the Fund discharge in full its central responsibilities in the debt strategy, *but without interference in negotiations between debtors and creditors*. . . .Directors agreed that there is a need for cautious adaptation of the Fund's policy in light of the changed financial environment and the possibility that in some cases significant time may be needed for banks and the members to agree on an appropriate financing package. In such circumstances, the Fund would on a *case-by case* basis, approve an arrangement outright before the conclusion of such negotiations, provided that *prompt Fund support is judged essential for program implementation, that negotiations between the member and its bank creditors have begun, and that it can be expected that a financing package consistent with external viability will be agreed within a reasonable period of time*. . . .Progress in the negotiations with bank creditors would be closely monitored. . . .Directors stressed that in promoting orderly financial relations, every effort must be made to avoid arrears, which cannot be condoned or anticipated by the Fund in the design of programs. Nevertheless, *an accumulation of arrears to banks may have to be tolerated* where negotiations continue and the country's financing

10. *See* Lee Buchheit, "The Evolution of Debt Restructuring Techniques," INT'L FIN. L. REV., August 1992, at 10.

11. *See* James M Boughton, *The Silent Revolution. The International Monetary Fund 1979-1989*, International Monetary Fund (2001) Chapter 11 at 520-531, *available at* http://www.imf.org/external/pubs/ft/history/2001/ch11.pdf. The Appendix at the end of Chapter 11, entitled "Fund Policy on Financing Assurances and Arrears," offers a summary of the LIA policy from 1970 to 1989.

12. *See* Arrears to Credit and Debt Strategy, The Chairman's Summing Up-Fund Involvement in Debt Strategy Board meeting 89/61, *available at* www.imf.org/external/pubs/Ft/sd/index.asp?decision=EBM/89/61.

> situation does not allow them to be avoided. Directors emphasized that *appropriate safeguards* would need to be incorporated into the monitoring procedures of the Fund arrangement. The *Fund's policy of non-toleration of arrears to official creditors remains unchanged. The debtor member would be expected to continue to treat creditors on a non-discriminatory basis*. . .[13]

There are several important points to be gleaned from the 1989 Summing Up. First, although the text strongly disavows any desire by the IMF to interfere with negotiations between debtors and private sector creditors, the primary motivation of the 1989 shift in LIA policy was to neutralize the ability of private creditors to use the IMF's "no arrears" rule as negotiating leverage over sovereign debtors. As we shall discuss below, however, the IMF's promise not to interfere in the debtor/creditor negotiation process proved to be a fragile undertaking. Second, the 1989 Summing Up expressed no opinion about *how* the debtor/creditor negotiations should be conducted; it only requires that such negotiations shall have begun. This too would soon change. Third, although the IMF Board was prepared to neutralize the negotiating advantage that its previous "no arrears" policy had conveyed to private sector creditors, the 1989 Summing Up vigorously retained that advantage for official sector, primarily Paris Club, creditors: "The Fund's policy of non-toleration of arrears to official creditors remains unchanged."[14] It is worth noting that the nineteen permanent members of the Paris Club represent, in aggregate, 60.67 percent of the voting power in the Executive Board of the IMF.[15]

E. LIA in Sovereign Bond Restructurings

The decade that followed after 1989 witnessed even more dramatic changes in the composition of capital flows to emerging market economies. Bonds replaced syndicated bank loans as the primary vehicle for financing emerging market sovereigns. Thousands of disorganized bondholders replaced the highly organized commercial banks as the predominant emerging market creditor class. All of this prompted yet another rethink of the LIA policy.

1. *The 1998 Formulation*

In 1998, the IMF's Directors agreed that IMF support following a default on sovereign bonds (an extension of the LIA policy) would be considered on a case-by-case basis but only where: (i) prompt IMF support was considered essential for the successful implementation of the member's adjustment program, (ii) negotiations between the member and its private creditors had begun, and (iii) there were firm indications that the sovereign borrower and its private creditors would *negotiate in good faith* on a debt restructuring plan.[16] The first two criteria replicated those in the 1989 Summing Up while the third criterion, good faith negotiations, was intended to address specific concerns relating to bond restructuring.

