

# CONTRACTING FOR STATE INTERVENTION: THE ORIGINS OF SOVEREIGN DEBT ARBITRATION

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## I

### INTRODUCTION

Most models of contracting behavior assume that contracts are drafted with the expectation that their terms will be enforced, whether through legal or relational means. That assumption extends to contract terms governing the method of enforcement, such as arbitration clauses. According to theory, contracting parties keep promises to arbitrate either because they know courts will compel them to do so (or will enforce an arbitral award rendered in their absence) or because compliance is necessary to avoid some reputational or other extra-legal sanction. In other words, parties include arbitration clauses in their contracts because they want to arbitrate disputes and because they believe that a counter-party who has agreed to arbitrate will be unable or unwilling to renege on this promise.

In this article, written for a symposium on innovations on the sovereign debt markets, I describe how this account cannot explain the origins of arbitration clauses in contracts related to sovereign lending.<sup>1</sup> Sovereign debt arbitration has been much in the news of late, primarily due to bondholders' efforts to arbitrate claims arising out of Argentina's 2001 default before the International Centre for Settlement of Investment Disputes (ICSID).<sup>2</sup> The reality, however, is that modern sovereign debt contracts generally choose litigation in national courts

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1. This article is concerned primarily with loans by private lenders to sovereign borrowers, whether in the form of commercial-bank loans or bonds, rather than loans by international financial institutions or government creditors. Although there have been times when commercial loans comprised the bulk of sovereign lending, most sovereign debt today is owed to holders of sovereign bonds, and the same was true during the period of interest in this article.

2. See, e.g., Michael Waibel, *Opening Pandora's Box: Sovereign Bonds in International Arbitration*, 101 AM. J. INT'L. L. 711 (2007).

over arbitration.<sup>3</sup> But this was not always the case. In the first several decades of the twentieth century, arbitration clauses appeared with some frequency in sovereign debt contracts.

That these contracts would have addressed dispute resolution at all is somewhat surprising. As part I of this article explains, one might expect such terms to have originated sometime in the mid-twentieth century, when changes to the law of sovereign immunity made it feasible for creditors to obtain a judgment based on a sovereign government's *ex ante* consent to litigation or arbitration. During the previous era of absolute immunity, by contrast, states typically were immune from suit unless they consented at the time of the lawsuit itself. Since any dispute-resolution process would require the sovereign's *ex post* consent, there would seem little point to bargaining over such a process *ex ante*. More puzzling still, there is little evidence that sovereign borrowers voluntarily complied with their promises to arbitrate future disputes. Thus, a ready solution to the puzzle—that borrowers kept their arbitration-related promises to maintain their reputations as reliable transaction partners—appears inapt.

So what explains the use of arbitration clauses in these early-twentieth century contracts? Part II of this article draws on both original archival research and secondary-source material to offer a preliminary answer to this question. Tracing the routine use of arbitration clauses in sovereign loans to U.S. dollar diplomacy in Latin America and the Caribbean in the early 1900s, it argues that arbitration clauses often had little to do with facilitating an arbitration between lender and borrower. Instead, the clauses were designed to encourage, and at times enable, influential capital-exporting *states* to participate in resolving disputes arising out of sovereign loans.<sup>4</sup> Equally important, the clauses signaled to investors—at times, inaccurately—that important creditor states supported the loan and would view default with disfavor. In their earliest incarnations, then, these clauses had little to do with facilitating an actual lender–borrower arbitration. They were instead tools to signify and justify the projection of power by creditor states.

This article then briefly explores what these findings imply about the relationship between state actors and contract design. It is widely recognized, of course, that state-supplied law constitutes a set of implied terms that govern the content and manner of private exchanges unless the contracting parties agree otherwise. General contract law, for example, provides off-the-rack terms allocating risk between the parties, and laws pertaining to dispute resolution establish off-the-rack procedures for enforcing contractual commitments. It is also widely recognized that state policies may both facilitate and deter efforts by contracting parties to design innovative terms. In each case, however, the focus

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3. See W. Mark C. Weidemaier, *Disputing Boilerplate*, 82 *TEMPLE L. REV.* 1 (2009).

4. For simplicity, I will sometimes use the term “creditor states” to refer to major capital-exporting jurisdictions like England and the United States, whether or not these states were themselves creditors of the borrower state.

is on the state as causal agent—that is, as an external force that shapes private contracts. But the findings described here serve as a reminder that causation runs both ways. Contracting parties also may design contracts in an effort to influence the behavior of state actors and other outsiders to the contract. This may be especially true of sovereign debt contracts, as illustrated briefly at the end of this article with examples from both historic and modern contracts.

## II

### THE PUZZLE OF UNENFORCEABLE DISPUTE RESOLUTION TERMS

#### A. Enforcement During the Era of Absolute Immunity

Accounts of sovereign lending emphasize that lenders had no effective legal recourse against defaulting sovereign borrowers before the latter half of the twentieth century.<sup>5</sup> The borrower's domestic courts were not exactly hospitable to foreign lenders,<sup>6</sup> and sovereign immunity and other legal barriers defeated most efforts to recover from state borrowers in the foreign investor's home courts. Sovereign immunity posed an especially high barrier in England and, to a perhaps lesser extent, in the United States.<sup>7</sup> French, German, and Swiss courts, for example, enforced *ex ante* waivers of state sovereign immunity under some circumstances, though typically only when the loan had some connection to the forum.<sup>8</sup> English courts, however, did not recognize such waivers, and their enforceability under U.S. law was uncertain at best,<sup>9</sup> for sovereign-immunity doctrine in both countries permitted the state to withdraw its consent to be sued at any time.<sup>10</sup> These difficulties encountered by sovereign lenders were compounded by a further problem: the inability to enforce any judgment

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5. See 1 EDWIN BORCHARD, *STATE INSOLVENCY AND FOREIGN BONDHOLDERS* 171 (1951); MICHAEL TOMZ, *REPUTATION AND INTERNATIONAL COOPERATION: SOVEREIGN DEBT ACROSS THREE CENTURIES* 158–59 (2007). This is not to say that modern sovereign loans are characterized by robust legal enforcement, only that lenders often lacked even formal enforcement rights until the adoption of restrictive theories of sovereign immunity.

6. As blandly put in a 1939 report by a League of Nations committee formed to study loan contracts: “[A]n action before the national courts of the debtor State is not always calculated to yield the results which the bondholder is entitled to expect.” *Report Presented by the Comm. for the Study of International Loan Contracts* at 24, League of Nations Doc. C.145M.93 1939 II A (1939).

7. In some jurisdictions, the principle of absolute immunity had begun to break down as early as the mid-nineteenth century. For a general summary, see Harvard Law School Research in International Law, *Competence of Courts in Regard to Foreign States*, 26 AM. J. INT’L L. SUPP. 473, 527–40 (1932) [hereinafter Harvard Draft Convention].

8. See *id.* at 548–80; Georges R. Delaume, *Jurisdiction of Courts and International Loans: A Study of Lenders’ Practice*, 6 AM. J. COMP. L. 189, 203–04 n.40 (1957).

9. See Harvard Draft Convention, *supra* note 7, at 549–51; Delaume, *supra* note 8, at 203–04 & n.40; Edwin D. Dickinson, *Waiver of State Immunity*, 19 AM. J. INT’L L. 555, 558–59 (1925); William Harvey Reeves, Remarks Before the Fifty-Fifth Annual Meeting of the American Society of International Law (Apr. 28, 1961), in PROC. OF THE AM. SOC. OF INT’L L. 130, 134–35 (1961).

