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## Review

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# Legal aspects of the Latin American Public debt: Relations with the commercial banks

*Gonzalo Biggs\**

In recent years, many studies have been published on the question of the Latin American external debt; almost all of them have focused on economic, financial or political aspects of the issue. The distinguishing feature of this article is that it looks at the much less discussed legal questions involved.

In the first few chapters, the author discusses certain historical developments, including the loans received during the period immediately following independence and some particularly important considerations, such as the principle of "diplomatic protection", the Drago Doctrine and the questions raised in connection with reparations for World War I. He then discusses the question of the international Financial responsibility of the State, and goes on to study in depth the legal aspects of the current debt, generated in the Eurodollar market.

In conclusion, the author states that the Latin American countries should stress the political nature of the debt and the need for increasing public credit to the region by increasing the contributions of developed countries to international financing agencies. Emphasis should be placed on the criterion that the debt burden should not exceed the capacity and needs of the debtor countries. Finally, he proposes specific formulas for reducing the debt by transforming it into bonds at fixed prices and interest rates.

\*The author is on the staff of the Inter-American Development Bank. This article reflects the personal views of the author and not necessarily those of the organization for which he works.

## Introduction

This article refers to the legal aspects of the Latin American public debt with commercial banks. It does not deal with the question of the private debt or that of the Latin American public debt with other governments or with governmental and intergovernmental agencies.

Although the legal issues which arise when a public body stops servicing its debt have been known in Latin America for a long time, there are certain elements in the current crisis which make it different from other situations that have arisen in the past. These include the fact that the financing all comes from the same source, i.e., the Eurodollar market, and the fact that the debt is so high that it has a paralyzing effect on the economic and social development of the region as a whole.

In discussing the question, it is useful to go into some of the historical background and the principles that apply with regard to the financial responsibility of the State. We shall also discuss the rights a creditor has when loan obligations are not met, the characteristics of some of the renegotiations that have already been carried out and certain legal decisions that have been handed down in litigation against Latin American public entities initiated by banks in United States courts.

The Latin American public debt with commercial banks is formally set down in private contracts which are drafted in fairly standard terms reflecting the practices and customs usually followed in respect of Eurodollar financing. Each clause in these contracts has been carefully drafted by highly experienced financiers and lawyers specializing in this field. The main language used is English and both the jurisdiction and the law applicable—usually those of London or New York—to the performance and execution of these contracts are chosen by the creditor banks. Any study of the legal issues arising from the performance and execution of these contracts must take into account Anglo-Saxon law.

As regards the amount owed, the Latin American debt is, both in worldwide and in regional terms, the highest financial obligation ever recorded. Estimated at US\$ 336 billion at the end of 1983 (IDB, 1984a, p. 21), it is constantly increasing and the burden it represents affects, both individually and collectively, the patrimony, the income and the living standards of approximately 350 million persons. Should this crisis be

aggravated, it could have an unprecedented effect on the economy and institutions of the region as a whole and of the individual countries in it.

Inasmuch as the burden of the debt also seriously impairs the State's ability to carry out its basic functions, its impact goes beyond the limits of a purely contractual, civil or commercial relationship to take on a clearly public significance. The considerations set forth below with respect to the implications of the debt for an individual State also apply, to a large extent, to the Latin American region as a whole.

In 1983, the region had to earmark for the service of its debt an amount equivalent to 64.6% of its current foreign-exchange income from exports of goods and services for that year; for the second year in a row, the net inflow of resources, measured as a proportion of gross outlay, showed a negative balance of 35% of disbursements, equivalent to an estimated net outflow in 1983, of US\$ 17 billion (IDB, 1984b, table 59, p. 490) thus making Latin America a net exporter of capital.

In view of the afflictions brought on by the crisis, we must take a new look at the validity of the financing scheme applied, as reflected in the structure of the debt. In 1965, only 12% of the Latin American public external debt was accounted for by loans from private banks, whereas 60% came from bilateral and multilateral official sources (IDB, 1984b, p. 490). In 1982 this structure had changed radically. Official financing had fallen to 30%, whereas commercial banks accounted for 60% of the debt (IDB, 1984b). At the same time, the financing scheme applied from the 1960s onwards allowed for the gross domestic product to grow steadily at annual average rates of no less than 5% and, during the period 1970-1974, as high as 7.3% (IDB, 1984a, pp. 25 and 75). From 1982 onwards, however, as soon as the impact of the debt with commercial banks began to be felt, the growth rates became consistently negative for the region as a whole, to the point that in 1983, the average rate was -3.8% (IDB, 1984a). In our view, these figures show the need for Latin America to insist, at the political level, that official financing be increased in order that it may resume a rate of growth that is suited to its

economic and social development needs.

At present, the bulk of the Latin American public debt is accounted for by the private commercial or transnational banks which have moved beyond the borders of their countries of origin and operate through the Eurodollar market, mainly in London or other cities, and even in some mini-States, where they are not subject to any regulation whatsoever. The establishment of these banking organizations in London coincided with the imposition by the United States of various taxes and restrictions on certain banking operations in order to reduce the outflow of dollars from that country during the 1960s. That policy, however, had the opposite effect, and a significant number of United States banks transferred their operations to London and other places where they were able to make spectacular profits without having to worry about the taxes, restrictions or regulations that normally apply to all banking operations. Although the issue is now a rhetorical one, this lack of regulation allowed the transnational banks to go overboard in their lending operations, increasing their risks to intolerable levels. This had a lot to do with the critical situation now being faced by Latin America and by the international banking system in general.

One of the obvious difficulties posed by the debt problem arise from the fact that the commercial banks and the governments pursue very different objectives. This contradiction in objectives led the Latin American countries to reiterate, in the Cartagena Consensus, the need for political consideration to be given to the question of the debt at the international level and stress that only a meeting of minds of the governments of the debtor and creditor countries will bring about a change.<sup>1</sup>

Latin America has repeatedly stressed the need for discussions on the debt to be taken out of the private sphere and dealt with at the highest intergovernmental level. Unfortunately, the governments of creditor countries have not yet agreed to this.

<sup>1</sup>Consensus of Cartagena de Indias, 22 June 1984, Declaration No. 9.

## I

## Historical background

1. *The early loans*

It is interesting to note some similarities between the current crisis and the experience of the Latin American republics in the early years of their history as independent nations.

Although the loans that enable the colonies to become independent from Spain were obtained from private London financiers, they clearly had political implications, inasmuch as they helped to further the British Government's objectives with respect to Spanish America. In many cases, beginning with the negotiations begun by Francisco de Miranda in 1791, the English Government even went so far as to finance the patriots who started the revolutionary process. Once independence had been declared, the new governments, having obtained these loans, were accepted as subjects of international credit even before they were officially recognized as governments. The early legitimacy which British trade and finance conferred on the Latin American nations was used to exert pressure on the British Government through Parliament, which conveyed the demands of those who had vested interests in the region and were pressing for official recognition (Lynch, 1980). Lord Palmerston subsequently stated that it was the financial aid received which had enabled the insurgents to achieve independence (Webster).

This initial Latin American experience with the London financial world was painful for both parties concerned. In the case of the Latin American governments, although the financial aid was very significant from the political standpoint, the terms under which it was granted were extremely harsh. As regards the English lenders, their expectations were also much greater than what could realistically be expected from the Latin American economy. The painful outcome of these transactions was a general suspension of payments which damaged Latin America's credit rating for many years and played a decisive role in the great crisis of 1825, when 36 banks went bankrupt and the Bank of England was forced to intervene in the financial markets, a situation

which gave rise, moreover, to a full parliamentary investigation (Andréadis, 1966, p. 248).

Another element in these loans was the fact that the investing public saw Spanish America as a single country; hence, suspension of payments on one loan affected the credit of the entire region. This explains why, in 1826, Mexico decided—in a manner similar to its most recent action with respect to the Argentine debt—to assist Gran Colombia when the latter country was unable to meet its commitments as a result of the bankruptcy of the Goldschmidt firm. On that occasion, Rocafuerte, the Mexican representative in London, stated that the cause of Spanish American solidarity made it essential for the nations of America to help each other preserve their good credit rating (Rodriguez, 1975) and announced that his country was granting a loan to Gran Colombia. This enabled that country to overcome its crisis but, unfortunately, it did not prevent a subsequent suspension of payments (Rodriguez, 1975, p. 168). As Lord Palmerston later pointed out, by 1837, Latin America had defaulted on the entire amount borrowed from 1822 onwards (8 023 008 pounds sterling) (Webster, Vol. 1, last page).

2. *Diplomatic protection*

During the nineteenth century and the early part of the twentieth century, the countries of the Northern Hemisphere applied, in their relations with other countries and particularly with the Latin American countries, the so-called doctrine of "diplomatic protection", the purpose of which was to assist the person, life or property of their nationals abroad. This principle, which dates back to ancient history, was taken up by Vattel and invoked frequently to justify intervention by one country in the affairs of another, under the argument that any harm done to a citizen of another State was also an offence to the State itself, which was thus entitled to demand reparation.

