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Sovereign Debt and the "Contracts Matter" Hypothesis

W. Mark C. Weidemaier & Mitu Gulati*

The academic literature on sovereign debt largely assumes that law has little role to play. Indeed, the primary question addressed by the literature is why sovereigns repay at all given the irrelevance of legal enforcement. But if law, and specifically contract law, does not matter, how to explain the fact that sovereign loans involve detailed contracts, expensive lawyers, and frequent litigation? This Essay makes the case that contract design matters even in a world where sovereign borrowers are hard (but not impossible) to sue. We identify a number of gaps in the research that warrant further investigation.

1. Introduction

Loans to sovereign governments present risks that are much reduced in loans to private borrowers. For one thing, creditors lack strong legal enforcement rights. If the sovereign does not pay, creditors cannot easily enforce their claims through the courts, which have little power to force compliance. There is also no bankruptcy mechanism to provide for a collectively-binding adjustment of a sovereign's debts. For all practical purposes, sovereign financial obligations last forever. This gives creditors an incentive to hold out from a restructuring in the hope of receiving a disproportionate share of the funds the sovereign is able and willing to pay. The associated deadweight costs can leave the sovereign and its creditors collectively worse off.

For the most part, the academic literature on sovereign debt examines two questions prompted by these distinctions between sovereign and private borrowers. Without legal enforcement, why do sovereigns repay at all? And how does the absence of bankruptcy impact the process of restructuring sovereign debt? There is by now a large theoretical and empirical literature, which mostly treats the law as of peripheral interest (if that) to these questions. Few authors pay attention to sovereign loans as *contracts*. The assumption seems to be that contract terms do not matter without strong legal enforcement rights.

Yet this assumption is at odds with the evidence from practice. For hundreds of years, sovereign borrowers and their lenders have negotiated detailed loan contracts as if the terms matter. Drafters have also revised loan contracts to account for changes in the political, economic, and legal climate (Choi et al. 2012). As an example, sovereigns perceived to present a greater risk of default have long been required to accept detailed contractual restrictions on their freedom of action. The nature of these restrictions has changed over time, and it is hard to square such an evolution with the view that contract terms do not matter.

This paper supplements the literature by exploring the role that contracts play in the market for sovereign debt. We keep our discussion of the background literature on the economics (with a little law) of sovereign debt brief, as there are thorough recent treatments by Tomz & Wright (2013), Panizza et al. (2009), and Reinhart & Rogoff (2009). We then turn to our primary focus: sovereign debt contracts. Because most sovereign debt today takes the forms of bonds, we focus on clauses

* Faculty at the University of North Carolina at Chapel Hill and Duke University.

found in sovereign bonds. We hope to persuade the reader that contracts matter and that, by taking contract terms seriously, it is possible to shed light on a number of open research questions. We identify four of these questions below. There are undoubtedly others.

2. The literature on sovereign debt, and why it should address debt contracts.

The central puzzle addressed by the sovereign debt literature is why sovereigns repay in the absence of legal enforcement. A related literature examines the problems of sovereign debt restructuring. Here, we briefly review the literature relevant to these questions and highlight the curious indifference to the terms of sovereign loan contracts.

We begin with a definitional matter. The term "sovereign" is not self-defining. There are many governmental entities below the level of a national or central government: provinces, municipalities, territories, states, etc. There are also quasi-governmental or supra-national entities such as development banks. To varying degrees, these entities (and, for that matter, private debtors) incur debt that shares the characteristics of sovereign debt. For example, creditors sometimes face legal barriers to enforcing claims. Likewise, national bankruptcy laws may not extend to some of these entities. In keeping with the literature, we do not define the term "sovereign" precisely. Country debt is the archetypal form of sovereign debt, but other entities can raise similar problems.

2.1 Why sovereigns pay and how they restructure: The prevailing view(s)

Traditionally, sovereigns were absolutely immune from suit and from having their assets seized to satisfy a judgment. In the United States and United Kingdom, this immunity began to erode in the latter half of the twentieth century; the transition began much earlier on the European continent (Verdier & Voeten 2014a, Verdier & Voeten 2014b). This transition—often described as the shift from absolute to restrictive sovereign immunity—is one of the most important developments in international law. We will say more about it below. For now, the important point is that, despite the demise of absolute immunity, creditors still face significant legal and practical barriers to enforcing claims against the sovereign.