10. See *Beers v. Arkansas*, 61 U.S. 527, 529 (1857); *Kahan v. Pakistan Fed’n*, [1951] 2 K.B. 1003, 1012.

rendered against the borrower. Even if the lender could obtain a judgment, the sovereign's assets would likely remain immune from execution.<sup>11</sup>

Nor would it have improved matters much for the lender to include an arbitration clause in the contract. The early part of the twentieth century was characterized by a growing interest in the use of arbitration to resolve disputes between states and foreign investors. For example, some of the so-called League Loans after World War I referred disputes to the Council of the League of Nations or to arbitration,<sup>12</sup> and in 1939, a League study committee recommended that arbitration clauses be included in all international loan contracts.<sup>13</sup> Yet during the period of interest here, recalcitrant states do not appear to have faced significant international pressure to comply with *ex ante* agreements to arbitrate disputes with private parties.<sup>14</sup> Moreover, formal law limited the enforceability of such agreements during much of this era, even when the relevant contract involved exclusively private parties.<sup>15</sup> Finally, even if the lender could procure an arbitration award, the award would have to be enforced in national courts, where the borrower might once again invoke sovereign immunity.<sup>16</sup>

For all these reasons, formal legal enforcement was virtually unavailable to sovereign lenders during the early twentieth century.<sup>17</sup> To be sure, sovereign states and their creditors could always agree to submit *existing* disputes to some

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11. See BORCHARD, *supra* note 5, at 158, 169.

12. See, e.g., Agreement Concerning Kingdom of Hungary 7.5% Sterling Loan of 1924 ¶ 14 (June 30, 1924). For more on such loans, see BORCHARD, *supra* note 5, at 37–38.

13. See League of Nations, *supra* note 6, at 24–27; see also FRANCIS ANTHONY BOYLE, FOUNDATIONS OF WORLD ORDER 80–81 (1999) (discussing the Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts [the Porter Convention] at the Second Hague Peace Conference in 1907); GUS VAN HARTEN, INVESTMENT TREATY ARBITRATION AND PUBLIC LAW 50–54 (2007) (discussing evolution of legal infrastructure supporting international commercial arbitration).

14. This is not to say that there are no instances of such compliance. In the context of the League Loans, for example, borrowers would have faced significant international pressure to submit to the specified dispute resolution process. Indeed, in at least one case, a borrower-state voluntarily participated in arbitration before an arbitrator nominated by the Council of the League of Nations and complied with the resulting award. See League of Nations, *supra* note 6, at 25 (discussing 1936 arbitration between Bulgaria and loan trustee).

15. Historically, both English and U.S. law treated agreements to arbitrate future disputes as revocable until the arbitrator rendered an award. See Katherine Van Wezel Stone, *Rustic Justice: Community Coercion Under the Federal Arbitration Act*, 77 N.C. L. REV. 931, 973–76 (1999). Although by 1889, this was no longer the case under English law, see English Arbitration Act, 1889, 52 & 53 Vict., c. 49, §§ 1, 2 (U.K.), the doctrine was widely accepted in the United States until the passage of the United States Arbitration Act in 1925, see Pub. L. No. 401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1–16 (2000)).

16. In one notorious English case, a state that participated in (and lost) an arbitration, and then went to court to challenge the award (and again lost), was allowed to invoke its immunity to prevent enforcement of the award. See *Duff Development Co. v. Gov't of Kelantan*, [1924] A.C. 797 (H.L.); see also *Kahan v. Pakistan Fed'n.*, [1951] 2 K.B. 1003, 1012 (opinion of Jenkins, L.J.).

17. As late as 1951, Edwin Borchard could write that “the judicial remedies of a bondholder in the forum of either the debtor or the creditor are exceedingly tenuous and in most cases practically unavailable.” BORCHARD, *supra* note 5, at 171.

dispute-resolution process, typically arbitration.<sup>18</sup> Likewise, a state that had promised to arbitrate or litigate future disputes could always keep that promise. But while lenders had significant extra-legal leverage, they had little reason to expect such cooperation after a default. Indeed, even outside the context of sovereign lending, there are relatively few instances during this era in which sovereign states voluntarily kept promises to arbitrate disputes with foreign investors.<sup>19</sup> Seemingly, then, lenders whose contracts specified how disputes were to be resolved were not much better off than those whose contracts were silent on the topic. In either case, no meaningful dispute-resolution process could go forward without the sovereign's post-default consent.

All of this means that lenders relied primarily on extra-legal sanctions to deter default and to obtain favorable restructuring terms post-default.<sup>20</sup> Lenders also might turn to their home states to represent their interests, occasionally through military force but, more commonly, through the institution of diplomatic protection.<sup>21</sup> Although rare, such interventions occasionally produced similarly favorable restructuring terms, sometimes accompanied by supervision or outright control of the borrower's finances by the lender's home state.<sup>22</sup> Although the evidence is mixed, some studies suggest that private lenders assigned significant value to the prospect of creditor-state intervention.<sup>23</sup>

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18. For references to some early examples, see SURVEY OF INTERNATIONAL ARBITRATIONS: 1794–1989, at 484–85, 488 (A.M. Stuyt ed., 3d ed. 1990).

19. As noted previously, Bulgaria voluntarily submitted claims to arbitration in 1936 pursuant to an arbitration clause agreed to in connection with League Loans. See League of Nations, *supra* note 6. Likewise, the Lena Goldfields arbitration of 1930 involved—at least initially—voluntary participation by the Soviet Union. See Jason Webb Yackee, *Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality*, 32 FORDHAM INT'L L.J. 1550, 1574–76 (2009). Some other exceptions are noted in SURVEY OF INTERNATIONAL ARBITRATIONS, *supra* note 18, at 472 *et seq.*

20. See, e.g., Paolo Mauro & Yishay Yafeh, *The Corporation of Foreign Bondholders* 9–12, 23–25 (Int'l Monetary Fund, Working Paper No. WP/03/107, 2003).

21. For relevant summaries, see CHRISTOPHER F. DUGAN ET AL., INVESTOR–STATE ARBITRATION 26–33 (2008); BORCHARD, *supra* note 5, at 217–48. On the infrequent use of force to support bondholder interests, see TOMZ, *supra* note 5, at 127–33.

22. See EMILY S. ROSENBERG, FINANCIAL MISSIONARIES TO THE WORLD: THE POLITICS AND CULTURE OF DOLLAR DIPLOMACY, 1900–1930, at 52–56 (2003); Mauro & Yafeh, *supra* note 20, at 21–22.

23. See Faisal Z. Ahmed, Laura Alfaro & Noel Maurer, *Lawsuits and Empire: On the Enforcement of Sovereign Debt in Latin America*, 73 LAW & CONTEMP. PROBS. 39, 45 (Fall 2010); Kris Mitchener & Marc Weidenmier, *Empire, Public Goods, and the Roosevelt Corollary*, 65 J. ECON. HIST. 658 (2005) [hereinafter Mitchener & Weidenmier, *Empire*]; Kris Mitchener & Marc Weidenmier, *Supersanctions and Sovereign Debt Repayment* (National Bureau of Econ. Research, Working Paper No. 11,472, 2005) [hereinafter Mitchener & Weidenmier, *Supersanctions*].

