# A Market Approach to Sovereign Debt Restructuring

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## I. A GAME WITHOUT CREDIBLE RULES

The international financial architecture for sovereign debt financing is missing its keystone—a collective procedure for restructuring sovereign debt.[1] A game without clearly defined and enforceable rules endangers all players. The sovereign debt crises in the Eurozone and the recent default of Argentina in 2014 illustrate that the factual insolvency of sovereigns is a highly topical issue.[2]

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[1] For an overview over concepts for sovereign debt restructuring: Kenneth Rogoff and Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas*, *1976 – 2001*, IMF Working Paper WP/02/133 (2002).

[2] After Argentina had rejected to make payments on bonds which were not exchanged in the 2005 and 2010 exchange offers, 'holdouts' successfully suit Argentina in the Southern District Court of New York. Confirming the original debt claim, the court ruled that Argentina were 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. See Republic of Argentina v NML Capital, Ltd. 699 F.3d 246 (2d. Cir. 2012). 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 by the Second Circuit Court (Republic of Argentina v NML Capital, Ltd. 695 F. 3d 201 (2d. Cir. 2012). The Supreme Court affirmed the previous courts' rulings in Republic of Argentina v NML Capital, Ltd 134 S. Ct. 2250 (2014). For an analysis of these decisions see: Howard Steel, Elnaz Zarrini, and Arkady Goldinstein, *NML Capital v Argentina: a lesson in indenture interpretation* 8 (2) Insolvency and Restructuring International 31 (2014).

The goal of this paper is to identify and analyze the challenges that creditors and sovereign debtors face in their lending relations, considering 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 signalling effect of how sovereign debt crises are resolved, or could be resolved under a collective restructuring procedure, will be of particular interest. Two cases will be distinguished in this respect: (1) the indebtedness of a sovereign debtor "on its own", and (2) the indebtedness of a sovereign debtor in a transfer union.

It will be shown:

(1) A sovereign debtor can be held legally responsible for its debt obligations. Nonetheless, enforcement against a sovereign that hides behind its national borders and does not honor its previous debt commitment 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 behaviour of creditors can be prevented in the interest of creditors and the debtor once the sovereign is factually insolvent[3] – and therewith deal with an essential problem in the design of an efficient sovereign debt restructuring regime. 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 to comply with its legal obligations or resorts to coercive strategies), holdouts

[3] For example: Lee Buchheit and Mitu Gulati, *Sovereign Bonds and the Collective Will* 51 (4) Emory Law Journal 1317 (2002); Lee Buchheit, Mitu Gulati, and Ignacio Tirado, *The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings*, Working Paper http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205704 accessed 1 March 2015; See also: Rohan Pitchford and Mark Wright, *Holdouts in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment*, The Review of Economic Studies 1 (2011) discussing comparatively the hold-out and free-rider strategies in sovereign debt negotiations. Proposals for sovereign debt restructuring mechanisms (more references in section IV.) deal explicitly with inter-creditor problems.

sanction the sovereign debtor for its misconduct. From an *ex ante* perspective, they perform an important disciplinary function.[4]

(2) 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.[5]

(3) 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 is a barrier for foreign investments into local businesses that suffer from their home countries' misbehaviour as a debtor. The costs ultimately fall back on the national economy.[6]

(4) 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.[7]

(5) A debt restructuring mechanism does not only function 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 signalling effect of its commitment. The existence of a cooperative debt restructuring mechanism destroys the arguments for unilaterally "enforced" restructurings, and therefore makes opportunistic and short-sighted political actions less likely. [8]

(6) The costs of a bailout are tremendous. Bailing-out an economically distressed debtor destroys the link between risks and returns, punishes the good and re-

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[4] See section III. A. 4., III B 1., III B. 4.

[5] See section III. B. 4.

[6] See section III. B. 1., III B. 2.

[7] See section IV. A.

[8] See sections III. B. 1., III. B. 3., IV. A., IV. B., IV. C.

wards the unreliable debtors in a transfer union. If the interest rates of the transfer union member states converge, interest rates will loose their disciplinary function. Money is cheap for economically and financially weak debtors. A pooling equilibrium destroys the incentive for an individually solid budget.[9]

(7) A predictable sovereign debt restructuring mechanism in public or private ordering is the keystone that stabilizes the international financial architecture.

