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ARTICLE

SOVEREIGN DEBTORS IN DISTRESS

DAVID EHMKE*

I. THE PATH TOWARDS A SOLID DESIGN FOR SOVEREIGN DEBT LENDING

“*The price for these quasi-bailouts is tremendous.*”¹ In 2012, Christian Kirchner and I published a proposal for how to resolve the situation of financial distress for sovereign debtors. We concluded that the quasi-bailouts practiced in the European Monetary Union (EMU) have erroneous consequences for a successful monetary union and that state intervention as it has been practiced in the euro crisis creates more harm than good. The topic of sovereign distress is still hot. In this paper, I will follow the path towards a market-approach in sovereign debt restructuring that the late Christian Kirchner, in whose honor I have presented this paper at the St. Thomas Christian Kirchner Memorial Symposium, had shown in our joint-article on sovereign debt restructuring. Different crisis resolution mechanisms will be discussed,² but most importantly the *ex ante* reflections of *ex post* outcomes will be analyzed. The “Greek tragedy” and the “Argentina default poker” will be analyzed as vivid examples for prominently practiced reactions to sovereign debt distress.

The goal of this paper is to identify and analyze the challenges that creditors and sovereign debtors face in their lending relations, considering

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1. Christian Kirchner & David Ehmke, *Private Ordering in Sovereign Debt Restructuring: Reforming the London Club*, OXFORD U. COMP. L. F., http://ouclf.iuscomp.org/articles/kirchner_ehmke.shtml (last visited Aug. 14, 2015).

2. For an overview of concepts for sovereign debt restructuring see Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001* (Int’l Monetary Fund, Working Paper WP/02/133, 2002).

the *ex ante* and *ex post* perspective (i.e., the situation of financial and/or economic distress and the *ex ante* reflections of the anticipated *ex post* situation). The reputational and signaling effect of how sovereign debt crises are resolved, or could be resolved under a collective restructuring procedure along with their factual consequences in *ex ante* reflections of anticipated *ex post* outcomes, will be of particular interest. Two entirely different types of sovereign debtors in distress will be distinguished: (1) the sovereign debtor “on its own”—the Argentina case,³ and (2) sovereign debtors in a transfer union—the Greek case.⁴

It will be shown:

First, a sovereign debtor can be held legally responsible for its debt obligations. Nonetheless, enforcement against a sovereign that hides behind its national borders is a challenging undertaking. The role of creditors that hold out and attempt to enforce debt obligations may be seen as two-faced. Most scholarship is concerned with the question of how opportunistic behavior of creditors can be prevented in the interest of creditors and the debtor once the sovereign is factually insolvent.⁵ From this perspective, holdouts appear to be the troublemakers. However, as long as the sovereign debtor does not credibly commit to a restructuring regime and “rules by action” (i.e., unilaterally stops complying with its legal obligations or resorts to coercive strategies), holdouts sanction the sovereign debtor for its misconduct. From an *ex ante* perspective, the threat of holdouts’ actions has an important disciplinary function.⁶

Second, a broken debt promise affects the debtor’s reputation as a future debtor. Expectations about *ex post* outcomes are reflected *ex ante* in the debtor’s options for debt acquisition and the cost of debt capital.⁷

Third, the credibility of a national lawmaker can be inferred from its behavior as a debtor. Lost confidence in the “rule of law” and the promise of legal certainty are barriers for foreign investments into local businesses that suffer from their home countries’ misbehavior as debtors. The costs ultimately fall back on the national economy.⁸

3. See *infra* Section III.C.2.

4. See *infra* Section III.C.1.

5. For a comparative discussion of the hold-out and free-rider strategy in sovereign debt negotiations, see Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L. J. 1317 (2002); Lee C. Buchheit, G. Mitu Gulati & Ignacio Tirado, *The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings* (Jan. 22, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205704. See also Rohan Pitchford & Mark L. J. Wright, *Holdouts in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment* (Nat’l Bureau of Econ. Research, Working Paper No. 16632, 2010) (discussing comparatively the hold-out and free-rider strategy in sovereign debt negotiations). See *infra* Section IV for discussion regarding proposals for sovereign debt restructuring mechanisms, which deal explicitly with inter-creditor problems.

6. See *infra* Sections III.A.4, III.B.1, III.B.4.

7. See *infra* Section III.B.4.

8. See *infra* Sections III.B.1, III.B.2.

Fourth, although there are decisive differences between a sovereign debtor and a private debtor, a collective procedure is still the best way to secure an *ex ante* and *ex post* efficient solution.⁹

Fifth, a debt-restructuring mechanism not only functions to regulate creditor-creditor problems of collective action and opportunistic actions, but also to exert a disciplinary effect on the debtor. What is true for private debtors is also true for sovereign debtors. In the long run, the sovereign will profit from the signaling effect of its credible commitment. The existence of a cooperative debt-restructuring mechanism reveals dubious exit strategies of unilateral actions. If a sovereign government faces a high risk to be unmasked as fraudulent debtors, opportunistic and short-sighted political actions will become less likely.¹⁰

Sixth, the costs of a bailout are tremendous. Bailing out an economically distressed debtor destroys the link between risks and returns, punishes the good and rewards the unreliable debtors in a transfer union. If the interest rates of the transfer union member states converge, interest rates will lose their disciplinary function. Money is cheap for economically and financially weak debtors. A pooling equilibrium destroys the incentive for an individually solid budget.¹¹

Eventually, a predictable sovereign debt restructuring mechanism (SDRM) in public or private ordering is the keystone that stabilizes the international financial architecture—in the interest of both sovereign debtors and creditors.

II. METHODOLOGICAL ISSUES

A. *Methodological Approach*

The focus of this paper will be consequentialist. Creditors care about the risk-return rate of their investment (positive question). The possible reactions to distress are important because they determine not only the creditors' return in distress, but are crucial for the probability (the incremental risk) that distress occurs. Creditors adjust their price expectations to the probability of distress occurring and their return in distress.

The political agents of the sovereign debtors can be expected to orient themselves to their fate in distress; they may be rescued in a bailout or be subject to a collective procedure to which they have bound themselves, and so forth. Debtors consider their reputation in lending relations for debt capital raising (i.e., the cost of debt capital and the opportunities for its acquisition). Furthermore, they are interested in attracting foreign investments into their local economy. Contagious effects of the debtor's previous misbehavior in lending relations on their reputation as a "host country" for invest-

9. See *infra* Section IV.A.

10. See *infra* Sections III.B.1, III.B.3, IV.A, IV.B, IV.C.

11. See *infra* Sections III.A.3, III.B.1, III.B.3.

ments into local businesses have to be accounted for. Since all parties are concerned with the factual consequences of their credit relations, the methodological approach cannot be purely legal, but must be consequentialist; that is, it must be a law and economics methodology.

The toolkit for analysis that shall be applied to questions addressed in this paper will be based on the methodological approach of the New Institutional Economics (NIE).¹² The laureate Christian Kirchner contributed significantly to the development of the consequentialist method. He was a pioneer in the introduction of NIE methodology in Germany.¹³ NIE focuses on the rules of the game. The question is how does the institutional setting affect the actions of individual players. The framework conditions are the scarcity of resources and existence of transaction costs,¹⁴ as well as incomplete and asymmetrically allocated information. It is assumed that the individual players act with bounded rationality¹⁵ and are self-interested towards their own goal. It is further assumed that they neglect harm to other players if that serves their own aims (opportunism).¹⁶ In order to guarantee a successful game that benefits all players, institutions should be designed in a way that avoids inefficient results and lets the players approach a win-win situation. Institutions are defined as rules fortified by an enforcement mechanism.¹⁷ The effectiveness of the institution depends on the credible enforcement of a positive sanction (a carrot) as a reward for compliance, or a negative sanction (a stick) as a punishment for non-compliance.

B. *Private and Public Ordering*

The distinction between private and public ordering is an important starting point for analysis within a national law context, since they both have their inherent qualities. While private ordering encompasses any kind of agreement between legally equal parties that are bound by rules made by themselves (self-binding regulation), public ordering comprises regulation imposed by an external body top-down (i.e., the democratic or dictatorial

12. See generally OLIVER WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985); DOUGLAS NORTH, *INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE* (1990); Ronald H. Coase, *The New Institutional Economics*, 140 J. OF INSTITUTIONAL AND THEORETICAL ECON. 229 (1984).

13. See, e.g., Heinz-Dieter Assmann, Christian Kirchner & Erich Schanze, *Ökonomische Analyse des Rechts* (UTB 1993); Christian Kirchner, *The Difficult Reception of Law and Economics in Germany*, 11 INT'L REV. L. & ECON. 277, 277–79 (1991).

14. R. H. Coase, *The Nature of the Firm*, 16 *ECONOMICA* 386 (1937).

15. See HERBERT A. SIMON, *MODELS OF MAN: SOCIAL AND RATIONAL – MATHEMATICAL ESSAYS ON RATIONAL HUMAN BEHAVIOUR IN SOCIAL SETTINGS* (1957); Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 THE Q. J. OF ECON. 99, 101–02 (1955).

16. Oliver E. Williamson, *Opportunism and its Critics*, 14 *MANAGERIAL AND DECISION ECON.* 97, 98 (1993).

17. EIRIK G. FURUBOTN & RUDOLF RICHTER, *INSTITUTIONS & ECONOMIC THEORY* 6–7 (2d ed. 2005).

state).¹⁸ The relation between private and public ordering is reciprocal. Decision-makers within each regulatory system adjust to developments in both systems. One regulatory system may be used to complement or to factually suspend and circumvent the other system. Thereby, private ordering allows for a higher degree of flexibility and adjustability to the individual case and is distinguished by a learning advantage, in contrast to public ordering decision-making, which is relatively ponderous. However, public ordering is broader-ranging, as it also binds those individuals who have not previously and expressly agreed to be bound, and can contribute to a reduction in transaction costs.¹⁹

In the context of sovereign debt relations and debt restructuring, the distinction is not as clear-cut. A public debt restructuring procedure for sovereigns with an “unsustainable debt” burden does not exist.²⁰ Private ordering exists in the form of loan/bond contracts, restructuring negotiations predetermined in loan/bond contracts, and ad hoc private agreements.²¹ A distortion in the case of private ordering is that although the sovereign has entered the stage of commercial contracting (*acta iure gestionis*), meaning the sovereign cannot claim state immunity from foreign judgments for its commercial activities,²² some sovereigns have—once troubled—treated the rules they allegedly subjected themselves to with contempt, and unilaterally declared they would pay less than they were obliged to.