Under US law, for example, the default rule (with exceptions not relevant here) is that a sovereign's assets are subject to execution only when "used for a commercial activity" in the United States *and* "used for the commercial activity upon which" the creditor based its claim (28 U.S.C. § 1610(a)(2)). When the commercial activity giving rise to the claim is borrowing money, few if any sovereign assets will have the required nexus to the loan. Moreover, if it is worried about asset seizure, the sovereign can keep assets safe within its own borders, where local officials may be unwilling or unable to enforce creditor claims.

Because of these and other barriers, most observers conclude that traditional legal enforcement, as it occurs in municipal courts, plays at most a peripheral role in the sovereign debt markets (Panizza et al. 2009). Explanations for why sovereigns repay therefore focus on non-legal mechanisms. One is reputation; sovereigns repay because they want to preserve access to credit markets and must be viewed as trustworthy to do so (e.g., Tomz 2007). A second emphasizes the possibility that default might prompt creditors and other outsiders to retaliate, as by denying trade credit or disrupting trade relations (Sachs and Cohen 1982, Bulow and Rogoff 1989a, Bulow and Rogoff 1989b). Yet a third emphasizes the collateral economic and political costs of default on the borrower and its governing officials. For example, default might magnify output losses associated with financial crisis via mechanisms such as domestic banking crises (Panizza et al. 2009, Gennaioli et al., 2014).

A related literature examines the problems of sovereign debt restructuring. In a financial crisis, restructuring can benefit both the sovereign and its creditors. Yet if restructuring is too easy, an opportunistic sovereign may try to reduce its debt when it is able to pay, and this possibility may cause lenders to demand higher interest rates ex ante. A growing literature addresses the resulting trade-off, asking how sovereigns restructure and what factors influence restructuring outcomes. For example, many observers feared that the shift from syndicated bank loans to bond lending in the 1990s would delay restructuring negotiations and allow sovereigns to impose coercive restructuring terms. These fears stemmed from the insight that, unlike a few concentrated bank lenders, a country's many and dispersed bondholders would find it difficult to coordinate their response to default (Panizza et al., 2009). Yet recent research provides limited support for these fears (e.g., Bi, Chamon, and Zettelmeyer 2013, Enderlein, Müller, and Trebesch 2008). If anything, a number of scholars have turned 180 degrees to posit that the central problem in sovereign debt restructuring is not that sovereign issuers will restructure opportunistically (too early, too often), but that they will wait too long to restructure (Brookings Institution 2013). The underlying agency cost story here is that government officials who announce a restructuring face high personal costs (they may lose power). Therefore, they delay the restructuring, taking economic risks that may ultimately disadvantage creditors and citizens alike in an effort to right the ship.

These inquiries into why sovereigns repay and how they restructure generally do not take into account the terms of loan contracts. This is not to say that the literature is completely indifferent to loan terms. The so-called "original sin" (Eichengreen et al. 2003) in the sovereign debt markets involves the inability to borrow abroad in domestic currency, and currency-of-payment is a term specified in the contract. Researchers have also noted the relevance of loan maturity, noting that weaker sovereign issuers may have to issue shorter-term debt (e.g., Arellama and Ramanarayanan 2013, Jeanne 2009).

A notable exception to the literature's general indifference to contracts involves so-called collective action clauses (CACs). The global debt crisis in the mid-1990s and early 2000s, and the resulting bailouts, prompted policymakers and academics to worry that bond contracts were too hard to restructure (Taylor 2007, Buchheit and Gulati 2002). Bonds issued by emerging market issuers in particular tended to allow each bondholder to hold out, and this potentially exacerbated the deadweight costs of restructuring. As a solution, reformers promoted CACs, which allow investors to hold a collectively-binding restructuring vote (Gelpern and Gulati 2006, Weidemaier and Gulati 2014). Some sovereigns worried that they might suffer a pricing penalty if they adopted CACs, and a number of studies explore this question with somewhat mixed results. The general conclusion, however, is that there is little if any pricing penalty associated with the use of CACs (Eichengreen and Mody 2004, Becker et al. 2003, Weinschelbaum and Wynne 2005, Richards and Gugiatti 2003, Bradley and Gulati 2013, Bardozzetti and Dottori 2014).