Latin America's response to the sometimes abusive application of diplomatic protection was

the so-called Calvo Doctrine (1896), according to which a State is not liable for harm suffered by aliens as a result of domestic disturbances or civil wars. Calvo, basing his conclusions on the practice of European States towards one another, held that the same principle applied to the relations of those countries with Latin American countries. With regard to the diplomatic protection doctrine invoked by foreign States, Calvo affirmed that a State had the sovereign right to submit claims by foreigners to its domestic jurisdiction and that, in any event, such foreigners had the duty to exhaust the national jurisdiction before invoking the protection of their governments. The Calvo Doctrine quickly became a Latin American doctrine and was incorporated into the political constitutions and domestic legislation of the countries of the region. At both the first American international conference, held in Washington in 1889-1890, and the second one held in Mexico in 1902, the Latin American countries adopted declarations and conventions which embodied the Calvo Doctrine (García Amador, 1981, p. 348, volume 1). More recently, this doctrine was used as the basis for the famous Tokyo "No", whereby the Latin American countries collectively refused to join the arbitration mechanism sponsored by the World Bank for the settlement of conflicts arising from foreign investments.<sup>2</sup>

### 3. *The Drago Doctrine*

The blockade of Venezuelan ports by Great Britain and Germany on 11 December 1902 had legal implications which completely changed relations between creditor and debtor countries with respect to payment of the public debt.

Venezuela had debts arising from indemnity claims for damages suffered by foreigners and from delays in payment of its external debt. In December 1902, the representatives of Great Britain and Germany presented an ultimatum, on behalf of their governments, demanding payment of their claims with no discussion whatsoever. They further stated that refusal to accept the

ultimatum would lead to the beginning of hostilities. Venezuela responded by stating that it was going through a civil war and that once the situation returned to normal, it would deal with the claims. It then proposed that the question should be submitted to arbitration. The European countries, supported by Italy, chose to ignore the offer of arbitration and impose a blockade on Venezuelan ports. On 29 December 1902, after the blockade had begun, the Minister of Foreign Relations of Argentina, Luis María Drago, sent the Argentine Minister in Washington a note in which he expounded what is now known as the Drago Doctrine.

Drago rejected the idea that relations between a private creditor and a private debtor were the same as those existing when the debtor was a sovereign State. In the first place, Drago supported the concept of the absolute sovereignty of the State, according to which a creditor who enters into a contract with a sovereign entity realizes that no executive procedures can be initiated or enforced against it since that would compromise its very existence, doing away with the independence and action of the government in question. In the second place, Drago, quoting Hamilton, held that contracts between a nation and private individuals were binding according to the conscience of the sovereign and could not be the object of compulsive force (Pérez Triana, 1908).

Finally, using the Monroe Doctrine as his basis, Drago argued that the use of military force to secure payment of loans entailed territorial occupation and territorial occupation entailed the suppression or subordination of local governments in those countries in which it was applied (Pérez Triana, 1908).

Drago's note gave rise to intensive diplomatic consultations and was widely commented on by the international press; it did not, however, influence the sentence handed down by the Permanent Court of Arbitration of The Hague on 22 February 1904. As Venezuela and the intervening countries did not reach an agreement with respect to the form of payment of the obligations due, the parties submitted the matter to arbitration by the aforementioned Court. The Court decided that as between those countries which had used force to secure payment of their loans and those which had not done so (at least

<sup>2</sup>The so-called Tokyo "No" was announced by the Chilean delegate at the Annual Conference of the World Bank, on behalf of the Latin American countries members of the Bank. See Ruiz, 1964.

eight countries were in the latter position), the former had priority. In other words, the Court, in this case, gave legitimacy to the use of force to secure payment of public debt (Scott, 1916, p. 55).

Nevertheless, during the Second Peace Conference, held at The Hague in 1907, the United States presented the "Porter proposition", which embodied the essence of the principles set forth by Drago, with, however, two significant modifications. In the first place, the Porter proposition only applied to contract debts, whereas the Drago Doctrine did not make such a distinction and hence applied to any pecuniary obligation of the State. In the second place, the Porter proposition required that the debtor show good faith and stipulated that such good faith would be deemed to be lacking if the debtor State rejected or failed to respond to an offer of arbitration or, having accepted such an offer, made it impossible for the arbitration to begin or, once the sentence had been handed down, refused to accept it (Pérez Triana, 1908, p. 88).

The Porter proposition was included in the text of the Convention which limited the use of force for the recovery of contract debts adopted by The Hague Conference. Nevertheless, the Latin American countries were not satisfied, inasmuch as the principle as approved was not an absolute one and, moreover, the Convention provided for arbitration to settle matters which, according to the Calvo Doctrine, fell exclusively within the jurisdiction of the debtor country.

On 23 December 1936, the non-intervention protocol was signed in Buenos Aires. This document states that intervention, whether direct or indirect, and for whatever reason, by one contracting party in the internal or external affairs of another party, is inadmissible (Article 1). Acceptance of the principle of non-intervention thus implied acceptance of the Drago Doctrine, inasmuch as it meant absolute rejection of the use of force to secure payment of a public debt. The prohibition against the threat or use of force by one State against another was also set forth, in broader terms, in the United Nations Charter (Article 2, paragraph 4) and in the Bogotá Charter (Article 18).

#### *4. Reparations claimed after World War I*

There are surprising similarities between the

current debt crisis and the so-called transfer problem of the 1920s, which was associated with the service of the debts arising from World War I (IDB, 1984b). Among the transfer problems, perhaps none was so pertinent to the case of Latin America as that experienced by Germany, which culminated in one of the most serious financial crises ever suffered by any country.

The Versailles Treaty justified the financial obligations imposed on the losing country by stating that Germany was solely responsible for starting the war (Article 231) and establishing that that country must pay compensation for all the damage suffered by the civilian population of the Allied Countries... and their property during the war (Article 232). It further stipulated that Germany must co-operate in the restoration of the economic and industrial life of those countries (Article 235).

Most of the obligations imposed on Germany were not for a specified amount. It was left up to the so-called Reparations Commission created under the Treaty to translate them into liquid sums which could actually be demanded. This was not by accident; the Treaty dealt only with the punitive aspects of the responsibilities established, but failed to determine the country's economic capacity to meet those responsibilities, although it did acknowledge the fact that Germany's resources were inadequate to make complete reparation for all losses and damages (Article 232).

In addition to paying reparations, Germany also had to make payments in kind. On 26 December 1922, the Reparations Commission ruled that Germany had failed to meet its obligation to deliver lumber to France. This circumstance was the basis for the occupation of the Ruhr by Belgian and French troops, beginning on 11 January 1923, for the purpose of extracting timber directly and charging it against the German debt. This effort failed because the German people, supported by their Government, prevented it from being carried out. The Government also suspended payment of reparations, giving rise to one of the most spectacular inflations in the monetary history of the world.<sup>3</sup>

<sup>3</sup>In January 1923, one dollar was worth 17 972 marks; on 14 November of the same year, it was worth more than one billion marks (Nussbaum, 1954).

The final amount of the reparations was only established in January 1930, at the equivalent of US\$ 26 billion, to be paid in 60 installments up to 1988 (Hemming, 1983, p. 339). By 1930, however, both the world economic situation and that of Germany made it impossible to service a debt of that magnitude. Some months later, the United States President declared a one-year moratorium of the payment of war debts by the allies and of reparations by Germany (Department of State, 1931).

From the practical standpoint, the payment of reparations was extinguished in June 1932, when the allies agreed to accept bonds in lieu of reparations. An intergovernmental organization—the Bank for International Settlements—was created especially to establish the date and terms of issuance of these bonds and to collect payment on them (Gathorne-Hardy, 1947). In addition, the allies, including Great Britain and France, also stopped making payments on their war debts with the United States. From 1931 onwards, these debts became merely symbolical; they were finally extinguished in 1933 (Flemming, 1938, p. 352).

The German experience provides the following precedents which are applicable to the Latin American debt:

a) There is no point in trying to find out who is to blame for the Latin American crisis; without question, the suggestion that the debtors alone are responsible for it and that only they should suffer the consequences is unacceptable. What is important is not to punish certain countries for the benefit of others—as was done in the case

of Germany—but rather to recognize that both the governments of the creditor countries and those of the debtor countries must share the consequences of the crisis and work together to solve it.

b) There is a limit to the amount of financial resources a country can transfer abroad without seriously upsetting the living standards of its population and its social and political organization. The example of Germany makes it unnecessary to comment on the disruptions which could be caused in Latin American institutions if the current negative transfer of resources were to continue for a long time.

c) The invasion of the Ruhr shows that the use of coercive measures as a method for obtaining payment of a public debt only aggravates relations between countries and does not accomplish the objectives sought. At the present time, coercion may be more subtle (one expert has suggested converting the debt into capital and allowing creditors to become the owners of the productive natural resources of the debtor countries) (*Wall Street Journal*, 1984).

d) The final solution which the creditor countries found to the problem of German reparations, which consisted in replacing reparations by bonds administered by an intergovernmental agency, has positive features which could be studied with a view to applying them to the Latin American case. The possibility of converting a variable and constantly increasing debt into a fixed debt at a term compatible with the payment capacity of the debtor country would appear to have definite advantages (Guerguil, 1984).

## II

### The international financial responsibility of the State

States meet their financial obligations not because of some binding legal rule requiring them to do so, but rather, according to Einzing (1973), because of their intention to borrow again. What worries creditors now, however, is the fact that there is no certainty this incentive can be maintained. The question is whether those banks that have already repeatedly risked their capital on

loans to Latin America can continue offering the incentive of new loans to the region.

In light of the above, it is important to consider what might happen if a government stopped its payments or refused to fulfil its international financial obligations. As is well known, this question falls within the more general issue of the international responsibility of



States, on which there is wide disagreement in international law. Since the 1930 codification conference held at The Hague, the serious differences in this regard have made it impossible to advance towards the adoption of rules or principles. Moreover, the United Nations International Law Commission, which in 1956 was charged with drawing up a draft convention on State responsibility has not yet fulfilled this mandate.

