LAWSUITS AND EMPIRE: ON THE ENFORCEMENT OF SOVEREIGN DEBT IN LATIN AMERICA

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> *"If a nation shows that it knows how to act with reasonable efficiency and decency in social and political matters, if it keeps order and pays its obligations, it need fear no interference from the United States."*[1]
>
> *— President Theodore Roosevelt, May 20, 1904*
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> *"We particularly condemn the perversity where vulture funds purchase debt at a reduced price and make a profit from suing the debtor country to recover the full amount owed—a morally outrageous outcome."*[2]
>
> *— Chancellor of the Exchequer Gordon Brown, May 10, 2002*

I

INTRODUCTION

Three things are eternal: death, taxes, and sovereign default. The latter is surprising in light of the fact that creditors continue to provide hundreds of billions of dollars to governments, despite a long and dolorous history of default.[3] One might imagine that the threat of losing access to future credit might be enough to discourage sovereign default, but there are ample reasons to believe otherwise. Investors do not deny credit to governments with a history

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1. Theodore Roosevelt, *Corollary to the Monroe Doctrine*, http://www.pinzler.com/ushistory/corollarysupp.html (last visited June 15, 2010).

2. *Zambia Loses "Vulture Fund" Case*, BBC NEWS (Feb. 15, 2007, 6:38 PM), http://news.bbc.co.uk/2/hi/business/6365433.stm.

3. World Bank, *Global Development Finance: The Development Potential of Surging Capital Flows: Review, Analysis, and Outlook*, 3 (World Bank Publications: Washington, D.C., 2006).

of default, and the interest-rate penalties that do arise are not very large.[4] "Markets have short memories" is practically a truism among investors. Insofar as countries do repay their debts, they appear to do so either because of their domestic political institutions or because defaults are often associated with painful macroeconomic crises.

Can sanctions play a role in improving sovereign debt markets? Sanctions, of course, play a key role in sustaining *private*-debt markets. The possibility of sanctions—asset seizures or income garnishments—makes private debtors less likely to default. Sovereign governments, on the other hand, are free from any sort of supranational authority that might enforce debt contracts.

Sanctions against sovereign debtor governments, however, were relatively commonplace before 1913. Between 1870 and 1913, defaulting governments ran a forty-percent chance of facing foreign intervention via blockades or, more commonly, via the imposition of foreign control over their domestic finances under the *threat* of blockade.[5] In this essay, we contrast the efficacy of two sanctioning regimes: U.S. "Dollar Diplomacy" of the early 20th century and private litigation in the contemporary period.

II

DOLLAR DIPLOMACY

During the epoch of "Dollar Diplomacy" (roughly from 1904 through 1929), the United States applied a strong debt-enforcement regime. First, the United States used its influence to facilitate restructuring. The United States brokered negotiations between Colombia and Venezuela in 1905. In 1913, the U.S. government arranged a deal in which Guatemala would start paying interest on its defaulted debts.[6] In 1923, the U.S. State Department sent a mission to Bogotá to propose reforms to Colombia's banking system, tax collection, and public administration. The Colombian legislature passed the proposed reforms, and two members of the mission stayed on as employees of the Colombian government.[7]

Second, the United States arranged "controlled loans" in which the debtor country pledged to allow the United States or U.S.-appointed agents to take over tariff collection in the event of default. The United States took over the customhouses of the Dominican Republic in 1905, Cuba in 1906 (as part of a

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4. Laura Alfaro & Fabio Kanczuk, *Sovereign Debt as a Contingent Claim: A Quantitative Approach*, 65 J. INT'L ECON. 297, 300 (2005).

5. Kris Mitchener & Marc Weidenmier, *Supersanctions and Sovereign Debt Repayment* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 11472, 2005).

6. Letter from Irwin Laughlin, U.S. Chargé d'Affairs at London, to Philander Knox, U.S. Sec'y of State (Jan. 28, 1913), *in* FOREIGN RELATIONS OF THE UNITED STATES, 814.51/225, 565 (1920).