Much of the empirical work demonstrating the efficacy of gunboat diplomacy as an enforcement regime focuses on relatively narrow time periods. Mitchener and Weidenmier, for example, focus on the years 1870–1913. See Mitchener & Weidenmier, *Supersanctions, supra*. Focusing on a longer time period, 1820–1913, Michael Tomz found a low absolute probability of military intervention and few instances in which actual or threatened military intervention could be attributed to the desire to protect bondholder interests. See TOMZ, *supra* note 5. Whatever the true significance of gunboat diplomacy for sovereign debt, it is clear that arbitration clauses were initially designed to link debt repayment to the U.S. foreign policy interest in regional financial stability, and that both bankers

On still other occasions, diplomatic or military intervention induced borrower states to enter bilateral treaties establishing arbitration tribunals or mixed-claims commissions to resolve claims by citizens of the creditor state.<sup>24</sup> Although they often declined jurisdiction over bondholders' claims,<sup>25</sup> these tribunals—which, it bears repeating, presided over *interstate* disputes—were the only form of adjudication that proved remotely effective at resolving disputes arising out of sovereign default. The function of such tribunals, moreover, was not to produce a judgment enforceable by private creditors against the borrower's assets; sovereign immunity would have prevented that. Rather, it was to break an impasse in settlement negotiations and thus to produce a settlement that both lender and borrower would accept.<sup>26</sup> The interstate character of the adjudication no doubt increased the likelihood of state compliance, for the borrower's refusal to comply with the award would violate a treaty and possibly invite diplomatic or military action by the lender's home state.<sup>27</sup> Indeed, the so-called Porter Convention, adopted at the Second Hague Peace Conference of 1907, implicitly authorized the use of force when a borrower state refused a creditor state's demand for arbitration or would not comply with an arbitration award. Although the Convention forbade states to use force to recover "contract debts" owed to their nationals, the prohibition did not apply when "the debtor State refuse[d] or neglect[ed] to reply to an offer of arbitration, or, after accepting the offer, prevent[ed] any 'Compromis' from being agreed on, or, after the arbitration, fail[ed] to submit to the award."<sup>28</sup>

## B. Modern Dispute-Resolution Terms and the Link to Sovereign-Immunity Doctrine

This landscape changed in the latter part of the twentieth century with a number of developments that enhanced private creditors' access to formal tools

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and State Department officials believed that these clauses could justify military action. *See infra* text accompanying notes 51–54.

24. *See, e.g.*, Treaty on Claims upon the Government of New Grenada, U.S.-New Grenada, Sept. 10, 1857, 1857 U.S.T. LEXIS 19. For a summary of U.S. executive agreements referring claims to arbitration commissions, see Ingrid Brunk Wuerth, *The Dangers of Deference: International Claim Settlement by the President*, 44 HARV. INT'L L.J. 1, 26–27 & n.176 (2003).

25. Early tribunals often justified this practice by reasoning that such claims were not interstate disputes, because states traditionally had declined to extend diplomatic protection to bondholders (as opposed to creditors who had lost property or suffered personal injury). *See* BORCHARD, *supra* note 5, at 36–37, 266–68; Award of Sir Frederick Bruce, *Columbian Bond Cases*, reprinted in 4 JOHN BASSETT MOORE, HISTORY AND DIGEST OF THE INTERNATIONAL ARBITRATIONS TO WHICH THE UNITED STATES HAS BEEN A PARTY 3591, 3614–15 (1898).

26. In some cases, for example, arbitrators might be asked to identify appropriate restructuring terms, rather than address questions concerning the legitimacy of the underlying debt. *See, e.g.*, 33rd Annual Report of the Council of the Corporation of Foreign Bondholders, at 340–41 (Jan. 1907) (describing arbitration conducted pursuant to agreement between the United States and Santo Domingo in which the award established payment, security, and other restructuring terms).

27. *See generally* BOYLE, *supra* note 13, at 80–81.

28. *See* Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts, Oct. 18, 1907, 36 Stat. 2241.

of legal enforcement. These developments include the gradual adoption in the United States and United Kingdom of restrictive theories of sovereign immunity,<sup>29</sup> the creation of a treaty-based infrastructure facilitating the recognition and enforcement of international commercial arbitration awards,<sup>30</sup> and the creation of a similar infrastructure to facilitate the arbitration of disputes between states and foreign investors.<sup>31</sup>

Given these developments, it is hardly surprising that modern sovereign debt contracts contain detailed terms pertaining to legal enforcement.<sup>32</sup> Table 1 summarizes the results of a survey of contract terms for sovereign issuances between 1991 and 2008.<sup>33</sup> The survey found that over ninety-five percent of issuers agree to submit to the jurisdiction of foreign courts or arbitration tribunals.

Table 1: Choice of Forum Clauses in Sovereign Bonds: 1991–2008

Choice of Forum		Issuers		
		Number	% of Total	Cumulative %
No External Forum	No Submission to Jurisdiction	1	1.4%	1.4%
	Domestic Courts Only	2	2.8%	4.2%
External Forum	Arbitration Only	2	2.8%	6.9%
	Arbitration and Foreign Courts	5	6.9%	13.9%
	Multiple Foreign Courts	5	6.9%	20.8%
	One Foreign Court	57	79.2%	100.0%
Total		72		

Many underwriting agreements contain similar provisions.<sup>34</sup> These clauses are closely linked to underlying legal doctrine. For example, sovereign-immunity statutes in the United States and United Kingdom recognize advance contractual waivers of immunity from both jurisdiction and execution.<sup>35</sup> Exploiting this exception to immunity, most modern bond contracts include not

29. In the United States, this process dates from the Tate letter in 1952 and culminates in the enactment of the Foreign Sovereign Immunities Act of 1976, 28 U.S.C. §§ 1605(a)(1), 1610(a)(1) (1976). See HAZEL FOX, *THE LAW OF STATE IMMUNITY* 185–87 (2002). For a description of sovereign immunity doctrine in the United Kingdom before and after the enactment of the State Immunity Act of 1978 (26 & 27 Eliz. 2, c. 33, §§ 2(2), 13(2), 13(3) (U.K.)), see FOX, *supra*, at 128–83.

30. See United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 3 [hereinafter New York Convention].

31. See Convention for the Settlement of Investment Disputes, Mar. 18, 1965, 4 I.L.M. 524.

32. For a discussion of the considerations involved in negotiating such terms, see LEE C. BUCHHEIT, *HOW TO NEGOTIATE EURO CURRENCY LOAN AGREEMENTS* 134–44 (2d ed. 2006); PHILIP K. WOOD, *CONFLICT OF LAWS AND INTERNATIONAL FINANCE* 141–54 (2007).

33. See Weidemaier, *supra* note 3, at 24–32 & tbl.2.

34. See, e.g., Form of Underwriting Agreement § 15, attached as Exhibit 4(l) to Registration Statement of Fed. Rep. of Brazil (filed Apr. 13, 2007).

35. See State Immunities Act of 1978 (26 & 27 Eliz. 2, c. 33, §§ 2(2), 13(2), 13(3) (U.K.)); Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1605(a)(1), 1610(a)(1) (1976).

only choice-of-forum clauses, but also terms explicitly waiving the sovereign borrower's immunity from suit, and often its immunity from execution as well.<sup>36</sup>

### C. Evidence of the Early Use of Dispute-Resolution Terms

Because they are so clearly tied to underlying legal doctrine, one might expect dispute-resolution clauses to have originated in the second half of the twentieth century. And with respect to contract terms providing for litigation in national courts, that expectation would be correct.<sup>37</sup> Arbitration clauses, however, appeared much earlier. Although seemingly quite rare in nineteenth century sovereign loans,<sup>38</sup> arbitration clauses began to appear with some frequency in the first decades of the twentieth century, primarily in loans to Latin American and Caribbean borrowers.