Despite the fact that there are no imperative norms governing the international financial responsibility of the State or establishing whether its obligations with a foreign private creditor are subject to public or private international law,<sup>4</sup> as regards changes in the political system, there are some important precedents which are worth mentioning.

#### 1. *Recognition of the obligations of previous governments*

Except in the case of the Cuban revolution and other less important ones, the Latin American countries have, from the time they gained independence and up to the Sandinista revolution, been absolutely consistent in the practice of recognizing the financial obligations undertaken by previous governments.

Latin American practice followed the principles of the first French Republic, which in its Political Constitution stated that it accepted and recognized the debts contracted by the deposed monarchy. The principles applied by France and Latin America are based on the theory of the permanent identity of the State and the continuity which must exist between governments and the obligations they contract. Whenever a government has repudiated the debts of its predecessor, it has applied a casuistic criterion based on the presumption that the debt was an illegitimate one or was used for illegitimate purposes.

Even before their independence had been recognized, the Spanish American republics, through their legislatures, solemnly accepted and

gave priority to the debts previously contracted by Spain in connection with its territories. Subsequently, in the treaties whereby the republics were recognized, they again expressly accepted responsibility for meeting the financial obligations previously contracted by Spain.<sup>5</sup>

The above precedents have been repeated many times. As an illustration we shall only mention the cases of Brazil in 1889 and Nicaragua in 1979.

When the Federal Republic of Brazil was established, rumors were started abroad which affected the new regime's credit and even gave the impression that a new positivistic calendar was to be imposed, thus making it necessary for the government to clarify its position *vis-à-vis* the international banks. The Minister of Finance, Ruy Barbosa, thus sent his historic telegram, which read as follows: "Government has been constituted as the Republic of the United States of Brazil. Monarchy deposed. Imperial family left the country. Provinces join. General peace and satisfaction. Executive branch governing provisionally... Republic strictly respects all commitments, obligations and contracts of the State" (Mangabeira, 1960, p. 43).

The precedent set by Nicaragua is important because the new Government, shortly after taking over, stated that it would not recognize, because of its illegitimate nature, debts contracted by the previous régime for the purchase of weapons or those on which disbursements had not yet entered the country (United Nations, 1979). It later changed this position in favour of the doctrine of complete recognition.

#### 2. *Repudiation of the obligations of a previous government*

The classical example of repudiation is that of

<sup>5</sup>Moore (1906, pp. 342 and 343) quotes Article vi of the Treaty of 16 February 1840 with Ecuador; Article xi of the Treaty of 9 October 1841 with Uruguay; Article iv of the Treaty of 25 April 1844 with Chile; Article v of the Treaty of 30 May 1845 with Venezuela; Articles v of the Treaties of 21 July 1847, 10 May 1850 and 25 July 1850 with Bolivia, Costa Rica and Nicaragua, respectively; Article iv of the Treaty of 9 July 1859 with the Argentine Confederation and of 21 September 1863 with the Argentine Republic; Articles iv of the Treaty of 29 May 1863 with Guatemala and of the Treaty of 24 June 1865 with El Salvador.

<sup>4</sup>Schuster (1973) points out that the law applicable to a contract between a State and a foreign private contractor is not absolutely clear; he quotes Jean-Flavien La Rive (1965, p. 265), who states that the law applicable to an international contract is a controversial and complex matter.

the Soviet Union which, by a decree dated 10 February 1918, declared that:

1. All State loans contracted by the governments of the large landholders and bourgeoisie of Russia... are annulled. The December coupons for those loans will not be honoured;
2. The guarantees granted by those governments for loans made by different enterprises and institutions are also annulled; and
3. All foreign loans are annulled without exception and unconditionally (Langsam).

Nevertheless, the Soviet Government gradually changed its position over the years that followed. During a conference held at Genoa in 1922, the Soviet delegation sent Great Britain a note stating that it could not accept responsibility for the debts of its predecessors so long as its Government was not formally recognized *de jure* by the Powers concerned (Wilson, 1934, p. 26). It thus suggested that payment of its public debts was subject to *de jure* recognition of the Soviet Government by the Western Powers.

The Soviet suggestion was quickly rewarded with recognition by the Labour Government, on the grounds that, although technically separate from the issue of recognition one of the most

important questions was the settlement of outstanding claims between the Governments and nationals of the two countries and the restoration of Russia's credit (Toynbee, 1926).

Payment of the Russian debt to the United States was also conditioned on recognition of the Soviet Union; one of the methods agreed on by the Governments in 1933 to facilitate settlement was the transfer or assignment to the United States Government of the stocks or rights held by the Soviet Government, as a successor to previous Russian Governments, on properties or goods in the United States. The execution of this transfer to the United States Government gave rise to several lawsuits. In one of its decisions, the Supreme Court ruled that recognition of the Soviet Union was retroactive and validated all action and conduct of that Government from the beginning of its existence.<sup>6</sup>

Subsequently, the Foreign Claims Settlement Commission assumed responsibility for collecting all monies owed or potentially owed to the United States Government as assignee of the rights transferred to it under the Litvinoff Agreement of 1933.<sup>7</sup> In practical terms, however, the bulk of the Russian debt outstanding prior to the repudiation decree remains unpaid and will probably never be paid.

### III

## Characteristics of the financing obtained from the Eurodollar market

The financing obtained from the London Eurodollar market has certain characteristics which make it different from conventional transactions. This is due to the special nature of the Eurodollar market, to the way in which the participating banks (organized in consortia) operate and to the standard loan contracts used.

#### 1. *The Eurodollar market*

From the legal point of view, there are three characteristics of this market which are worth stressing.

In the first place, there is a complete lack of regulation on the part of any governmental or intergovernmental body; this is, in fact, the very reason why this market exists. The absence of regulation extends not only to individual operations but also to the operations of associated banks.

In practical terms, the lack of regulation means that a bank is not subject to the restrictions

<sup>6</sup>United States v. Belmont (301 U.S. 324) (1937).

<sup>7</sup>*Settlement of International Claims*, Act 96-209 (1980); the original version is dated 1949.

usually imposed on banking activities by national legislation. The most critical such requirement is that which concerns the reserves a bank must keep in respect of its operations; the banks taking part in the Eurodollar market are not subject to this requirement.

In the second place, there is the large volume of interbank loans and deposits which allow for the rapid transfer of resources from one bank to another with no other formality than a telephone call. Thus, when a bank grants a loan, it may use its own resources or, depending on circumstances, resources borrowed from other banks. This flexibility in the mobilization of resources enables the banks to meet a large demand quickly but, at the same time, it means that non-compliance by one single bank can jeopardize the working of the entire system. This vulnerability became evident during the Mexican crisis of 1982, when six banks —Bancomer, Banamex, Banco Serfin, Comermex, Somex and Banco Internacional— which had agencies in the London interbank market, were unable, for several days, to meet their deposit obligations with other banks. According to one journalist, if those accounts had been frozen..., the entire interbank market could have collapsed and the effect in London and, probably, New York would have been devastating (Kraft, 1984). Fortunately, the Mexican crisis was solved, to the great relief of the London and New York financiers.

Finally, the Eurodollar market has its own rules for establishing the London Interbank Offered Rate (LIBOR) of interest. This rate represents the amount which a bank operating on the London interbank market pays to another bank operating on the same market for a Eurodollar deposit for a term of not longer than one year. LIBOR is determined by the quotation given by the so-called reference banks participating in a loan transaction at a given hour on a contractually pre-established date for determining the applicable interest rates, which is usually paid every three or six months. Thus, LIBOR is a variable interest rate which fluctuates according to the market in London. Debtors pay a fixed percentage (spread), which is negotiated in each case, over LIBOR.

This explains why the Latin American debt fluctuates periodically; it has been contracted at the variable LIBOR interest rates or at the United

States prime rate (the interest rate United States banks charge their best customers), which reflect the fluctuations on the London and United States markets.

The Latin American governments would like to see some government assume responsibility for the activities of the creditor banks and act as a counterpart in negotiations pertaining to the debt. As is well known, up to now, the creditor countries have not done anything to satisfy this desire. This is in contrast with what has happened in the case of private-sector obligations in some countries, where, when debtors have had difficulty making payments, the creditors have obtained a government guarantee on the obligations, despite the fact that many of them have involved speculative or fraudulent operations which were harmful to the national economy. The banks have succeeded in obtaining this State guarantee by pressuring the governments, which had initially refused. One particularly effective form of pressure was the reduction or elimination of short-term loans (ECLAC, 1984, p. 74).

## 2. *The consortia*

The granting of loans by banks organized in consortia —another result of the lack of regulation of the London market— became a widespread practice beginning in 1972, when a total of US\$ 11 billion were loaned under this type of arrangement. The use of this system increased so dramatically that by 1981, syndicated loans totalled US\$ 178 billion (Mac Donald, 1982).

