

Back to the future

A sovereign debt standstill mechanism

IMF Article VIII, Section 2 (b)

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The Covid-19 crisis has placed huge pressure on public budgets, forcing governments to respond by increasing their public spending. At the same time, the crisis has decreased public revenues due to vital prophylactic measures that have slowed economies down. As a result, developing countries are experiencing acute financial pressures. They are faced with tough questions: prioritise health care and social safety expenditures to save lives, or divert scarce resources to meet creditor claims? The outlook is grim; experts predict a cascade of defaults among developing nations within the next 12 months.³

In anticipation of the imminent sovereign debt crisis, there are numerous calls for the adoption of measures for developing countries in need. These include standstills on public external debt. This is a mechanism that allows the postponement of debt repayments and provides some 'breathing space' to recover and, if necessary, restructure the debt. While the public sector creditors – G20 and the International Monetary Fund (IMF) – have granted some relief, the situation with private sector creditors is daunting and complicated by a collective action problem.

It seems inexcusably naïve to expect that all private sector creditors will voluntarily suspend debt service payments or join other debt relief initiatives for countries in need. It is very dangerous to put faith in the compassion of private sector creditors to join debt relief programmes on a voluntary basis. The private creditor base is heterogeneous and fraught with diverse interests. Only a minority of non-participating creditors can neutralise the efforts of the rest of the creditor base by pushing for full enforcement of the debt contracts in foreign courts. Therefore, the necessity of a binding debt standstill mechanism for private sector creditors cannot be overestimated.

This article suggests that the IMF already has a mechanism in place to impose debt standstills: Article VIII, Section 2 (b) of the IMF Articles of Agreement. The article in question allows the IMF to render exchange contracts unenforceable in domestic courts of IMF member countries following specific criteria. The envisaged mechanism presents several advantages over recent proposals for a binding standstill mechanism, such as the International Developing Country Debt Authority (IDCDA) by the United Nations Conference on Trade and Development (UNCTAD)⁴ and a Central Credit Facility (CFF) by Bolton et al.⁵ First, this approach can be implemented in a short period of time as it does not require the creation of new intergovernmental mechanisms or facilities.⁶ Second, the activation of the standstill mechanism can be set in motion by any IMF member country and does not require a modification of its Articles of Agreement. Third, debtor countries acting in good faith under an IMF programme would be protected from aggressive litigation strategies from holdout creditors in numerous jurisdictions, including the US and the UK. Fourth, courts in key jurisdictions would avoid becoming overburdened by a cascade of sovereign debt litigation covering creditors and debtors across the globe. Fifth, private creditors would receive uniform treatment and ensure intercreditor equality. Sixth and last, the mechanism would provide additional safeguards to protect emergency multilateral financing provided to tackle Covid-19.

This idea is not new and has been revisited several times over the decades.⁷ The discussions have never made it past the stage of consideration by the IMF Executive Board due to a combination of historical circumstances and vested interests. However, the unprecedented character of the current crisis highlights that the time has come for Article VIII, Section 2 (b). While the mechanism is still missing a few gears to provide operability, there are several ways to introduce it swiftly. This solution seems to be the best option in the current political international environment in terms of its promptness and effectiveness.

1. What is Article VIII, Section 2 and what does it allow?

Almost three decades ago, it was observed that Section 2 of Article VIII of the IMF Articles of Agreement could be used to impose standstills on private creditors of the IMF member.⁸ One should read both parts (a) and (b) of Section 2 together. Section 2 (b) provides unenforceability of the exchange contracts in domestic courts of the IMF members if those contracts are against exchange control regulations of another IMF member.⁹ Section 2 (a) requires the approval of the Fund for the country to impose restrictions on current international transactions, including external debt interest and amortisation payments,¹⁰ and be covered by the provisions under Section 2 (b).¹¹

Article VIII, Section 2 (b) is a powerful tool that is effective among all IMF member countries.¹² It allows the imposition of a debt standstill through the temporary suspension of enforceability of debt contracts in domestic courts of more than 189 IMF member countries,¹³ including the US and the UK. Effectively, it ensures uniformity and comparability of treatment of the private creditors on a global level. This creates incentives and provides time for creditors and debtors to negotiate in good faith to find a solution representing the best collective interest. Investors focused on aggressive litigation would be unable to pursue their claims during the duration of the standstill. Thus, they would effectively be unable to disrupt negotiations or put at risk an IMF programme and its financing.