## 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. The political agents of the sovereign debtors can be expected to orient themselves to their fate in distress, may they be rescued in a bailout or be subject to a collective procedure to which they have bound themselves, and so forth. Creditors adjust their price expectations to the probability of distress occurring and their return in distress. 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 investments into local businesses have to be accounted for. Since all parties are concerned with the factual consequences of their credit relation, the methodological approach cannot be purely legal, but must be consequentialist, that is, a law and economics methodology.

[9] See sections III. A. 3., III. B. 1., III. B. 3.

The toolkit for analysis that shall be applied to questions addressed in this paper will be based on the methodological approach of New Institutional Economics (NIE).[10] 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 scarcity of resources, the existence of transaction costs,[11] as well as incomplete and asymmetrically allocated information. It is assumed that the individual players act with bounded rationality[12] 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).[13] In order to guarantee a successful game that benefits all players, institutions shall 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.[14] 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 im-

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[10] Ronald Coase, 'The New Institutional Economics' (1984) 140 JITE 229; Douglas North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press 1990); Oliver Williamson, *The Economic Institutions of Capitalism* (Free Press 1985).

[11] Ronald Coase, *The Nature of the Firm* 16 (4) Economia 386 (1937).

[12] Herbert Simon, *Models of Man: social and rational; mathematical essays on rational human behaviour in social settings* (Wiley 1957); Herbert Simon, *A Behavrioul Model of Rational Choice* 69 (1) The Quarterly Journal of Economics 99 (1955).

[13] Oliver Williamson, *Opportunism and its Critics,* 14 Managerial and Decision Economics 97 (1993).

[14] Eirik Furubotn and Rudolf Richter, *Institutions and Economic Theory* 6 – 7 (2nd edn, University of Michigan Press 2005).

posed by an external body top-down (i.e., the democratic or dictatorial state).[15] 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 expressively agreed to be bound, and can contribute to a reduction in transaction costs.[16]

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.[17] Private ordering exists in the form of loan/bond contracts, restructuring negotiations pre-determined in loan/bond contracts, and ad hoc private agreements.[18] 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 judgements for its commercial activities,[19] some sovereigns have—once troubled—treated the rules they allegedly subjected themselves to with contempt, and unilaterally declared to 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

[15] Christian Kirchner and David Ehmke, 'Staat und Recht' in Raj Kollmorgen, Wolfgang Merkel, and Hans-Jürgen Wagener (eds), *Handbook of Transformation Research* 455 (VS Springer 2015).

[16] Christian Kirchner, *Evolution of Law: Interplay between Public and Private Law Making – A New Institutional Analysis* 4 (4) Erasmus Law Review 161 (2012); Kirchner and Ehmke (2015, n 15).

[17] The term "unsustainable debt" has been suggested by the IMF, section 4.4, and points to the challenging undertaking to define the "point of no return" for a sovereign debtor when a debt restructuring becomes necessary/recommendable.

[18] For a critic of ad hoc private agreement in context of bail-out expectations see: Barry Eichengreen and Christof Rühl, The bail-in problem: systematic goals, ad hoc means 25 Economic Systems 3 (2001).

[19] U.S. Sovereign Immunity Act 1976, U.K. State Immunity Act 1978.

more awkward. Even though it is theoretically possible to enforce repayment against a sovereign debtor, enforcement factually stops at the sovereign debtor's boarders.[20] 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 positions in relation to the sovereign's creditors.[21] 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 fulfil its obligations.[22]

## 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.[23] If a cloudy body of creditors makes effective monitoring and control less likely (section III. A. 2), 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, ac-

[20] See section III. A. 4.

[21] See section III. A. 4.

[22] See section III. A. 4.

[23] On ex ante calculations of creditors in corporate bond investments see: David Ehmke, *Publicly Offered Debt in the Shadow of Insolvency*, European Business Organization Law Review (forthcoming) section *Ex Ante Efficiency of Insolvency*.

counted 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 (III. A.) before analyzing the *ex ante* reflections (III. B.).

### 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.[24] 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.[25] 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 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.[26] Information and coordination problems (collective action problems) arise, creditors are caught in prisoner's dilemma

[24] John Clark, *Debt Reduction and Market Reentry under the Brady Plan*, FRBNY Quarterly Review Winter 38 (1993); Philip Power, *Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructuring* 64 The Fordham Law Review 2701, 2715 – 2723 (1996).

[25] Jill Fisch and Caroline Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring* 53 Emory Law Journal 1047, 1070 – 1073 (2004).

[26] Fisch and Gentile (2004, n 25) 1074 – 1079.