More recently, a few studies have addressed whether investors demand a premium to hold bonds governed by the sovereign's domestic law, relative to bonds governed by foreign law. Investors might expect a premium to compensate for the risk that the government will manipulate its domestic law to reduce its obligation, which it cannot do when bonds are governed by foreign law (Chamon et al., 2014; Clare and Schmidlin 2014). The stark difference in the protections that investors have under domestic versus foreign laws was brought to the forefront in March 2012 where Greece imposed a restructuring on its local-law sovereign bonds but could not restructure most of its foreign-law debt.

Beyond these exceptions, the literature is generally indifferent to sovereign loans as contracts. This oversight is unfortunate.

2.2 Why contract terms matter

Contract terms matter for at least two reasons. The first is that legal enforcement rights, while much reduced in the sovereign context, are not entirely absent. In a typical lawsuit arising from a defaulted loan, the creditor obtains a money judgment and enforces it by executing on the debtor's assets. As noted, however, most of the sovereign's assets (even commercial assets) will be immune from execution or kept safe within the sovereign's own borders. As a result, a money judgment is valuable only to the extent it allows a creditor to interfere with the sovereign's foreign trade or ability to borrow abroad (Bulow and Rogoff 1989). This threat, a creditor-imposed embargo, provides an incentive to repay the loan, but the threat is generally thought to be a modest one (Panizza et al. 2009).[1]

However, contract terms can expand the scope of this embargo. Many sovereign bonds include detailed provisions specifying where the sovereign may be sued and what assets may be seized to satisfy a judgment. For example, many sovereigns waive immunity from execution (Weidemaier 2014). Under US law, such a clause lets creditors execute on sovereign commercial assets even if there is no nexus between the asset and the loan (28 U.S.C. § 1610(a)(1)). The result is that the creditor may disrupt a much wider range of commercial and financial transactions with US ties. Moreover, Weidemaier (2009, at pp. 35-38) identifies bonds that arguably allow creditors to seize the sovereign's governmental (not just commercial) assets.

In at least two recent cases, moreover, courts have awarded relief beyond the typical money judgment, entering orders that effectively forbid the sovereign to service its debt post-restructuring.[2] These decisions result from creative interpretations of a contract term, the *pari passu* clause, that is routinely included in sovereign bonds. If courts will fashion creative injunctive remedies, this has the potential to significantly enhance enforcement rights (Weidemaier and Gelpern 2014). It is perhaps too early to say whether these cases are outliers or indicia of a general trend towards greater enforcement of the terms of sovereign bond contracts. But certainly, the second possibility is quite real, given that the most recent of these *pari passu* cases (*NML Capital v. Republic of Argentina*) occurred in New York, a global financial capital where much sovereign debt litigation takes place.

The second reason contract terms matter is independent of legal enforcement (Triantis and Gulati 2007). Sovereigns honor other contract terms for the same reason they honor promises to repay: the desire to avoid reputational harm. As famously observed by Macaulay (1963), Goetz and Scott (1981), and others, business contracting is often relational; litigation is but a distant possibility.

[1] We use the term "embargo" rather than "blockade" (Schumacher et al. 2014) because national courts typically have power only to disrupt transactions with a sufficient nexus to the jurisdiction. As a practical matter, this means that a creditor holding a money judgment from, say, a US court, can prevent or complicate the sovereign's commercial dealings with US parties. To be sure, the judgment may be enforceable outside the United States, but this depends on the law of the relevant jurisdiction.

[2] The cases are *Elliott Associates v. Banco de la Nación (Peru)* and *NML Capital v. Republic of Argentina*.

In such relational settings, legal enforcement—often extremely impractical even when no sovereign is involved—is less relevant than community judgment or other non-legal sanction.

To a degree, a sovereign's reputation for promise-keeping is distinct from other aspects of its reputation (Brewster 2009). For example, a sovereign's conduct (say, currency devaluation) might earn it a reputation for macroeconomic instability but not impair its reputation for keeping promises. In that case, the sovereign could regain access to capital markets by agreeing to terms that minimize the risk of macroeconomic instability, such as the obligation to repay in foreign currency (Choi et al. 2012). Conduct that impairs a sovereign's reputation for promise-keeping, however, imposes an additional cost, and this provides some incentive to honor contract terms.

As contracts, sovereign debt agreements raise a number of important questions relevant to both the law and the economics of sovereign debt. To preface our discussion of these questions, we first explore the multiple and overlapping bodies of law relevant to sovereign loans.