Focusing on that era and subset of borrowers, Table 2 depicts a relatively sudden shift in which loan contracts between U.S. or English banks, on the one hand, and Latin American and Caribbean sovereigns, on the other, began to incorporate arbitration clauses. As the table indicates, these clauses first appeared in loans made (or proposed) by U.S. bankers or industrialists in the early 1900s.<sup>39</sup> Thereafter, English banks began to include similar clauses in some of their contracts, although they had not previously done so when making loans to borrowers in the region. Often, the contracts envisioned an arbitration between the issuer and its bankers; bondholders were not explicitly granted permission to invoke the arbitration process. Perhaps for that reason, the clauses tended to appear in the underlying loan contract, which governed the relationship between the issuer and the banks, rather than in the bond or prospectus.<sup>40</sup> In virtually every case, however, the arbitration clause was broad enough in scope to cover claims arising out of default on the bonds.<sup>41</sup> Note that

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36. See Weidemaier, *supra* note 3, at 32–38.

37. The findings in this section are drawn from a dataset of sovereign debt-related contracts, which is described more fully elsewhere. See Mark Weidemaier, Robert Scott, and Mitu Gulati, *Origin Myths, Contracts, and the Hunt for Pari Passu* (on file with author). The dataset consists of documents compiled from Thomson OneBanker and from a number of financial archives and libraries, including the Rothschild archives, the HSBC archives, the Barings archives, the Duke University archives, the UBS library, the J.P. Morgan Library and Museum, the Guildhall library, the Harvard Business School library archives, and the Willard Straight papers at Cornell University.

38. There are some exceptions. For example, at least some Confederate cotton bonds included limited arbitration clauses encompassing disputes over cotton quality. See Confederate States of America 7% Cotton Loan of 1863. See also Loan dated July 21, 1860 between Banque Ottomane and European Commission for the Danube, art. IX (cited in Delaume, *supra* note 8, at 192 n.11).

39. Some of the contracts are for proposed loans that were not ultimately made.

40. Sovereign bond issuances of the era included at least three documents: the loan agreement between the issuer and the underwriting banks; the bond itself, which governed the relationship between the issuer and bondholders; and the prospectus, which described the terms of the proposed issuance in detail. For a general description, see BORCHARD, *supra* note 5, at 18–25.

41. In many cases, the banks also would have held bonds, and the issuer's default on the bonds would have breached the underlying loan contract. In that sense, at least, the arbitration clauses did encompass bondholder claims.

Table 2 stops in the mid-1930s, around the time that a wave of Depression-era defaults brought the sovereign bond markets to a relatively abrupt halt.

Table 2: Dispute Resolution Terms in Loan Contracts: 1858–1936

Date	Issuer	Origin of Lead Bank	Suit in Lender's Home Courts	Suit in Borrower's Courts	Arbitration or Other Non-Judicial Body
1858	Brazil	English			
1865	Brazil	English			
1883	Brazil	English			
1886	Chile	English			
1903	Mexico	U.S.			
1904	Cuba	U.S.			
1906	Costa Rica	U.S.			√
1909	Costa Rica	U.S.			
1909	Guatemala	U.S.			√
1909	Guatemala	U.S.			√
1910	Costa Rica	U.S.			
1911	Nicaragua	U.S.			√
1911	Brazil	English			
1913	Brazil	English			
1921	San Paulo	English			√
1922	El Salvador	U.S.			√
1922	Brazil	English			√
1922	Brazil	English			√
1922	Haiti	U.S.			√
1922	Bolivia	U.S.			
1923	Brazil	English			
1925	Argentina	U.S.			√
1925	Argentina	U.S.			√
1926	Honduras	U.S.			√
1926	Costa Rica	U.S.			√
1926	Argentina	U.S.			√
1926	Argentina	U.S.			√
1927	Argentina	U.S.			√
1927	Brazil	English			
1930	San Paulo	English			√
1932	Brazil	English			
1936	Brazil	English	√		√

Significantly, it does not appear that either U.S. or English bankers adopted arbitration clauses as standard terms presumptively applicable to all loans. For the most part, these clauses appeared only in loans to a subset of Latin American and Caribbean borrowers. For example, J.P. Morgan loans in the 1920s to Australia, Italy, and France do not address dispute resolution at all; nor do most of the loans made during the era by the Rothschilds bank in London, with the exception of some of the so-called League Loans made under the auspices of the League of Nations after World War I.<sup>42</sup>

42. On the League Loans generally, see Margaret G. Myers, *The League Loans*, 60 POL. SCI. Q. 492 (1945).

Another distinguishing feature of these early arbitration clauses is that they tended to appear in loans that subjected the borrower to the supervision or control of external political actors. This basic political reality was reflected in the contract's dispute-resolution provisions. Most notably, contracts involving U.S. banks often called for U.S. political actors either to resolve any dispute or to facilitate an arbitration before a member of the federal judiciary. For example, a 1911 loan agreement between Nicaragua and two New York banks referred disputes to the U.S. Secretary of State for a binding "determination, resolution, and sentence."<sup>43</sup> Another example, a 1922 El Salvadoran loan contract, called for the Secretary of State to refer disputes for arbitration to the Chief Justice of the U.S. Supreme Court or another federal judge.<sup>44</sup> These loans were negotiated with the involvement of the U.S. government under circumstances that involved a palpable threat that default could result in diplomatic or even military intervention.<sup>45</sup> Apparently to emphasize that possibility, some of the contracts ominously noted that the bankers could "solicit the United States for protection against the violation of this agreement, or aid in imposing its fulfillment."<sup>46</sup>

Not every arbitration clause envisioned such direct involvement by state actors. Loans in the 1920s and 1930s to Argentina and Brazil, neither of which had much reason to fear U.S. intervention, included arbitration clauses resembling those one might see in a contract between private commercial actors. For example, a 1925 contract between J.P. Morgan and Argentina contained a relatively standard arbitration clause referring questions concerning the bankers' rights and duties "to an arbitrator named by the Argentine Ambassador to the United States of America and the Bankers by common accord, whose decisions shall be final."<sup>47</sup> Clauses like these, which appeared somewhat later in the century, adopted a somewhat different conception of arbitration—one that did not call for the direct involvement of creditor states. Regardless of the form they took, however, arbitration clauses remained rare. They did not become standard terms in loan contracts.

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43. See Agreement on Gold Treasury Bills, Sept. 1, 1911, § 2, *reprinted in* Foreign Loans, Relative to Engaging the Responsibility of the Government in Financial Arrangements between its Citizens and Sovereign Foreign Governments: Hearings Before the Subcommittee of the Comm. on Foreign Relations, 68th Cong. 155 (1925) [hereinafter Senate Hearings].

44. See Loan Contract Between the Republic of El Salvador and Minor C. Keith, June 24, 1922, art. IX, *reprinted in* Senate Hearings, *supra* note 43, at 112–13.

45. On U.S. foreign policy in the region in general, and involvement in such loans in particular, see ROSENBERG, *supra* note 22, at 61–75; BOYLE, *supra* note 13, at 86–94; BORCHARD, *supra* note 5, at 224–25; John Foster Dulles, *Our Foreign Loan Policy*, 5 FOREIGN AFF. 33 (1926).

46. Agreement on Gold Treasury Bills, Sept. 1, 1911, § 2, *reprinted in* Senate Hearings, *supra* note 43, at 155; excerpt of Agreement Between Speyer & Co. & Costa Rica from the FINANCIAL NEWS (London), June 3, 1905, *reprinted at* 40 Cong. Rec. 9010, 9013–14 (1906).