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.[27]

While the Paris Club for sovereign creditors and the London Club for private creditors, as informal institutions, have proven to facilitate debt restructuring negotiations,[28] 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.[29] 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.[30] 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. *NML Capital, Ltd. v Republic of Argentina* is a vivid example of the strategy of a fund to block a sovereign debtor's access to the capital markets. In this case, the fund achieved a court order to halt interest payments on the sovereign's other debt

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[27] See section IV. for private and public ordering answers that were developed in response to the mentioned problems.

[28] 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 Brown and Timothy Bulman, *The evolving role of the clubs in the management of international debt* 33 (1) International Journal of Social Economics 11 (2006).

[29] Power (1996, n 24) 2709 – 2714.

[30] On the buoying-up effect in corporate insolvency see: Mark Roe, *The Voting Prohibition in Bond Workouts* 97 Yale Law Journal 232, 236–239 (1987).

obligations, since these payments would violate the contractual *pari passu* principle, as long as holdouts' claims are not being satisfied.[31] This means creditors can set an incentive for the sovereign to fulfil its obligations. 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.[32] 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, that 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,[33] they will have to be rescued by their national government with massive liquidity input. 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

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[31] Republic of Argentina v NML Capital, Ltd. 699 F.3d 246 (2d. Cir. 2012).

[32] For a critical analysis of the bailout strategy see: Norbert Berthold and Klaus Gründler, *Dezentrale Wirtschaftspolitik in Europa: Basis einer stabilen Währungsunion* 121 Wirtschaftswissenschaftliche Beiträge des Lehrstuhls für Volkswirtschaftslehre, Wirtschaftsordnung und Sozialpolitik, Universität Würzburg (2013); Charles Blankart, *Macht der Euro süchtig?* 84 (31) Finanz und Wirtschaft 1 (2011); Charles Blankart, 'Goldgräber bedrohen Euroland' in Dirk Mayer (ed) *Die Zukunft der Währungsunion, Chancen und Risiken des Euro* 291 (Lit Verlag 2012); Ottmar Issing, *Moral hazard will result from ECB bond buying,* Financial Times (30 November 2011), < http://www.ft.com/cms/s/0/41640740-1a7a-11e1-ae4e-00144feabdc0.html#axzz3TG9dLFrk> accessed 2 March 2015.

[33] On misleading incentives of the too-big-to-fail: Alan Morrison, *Systematic risks and the 'too-big-to-fail problem* 27 (3) Oxford Review of Economic Policy 498 (2011).

risk and return and promote moral hazard.[34] 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.[35] The diktat of the *troika*[36] 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 re-establish that link. While a sovereign debt restructuring mechanism may cause a concern that it does not fully respect the sovereignty of the debtor, the price of giving up autonomy and sovereignty that factually insolvent debtors have to pay in a transfer union seems to be much higher. The political protest in distressed Eurozone member states subject to a harsh austerity policy illustrates the displeasure and disagreement with such bailout policies, which consequently come with a price tag in terms of less autonomy and sovereignty. Eventually, a bailout with conditions of subsequent political change has the disadvantage of being reactive instead of preventive. Instead, a collective restructuring mechanism with a strict no-bailout principle confirms the link between risk and return *ex ante*, and therewith lets the credit market perform a control function for the debtor's budgetary policy with the interest rate as a measure for the debtor's performance.

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

There are at least two stories to tell about the Argentina debt crisis management. In the first story, the emphasis is on the need to relieve a sovereign from an "unsustainable" debt burden and to give the sovereign's citizens a chance for a fresh start. The sovereign's government is

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[34] Charles Blankart and David Ehmke, 'Are euro and transfer union the price for German reunification?' in Kaal, W., Schmidt, M., and Schwartze, A., *Festschrift in Honour of Christian Kirchner* 665, 670 – 675 (Mohr Siebeck 2014). The *ex ante* cost of the bail-out are further outlined in section III. B. 3.

[35] Charles Blankart and David Ehmke, *Kostenkontrolle im Föderalismus* 2 Zeitschrift für Wirtschaftspolitik 173 (2014); Charles Blankart and David Ehmke, *Collective Decisions on Public Debt,* work in progress presented at the Annual Meeting 2015 of the European Public Choice Society in Groningen.

