THE ASIAN CURRENCY CRISIS – DEBT RESTRUCTURING

PHILIP WOOD

Senior Partner
Allen & Overy, London

INTRODUCTION

This note is intended as a background to the Asian currency crisis so as to put it into historical context, as I also comment on the moves to re-examine the bankruptcy laws of the affected countries.

STATE INSOLVENCY AND ITS HISTORY

The Asian currency crisis in one more stage in the series of periodic bouts of the bankruptcy of states. A state becomes insolvent when it is unable to meet its foreign currency liabilities as they fall due. This usually happens when fresh credit is not available from commercial banks: commercial banks determine to cancel short-term debts and not to renew long-term debt when it falls due. The alternative bankruptcy test of deficiency of assets to cover liabilities is not appropriate. The inability to pay relates only to foreign currency obligations: a state need never be bankrupt by reason of liabilities denominated in its domestic currency because it can print as much as it wants, subject of course to the inflationary and other economic consequences.

One feature of the bankruptcy of the state is that the bankruptcy quickly feeds through to the private sector. The private sector itself may consist of financially healthy companies, but they are immediately rendered insolvent if they are unable to acquire from the central bank or in the market the foreign currency needed in order to repay their foreign currency loans. This will happen if the state itself becomes bankrupt with the result that the domestic currency depreciates or becomes worthless so that the market for foreign currency dries up or is simply not available to the private sector.

It can of course happen that the private sector simultaneously suffers a run on its credit at the same time and for the same reasons as the state itself, eg a sudden collapse in confidence by the international banking community.

What seems to have happened in the countries of East Asia is that, notwithstanding several decades of outstanding economic success and notwithstanding that these countries had substantial reserves, the international banking community lost confidence in the countries concerned, particularly in their banks and other major corporations which had borrowed large amounts of short term debt in foreign currency without hedging it and were either financially weak or, in the case of banks, had used the money to make poor loans. This borrowing in foreign currency seemed to have been encouraged by the maintenance of relatively fixed exchange rates. Coupled with these factors was a lack of transparency and information about the real credit standing of the financial sector and some of the corporations (because of poor accounting standards) and on top of this, especially in Indonesia, there was the problem of crony capitalism which, in Indonesia's case, was not merely cronyism but a serious abuse of governmental power.

The result was that the currencies of the countries collapsed in value and so the "currency crisis" can properly be called a state of insolvency although, especially in the case of Korea, this was quite momentary while the creditors agreed a standstill.

BANKRUPTCY LAW AND CULTURE

Before placing this currency crisis in the historical context of state insolvencies, it is worth diverting to discuss the role which bankruptcy law in relation to corporations plays in the context of such a situation. For example, one of the missions of the IMF has been to ensure that there are effective structures for orderly debt work-outs including appropriate bankruptcy laws at the national level.

All of the countries concerned have bankruptcy laws based more or less on European models – although Korea has a bit of the US Chandler Act of 1938 – but none of them had the latest versions of rehabilitation proceedings. Some creditors protested that there did not appear to be any bankruptcy laws – this is a complete misunderstanding – what they really meant is that there were bankruptcy laws but there was inadequate machinery for implementing them and a general cultural objection to bankruptcy as a means to resolving debtor/creditor difficulties. In Indonesia, for example, effectively the bankruptcy of corporations had been nationalised by use of the Orphan's Chamber and actual proceedings had been few and far between, not least because of government interference in the private sector. Indonesia's bankruptcy laws are based upon those of the Netherlands which are perfectly satisfactory and the Dutch lawyers, who indignantly wrote articles protesting that there was nothing wrong with the content of Indonesia's bankruptcy laws, but only with their application, were quite right.

Over the last twenty years or so, and more or less up to the fall of the Berlin Wall, virtually the entire world went through a phase of greater sympathy for the debtor and a desire to protect jobs. In the United States, this cultural approach reflected itself in the Ralph Nader consumer movement, in President Jimmy Carter's administrative policies and in the Bankruptcy Code of 1978 which is considered very debtor-protective. In France the *redressement judiciaire* of 1985 was even more debtor-protective and was explicitly intended to protect jobs according to the socialist philosophy of the government of the day. In some East Asian countries there were outbursts of extreme anti-money utopian agricultural idealism, and while these occurrences were millions of miles away from sedate bankruptcy statutes in western countries, the underlying drift in world culture over those decades seems inescapable, including the notion that the state was everything and ought to own everything. One must admit that, however, one is still far too close to these events to say whether the above sweeping generalisation are true or not, but at least they might provide a background cultural framework for the developments in bankruptcy law.