47. Loan Contract Dated May 25, 1925 Between Argentina & J.P. Morgan & Co. & The National City Company, § 5.

## III

## CONTRACTING FOR STATE INTERVENTION

What explains this selective use of arbitration clauses? One possibility is that, despite the modern “absolute immunity” narrative, legal or relational sanctions were sometimes potent enough to give meaning to a borrower’s promise to arbitrate. For example, if there was some chance that courts *might* enforce arbitration clauses, it could not hurt for lenders to include the term whenever borrowers would agree to it.<sup>48</sup> In addition, there was always the hope that a borrower would keep its promise to arbitrate, perhaps in response to pressure from bankers or groups, like the Corporation of Foreign Bondholders (CFB), that represented bondholder interests.<sup>49</sup> To support this argument, one might cite the handful of cases—primarily outside the sovereign debt context—in which states *did* honor preexisting arbitration agreements.<sup>50</sup>

As is explored more fully below, however, this explanation is incomplete at best. In fact, the earliest arbitration clauses had little in common with modern dispute-resolution terms, which are intended to facilitate *private* legal enforcement. Instead, early arbitration clauses often served one or both of two functions. First, the clauses signaled to investors that influential creditor states, especially the United States, backed the loan and would intervene in the event of a default. That signal (which may not always have been accurate) reduced the perceived risk of default and made it easier to market the loan to a skeptical public. Second, in some cases, lenders may have hoped that creditor states would in fact be more willing to intervene when the relevant loan contract already included an arbitration clause.

## A. Legal and Relational Enforcement Revisited

For several reasons, an explanation focused on legal or relational enforcement cannot provide an adequate account of contracting practices during the period of interest here. First, I have found very little evidence that states routinely complied with promises to arbitrate. In the context of sovereign loans, I do not assign too much weight to this evidentiary void, for there is only

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48. The creditor in a 1924 English case, for example, argued that an arbitration clause that explicitly invoked the English Arbitration Act should be interpreted and enforced as a waiver of sovereign immunity, notwithstanding English law requiring waivers to be made at the time of the lawsuit itself. *See Duff Development Co. v. Gov’t of Kelantan*, [1924] A.C. 797, 810, 816–17 (H.L.). The argument was unsuccessful, but jurisdictions in continental Europe had already begun to recognize advance waivers of immunity, *see Harvard Draft Convention*, *supra* note 7, at 548–60, and the fact that the creditor was willing to litigate the question at all suggests a belief that English courts just might agree. (On the other hand, the facts of *Duff* were exceptionally favorable to the creditor, for the state invoked its immunity only after participating in the arbitration and voluntarily invoking court jurisdiction in an unsuccessful attempt to challenge the award.)

49. With respect to payment terms, the borrower could always claim—more or less plausibly—that compliance was impossible. But no such claim could be made if the borrower failed to participate in an arbitration process to which it had previously agreed. Such a breach could only be viewed as intentional and might call into question the borrower’s honesty and the reliability of its promises generally.

50. SURVEY OF INTERNATIONAL ARBITRATIONS, *supra* note 18, at 472 *et seq.*

one episode of default (Nicaragua, in 1912) in which I can be certain that the underlying contract contained an arbitration clause. It is revealing, however, that Nicaragua's default was followed by prompt U.S. military intervention rather than by a demand for arbitration.<sup>51</sup> Moreover, even outside the context of sovereign debt, foreign investors historically have had little certainty that sovereign states would keep their promises to arbitrate.<sup>52</sup>

Second, if arbitration clauses were subject to legal or relational enforcement, it is not clear why lenders would use them so selectively. Issuers with significant reputational capital to protect, such as France (1925), did not agree to arbitrate, nor did many high-risk issuers with a history of default, such as Liberia (1912) and Mexico (1899, 1903). In fact, there is little reason to believe that lenders favored formal adjudication over other means of pressuring borrowers in default. (Recall that under no circumstances would formal adjudication result in any significant seizure of sovereign assets.<sup>53</sup>) For example, the annual reports of the Council of the Corporation of Foreign Bondholders—an association of British investors holding foreign bonds—detail the CFB's efforts to represent bondholder interests by threatening or imposing relational sanctions, by petitioning the English government for assistance, and, occasionally, by requesting or instituting litigation or arbitration.<sup>54</sup> But the reports do not suggest that the CFB viewed arbitration as an especially effective means to force a favorable settlement.

Finally, as detailed further below, loan contracts in the first half of the twentieth century often sought to involve creditor states in the resolution of any disputes. This relatively consistent preference for creditor-state involvement suggests that arbitration clauses were not exclusively intended to be enforced through legal or relational means. As further evidence of this fact, arbitration clauses seem to have been more common in contracts with borrowers subject to the supervision, control, or influence of the lender's home state or another

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51. See generally ROSENBERG, *supra* note 22, at 77–78; Mitchener & Weidenmier, *Supersanctions*, *supra* note 23, at 24 n.23. In this and many other cases of “gunboat diplomacy,” creditor states relied on threatened or actual military force to protect broader political or territorial interests, rather than merely to induce a resumption of payments to foreign bondholders. See TOMZ, *supra* note 5, at 152–53. Thus, I do not suggest that U.S. intervention was motivated primarily by the desire to protect U.S. investors.

52. As late as the 1960s, the insufficiency of relational sanctions was invoked to explain the need for a multilateral treaty supporting international-investment arbitration. The explanation was that few individual creditors had the leverage to obtain an arbitration clause in the first place and that even these creditors were largely dependent on the state's willingness to participate in the arbitration and to comply with any award. See Aron Broches, Gen. Couns., Note Transmitted to the Executive Directors: *Settlement of Disputes Between Governments and Private Parties*, SecM 61-192, in 2 CONVENTION ON THE SETTLEMENT OF THE INVESTMENT DISPUTES BETWEEN STATES AND NATIONALS OF OTHER STATES, DOCUMENTS CONCERNING THE ORIGIN AND FORMULATION OF THE CONVENTION 2 (1968). See also DUGAN, *supra* note 21, at 42–43.

53. See *supra* text accompanying note 26.

54. See Mauro & Yafeh, *supra* note 20, at 22; Barry Eichengreen & Richard Portes, *Settling Defaults in the Era of Bond Finance*, 3 WORLD BANK ECON. REV. 211, 215–17 (1989).

external political actor.<sup>55</sup> This apparent link between arbitration and external political influence is difficult to square with an explanation focused on legal or relational enforcement.

## B. The Link Between Arbitration and State Intervention

Arbitration clauses may have served a function even if they were not likely to be honored by borrowers or enforced by courts. One possible function was to signal that an external political actor—particularly the United States—backed the loan and would intervene in the event of a default. In some cases, intervention might plausibly include the use of military force, although typically only when this was consistent with a creditor state’s broader geopolitical interests.<sup>56</sup> As the century wore on and the prospect of military intervention became more remote, lenders may have adopted new contracting strategies. Many of their contracts, however, still manifest a preference for resolving loan-related disputes as disputes between states.

### 1. The Origins of Sovereign Debt Arbitration Clauses in U.S. Dollar Diplomacy

“Dollar diplomacy” refers to the U.S. policy in the first decades of the twentieth century of “arranging loans [to certain borrowers in the western hemisphere] in exchange for some kind of financial supervision.”<sup>57</sup> The United States, of course, was keenly interested in limiting the influence of European powers in the hemisphere—influence that could hardly be seen as consistent with the Monroe Doctrine.<sup>58</sup> Yet the chronic state of default and financial instability of some borrowers in the region meant that European intervention was seen as a genuine threat. Venezuela’s 1899 civil war and subsequent default on its foreign debt, for example, was followed by a joint British-German-Italian naval blockade,<sup>59</sup> and in 1913 English officials convinced Guatemala to resume

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55. Dispute-resolution clauses appeared in the League Loans and referred disputes to the Council of the League of Nations or to arbitration. In either case, borrowers presumably would have encountered international pressure to keep their dispute-resolution promises. Arbitration clauses also appeared in contracts of Latin American or Caribbean borrowers in whose financial affairs the United States was heavily involved. *See generally* BOYLE, *supra* note 13, at 88–89. The story may be somewhat more complicated with Brazil and Argentina, which do not fit neatly into this model.