Since enforcement against a sovereign is still a daunting task, the lending game involves a lot of hurdles. The case of public ordering in the context of sovereign debt is even more awkward. Even though it is theoretically possible to enforce repayment against a sovereign debtor, enforcement factually stops at the sovereign debtor’s borders.²³ The larger share of the sovereign’s assets is generally not available for distribution to the creditors. The dogma that sovereigns cannot be liquidated shall not be questioned in this paper. However, one has to note that the absence of this option removes a threat that would be available in corporate debt lending, and this impacts the behavior of the debtor’s political agents who maintain strong bargaining

18. Christian Kirchner & David Ehmke, *Recht und Staat in* HANDBUCH TRANSFORMATIONSFORSCHUN 455 (Raj Kollmorgen, Wolfgang Merkel & Hans-Jürgen Wagener eds., 2015).

19. See Christian Kirchner, *Evolution of Law: Interplay between Private and Public Rule-Making – A New Institutional Economics-Analysis*, 4 ERASMUS L. REV. 161 (2011); Kirchner & Ehmke, *supra* note 18.

20. The term “unsustainable debt” has been suggested by the IMF, and points to the challenging undertaking to define the “point of no return” for a sovereign debtor when a debt restructuring becomes necessary/recommendable. THE INTERNATIONAL MONETARY FUND, ANNUAL REPORT 2008: MAKING THE GLOBAL ECONOMY WORK FOR ALL 54 (2008).

21. For a critique of *ad hoc* private agreement in context of bailout expectations, see Barry Eichengreen & Christof Rühl, *The Bail-in Problem: Systematic Goals, Ad Hoc Means*, 25 ECON. SYS. 3 (2001).

22. See generally Foreign Sovereign Immunities Act of 1976, Pub. L. No. 94-583, 90 Stat. 2891; State Immunity Act, 1978, c. 33, (U.K.).

23. See *infra* Section III.A.4.

positions in relation to the sovereign's creditors.²⁴ Creditors claiming the repayment of the debt owed to them have to resort to other strategies that seek to punish the sovereign debtor for non-compliance with its debt promise and incentivize the sovereign to fulfill its obligations.²⁵

III. THE CHALLENGES AHEAD

A. *The Ex Post Perspective: Sovereign Debtors in Financial and/or Economic Distress*

1. *Preliminary Considerations*

Creditors and debtors adjust their actions based on their expectations about the probability of distress and its consequences. Players on the side of creditors and debtors invest more or less effort in monitoring and control mechanisms aimed at reducing the risk of an unsustainable debt burden (or may even facilitate a default) depending on what the individual players assume their individual harm or benefit to be in the anticipated case.²⁶ If a cloudy body of creditors makes effective monitoring and control less likely, the increased risk will be priced into the cost of debt capital. If an opaque situation for debt restructuring or a dilemma situation diminishes the chance of an efficient outcome, the risk will be, again, accounted for by the disadvantage of the debtor *ex ante*. Since all players orient their actions *ex ante* to their expectations about the situation of distress and its consequences, it appears appropriate to begin with the *ex post* perspective on financial and/or economic distress before analyzing the *ex ante* reflections.

2. *A Cloudy Body of Creditors*

Publicly offered and traded debt has become a major source of sovereign debt capital acquisition and has widely replaced commercial bank loans for private creditors since the debt crisis in Latin America.²⁷ This has important implications. Debtors benefit from the opportunity to attract various creditors that can more easily diversify their portfolio and flexibly trade their claims on secondary markets.²⁸ The bond covenants can be assumed to be less strict, giving the sovereign debtor more room to maneuver than with bank loan covenants. Moreover, debt capital acquisitions on capital markets

24. See *infra* Section III.A.4.

25. See *infra* Section III.A.4.

26. For a discussion on *ex ante* calculations of creditors in corporate bond investments see David Christoph Ehmke, *Publicly Offered Debt in the Shadow of Insolvency*, 16 EUROPEAN BUS. ORG. L. REV. 63 (2015).

27. See John Clark, *Debt Reduction and Market Reentry under the Brady Plan*, FRBNY QUARTERLY REV. WINTER 38, 44–45 (1993); Philip J. Power, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings*, 64 FORDHAM L. REV. 2701, 2715–23 (1996).

28. Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguard? The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L. J. 1043, 1070–73 (2004).

can make the sovereign less dependent on political obligations that may be (directly or indirectly) attached to bilateral debt.

The other side of the coin is that private creditors are, first and foremost, focused on their return, and thus may be less lenient than public creditors to forgive debt. Bond creditors are also less likely to have further-reaching business relations with the debtor, as compared to bank creditors that may be willing to forgive debt in order to strengthen their business relations with the debtor. Most importantly, this development has led to a cloudy body of creditors that is entirely fragmented, anonymous, and steadily changing.²⁹ Information and coordination problems (collective action problems) arise, creditors are caught in prisoner's dilemma situations, and the risk of opportunistic actions by creditors and the sovereign debtor hidden in the shadows of an opaque and disorderly situation are exacerbated.³⁰

While the Paris Club for sovereign creditors and the London Club for private creditors, as informal institutions, have proven to facilitate debt restructuring negotiations,³¹ a shift towards debt capital acquisition by publicly offered and traded bonds requires new solutions. A changing structure of the body of creditors makes a bargaining solution in spontaneous ordering (i.e., neither pre-determined by bond terms nor in a public procedure) unlikely to succeed.

The more the body of creditors is fragmented and anonymous, the higher the costs are for information and coordination once restructuring becomes necessary, and creditors have to be identified, negotiations have to take place, and a vote on a restructuring plan has to be organized. In the time of syndicated bank lending, a relatively homogeneous group of private creditors with regular inter-creditor relations could exert peer pressure on non-cooperating creditors in order to promote an agreement.³² It is a common phenomenon in restructuring negotiations that although a solution appears to be pareto-efficient, some players gamble on a higher individual outcome, neglecting harm to other players—they might do so because they are captured in a prisoners' dilemma situation.³³ They can hold out and try to delay negotiations, individually enforce their claim, or threaten the sovereign and its creditors with (long-term) negative consequences. The Argentina case presented in Section III.C gives an illustrative example for the

29. *Id.* at 1074–79.

30. See *infra* Section IV for private and public ordering answers that were developed in response to the mentioned problems.

31. For example, the London Club has functioned as a forum for debt restructuring negotiations between sovereign debtors and (syndicated) bank lenders in Latin America (1980s) and Eastern Europe (1990s). On the work of the Paris and the London Club see Richard P.C. Brown & Timothy J. Bulman, *The Evolving Role of the Clubs in the Management of International Debt*, 33 INT'L J. OF SOC. ECON. 11 (2006).

32. Power, *supra* note 27, at 2709–14.

33. On the buoying-up effect in corporate insolvency, see Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L. J. 232, 236–39 (1987).

strategic games played by sovereign debtors and holdout creditors. Proposals for a comprehensive collective restructuring procedure designed to answer the challenges of a cloudy body of creditors will be presented in Section IV.

3. *The Bailout*

A default can be avoided by a bailout from a third party. The recent sovereign debt crisis in the Eurozone was “solved” through a bailout.³⁴ A bailout of an economically healthy but financially troubled sovereign can be justified by the chance to avoid the (indirect) cost of factual insolvency through the injection of liquidity. The prevention of contagious effects for the local economy and creditors, which may be troubled with their debtor’s default, is another valid argument. Moreover, the crisis should be prevented from spreading to other countries. It is argued that if the sovereign defaults, its creditors will follow, and if such institutional creditors are system-relevant, they will have to be rescued by their national government with massive liquidity input.³⁵ This in turn can cause the rescuing sovereign to totter. The bailout should initially stop a knock-out effect.

In the case of an economically distressed country, a bailout entails the risk of curing the symptom instead of the problem itself. A bailout can weaken or destroy the link between risk and return and promote moral hazard.³⁶ In order to establish (or re-establish) the link between risk and control, a high level of institutional congruency has to be secured. The party bearing the risk and taking the responsibility in the case of distress has the strongest incentive to work toward a solid budgetary policy, and therefore should be in control in order to approach efficiency and to avoid opportunism.³⁷ Eventually, a bailout with conditions of subsequent political change will have the disadvantage of being reactive instead of preventive. A collective restructuring mechanism with a strict no-bailout principle instead con-

34. For a critical analysis of the bailout strategy, see Charles B. Blankart, *Macht der Euro süchtig?* 84 (31) FINANZ UND WIRTSCHAFT 1 (2011); Charles Blankart, *Goldgräber bedrohen Euroland in DIE ZUKUNFT DER WÄHRUNGSUNION, CHANCEN UND RISIKEN DES EURO* 291 (Dirk Mayer ed., 2012); Otmar Issing, *Moral Hazard will Result from ECB Bond Buying*, FINANCIAL TIMES NOV. 30, 2011, <http://www.ft.com/cms/s/0/41640740-1a7a-11e1-ae4e00144feabdc0.html#axzz3TG9dLFrk>.

35. For information on misleading incentives of the too-big-to-fail question, see Alan D. Morrison, *Systemic Risks and the ‘Too-Big-to-Fail’ Problem*, 27 OXFORD REV. OF ECON. POLICY 498 (2011).

36. Charles B. Blankart & David Ehmke, *Are Euro and Transfer Union the Price of German Reunification?*, in FESTSCHRIFT IN HONOUR OF CHRISTIAN KIRCHNER 665, 670–75 (Wulf A. Kaal, Matthias Schmidt & Andreas Schwartze eds., 2014). The *ex ante* costs of the bailout are further outlined in Section III.B.3.

37. Charles B. Blankart & David Christoph Ehmke, *Kostenkontrolle im Föderalismus*, 63 ZEITSCHRIFT FUER WIRTSCHAFTSPOLITIK 173 (2014); Charles Blankart & David Ehmke, *Collective Decisions on Public Debt*, work in progress presented at the 2015 Annual Meeting of the European Public Choice Society in Groningen [hereinafter Blankart & Ehmke (work in progress)].

firms the link between risk and return. In case of budgetary autonomy and an institutionally coherent no-bailout-principle, credit markets perform a control function for the debtor's budgetary policy with the interest rate as a measure of the debtor's budgetary performance.

4. *A Broken Promise: The Case of Unilateral Cessation of Payments*

The goal of this paper is not to answer what is right or wrong, just or unjust, but to draw key conclusions for a positive economic analysis. In this light, the case of unilateral cessation of payments to holdout creditors after an exchange offer is two-faced. There is one story that is well-known, quite often told by the political agents of sovereign debtors in default, and by people with "good intentions" concerned about the troubled sovereign's citizens' benefit. The moral of that story is simple: a sovereign seeks relief from an "unsustainable" debt burden. The sovereign's citizens struggle and long for a second chance, a fresh start. The sovereign's government plays fair and is thus seen to be in the best position to assess and decide on the appropriate haircut. Those who do not accept the sovereign's offer to exchange are greedy investors. However, the most evil villains enter the game when the sovereign is in severe distress. They buy original claims and attempt to enforce repayment against the sovereign through litigation and devious enforcement strategies. Such "vulture funds" speculate on excessive profits.