INSOLVENCY OPTIONS

The main options in relation to insolvency are three-fold:

(1) a private work-out;

(2) a judicial rehabilitation; or

(3) a liquidation.

A liquidation is a disaster because it is the stroke at midnight: it is the end of the business and the complete devastation of goodwill and the value of the assets which are sold on a break-up basis. So the real choice is between a private work-out and a judicial rehabilitation.

The advantages of a private work-out include: no insolvency stigma, eg orders, continuing credit, employees; quicker and less expensive; only banks and bondholders are involved; security is available; new money is easier; the success rate is considered to be much higher; and debt/equity conversions are in practice easier.

The disadvantages are: there may be no proper rescue culture in the country concerned, eg responsible ideas about sharing of information, disclosure, parity between banks, reaching a consensus, etc; hold-out creditors continue to hold out; parity is difficult, eg in the case of bondholders and foreign creditors; management is reluctant; there are lender liability risks; there is no time; and there are international inequalities.

Most practitioners in this field agree that a work-out is by far the best if it is achievable and, therefore, the policy of the law should be to decide whether or not to encourage work-outs or to encourage judicial reorganisation proceedings. Essentially, it comes down to bargaining position and the atom bomb theory of bankruptcy, ie each party has a nuclear bomb (the threat of a liquidation), but neither can let it off because mutual destruction is assured.

Still, I believe that a judicial reorganisation procedure for corporations is desirable and the real question is what it should say. There is now a considerable historical track record on these modern reorganisation laws which have advanced beyond the traditional deeds of arrangement, judicial managements, preventive compositions and concordats developed in the 19th century and the earlier part of this century. These, for various reasons, did not work and were little used.

Countries which over the recent twenty years have introduced reorganisation proceedings include: United States, Britain, France, Finland, Sweden, Canada, Australia, Singapore, Belgium, Austria, Germany, Czech Republic, Russia, Italy and, I believe, some countries in Latin America, although I have not reviewed their legislation.

I raise this in the context of the changes in the bankruptcy laws of Thailand, Indonesia and Korea, as well as the potential for the variation of the bankruptcy laws in other countries.

By way of summary, I think that a judicial reorganisation law for corporations should have the following characteristics:

- Entry should be relatively easy, but should require actual insolvency and reasonable feasibility. There should be at least some requirement to suggest that the return will be better than a liquidation.

- Director penalties and personal liability risks to encourage them to petition for insolvency should be very restrained since these can seriously inhibit a work-out.

- The overall control of the proceedings should be vested in a representative of the creditors, eg an administrator. The creditor's representative should have the first right to put a plan. I do not agree with the debtor's management remaining in possession – the debtor-in-possession concept in the US Chapter 11 – and I think that this approach would be wholly unsuitable for East Asian countries, as indeed it is unsuitable everywhere else. It is open to the administrator to continue to employ the existing management if he so wishes.

- There must be a stay on creditor attachments, creditor proceedings and liquidations. It is arguable that there should be a stay on creditor enforcement of security, but I am not convinced and, if there is such a stay, then there ought to be adequate protection for the secured creditor, including protection against loss of interest and losses in value in the meantime. I understand the reasons for the stay, but the real question is whether one is going to support security or not. Similar remarks apply to title finance repossessions, but here the field is murkier because these are not necessarily security approximates. In any event, security should not be demoted below new money or administrative costs.