13. *Id.* (emphasis added).
14. *Id.*
15. *See* Appendix.
16. Concluding Remarks by the Chairman on Involving the Private Sector in Forestalling and Resolving Financial Crises, Buff/98/85 (9/14/98), at 5.

The only contemporaneous justification for inserting this "good faith" qualification into the requirement for debtor/creditor negotiations is found in the 1998 IMF staff report that preceded the Executive Board meeting.[17] The staff there offered the view that: "To help ensure that such a policy [lending into arrears on bonds] is not viewed by financial markets as weakening members' obligations to their creditors, it would seem desirable for the Fund to approve arrangements only when the sovereign was judged to be making a good faith effort to regularize creditor relations."[18] In this single sentence of the 1998 staff report, one can mark the beginning of the confusion. The ordinary meaning of the phrase "good faith effort" in this context would be "genuine" in the sense that the sovereign could not pretend to be negotiating with its creditors in order to access IMF resources. "Good faith" does not prescribe *how* the negotiations would be conducted, for example whether creditor committees would be recognized, nor does the phrase constrain the nature of the bargain the sovereign might seek to drive. When the phrase "good faith" entered the LIA discourse for the first time in 1998, it may thus have meant only "not a pretext".

2. *The 1999 Formulation*

Further Executive Board discussions regarding the LIA policy took place in 1999, shortly after the Asian debt crisis.[19] The Board concluded that bondholders, by simply refusing to negotiate with a sovereign debtor, could effectively prevent the IMF from assisting a member country. This prompted a 1999 revision of the policy.[20] The simple "good faith negotiation" criterion of the 1998 iteration of the policy was replaced by the following formulation: "the member is . . . making a good faith effort to reach a collaborative agreement with its creditors."[21]

The shift in emphasis between the 1998 and 1999 versions is obvious. The focus in 1999, unlike all prior statements of the IMF's LIA policy, was on the nature of the resulting agreement with creditors ("collaborative"), not on the willingness of the sovereign to enter into genuine (good faith) negotiations. And in this shift of emphasis, the IMF introduced for the first time a motivation for the LIA policy that went beyond the traditional "protect Fund resources" explanation. After all, if the sovereign debtor can reach a satisfactory deal with its private creditors, who cares, from a "protect Fund resources" standpoint, whether it was reached collaboratively or not? In other words, by 1999, the Executive Board had decided that it had a legitimate interest in seeing that member countries dealt with their private creditors, and *vice versa*, according to someone's notion of fair play.

17. *See* International Monetary Fund, "Fund Policy on Sovereign Arrears to Private Creditors," prepared by the Policy Development and Review and Legal Departments (in consultation with other departments) approved by Jack Boorman and François Gianviti, January 9, 1998, SM/98/8.

18. *Id.* at 9, ¶ 70.

19. *See* EBS/99/67, Apr. 30, 1999, at 9.

20. The staff paper "Fund Policy on Arrears to Private Creditors – Further Considerations," prepared by the Policy Department and Review and Legal Departments and approved by Jack Boorman and François Gianviti, April 29, 1999, was discussed by the Executive Board on June 14, 1999. *See* Summing Up by the Acting Chairman, 99/64, *available at* http://www.imf.org/external/pubs/ft/privcred/lending.pdf.

21. *Id.* at viii.

3. *The Backstory*

The Executive Board's LIA deliberations during the period 1999-2002 were not occurring in a vacuum. In 1999, three countries, Pakistan, Ukraine, and Ecuador —unable to access the official sector bailouts that had kept countries like Mexico, Thailand, South Korea, and Indonesia from having to restructure their bond indebtedness in the mid -to-late 1990s—were forced to approach their bondholders with offers to exchange existing bonds for new instruments that conveyed a measure of debt relief to the sovereign borrower. These countries, however, approached the debt restructuring process very differently from their counterparts in the 1980s.

When commercial banks dominated the creditor class during the 1980s and early 1990s, they established a formal negotiation process with the sovereign debtors. At the outset of the process for any particular country, the banks would form a "Bank Advisory Committee " (BAC) or "Steering Committee ," usually composed of the twelve to fourteen banks having the largest exposures to that country. The Advisory Committees acted, although they denied it at the time, as fully fledged negotiating committees. Once a deal was struck with the committee, the sovereign could count on the BAC's influence to sell the deal to the broader commercial banking community.