There exists another less prominent version of that story—a debtor breaks its promise to repay its loan. The debtor rejects fulfilling its legal duty and threatens its creditors: "Take what I am willing to pay or you will get nothing!" Most creditors accept, but some resist the reckless "black-mail."³⁸ Since they are individually too weak to enforce their legal rights against the sovereign debtor that hides behind its national borders, they trade their claims to a specialized creditor fund that takes the burden of risk. All around the world the fund tries to uphold the betrayed creditors' rights and restore the "rule of law" with only the distant chance that its efforts will succeed.³⁹ In the rare case that the "white knight fund" can enforce the debt promise against a sovereign, the fund will be honored with a capital treasure.

The truth lies between both stories. First, there are situations when a debt restructuring is inevitable. Second, it is hard to measure when a debt burden is "unsustainable" and how high a proper haircut would be. What is

38. See generally Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 CHI. J. OF INT'L L. 311 (2005) (emphasizing the risk for sovereign debt lending that comes from opportunistic behavior of sovereign debtors).

39. For an overview of litigation against sovereign debtors that defaulted on their obligation see Jonathan I. Blackman & Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna*, 73 LAW & CONTEMP. PROBS. 47 (2010).

required is a complex assessment of the national economy. There is no threat of liquidation, and the potential for taxation and savings is not only determined by the economy but also by political factors. Third, this process, in absence of a public sovereign debt restructuring mechanism, is disorderly if no collective action clauses allow for a majority decision binding a non-cooperating minority. The unilateral cessation of payments is clearly illegal. Fourth, funds that specialize in litigation and enforcement against a sovereign gamble on high returns when they buy bonds with a sharp discount on the secondary market; but they assume a high risk at the same time, and it is the rational choice for creditors to concentrate on outstanding bonds in order to profit from synergies in litigation and enforcement costs and the expertise of the so-called “vulture funds.” Certainly, their strategy is self-interested if not opportunistic. However, calling them “white knight funds” casts light on another function they perform even though this might not be their actual goal—a sovereign, who can shield itself against lawful enforcement behind national borders, has a strong bargaining position that the sovereign’s political agents can exploit. The threat that a creditor fund can win a title against a sovereign, and if not enforce but at least block the sovereign’s access to the international capital markets and cause serious harm to the sovereign, is a deterrent and constant reminder for sovereigns to play fair.⁴⁰ Finally, those who call for debt relief and a debtor-friendly exit from unsustainable indebtedness—in particular for developing countries—may have good intentions.⁴¹ However, such proposals factually implemented are likely to cause more harm than good, considering the *ex ante* cost in debt capital lending, with serious spill-over effects to the reputational damage to sovereign debtors.⁴²

40. The question of “vultures or vanguards” and the role of holdouts along these lines is discussed by Fisch & Gentile, *supra* note 28.

41. See generally Kunibert Raffer, *Sovereign Debt Workout Arrangements*, in *AFTER NEOLIBERALISM: ECONOMIC POLICIES THAT WORK FOR THE POOR* 88 (Jim Weaver, Didier Jacobs & Jamie Baker eds., 2002) (claiming the ideas of the United States Treasury with Chapter 9 based insolvency); Ann Pettifor, *Resolving International Debt Crises Fairly*, 17 *ETHICS & INT’L AFF.* 2 (2003) (presenting the case for institutional reforms that can better protect the human rights of citizens of sovereign debtor nations during debt crises); Kunibert Raffer, *Let Countries Go Bankrupt The Case for Fair and Transparent Debt Arbitration*, 4 *INT’L POL. AND SOC’Y* 367 (2001) (stating that Chapter 9 insolvency can be easily applied to sovereign insolvency); Ann Pettifor, *Chapter 9/11? Resolving International Debt Crises – the Jubilee Framework for International Insolvency*, JUBILEE DEBT PROGRAMME (Jan. 2002), http://www.i-r-e.org/bdf/docs/a002_jubilee-framework-for-international-insolvency.pdf (making the case for regulations that would both discipline lax lenders and reckless borrowers).

42. See *infra* Sections III.B.1, III.B.2.

B. *The Ex Ante Perspective: Sovereign Debtors in Financial and/or Economic Distress*

1. *Reputation and Signalling*

Lending, as any commercial activity, is a bet. Creditors expect to be compensated for their time and the risk they assume in providing debt capital (plus a spread), which shall incentivize creditors to overcome their inherent risk aversion.⁴³ Pricing the “appropriate risk rate” includes an estimation of (1) the risk of distress and (2) the loss in distress. Besides the probability of financial distress and the necessity to restructure the debt, creditors have to anticipate alternative scenarios of how other creditors, the sovereign debtor, and, if applicable, third parties (European Central Bank (ECB), International Monetary Fund (IMF), Eurozone member states, etc.) will behave in the case of financial and/or economic distress.

Therefore, creditors have to consider the rules of the game (i.e., the factual and legal circumstances) under which all concerned parties act—not the “legal rules in the book,” but their credible enforcement—the “law in action.”⁴⁴ Taking into account the already mentioned difficulty of enforcing repayment against a sovereign debtor, the signaling effect of the sovereign’s actions and the sovereign’s reputation to fulfill its obligation, even though this may be currently burdensome, is at least as important as the sovereign’s ability to serve its debt (e.g., by increasing the tax level).

The legal provisions to which a sovereign binds itself in a bond/loan contract, or the law to which a sovereign subjects itself in an international sovereign debt restructuring mechanism, send out an initial signal to the creditors.⁴⁵ Creditors can calculate the hypothetical scenario of distress under the assumption that the “law in the books” will be enforced as the first step. Although one might question whether a debtor should raise awareness of the possibility that its debt may need to be restructured, it is irrational to assume that creditors would punish a debtor that foresees the possibility of distress and implements a mechanism to pre-determine the

43. JONATHAN BERK & PETER DEMARZO, *CORPORATE FINANCE* 85–86 (3d ed. 2014).

44. KENNETH W. DAM, *THE LAW-GROWTH NEXUS: THE RULE OF LAW AND ECONOMIC DEVELOPMENT* 93–122 (2006); EUGEN EHRlich, *FUNDAMENTAL PRINCIPLES OF THE SOCIOLOGY OF LAW* (Walter L. Moll trans., 1936); Roscoe Pound, *Law in Books and Law in Action*, 44 *AM. L. REV.* 12, 15 (1910).

45. In Stephan J. Choi, Mitu Gulati & Eric A. Posner, *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism* (Univ. of Chi. Law & Econ., Olin Working Paper No. 541, 2011), <http://ssrn.com/abstract=1713914>, the authors show that creditors adjust their price expectations to the signal that a sovereign sends out when making its bond contract subject to a different national law. For bonds with Greek law as the governing law, creditors accordingly charged a risk premium, compared to bonds governed by English law.

restructuring since the alternative would obviously be a disorderly scenario.⁴⁶

In this context, the market reaction to the introduction of a private ordering bond debt restructuring regime: the question as to whether collective action clauses (i.e., the core element of a private ordering debt restructuring regime) raise borrowing cost for certain creditors and lower borrowing cost for other creditors is discussed controversially. Eichengreen and Mody draw the conclusion that collective action clauses (at the time of the study typical for U.K. bonds, not for U.S. bonds) decrease credit cost for strong debtors and increase borrowing cost for weak debtors.⁴⁷ They connect the rise in borrowing cost with the expectation of moral hazard. A study by Becker, Richards, and Thaichareon reveals a statistically less significant impact of collective action clauses (CAC) and does not see any negative effect on interest rates for weak debtors, concluding that strong and weak debtors receive a marginal benefit from the implementation of collective action clauses.⁴⁸ In a more recent study, Bradley and Gulati evaluate data from the post-2002 period (i.e., after 2002, when CAC became a common feature in U.S. bonds). They focus on different voting requirements for the modification of payment terms. According to their findings, the implementation of CAC lowers the cost of capital, particularly for weak debtors (with a positive correlation between lower voting standards and

46. The question as to whether collective action clauses (i.e., the core element of a private ordering debt restructuring regime) raise borrowing cost for certain creditors and lower borrowing cost for other creditors is controversial. See Barry Eichengreen & Ashoka Mody, *Do Collective Action Clauses Raise Borrowing Costs?*, 114 *ECON. J.* 247 (2004) (drawing the conclusion that collective action clauses [at the time of the study typical for U.K. bonds, not for U.S. bonds] decrease credit cost for strong debtors and increase borrowing cost for weak debtors). Eichengreen and Mody connect the rise in borrowing cost with the expectation of moral hazard. See Torbjörn Becker, Anthony Richards & Yunyong Thaichareon, *Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?*, 61 *J. OF INT'L ECON.* 127 (2003) (revealing a statistically less significant impact of collective action clauses and not seeing any negative effect on interest rates for weak debtors, concluding that strong and weak debtors receive a marginal benefit from the implementation of collective action clauses). A more recent study was conducted by Michael Bradley & Mitu Gulati, *Collective Action Clauses for the Eurozone: An Empirical Analysis*, *REV. OF FIN. I* (2013). Bradley and Gulati also evaluated data from the post-2002 period (after 2002 CAC became a common feature in U.S. bonds). They focus on different voting requirements for the modification of payment terms. According to their findings, the implementation of CAC lowers the cost of capital, in particular for weak debtors (with a positive correlation between lower voting standards and lower bond spreads) while the correlation for high voting standards and high bond spreads is negative for strong issuers (i.e. the lower the voting requirement for a change of payment terms, the higher the bond spreads). The effect is more significant for weaker debtors. Economic reasoning suggests that the chance to prevent holdout behavior should be valued by creditors to the advantage of the debtor. However, low voting standards (i.e., a cheap exit route for the debtor) send out a negative signal and may raise doubt about the debtor's financial stability. A balanced solution appears to be the implementation of a sovereign debt restructuring regime that prevents opportunistic behavior on both sides (i.e., overcomes holdout strategies but at the same time curtails the debtor's misbehavior and closes the door for an opportunistic restructuring offer by reasonable high voting standards). See *supra* Section III.A.2; *infra* Section IV.

47. Eichengreen & Mody, *supra* note 46.

48. Becker, Richards & Thaichareon, *supra* note 46.

lower bond spreads), while the correlation for high voting standards and high bond spreads is negative for strong issuers (i.e., the lower the voting requirement for a change of payment terms, the higher the bond spreads). The effect is more significant for weaker debtors.⁴⁹ Economic reasoning suggests that the chance to prevent holdout behavior should be valued by creditors to the advantage of the debtor. However, low voting standards (i.e., a cheap exit route for the debtor) send out a negative signal and may raise doubt about the debtor's financial stability. A balanced solution appears to be the implementation of a sovereign debt restructuring regime that prevents opportunistic behavior on both sides (i.e., overcomes holdout strategies but at the same time curtails the debtor's misbehavior and closes the door for an opportunistic restructuring offer by reasonably high voting standards).⁵⁰

However, the availability of a sovereign debt restructuring mechanism—either in public or private ordering—may also lead to an “efficient” rise in interest rates for certain debtors that were previously assumed to be bailed out in case of distress.⁵¹ As I will later show, such an increase in the cost of debt capital for some creditors leads to overall efficiency in an equilibrium, and finally, even benefits weaker sovereign debtors since their political agents are incentivized to work toward a solid budget in the long run.