56. *See* TOMZ, *supra* note 5, at 152–53.

57. ROSENBERG, *supra* note 22, at 2. On U.S. foreign policy in the region, and the ties between private bankers and U.S. political officials, see Louis A. Pérez, Jr. & Deborah M. Weissman, *Public Power and Private Purpose: Odious Debt and the Political Economy of Hegemony*, 32 N.C.J. INT’L L. & COM. REG. 699, 708–21 (2006–2007).

58. *See* Pérez, Jr. & Weissman, *supra* note 57, at 709.

59. *See* BOYLE, *supra* note 13, at 81–82. The Venezuelan blockade was not necessarily motivated by the desire to protect bondholders. *See* TOMZ, *supra* note 5, at 135–43. That fact, of course, did not make the intervention any more palatable to the United States. Indeed, it seems fair to characterize U.S. interventions in the region as motivated more by the desire to promote financial and political stability than by the desire to protect bondholders. Financial and political instability, however, were often accompanied by default, and in this sense, the banks’ interests were aligned with those animating U.S. foreign policy.

debt service by threatening to collect customs duties by force.<sup>60</sup> Such episodes were deeply unsettling to U.S. hopes for maintaining regional hegemony.

The United States adopted several strategies to forestall further European intervention in the region. One involved promoting arbitration as a means of resolving disputes between states and foreign investors. The Porter Convention,<sup>61</sup> proposed by the United States at the Second Hague Peace Conference in 1907, forbade creditor states to use force to recover “contract debts” owed to their nationals unless the debtor country refused to participate in an arbitration or to honor an arbitration award.<sup>62</sup> As noted previously, the Convention had a dual effect. By obliging creditor states to submit their citizens’ contract claims to international arbitration, the Convention gave borrower states some protection against the use of force.<sup>63</sup> On the other hand, the Convention implicitly *authorized* the use of force when the borrower would not arbitrate.

The second strategy, articulated in the Roosevelt Corollary to the Monroe Doctrine, was to assert that the United States possessed an “international police power” that entitled it to intervene “into the domestic affairs of Latin American and Caribbean countries delinquent in the payment of their public debts, in order to forestall intervention by European creditor states.”<sup>64</sup> In keeping with this policy, the United States embarked on a policy of financial reform in the region under which it arranged for private loans conditioned on the borrower’s agreement to submit to some form of financial supervision.<sup>65</sup>

Although it bears no explicit relationship to arbitration, this brief and simplified history explains the initial inclusion of arbitration clauses in contracts employed by U.S. bankers. For the bankers, the backing of the U.S. government was necessary to market the bonds to a skeptical public.<sup>66</sup> One possibility was for the U.S. government to enter a customs-receivership convention with the borrower state, under which the United States would collect customs revenues and ensure that these funds were used to repay the loan.<sup>67</sup> Such an arrangement would virtually ensure repayment, for any effort by the borrower to disrupt the collection of customs duties would surely provoke a forceful reaction by the United States. Yet such explicitly interventionist arrangements were controversial, and the Senate withheld approval from some receivership conventions, including those planned in connection with loans to

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60. See generally TOMZ, *supra* note 5, at 132–33; D. H. Dinwoodie, *Dollar Diplomacy in Light of the Guatemalan Loan Project, 1900–1913*, 26 AMERICAS 237 (1970).

61. See Convention Respecting the Limitation of the Employment of Force for the Recovery of Contract Debts, Oct. 18, 1907, 36 Stat. 2241.

62. See *id.* at art. I.

63. BOYLE, *supra* note 13, at 80.

64. See *id.* at 89.

65. See ROSENBERG, *supra* note 22, at 31–96; Pérez, Jr. & Weissman, *supra* note 57, at 710–17.

66. See *id.* at 73.

67. See *id.* at 41–47.

Nicaragua and Honduras.<sup>68</sup> As a result, U.S. banks, with the active participation of the State Department, turned to private contract to achieve a similar degree of financial control.<sup>69</sup>

Beginning as early as 1904, U.S. bankers began to include arbitration clauses in proposed loans that were clearly and rather transparently designed to facilitate U.S. intervention after a default. For example, a proposed loan to Costa Rica called for disputes to be resolved by the Permanent Court of Arbitration or a panel of three arbitrators and noted, in addition, that bondholders could “apply to the United States of America for protection against any violation of, or for aid in the enforcement of the agreement.”<sup>70</sup> Through such contracts, banks sought to harness the “international police power” claimed by the Roosevelt Corollary by linking repayment of the loan to U.S. foreign policy in the region.<sup>71</sup>

Apparently recognizing that U.S. foreign policy might favor intervention in some cases, the State Department concluded that arbitration clauses might provide a justification should intervention become necessary. After all, the Porter Convention authorized creditor states to use force when a borrower country refused to arbitrate. In connection with a proposed loan to Honduras, State Department officials suggested that the bankers include an arbitration clause that authorized the Secretary of State to appoint an umpire to resolve disputes.<sup>72</sup> In the State Department’s view, the involvement of the Secretary of State would “lend more political significance to the arbitration clause.”<sup>73</sup> Indeed, J. Reuben Clark, solicitor for the State Department, reportedly informed the bankers that a borrower’s refusal to participate in an arbitration might justify the use of military force. According to Clark, the clear inference from the Porter Convention was that “this Government would have the right . . . to use force in behalf of the Americans making the loan.”<sup>74</sup> These discussions make plain what is only suggested by the literal contract language: these early arbitration clauses were not designed to produce a formal

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68. See *supra* note 43 and accompanying text; ROSENBERG, *supra* note 22, at 68–70.

69. See ROSENBERG, *supra* note 22, at 73–75.

70. Extract of loan contract printed in Cong. Rec., *supra* note 46, at 9011.

71. For example, at least one of the banks proposing a loan to Guatemala in 1909 and 1910 explicitly noted the Roosevelt Corollary’s implications for loan enforcement in communications with the State Department. See Dinwoodie, *supra* note 60, at 240–44, 252; see also 33rd Annual Report of Corporation of Foreign Bondholders, *supra* note 26, at 23 (noting, in connection with the proposed loan to Costa Rica discussed at *supra* note 70, that post-default intervention was “no more than [the U.S.] government has stated it is their duty to do if the principles of the Monroe Doctrine are to be brought into line with the march of events”).

72. See Memorandum of Mr. Pierrepont of the Div. of Latin-American Affairs of the Dep’t of State Concerning an Interview with the Agent of Hond., 1912 FOR. REL. U.S. at 616 (June 11, 1912).

73. *Id.*

74. *Id.* See also Pérez, Jr. & Weissman, *supra* note 57, at 710 (noting that, after the announcement of the Roosevelt Corollary, the United States “increasingly resorted to military and political intervention to force the repayment of foreign debt”).

adjudication. Instead, they were a “means of signaling the U.S. government’s potentially forcible backing of the loan.”<sup>75</sup>

## 2. English Banks and Low(er) Risk Borrowers: Arbitration’s Use in Other Contexts

Beginning in the 1920s, arbitration clauses also began to appear in loans made by English banks and in loans to borrowers, such as Argentina and Brazil, that had little reason to fear heavy-handed intervention by creditor states.<sup>76</sup> Beginning in 1922, for example, the Rothschilds bank in London included arbitration clauses in some loans to Brazil. Likewise, J.P. Morgan in New York included arbitration clauses in loan contracts with Argentina in the 1920s, although not in contracts with a number of other borrowers. What explains the extension of arbitration to this new context?