- There should be no freeze on express rights of contract cancellation. Again, I understand the reasons for the freeze, but on the other hand there are too many contracts to create fairness and the freeze interferes with netting: it also proceeds on the assumption that the debtor can cancel and need not pay, but the creditor is prevented from doing so, notwithstanding that it is the debtor who is in default (cherry-picking). Examples of contracts which might be involved are: sales contracts for land, goods, securities and foreign exchange; construction contracts; agency contracts for securities, realty; custodianship; transportation contracts; leases of land or equipment; licences for intellectual property or software; franchising and distributorship; employment contracts; loan contracts and underwriting contracts. The insolvent may be on either side of the contract, eg a buyer or seller, agent or principal, trustee or beneficiary, lessor or lessee, licensor or licensee. I do not see how it is possible to establish a fair regime without enormous complexity and carve-outs.

- There should be no freeze or set-off. Either one has set-off, or one does not. Set-off which is abrogated on insolvency is futile.

- Whether there should be freezes on utilities, business licences and administrative orders, eg for clean up, is a matter of detail.

- As mentioned, the plan should be under the control of the representative of the creditors. The position should be left open and not too prescriptive. I favour fairly simple voting without a requirement to divide the creditors into classes. The matter should be controlled by an "unfair prejudice" rule and a rule that preferential creditors must be provided for.

- The involvement of the court should be minimal and limited to the initial order, to the approval of the plan and as a remote umpire. The involvement of the court in France, for example, is very pronounced and is fairly intense in the United States. I do not think this model is appropriate for East Asia.

- It seems inevitable that new money should rank ahead of existing creditors, but the new money should not rank ahead of secured creditors and there ought to be serious responsibilities on the administrator to have regard to potential prejudice to unsecured creditors – who would be prejudiced if the reorganisation fails, in which event the old creditors are subordinated to the new.

- There should be no shareholder vote.

- The administrator should be a qualified insolvency practitioner.

LESSONS FOR HISTORY OF STATE INSOLVENCY

It is worth examining in what way the Asian currency crisis of 1998 is the same as previous onsets of state bankruptcy and in what respects the crisis differs and whether any lessons are to be drawn from the situation.

One can dispense with the defaults of European kings such as King Edward III who ruined the banks of Bardi and Peruzzi after his accession in 1327, the massive write-offs of the Medici Bank of most of its loans to King Edward IV following his expensive embroilment in the Wars of the Roses, the disastrous bankruptcy of Spain under Philip II in the 17th century (who totally mismanaged the South American bullion deliveries) and the ruinous extravagances of Louis XIV of France. There were typical cases of over-ambitious wars and of despotic mismanagement.

Since the Napoleonic wars, there have been six periods of widespread defaults.

1825 – 1835

The first foreign bond default on the London Stock Exchange was an 8% £500,000 loan to Joseph I, Emperor of Germany, floated in 1706 and raised at the suggestion of the Duke of Marlborough. Apparently it was ultimately paid. It was only after the Napoleonic wars that London was besieged by states desirous of obtaining bond loans, with unhappy results. In the decade after 1825, London bond issues raised on the basis of colourful prospectuses by the newly independent South American republics quickly went into default and remained so episodically throughout much of the 19th century. Indeed, many of these countries have had a season ticket to insolvency ever since. Spain defaulted in 1823. Greece was soon in default on its romantic independence loans of 1824 and 1825 – hardly surprisingly since the nominal amount of one of the loans was £2 million, but after deduction of this and that, only £275,000 reached Greece, £60,000 of it in stores. This loan remained dishonoured until 1879.

1870s

The 1870s brought to an end another period of foreign loan mania. Again most of the defaulters were Latin American states, joined now by Turkey and Egypt. Some investors had purchased £200,000 of bonds secured on the wealth of Poyais. Poyais was in fact a swamp in South America. Portugal and Greece again went into default in the 1890s and there were scandals and select committee reports. In the 19th century, the European Continental powers, as well as the United States, made a practice of intervening in foreign states on the pretext of securing the repayment of debt and indeed there were many instances where effectively foreign states were placed under receivership, eg the Ottoman Debt Council (1881-1944) controlled by Foreign Allied Powers, and the effective receiverships of Egypt, Greece, Morocco, Santo Domingo, Haiti, Nicaragua, Panama, Cuba and Liberia – the last few established by the United States by virtue of customs receiverships.