A history of unilateral cessation of payments (i.e., of broken debt promises) shows that the “law in the books” does not suffice as a foundation for risk assessment.⁵² The law is not worth the paper if it cannot be enforced. The debtor's performance and willingness to cooperate contributes to its reputation. The same is true for a no-bailout principle in the European treaties,⁵³ which has proven to be without value.⁵⁴ Reputation building is costly but should pay off in an option value (e.g., more investment offers), lower risk rates for a reliable and predictable debt service,⁵⁵ and in the avoidance of a pooling equilibrium for a credible no-bailout policy.⁵⁶

While the process of reputation building is relatively cumbersome, reputation can be lost abruptly, and the retrieval of reputation requires even more effort and time than its initial acquisition. Reputation building takes place via reliable exercise of rules, even though acting in accordance with the rules may be a current disadvantage to the actor. In contrast, the expectation that the actor will adhere to a particular set of rules is destroyed with

49. Bradley & Gulati, *supra* note 46.

50. *See supra* Section III.A.2; *see infra* Section IV.

51. Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37.

52. *See supra* Section III.A.4 with further references, especially *supra* notes 35–38.

53. Consolidated Version of the Treaty on the Functioning of the European Union art. 123, May 9, 2008, 2008 O.J. (I 125).

54. Blankart & Ehmke, *supra* note 36, at 670–75.

55. *See infra* Section III.B.4.

56. *See infra* Section III.B.3.

the actor's (intentional) violation of similar rules.⁵⁷ The opportunistic breach of rules can always be seen as an indicator of an actor's future behavior.⁵⁸

In the case of a transfer union, the focus on the reputation of the debtor shifts to the reputation of the guarantor for the calculation of the cost of capital.⁵⁹ However, investors can still rely upon a sovereign's past opportunistic behavior to draw conclusions about the sovereign's tendency to act opportunistically for a short-term gain as a national lawmaker.⁶⁰

2. *The Stigma of the Unreliable Debtor*

a. *The Effect of the Sovereign Debtor's Reputation on its Reliability as a Debtor in its Future Lending Relations*

Clearly, the reliability of a debtor to honor its debt impacts the debtor's options for debt capital acquisition and the cost of debt capital. This can be traced quite easily by comparing interest rates and the success of bond issuances and relating this data to the credit history of a sovereign debtor (i.e., not only the mere fact that a sovereign defaulted on its debt obligations but in particular, the concrete loss suffered by creditors is important, as empirical data suggests). The cost of default in sovereign debt lending can be defined as (1) the exclusion from the debt markets, and (2) the risk premium charged for the debtor's anticipated opportunism and calculated on its past unreliability.⁶¹ Empirical research confirms the theoretical analy-

57. In Harold L. Cole & Patrick J. Kehoe, *Models of Sovereign Debt: Partial Versus General Reputations*, 39 INT'L ECON. REV. 55 (1998) (theoretically proving that a sovereign's reputation as a debtor has an impact on its reputation in other areas [e.g., that a sovereign that breaches a debt contract can be expected to act similarly opportunistically in other areas of investment]).

58. See generally Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857 (1989) (illustrating the functionality of reputational enforcement mechanisms on the example of long-distance/oversea trade and medieval trade in a time when monitoring and legal enforcement was weak).

59. Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37, at 178–79.

60. See *supra* Section III.B.2.

61. Juan Cruces and Christoph Trebesch find, based on a profound empirical analysis, that the size of a haircut is positively correlated to (1) the time that a sovereign is excluded from capital markets, and (2) the increase of bond spreads. Juan J. Cruces & Christoph Trebesch, *Sovereign Defaults: The Price of Haircuts* (Monetary Pol'y & Int'l Fin., Working Paper No. 3604, 2011). This paper confirms the theoretical analysis and quite intuitive reasoning that creditors account for the sovereign debtor's previous behavior for their future investment decisions. See Jonathan Eaton & Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis*, 48 REV. OF ECON. STUDIES 289 (1989); Sule Ozler, *Have Commercial Banks Ignored History?*, 83 AM. ECON. REV. 608 (1993) (empirically highlighting the increased cost of debt financing for previous defaults in commercial bank lending). Christine Richmond and Daniel Dias find that a sovereign debtor takes an average of 5.7 years to regain partial market access (defined as net positive bank and bond transfers) and 8.4 years for full market access (defined as net positive borrowings exceeding 1 percent GDP) (period analyzed: 1980–2005). Christine Richmond & Daniel A. Dias, *Duration of Capital Market Exclusion: An Empirical Investigation* (July

sis⁶² and quite intuitive reasoning that creditors account for the sovereign debtor's previous behavior for their future investment decisions. Cruces and Trebesch, for instance, find based on a profound empirical analysis that the size of a haircut is positively correlated to (1) the time that a sovereign is excluded from capital markets and (2) the increase of bond spreads.⁶³ Richmond and Dias find that a sovereign debtor takes in average 5.7 years to regain partial market access (defined as net positive bank and bond transfers) and 8.4 years for full market access (defined as net positive borrowings exceeding one percent GDP) for the period analyzed 1980–2005. Moreover, they prove that debtors having suffered from a shock out of their control (i.e., a natural catastrophe) regain market access significantly faster. This observation is in line with the reputation hypothesis. If a debtor totters because of events out of its control, creditors will not deduce that the debtor is unreliable and will not punish the debtor as if the default were caused by an opportunistic budget policy, et cetera.⁶⁴

b. The Effect of the Sovereign Debtor's Reputation as a National Lawmaker and as a "Host Country" for Foreign Investments

It is harder to find a price tag for another effect of the sovereign debtor's misbehavior—in lending relations, sovereigns meet with their creditors in capital markets as legal equals, though the reality is often different.⁶⁵ In the context of foreign investments in local businesses, sovereigns have the ultimate decision-making power over their own national law—as the case may be, subject to international law obligations.⁶⁶ Trade partners, entrepreneurs, and foreign investors, who are considering an investment in a private business or trade with a local company, care about the law that

1, 2009) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027844. Debtors that have suffered from a shock out of their control (i.e., a natural catastrophe) regain market access significantly faster. This observation is in line with the reputation hypothesis. If a debtor totters because of events out of its control, creditors will not deduce that the debtor is unreliable and will not punish the debtor as if the default were caused by an opportunistic budget policy, et cetera. Gelos et al. see a downward trend in the time of market exclusion: approximately two years after default for the 1990s. Their focus is on partial market access (taking the definition of Dias and Richmond). See R. Gaston Gelos, Ratna Sahay & Guido Sandleris, *Sovereign borrowing by developing countries: What determines market access?*, 83 J. OF INT'L ECON. 243 (2011).

62. Eaton & Gersovitz, *supra* note 61.

63. Cruces & Trebesch, *supra* note 61. See Ozler, *supra* note 61 (empirically highlighting the increased cost of debt financing for previous defaults in commercial bank lending).

64. Richmond & Dias, *supra* note 61. See Gelos et al., *supra* note 61 (noting a downward trend in the time of market exclusion: approximately two years after default for the 1990s. Their focus is on partial market access [taken the definition of Dias and Richmond]).

65. See *supra* Sections II.B, III.A.4.

66. The sovereign may have made itself subject to investor-protection agreements. See e.g., Jörn-Axel Kämmerer, *Der Schutz des Eigentums im Völkerrecht*, in BITBURGER GESPRÄCHE 143 (2004).

governs their contractual arrangements.⁶⁷ If the national lawmaker can be assumed to opportunistically change the law and discriminate against foreign investors, investors will price in the concomitant risk of their investment. Hence, the assumption is that a sovereign that unlawfully neglects its debt obligations will be even more willing to act opportunistically as a national lawmaker, which will have a deterrent effect on foreign investments into the national economy.⁶⁸

Empirical research supports the analytically consequent assumption that an unreliable debtor is expected to be an unreliable “host country” for foreign investments: Arteta and Hale find that a sovereign debt crisis leads to a drop of more than 20 percent for debt capital lending to private firms for the time of debt restructuring negotiations and more than two years after the debt renegotiations were concluded—the results are already adjusted to a decline in the macroeconomic performance due to the debt crisis (i.e., demand for credit); without adjustment the drop would amount to 30–40 percent. Notably, voluntary restructuring strategies (e.g., debt buybacks) did not show similar negative effects.⁶⁹ Rose empirically investigates the question as to whether debt renegotiations in the Paris Club have a negative effect on bilateral trade between the debtor and its creditor countries and finds a decline in trade of 8 percent per year for a period of fifteen years. Rose does not empirically analyze the reasons for that decline. However,

67. The impact of national insolvency law on investment decisions, for instance, has been empirically evaluated. See Sergei A. Davydenko & Julian R. Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the U.K.*, 63 J. OF FIN. 565 (2008); Rainer Haselmann, Katharina Pistor & Vikrant Vig, *How Law Affects Lending*, 23 REV. OF FIN. STUD. 549 (2010); Rafael La Porta & Florencia Lopez-de-Silanes, *Creditor Protection and Bankruptcy Reform, in RESOLUTION OF FINANCIAL DISTRESS – AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS* 65 (Stijn Claessens, Simeon Djankov & Ashoka Mody eds., 2001).

68. Carlos Arteta and Galina Hale find that a sovereign debt crisis leads to a drop of more than 20 percent for debt capital lending to private firms for the time of debt restructuring negotiations and more than two years after the debt renegotiations were concluded—the results are already adjusted to a decline in the macroeconomic performance due to the debt crisis (i.e., demand for credit); without adjustment the drop would amount to 30–40 percent. Notably, voluntary restructuring strategies (e.g., debt buybacks) did not have the outlined negative effect. Carlos Arteta & Galina Hale, *Sovereign Debt Crises and Credit to the Private Sector*, 74 J. OF INT'L ECON. 53 (2008). Andrew Rose empirically investigates the question as to whether debt renegotiations in the Paris Club have a negative effect on bilateral trade between the debtor and its creditor countries and finds a decline in trade of 8 percent per year for a period of fifteen years. Rose does not empirically analyze the reasons for that decline. However, one should note that Rose deals with debt renegotiations in an institutional setting. A debtor that breaks its debt promise, makes an exchange offer designed as blackmail, and escapes lawful enforcement signals a substantially high degree of short-sighted opportunism that should cause further damage to its trade balance. Andrew K. Rose, *One reason countries pay their debts: Renegotiation and international trade*, 77 J. OF DEV. ECON. 189 (2005). For the theoretical account see Cole & Kehoe, *supra* note 57. Similarly, Fuentes and Saravia make an empirical analysis using data from past defaults in debt owed to official creditors and FDI flows with the result that default is punished with less foreign direct investments from creditor countries depending on the frequency of default and the size of the haircut, supporting the reputation hypothesis. See Miguel Fuentes & Diego Saravia, *Sovereign Defaulters: Do International Capital Markets Punish Them?*, 91 J. OF DEV. ECON. 336 (2010).