The missing element to deploy the full power of Article VIII is an interpretation of the key definitions used in Sections 2 (a) and (b). Most of all, the understanding of whether the term 'exchange contract' covers debt contracts of different kinds. Fortunately, as discussed in section 3, there is a way to fill this gap promptly and without amending the IMF Articles of Agreement.

2. If Article VIII of the IMF is such a powerful tool, why hasn't it been used?

Since the debt crisis in the 1980s, the Executive Board of the IMF has discussed the possibility of using Article VIII, Section 2 (b) on several occasions as a mechanism to provide legal protection to debtor countries in distress. Confidential IMF staff papers prepared for these discussions explain the implications of this course of action. In 1988, IMF staff explicitly supported the idea of adopting a broad and authoritative interpretation of Article VIII, Section 2 (b). One of the reasons was the legislative history, which traces three different proposals discussed by the drafters at the Bretton Woods Conference in July 1944, supporting the broad interpretation of the term 'exchange contract' under Article VIII, Section 2 (b).¹⁴ The staff proposal included specific language to include debt contracts under the scope of Section 2 (b).¹⁵ In 1996, another confidential IMF staff paper revisited the issue.¹⁶ The document adopted a more sceptical view than its predecessor. However, the paper still highlights the potential and strengths of the proposal.

The proposals for a broad and authoritative interpretation of Article VIII, Section 2 (b) have been met by strong opposition from creditor countries, led by the US, UK and Canada. The main issue raised by the Executive Directors of these countries focused on the actual effectiveness of an authoritative interpretation given the diverse set of legal interpretations to the concept of 'exchange contracts' developed under different jurisdictions.¹⁷ From their point of view, it was unlikely for courts in their countries to accept the unenforceability of debt contracts under a broad definition of Article VIII. Preference for market-based approaches to sovereign debt resolution, lack of a mechanism for selective application of the interpretation, as well as concerns regarding the negative impact of a leak of the discussions on external financing, led to a closure of the discussion.¹⁸

Ultimately, the IMF decided to pursue alternative approaches to address the issue of sovereign debt restructuring. These include the Lending into Arrears Framework (LIA) (1989), the Sovereign Debt Restructuring Mechanism (SDRM) (2002) and a contractual-based approach based on the inclusion of Collective Action Clauses (CACs) on sovereign debt contracts (2003). Despite the decision to pursue other options, the IMF did not adopt an official interpretation of Article VIII, Section 2 (b). This allowed the IMF to retain its flexibility. As a result, the legal options to use it in the context of the Covid-19 crisis remain open more than 30 years after the initial discussions.

3. What has changed now?

As in the 1980s, the IMF finds itself now dealing with an unprecedented crisis that has the potential to engulf a large number of developing countries. The heterogeneity of the creditor base has increased the complexity of debt restructurings and increased the likelihood of holdouts of different kinds. A cascade of sovereign debt litigation can overwhelm the capacity of courts in the US and the UK. This would impose additional costs on both creditors and debtors. While the IMF has pushed over the last decade for the widespread introduction of CACs in sovereign bonds, the current crisis is highlighting their limitations.¹⁹ In this context, it is in everyone's interest to have a mechanism in place that establishes a binding temporary standstill on litigation. A standstill under Article VIII, Section 2 (b) could provide the time required for a mutually beneficial understanding between creditors and debtors without resorting to litigation.

To activate the proposed standstill mechanism, any IMF member country can formally ask the organisation for an interpretation of the provisions of Article VIII, Section 2 (b). While countries in the past have approached IMF staff on an informal basis to inquire about this issue, there is no record of a formal request.²⁰ If such a request were to take place, the IMF Executive Board is bound under Decision no. 446-4 to provide an interpretation.²¹

If the IMF Executive Board were to adopt a narrow interpretation of Article VIII, Section 2 (b) that explicitly excludes debt contracts, member countries can request for the decision to be referred to the Board of Governors for a final decision under Article XXIX Section (b). The Board of Governors would make a decision through a Committee, where each member would have one vote.²² This might be helpful to avoid a de facto veto power of the US in the interpretation of the IMF's Articles of Agreement.

If the IMF Executive Board or the IMF Board of Governors were to adopt a broad interpretation of Article VIII, Section 2 (b), as advocated by the IMF staff in 1988, this would set the required precedent for an authoritative interpretation. The IMF Executive Board would be required to issue such an interpretation in order to respect the principle of uniformity of treatment. This interpretation would establish a legally binding debt standstill mechanism for all member countries under the authority of Article XXIX.