The consortia were successful because they made it possible to channel resources for an amount larger than that which any individual bank could loan, thus proportionally reducing the risk to each member of the consortium. Thus, they were quite successful during the periods of liquidity prior to the crisis and offered advantages to governments which, through this mechanism, found it relatively easy to obtain medium-term (from five to seven years and more) loans for amounts which up to then were unprecedented for Latin America.<sup>8</sup>

Nevertheless, as soon as difficulties began to arise in connection with the service of these loans,

<sup>8</sup>So-called "jumbo" loans were for amounts in excess of US\$ 1 billion.

the debtor governments virtually lost their bargaining power *vis-à-vis* the consortia. A consortium is organized through a mandate-letter from the loan applicant authorizing a bank to act as the lead manager bank in forming the consortium. At the same time, the applicant sends a memorandum giving detailed information on his economic and financial situation; this is very important because if it is later discovered that the memorandum contains false information, the creditors may even demand payment of the total amount outstanding on the loan.<sup>9</sup> Both documents (the mandate-letter and the information memorandum) enable the lead bank to invite other banks to participate in the formation of a consortium. The consortium establishes a separate legal relationship which is independent of the loan contract between the lead bank and the borrower.

The consortium reflects the sophisticated organizational capability and the institutional solidarity of the banks. Contractually, it is strengthened by a cross-default clause which entitles a creditor to demand payment of the entire balance on the loan whenever the debtor has failed to meet a Financial obligation with another creditor. Through this clause, therefore, the banking system obtains additional protection which prevents a debtor from choosing to meet only some obligations and not others. The cross-default clause prevents him from making this choice and forces him to meet each and every one of his obligations.

### 3. *The loan contract*

Loan contracts granted under the rules of the London interbank market have certain unique features which makes them different from any other contract. They are drafted in standard language which reflects the many years of experience of the banks operating in this market. Consequently, the possibility of modifying these contracts is very remote.

Of the different clauses contained in these loan contracts, we shall now discuss those relating

<sup>9</sup> The so-called "Colocotronis" lawsuit of 1975, between United States banks and the lead bank, European American Bank, involved allegations of falsehood in the information memorandum (Mac Donald, 1982, p. 126).

to the payment of commissions and expenses, jurisdiction and the applicable law.

#### a) *Commissions and expenses*

In addition to paying interest, a borrower must pay a number of commissions and miscellaneous expenses which considerably increase the cost of financing. Commissions include the management fee, which consists of a fixed percentage over the total amount borrowed and which must be paid to the agent bank at the time of signature of the contract. The purpose of this fee is to cover the expenses and effort involved in organizing the consortium.

The commitment commission is an annual percentage paid on the undisbursed balance of the loan during the entire period in which the bank keeps the resources available. In this regard, it should be noted that the contracts include many prerequisites which must be met before the funds are actually disbursed. The borrower must pay the commitment commission until disbursement is actually made.

The agency fee is paid annually to the agent bank for services provided during the disbursement period. It also is a fixed percentage.

In addition, the borrower must reimburse the banks for specific expenditures incurred in organizing the financing. These include services such as travel expenses, communications, postal expenses, lawyers' fees, advertising, preparation and printing of the information memorandum and others.

#### b) *Jurisdiction and applicable law*

Depending on where the financing comes from and where the banks have their domicile, the law applicable for purposes of interpreting and executing the contract will usually be that of the United Kingdom or of the State of New York. For the same reasons, the contract stipulates that the courts of those same places shall settle any controversy or dispute arising between the parties, without prejudice to the creditor's always having the option of claiming his rights before the courts of the borrower's country. The jurisdiction clause also includes the designation by the debtor of a representative holding power of attorney to receive claims and a waiver of immunity in respect of the initiation of lawsuits and

the execution of sentences. Difficult questions have arisen as regards the validity of these stipulations on jurisdiction and the applicable law, inasmuch as the constitutional and legal provisions in force in most Latin American countries prohibit, in different ways, the settlement of public affairs by jurisdictions other than the national ones. Infringement of these provisions is usually sanctioned by annulment of the act.

This also gives rise to a political problem which Aldo Ferrer (1984) mentions in stating that negotiations on the external debt should be transferred from London or New York to Buenos Aires, Mexico or Rio de Janeiro. Aside from the political issue involved, it must be recognized that the banks will never agree to a financing contract which grants the debtor the power to decide which law or jurisdiction is applicable. In practical terms, therefore, the debtor has no choice in the matter.

It should also be noted that many of the legal requirements imposed by the Latin American countries in this regard are extreme, considering the realities of contemporary finance. The governments and central banks are undoubtedly aware of this fact and have interpreted the law in such a way as to allow for flexibility in the application of the relevant constitutional norms.

An example of this is the interpretation developed by the Attorney General of Venezuela (1977, pp. 55 ff.), who considered Article 127 of the Constitution to be inapplicable to loan contracts between the public sector and foreign private banks, because those contracts had to do with commercial activities which did not affect the security and sovereignty of the State.

Another example is that of the Federal Court of Comodoro Rivadavia, which reversed the decision of the judge of Río Gallegos preventing the extension of jurisdiction to foreign courts in respect of contracts pertaining to the renegotiation of the external debt of the Argentine Republic.<sup>10</sup> In this significant decision, the Court made a distinction between federal jurisdiction in respect of the party and federal jurisdiction in respect of the matter, and concluded that federal jurisdiction in respect of the party could be extended, even though the party might be the Argentine State. Bidart Campos added, in a footnote, that the extension agreed on was in order because there did not seem to be any federal matter at issue.

Moreover, it is questionable whether a government can free itself of its contractual obligations by invoking non-compliance with its own legislation and arguing, for example, that a contract has violated the constitutional prohibition against submitting to a foreign law or jurisdiction. Once a contract has been signed and disbursements have begun, such a behaviour would be equivalent to repudiation without just cause. On this point, Borchard (1951, p. 120) mentions the case of a loan granted by United States banks to Bolivia and the communication which the United States Secretary of State sent to the Bolivian Minister stating that, leaving aside the question of the legality of the loan, the State Department wished to draw attention to the fact that the Government of Bolivia, after having accepted and used the product of the loan, was hardly in a position to argue later that the loan was illegal.<sup>11</sup>

## IV

### Creditor's rights in respect of the Latin American public debt

Without prejudice to collection by legal means, United States legislation grants banks a right which, in practice, is perhaps more expeditious than a lawsuit; it allows creditors to apply the liquid amounts deposited in checking accounts to the payment of amounts owed by their customers for other purposes. This set-off right allows creditor banks to retain and collect directly the

amounts owed them on delinquent loans from the liquid product of the exports of debtor

<sup>10</sup>*Revista argentina de jurisprudencia*, decision of 8 October 1983 in lawsuit against Aerolíneas Argentinas. In his decision, the judge of Río Gallegos also ordered the arrest of the President of the Central Bank of Argentina.

<sup>11</sup>The State Department communication, dated 9 April 1922, is reproduced in *Foreign Relations*, 1923, i, p. 443.

countries which are on deposit in those same banks (Mayer and Odorrizi, 1982, p. 289).

In the context of the current crisis, both creditors and debtors realize that there are no immediate solutions and that a lawsuit would entail many risks which none of the parties wishes to take.

The Mexican crisis of 1982 showed, moreover, that the problems related to the Latin American debt, and especially those of the larger countries, can affect the viability of the international financial system and that, therefore, the banks cannot be allowed, on their own, to decide how they should be solved. Indeed—although the principle of a political solution has not yet been accepted by the creditor countries—the Mexican crisis was resolved through intergovernmental negotiations which involved, among many others, the United States Treasury Department and Federal Reserve Bank, the Bank of England, the International Monetary Fund and the Bank for International Settlements.

Nevertheless, because the solution to the Mexican crisis of 1982 did not provide a precedent that could be applied to other countries, nor have the creditor countries accepted the proposal set forth in the Cartagena Declaration to the effect that an overall political solution should be sought for the problem of the debt, the banks still have ample room for exercising their rights without taking long- or medium-term political considerations into account.

When a debtor defaults on his financial obligations, the banks have the option of suing for payment or renegotiating the debt. In general, they have co-ordinated their action in exercising these options, going even so far as to set up steering committees organized vertically under the chairmanship of one of the more powerful banks. We shall now look at these two options.

#### 1. *Judicial collection of the public debt*

It is important to determine whether the lawsuit is brought before the courts of the country in which the debt was contracted or payment is to be made, or the courts of the debtor's country. In either case, what makes the situation with respect to the collection of the Latin American debt unique is the high amount involved. Theoretically,

under the private law of most of the countries concerned, when a debtor does not pay, the courts are required to order the attachment and auction of the goods and assets of the debtor the creditor's claim. In other words, in the hypothetical case that the banks should succeed in having the courts order the attachment and auction for the goods and assets of the debtor governments and public entities in order to satisfy the entire amount owed, virtually the entire productive sector of Latin America and a good part of its territory would come under the ownership of the creditor transnational banks. There are many reasons why such a situation cannot arise. Because the State is a member of the international community, its existence or operation cannot validly be discussed or restricted by the jurisdiction of another State and much less so in connection with proceedings to secure payment of private loans.

If a State does not pay its debt, therefore, a creditor cannot initiate execution proceedings that might lead it to bankruptcy. This principle is recognized in the domestic legislation of the individual countries, as well as in international law. United States legislation, for example, expressly makes bankruptcy proceedings inapplicable to States.<sup>12</sup> At the international level, The Hague Court ruled, in the case of Venezuela, that the property of a State could not be the object of proceedings leading to sequestration or attachment and that such a proceeding would be inconsistent with the existence of a State as an independent entity. It further stated that it was obvious, therefore, that bankruptcy proceedings could not be applied to States in the same way as they were applied to individuals or commercial societies.<sup>13</sup>

Although this principle is quite clear, it is difficult to apply it in practice because of the increasing involvement of States in commercial activities and the development, in the United Kingdom and the United States—among other countries—of the doctrine of restricted immunity of jurisdiction.