69. Arteta & Hale, *supra* note 68.

one should note that Rose deals with debt renegotiations in an institutional setting. A debtor that breaks its debt promise, makes an exchange offer designed as a blackmail, and escapes lawful enforcement signals a substantially high degree of short-sighted opportunism that should cause further damage to its trade balance.⁷⁰ Similarly, Fuentes and Saravia make an empirical analysis using data from past defaults in debt owed to official creditors and foreign direct investment (FDI) flows with the result that default is punished with less FDI from creditor countries depending on the frequency of default and the size of the haircut, supporting the reputation hypothesis.⁷¹

Of course, investors can partially shield themselves from opportunistic national lawmakers by choosing a different national law for their contract or another jurisdiction for trial. The reason, therefore, could be that a different national law is more sophisticated and advanced in its understanding of business cases. However, even though foreign investors may secure a title for their claim in foreign courts with legal certainty, the market value of their claim is determined by the probability that they can actually enforce their claim.⁷² Thus, the question arises as to whether the enforcement variables in the country of local investment provide for an efficient and predictable outcome.

Again, the most decisive player is often the sovereign. If the national law or its practical application by the local courts does not recognize the foreign judgment, or set legal or factual barriers for enforcement, the title will be worth far less if there are not sufficient attachable assets abroad in which there is a promising perspective of enforcement. An obvious reaction may be to require assets to be held in trust as security for investments in businesses based in a country with a poor reputation. The chilling effect for investments in the national economy would be tremendously expensive. Local businesses, especially those in developing countries, which themselves cannot credibly signal to perform their obligations without the Damocles sword of an effective and predictable judicial infrastructure for law enforcement and an efficient insolvency law, would suffer the most from the lack of the sovereign's reputation.⁷³ Only those local businesses that have sufficient assets abroad or have already established an international reputation, which they will be in danger of losing if they hide behind a discriminatory national law, could send out a signal that would help them escape the shadows of their home country's (suspected) misbehavior. Eventually, tak-

70. Rose, *supra* note 68. For the theoretical account see Cole & Kehoe, *supra* note 57.

71. Fuentes & Saravia, *supra* note 68.

72. See *supra* Sections II.B, III.A.4.

73. See Davydenko & Franks, *supra* note 67; Haselmann, Pistor & Vig, *supra* note 67; La Porta & Lopez-de-Silanes, *supra* note 67. These authors underline the importance of law for equity and debt investments. The Doing Business studies by the World Bank deal similarly with the legal environment for investments.

ing the easy route in the short run is likely to have harmful consequences for the national economy in the long run.

The inferences about a sovereign's behavior in its own lending relations based on its behavior as a national lawmaker are rational. This conclusion will hold even more true if one notes that the national lawmaker is indeed "sovereign" in its national legal policy (if not bound by international law), which makes it easier for a national lawmaker to play *ex post* opportunistic strategies.⁷⁴ The sovereign that breaches a lending contract for a short-run benefit can hardly be assumed to apply a reliable policy of legal certainty and impartiality with a focus on long-run reputation building. Even if the sovereign did, it would be difficult to credibly signal a sound national legal policy. An orderly procedure can help reestablish the "rule of law" as an economic principle.⁷⁵

3. Reflections of a Bailout

In a complete market economy, the risk rate reflects the success of the sovereign's budgetary policy and exerts a disciplinary function for the government. The cost of debt capital honor and punish the sovereign's performance, which gives the sovereign an incentive to invest effort and to follow the path of a sound budgetary policy. In the long run, creditors, but even more, the debtor itself, will benefit from this incentive mechanism.⁷⁶

In order to collect the benefits of a successful and/or promising budgetary policy, the sovereign has to credibly signal its performance and a decreased risk of default to the capital markets. In a transfer union, the risk rate is not calculated by the individual debtor's performance, but by the probability of a bailout and the overall transfer union's performance.⁷⁷ The expectation of a bailout is a distortion of the individualized risk assessment. If a predictable procedure for debt restructuring is missing and if a bailout is likely, the credit costs will tend towards a pooling equilibrium rather than a

74. See generally Cole & Kehoe, *supra* note 57 (establishing the theoretical account). For an empirical account related to that question, see Fuentes & Saravia, *supra* note 68.

75. See *infra* Section IV.

76. Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37.

77. The bond yields for ten-year government bonds issued by eurozone member states illustrate the creditors' calculation. The closer the introduction of the euro came, the more the bond spreads converged. Even though the Maastricht Treaty signals a policy of self-responsibility (no bailout), the market anticipated that the no-bailout provisions would not be enforced—a pooling equilibrium led to almost similar bond spreads (e.g., Greece profited from being a member of an expected transfer union and gained access to cheap debt capital). Following the Ecofin decision on October 5, 2008, holding that member states should guarantee their national bank's debt and the feasible distress of certain peripheral Euro member states, the bond spreads of weak debtors increased sharply. A remainder of doubt as to whether a bailout would take place is the most reasonable explanation. The bailout, which then actually took place, was followed by a convergence of bond spreads. For an analysis of the pooling equilibrium problem in the EMU, see Charles B. Blankart, *What the Euro Zone Could Learn from Switzerland*, Institute of Economic Affairs (May 18, 2015), <http://www.iea.org.uk/blog/what-the-euro-zone-could-learn-from-switzerland>; Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37.

clear-cut separating equilibrium,⁷⁸ which will punish the debtors in a good way and reward the debtors in a bad way.⁷⁹ Then the incentive to invest effort will diminish and the moral hazard will rule on the side of creditors and debtors, so that the cost of the bailout may turn out to be enormous.

4. *Reflections of a Broken Promise*

If one wanted to take a biased perspective in favor of the sovereign, assuming that the citizens would suffer the most from savings and taxation and blame the creditors for being “greedy investors,” there would not be a good reason to take a different view as in the previous sections. It is still in the best interests of the sovereign’s citizens to have strong creditors that can enforce their rights and a sovereign that keeps its promises and subjects itself to a public or private ordering debt restructuring procedure. Lending to sovereigns is not a charity for private creditors. The *ex ante* reflections of risky and uncertain *ex post* outcomes can affect developing countries with a less established reputation in lending relations more harshly.⁸⁰ This does not apply only to the terms of lending and pricing (i.e., an unnecessarily high-risk rent for less stable countries that are unlikely to expect a bailout). Investors may draw conclusions about the state of legal certainty and the rule of law in a country from the sovereign debtor’s breach of credit contracts in the past, so that private businesses suffer from their home countries’ “misbehavior” as a debtor.⁸¹ If creditors are uncertain about a specific sovereign debtor’s credibility, other “comparable” sovereign debtors’ previous and current behavior will have an influence on the creditors’ calculation about the expected sovereign debtor’s performance in distress. Accordingly, the higher the uncertainty is, the more sovereign debtors suffer from external effects of other sovereign debtor’s misbehavior. It is in the debtor’s own interest to build up its reputation in order to have the ability to credibly signal its commitment to fulfill its debt obligations so as to enhance options for debt capital acquisition and to lower interest rates (i.e., the risk rate component).

Assuming that the sovereign has to pay dearly for its broken promise, there are still multiple reasons why sovereigns default. First, the absence of an orderly insolvency procedure in public and/or private ordering may force sovereigns to walk a misleading path.⁸² Second, even though it may be in the interests of the sovereign’s citizens, the political agents and decision-

78. George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. OF ECON. 488 (1970); Michael Spence, *Job Market Signaling*, 87 Q. J. OF ECON. 355 (1973).

79. Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37.

80. Ozler, *supra* note 61, at 614–16 (pointing out that countries that just recently become sovereign have to pay a risk premium [i.e., a reliable credit history let credit cost decrease]).

81. *See supra* Section III.B.2.

82. *See supra* Section III.A.2.

makers' interests can be distinct. If negative effects of their decision surface with significant delay, it is tempting for politicians to heavily discount (down to zero) those consequences that are less likely to damage their political reputation.⁸³ The problem of time inconsistency in politics appears when politicians only take into account those consequences that affect their reputation and could cause their position to totter. If flaws of a broken debt promise are hidden, the incentive for a reasonable and sometimes uncomfortable budgetary policy will fade. Moreover, even though the strategy to declare a cessation of payments on certain debt claims may be damaging to the national economy, politicians may gain a popularity bonus when they can blame "greedy investors" and "vulture funds" for their countries' "misfortune." A populist scapegoat strategy may not improve the sovereign's economic situation, but may help politicians gain reelection. The strength of an efficient sovereign debt-restructuring regime is that its existence closes down the exit route for unilateral actions justified by the emergency situation of a troubled debtor confronted with a cloudy body of creditors without any regulatory procedure to resolve the crisis.

From an *ex ante* perspective, any regime that responds to challenges of financial and/or economic distress can be evaluated according to the criteria of *ex post* efficiency, since all concerned parties that are able to adjust react *ex ante* to expected *ex post* outcomes. Investors make their investment decisions based on their expectations about the sovereign debtor's or national lawmaker's future behavior—before and during financial and/or economic distress.

C. Reality Check: Painful Solidarity and Blackmail

1. A Greek Tragedy

The prologue of the Greek debt crisis foreshadowed a tragic end for Greece and its apparently "noble rescuers." The faulty institutional design of the European treaties and political opportunism are the slow-acting poison for the Euro Monetary Union. When Greece became a member of the EMU, it was not because Greece was able to meet the criteria of budgetary discipline, but because of a cabal by the Greek administration. Other members of the EMU turned a blind eye to the betrayal.⁸⁴ To be fair, Ger-

83. Christian Kirchner, *Public Choice and New Institutional Economics*, in PUBLIC ECONOMICS AND PUBLIC CHOICE, CONTRIBUTIONS IN HONOR OF CHARLES B. BLANKART 19, 21–23 (Pio Baake & Rainald Borck eds., 2007); Christian Kirchner & David Ehmke, *Economics of Legal Concepts for Management Compensation Schemes in the Credit Sector and of their Regulation – A Critical Contribution to the European Regulatory Discussion*, OXFORD U. COMP. L. F. (2013), http://ouclf.iuscomp.org/articles/kirchner_ehmke2.shtml.

84. Charlotte Forelle and Stephen Fidler, *Europe's Original Sin: National Leaders Ignored Greece's Soaring Debt for Years*, THE WALL STREET JOURNAL (Mar. 3, 2010), <http://www.wsj.com/articles/SB10001424052748704548604575097800234925746>; Allan Little, *How 'Magic' Made Greek Debt Disappear Before it Joined the Euro*, BBC NEWS (Feb. 3, 2012) <http://www.bbc.co.uk/news/world-europe-16834815>.

many and France did undermine the credibility of the EMU criteria for a sustainable budget and therewith sent out a fatal signal to the Southern European countries.⁸⁵ Eventually, an entirely diverse group of sovereigns with strong and highly developed economies on the one hand, and comparatively weak economies on the other hand, started the common adventure of the euro.