3. The law of sovereign lending

Sovereign debt issues are subject to multiple forms of legal and private governance, including international law, municipal law, and private regulatory regimes such as stock exchange rules.

International law. Many of the most basic questions of sovereign debt are determined by international law. That law includes treaties among nations as well as customary law, understood as the general (if not uniform) and consistent practice of states followed from a sense of legal obligation. International law may determine such questions as whether a new government will inherit the debts of a prior government, how to allocate responsibility for debt when a country dissolves into separate states, and whether national courts must enforce judgments entered by courts of another nation. For the most part, customary international law is mandatory. The rules can change over time, but a practice with the status of customary international law generally binds even nations that do not follow it.[3] For example, until the early 1900s, international law arguably allowed nations to use force, in some circumstances, to collect sovereign debts owed to their citizens. That is no longer the case (Finnemore 2003). It is safe to say that, today, customary international law forbids the use of military force to collect a sovereign debt obligation.

Municipal law. To oversimplify a complex and contested subject, municipal law regulates the relationship between sovereign states and the individuals and entities subject to their jurisdiction. As relevant to sovereign bonds, municipal law includes rules that define the parties' primary obligations, such as rules of contract interpretation; jurisdictional rules that determine when domestic courts may hear sovereign debt disputes; procedural and evidentiary rules that govern the details of litigation in those courts; and rules for enforcing court judgments. The parties can choose many of these rules. Thus, sovereign bonds typically designate the governing law and also include clauses in which the sovereign submits to the jurisdiction of specified courts and waives any sovereign immunity it might otherwise enjoy. There are exceptions, but these choices usually match. Bonds governed by New York law, for example, typically include jurisdictional provisions in which the sovereign agrees to be sued in New York courts (Weidemaier 2014, at n.120). These jurisdictional clauses are rarely exclusive.

[3] This prohibition on withdrawal from customary international law has not always been the rule (Bradley and Gulati 2010). And international law in its treaty form allows withdrawal in certain circumstances.

Investors retain the right to sue in other jurisdictions when consistent with municipal law in the place of suit.

Exchange rules. For much of the 1800s and the early portion of the 1900s, stock exchanges provided the most important rules applicable to sovereign debt. The London Stock Exchange's internal dispute resolution mechanisms—especially those that determined whether a defaulted sovereign could list new bonds on the exchange—were arguably the most potent means of enforcing sovereign debt obligations. A sovereign that had defaulted but not reached a satisfactory arrangement with its creditors could not list new securities on the exchange, and creditors with economic and institutional power attempted to use this veto point to their advantage (Flandreau 2013).

In the modern era, most sovereigns choose to list their bonds on one and sometimes several exchanges. Listing entails a promise to abide by exchange rules. Exchanges are no longer the primary judge, jury, and executioner in the sovereign debt markets, but they remain part of the regulatory and enforcement infrastructure that supports the issuance of sovereign debt. An exchange that denies listing privileges limits the sovereign's market access, and this potential penalty (or its reputational consequences) may still have value as an enforcement device.

The literature on sovereign debt, having given relatively little attention to law as a general matter, has had even less to say on how these different bodies of law have interacted with contract terms over history. We hope to persuade readers, however, that there are a number of open and important research questions in this area that are well worth exploring.

4. Contracts as a Window into the Sovereign Debt Markets: Four Research Questions

4.1 Waiver: A Window into the Relation Among Contract, International and Municipal Laws

The assumption that contracts are irrelevant to the sovereign debt markets is premised on the belief that creditors cannot easily obtain and enforce judgments against sovereigns. As explained, however, sovereigns can make promises in the bond contract that expand creditor enforcement rights. These include waivers of immunity from suit, waivers of immunity from execution, as well as a suite of contract terms, such as terms facilitating service of process, to pave the way to the courthouse. These enforcement-enhancing clauses can and do vary in scope. In theory, a sovereign can bond its promise to repay by waiving execution immunity even with respect to its diplomatic assets abroad.[4]

If investors do not value legal enforcement rights, it is a puzzle why sovereign issuers agree to these sovereignty-offending clauses. And it is particularly puzzling when one takes into account the legal costs and inconvenience imposed on a sovereign that has given such consent, *even if* the creditor ultimately cannot find assets to seize.[5] Absent these provisions, after all, creditors could less easily drag

[4] *Société NML Capital Ltd v. République Argentine*, Cour de Cassation (1ère Chambre Civile), No. 09-72.057 (Sept. 28, 2011). The case holds that such a waiver must be express, and we know of no sovereign that expressly agrees to let creditors seize diplomatic assets. But we have seen waivers of immunity from execution that extend to "any property whatsoever (irrespective of its use or intended use)" (Republic of Estonia, Offering Circular for 5% Notes due 2007). Courts in the United States would not likely allow creditors to seize diplomatic assets even given an express waiver, as only assets "used for a commercial activity" are subject to execution (28 U.S.C. § 1610(a)).