By 1999, commercial banks had ceded to bondholders their place as the dominant creditors. When approaching the restructuring of bond indebtedness, a sovereign borrower would typically appoint financial advisers or dealer managers who would informally consult with representative bondholders in order to gauge the financial terms of a restructuring that would find broad acceptance in the market. Following these consultations, the terms of an exchange offer would be formulated by the sovereign, often in consultation with the IMF, and the offer sent out to the holders of all eligible claims.

The crucial difference in the bond context is the absence of face-to-face negotiations between the bondholders, or a committee purporting to represent the bondholders, and the sovereign debtor. As some bondholders view things, however, any exchange offer that has not been forged in the crucible of a negotiating room is, by definition, a "take it or leave it" offer. These holders look back fondly on the golden era of BACs while perhaps forgetting, through the rosy haze of that memory, just how dysfunctional some of the BACs had become toward the end of the commercial bank debt restructuring process.

When the Executive Board of the IMF announced in 1998 that sovereign debtors wishing to access IMF resources under the LIA policy should negotiate "in good faith" with their private creditors, the bondholders thought they saw an opportunity to get back into the game. If only the Executive Board could be persuaded to elaborate on the meaning of a good faith negotiation, the bondholders reasoned, this would provide the leverage needed to reestablish the Arcadian primacy of creditor committees in sovereign debt restructurings.

The utility of creditor committees in sovereign debt workouts involving thousands of disparate creditors is, of course, a complicated subject beyond the scope of this paper. The significant point for these purposes is that the LIA policy, introduced in 1989 to prevent private creditors from using IMF policies as leverage in their dealings with sovereign debtors, had (just over a decade later) been allowed to slip insensibly back into just that position. The struggle over whether and to what degree the Executive Board prescribes the characteristics of a "good faith negotiation" needs to be understood in light of this background.[22]

4. *The 2002 Formulation*

On September 4, 2002, the Executive Board considered, once again, the good faith criterion in the IMF's LIA policy[23] based upon a paper prepared by IMF staff[24] in light of the bond restructurings concluded by Ecuador, Pakistan and Ukraine.[25] This time around, the good faith criterion was elaborated into a full-blown set of prescriptions and procedural rules for conducting negotiations with creditors. We quote from the 2002 Summing Up at length in order to give the reader some idea of just how much flesh had been wrapped around the good faith bone. The 2002 Summing Up contained the following precepts:

> Directors considered that the following principles would strike an appropriate balance between clarity and flexibility in guiding the dialogue between debtors and their private external creditors.
>
> - First, when a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete.
> - Second, the member should share relevant, non-confidential information with all creditors on a timely basis, which would normally include:
>   - an explanation of the economic problems and financial circumstances that justify a debt restructuring;
>   - a briefing on the broad outlines of a viable economic program to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims; and
>   - the provision of a comprehensive picture of the proposed treatment of all claims on the sovereign, including those of official bilateral creditors, and the elaboration of the basis on which the debt restructuring would restore me-

22. Following the Asian debt crisis, the IMF also began considering the so-called Sovereign Debt Restructuring Mechanism (SDRM), though the idea of an international bankruptcy procedure was also discussed in the 1980s. *See* Anne Krueger, International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring, address at the National Economists' Club Annual Members' Dinner American Enterprise Institute, (Nov. 26, 2001), *available at* http://www.imf.org/external/np/speeches/2001/112601.htm. The SDRM proposal went through several modifications in 2002 and 2003. *See* Anne Krueger, New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Conference on "Sovereign Debt Workouts: Hopes and Hazards," Institute for International Economics (Apr. 1, 2002), at http://www.imf.org/external/np/speeches/2002/040102.htm; *see also* PIN No. 03/45, Apr. 3, 2003, *IMF Board Discusses Possible Features of a Sovereign Debt Restructuring Mechanism*, *available at* http://www.imf.org/external/np/sec/pn/2003/pn0345.htm. However, the enthusiasm for the SDRM has waned since 2003, and reliance on market solutions (contractual mechanisms) has become the preferred approach.