<sup>12</sup>US Bankruptcy Code, n U.S.C., chapter 9, paras. 901-906; supplement iv-1980.

<sup>13</sup>"Arbitration between Venezuela and other countries, Permanent Arbitration Court of The Hague, 1903, quoted by Borchard(1951,p. 122).

As a result of these developments, loans contracted by foreign States in those countries are considered to be commercial in nature; hence, it is not possible to invoke immunity of jurisdiction or of execution in lawsuits brought in cases of default. The creditors, however, are able to use all the resources permitted by the legislation of those countries, including the attachment, withholding, sequestration or auction of goods. Nevertheless, if the debtor countries do not have a sufficient amount of goods in the aforementioned countries to satisfy their overdue debts, creditors will not accomplish much through this means. At any rate, the question is a difficult one, since a significant part of Latin American trade is transacted through London and New York banks and thus the bank accounts in question can easily be attached in those countries.<sup>14</sup>

The other stage in this hypothesis is a lawsuit before the courts of the debtor countries where, obviously, there are enough goods to justify such a request. This might involve bringing suit before the local courts or requesting enforcement of a decision of a foreign court. In either case, the creditor's request will only succeed to the extent that it is compatible with local legislation. Even so, a distinction would have to be made between an isolated suit for a specific and relatively moderate amount and a suit for large amounts. In the first case, there should be no difficulty in effecting collection, but in the second case, if the amount claimed is beyond the payment capacity of the State, the situation will be different.

For obvious reasons of public order and national sovereignty, the courts of a country cannot make decisions which would affect or restrict the State's ability freely to dispose of its goods or the normal functioning and operation of essential economic activities, in order to favour foreign private creditors. The idea put forth by some creditors of capitalizing the Latin American debt by converting their loans into tangible assets is not, therefore, legally feasible. Nor have the banks considered this feasible; hence they have had to realize that the only valid option is a periodical renegotiation of the debt.

<sup>14</sup>Among the many cases that have occurred in recent months, one may mention the attachment of four Bolivian Government accounts in Washington banks (UPI, January 14, 1985).

## 2. *Renegotiation of the debt*

It is clear from the above that, in the context of the current crisis, this has been the best alternative available. Without prejudice to this, and despite the adverse circumstances, the exceptional organizational capacity of the banks has enabled them successfully to manage these renegotiations in such a way that, up to now, the crisis has not significantly affected their financial interests.

Up to 1981, the annual average debt of the developing countries with the commercial banks which was restructured was under US\$ 1.5 billion; in 1982 this figure rose to US\$ 5 billion and in 1983, it was over US\$ 60 billion (IMP, 1983, pp. 22 ff.). These figures are an indication of the high priority that has been attached, from 1983 onwards, to questions pertaining to the renegotiation of the debt of developing countries, and particularly of the Latin American debt.

The question arises whether, in view of the tremendous importance of the renegotiation process, the countries have received or are receiving the technical and professional advice they need in order to handle these complicated operations successfully. We believe that in the case of many Latin American countries, this has definitely not been the case. This is confirmed by a commentary in the *Financial Times*, which states that the developing countries have great advantages *vis-à-vis* the private banks, but have shown little imagination in using them.<sup>15</sup> Whether or not this is true, the suggestion that the countries should request international technical cooperation in order to strengthen their bargaining capacity *vis-à-vis* the banks would seem to be fully justified.

The banks, on the other hand, have used to advantage many resources, including the following; acting under the leadership of a single committee presided over by one of the more powerful banks; keeping negotiations separate, dealing with them on a case-by-case basis; conducting negotiations and signing contracts at the sites of their main offices (London or New York); using English as the official language for renegotiations and contracts; using highly sophisticated

<sup>15</sup>Editorial entitled "Third World Leverage", dated 12 February 1983, quoted by Devlin (1983).

legal and financial advice at practically no cost; and applying as a precedent for the terms and financial conditions of their negotiations with other countries those agreed on with Mexico in 1982.

Recent studies show that the renegotiations carried out by the countries of the region between 1978 and 1983 have several characteristics in common (IMF, 1983; Devlin, 1983; and ECLAC, 1984).

That is why the rescheduling of the Mexican debt in 1982 is so important as a model applied to other countries. Nevertheless, what was acceptable to Mexico in 1982 is not necessarily acceptable now to countries with serious structural problems, whose possibilities for achieving a true recovery—contrary to the case of Mexico—are remote. Hence, it does not seem right for precedents or models that are not based on the specific economic circumstances of each debtor country to be applied to current renegotiations. The recommendation made by the United States Congress upon approving the last increase in IMF capital is consistent with this view. The Congress stated that the annual service of the external debt required of a given country should represent a wise and reasonable percentage of the estimated annual export income of the country in question.<sup>16</sup>

As we shall see, however, in the past few years, renegotiations have been based exclusively on the conditions prevailing on the international markets and not on those existing in the debtor countries.

Some of the main features of the renegotiation are the following:

#### a) *Concepts*

The banks consider that the debt should be refinanced and defined as a separate transaction from the original one, thus replacing the previous obligation by a new one. This strategy allows the banks to obtain more favourable terms because of the obvious reduction in the bargaining power of the debtor—who is virtually in default—and the great reduction in the supply of credit to Latin America (ECLAC, 1984).

"Rescheduling" or "restructuring", on the

other hand, consists of extending or delaying the periods allowed for amortization and interest payments or reducing the amount of a particular obligation. The difference between these latter arrangements and that described as refinancing is not purely semantic; rather, there is a fundamental difference for both parties concerned. Up to now, the banks have managed to impose the concept of refinancing so that loans which originally were only marginally profitable have become highly profitable transactions.

Following the oil crisis of 1973, when there was an excess supply, and the banks were rushing to lend to the Latin American countries, these countries could practically choose the best offer, thus forcing the banks to reduce the interest spread—in other words, their profits—to minimal amounts. Since 1982, when the supply of credit ended, countries coming to the bargaining table have simply had to do whatever the banks tell them to. Through refinancing, the banks are now able to increase the spread and thus obtain profits which up to then had only been dubious. Refinancing also favours the banks because it allows them to again charge commissions and reimbursement of miscellaneous expenditures on the amount of obligations refinanced.

#### b) *Relationship with the Fund*

After an unsuccessful experiment in which a consortium of banks tried, in 1976, to engage in direct supervision of an economic stabilization plan for Peru, debt renegotiations have been subject to the signature, by the country concerned, of an economic stabilization plan with the International Monetary Fund (Dammers, 1984, p. 83; Akhund, 1978, pp. 66-72).

At present, renegotiations with the banks even consider non-compliance with the Fund agreement as grounds for claiming non-compliance with the loan agreement.

Since the Mexican crisis of 1982, Fund intervention in debt renegotiation has become even more significant. On that occasion, the Fund took the bold step of requiring the banks to participate and, in practice, it required the banks to grant new loans to Mexico amounting to 1% of the amount they had already committed; the total amount loaned in this way was US\$ 5 billion.

<sup>16</sup>Public Act 98/181, quoted in ECLAC, 1984, p. 73.



At the same time, the banks had to renegotiate US\$ 20 billion of the debt which matured in 1983 and 1984 (Kraft, 1984, p. 49). Although the new loans and the renegotiation had been granted at the instigation of the Fund, or, to be more exact, of its Director, Mr. Larosiere, this did not mean that the banks did not get a fabulous deal; they earned from 70 to 90% over their capital, so that the restructuring turned into a very good business for them.<sup>17</sup>

c) *Exclusion of interest*

For many reasons, the banks have systematically refused to include interest payments—either currently due or future—in debt renegotiations. They have no problem, however, with refinancing capital payments. In proceeding thus, they are following a banking tradition, i.e., to keep money in circulation. Moreover, if under the present circumstances, the entire amount of the debt were to be paid, the banks would have serious difficulties in relending that money. As long as countries continue paying interest, the banks are able to reassure their stockholders and the authorities that everything is normal.

Non-payment of interest on a bank loan has different administrative and legal implications in the United States. From a bookkeeping point of view, the transaction must necessarily be recorded as non-performing and withdrawn from assets. Generally, this also means that there will be no dividend payment, a fact which must be reflected in quarterly reports to stockholders. Hence, the banks need to give an appearance of normality to their operations; this is why they prefer to grant new loans rather than to include interest payments in a refinancing arrangement. As a result, despite the fact that defaults have occurred on a large scale, the banks have seen to it that interest payments continue without interruption. Thus, they have established a sort of perpetual rent in their favour which, theoretically, could continue indefinitely, since, as far as the banks are concerned, they are not interested in seeing interest payments suspended and, as far as the debtors are concerned, up to now they have had no choice.

<sup>17</sup>Attributed to one of the Mexican negotiation (see Kraft, 1984, p. 52).

d) *Maturities included*

One of the fictions which the banks have insisted on maintaining is that of the temporary and exceptional nature of debt rescheduling. Thus, each case of non-performance is treated individually, without taking into account the overall crisis affecting the region. This strategy is designed to gain time, on the assumption that in a few years, an overall recovery will enable the debtor to meet his obligations in a normal manner. According to this criterion, the reschedulings that have actually been carried out only include maturities falling within periods of no more than 12 months. Naturally, this means ignoring the structural aspects of the crisis and, moreover, helps to aggravate it; after two years, the debtors will be in even deeper troubles, since they will then have to meet new maturities, as well as the old ones.

e) *Financial conditions in recent negotiations*

A study was recently made of 43 negotiations on debt restructuring with 28 countries. This study, carried out from 1978 to October 1983, showed that the negotiations all had the following features in common:<sup>18</sup>

—The renegotiations were closely linked to IMF adjustment programmes and the banks were organized into directing committees.