[5] Creditors need an incentive to bring the lawsuit (Bulow and Rogoff 1989a). But this incentive is not hard to see. In a lawsuit, the creditor bears only its litigation costs, which are a fraction of what it might hope to recover by settlement. By contrast, the sovereign bears litigation costs plus an embargo on its foreign trade and commerce. In some cases, these costs will outweigh those associated with settlement, and this possibility may encourage the creditor to sue.

the sovereign into foreign courts and would have a narrower range of assets to pursue. Moreover, why would creditors demand such provisions if they offer no value?

Over time, the sovereign debt instruments of many states (not all) have changed form, becoming increasingly (if not comprehensibly) recognizable as contracts. In the 1700s, a short ledger entry might memorialize a sovereign loan. Today, a single bond clause can cover many pages; the provisions relating to legal enforcement might consume hundreds of words. When in this transition did sovereigns begin to make promises with respect to enforcement rights? What developments in the law, international and municipal, prompted this dramatic increase in the willingness of sovereigns and their creditors to invest in formal contracts? These questions highlight the uncertain relationship between municipal law and customary international law.

As relevant here, the sovereign debt literature paints a clear picture, at least of bonds issued in New York and London. By the early twentieth century, a small handful of sovereign loan contracts allowed creditors to bring claims before arbitral tribunals. For over a century, international tribunals have also (if rarely) heard disputes arising from sovereign debt obligations (Waibel 2011). But the vast majority of bonds did not address legal enforcement until the mid- to late-1970s. After that point, and putting aside the bonds of the AAA countries such as the United States and Germany, virtually every bond issued to foreign investors waived the sovereign's immunity from suit (Weidemaier 2014). These clauses became even more widespread after the Latin American debt crisis of the 1980s (Choi et al. 2012).[6]

As best we can tell, this shift in contracting practices was triggered by changes in the municipal law of the United States and United Kingdom. After the 1976 passage of the Foreign Sovereign Immunities Act (FSIA) in the United States, and the State Immunity Act of 1978 (SIA) in the United Kingdom, virtually all foreign issued sovereign bonds waived immunity from suit. Before these statutes, virtually no bond contained such a waiver. The significance of these statutory developments is corroborated by veteran sovereign debt practitioners, who in our experience tend to assign great significance to the FSIA and SIA as drivers of contracting practices. But neither practitioners nor the literature on sovereign debt ties contracting practices to customary international law.

There is a disconnect between this understanding of the FSIA and SIA and the understanding held by many scholars of international law. Under that understanding, the FSIA and SIA merely codified the shift from the absolute to the so-called restrictive theory of immunity—a shift that had in fact occurred many decades earlier. This shift from absolute to restrictive sovereign immunity, moreover, supposedly represented only a change in the default rule.[7] Under the doctrine of absolute immunity, sovereigns were presumptively immune from suit even when engaged in commercial activity abroad, but could waive this immunity by contract (Verdier and Voeten 2014a). Under the modern, restrictive theory of immunity, sovereigns are presumptively *not* immune from suit for commercial acts.

But this understanding of customary international law is hard to square with the evolution of sovereign bond contracts. In particular, it does not explain why the FSIA and SIA would have prompted one of the most radical shifts in contracting practices in over 200 years of sovereign debt

[6] A similar, if less sudden, transition occurred with respect to waivers of immunity from execution (Weidemaier 2014).

[7] This is true with respect to immunity from suit. The law was less clear with respect to the enforceability of a waiver of execution immunity (Delaume 1967, pp. 204-08).

history. Consider two possible hypotheses generated by the conventional understanding of how international law developed:

1. If absolute sovereign immunity was merely the default, and assuming that some issuer-investor pairs valued legal enforcement rights, then we would expect to see some explicit waivers of immunity from suit, and perhaps execution, even during the era of absolute immunity.