23. *See* Public Information Notice (PIN) No. 02/107, Sept. 24, 2002, http://www.imf.org/external/np/sec/pn/2002/pn02107.htm#P40_2845.

24. *See* International Monetary Fund, "Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion," prepared by the International Capital Markets, Policy Development and Review and Legal Departments (in consultation with the other Departments), approved by Gerd Häusler, Timothy Geithner, and François Gianviti, SM/02/248, July 30, 2002, *available at* http://www.imf.org/external/pubs/ft/privcred/073002.htm.

25. *Id.*

dium-term sustainability, bearing in mind that not all categories of claims may need to be restructured.

° Third, the member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.

- Although, as a general premise, the form of the dialogue would be left to the debtor and its creditors, under this approach a member in arrears would be expected to initiate a dialogue with its creditors prior to agreeing on a Fund-supported program consistent with the principles discussed above. In cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good faith negotiations with this committee, though the unique characteristics of each case would also be considered. This formal negotiating framework would include, *inter alia*, the sharing of confidential information needed to enable creditors to make informed decisions on the terms of a restructuring (subject to adequate safeguards), and the agreement to a standstill on litigation during the restructuring process by creditors represented in the committee. By the same token, in less complex cases, where creditors have not organized a representative committee within a reasonable period, or where for other reasons a formal negotiation framework would not be effective, the member would be expected to engage creditors through a less structured dialogue. Directors stressed that, in going forward with the suggested approach, it would be crucial to strike the appropriate balance between the need to promote effective communication between a debtor and its creditors, and the need to retain flexibility to address the diversity of individual country circumstances. . .
- Directors emphasized that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the design of the adjustment program.[26]

This was a dangerous path on which to embark. As with all attempts to define the correct deportment of human beings, one either stays at the level of Sermon on the Mount generality (in this case, the 1999 encouragement of a "collaborative" process), or one descends into detailed behavioral prescriptions (such as the Board's 2002 essay at defining the operation of a suitable creditor committee). Similar exercises have been undertaken in other fields, usually with comparable results. The Hays Code,[27] promulgated in the Hollywood of the 1930s, for example, started off at the splendidly Olympian level of requiring the production of motion pictures that present the "correct standards of life." The Code soon refined this, however, into a series of highly specific admonitions, such as forbidding film portrayals of "excessive and lustful kissing." (On balance, it seems likely that being a member of the Hays Committee was more entertaining than being a member of the Executive Board of the International Monetary Fund.)

26. *See* PIN, *supra* note 23 (emphasis added).

27. Motion Picture Production Code of 1930, *Hays Code, available at* http://www.artsreformation.com/a001/hays-code.html.

III. Muddled Objectives

As the previous discussion shows, at various times and in various ways, the IMF has signaled that the LIA policy serves one or both of the following objectives: (i) to safeguard IMF resources and (ii) to act as referee in a sovereign debtor's relationship with its private creditors.

A. Safeguard IMF Resources

The IMF is only called upon to provide financial assistance to member countries when something has gone wrong. That's the business the IMF is in—a lender of last resort when access to normal sources of finance have been shut off.

Lending into a distressed situation calls for special vigilance on the part of the creditor. There will undoubtedly be other creditors lurking about, usually unpaid, sore and twitchy. Unless the new lender is careful, it will just pour good money into a leaky financial structure and thereby join the ranks of the unpaid, the sore, and the twitchy. In corporate bankruptcy systems, there are rules that give a priority to lenders that advance funds *after* the company has filed for bankruptcy, but these rules are obviously not applicable to sovereign debtors.[28]

So, there is nothing unusual about the IMF's desire to ensure that a member country resolve or neutralize the threat posed by unsatisfied existing creditors before the IMF advances its own money. The LIA policy announced in 1989 represented a limited exception to this perfectly understandable concern. The 1989 iteration of LIA, however, was expressly result-oriented, not process-oriented. The IMF would consider lending, as stated by the 1989 Summing Up, provided "that negotiations between the member country and its bank creditors have begun, and that it can be expected that a financing package consistent with external viability will be agreed within a reasonably period of time." Note the absence of any adjectives qualifying the word "negotiations."