4. How would it work?

In simplified terms, once the IMF Executive Board has adopted a broad and authoritative interpretation of Article VIII, Section 2 (b),²³ the temporary standstills on servicing the external sovereign debt would operate as following:

1. A country at high risk of debt distress designs exchange restrictions to cover forthcoming interest and amortisation payments on public external debts. The restrictions would be designed taking into account relevant IMF and domestic legal requirements.²⁴
2. The country requests the IMF to approve the relevant exchange restrictions already imposed or to be imposed, pursuant to Article VIII, Section 2 (a). Approval by the IMF would be subject to specific criteria (described below).
3. Debt repayments are initiated on schedule but barred from leaving the country due to imposed exchange restrictions. This will effectively constitute an event of default and will allow creditors to enforce the debt contracts in courts.
4. If creditors and debtors fail to reach a compromise to reprofile or restructure outstanding claims, and the former decides to initiate litigation to enforce their claims in a foreign court, the sovereign borrower invokes a defence based on Article VIII, Section 2 (b). The debtor should request an official communication of the IMF supporting the use of Article VIII, Sections 2 (a) and (b) under Decision no. 446-4.
5. The foreign court should dismiss the case due to temporary unenforceability of debt contracts following Article VIII, Section 2 (b) and IMF's authoritative interpretation of it. The claims would remain valid throughout the duration of the standstill.
6. Unenforceability of debt contracts would remain in place until the IMF considers the measures necessary. Refusal by the debtor to engage with creditors in good faith would cause a lapse on the approval of exchange restrictions by the IMF under Article VIII, Section 2 (a).

5. What are the criteria the IMF would use to implement exchange restrictions?

Throughout the process, the IMF would follow specific criteria already established in the Articles of Agreement. Approval by the IMF of exchange restrictions would follow basic established principles:

- Restrictions are imposed for Balance of Payments purposes.²⁵
- Restrictions are non-discriminatory.²⁶
- Restrictions have a temporary nature.²⁷

Furthermore, since the discussions in the 1980s, the IMF has introduced procedures that, when used in conjunction with the provisions of Article VIII, Section 2 (b), would create additional institutional safeguards for the standstill mechanism. First, in line with the LIA policy, a member country requesting the approval of the exchange restrictions would be expected to submit a satisfactory programme for the elimination of the existing or envisaged payment arrears.²⁸ Second, in order to establish the principle of good faith, the Executive Board would issue a decision on the nature of the engagement between creditors and debtors.²⁹

The beauty of the solution is that the exchange restrictions do not preclude an IMF programme.³⁰ Those programmes come with an obligation on the borrower to negotiate its debt restructuring with creditors in good faith. Likewise, the IMF does not approve the arrears as such, but the exchange restrictions leading to the arrears.³¹ Furthermore, the IMF preserves a flexible case-by-case approach in deciding on the specific request for approval of exchange restrictions based on the economic fundamentals of the country. One could argue that the IMF in its Article VIII, Section 2 (a) decisions could adopt a selective approach. This means that the IMF can approve, and hence provide them with an Article VIII, Section 2 (b) protection, only some of the imposed or contemplated exchange restrictions by an IMF member country. Once the approval is granted, the IMF will provide surveillance of the restrictions and may require the IMF member to lift them off if restrictions are no longer necessary. In any case, the approval of exchange restrictions, if given, should generally specify a terminal date.³²

To further strengthen these criteria, the IMF Executive Board could decide to combine the provisions on exchange restrictions with those of debt sustainability set forth in the IMF Exceptional Access Lending framework. Approval by the IMF of exchange restrictions on debt related payments under Article VIII, Section 2 (a) would take place only in scenarios where a Debt Sustainability Analysis (DSA) finds debt either to be sustainable without high probability or unsustainable. The provision would limit the legal protection provided by Article VIII, Section 2 (b) to countries at high risk of debt distress that fulfill a series of criteria explained above. This would ensure the protection of IMF funding in scenarios where holdouts refuse to negotiate in good faith and debt sustainability remains uncertain. The current standoff between Argentina and its creditors is a relevant example of such a scenario.