2. The shift from absolute to restrictive immunity may have decreased, but certainly did not increase, the value of a waiver of immunity from *suit*. The reason for a decrease is that a restrictive immunity regime presumptively denies the sovereign immunity for its commercial activity, so there is less need for an explicit waiver. On the other hand, there remained some uncertainty about whether sovereign lending constituted a commercial act, and a waiver could remove the uncertainty.[8] Whatever weight we assign to these factors, we would not expect waivers of immunity from suit to become more frequent under the restrictive immunity rule.[9]

Our initial examination of the data undermines at least the first, and possibly both, of these hypotheses. In both separate and joint work, we have gathered thousands of bond contracts, spanning nearly two centuries, for sovereign issues in New York, London, and elsewhere (e.g., Weidemaier 2014, Weidemaier et al. 2013, Choi et al. 2012). Contrary to prediction one, we see almost no waivers of sovereign immunity in the New York market before the FSIA or in the London market before the SIA. Nor do we see waivers in our smaller sample from other markets. By contrast, after the passage of the FSIA and SIA, virtually all sovereigns waived immunity from suit and, increasingly, execution immunity.

Although international law scholars generally treat absolute immunity as a default rule, the pattern in the data suggests that investors—key *consumers* of law—saw things differently. The consistent and near uniform absence of waivers of immunity implies that investors viewed the absolute immunity rule as mandatory. The standard account, moreover, is that international law with respect to sovereign immunity began to change well before the FSIA and SIA. Yet contracting practices suggest that investors did not assign significance to these pre-statutory developments. One possibility is that the investors and issuers were simply unaware of, or misunderstood, the relevant law. But that is implausible given the context.[10] The implication is that, contrary to the conventional international law wisdom, that the FSIA and SIA actively drove, rather than passively followed, international law and practice.

To be sure, there are competing explanations and open questions. For one thing, most of our data involves bonds issued in London and New York. Under English law until the SIA, a foreign sovereign could withdraw a waiver of immunity. Although the law was less clear, the same may have

[8] In the United States, this uncertainty was not finally removed until 1992 (Republic of Argentina v. Weltover, 504 U.S. 607 (1992)).
[9] The picture is less clear with respect to waivers of execution immunity. Under the absolute immunity rule, a creditor might have had less hope that such a waiver would be enforced. Moreover, as noted previously, a money judgment results in a creditor-imposed embargo, and a broad waiver of execution immunity can significantly expand the scope of this embargo even under the restrictive immunity regime.
[10] Investors in sovereign bonds in the 1800s and early 1900s, even more so than today, tended not to be ordinary (and perhaps uninformed citizens). Many investors were wealthy elites with political and economic influence and access to good legal advice.

been true, pre-FSIA, in the United States (Weidemaier 2014). The statutes made clear that a waiver was irrevocable. Even before the statutes, however, a waiver of the sovereign's immunity could only have helped an investor. More important, if absolute immunity were really a default rule, we would expect to see frequent waivers in pre-1970s bonds issued in jurisdictions such as France, Belgium and Switzerland, where municipal law supposedly allowed the sovereign to waive its immunity. Yet our preliminary examination of the data reveals that bonds issued in these jurisdictions rarely if ever included waivers.

Data from sovereign bonds, then, complicates the general understanding of how customary international law develops. That understanding infers the content of international law from state practices, such as judicial decisions purporting to recognize waivers of sovereign immunity. But the absence of waivers in early sovereign bonds suggests that market actors may not have taken these state practices seriously.[11] In turn, the rapid shift in contracting practices after the FSIA and SIA suggests that municipal statutes restating (supposed) principles of international law may play a crucial role in the development of customary international law. In the sovereign debt context, it is possible that the statutes, but not prior developments, signaled a genuine commitment to entertain claims against foreign governments.[12]

4.2 Do legal rules and institutions matter? If so, why?

When it issues bonds, the sovereign typically specifies the law that will govern its obligations. Bonds governed by foreign law are widely thought to be safer investments than bonds governed by the sovereign's domestic law. The reason is that the sovereign may be able to change its law ex post to facilitate a restructuring. In 2012, for example, Greece restructured its domestic-law debt by enacting a law providing that a two-thirds bondholder vote to approve a restructuring would bind bondholders as a group. By contrast, Greece could not restructure the majority of its foreign-law bonds and has continued to pay these investors in full (Chamon et al. 2014).[13] Investor preference for foreign-law bonds may explain why a substantial proportion of emerging market bond debt is governed by New York or English law (Das et al. 2012).