[36] European Commission, European Central Bank, and International Monetary Fund.

thus seen to be in the best position to assess and decide on the appropriate haircut. Those who did not accept the sovereign's offer to exchange its old debt obligations against a reduced debt claim (around one-third of the original face value), and instead held out, traded, or bought original claims, and tried to enforce repayment against the sovereign through litigation, are considered "greedy creditors" and "vulture funds" are blamed for using devious tactics for excessive speculative profits, which prevents the rebirth of a struggling country.[37]

There exists another version of that story—a debtor breaks its promise to repay. In this scenario, 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 "black-mail."[38] Since they are individually too weak, they trade their claims and a creditor fund takes the burden of risk. All around the world the fund tries to uphold the creditors' rights and re-store 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 that hides behind its national borders the fund will be honoured with a capital treasure.

The truth lies between both stories. 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. 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 re-quired 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 polit-ical factors. Third, this process, in absence of a public sovereign debt restructuring mecha-

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[37] Cristina Fernandez Kirchner, Speech at the 69th U.N. General Assembly, <https://www.youtube.com/watch?v=EyShGogzIn4#t=1267> (video with English subtitles) (2014). In this line, Jubilee Debt Campaign, *Stand with Argentina against the debt vultures,* < http://jubileedebt.org.uk/actions/support-argentinas-fight-against-vulture-funds> accessed 1 March 2015.

[38] Arturo Porzecanski, *From Rough Creditors to Rough Debtors: Implication of Argentina's Default* 6 (1) Chicago Journal of International Law 311 (2006). Porzecanski emphasis the risk for sovereign debt lending that comes from opportunistic behaviour of sovereign debtors.

[39] For an overview over litigation against sovereign debtors that defaulted on their obligation see: Jon-athan Blackman and Rahul Mukhi, *The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna* 73 Law and Contemporary Problems 47 (2009).

nism, 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 'vultures or vanguards' and the role of holdouts along theses lines is discussed by Fisch and Gentile (2004, n 25).

[41] Kunibert Raffer, *Let Countries Go Bankrupt, The Case for Fair and Transparent Debt Arbitration* 4 Internationale Politik und Gesellschaft (IPG) 367(2001); Kunibert Raffer, 'Sovereign Debt Workout Arrangements' in Jim Baker, Didier Jacobs, Jamie Weaver (ebs) *After Neoliberalism – Economic Policies That Work for the Poor* (Washington D.C. 2002) 88; Ann Pettifor, *Chapter 9/11? Resolving international debt crisis – The Jubilee Framework for a international insolvency* (2002) Jubilee Debt Programme <http://www.i-r-e.org/bdf/docs/a002_jubilee-framework-for-international-insolvency.pdf> accessed 7 December 2014; Ann Pettifor, *Resolving International Debt Crisis Fairly,* 17 (2) Ethics & International Affairs 2 (2003).

[42] See section 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 (ECB, 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 signalling effect of the sovereign's actions and the sovereign's reputation to fulfil 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, sends 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 in a first

[43] Jonathan Berk and Peter DeMarzo, *Corporate Finance* 85 – 86 (3th edn, Pearson 2014).

[44] Kenneth Dam, *The Law-Growth Nexus* (The Brookings Institution 2006) 93–122; Eugen Ehrlich, *Fundamental Principles oft the Sociology of Law* (W Moll tr, Harvard University Press 1936); Roscoe Pound, *Law in Books and Law in Action,* 44 American Law Review 12 (1910).

[45] In Stephan Choi, Mitu Gulati, and Eric Posner, *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechanism,* University of Chicago Law & Economics, Olin Working Paper No. 541 (2011) <http://ssrn.com/abstract=1713914> accessed 8 December 2014, 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.

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 restructuring since the alternative would obviously be a disorderly scenario[46] However, the availability of a sovereign debt restructuring mechanism—either in public or private ordering—may lead to an "efficient" rise in interest rates for certain debtors that were previously assumed to be bailed-out in case of distress.[47] 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.[48] The law is not

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[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. In Barry Eichengreen and Ashoka Mody, *Do Collective Action Clauses Raise Borrowing Cost?* 114 The Economic Journal 247 (2004) the authors 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. Eichengreen and Mody connect the rise in borrowing cost with the expectation of moral hazard. The study of Thorbjörn Becker, Anthony Richards, and Yonyong Thaichareon, *Bond restructuring and moral hazard: are collective action clauses costly?* 61 Journal of International Economics 127 (2003) reveals a statistically less significant impact of collective action clauses and does not see any negative effect on interest rates for weak debtors, concluding that strong and weak debtor receive a marginal benefit from the implementation of collective action clauses. A more recent study was conducted by Michael Bradley and Mitu Gulati, *Collective Action Clauses for the Eurozone: An Empirical Analysis*, Working Paper <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948534> accessed 2 March 2015. Bradley and Gulati also evaluated data from the post-2002 period (i.e. after 2002 CAC became a common feature in U.S. bonds). They focus on different voting requirements for the modification on payment terms. According to their findings, the implementation of CAC lowers the cost of capital and this 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 behaviour 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 behaviour on both sides (i.e. overcomes holdout strategies but at the same time curtails the debtor's misbehaviour and closes the door for an opportunistic restructuring offer by reasonable high voting standards). See therefor: sections III. A. 2, IV.