6. Would courts in the UK and the US be bound by an interpretation of Article VIII?

All that is necessary to activate the proposed debt standstill mechanism is a formal request by any IMF member for an interpretation of the provisions of Article VIII, Section 2 (b) in respect of external sovereign debt. Once the request for interpretation is submitted, it is up to the IMF to show its leadership and issue an authoritative interpretation, taking into consideration that 'exceptional measures might be needed in this exceptional crisis'.³³

There are various grounds to assert that the interpretation by the IMF is binding on the courts of signatory nations. First of all, since Article XXIX makes interpretations by the IMF binding on its member countries, they are as a result binding on the domestic courts of those countries.³⁴ What is especially relevant to the common law countries, Article XXXI, Section 2 (a) encapsulates a general principle in international law – the doctrine of estoppel – which effectively precludes nonfulfillment of obligations by a member country under the IMF Articles of Agreement because of a domestic impediment unless the other parties to the treaty were aware of them.³⁵ In addition, the GATT Article XV, Section 2 prescribes that 'contracting parties shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments'.³⁶ The bottom line is that the IMF member country should make an authoritative interpretation of the IMF effective in its domestic legal environment by any means it sees fit.

Nevertheless, there is still some scepticism among commentators that the US courts, being disciples of the narrow interpretation, would not recognise the IMF's interpretation of Article VIII, Section 2 (b) that 'exchange contracts' include external sovereign debt. However, already in the 1980s, the IMF staff observed that the US courts do not have a unified approach and adopted both narrow and broad interpretations in different cases.³⁷ There are cases where judges have favoured a broad interpretation of the 'exchange contract' under Article VIII, Section 2 (b).³⁸ Furthermore, there is no set-in-stone narrow or broad interpretation as the content of the interpretation differs from one jurisdiction to another.³⁹ The lack of uniformity leads to a different burden on IMF members under Article VIII, Section 2 (b) as the same exchange control regulation may be recognised by courts of one member but not another.⁴⁰

The law and its interpretation by the courts evolves with the proverbial *Zeitgeist*.⁴¹ A few examples below are illustrative in this regard. A narrow interpretation of the 'exchange contract' definition, which was first proposed by Professor Nussbaum in 1949, seems to be at least partially politically motivated by the beginning of the Cold War.⁴² The UK courts, and later their US colleagues, adopting a narrow interpretation, took into account the benefits of protecting the position of their jurisdictions in international trade and financial markets.⁴³ Even German courts, which followed a broad interpretation for a long time, made a pivot in 1992. Presumably driven by domestic interests to improve protection for creditors, the district courts upheld by the German Supreme Court adopted a more narrow approach and brought its practices closer to the US and UK courts.⁴⁴

However, previous interpretations of the IMF Articles by domestic courts is a secondary concern as they were left in the 'wild west' legal environment absent of the guidance from the very guardian of the IMF Articles. What is important is that the courts defer to the IMF.⁴⁵ Its authoritative interpretation will provide legal certainty and uniformity in applying Section 2 (b) of Article VIII in sovereign debt disputes.

Furthermore, in a few countries, most notably the UK, existing legislation provides a procedure for the recognition of IMF interpretations under Article XXIX. As described by IMF staff, 'in the United Kingdom, an Order in Council may be adopted "for carrying into effect . . . any of the provisions of the Fund Agreement as to the unenforceability of exchange contracts."⁴⁶ As explained by the IMF General Counsel, a specific provision authorises 'the Queen to adopt by an Order in Council all the measures necessary to give effect to the provisions of that Article.'⁴⁷ This obligation is of special relevance in the current crisis, as 90 per cent of the bonds of countries eligible to participate in the G20 Debt Service Suspension Initiative are governed by English law.⁴⁸

7. Concluding remarks

Article VIII, Section 2 (b) has attracted the attention of many scholars over the decades. Most relevant amongst them is the figure of Sir Joseph Gold, former IMF General Counsel (1949-1979).⁴⁹ Few people have had a better vantage point to assess the merits of this crucial tool. Sir Joseph "was convinced that only a liberal construction of the key elements of Article VIII, Section 2 (b) would help accomplish the Fund's macro objectives and improve the stability of the volatile international monetary system."⁵⁰ The current crisis has tested the capacity of the IMF to deliver on both fronts. It is crucial for member countries to step up to the challenge and deploy in earnest the full potential of Article VIII, Section 2 (b) and establish a legally binding debt standstill mechanism.

Endnotes

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