7. Emily Rosenberg & Norman Rosenberg, *From Colonialism to Professionalism: The Public-Private Dynamic in United States Foreign Financial Advising, 1898–1929*, 74 J. AM. HIST. 59, 75–76 (1987).

broader intervention), Nicaragua in 1911, and Haiti in 1915.[8] The United States arranged a controlled loan with Costa Rica in 1911 but did not take over the customhouses.[9] An additional loan in 1926 stipulated that the United States would take over Costa Rica's *internal* tax collection should it default.[10] In 1918, after Panama used the proceeds from a railroad loan to meet current expenses, the United States forced the Panamanian government to allow an American "fiscal agent" to take "control and charge of the national treasury."[11] El Salvador signed a controlled loan in 1921.[12] In 1926, a loan to Honduras required the country to impose a dedicated three-percent export tax as collateral. The enforcement mechanism was ingenious: exporters needed to purchase stamps equal to the tax . . . and the stamps were sold exclusively by the National City Bank of New York.[13] Also in 1926, Peru appointed an American to head the customs service as a condition for a loan, and Bolivia accepted a team of "advisors" to monitor its finances.[14]

Third, the United States used its military to prevent instability from forcing governments into default. The United States intervened in nations including Cuba, the Dominican Republic, Haiti, Honduras, Nicaragua, and Panama.[15] In three of these nations—Cuba, the Dominican Republic, and Haiti—the United States went so far as to administer them when local governments collapsed. The United States ran Cuba from 1906 through 1909 (and again in 1912 and from 1917 through 1922), Haiti from 1915 through 1934, and the Dominican Republic from 1916 through 1924.[16] In Nicaragua, the United States never formally took

8. *See* WHITNEY PERKINS, CONSTRAINT OF EMPIRE: THE UNITED STATES AND CARIBBEAN INTERVENTIONS 1–74 (1981).

9. EDWIN BORCHARD, STATE INSOLVENCY AND FOREIGN BONDHOLDERS: GENERAL PRINCIPLES 277–78 (1951).

10. In addition, the contract stipulated that any disputes would be submitted to the Chief Justice of the Supreme Court of the United States for binding arbitration. La República de Costa Rica and Central Union Trust Company of New York as Trustee, Trust Agreement (Nov. 1, 1926) (on file with *Law and Contemporary Problems*).

11. JOHN MAJOR, PRIZE POSSESSION: THE UNITED STATES GOVERNMENT AND THE PANAMA CANAL 1903–1979, at 139–40 (1993).

12. *See* ROBERT DUNN, AMERICAN BUSINESS ABROAD 219–47 (1926) (reprinting the complete text of the controlled loan contract).

13. CHESTER JONES, THE CARIBBEAN SINCE 1900, at 432–33 (1936).

14. Rosenberg & Rosenberg, *supra* note 7, at 71.

15. *See* PERKINS, *supra* note 8, at 1–74. U.S. troops ostensibly landed to prevent disorder. In Cuba, the U.S. intervened in 1906 when the Liberal Party launched an armed rebellion against the incumbent Moderates after a contested election. Similarly, U.S. troops intervened in Panama on multiple occasions (most notably in 1925) after contested elections prompted violence. Both countries had formal clauses in their constitutions permitting U.S. intervention to preserve order. The U.S. intervened in Nicaragua in 1912 when rebels opposed to a loan contract with the U.S. neared Managua. In Haiti and the Dominican Republic, American troops intervened in 1915 and 1916 when rebels threatened to take control of the customhouses, imperiling government revenues. In Honduras, U.S. Marines briefly landed in 1911 and 1912 to protect U.S. investments during a civil war.

16. The seminal works on the U.S. occupation of the Dominican Republic and Haiti are BRUCE CALDER, THE IMPACT OF INTERVENTION: THE DOMINICAN REPUBLIC DURING THE U.S. OCCUPATION OF 1916–1924 (2006) and HANS SCHMIDT, THE UNITED STATES OCCUPATION OF HAITI, 1915–1934 (1995).

over the government, but American Marines actively fought antigovernment insurgents in 1912 and from 1926 through 1933.[17]

The Great Depression brought Dollar Diplomacy to an end. American advisors to Bolivia began to call default "inevitable" as early as 1928, and they agreed to allow Bolivia to suspend interest payments in January 1931, after government revenue fell twenty-eight percent. Peru, Chile, and Ecuador soon followed.[18] In October 1931, America's debt-enforcement empire officially closed when the U.S. administrators in charge of Dominican finances allowed the country to default in the face of economic collapse.[19]