The early euro years started in harmony. With a common currency, barriers for trade, such as unsteady exchange rates, were removed. Especially businesses that could produce high-quality goods cost-effectively could increase their exports substantially. Businesses in countries with less developed industries struggled to keep pace in competition with one single European currency. Their governments had given away the opportunity to devalue their national currency so as to increase the attractiveness of their national products for domestic and foreign buyers. What could have soon turned into a disaster stayed under the surface for quite some time. Sovereigns with a backward economy and a poor budgetary performance gained access to the common pool of a transfer union. Debt for EMU member states was priced at almost the same interest rates with just insignificant spreads between strong and weak debtors. Cheap debt enabled the governments of countries with poor economic performance to delay necessary, but painful, and most crucially, unpopular reforms. They could cure the symptoms of economic failure in competition with other EMU member states under one single currency; without that, they had to deal with the underlying problems until the Ponzi game would end.

There is only one rational explanation why Greece could borrow at a “German” rate, since the incremental risk of an unsustainable debt burden did not decrease but increased. The markets, however, expected Greece to be rescued if it became bankrupt. The markets were right. Giant rescue packages were tied and dispatched to Greece once it could not continue its Ponzi scheme on the markets anymore. However, European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) were established to grant credits and guarantees to Greece without a realistic prospect of being repaid, and most importantly, at interest rates that did not remotely reflect the default risk.⁸⁶

Illustrative of this development are the bond yields for ten-year government bonds issued by eurozone member states. The closer the introduction of the euro came, the more the bond spreads converged until there was

85. Allan Little, *Did Germany Sow the Seeds of the Eurozone Debt Crisis?*, BBC NEWS (Jan. 29, 2012), <http://www.bbc.co.uk/news/world-europe-16761087>.

86. Werner Mussler, *Hilfskredite ersparen den Griechen 8,5 Milliarden*, FRANKFURTER ALLGEMEINE ZEITUNG (June 19, 2014), <http://www.faz.net/aktuell/wirtschaft/eurokrise/griechenland/hilfskredite-ersparen-griechenland-8-5-milliarden-euro-12999178.html>; FAZ, *Griechenland Zahlt Weniger Zinsen als der Bund*, FRANKFURTER ALLGEMEINE ZEITUNG (Jan. 2, 2015), <http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/schuldendienst-griechenland-zahlt-weniger-zinsen-als-der-bund-13350685.html>.

a negligible spread—interest rates were calculated in a pooling equilibrium. Following the Ecofin decision on October 5, 2008, which held that member states should guarantee their national bank's debt and the feasible distress of certain peripheral Euro member states, the bond spreads of weak debtors increased sharply. A remainder of doubt as to whether a bailout would take place is the most reasonable explanation. The bailout, which then actually took place, was followed by a convergence of bond spreads. The pooling equilibrium was reestablished. Most notably, a new and even more attractive source of cheap money came into existence: the European "rescue loans."⁸⁷

The consequences of a European act of solidarity were devastating. While a sovereign debt restructuring mechanism may cause the concern that it does not fully respect the sovereignty of the debtor, the price of a bailout is substantially higher for the debtor and its saviors. Since a common pool financing with independent budgets is logically incoherent and sets perverse incentives to contribute less and to spend more,⁸⁸ the payers do have to take over control so as to enforce a reasonable budgetary policy. The factually insolvent debtor has to give up autonomy and sovereignty. The diktat of the *troika*⁸⁹ in eurozone member states with unsustainable debt levels, which received support from the eurozone member states, the ECB, and the IMF, is such an attempt to reestablish the link between risk-bearing, responsibility, and control. The political protest in distressed euro zone member states subject to a harsh austerity policy illustrates the displeasure and disagreement with such bailout policies that, consequently, come with a price tag in terms of less autonomy and sovereignty.

So far the theory of how a transfer union has to be designed is essentially that control and responsibility need to go hand in hand. The fact, however, that the eurozone transfer union is unsustainable is due to the sovereignty of its members. With the election of the Tsipras administration, the Greek people have expressed their disapproval of a bailout policy that came with strict conditions for austerity measures. In a recent referendum,⁹⁰ the Greek people rejected the austerity conditions they were supposed to be made subject to. The lenience the public creditors can encourage other nations to avoid or delay necessary but uncomfortable reforms—a contagious effect of a loose link between responsibility and control. While a politically opportunistic response to the Greek vote is quite likely a prolongation of the Ponzi scheme so as to disguise the malinvestment into the EMU "rescue" policy, a rational decision would be to consider the EFSF and ESM loans

87. See Blankart, *supra* note 77 (analyzing the pooling equilibrium problem in the EMU); Blankart & Ehmke (work in progress), *supra* note 37; Blankart & Ehmke, *supra* note 37.

88. See *supra* Section III.B.3.

89. European Commission, European Central Bank, and International Monetary Fund.

90. *Greece Debt Crisis: Greek Voters Reject Bailout Offer*, BBC NEWS (July 6, 2015), <http://www.bbc.co.uk/news/world-europe-33403665>.

and guarantees sunk costs and to turn the wheel to the exit of a sovereign debt restructuring mechanism.

2. *The Argentina Gamble*

After a sharp economic downturn since the late '90s, Argentina, which had accumulated an unsustainable amount of debt, defaulted on its outstanding debt obligations at the end of 2001. In order to regain access to the capital markets and foreign currencies so as to finance its imports, Argentina approached its creditors with an exchange offer for their bonds in 2005 and 2010. The offer stipulated a significant haircut (the new bonds should be valued at around one-third of their original face value). After the 2010 debt exchange, bondholders representing almost 93 percent in face value had exchanged their bonds, leaving approximately 7 percent of debt owed to holdout creditors. Argentina has refused to repay its holdout creditors so far, but rather attacked them as ruthless vulture funds.⁹¹

As previously discussed in Section III.A.4, there is a different way to think about the role of holdouts. The Argentina exchange offer can be seen as being extortionate—creditors were left without a realistic prospect to enforce their claim against Argentina. Even though they still held their legal claim they were confronted with a “take it or leave it” offer. The debtor, eventually, fashioned the conditions of its own debt restructuring. Traded bonds were concentrated in the ownership of specialized distressed debt funds that took up the challenge to enforce against Argentina. Apart from previous attempts to enforce against Argentina, the most promising strategy by the “holdout” creditors was to block Argentina’s access to the capital markets.

The Southern District Court of New York held in favor of the holdouts, led by Neuberger Berman MLP Income Fund Inc. (NML), finding that the original debt claims were valid and that Argentina was not entitled to make payments on newly issued bonds unless the original bond claims were satisfied equally. Otherwise, Argentina would be in breach of the *pari passu* clause that was part of the original bond documentation. Argentina appealed and the “holdout creditors” succeeded again.⁹² In order to effectively collect their debt claim confirmed by the Southern District Court, NML served subpoenas on two banks so as to discover Argentina’s property. The Southern District Court ordered compliance with the subpoena regarding the discovery of attachable assets. An appeal against this order was first dismissed

91. AudiovisualTelam, *Speech of the President Cristina Fernández During the United Nations General Assembly, New York, USA*, YOUTUBE (Sept. 27, 2014), <https://www.youtube.com/watch?v=EyShGogzLn4#t=1267>. In this line, see *Stand with Argentina Against the Debt Vultures*, JUBILEE DEBT CAMPAIGN, <http://jubileedebt.org.uk/actions/support-argentinas-fight-against-vulture-funds> (last visited Mar. 1, 2015).

92. *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246, 250 (2d Cir. 2012).

by the Second Circuit Court of Appeals.⁹³ The United States Supreme Court affirmed the lower courts' rulings.⁹⁴

Argentina faced a dilemma: in the exchange of offer bonds, Argentina had implemented a rights upon future offers clause (RUFO), which would grant the creditors that had accepted Argentina's restructuring plan the right to be paid in full if other creditors received full satisfaction. So, Argentina could either pay all creditors at full or face default. Argentina lacked the cash for the first option, so that it was forced into default without access to the New York capital markets. After the RUFO clause expired at the end of 2014, the Kirchner administration had aggressively blamed the holdout creditors for Argentina's misfortune. In lacking the political will to proceed with a cooperative debt restructuring, the price tag for a unilateral cessation of payments that the Argentinean population had to pay was high.⁹⁵

IV. HOW TO ESCAPE THE VICIOUS CYCLE

A. *The Economics of Insolvency Transferred to the Case of Sovereign Debt*

In a private sector economy, insolvency performs a collective debt collection and asset distribution function *ex post*,⁹⁶ and restructuring and reorganization may lead to a brighter future for the debtor's business. Thus, insolvency crucially shapes credit relations *ex ante*. Lending practices reflect expectations about the state of financial distress. Before the problem of an unsustainable debt burden occurs, insolvency procedures exert a disciplinary effect on debtors and creditors, ameliorate problems of strategic and opportunistic behavior, and essentially strengthen the link between risk and return so as to avoid moral hazard.⁹⁷ In the case of corporate debt lending, the stick or carrot that insolvency procedures provide for the directors significantly influences their actions in the vicinity of insolvency.⁹⁸ Orderly

93. *NML Capital, Ltd. v. Republic of Argentina*, 695 F.3d 201, 203 (2nd Cir. 2012).

94. *Republic of Argentina v. NML Capital, Ltd.*, 134 S. Ct. 2250, 2258 (2014).

95. See Howard S. Steel, Elnaz Zarrini & Arkady A. Goldin, *NML Capital v Argentina: A Lesson in Indenture Interpretation*, 8 *INSOLVENCY AND RESTRUCTURING INT'L* 31 (2014); Jon Hartley, *Argentina's Default: Lessons Learned, What Happens Next*, *FORBES* (Aug. 3, 2014), <http://www.forbes.com/sites/jonhartley/2014/08/04/argentinas-default-lessons-learned-and-what-happens-next/>; *Argentina Suffers from Fresh Defeat in Default Row*, *THE TELEGRAPH* (Mar. 12, 2015), <http://www.telegraph.co.uk/finance/financialcrisis/11468637/Argentina-suffers-fresh-defeat-in-default-row.html>.

96. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 *U. CHI. L. REV.* 97 (1984); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 *YALE L. J.* 857 (1982); THOMAS JACKSON, *LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

97. Ehmke, *supra* note 26, at Section "Economic Theory of Insolvency".

98. Michelle J. White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison*, in *CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES* 467 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996).

insolvency is of utmost importance in achieving *ex ante* and *ex post* efficiency. The question is whether and with what modifications the economic arguments in favor of an orderly insolvency procedure for private debtors hold once they are transferred in the case of sovereign debt.