That said, safeguarding the IMF's resources cannot be the sole motivation for the LIA policy as it is currently implemented. The evidence?

- A new lender into a distressed situation will be concerned with whether the threat posed by existing creditors has been neutralized, not by *how* it has been neutralized.
- Indeed, a new lender behaving rationally will openly applaud a debtor that drives a hard bargain with its existing lenders—the harder the better. The less money that the debtor owes to the universe of existing creditors, the better the chances that the new lender will be able to recover its loans.
- Existing claims that are barred from legal enforcement by a statute of limitations or other legal defense should not worry a new lender.
- A small stub of unresolved residual claims whose aggregate amount is immaterial to the financial position of the borrower should also not trouble a new lender motivated exclusively by a desire to "safeguard its own resources." Even if all of those stub claims were paid in full, it would not jeopardize the borrower's financial ability to pay the new lender.

28. IMF conditionality operates in part as a substitute for collateral in lending to sovereign borrowers. *See* Lastra, *supra* note 6, at 417.

History shows, however, the IMF *does* worry about all of these things. The IMF visibly winces when a member country seeks debt relief from its existing creditors in excess of that contemplated by the IMF's own program. The IMF entertains the complaints of private creditors who feel that they have been roughly handled in the debt restructuring process. And, as part of a "no creditor left behind" philosophy, the IMF's solicitude extends even to existing creditors whose claims are no longer legally enforceable or that are, in aggregate, of only a negligible size. The modern IMF shepherd thus purports to guard the entire flock of private creditors, including the small, the powerless and the disorganized.

This suggests that another motivation, apart from or in addition to the desire to safeguard IMF resources, is therefore at work. That motivation appears to be a desire to act as a referee in the process of sovereign debt restructuring with private creditors.

B. Referee

Since the LIA policy was first introduced in 1989, it has evolved in a manner that shows a much greater concern for how a sovereign debtor reaches its settlement with its private creditors, not just whether such a settlement has been concluded. What explains this growing concern about the process by which the sovereign debtor reaches a settlement? In 1989, the IMF probably believed that commercial bank advisory committees were fully capable of holding their own in negotiations with their sovereign borrowers.[29] Disparate, disorganized, occasionally unsophisticated bondholders, however, may be a different matter. Perhaps the Board has now concluded that bondholders require a champion, a paladin to ensure that they are not stampeded into a disadvantageous deal with a sovereign debtor.

If indeed the IMF has now decided, through the medium of its lending into arrears policy, to referee the negotiations between sovereign debtors and their bondholder creditors (something that the 1989 Summing Up expressly declared should never happen), the Fund will have to confront several uncomfortable facts.

- The IMF staff never, ever enters a sovereign debt restructuring negotiating room with private creditors. (They are present, however, in all Paris Club negotiations.) The staff has repeatedly warned the Board that it fears the IMF could be accused of tortious interference with contractual relationships were it openly to take a position on matters, such as whether the sovereign should stay in default on its bonds, likely to be discussed in such a room.[30]
- The IMF can apply sanctions to a sovereign debtor that it finds has breached the requirement of fair play (the IMF refuses to lend into that country's arrears), but it has no ready sanctions to punish uncooperative private creditors. Here again, the Fund has had a consistent record of staying out of harm's way, even at the cost of leaving a member country without a useful ally in a litigation.
- Before a sovereign debtor ever enters a negotiating room with its private creditors, the IMF's program will have defined the "payments envelope" that will constrain how much the sovereign can pay in debt service to those creditors over the medium

29. And they were. *See* Lee Buchheit, *Advisory Committees; What's in a Name?*, INT'L. FIN. L. REV., Jan. 1991, at 9.

30. *See* International Monetary Fund, *supra* note 17, at 32, ¶ 62.

term.[31] It is astonishing that some of the bondholders who clamor most loudly for Fund assistance in forcing the sovereign into a "good faith" negotiation do not appreciate that the IMF itself will have preordained the financial outcome of that very negotiation in its stabilization program (although the debtor and its creditors will be left to agree on the method by which this aggregate financial outcome will be achieved).[32] It is like telling the candy shop owner that Johnny has free license to buy anything he wants in the shop without adding that Johnny's weekly allowance is now fixed at 75 cents.