III

SUING SOVEREIGNS

Starting with the 1976 Foreign Sovereign Immunity Act (FSIA), legal changes eroded the doctrine of sovereign immunity. In 1992, the Supreme Court decided *Republic of Argentina v. Weltover*, holding that sovereign bond issues in the United States qualified as commercial activities.[20] Sovereign immunity, therefore, did not automatically apply. *Weltover* ushered in a series of attempts by creditors to use the legal system to create a regime not unlike Dollar Diplomacy, only now enforced by court orders rather than by executive decisions.[21] Distressed funds (also known as "vulture funds") began to purchase defaulted sovereign debt on the open market, and then subsequently sued the defaulting governments. Courts deciding in favor of the funds enforced those decisions by seizing assets or by attaching government revenues or other payments that passed through their jurisdictions, in effect imposing a "virtual blockade" that was difficult for defaulting countries to avoid.[22] Creditors went after oil sales, privatization revenues, and airline landing fees. In May 1995, a New York court sided with the Dart family over defaulted Brazilian debt; Brazil settled.[23] In 1995, Elliott purchased Panamanian debt with a face value of $28.75 million for approximately $17.5 million. In July 1996, Elliott sued Panama

17. For an account of the U.S. intervention in Nicaragua, see LESTER LANGLEY, THE BANANA WARS: UNITED STATES INTERVENTION IN THE CARIBBEAN, 1898–1934, at 59–71, 175–212 (2002).

18. On U.S. fears of a Bolivian default, see State Department Records (Record Group 59), National Archives, *Memorandum from the Economic Adviser of 9 May 1928*, NA 824.5 11449. For a discussion of the Bolivian situation at the time, see generally Manuel Contreras, *Debt, Taxes, and War: The Political Economy of Bolivia, c. 1920–1935*, 22 J. LAT. AM. STUD. 265 (1990).

19. DOMINICAN CUSTOMS RECEIVERSHIP, REPORT OF THE TWENTY-FOURTH FISCAL PERIOD 9, 28 (1932).

20. *See* Republic of Arg. v. Weltover, Inc., 504 U.S. 607, 618–20 (1992).

21. *See generally* FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES (2007); Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001*, at 470–507 (Int'l Monetary Fund, Working Paper No. WP/02/133, 2002).

22. For instance, the decisions in *Dart v. Brazil*, 886 F. Supp. 1105 (S.D.N.Y. 1995), and *Elliott Associates, L.P. v. Republic of Panama*, 975 F. Supp. 332 (S.D.N.Y. 1997), permitted attachments.

23. STURZENEGGER & ZETTELMEYER, *supra* note 21, at 69.

seeking full payment of the debt.[24] When Panama balked at paying, a judge attached the proceeds from the privatization of the country's telecoms company; Elliott ultimately received $71 million in payments, including interest.[25] In 1999, a Brussels appellate court agreed to attach interest payments on Peru's Brady bonds.[26] The Peruvian government paid Elliott $63.5 million.[27] More suits followed.

Successful lawsuits made it extremely difficult for a defaulting country to issue new credit without paying off old creditors, thereby imposing the kind of credit boycott that short-memoried markets had been unable to impose on their own. In 1999, Elliott Associates successfully sued Peru. The lawsuit left the Peruvian government with two options: pay Elliott or allow the Brady bonds to default. Why would the Peruvian government fear a default on its Brady bonds when it was *already* in default on so many other securities? First, Peru feared that disrupting its Brady deal would lead it to be locked out of capital markets altogether. Second, a Brady default would result in a downgrade of all Peruvian securities, which many U.S. mutual and pension funds would then be prevented from holding.[28] The result would have been fire sales of Peruvian securities of all sorts and a severe financial crisis—quite a punishment from a "virtual" blockade!

The vulture funds attracted a great deal of opprobrium for taking advantage of poor countries. Activists, NGOs, journalists, and U.K. Prime Minister Gordon Brown condemned them on moral grounds.[29] A more sophisticated critique emerged from the IMF: the vulture funds interfered with the orderly

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24. *See Elliott Assocs.*, 975 F. Supp. at 334–35.

25. For the details of the final settlement, see Emerging Markets Trade Association, *Preliminary Analysis of Creditor Litigation in the Non-HIPC Sovereign Debt Restructuring Context*, June 16, 2009, 8–9, *available at* http://www.clubdeparis.org/sections/communication/evenements/rencontre-avec-secteur/secteurprive2009/document-emta/downloadFile/file/EMTA_Analysis.pdf?nocache=1256649422 (last visited May 22, 2010).

26. Brady bonds are dollar-denominated bonds, issued mostly by Latin American countries in the 1980s, in the aftermath of the 1982 debt crisis. In 1989, U.S. Treasury Secretary Nicholas Brady arranged for the commercial banks that had lent to Latin American countries to write down the value of their outstanding loans in arrears, exchanging them for newly issued long-term dollar-denominated bonds. The U.S. Treasury secured the principal and one year's worth of interest payments. In total, Brady deals restructured $202.8 billion of debt for eighteen countries. The result was $63.7 billion of debt relief—and the creation of an active secondary market in bonds issued by developing-country governments. Laura Alfaro & Ingred Vogel, *Creditor Activism in Sovereign Debt: "Vulture" Tactics or Market Backbone?* at 3–4 (Harvard Business School, Case No. 706-057, 2007).