There is no easy answer to this question, not least because the contracts at issue involve different borrowers, different banks, and different legal and geopolitical contexts. One possibility is that English banks modeled their arbitration clauses on similar terms developed in connection with the League Loans issued after World War I. For example, the arbitration clause in a 1925 loan contract between Rothschilds and Brazil is virtually identical to clauses that appeared in the bank’s loans to Czechoslovakia in 1922 and to Hungary in 1924. This suggests that arbitration clauses developed by the League of Nations for post-war European reconstruction loans may have been transplanted into other sovereign-lending contexts. The expanded use of arbitration also may suggest that lenders and borrowers had begun to take seriously the idea that private, consensual dispute-resolution procedures could resolve disputes arising out of sovereign loans. Indeed, even before the widespread adoption of restrictive theories of sovereign immunity, both borrowers and creditor states had reason to favor a system of international arbitration. Borrowers who agreed to arbitrate could effectively insulate themselves from the threat of military intervention.<sup>77</sup> And by supporting international arbitration, creditor states may have found it easier to resist demands for military or other costly forms of intervention on behalf of citizens disappointed by their foreign investments.

By the mid-1920s, then, arbitration may have begun to gain currency as a means of resolving disputes arising out of sovereign loans. At least one other source of evidence, however, cautions against assigning too much significance to this development. Indeed, there is reason to believe that lenders continued to view dispute-resolution terms, at least in part, as a means to harness the enforcement capacity of creditor states.

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75. ROSENBERG, *supra* note 22, at 74. This use of arbitration clauses continued until the early 1920s. For example, loans to Honduras and El Salvador in 1922 and 1923 included such clauses. See ROSENBERG, *supra* note 22, at 109–10; *supra* tbl.2.

76. See *supra* tbl.2; ROSENBERG, *supra* note 22, at 62.

77. See BOYLE, *supra* note 13, at 80–81.

### 3. A Lasting Preference for Harnessing State Enforcement Power

In 1957, Georges Delaume noted a curious feature of some recent sovereign debt contracts: their dispute-resolution terms seemed utterly inadequate to the task of structuring an adjudication involving a sovereign borrower. Some of the contracts called for a dispute-resolution process that could not have gone forward even if the borrower had been willing to participate. For example, French bonds issued in Switzerland and the Netherlands in 1939 required France to “undertake[] to subject any disputes” to the jurisdiction of the Permanent Court of International Justice (PCIJ), the predecessor to the International Court of Justice (ICJ).<sup>78</sup> Yet the PCIJ’s jurisdiction extended only to disputes between states, meaning that, unless the Swiss or Dutch governments espoused their citizens’ claims, bondholders would have no contractually approved forum in which to press their claims.<sup>79</sup> Similarly, bonds issued in Switzerland in the 1940s and 1950s provided that bondholder disputes would be resolved “exclusively” by the ICJ or, “in default thereof,” by the Swiss Federal Tribunal.<sup>80</sup> Delaume dismissed these as “sham provisions” that would merely “confer jurisdiction upon the Swiss Court.”<sup>81</sup> So why provide for “exclusive” ICJ jurisdiction in the first place?

I am less willing to attribute such irrationality to the drafters of these contracts, who were surely aware of the jurisdictional requirements for the relevant international tribunals. Indeed, their contracts bear a functional resemblance to the arbitration clauses that appeared in loan contracts twenty to thirty years earlier, in that each contract reveals a preference for involving state actors in the resolution of any disputes. To the extent there are differences, these may reflect the different geopolitical contexts in which the various contracts were drafted.

For loans to Latin American and Caribbean borrowers in the early 1900s, U.S. military intervention was a very real possibility. In that context, early loan contracts employed arbitration as a means to both signal and justify heavy-handed, post-default intervention in the borrower’s affairs. As the century wore on, private lenders had less reason to anticipate that creditor states would employ such direct means of controlling sovereign borrowers.<sup>82</sup> Yet they had some reason to hope that creditor states might espouse their citizens’ claims before international tribunals like the ICJ.

In fact, it seems likely that the clauses that so puzzled Delaume originated in loans that had been *guaranteed* by the lender’s home state.<sup>83</sup> In such loans, the

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78. See Delaume, *supra* note 8, at 205.

79. See League of Nations Committee for the Study of International Loan Contracts, II Econ. & Fin. 1939 II A, 25.

80. See *id.* at 206.

81. *Id.*

82. See TOMZ, *supra* note 5, at 117; see also ROSENBERG, *supra* note 22, at 122–50 (discussing the increasingly controversial nature of dollar diplomacy).

83. See Delaume, *supra* note 8, at 206 n.46.

guarantor state's own liability for the debt surely would have induced it to invoke the ICJ's jurisdiction after a default.<sup>84</sup> But the clause did not lose its value simply because the lender's home state had not guaranteed the loan. Although lenders were not entitled to have their home states espouse their claims, it was hardly inconceivable that the states might choose to do so. Indeed, disputes under loan contracts from the late 1920s had already been resolved by the PCIJ, apparently notwithstanding the absence of dispute-resolution provisions in the underlying loan contract.<sup>85</sup> When seeking the intervention of its home state, surely it could only strengthen the lender's hand to obtain the borrower's advance agreement that the ICJ was an appropriate forum, along with its promise to do whatever was necessary to invoke the court's jurisdiction.<sup>86</sup>

Thus, it is possible that lenders hoped these clauses would increase their home states' willingness to espouse their claims and, if necessary, to invoke the jurisdiction of the relevant international tribunal. These hopes may not have been realized. In the mid-1950s, the ICJ clause dropped out of bonds issued in Switzerland in favor of a clause that provided for litigation in Swiss courts.<sup>87</sup> Yet the change serves to emphasize that dispute-resolution terms must be understood in light of the enforcement options that are actually available to creditors. Given the limits to what could be accomplished through private adjudication, lenders may have been attracted to terms that offered even modest hope for intervention by creditor states. On that score, it is noteworthy that the contracts noted by Delaume conferred primary jurisdiction on the ICJ even though Swiss courts, unlike those in England and (perhaps) the United States, recognized and enforced *ex ante* submission to jurisdiction clauses.<sup>88</sup>

Arguably, then, these contracts manifest a preference among lenders for treating disputes between private bondholders and state borrowers as interstate disputes. In that sense, they are functionally related to earlier arbitration clauses that were (more coarsely) intended simply to justify post-default military intervention. They also lend credence to the notion that, to the extent possible, lenders sought to use contract terms in ways that would allow them to tap into the enforcement capacity of creditor states.

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84. *See id.*

85. *See* Case Concerning the Payment of Various Serbian Loans Issued in France (Serb. v. Fr.), 1929 P.C.I.J. 20 (July 12, 1929); Case Concerning the Payment in Gold of Brazilian Federal Loans Contracted in France (Braz. v. Fr.), 1929 P.C.I.J. 21 (July 12, 1929).

86. Viewed in this light, the clause that most puzzled Delaume—within French bonds that provided *only* for PCIJ jurisdiction—is not so puzzling after all. The French government had previously invoked PCIJ jurisdiction on behalf of *its* citizens who held bonds issued by other countries. *See* Case Concerning the Payment of Various Serbian Loans Issued in France (Serb. v. Fr.), 1929 P.C.I.J. 20 (July 12, 1929); Case Concerning Payment of Brazilian Loans Contracted in France (Braz. v. Fr.), 1929 P.C.I.J. 20 (July 12, 1929). Under the circumstances, it would have been difficult for France credibly to object to having the PCIJ resolve disputes arising out of French bonds.

87. *See* Delaume, *supra* note 8, at 206–07 (describing 1955 Australian bonds issued in Switzerland).

88. *See* Harvard Draft Convention, *supra* note 7.