—The long- and medium-term debt contracted or guaranteed by the public sector was included; in exceptional cases, the long- or medium-term private debt was included.

—The short-term debt was only included in half the cases.

—The interbank debt was excluded, as regards both deposits and loans.

—In some cases, notes or floating interest rates were included; in others, the agreement only included bonds and notes at floating interest rates of financial institutions.

—The agreements usually covered maturities (capital) falling within the 12 months after the initiation of negotiations.

—Except in two cases, the agreements excluded from negotiation interest already due or future interest.

<sup>18</sup>information taken from IMF (1983, pp. 25 ff.). The information refers to debt renegotiations of 28 countries, 15 of which are in Latin America.

—Debt consolidation periods, understood as the period between the maturity of the original debt being restructured and the payment date of the future debt, ranged between one and two years; in the case of the debt that was already due, repayment periods were extended up to a little over three years.

—With only four exceptions, the agreements covered 80% of the capital maturing during the consolidation period and, in more than half the cases, 100% of the capital.

—Amortization terms for payment of the restructured debt ranged between 5 and 7 years.

—In most cases, interest rates were based on the three- or six-month dollar rates under LIBOR. In some cases, however, interest rates were based on the LIBOR rate or on the United States prime rate, the choice being up to the creditor.

—The margin applied to the basic LIBOR interest rate or to the prime rate ranged between 1.75% and 2.25% (only in one case was it 2.5%).

Restructuring commissions were estimated on the basis of limited information. They ranged between 1% and 1.5% of the amounts restructured.

#### f) *The case of Nicaragua*

The renegotiation of the Nicaraguan debt, which was carried out in 1980, has certain unique features which make it different from all other cases. In almost every regard, the agreement breaks with all precedents in matters of renegotiation.

The fear that the new government might repudiate the previous government's debt was

quite justified in 1979. Thus, when, in December 1979, at a meeting held at the Mexican Ministry for Foreign Affairs, the Minister of the International Reconstruction Fund of Nicaragua acknowledged the debt, the bankers were relieved (Ugarteche, 1983, p. 192).

For purposes of renegotiation, the debt was divided into four parts and, contrary to custom, negotiations were begun in Mexico and concluded in Panama. None of the meetings were held in New York or London. Although the banks wished to impose market conditions and market interest rates (Ugarteche, 1983, p. 193), they recognized that the situation was such that it was both necessary and right to allow for conditions that were less harsh than *usual*.<sup>19</sup>

The banks' original proposal was to grant a two-year grace period and a five-year amortization period, at a rate of 1.75% over LIBOR. Nicaragua's counter-offer was 23 years for amortization.

The final agreement represents one of the most favourable renegotiations obtained by a debtor country in recent years. The refinancing included interest due since 1978, calculated at a rate of 10.875%; when the LIBOR rate at that moment was 20%. Nicaragua was to pay an interest rate of 7% during the first five years and the market rate from 1986 onwards.

Another innovation was the provision that, instead of including capital maturities of 1 or 2 years, as was the rule, the entire debt was restructured.

The amortization period was 12 years instead of 5 or 7 and no rescheduling fee was charged (Ugarteche, 1983).

## V

### Doctrines invoked in lawsuits involving Latin American enterprises

Recent decisions handed down by United States courts in lawsuits brought by transnational banks against Latin American public bodies that had defaulted on their loans make it necessary to mention the doctrines on which these decisions have been based.

These doctrines were developed a long time ago; however, in light of the increase in transnational activity and the conflicts which have in-

<sup>19</sup>Ugarteche, 1983, p. 193. The expression is attributed to the economist Richard Wemert.

evitably arisen from the interaction of different systems, they have become increasingly important since the 1964 Supreme Court decision in the *Sabbatino* case.<sup>20</sup>

The doctrines on which these court decisions have been based, which are also closely interrelated, are the act of state doctrine and the doctrine of immunity of jurisdiction.

#### 1. *The act of state doctrine*

Under this doctrine, the courts refrain from deciding on a question submitted to them when this would involve qualifying the validity of a public act by a foreign government within its territory and jurisdiction.

The doctrine was originally conceived on grounds of courtesy and international respect for the public acts of other States. Subsequently, however, the courts' refusal to decide on such cases was based on the problems involved in interfering in the area of foreign relations.

In the United States, the concept was first developed in 1897 as a result of a claim brought by a United States citizen before the courts of his country against the military government of Venezuela, because of his arrest and illegal imprisonment.<sup>22</sup> His claim was rejected on the grounds that every sovereign State was obliged to respect the independence of all sovereign States and the courts of a country could not devote themselves to judging the acts of other governments carried out within their own territory. It was argued that reparation for damage caused by such acts should be made through the means made available by the sovereign governments between each other.<sup>23</sup>

This doctrine was based on international courtesy and was applied without any major variations up to 1954, when the decision in the *Bernstein* case became the first exception. In this case, the plaintiff tried to recover the remains of

goods confiscated by Germany between 1937 and 1939.<sup>24</sup>

In its traditional form, the doctrine would also have prevented the courts from deciding on the legality of the decisions of the German Government. In this case, however, the State Department was in favour of reviewing the legality of the acts of the German Government.<sup>25</sup> On this basis, the courts, disavowing their previous decisions, ruled that the act of state doctrine was inapplicable and decided on the substance of the issue raised (Delson, 1972, p. 90).

Later on, the *Sabbatino* case was brought before the courts, leading to what must be the most controversial decision ever made by the United States Supreme Court. One author called it the doctrine of "compulsive irrational abstention" (MacDougal).

In 1960, Farr, a New York broker, bought sugar from C.A.V., a company organized in Cuba with capital belonging to United States citizens. He undertook to pay for the sugar against delivery of the shipping documents in New York. After the sugar had been shipped, G.A.V. was expropriated and became the property of the Banco Nacional de Cuba, which charged its agent in New York with delivering the shipping documents against payment of the price. Farr refused to receive the documents and deposited the price with *Sabbatino*, the receiver appointed by the New York courts at the request of C.A.V. Banco Nacional's claim was rejected by the courts of first and second instance, which refused to apply the act of state doctrine and considered instead that international law had been violated by the Cuban Government in taking over the sugar by means of a discriminatory and vindictive act and without prior payment of compensation. The Supreme Court rejected the arguments of the lower courts and decided that it was not up to the judiciary branch to review the validity of an appropriation carried out by a foreign government within its territory in the absence of a treaty or agreement setting forth the legal rules applicable to expropriation. In brief, the Court considered that the act of state doctrine

<sup>20</sup>*Banco Nacional de Cuba versus Sabbatino*, 376 U.S. 398. (The reference is to the compilation of sentences of the United States Supreme Court).

<sup>21</sup>On the act of state doctrine of the United Kingdom, see Singer (1981).

<sup>22</sup>On the act of state doctrine of the United States, see Leigh and Sandler (1976) and Rabinowitz (1977).

<sup>23</sup>*Underhill v. Hernández*, 168 U.S. 250 (1897).

<sup>24</sup>*Bernstein v. N.V. Nederlandsche-Amerikaansche*, 210 F. 2d. 375 (2 Cir. 1954); 48A. J.I.L. 499 (1954). See also Delson (1972).

"Department of State Bulletin (May 8 1949).

was applicable and that any decision to the contrary could create a conflict between the executive and the judiciary branches, despite the fact that through the State Department, and in keeping with the Bernstein exception, the executive had stated that it had no objection to the court's reviewing the legality of the Cuban expropriation decrees. Consequently, the act of state doctrine prevented the defendants from attacking the validity of the Cuban expropriation and the title of ownership presented by the plaintiffs.<sup>26</sup>

In a later decision, the Court<sup>27</sup> invoked the act of state doctrine in recognizing the validity of exchange controls and restrictions applied by a government on transactions in national and foreign currency. In this case, an investor had received certificates from the Cuban Government which guaranteed him access to the foreign exchange market at a given rate of exchange. Subsequently, the Government had suspended indefinitely the conversion of those certificates into foreign exchange. The Court refused to reject the validity of that resolution, considering it to be inherent to the essential functions of a government for the purpose of protecting its scanty resources in foreign currency, so that it could not be considered a "confiscation" or "appropriation".<sup>28</sup> As will be noted, this decision is in harmony with the experience of foreign investors in the United States when, in 1933, the United States Congress revoked guaranteed metal conversion for the so-called gold clause, with respect to obligations payable in legal United States currency.<sup>29</sup> On that occasion, the creditors had to resign themselves to receiving money the value

of which was 59.06% lower than the value of cash before the Congressional resolution.<sup>30</sup>

## 2. Immunity of jurisdiction

Recognition of the international personality of a State as a member of the community of nations implies recognition of its equality, dignity, independence and territorial and personal supremacy (Oppenheim). The United Nations Charter, in article 2, para. 1, states that the Organization is based on the principle of the sovereign equality of all its Members. One consequence of the principle of sovereign or juridical equality is that a State cannot exercise jurisdiction over another State nor can it be sued before foreign tribunals unless it voluntarily submits to such jurisdiction.