In short, in its role as a self-appointed referee in negotiations between sovereign debtors and their bondholders, the IMF suffers from these disabilities: This referee never actually enters the arena; it relies for information on how the game is going based on verbal reports by the two contestants. This referee can sanction only one of the teams. Finally, this referee has, well before the game has begun, already decided the final score.

IV. Conclusion

The IMF's lending into arrears policy has drifted a long way from its original moorings. The critical turning point in the evolution of the LIA policy occurred in 1998-99, when the IMF for the first time expressed a concern about how a sovereign debtor deals with its private sector creditors and not simply whether it has done so. Once subjective criteria like "good faith" and "collaborative" negotiations were allowed to enter the picture, they inevitably became a magnet for lobbying by creditors and industry groups that perceived an opportunity to obtain higher financial recoveries through face-to-face negotiations, as

31. The 2002 Summing Up makes it clear that the IMF will brook no interference in its role as the sole arbiter of the payments envelope:

> [Directors] also noted that to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameter that have been established under a Fund-supported program, the Fund should retain the flexibility to continue to support member notwithstanding the lack of progress in negotiations with creditors. In this connection, it was stressed that decisions on an adequate macroeconomic framework that could form the basis for the Fund's lending into arrears will remain in the sole purview of the Fund. . . .Directors emphasized that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the design of the adjustment program.

PIN, *supra* note 23.

32. This feature of the current sovereign debt restructuring process is, for obvious reasons, rarely mentioned in public. One notable exception is the following reference in a speech given by Timothy D. Adams, U.S. Department of the Treasury, on September 23, 2005 to a conference on IMF Reform at the Institute for International Economics:

> There has been considerable discussion about whether the IMF should set the "resource envelope" or debt restructuring through the primary fiscal surplus in a Fund program. It is helpful for a country and the IMF to reach agreement on the primary surplus. This greatly facilitates a subsequent determination of whether the country is making a good faith effort to resolve its defaulted debt to private creditors—a precondition for the IMF to lend.

http://www.iie.com/publications/print.cfm?doc=pub&ResearchID=564.

opposed to being the passive recipients of exchange offers formulated by the sovereign debtors.[33]

In matters involving hundreds of millions, often billions, of dollars, a vague and subjective test of fair play would inevitably cry out for further elaboration. The Executive Board succumbed to the temptation to elaborate on its understanding of a good faith/collaborative negotiation in 2002. Unless it consciously arrests the process, the Board will presumably be drawn into further elaborations, clarifications and glosses in the future.

The irony, of course, is that the Executive Board relaxed its "no arrears" policy in 1989 precisely because it saw that private creditors were using the policy as leverage in their negotiation with sovereign borrowers. Then, roughly a decade later, it slipped back into that same uncomfortable position by giving private creditors a new kind of leverage—the threat that they will lobby the IMF to withhold funds because of the sovereign's alleged bad faith approach to resolving private sector claims.

The important point, however, is that the presence or absence of collaborative negotiations has nothing to do with safeguarding the IMF's own resources or achieving an orderly balance of payments adjustment for the member country. The IMF, perhaps for the most noble of reasons, is now taking on a role as the arbiter of correct behavior in sovereign debt workouts. No doubt the justification is that the overall health of the financial system is injured when rogue debtors or rogue creditors violate these norms of good behavior, but the jurisdictional question is where, in the Fund's Articles of Agreement, have the member countries given this responsibility to the IMF?

For the last few years, we have lived through a fairly benign economic period in which there have been relatively few sovereign debt restructurings. But were a more systemic crisis to occur, the Executive Board of the IMF could easily finding itself sitting as a quasi-judicial body, reaching moral judgments about the conduct of member countries in their dealings with private creditors. A small jurisprudence could develop about what is, and is not, permissible in the eyes of the Board. Precedents will be cited. Articles will be written on this jurisprudence. Conferences organized. Lectures prepared and delivered.