First, in the case of private debtors, the common pool problem is a strong argument for a collective procedure. The pool of assets available for distribution is limited, and individual enforcement could lead to an inefficient deployment of resources, in particular, if resources are worth more held together than in piecemeal liquidation. From an *ex ante* and *ex post* perspective, a disorderly race to enforcement would burden all creditors with increased and unnecessary multiplied monitoring, litigation, and enforcement costs.⁹⁹ In the case of a sovereign debtor, there is neither a liquidation scenario nor a strong chance for individual enforcement if the sovereign does not hold attachable assets abroad.¹⁰⁰ The debtor is less vulnerable against individual enforcement, which could raise doubt about the necessity for a collective procedure.

There is another side of the coin—the fact that the debtor is less vulnerable makes the individual creditors, in the absence of an orderly collection and distribution procedure, more vulnerable.¹⁰¹ If there is not a transparent registration of claims held by bondholders, commercial banks, and sovereign creditors, and if the sovereign can arbitrarily decide to renegotiate the debt contracts with selected creditors and repay certain creditors in full or subject to an “unilaterally enforced haircut,” there will be a risk of opportunistic behavior by the sovereign. The sovereign debtor can discriminate in favor of those creditors with which the sovereign has close and/or constant credit, trade, and/or political relations, domestic creditors,¹⁰² or those creditors with a strong bargaining position. Predictable and factually enforced procedural rules for debt restructuring may block the sovereign debtor’s way to hidden opportunism. Again, what prevents the debtor from cheating and reduces the creditors’ risk of being exploited *ex post*, benefits the debtor *ex ante* in lower interest rates and improved options for debt capital acquisition.

Second, since a sovereign debtor will not be liquidated and can acquire further assets by raising taxes, one could question whether the pool is lim-

99. Robert K. Rasmussen, *Behavioral Economics, The Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679, 1681–82 (1998).

100. Yanying Li, *Question the Unquestionable Beauty of A Collective Proceeding for All Sovereign Debt Claims* 21–23, 24–25 (Working Paper, 2013), <http://ssrn.com/abstract=2234210>.

101. See Porzecanski, *supra* note 38.

102. The discrimination between private bondholders is difficult to implement. Since creditors can trade their claim on the secondary markets, we should expect an arbitrage trade from foreign to domestic creditors. Guembel and Sussman suggest that the median voter’s preference to repay domestic debt may, therefore, incentivize the sovereign’s government to repay its bond debt. Alexander Guembel & Oren Sussman, *Sovereign Debt without Default Penalties*, 76 REV. OF ECON. STUD. 1297 (2009).

ited. Moreover, one could ask whether all debt should be dealt with in a single collective procedure since debt with a distant maturity date could—if not being included in the collective procedure—become due in a time when the debtor has fully recovered.¹⁰³ However, similar considerations apply to the case of private debtors that continue trading to serve their obligation on a going-concern basis, possibly in a different ownership structure. So, if one rejected a sovereign debt restructuring procedure based on the argument that the pool is not limited, one could also make the corresponding argument that there is not a necessity for a collective procedure for corporate debt restructuring. Moreover, the statement that the pool of assets available for distribution to the creditors of the sovereign debtor is not limited creates the illusion that the sovereign had an unlimited tax potential. Eventually, the potential for taxation is limited and depends on the national economy. Increasing the tax rate may—in the long run—even decrease the tax volume, as it can harm the economy. Surely, the assessment of a sovereign's potential to repay its debt is a daunting task. Considering the associated potential for hidden opportunistic actions by the sovereign, it becomes even more obvious that increasing the creditors' collective bargaining power in an orderly and transparent procedure is of utmost importance.

Third, a sovereign debtor has creditors that pursue interests different from the return on their investment and are more willing to forgive debt.¹⁰⁴ Lending may have been motivated by the intention to stabilize or to promote a political ally or by the possibility to wield political influence by attaching conditions to the loan. Even though the interest may be an economic one, it may not be the debtor's payments on the loan, but the option value of established relations that motivated the investment decision. Creditors with interests other than the immediate return on their investment can be assumed to be more lenient and rather willing to accept a substantial haircut. This specialty does not contradict the need for a collective procedure at all. The *par conditio creditorum* or *pari passu* principle does not prevent debtors and creditors from individually negotiating a higher haircut than normal. Equal treatment protection (within a class) prevents creditors from being forced to sacrifice a greater share of their claim to fund the preferred treatment of others.¹⁰⁵ The separation of one debt restructuring procedure into multiple procedures is marred by an institutional deficit (i.e., the possibility for opportunistic hold out behavior). Creditors could await the haircut of other creditor groups in order to negotiate a more favorable deal on the costs of previous creditor groups' concessions. If the collective procedure were split up into several parallel debt restructuring negotiations, the prisoner's dilemma situation, in which noncooperation and holding out

103. Li, *supra* note 100, at 21–23.

104. *Id.* at 26.

105. ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 9–12, 87–91, 235–43 (4th ed. 2011); CHRISTOPH THOLE, GLÄUBIGERSCHUTZ DURCH INSOLVENZRECHT 61–66 (2010).

is a dominant strategy, would just shift to another level.¹⁰⁶ Moreover, a collective procedure with a single restructuring plan offers the transparency that can prevent opportunistic favoritism by the sovereign debtor. The economically efficient solution is still a single vote (in groups) on a single plan.¹⁰⁷ Nevertheless, while the preferred satisfaction of certain debt requires the creditors' approval, a higher debt relief can be individually agreed upon since it does not negatively affect (or may even benefit) other creditors.

To summarize, the economic considerations that call for an insolvency procedure in a private sector economy largely apply to the case of sovereign debt. There are particularities which one has to bear in mind—a sovereign will neither be liquidated nor be put under forced administration because of its sovereign status or political considerations that play a role and may motivate other sovereigns to be lenient creditors. Taking this into account, a sovereign debt restructuring mechanism can be designed to improve *ex ante* and *ex post* efficiency.

B. Sovereign Debt Restructuring in Public Procedures

In the beginning of the 21st century, when Argentina defaulted, the IMF came up with a prominent proposal for a sovereign debt restructuring mechanism in public ordering.¹⁰⁸ The SDRM applied an insolvency procedure to the special case of a sovereign debt crisis, and should have been implemented through a change of the IMF statutes binding the IMF member states, requiring them to change their national laws accordingly. Further proposals for a sovereign debt restructuring mechanism in public ordering have been presented.¹⁰⁹ As the realization that the SDRM would not be instantly feasible,¹¹⁰ private ordering solutions for a sovereign debt restructuring mechanism were designed after the model of the public ordering debt

106. Ehmke, *supra* note 26, at Section “Majority Amendment Clauses”; see Kirchner & Ehmke, *supra* note 1.

107. Ehmke, *supra* note 26, at Section “Majority Amendment Clauses”; Kirchner & Ehmke, *supra* note 1.

108. ANNE O. KRUEGER, INTERNATIONAL MONETARY FUND, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING (2002); Proposed Features of a Sovereign Debt Restructuring Mechanism, Int'l Monetary Fund (Feb. 12, 2003) (approved by François Gianviti & Timothy Geithner) [hereinafter *Proposed Features*]; The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations, Int'l Monetary Fund, (Nov. 27, 2002) (approved by François Gianviti & Timothy Geithner) [hereinafter *Design of the SDRM*].

109. See, e.g., Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763 (2003); Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, 50 INT'L MONETARY FUND STAFF PAPERS 41 (2003); Christoph Paulus, *A Statutory Proceeding for Restructuring Debts of Sovereign States*, RECHT DER INTERNATIONALEN WIRTSCHAFT (RIW) 401 (2003); Christoph G. Paulus, *Some Thoughts on an Insolvency Procedure for Countries*, 50 AM. J. OF COMP. L. 531 (2002).

110. For an analysis of why the SDRM proposed by the IMF and previous attempts to create a sovereign debt restructuring mechanism (in public ordering) have failed in the past, see Eric Hel-

restructuring procedures.¹¹¹ The features of the SDRM, which respond to the challenges of distress, have model characteristics for a later sovereign debt restructuring proposal, as outlined below.

1. *Release and Termination*

According to the IMF proposal, the right to release the procedure should belong exclusively to the sovereign. This restriction can be attributed to the sovereignty of the debtor and the resulting voluntary character of the procedure, which requires the debtor's cooperation. Therefore, the SDRM is less similar to insolvency procedures, which provide for coercive instruments, and rather is more comparable to voluntary debt restructuring schemes. Since negotiations about a debt restructuring plan require the willingness of both sides, it makes sense to give the sovereign and creditors, holding a qualified share of the outstanding debt that would be sufficient to block a restructuring plan, the right to terminate the procedure.¹¹²

Even though the sovereign gains an exclusive right to release the procedure, the pure availability of a restructuring mechanism (a) exposes any opportunistic escape to a unilateral cessation of payments because cheating on creditors will not be justified as an exit option without alternatives, and (b) is likely to cause harsh opposition by the taxpayers and voters in those countries which would otherwise bailout the debtor. Thus, the sovereign is under pressure to initiate the procedure when necessary. Moreover, the debtor has an inherent interest to start the procedure early enough to provide an efficient collective mechanism to turn around the debtor.

2. *Coordination and Information*

The more fragmented the body of creditors, the more pressing the need to assemble a representative committee to speak in favor of each creditor class's interest in order to secure a coordination of creditors' interest at the lowest possible transaction costs, and as the case may be, the confidential evaluation of sensitive information. The committee itself has to be provided with all requested information necessary to evaluate and negotiate the debt restructuring plan.¹¹³

3. *Plan, Fresh Capital, and Creditors' Vote*

The plan is finally a renegotiated debt contract between the parties, in which the creditors assent to a reduction of the principal, the interest, a prolongation of the debt, and so forth. Thereby, different groups may make

leiner, *The Mystery of the Missing Sovereign Debt Restructuring Mechanism*, 27 CONTRIBUTIONS TO POL. ECON. 91 (2008).

111. See *infra* Section IV.C.

112. *Design of the SDRM*, *supra* note 108, at 56; *Proposed Features*, *supra* note 108, at 15.

113. *Design of the SDRM*, *supra* note 108, at 42–44.

different concessions. A vote with (qualified) majorities, overall and in each creditor group, would then bind all creditors. A binding majority vote is a common feature in insolvency procedures and should overcome strategic hold out behavior and prisoner's dilemma situations. Debt claims directly or indirectly (e.g., via the central bank) held by the debtor would be disqualified since the debtor could obviously misuse its voting power.¹¹⁴ Since the inflow of fresh debt capital stops once the situation of financial distress becomes public, fresh capital should be granted priority status over other debt claims upon the qualified approval of the creditors. According to the IMF proposal, debt owed to the IMF should have unconditional (i.e., without the creditors' approval) priority, which understandably provoked criticism.¹¹⁵

4. *Guarding the Restructuring Procedure*

National insolvency laws regularly provide for some kind of a moratorium (i.e., a stay on payments and enforcement). The initial proposal of the SDRM contained an automatic stay.¹¹⁶ Since the debtor should have ample leeway in choosing the debt to be restructured in the SDRM,¹¹⁷ the protection is rather one-sided. It prevents creditors from individual enforcement or a grab race, but not necessarily debtor discrimination between its creditors. This is a dangerous option for opportunism, as previously noted.¹¹⁸ In a later version of the SDRM, the stay was replaced by a hotchpot rule. According to the hotchpot rule, creditors are excluded from payments in the plan to the amount of a previously received payment on their claim, which they have achieved through individual action.¹¹⁹ Different from a *pro-rata* rule, the body of creditors has no legal claim against them to transfer the proceeds of their action to the pool of assets available for distribution to all creditors. Thus, the hotchpot rule prevents individual action if a creditor expects to collect not substantially more than the restructuring plan satisfaction quota.