[47] Blankart and Ehmke (work in progress, n 35); Blankart and Ehmke (2014, n 35).

[48] See section III. A. 4 with further references, especially n 37 – 40.

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,[49] which has proven to be without value.[50] Reputation building is costly and should pay off in an option value (e.g., more investment offers), lower risk rates for a reliable and predictable debt service,[51] and in the avoidance of a pooling equilibrium for a credible no-bailout policy.[52]

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 the actor's (intentional) violation of similar rules.[53] The opportunistic breach of rules can always be seen as an indicator of an actor's future behavior.[54]

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.[55] However, investors can still draw conclusions about the sovereign's tendency to act opportunistically for a short-term gain as a national lawmaker from the sovereign debtor's opportunistic behavior in the past.[56]

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[49] Artt. 123 I, 125 I TEUF.

[50] Blankart and Ehmke (2014, n 34) 670 – 675.

[51] See section III. B. 4

[52] See section III. B. 3

[53] In Harald Cole and Patrick Kehoe, *Models of Sovereign Debt: Models of Partial Versus General Reputation* 31 (1) International Economic Review 55 (1998) the authors theoretically prove that a sovereign's reputation as a debtor has an impact on ist 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).

[54] Avner Greif illustrates the functionality of reputational enforcement mechanisms on the example of long-distance/oversea trade medieval trade in a time when monitoring and legal enforcement was weak: Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders* 49 (4) The Journal of Economic History 857 (1989).

[55] Blankart and Ehmke (work in progress, n 34); Blankart and Ehmke (n 34) 178 – 179.

[56] See section III. B. 2..

## 2. The Effect of the Sovereign Debtor's Reputation on its Reliability as a National Law-Maker and as a "Host Country" for Foreign Investments

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.[57] 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.[58] In the context of foreign investments in local businesses, sovereigns have the ultimate decision-making power over

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[57] In Juan Cruces and Christoph Trebesch, *Sovereign Defaults: The Price of Haircuts* 3604 CESIFO Working Paper (2011), the authors 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. This paper confirms the theoretical analysis and quite intuitive reasoning that creditors account for the sovereign debtor's previous behaviour for their future investment decisions. See therefor: Jonathan Eaton and Mark Gersovitz, *Debt with Potential Repudiation: Theoretical and Empirical Analysis* 48 (2) The Review of Economic Studies 289 (1989). In this line, Sule Ozler, *Have Commercial Banks Ignored History?* 83 (3) The American Economic Review 608 (1993) empirically highlights the increased cost of debt financing for previous defaults in commercial bank lending. In Christine Richmond and Daniel Dias, *Duration of Capital Market Exclusion: An Empirical Investigation* (2009) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1027844> accessed 1 March 2015, the authors 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 1 per cent GDP) (period analysed: 1980-2005). 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: approx. 2 years after default for the 1990s. Their focus is on partial market access (taken the definition of Dias and Richmond). See: Gaston Gelos, Ratna Sahay, Guido Sandleris, *Sovereign borrowing by developing countries: What determines market access?* 83 Journal of International Economics 243 (2011).

[58] See sections II. B, III. A. 4.

their own national law—as the case may be, subject to international law obligations.[59] Trade partners, entrepreneurs, and foreign investors, considering an investment in a private business or trade with a local company, care about the law that governs their contractual arrangements.[60] 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.[61]

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

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[59] 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* (C.H. Beck 2004).

[60] The impact of national insolvency law on investment decisions, for instance, has been empirically evaluated: Sergei Davydenko, Sergei and Julian Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the U.K.* 63 Journal of Finance 565 (2008); Rainer Haselmann, Katharina Pistor, and Vikrant Vig, *How Law Affects Lending* 23 (2) The Review of Financial Studies 549 (2010); Rafael La Porta and Florencia Lopez-de-Silanes, *Creditor Protection and Bankruptcy Reform*, in Stjin Claessens, Simeon Djankov, and Ashoka Mody (eds), *Resolution of Financial Distress – An International Perspective on the Design of Bankruptcy Laws* (World Bank Institute 2001) 65.