A sovereign that issues bonds governed by foreign law gives up the right to unilaterally change the rules of the game in ways that disfavor investors. The result is that bonds governed by foreign law may be harder to restructure. If this is so, choice of law clauses designating foreign law may allow a sovereign to more credibly signal its ability and intent to repay. A small body of research supports this intuition but also suggests that investors assign more value to foreign-law debt in times of financial

[11] A scholar of international law might object that we are looking at the wrong state practice—i.e., contractual waivers of immunity by states who might be subject to litigation in foreign courts—and should look instead at the practices of states expecting to host such litigation. By that metric, the FSIA indeed codified the restrictive immunity rule announced by the United States Department of State decades earlier in the so-called Tate Letter (Weidemaier 2014). After the Tate Letter, investors had some (hardly certain) hope that they could bring sovereign debt claims against foreign governments in US courts. But the contracts suggest that investors did not take these pre-statute state practices seriously.

[12] Finally, a recurring policy question in the sovereign debt markets is how public officials can shape contracting practices. The data suggest that statutory enactments, unlike less formal articulations of national policy, may be a more meaningful policy tool.

[13] In effect, the Greek law retroactively introduced a statutory collective action clause (CAC) into domestic-law bonds, which had been issued without such a mechanism. Although Greece's foreign law bonds included CACs, these required an issue-by-issue vote, which allowed holdouts with relatively small positions to block the restructuring of individual bond issues and may have deterred otherwise-willing investors from accepting restructuring terms (Zettelmeyer et al., 2013). By contrast, the retroactive CAC introduced into Greece's domestic-law debt aggregated the vote across issues.

distress. Comparing a single pair of Greek bonds, Choi et al. (2011) find that investors accepted a lower yield on bonds governed by English law than on bonds governed by Greek law, but that the yield differential increased as Greece's financial crisis deepened. Studying a large sample of Eurozone government bonds, Chamon et al. (2014), find little if any premium associated with foreign law debt in times of relative calm, but a significant premium in times of financial crisis. One implication is that foreign-law bonds may function as a commitment device primarily in times of financial distress.

Even if investors sometimes distinguish between domestic-law and foreign-law bonds, questions remain. It is possible that any premium associated with foreign law debt is attributable mainly to scarcity. At the time of the Greek restructuring, for example, bonds governed by foreign law comprised less than ten percent of the country's outstanding debt (IMF 2013). In such a case, it may be comparatively easy for the sovereign to obtain the necessary debt relief while sparing holders of its foreign-law bonds (Chamon et al. 2014). As the proportion of foreign-law debt rises, investors may begin to discount the protection offered by foreign law.

A more fundamental question is whether the distinction between foreign and domestic law is the right one. Perhaps the more relevant distinction is between credible and non-credible legal institutions. That is, a focus on governing law may obscure a more meaningful dynamic, in which legal institutions with certain features enable credible commitments, while others do not. A quick glance at sovereign bond contracts reveals that legal institutions matter as much as, or more than, legal rules. As noted earlier, for example, sovereigns that issue bonds governed by foreign law almost always submit to the jurisdiction of courts in the designated jurisdiction. Aside from basic considerations of institutional competence (courts are better at applying their own law), this practice presumably reflects a judgment that foreign courts will more rigorously enforce sovereign debt obligations. Other international enforcement agents, such as investment arbitration panels, may develop similar comparative advantages. For example, arbitrators have shown some inclination to entertain mass claims brought by disappointed bondholders (Strong 2013).

Credible legal institutions need not be foreign ones. The relationship between political, economic, and legal institutions and economic growth is a central subject of inquiry in the development literature (e.g., La Porta et al. 1998). Going back further, classic work by North and Weingast (1989) suggests that strong and independent domestic institutions can be crucial determinants of a sovereign's ability to borrow. More recently, work by Klerman and Mahoney (2005), Feld and Voigt (2003), and others suggests a positive association between de facto judicial independence and economic growth. This research suggests that credible domestic institutions—defined to include not just legal rules but also courts, financial regulators, exchanges, and other enforcement agents—should enable sovereigns to issue domestic-law debt, enforceable primarily in domestic courts, with little to no pricing penalty. In fact, many sovereigns, particularly those of the AAA variety, issue most or all debt under domestic law (Das et al. 2012).