## IV

## CONTRACTS AS TOOLS TO SHAPE STATE BEHAVIOR

If the foregoing story is correct, then dispute-resolution terms during the era of absolute immunity bear only modest resemblance to similar terms today. Instead of facilitating legal enforcement by private actors, dispute-resolution terms were seemingly designed to signal that default might result in intervention by creditor states and, in some cases, to increase the likelihood that such intervention would occur. As the century wore on, no doubt, contracts increasingly employed dispute-resolution clauses in the hope of prompting a formal adjudication. That transition is itself worthy of study, not least because it cannot be attributed solely to changes in the law of sovereign immunity.<sup>89</sup> Rather than explore that transition here, I close by exploring what the contracting practices described in this article suggest about the relationship between state actors and contract design.

For the most part, contract theory focuses on the state's causal influence on contract design. General contract law, for example, is understood as a set of implied terms allocating risk between the parties, just as the evidentiary and procedural rules governing litigation constitute default procedures for enforcing contractual commitments.<sup>90</sup> Much of the relevant literature, then, focuses on how these state-supplied preformulations shape contracting practices<sup>91</sup> and on the ways in which state actors can mandate or facilitate solutions to the coordination problems that sometimes plague private contracts.<sup>92</sup> Yet early sovereign debt contracts illustrate a rather different dynamic, one in which contract terms seek to influence the behavior of state actors and other outsiders to the contract.

As it turns out, it may be quite common for contracting parties to structure contracts in an effort to influence third-party behavior. Indeed, given the importance of relational sanctions in sovereign borrowing, it is plausible to assume that such terms appear with some frequency in sovereign debt contracts. The essence of relational enforcement, after all, is that promise-breaking results in the imposition of sanctions by members of some community.<sup>93</sup> In a world of

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89. As noted previously, both borrower and creditor states may have had some reason to favor a system of international arbitration. Certainly the creation of such a system would have been consistent with the broader effort to fashion a workable system of international adjudication. On this effort more generally, see BOYLE, *supra* note 13.

90. See, e.g., Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2004–2005).

91. See, e.g., Goetz & Scott, *supra* note 90, at 289–305 (exploring how state-supplied default rules may impede the development of express terms); Scott & Triantis, *supra* note 90 (exploring how the anticipated enforcement mechanism shapes contracting practices).

92. See Robert B. Ahdieh, *Between Mandate and Market: Contract Transition in the Shadow of the International Order*, 53 EMORY L.J. 691 (2004).

93. See Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977, 988 (2006–2007).

relational enforcement, terms that induce third parties to monitor and punish noncompliance can maximize contract value.

This possibility has been noted in connection with terms in some modern sovereign debt contracts. Thus, Mitu Gulati and George Triantis explain the International Monetary Fund (IMF) clause, in which borrowers promise to maintain their membership in the IMF, as an effort to exploit the IMF's superior monitoring and control abilities.<sup>94</sup> They argue that sovereign bonds include such terms "to compel the IMF to participate in the creditors' private lending relationship with the sovereign."<sup>95</sup> In that same vein, I offer another brief, historical example of a sovereign debt contract term that derives much of its value from its impact on third parties, including creditor states.

Many nineteenth-century sovereign loans provided that the borrower would set aside a particular stream of income as "security" for the loan.<sup>96</sup> These contracts often did not create a formal security interest and amounted, instead, merely to a promise to earmark certain funds for use in repaying the loan. That is, the borrower promised "notionally to hive off the specified asset or revenue stream from the debtor's general property and to treat the foreign debtholders as having a preferential interest in those funds."<sup>97</sup> Such clauses may have benefited bondholders in a fairly direct fashion, as by freeing payment from the vicissitudes of the state's budgeting process.<sup>98</sup> Yet they also, and perhaps more importantly, shaped the behavior of two sets of important external actors.

First, earmarking clauses may have influenced investors by signaling—perhaps falsely—that the loan was a relatively low-risk venture, akin to a secured loan to a private borrower with pledged assets located in the investor's jurisdiction.<sup>99</sup> There is in fact some evidence that these security provisions were used in bonds issued by countries unfamiliar to many bondholders to render those bonds marketable.<sup>100</sup> There is also evidence that banks were reluctant to

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94. *See id.* at 1001.

95. *Id.*

96. *See generally* Delaume, *supra* note 8, at 86–93.

97. Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 907 (2004).

98. *See* Ernst H. Feilchenfeld et al., *Priority Problems in Public Debt Settlements*, 30 COLUM. L. REV. 1115, 1125 (1930).

99. *See* Buchheit & Pam, *supra* note 97, at 907 (referring "charitably" to offering circulars that touted such terms as employing "figures of speech"); Ernst H. Feilchenfeld, *Rights and Remedies of Foreign Bondholders*, in 2 BONDS AND BONDHOLDERS: RIGHTS AND REMEDIES, WITH FORMS 180 (Sylvester E. Quindry ed., 1934) (referring to the "unsound psychology" generated by these provisions).

100. *See* Feilchenfeld, *supra* note 99, at 180. This signaling function is analogous to that served by the provision, in the 1911 Nicaraguan loan contract mentioned earlier, confirming that the bankers "have the right to solicit the United States for protection against the violation of this agreement, or aid in imposing its fulfillment." *See supra* note 43 and accompanying text. The term itself served no governance function in the lending relationship, as the borrower was no doubt aware of the possibility of U.S. intervention. It did, however, permit the bankers to market the bonds by emphasizing that the U.S. government would intervene in the event of a default. *See* Senate Hearings, *supra* note 43.

underwrite issuances they perceived to be risky without some form of security, as default could negatively impact a bank's reputation among investors.<sup>101</sup>

Second, and much like the dispute-resolution clauses discussed earlier, earmarking clauses allowed bondholders to tap into the enforcement capacity of their home states. This is because, although bondholders could rarely foreclose on state assets, creditor states may have been more willing to intervene diplomatically on behalf of lenders whose contracts contained a specific pledge of revenues or assets.<sup>102</sup> Indeed, creditor states intervened on a number of occasions to protect lenders' rights in some pledged revenue stream.<sup>103</sup> In some cases, creditor states also prevented the issuance of new bonds that would have disrupted the priority that an earmark granted to existing bondholders.<sup>104</sup>

## V

### CONCLUSION

The rather cursory example of "earmarking" funds to repay a loan emphasizes an important point that animates recent contracts scholarship: parties structure their contracts in ways that reflect the anticipated means of enforcement.<sup>105</sup> That insight, in turn, helps explain the use of dispute-resolution provisions during the era of absolute immunity. During that era, lenders sometimes had sufficient leverage to obtain a resumption in payments or satisfactory settlement after a default. But when they did not, effective "dispute resolution" rarely meant formal adjudication. It meant, instead, that a favorable resolution occurred after the intervention of some external political actor, typically the creditor's home state. This basic reality may explain the apparent puzzle of why some sovereign debt contracts included seemingly unenforceable dispute-resolution terms. It appears that these terms were included because they signaled that creditor states backed the loan and, sometimes, in the hope that creditor states might be willing to intervene on behalf of disappointed investors.

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101. Correspondence in the J.P. Morgan archives, for example, reveals internal debate over whether to participate in a 1914 issuance of unsecured Argentine debt, with the bank initially unwilling to "stand sponsor" for the loan. *See* Telegram from J.P. Morgan & Co. to H.P. Davidson, Esq., Dec. 21, 1914 (on file with author).

102. BORCHARD, *supra* note 5, at 98.

103. *See* BORCHARD, *supra* note 5, at 98.

104. *See* BORCHARD, *supra* note 5, at 96–97.

105. *See* Scott & Triantis, *supra* note 90.