If the Executive Board wishes to alter course in the LIA policy, we can see at least three alternatives:

Option One: Return to Basics

The Executive Board could reverse its recent drift toward assuming a referee function in sovereign debt workouts and return to the original goal of implementing an LIA policy that focuses only on achieving adequate safeguards for protecting IMF resources. This would produce an LIA policy along these lines:

33. *See* Krishna Guha, *Finance lobby warns of risks to global growth*, FIN. TIMES, Apr. 5, 2007, at 7, reporting on an open letter from the Managing Director of the Institute for International Finance ("IIF") to the Chairman of the IMF's Governing Council:

> [The IIF] also called on the IMF to do more to support a set of voluntary principles for relations between sovereign borrowers and lenders which the IIF developed. . .[The IIF] added that a possible redrafting of IMF rules on lending into arrears raised concerns that the policy could be diluted further, weakening creditor rights.

Directors will countenance lending to a member that has accumulated arrears to private sector lenders, but only if the Board has concluded that the member is embarked on a program that stands as a high chance of clearing those arrears within a reasonable period of time to the point that any residual (unresolved) claims do not pose a threat to the member's repayment of the Fund's advances or its achievement of an orderly balance of payments adjustment. Subsequent purchases under the Fund's program may be conditional on satisfactory progress of the member toward this goal.

Option Two: Back to Basics, but with Avuncular Advice

This alternative tracks Option One, except that the Executive Board may, in separate pronouncements, volunteer its views about what practices work best in sovereign debt restructurings. We now have sufficient examples of sovereign bond restructurings to extrapolate some general lessons about which techniques tend to facilitate, and which to retard, these operations. To be clear, the Board's pronouncements about its views of best practices would, under Option Two, not be prescriptive or binding on member countries. They would rather be advisory, perhaps hortatory, in nature.

Option Three: Candid and Symmetrical LIA

Under this Option, the Board would openly embrace a role as the arbiter of acceptable practices in workouts of sovereign debts owed to private creditors. But the Board would crack the whip on the backs of both debtors and creditors alike. The resulting LIA policy might read something like this:

- Directors have approved the attached Statement of Best Practices in the restructuring of member country debts owed to private creditors.
- Any member country that deviates (without Board approval) from these Best Practices will be deemed not to have acted in good faith in its dealings with its private creditors, and the Board will not approve a program for that country until private sector arrears have been cleared.
- If, however, a member county follows these Best Practices and makes a restructuring proposal to its private sector creditors containing financial terms that are consistent with the Fund's stabilization program for that country, any private sector creditor declining such a proposal will be deemed by the Board not to have acted in good faith in its dealings with the member country.
- Under these circumstances, the Fund will reserve the right to assist the member country in defending against any effort by such a creditor to seek a preferential monetary recovery from the member country including, if the Board thinks appropriate, appearing as an interested party in any litigation commenced by such a creditor against the member.

Naturally, some observers will see in Option Three a backdoor return to the objectives of the IMF's proposed Sovereign Debt Restructuring Mechanism. But if the IMF really wishes to referee these matches, Option Three at least embraces the virtues of candor and symmetry.

APPENDIX
IMF Voting Rights of Paris Club Members[34]

MEMBER	IMF QUOTA (Millions of SDRs)	IMF QUOTA (Percent of Total)	VOTE IN PERCENTAGE
Australia	3,236.4	1.49	1.48
Austria	1,872.3	0.86	0.86
Belgium	4,605.2	2.12	2.10
Canada	6,369.2	2.94	2.89
Denmark	1,642.8	0.76	0.76
Finland	1,263.8	0.58	0.58
France	10,738.5	4.95	4.87
Germany	13,008.2	6.00	5.90
Ireland	838.4	0.39	0.39
Italy	7,055.5	3.26	3.21
Japan	13,312.8	6.14	6.04
Netherlands	5,162.4	2.38	2.35
Norway	1,671.7	0.77	0.77
Russian Federation	5,945.4	2.74	2.70
Spain	3,048.9	1.41	1.39
Sweden	2,395.5	1.11	1.10
Switzerland	3,458.5	1.60	1.58
United Kingdom	10,738.5	4.95	4.87
United States of America	37,149.3	17.14	16.83
TOTAL	133,513.3	61.59%	60.67%

34. *See* International Monetary Fund, IMF Members' Quotes and Voting Power, and IMF Board of Governors, July 12, 2007, *available at* http://www.imf.org/external/np/sec/memdir/members.htm.