27. Noel Maurer & Aldo Musacchio, *The Barber of Buenos Aires: Argentina's Debt Renegotiation* at 8 (Harvard Business School, Case No. 706-034, 2006).

28. For the details of the Peruvian case, see Ugo Panizza, Federico Sturzenegger & Jeromin Zettelmeyer, *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LIT. 1, 7 (2009). For a discussion of the behavior of mutual funds in economic crises, see Graciela Kaminsky, Richard Lyons & Sergio Schmukler, *Economic Fragility, Liquidity, and Risk: The Behavior of Mutual Funds during Crises*, Jan. 29, 2000, Mimeo, *available at* http://citeseerx.ist.psu.edu/viewdoc/summary?doi=10.1.1.12.8916 (last visited June 15, 2010), and INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MARKET DEVELOPMENTS AND ISSUES (2004), particularly chapter four.

29. Africa Political and Economic Strategic Center, *What is a Vulture Fund and Why Africa*, http://www.afripol.org/VultureFunds.htm (last visited June 15, 2010).

restructuring of sovereign debt.[30] Sometimes, argued the IMF, governments, like private companies, simply cannot pay their debts at an acceptable cost. In such cases, the most beneficial outcome would be an amicable renegotiation. The possibility of legal restitution, however, gave creditors an incentive to hold out from restructuring in hopes of getting their face value. In fact, even creditors who *wanted* to restructure might refuse to do so out of the fear that holdouts might succeed at getting a priority claim on the debtor's resources in court.

Sovereign lawsuits also had their defenders. In the defenders' view, the threat of litigation made sovereign lending cheaper.[31] This view garnered support among U.S. lawmakers: in May 2009, Representative Eric Massa (D-NY) introduced the Judgment Evading Foreign States Accountability Act, which mandated that foreign states (and their corporations) be denied access to U.S. capital markets if they had been in default for more than two years on U.S. judgments exceeding $100 million.[32] The Act also required that the defaulting government explain why it deserved aid, in addition to mandating that any aid granted bear notice that the country is a "judgment evading state."[33]

IV

LAWSUITS VERSUS EMPIRE

Absent in this debate were two questions: First, were lawsuits effective? In other words, did the *threat* of a virtual blockade increase investor confidence in the security of sovereign debt? If sovereign debt lawsuits decreased investor confidence in a sustained way, then their opponents had evidence that the vulture funds interfered with sovereign debt restructurings and that vulturing activities should be curtailed. If, on the other hand, the lawsuits did not matter, then those opponents were making a mountain out of a molehill. There were reasons to believe that legal remedies might be ineffective. Relatively few lawsuits were successful, and judgments against defaulters were not automatically enforceable in foreign countries. Finally, judges could not sanction private actors who chose to do business with a defaulting government.

Second, if vulture funds did increase investor confidence, against what benchmark should they be measured? That is, even if the vulture funds were effective at increasing market perceptions about the security of sovereign debt, one might still argue that the system needed improvement. Legal reforms that allowed for even stronger debt enforcement *might* further increase investor

30. Anne Krueger, First Deputy Managing Director, International Monetary Fund, *New Approaches to Sovereign Debt Restructuring: An Update on Our Thinking, Address Before the Int'l Monetary Fund Conference on Sovereign Debt Workouts: Hopes and Hazards, Institute for International Economics* (Apr. 1, 2002), *available at* http://imf.org/external/np/speeches/2002/040102.htm (last visited June 15, 2010).

31. Hal S. Scott, *Sovereign Debt Defaults: Cry for the United States, Not Argentina* 42–43 (Wash. Legal Found., Critical Legal Issues Working Paper Series No. 140, 2006).

32. H.R. 2493, 111th Cong. §§ 4, 6 (2009).

33. *Id.* at § 15.

perceptions of security and, by extension, lower the cost of capital faced by borrowing governments. Conversely, in the absence of evidence about the effectiveness of stronger debt-enforcement regimes, this might be nothing more than a nirvana thesis.[34]

In order to test the hypotheses, two things are needed: a logical framework and data. How would bond spreads be expected to react (against, say, U.S. Treasury bonds) under a credible debt-enforcement regime? First, one would expect to see a large drop in spreads when the regime began (in the countries that were subject to it). Second, every enforcement action or intervention would bring a temporary rise in yields for bonds issued by the countries subject to the regime but against which no intervention or enforcement was being taken. This rise in prices would continue until it became clear that the intervention had succeeded, at which point yields would drop.