What distinguished these 19th century defaults was the fact that most of the debt was not commercial bank debt, but was represented by bonds and it was this historical fact which gave particular prominence to the role of a trustee of bonds which is a common practice in the euromarket – except ironically in relation to states.

1930s

The next general collapse in foreign debt payments took place in the 1930s largely as a result of the Depression and as a result of the running sore of German reparations. Previously there had been a massive repudiation by the Soviets of the Tsar's foreign debt which had the most impact on French investments. The United States replaced Britain as the main provider of foreign capital. During the 1930s, all European countries (except Finland) defaulted on World War I loans made by the United States, thereby provoking much US resentment, a resentment captured by President Coolidge's remark: "They hired the money, didn't they?". Seventeen out of 20 Latin American states fell into arrears on their external bond issues. New South Wales was one of a number of British Commonwealth territories which imposed a moratorium on foreign loans and some bondholder claims were diminished by other means, eg the outlawing of gold clauses by the United States and other countries.

After World War II, many outstanding defaults remained unsettled and were adjusted by multilateral agreements.

1960s and 1970s

The 1960s and 1970s were relatively quiet in comparative terms although Latin America remained a bad spot. The first Argentine insolvency of this period was in 1956. India and Turkey were chronically insolvent during most of the 1970s. It was this period which saw the establishment of the Paris Club as a club of industrialised creditor nations under the chairmanship of the French Minister of Finance.

1980s

State insolvency in the 1980s dwarfed all previous eras. Nearly all the countries in Africa, Latin America, the independent Caribbean and most of Eastern and Central Europe became insolvent in this period. Other countries include Egypt and North Korea – virtually the whole world outside the developed countries and apart from China and the USSR.

The new features of state insolvency in the 1980s compared to a century before included (amongst other things): the de-immunisation of states from judicial process in many jurisdictions, backed by express waivers of immunity in credit contracts; the replacement of direct foreign intervention in the management of a country's finances (customs receiverships, foreign financial control, military pressure) by the orderly and voluntary economic intervention achieved through IMF programmes; limitations on the monetary sovereignty of states resulting from global economic independence; a change in the identity of creditor, namely the replacement of public bond debt by government or government-insured credits and by commercial bank loans; the relative co-ordinated efficiency of negotiating committees and commercial bank rescheduling agreements under the aegis of the Paris Club and the London Club and the proliferation of state agencies as state borrowing arms, some of which may be subject to conventional bankruptcy jurisdiction or may benefit from the veil of incorporation.

THE ASIAN CURRENCY CRISIS

The chief difference with the Asian series of insolvencies compared to previous eras is that the insolvency has primarily not only been felt at the state level, but also and more particularly at the level of the private sector in the countries concerned. As mentioned above, an otherwise financially sound company can become insolvent if it has borrowed foreign currency debt and not hedged it, but by reason of the collapse of the country's currency, is unable to obtain foreign currency from the central bank or in the market at reasonable cost. The run often starts at the level of commercial banks in the country concerned, spreads to the state itself and then quickly acts by contagion on the corporate sector. These collapses in confidence can be extremely rapid and difficult to foresee.

The result is that one is on the one hand dealing with the rescheduling of state debt and on the other hand, dealing with conventional work-outs and actual bankruptcies in relation to the corporate sector.

Although recent trends have tended to approximate states increasingly to the legal status of other subjects of law following the extensive participation by states in commercial activities, a great and inevitable disparity still exists between municipal corporate bankruptcy and the bankruptcy of a state. Some of the differences are as follows: no realisation in the case of a state (although this can be achieved by privatisations etc); a state's management cannot be displaced by creditors; states are not subject to bankruptcy proceedings whereby they can seek the protection of a freeze on creditors' attachments, suits; dissenting creditors cannot be bound by mandatory creditor plans and voting; apart from statistics, such as those collected by the IMF, there are no internationally enforced disclosure obligations; the rules relating to fraudulent preferences do not apply; the ladder of payment must be settled by the difficult process of agreement; states cannot secure a discharge from their debts except by agreement; the management of the state is not generally subject to tough rules imposing sanctions for delinquencies; interest continues to run; set-offs continue to be available. Although debt/equity conversions are not available, there are rough approximations, eg debt for debt swaps and debt for equity swaps.