For many years, the prevailing doctrine was that of the absolute immunity of the State, according to which all acts of the State and of its bodies, the acts and the person of its agents and representatives, its goods and properties could not be judged by courts other than those of the State itself. Nevertheless, in view of the economic activity carried out by the public sector after World War I, the European courts (Belgium and Italy) began to make a distinction between acts of the government as such —*jure imperii*— and acts of a commercial nature —*jure gestionis*— and to refuse immunity for the latter (Brownlie). Despite this, during the same period, a Harvard University study came to the conclusion that the distinction between acts of government and acts of a commercial nature did not justify bringing a claim against a State for matters pertaining to its public debt (*American journal of international Law*, 1932, p. 597). This conclusion was consistent with the opinion of Luis María Drago, according to whom public loans were sovereign acts (quoted by Borchard, 1951, p. 168), and with the position taken a long time ago by the English courts, when they refused to assume jurisdiction in respect of a claim brought to secure payment from Peruvian Government agents for bonds pertaining to that

<sup>26</sup>Public reaction to the Sabbatino case led the Congress to approve the two Hickenlooper amendments (77 Stat. 336 (1963) 78 Stat. 1013 (1964)). The first amendment ordered the Executive to suspend foreign aid to countries which had not taken adequate measures in certain cases of expropriation or nationalization or repudiation or annulment of contracts with United States citizens or companies. The second amendment prohibited the courts from applying the act of state doctrine in cases in which the title of ownership invoked was based on a confiscation carried out in violation of the principles of international law.

"French v. Banco Nacional de Cuba (23 N.Y., 2d, 63, 295, N.Y., 2d, 449, 242, N.Y., 2d, 751-16).

<sup>28</sup>French v. Banco Nacional de Cuba, *ibid.*

<sup>29</sup>The joint resolution of Congress is dated 5 June 1933 (48 Stat. 113 (1933), 31 U.S.C.A. 463 (1933)).

<sup>30</sup>Under decree dated 31 January 1934, the United States President fixed the new price of the gold dollar at a parity of 0.35 dollars per ounce of refined gold (Nussbaum, 1954).

country's public debt.<sup>31</sup> In that case, it was noted that the bonds were none other than commitments of honour and that the contracts concerned could not be executed before the courts of a foreign country, or even before those of the country which issued the bonds, without the consent of the government of the latter country.

There has been much theoretical discussion about the advisability of including the principles relating to sovereign immunity in a multilateral convention. Except for the 1972 European Convention, which entered into force in 1976,<sup>32</sup> however, these efforts have not been successful. Considerable progress has been made, however, in the national legislation of several countries, especially the United States and the United Kingdom, whose laws are similar from both the philosophical and the practical standpoints. In 1952, the United States declared, through the so-called "Tate Letter",<sup>33</sup> that it accepted the restrictive doctrine of immunity and the distinction between acts of government and commercial acts of the State, and that it did not recognize immunity in respect of the latter.

This, however, was not enough, and soon a special law had to be enacted.<sup>34</sup> The United Kingdom, for its part, enacted its own special law, on 22 November 1978.<sup>35</sup> We shall not go into this legislation in detail here, but will only point out that it restricts the immunity which had traditionally been invoked by Latin American governments and public entities in respect of their activities abroad. The new legislation favours creditors, identifying and expanding on those cases in which they can exercise their rights before the courts of those countries, and restricting the occasions on which foreign defendants may invoke immunity of jurisdiction or of execution with respect to their persons or properties.

In addition to reaffirming the immunity of

jurisdiction and of execution of a foreign State and its agents or enterprises in respect of federal and state courts, the United States law lists several exceptions to this immunity. These include cases when the foreign State expressly or implicitly waives jurisdiction and cases relating to the commercial nature of the act.

One example of an explicit waiver of immunity is the clause usually included in treaties on trade, friendship and shipping which the United States has signed with several countries (Crawford, 1981, p. 826). With regard to tacit or implicit waivers, it was noted, during discussions on the law in Congress, that the courts have considered that immunity is implicitly waived when a foreign State accepts arbitration in another country or when a foreign State agrees that the law of a given country is applicable to the contract.<sup>36</sup> As is known, most loan contracts signed by the Latin American public sector include clauses on the application of foreign jurisdictions or laws and this, according to the above interpretation, would constitute an implicit waiver of immunity.

The exception based on the commercial nature of the act includes the following three situations: i) commercial activities carried out in the United States by a foreign State, its agencies or enterprises; ii) acts carried out in the United States in connection with commercial activities carried out in another place by a foreign State, its agencies or enterprises; and iii) acts carried out outside the territory of the United States by a foreign State, its agencies or enterprises, in connection with commercial activities also carried out outside that territory but which produce direct effects in the United States.<sup>37</sup>

The original bill included a provision in which a distinction was made between the public debt of the central government and that of its political subdivisions, agencies or instrumentalities and immunity of jurisdiction was granted only to the central government but not to the other bodies. Although this provision was eliminated from the final text, the interpretation has been that this means that both the public debt of the

<sup>31</sup>Twycross v. Dreyfuss, 5 Ch. D. 605, 616 (C.A. 1877).

<sup>32</sup>The text of this convention appears in "17 International Legal Materials", Washington D.C. (1978), p. 1123.

<sup>33</sup>Communication from the Deputy Legal Adviser to the Department of State, 19 March 1952 (26 Dept. State Bull. 984, 1952).

<sup>34</sup>Foreign Sovereign Immunities Act, No. 94-583, 21 October 1976.

<sup>35</sup>The text appears in Lauterpacht (1983).

<sup>36</sup>Report of the Senate Committee on the Immunities Act (Senate Report No. 1310, 94th Congress, 2d. Sess. 18) (1976).

<sup>37</sup>Article 1603 (d) of the Foreign Sovereign Immunities Act.

central government and that of its agencies, subdivisions or enterprises constitute commercial transactions and are governed by the same rule and hence excluded from immunity. Delaume (1977, p. 405) points out that this interpretation would be consistent with Article 4 of the European Convention, which states that all contracts, including loans and other financial transactions, between a Contracting State and private persons which are to be performed in another Contracting State, are subject to the non-immunity rule set forth in the Convention.

English law, on the other hand, has been more explicit and has established that a State does not enjoy immunity in respect of its commercial transactions. The concept of "commercial transactions", includes any loan or other transaction for the obtaining of financing and any guarantee or indemnity for such transaction or for any other financial obligation.<sup>38</sup>

The United States Act also covers the property of a foreign State and declares that it shall not be immune from attachment, sequestration and execution, without prejudice to several exceptions. One exception concerns property being used in commercial activities in the United States, which can be attached by a federal or State court when the foreign State has expressly or tacitly waived its immunity or the property has been or is being used in the commercial activities which gave rise to the lawsuit. In the case of property of agencies or enterprises of a foreign State involved in commercial activity in the United States, the exception is governed by the same rules as above, but is broader and covers

any property of such enterprises or agencies, whether or not they have been used in the aforesaid commercial activity.

Finally, as regards the property of a foreign central bank or monetary authority, there is a special rule according to which such property enjoys immunity from attachment and execution, provided the said central bank or monetary authority holds it on its own account and the government, bank or authority in question has not expressly waived immunity.

The legal provisions mentioned above give rise to difficult problems of interpretation which have to be decided by the courts. We shall not list them all, but it is worth mentioning what has already happened with mixed bank accounts of foreign embassies, agencies and central banks. In a suit against the Embassy of Tanzania,<sup>39</sup> the court authorized attachment of the Embassy's bank account because it was being used for the purchase of supplies, and this was considered to be a commercial activity. The court considered that immunity did not apply because the account had been used for other purposes and to decide otherwise would be to weaken the principle of the immunity of official bank accounts by allowing their use for commercial activity (Crawford, pp. 863 and 864).

The obvious risks of the above legal interpretation have led one author to recommend that a foreign central bank in the United States should have a number of banks accounts in order to avoid possible attachment (Patrikis, 1982, p. 287).

## VI

### Recent decisions of United States courts in lawsuits against Latin American public entities

In-1982, the problems arising from the Latin American financial crisis began to be brought up in New York courts as a result of lawsuits brought by transnational banks against Latin American

public entities which had stopped making payments on their obligations.

The decisions that have been adopted up to

<sup>38</sup>State Immunity Act, article 3, 3(b).

<sup>39</sup>Birch Shipping Corporation v. Embassy of Tanzania, 507.

now are, as we shall see, confusing and contradictory, and the controversies they have aroused in international circles are fully justified. This is not surprising if one considers the complexity of the issues raised and the fact that national courts are being forced to decide on international affairs. Although from the Latin American point of view, these decisions have already had a significant impact, inasmuch as they reveal the context and modalities within which creditors exercise their rights, we can, at this point, only make some preliminary remarks, inasmuch as judicial review procedures have not yet been concluded and the number of lawsuits that have been brought is still small. Nonetheless, whatever criteria may prevail, what does seem clear is that the act of state doctrine and the doctrine of sovereign immunity will continue to have a decisive influence on the legal decisions that may be taken.

In the judgements we shall discuss, the claim is made by a creditor who demands payment of the debt contracted by a public entity which has defaulted on one or more payments because of the enactment, by its government, of monetary control measures which have prevented it from obtaining foreign exchange to make payment. The events take place in the interval between the cessation of payment and the completion of formalities pertaining to agreements on renegotiation of the debt between the governments concerned and their creditors.

The lawsuits we shall discuss are *Frankel v. Banco Nacional de México* (hereinafter *Frankel*);<sup>40</sup> *Libra Bank Ltd. v. Banco Nacional de Costa Rica* (hereinafter *Libra Bank*);<sup>41</sup> and *Allied Bank International v. Banco de Crédito Agrícola de Cartago* (hereinafter *Allied Bank*).