[61] In Carlos Arteta and Galina Hale, *Sovereign debt crises and credit to the private sector* 74 Journal of International Economics 53 (2008) the authors find that a sovereign debt crisis leads to a drop of more than 20 per cent 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 per cent. Notably, voluntary restructuring strategies (e.g. debt buybacks) did not have the outlined negative effect. In Andrew Rose, *One reason countries pay their debts: renegotiation and international trade* 77 Journal of Development Economics 189 (2005), the author empirically investigates the question as to whether a 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 per cent per year for a period of 15 years. Rose does not empirically analyses 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 a blackmail, and escapes lawful enforcement signals a substantially high degree of short-sighted opportunism that should cause further damage to its trade balance. For the theoretical account see: Cole and Kehoe (1998, n 53). 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 and Diego Saravia, *Sovereign defaulters: Do international capital markets punish them?* 91 Journal of Development Economics 336 (2010).

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.[62] 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 do not recognize the foreign judgement, 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 a 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 efficient national enforcement mechanism and finally insolvency law, would suffer the most from the lack of the sovereign's reputation.[63] Only those local business 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, taking 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 law-maker to play *ex post*

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[62] See sections II. B., III. A. 4.

[63] See references in n 60. 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.

opportunistic strategies.[64] 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 to re-establish the "rule of law" as an economic principle.[65]

### 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.[66]

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.[67] 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

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[64] For the theoretical account see Cole and Kehoe (1998, n 53). See further n 61 for the empirical account related to that question.

[65] See section IV.

[66] Blankart and Ehmke (work in progress, n 35); Blankart and Ehmke (2014, n 35).

[67] The bond yields for 10-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 will not be enforced–a pooling equilibrium led to almost similar bond spreads (e.g. Greece profited from being member of an expected transfer union and gained access to cheap debt capital). Following the Ecofin decision (5 October 2008) 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 for the pooling equilibrium problem in the EMU see: Charles Blankart, *On your own - What the euro zone could learn from the Swiss*, Economic Affairs (forthcoming); Blankart and Ehmke (work in progress, n 35); Blankart and Ehmke (2014, n 35).

toward a pooling equilibrium rather than a clear-cut separating equilibrium,[68] which will punish the debtors in a good way and reward the debtors in a bad way.[69] 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.[70] 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 and other "comparable" countries' breach of credit contracts in the past, so that private businesses suffer from their home countries' "misbehavior" as a debtor.[71] 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).

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[68] George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism* 84 (3) The Quarterly Journal of Economics 488 (1970); Michael Spence, *Job Market Signalling* 87 The Quarterly Journal of Economics 355 (1973).

[69] Blankart and Ehmke (work in progress, n 35); Blankart and Ehmke (2014, n 35).

[70] Ozler (1993, n 57) 614 – 616. Ozler points out that countries that just recently become sovereign have to pay a risk premium (i.e. a reliable credit history let credit cost decrease).

[71] See section III. B. 2.

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.[72] Second, even though it may be in the interests of the sovereign's citizens, the political agents and decision-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.[73] 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."[74] A populist scapegoat strategy may not improve the sovereign's economic situation, but may help politicians gain re-election. 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 in financial and/or economic distress.

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[72] See section III. A. 2.

[73] Christian Kirchner, 'Public Choice and New Institutional Economics' in Pio Baake and Rainald Borck (eds) *Public Economics and Public Choice, Contributions in Honor of Charles B. Blankart*19, 21 – 23 (Springer 2007); Christian Kirchner and David Ehmke, *Economics of Legal Concepts for Management Compensation Schemes in the Credit Sector and Their Regulation* 2 Oxford University Comparative Law Forum 3.2.4 (2013).

[74] See n 37.

## 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*,[75] 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.[76] 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.[77] Orderly 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 un-

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[75] Douglas Baird and Thomas Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy,* 51 The University of Chicago Law Review 97 (1984); Thomas Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain,* 91 Yale Law Journal 857 (1982); Thomas Jackson, *Logic and limits of bankruptcy law* (Harvard University Press 1986).

[76] Ehmke (forthcoming, n 23) section *Economic Theory of Insolvency*.