On the other hand the corporate sector is subject to ordinary bankruptcy statutes: the topic of restructuring either by consensual work-out or by corporate rehabilitation proceeding is the subject of a separate talk at this Conference.

IMF AGREEMENTS

Under Article VIII, section 2(b) of the Bretton Woods Agreement establishing the IMF, there is provision for mutual recognition by the courts of IMF members of each other's exchange controls applicable to "exchange contracts" if the controls are consistent with the IMF Agreement. The effect is that if a country imposes an IMF-consistent exchange control, the municipal courts of other countries will give effect to it, regardless of an external insulating governing law for the loan contract. This provision has had a limited reception by the municipal courts. England, Belgium and the United States will not normally regard a loan contract as being within the provision, but the courts of Germany, Luxembourg and France may do so. This would point to the undesirability of the governing law and jurisdiction of these states for international loan contracts.

One might say that Article VIII 2(b) – which has not been accepted either by Australia or Mexico (very sensibly in my opinion) – was James Maynard Keynes' version of Chapter 11 of the US Bankruptcy Code, as adapted to states. The underlying objective was that states in financial difficulties could be free of the harassment of their creditors, in the same way that a company in financial difficulties can seek the protection of a judicial corporate reorganisation. It is considered fortunate that the courts of many important nations have not permitted states to use the Article for the purposes of imposing a unilateral moratorium on their creditors, and that Keynes' objectives have not been met.

There have been various moves in order to increase the protection of Article VIII 2(b) and even to implement some sort of international law equivalent of judicial rehabilitation proceedings. The argument is that states are exposed to foreign creditors by reason of the removal of the barrier of state immunity in so many legal systems.

My view would be that the question of whether states are entitled to extra protection ought to be carefully considered since the main difference with the bankruptcy of an individual or a corporation is that state's assets are not available to its creditors, whereas in the case of an ordinary domestic bankruptcy, the debtor's assets are available to creditors; further, states are not subject to the legal disciplines and bankruptcy protections which apply to their citizens.

CAUSES OF STATE INSOLVENCY

States become insolvent for much the same reasons as do corporations: mismanagement or misfortune or both. Mismanagement includes over-borrowing, government over-spending, poor financial management, inadequate financial statistics and, in some cases, particularly with despotic governments, official embezzlement, official fraud and official incompetence on a gigantic scale.

Misfortune outside the reasonable control of a state have included wars, economic slumps, increases in interest rates, collapse of commodity prices, uplifts in the price of essential imports such as oil and various acts of God.

A few recent examples will show the range of causes: Mexico became insolvent in the early 1980s because it borrowed too much; Nigeria became insolvent a little later mainly because of corruption and fraud at all levels in the society, from the government down; South Africa became insolvent because its political policies were unpopular so that commercial banks pulled their loans; Russia became insolvent around the turn of the decade because of the collapse of its empire; South Korea became insolvent for a short period at the turn of 1997/98 for no really sound reason, other than a sudden crisis of confidence by the international banking community.

CURRENCY CONVERSIONS ON BANKRUPTCY

One of the fundamental risks of a state insolvency in its impact upon the private sector is the virtually universal rule that, in a bankruptcy (and sometimes also on corporate rehabilitation) the foreign currency debts of the debtor are converted into local currency at the rate of exchange existing at the time of the judicial order for the bankruptcy or liquidation. The result is that, if the local currency is depreciating very quickly, which it usually is in this type of situation – the foreign currency creditor is effectively expropriated. Thus if the local currency is depreciating at 100% per year and the liquidation lasts for five years, a very simple calculation will show the extent to which the foreign currency claim is lawfully diminished.

The existence of this rule has led to very great pressure on foreign currency creditors to agree private work-outs rather than to pursue liquidation. The overall effect is to weaken the bargaining position of foreign currency creditors in work-out negotiations so that the negotiations can be discriminatory.

CONCLUSION

I have no particular conclusion other than to draw the simplistic moral that state insolvency is a thing of the past is really not justified by the realities, and it is unduly optimistic to think that it is a problem which is isolated or can easily be solved. The more historically minded might well consider whether the same remark also applies to wars.