### 1. *Frankel*

This lawsuit arose from the violation of obligations under a deposit contract on the part of Banco Nacional de México, a nationalized entity belonging to the Mexican State. The court accepted the immunity of jurisdiction invoked by

<sup>40</sup>*Frankel v. Banco Nacional de México*, No. 82-6457 slip, op (S.D.N.Y. 1983).

<sup>41</sup>*Libra Bank v. Banco Nacional de Costa Rica*, 570 F. Supp. 870 (S.D.N.Y. 1983).

the defendant and held that the acts which were the object of litigation were not related to the certificate of deposit but rather to the norms and regulations enacted by the Mexican Government to control its currency and organize its economy. The court pointed out that the plaintiffs' claim against the behaviour of the defendant bank was none other than that the latter had complied with its country's exchange control norms and regulations. According to the court, the control of its foreign exchange on the part of the Government of Mexico was a public act which could only be carried out by a sovereign State; it added that it was precisely that type of governmental act which could not be the object of judicial review under the doctrine of sovereign immunity.

As we have seen, in a very similar situation, such as the one arising from the devaluation of Cuban investment certificates in the French suit, the court also refused to review the acts of government. Nevertheless, although the result in both cases was the same, the doctrine invoked in French was the act of state doctrine, rather than the doctrine of sovereign immunity, which evidently would also have been the correct one to invoke in the *Frankel* case.

### 2. *Libra Bank*

In 1981, the Banco Nacional de Costa Rica (hereinafter Banco Nacional), which belonged to the State of Costa Rica, defaulted on payments on loans contracted a year before with Libra Bank. In August 1981, the Banco Central decided that the only amortization payments on external loans that would be authorized would be those owed to multilateral financing agencies. In November, the Government enacted decree No. 13103-H, which prohibited the Republic and the entities of the public sector from making capital or interest payments on the external debt without the prior authorization of the Banco Central, in consultation with the Minister of Finance. Banco Nacional did not obtain the authorization to make payments on its debt with Libra Bank and the latter sued in New York, demanding payment of the entire amount owed, arguing that the notes extended by Banco Nacional stipulated that New York would be the place of payment, and there was a clause in the contract

whereby Banco Nacional expressly accepted to be sued in that city.

Libra Bank asked for a summary judgement and Banco Nacional invoked, in its defence, the act of state doctrine, arguing that it had not been able to make payment because of the imposition of exchange restrictions in Costa Rica which constituted a decision that was not subject to judicial review.

The court accepted the claim and rejected the defence of Banco Nacional with a reasoning which we can only qualify as unusual. The Court stated that the *situs* of the debt was New York and not Costa Rica and then drew an analogy between Costa Rica's action and the confiscation of the goods and property of King Faisal n by the Government of the Republic of Iraq. In the latter case, the courts refused to grant extra-territoriality to Iraq's confiscation decrees in respect of the goods which Faisal possessed in New York, arguing that, although the decrees constituted an act of state, such an act of state only affected the goods located within the territory of Iraq; with respect to those located in the United States, the courts would only enforce the decrees to the extent that they were consistent with the policy and law of the United States.<sup>42</sup> The court reached the conclusion that the decrees were not consistent with the policy and law of the United States and therefore refused to enforce them. In the case of Costa Rica, the court considered that the 1981 decrees could not have extra-territorial effect but that the acts equivalent to confiscation were not the decrees but rather the government's decision to deprive Libra Bank of the right of receiving the payment owed to it by Banco Nacional. This decision of the Government of Costa Rica was assimilated to the act of confiscation by Iraq, with the only difference, according to the court, that in the latter case the property confiscated was tangible, while in the case of Costa Rica, it was intangible. After concluding that the *situs* of the debt was New York, the court, without analysing the 1981 decrees, considered the act of state doctrine to be inapplicable because the acts of the Government of Costa Rica could only have had extra-territorial effect to the extent that they were consistent with the policy

and law of the United States. Considering that the acts in question were qualified as confiscatory and that no compensation was paid and that they would be repugnant to the constitution and laws of the United States, the Court refused to give validity to the defence of Banco Nacional based on the act of state doctrine and accepted the claim by Libra Bank.

This decision also seems wrong and shows a failure to recognize the reasons of public order which lead a country affected by a severe financial crisis to restrict foreign exchange transactions. The assimilation of a government act prohibiting payment abroad in foreign exchange to the confiscation of the goods of a deposed monarch and the use of this as grounds for a sentence only reveals a regrettable confusion on the part of the court.

### 3. *Allied Bank*

The events which gave rise to this lawsuit were identical to those of the Libra Bank case. Allied Bank is the leader of a consortium of 39 banks which also brought suit in New York against a group of banks belonging to the Government of Costa Rica which had gone into default because of the 1981 decrees of that Government.

The defendants (hereinafter Banco de Cartago), based their defence on the sovereign immunity and the act of state doctrines. The first defence was rejected because the judge considered that the collection of a note, which was what gave rise to the suit, constituted a commercial act to which immunity did not apply. On the other hand, the judge did accept the defence based on the act of state doctrine because he considered that what had prevented Banco de Cartago from meeting its obligations with Allied were the Banco Central decisions, which the United States courts could not review. The judge added that a decision in favour of Allied in this case would entail a determination that the defendants would have to make a payment which went against the orders of their government. This, according to the judge, would bring the United States judiciary into conflict with a foreign government, and that would upset relations between the executive branch of the United States Government and the Government of Costa Rica.

<sup>42</sup>Republic of Iraq-First National City Bank (353 F 2d 47 (2d Cir 2965), cert, denied, 382 U.S. 10271 (1966)).



In short, in this case, the court reached different conclusions than the judge in the *Libra Bank* case, despite the fact that the events and the defendants' arguments were the same. Nevertheless, the *Allied* case brought up an interesting side issue.

In July, 1983, the parties abandoned the suit while steps were being taken to reschedule Costa Rica's external debt. On 9 September of the same year, the Government of Costa Rica and the Banco Central signed a refinancing agreement with *Allied* and its representatives; of the 39 banks involved, however, one rejected the agreement: Fidelity Union Trust Company of New Jersey (*Fidelity*), which continued with the suit.

The Court of Appeals rejected *Fidelity's* appeal, but for reasons entirely different from those adduced by the trial judge. The Court took into consideration the fact that the economic crisis of Costa Rica had led the executive and legislative branches of the United States Government to provide economic assistance to that country and that, moreover, in the negotiations of the Club of Paris, the United States had approved the renegotiation of Costa Rica's intergovernmental debt. This circumstance was taken into account by the Court in rejecting *Fidelity's* argument on the inapplicability of the act of State doctrine, on the grounds that the *situs* of the obligation was New York and not Costa Rica. The Court's reasoning was that when the goods or contractual obligations affected by a decision of a foreign

government are located in the United States, the courts will only recognize their validity when that is consistent with the policy and law of the United States.

The court reached the conclusion that the decisions of the Costa Rican Government which resulted in the prohibition to pay the external debt were consistent with the policy and law of the United States and to support this conclusion, it referred to an 1883 decision.<sup>43</sup>

On that occasion, the Supreme Court rejected a demand for payment brought by United States citizens holding bonds in a Canadian railway company on the grounds that the company was being reorganized and was negotiating an agreement with its creditors. The Court considered this to be in harmony with the spirit of the bankruptcy laws recognized in all civilized countries. Similarly, the Court continued, Costa Rica's prohibition against making payments on its foreign debt was analogous to the reorganization of a business envisaged in the United States Bankruptcy Law<sup>44</sup> and did not constitute repudiation of its obligations, but rather an extension of payment made in good faith for the purpose of renegotiating its obligations. In brief, the court decided that the decrees and decisions of the Costa Rican Government which prevented Banco de Cartago from paying its obligations in New York were consistent with the policy and law of the United States and that its validity should be recognized by the courts of that country.

## VII

### Conclusions

It is evident from the above that the legal aspects of negotiations concerning the refinancing or rescheduling of the Latin American public debt are extremely complex. Naturally, the legal aspects are only one part—though a very fundamental one—of the issue, and must be viewed within the broader context of relations between the Latin American governments and public entities and the transnational commercial banks.

In light of the analysis we have made and of the need for these countries to take more suitable

measures to protect their interests, we would like to make the following suggestions:

- a) The debtor countries should contract for permanent consultant services in London and/or New York. The consultant(s) should
  - i) centralize, co-ordinate and make avail-

<sup>43</sup>Canada Southern Railway Co. and Gebbhard, 109 U.S. 527 (1883).

<sup>44</sup>United States Bankruptcy Law, chapter 11, 11 U.S.C., paras. 1101-74(1982).

- able to governments the up-to-date information needed for an adequate renegotiation of each country's public debt; and
- ii) provide the legal advice that is essential for the proper conduct of the relevant negotiations.
- b) In emphasizing to the governments of the industrialized countries the importance of recognizing the political nature of the debt, the debtor countries should insist on:
- i) an increase in the contributions of governments of industrialized countries to the international financing agencies, as a means of increasing the supply of public credit to Latin America and counteracting the high cost of private credit and the burden which the service of this type of credit represents for the development of the region;
  - ii) the adoption, in any renegotiation, of the imperative norm that the burden of the debt shall not be in excess of an amount that is compatible with each debtor country's payment capacity and development needs; and
  - iii) consideration of specific formulas for reducing the burden of the debt, which may include conversion into bonds at fixed prices and interest rates, whose collection and management might be entrusted to an existing intergovernmental entity or to one which might be established in future.

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