[77] Michelle White, *The Costs of Corporate Bankruptcy: A U.S.-European Comparison*, in Jagdeep Bhandari and Lawrence Weiss (eds), *Corporate Bankruptcy – Economic and Legal Perspectives* 467 (Cambridge University Press 1996).

necessary multiplied monitoring, litigation, and enforcement costs.[78] 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.[79] 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.[80] If there is not a transparent registration of claims held by bondholders, commercial banks, and sovereign creditors, etc., 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 favour of those creditors with which the sovereign has close and/or constant credit, trade, and/or political relations, domestic creditors,[81] 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 rate 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 limited. Moreover, one could ask

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[78] Robert Rasmussen, *Behavriol Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credits,* 51 Vanderbilt Law Review 1679, 1681 – 1682 (1998).

[79] Yanying Li, *Question the Unquestionable Beauty of A Collective Proceeding for All Sovereign Debt Claims*, SSRN Working Paper 21 – 23, 24 – 25 <http://ssrn.com/abstract=2234210> accessed on 8 December 2014.

[80] See Porzecanski (2006, n 38).

[81] The discrimination between private bondholders is hard to be implemented. 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 voters preference to repay domestic debt may, therefore, incentivize the sovereign's government to repay its bond debt: Alexander Guembel and Oren Sussman, Sovereign Debt without Default Penalties 76 Review of Economic Studies 1297 (2009).

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.[82] 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 argue that there is not a necessity for a collective procedure for corporate debt restructuring correspondingly. 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.[83] 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 speciality 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

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[82] Li (2013, n 79) 21 – 23.

[83] Li (2013, n 79) 26.

a class) prevents creditors from being forced to sacrifice a greater share of their claim to fund the preferred treatment of others.[84] 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 non-cooperation and holding out is a dominant strategy, would just shift to another level.[85] 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.[86] 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.

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[84] Roy Goode, *Principles of Corporate Insolvency Law* 9 – 12, 87 – 91, 235 – 243 (4th edn, Sweet and Maxwell 2011); Christoph Thole, *Gläubigerschutz durch Insolvenzrecht* 61 – 66 (Mohr Siebeck 2010).

[85] Ehmke (forthcoming, n 23) section *Majority Amendment Clauses*; Christian Kirchner and David Ehmke, *Private Ordering in Sovereign Debt Restructuring: Reforming the London Club* 3 Oxford University Comparative Law Forum (OUCLF) section 3.8.3 (2) (2012) <http://ouclf.iuscomp.org/articles/kirchner_ehmke.shtml> accessed 8 December 2014.

[86] Kirchner and Ehmke (2012, n 85) 3.8.3.

*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 (SDRM) in public ordering.[87] 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.[88] As the realization that the SDRM would not be instantly feasible,[89] private ordering solutions for a sovereign debt restructuring mechanism were designed after the model of the public ordering debt restructuring procedures.[90] The features of the SDRM, which respond to the challenges of distress, have model character for a later sovereign debt restructuring proposal and are 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

[87] Anne Krueger, *A New Approach to Sovereign Debt Restructuring* (International Monetary Fund 2002). François Gianviti and Timothy Geithner, *Proposed Features of a Sovereign Debt Restructuring Mechanism* (International Monetary Fund 2003); François Gianviti and Timothy Geithner, *The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations* (International Monetary Fund 2002).

[88] Amongst others: Patrick Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Around the World* (2003) 50 IMF Staff Papers 41; Christoph Paulus, *A Statutory Proceeding for Restructuring Debts of Sovereign States,* Recht der Internationalen Wirtschaft (RIW) 401 (2003); Christoph Paulus, *Some Thoughts on an Insolvency Procedure for Countries*, 50 The American Journal of Comparative Law (AJCL) 531 (2002).

[89] 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 Helleiner, *The Mystery of the Missing Sovereign Debt Restructuring Mechanism* 27 Contributions to Political Economy 91 (2008).

[90] See section IV. C..

share of the outstanding debt that would be sufficient to block a restructuring plan, the right to terminate the procedure.[91]

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 is the need to assemble a representative committee to speak in favor of each creditor class' 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.[92]

(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 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.[93] Since the inflow of fresh debt capital

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[91] Gianviti and Geithner (2002, n 87) 56; Gianviti an Geithner (2003, n 87) 15.

[92] Creditor Committee: Gianviti and Geithner (2002, n 87) 42 – 44.

[93] Gianviti and Geithner (2002, n 87) 31 – 32, 44 – 45; Gianviti and Geithner (2003, n 87) 13.

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.[94]

(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.[95] Since the debtor should have ample leeway in choosing the debt to be restructured in the SDRM,[96] 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.[97] 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.[98] 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.