114. *Design of the SDRM*, *supra* note 108, at 31–32, 44–45; *Proposed Features*, *supra* note 108, at 13.

115. Christoph Paulus, *Die Rolle des Richters in Einem Künftigen SDRM*, in Hans Haarmeyer and Gerhard Kreft (eds) *Insolvenzrecht im Wandel der Zeit – Festschrift für Hans-Peter Kirchhof* (ZAP-Verlag 2003) 421, 426 – 427; Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 43–44 (Harvard Law Sch. Pub. Law, Research Paper No. 53, 2003), <http://ssrn.com/abstract=384220>.

116. Krueger, *supra* note 108, at 25–28.

117. *Design of the SDRM*, *supra* note 108, at 12–13.

118. *See supra* Section III.A.4.

119. *Design of the SDRM*, *supra* note 108, at 35–38; *Proposed Features*, *supra* note 108, at 10–13.

5. *Sovereign Debt Dispute Resolution Forum (SDDRF)*

Disputes about the interpretation and compliance with SDRM rules and questions concerning the debt contract should be dealt with by a specialized court having the last word and a *vis attractiva concursus*.¹²⁰ The advantage of the SDDRF would be the special knowledge acquired for sovereign debt cases, the avoidance of forum shopping, and the legal certainty to have a single authority to settle disputes. Eventually, the reputational damage would be serious if the sovereign treated the decisions of the SDDRF, to which the sovereign had subjected itself to in the IMF statutes and in its national law, with misconduct.

C. *A Market Approach to Sovereign Debt Restructuring*

Multiple proposals exist on how to deal with and resolve sovereign debt crises in private ordering.¹²¹ Any set of rules for “fair, just, or equal” treatment of creditors, but with the sovereign debtor remaining at the wheel and without introducing a comprehensive procedure, is a desperate solution. From a legal or normative perspective, one could ask whether illegal behavior would be “more” justified if the violation of the law by the wrongdoer is equally grave in every case. Will there be an excuse for fraud if all victims suffer an equal loss? Nobody would grant a private debtor the right to decide its own debt relief as long as the haircut is equal and no creditor is unfairly discriminated against. From an economic perspective, the unilateral cessation of payment without a legitimate procedure to which the parties have agreed *ex ante* is a question of reputational damage and its consequences.¹²²

This paper does not claim to provide a complete overview about private ordering proposals for sovereign debt restructuring, but following is a description of two proposals, both of which translate the economics of insolvency in private sector economy to the case of sovereign debt. The intention being to create a restructuring procedure that is able to efficiently regulate debtor-creditor issues, and of similar importance, creditor-creditor issues.

A Resolving Proceeding for Defaulting Sovereigns by Christoph Paulus¹²³ has further developed and transferred the proposals for a sover-

120. *Design of the SDRM, supra* note 108, at 58–70.

121. *See, e.g.,* Kirchner & Ehmke, *supra* note 1; Christian Kirchner and David Ehmke, *Restrukturierung von Schulden souveräner Staaten aus Forderungen privater Gläubiger: Zu einer künftigen Rolle des Londoner Clubs*, 112 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT 438–70 (2013); Christoph Paulus, *A Resolving Proceeding for Defaulting Sovereigns*, IILR 1 (2012) [hereinafter *A Resolving Proceeding*]; Christoph G. Paulus, *A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings*, in SOVEREIGN DEBT AND THE FINANCIAL CRISIS: WILL THIS TIME BE DIFFERENT? 317 (Carlos A. Primo Braga & Galli A. Vincelette eds., 2010) [hereinafter *A Standing Arbitral Tribunal*].

122. *See supra* Sections III.B.1, III.B.2, III.B.4.

123. *A Standing Arbitral Tribunal, supra* note 121; *A Resolving Proceeding, supra* note 121.

eign debt restructuring mechanism in public ordering to a private ordering approach. Key features of the “resolvency proceedings” are a “Standing Arbitral Tribunal” and the voluntary character of the proceeding. Debtor and creditors predetermine their relations in bond and loan contracts so that whatever limitations to the original claim occur *ex post*, the proceeding has no coercive element other than clearly defined procedural rules for modifications of the debt contract to which the parties have agreed *ex ante*.

Christian Kirchner and David Ehmke have presented another private ordering procedure.¹²⁴ According to their proposal, the London Club should be reformed and an informal forum for commercial bank lenders should be developed to establish an institutional discussion for all private creditors in response to the change in creditors’ structure. A core element of the reformed London Club proposal is the voluntary character of the contractual agreement and the predetermined negotiation process in bond and loan terms.

The contractual—or market—approach has certain advantages in contrast to a public procedure like the SDRM. Any feature of an efficient insolvency regime can be contractually agreed upon without the need for subjecting nonconsenting creditors to a public procedure.¹²⁵ Since changes to the debt contracts are only possible with the creditors’ consent, legal certainty is enhanced. Moreover, the procedure can be more quickly adjusted to changing circumstances and fashioned to respond to the individual case.¹²⁶ An efficient procedure can emerge from an institutional competition between different concepts to regulate debtor-creditor and creditor-creditor relations in bond and loan contracts. A learning process should be initiated.¹²⁷

Some key bond clauses include a majority amendment clause, which empowers a (qualified) majority to modify payment and non-payment terms with binding effect for all creditors. In order to prevent strategic holdout behavior between different creditor groups, all debt contracts are linked by an aggregation clause so that the creditors can vote—maybe in classes—on a single restructuring plan. The negotiation process is protected by clauses that limit the options for individual action (e.g., by concentrating on legal

124. Kirchner & Ehmke, *supra* note 1; Kirchner & Ehmke, *supra* note 121.

125. Kirchner & Ehmke, *supra* note 1.

126. Anna Gelpern & Mitu Gulati, *Innovation after the revolution: Foreign sovereign bond contracts since 2003*, 4 *CAP. MKTS. L. J.* 85 (2009). Gelpern and Gulati show developments in sovereign debt contract design and suggest that different issuers offer different combinations of bond contracts (i.e., that standardization is limited and different approaches compete on the market).

127. For an empirical analysis of the shift from “unanimous action clauses,” which do not allow for a binding majority decision, to “collective action clauses” in sovereign bond contracts, see Stephen J. Choi & G. Mitu Gulati, *Innovation of Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 *EMORY L. J.* 929 (2004). For a test confirming the expectation that creditors care about sovereign debt contracts, see Choi, Gulati, & Posner, *supra* note 45.

entitlement for the exercise and enforcement of a right in a trustee). Which law should be applicable to the debt contract, and whether and with which powers an arbitral tribunal should decide a dispute, has to be contractually agreed upon *ex ante*.¹²⁸ Terms in bond and loan contracts perform another important function in the avoidance of an unsustainable debt burden by curtailing debtor's misbehavior *ex ante* (e.g., by the introduction of a negative pledge [competing paper] clause that restricts the debtor's ability to offer security for its debt and reduces the potential to acquire further debt). The implementation of collective action clauses to regulate debtor-creditor and creditor-creditor issues has received broad political support.¹²⁹

V. OUTLOOK

A sovereign debt restructuring regime in either private or public ordering is a mainstay in the international financial architecture. It can not only resolve inter-creditor conflicts, but facilitate debt restructuring negotiations. A sovereign debt restructuring mechanism has to be designed in order to curtail the sovereign debtor's misbehavior. In the long-run interest of creditors and sovereign debtors, the sovereign debt restructuring mechanism is the superior alternative to a bailout in a transfer union as well as to a unilateral and illegal cessation of payments.

First, sovereign indebtedness in a transfer union with a predictable bailout is likely to entail tremendous moral hazard. A pooling equilibrium permits the incentive for monitoring and the disciplinary and informative function of interest rates to vanish.¹³⁰ The weaker members of a transfer union are virtually encouraged to accumulate cheap debt capital at the cost of the stronger members, while the overall incentive to invest in a solid budgetary policy (and if necessary, to tighten the belt) sharply decreases.

Second, sovereign debtors "on their own" that cannot make a credible commitment as a debtor subject to a collective procedure in case of distress, if not considered "risk free," will have to bear the cost of their own anticipated opportunism. While strong debtors are still seen as safe havens for investors, especially in times of uncertainty about where to find safe investment opportunities, weak debtors, such as developing countries, will suffer the most from the missing keystone of a credible and predictable collective restructuring procedure.¹³¹ The chance for weak debtors to escape enforcement behind sovereign borders after an "illegal" and unilateral cessation of

128. See Kirchner & Ehmke, *supra* note 1.

129. Statement by the Eurogroup (Nov. 28, 2010); *Report of the G-10 Working Group on Contractual Clauses*, BIS.ORG (Sept. 26, 2002), <http://www.bis.org/publ/gten08.pdf>; John B. Taylor, Under Secretary of Treasury for International Affairs, Speech at the Institute for International Economics: Sovereign Debt Restructuring: A US Perspective (Apr. 2, 2002).

130. See *supra* Sections III.A.3, III.B.3.

131. See *supra* Sections III.B.1, III.B.2, III.B. 4.

payment will be priced into credit cost *ex ante*.¹³² An efficient restructuring procedure, on the other hand, will decrease the cost of debt capital if the procedure itself promises to lower the cost of factual insolvency. However, debtor-friendly collective procedure that offers a cheap exit route is likely to have the opposite effect. Beyond the effect of debtors' anticipated behavior on the cost of debt capital, the signaling effects of the sovereign debtor's behavior can be expected to have an impact on the sovereign's credibility as a "host country" for investments in its national economy (apart from sovereign debt lending). The sovereign debtor's reputation should impact investors' expectations about the sovereign's behavior as a national lawmaker as far as it affects legal certainty and therewith the risk of local investments.¹³³

It can be concluded that the long-term costs and *ex ante* inefficiencies of unilateral actions by sovereign debtors and bailouts outweigh any short-term benefits of delayed default. A public and/or private ordering debt restructuring mechanism can illuminate a market-oriented exit route from disorderly and costly attempts to cure the symptoms of distress. It can provide an answer to the underlying problems of moral hazard in sovereign indebtedness.

132. *See supra* Section III.B.4.

133. *See supra* Section III.B.2.