How would spreads likely react under a noncredible debt-enforcement regime? Yields would likely remain stable when the regime first came into being and remain so after any debt-enforcement interventions. After all, if the actions were not expected to change behavior—either because the enforcement was too unpredictable or because the sanctions were too weak—then the holders of the bonds of third countries would gain no information from an enforcement action.

And what do the data show?[35]

The evidence suggests that the informal American empire of 1905 through 1929 formed a credible regime.[36] The initial intervention generated a large and sustained fall in the perceived default risk of the bonds of circum-Caribbean countries, including El Salvador. The drop was sustained until the late 1920s despite statements by the U.S. government that it intended to get out of the debt-enforcement business. Other Latin American countries that were not under America's wing—notably Brazil and Argentina—did not show this pattern. Only when America *did* get out after 1928 did yields rise.[37]

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34. *See generally* Harold Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & ECON. 1 (1969).

35. We coded up the yields on sovereign debt issues for all Latin American nations with traded debt from the *Investor's Monthly Manual* and the *Economist* from 1904 through 1929. We then calculated the spreads over U.S. Treasury bonds, adjusting (when possible) for the term structure. We also coded up data on the emerging-market bond spreads (EMBI) for Latin American borrowers from 1994 through 2007. For comparability to Dollar Diplomacy, we limited our sample to Latin American countries. Not all Latin American countries have EMBI data before 1994. Hence, we benchmarked against the Peruvian case of 1995, although the vulture regime arguably started with the 1992 *Weltover* decision. *See* Faisal Ahmed, Laura Alfaro & Noel Maurer, *Gunboats and Vultures: On the "Market Reaction" to the Enforcement of Sovereign Debt*, Mimeo, 2009. We collected data from "Jury Verdicts, Settlements & Judgment" directory in Lexis-Nexis, the Westlaw database, newspapers, and law journals, and identified the filing and settlement or attachment dates for all successful lawsuits over defaulted sovereign debt. We thank Lee Buchheit and Jay Newman for generous help in identifying successful lawsuits and attachments.

36. Our findings are consistent with those in MITCHENER & WEIDENMIER, *supra* note 5.

37. These findings are documented in Ahmed, Alfaro & Maurer, *supra* note 35.

The sovereign lawsuits from 1994 through 2007, on the other hand, did not appear to have created a credible regime. Most lawsuits had no effect on bond yields, although there is evidence of a small and transient (but significant) negative effect on investor expectations of default risk from a successful lawsuit. Apparently, neither the fears of opponents nor the hopes of supporters were justified by the data. We have seen neither a return to the halcyon days of Teddy Roosevelt nor a pernicious interference in the ability to restructure the debts of poor countries.[38] If one believes that a credible sanction regime would be "desirable" for developing countries, then the current legal framework needs to be tightened considerably. But if one worries that suing sovereign states over their debts has overall negative consequences, then these results imply that the fear is misplaced.

Perhaps this result should not be surprising. Representative Massa notwithstanding, lawsuits against sovereign debtors have received little official support. Belgium, for example, altered its law after Elliott Associates managed to attach Peruvian payments that passed through the Euroclear system.[39] Even under the Bush Administration, when asked by Congress why the United States wasn't helping African countries fend off the vulture funds, Treasury Secretary Henry Paulson replied, "We are doing everything we can to help them, and I deplore what the vulture funds are doing, and we use moral solutions. But the vulture funds have the rule of law on their side. When countries enter into debt agreements, laws apply. And so the one thing I take some comfort in is that they haven't been overly successful."[40]

In short, the Western Hemisphere saw a credible debt-enforcement regime in the early twentieth century. In theory, the features of this regime should be replicable in the early twenty-first century, even without recourse to the Marines. There are few practical reasons why virtual (legal) blockades cannot be as effective as (and less costly than) real ones. In practice, however, the world has not created a credible debt-enforcement regime, and without an explicit political decision to do so, there is little sign of such a regime spontaneously emerging as a result of judicial action.

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38. The empirical analysis in Ahmed, Alfaro & Maurer does not comment directly on the welfare implications associated with the enforcement of sovereign debt.

39. Press Release, World Bank, *World Bank to Increase Support to Curb Vulture Fund Actions*, Press Release No:2007/415/PREM (May 31, 2007), *available at* http://go.worldbank.org/J2FE06IQI0.

40. *The State of the International Financial System: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 39–40 (2007).