(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*.[99] The advantage of the SDDRF would be the special knowledge acquired for sovereign debt cases,

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[94] 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 Scott, *A Bankruptcy Procedure for Sovereign Debtors,* Harvard Law School Public Law, Research Paper No. 53, 43 – 44 (2003) <http://ssrn.com/abstract=384220> accessed 8 December 2014.

[95] Krueger (2002, n 87) 25 – 28.

[96] Gianviti and Geithner (2002, n 87) 12 – 13.

[97] See section III. A. 4.

[98] Gianviti and Geithner (2002, n 87) 35 – 38; Gianviti and Geithner (2003, n 87) 10 – 13.

[99] Gianviti and Geithner (2002, n 87) 58 – 70.

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.[100] Any set of rules for "fair, just, or equal" treatment of creditors, but with the sovereign debtor remaining at the wheel, deciding about the appropriate haircut, without introducing a comprehensive procedure, is a desperate solution. From a legal or normative perspective, one could ask whether illegal or wrong 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.[101]

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.

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[100] Amongst others: Patrick Bolton and David Skeel, *Inside the Black Box: How Should a Sovereign Bankruptcy Framework Be Structured?,* 53 Emory Law Journal 763 (2004); Kirchner and Ehmke (2012, n 85); Christian Kirchner and David Ehmke, *Restrukturierung von Schulden sourveräner Staaten aus Forderungen privater Gläubiger: Zu einer künftigen Rolle des Londoner Clubs*, 112 Zeitschrift für Vergleichende Rechtswissenschaft 438 – 470 (2013); Christoph Paulus, *A Resolving Proceeding for Defaulting Sovereigns,* IILR 1 (2012); Christoph Paulus, *A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings,* in Braga, Primo, and Vincelette, Galli (eds), *Sovereign Debt and the Financial Crisis - Will This Time be Different?* (Worldbank 2010) 317.

[101] See sections III. B. 1., III. B. 2., III. B. 4.

A Resolvency Proceeding for Defaulting Sovereigns: Christoph Paulus[102] has further developed and transferred the proposals for a sovereign 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 pre-determine 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.[103] 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 pre-determined 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 unconsenting creditors to a public procedure.[104] 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.[105] An efficient procedure can emerge from an institutional competition between different concepts to regulate debtor-creditor and

[102] Paulus (2010, n 100) and Paulus (2012, n 100).

[103] Kirchner and Ehmke (2012, n 85); Kirchner and Ehmke (2013, n 100).

[104] Kirchner and Ehmke (2012, n 85).

[105] Anna Gelpern and Mitu Gulati, *Innovation after the revolution: foreign sovereign bond contracts since 2003* 4 (1) Capital Markets Law Journal 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)

creditor-creditor relations in bond and loan contracts. A learning process should be initiated.[106]

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 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*.[107] 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.[108]

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[106] 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: Choi and Gulati, *Innovation of Boilerplate Contracts: An Empirical Examination of Sovereign Bonds,* 53 Emory Law Journal 930 (2004). For a test confirming the expectation that creditors care about sovereign debt contracts see: Choi, Gulati, and Posner (2011, n 45).

[107] Kirchner and Ehmke (2012, n 85) 3.7.4, 3.8 with further references.

[108] Eurogroup, 'Statement by the Eurogroup' (28 November 2010); Group of Ten, *Report of the G-10 Working Group on Contractual Clauses* (26 September 2002) <http://www.bis.org/publ/gten08.pdf> accessed on 8 December 2014; John Taylor, *Sovereign Debt Restructuring: A U.S. Perspective* (Speech at the Institute for International Economics, Washington D.C., 2 April 2002).

## V. OUTLOOK

A sovereign debt restructuring regime in either private or public ordering is a mainstay in the international financial architecture. It cannot only resolve inter-creditor conflicts and facilitate debt restructuring negotiations. A sovereign debt restructuring mechanism has to be designed in order to curtail the sovereign debtor's misbehaviour. 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 an 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.[109] 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 a safe haven 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.[110] The chance for weak debtors to escape enforcement behind sovereign borders after an "illegal" and unilateral cessation of payment will be priced into credit cost *ex ante*.[111] 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, it can be assumed that a

[109] See sections III. A. 3., III. B. 3.

[110] See sections III. B. 1., B. 2., B. 4.

[111] See section III. B. 4.

debtor-friendly collective procedure that offers a cheap exit route will have the opposite effect.[112] Beyond the effect of debtors' anticipated behavior on the cost of debt capital, the signalling 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.[113]

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 indebtness.

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[112] See n 46, 57, and 60.

[113] See section III. B. 2.