Nevertheless, it remains unclear just what institutional features matter. Presumably, investors must believe that the sovereign's judiciary will recognize and enforce sovereign debt obligations and the sovereign will incur some cost (reputational or otherwise) if it defies the judgments of its own courts (Posner 2007). But this only scratches the surface. For example, might constitutional limits on ex post changes in the law, such as that found in the United States Constitution, enable more credible repayment promises (at least when paired with independent domestic courts)?

Finally, if the content of legal rules is important, it remains to be seen which legal rules matter. It bears emphasis that a choice of law clause incorporates a complex bundle of legal rules, the net effect of which can be difficult to predict. As a result, it is possible that investors do not really prefer foreign law so much as they prefer foreign courts, and that they view foreign law as a necessary (or at least) harmless adjunct to that choice. But it is also possible that jurisdictional differences in the content of the law matter. For example, rules of contract interpretation differ across jurisdictions, and the differences may affect the ability of creditors to enforce the sovereign's obligations (Burn 2014). Likewise, the most notable creditor victories in sovereign debt litigation have involved grants of injunctive relief, such as the injunction preventing Argentina from continuing to service its restructured debt (Weidemaier and Gelpern 2014). Not all courts are equally willing (or able) to award such relief. *NML v. Argentina*, 699 F.3d 246 (2d Cir. 2012), provides a nice natural experiment, as the market reaction to the injunctive relief awarded in that case may offer insight into whether investors value the prospect of potent injunctive remedies.

4.3 Granting Collateral and Attaching Assets

Corporate borrowers regularly grant lenders a security interest in corporate assets. Sovereign borrowers, by contrast, issue mostly unsecured debt and do not recognize formal differences in the legal priority of their creditors (Borensztein et al. 2004). Why? As an initial matter, the rarity of secured debt is puzzling, as there is a theoretical literature examining the potentially beneficial role of senior debt in the sovereign debt markets (e.g., Bolton and Jeanne 2009, Zettelmeyer 2004, Gelpern 2004, Bolton and Skeel 2004). For example, secured debt can protect against debt dilution: a decrease in the value of debt caused by the issuance of new debt. Moreover, there is historical precedent for sovereign loans in which borrowers receive, if not a formal security interest, then at least a promise of priority with respect to revenue streams such as customs receipts or export revenues (Borchard 1951).

In our experience, sovereign debt practitioners tend to attribute the dominance of unsecured debt to the lack of a mechanism for enforcing security interests. With no international court capable of overseeing a debt composition and enforcing creditor priorities, a sovereign cannot credibly promise that investors will enjoy priority in the event of a default. This explanation is echoed by the academic literature. For example, Zettelmeyer (2004) suggests that, in order to enforce creditor priorities in a restructuring, senior creditors must be able to sue junior creditors to recoup payments made in contravention of the priority structure. But without privity of contract between the two sets of creditors, it is not clear that senior creditors would have this right.[14]

We are persuaded that there is no sure means for enforcing creditor priorities in the context of sovereign loans. Yet it is still puzzling that sovereigns so rarely issue secured debt (broadly defined to include debt backed by a promise of priority to a revenue stream). Evidence from the market in sub-sovereign debt implies that investors see value in grants of priority. To take two prominent recent examples, the City of Detroit and the Commonwealth of Puerto Rico each have issued debt secured by an interest in particular revenue streams. We have seen similar examples outside the United States. For example, a 2004 bond issued by the City of Rome is backed by a pledge of certain city revenues. For some sub-sovereign issuers, such as the City of Detroit, creditors may have somewhat greater enforcement rights than would be available against a sovereign country.[15] There may be a formal

[14] One possibility is a claim for tortious interference with contract. But there is little if any case law on whether creditor A can sue creditor B for lending money on terms that violate the sovereign's promise of priority status to A.

[15] For example, creditors might sue the City of Detroit in state court for a writ of mandamus. See John Wittbold & Co. v. City of Ferndale, 281 Mich. 503 (1937).

bankruptcy procedure available as well. But for other sub-sovereigns, such as the Commonwealth of Puerto Rico, the analogy to a sovereign country will be much closer.

To be sure, many outstanding sovereign bonds include negative pledge clauses, which forbid the issuance of new secured debt. Yet when they wish to do so, sovereigns have shown themselves capable of granting creditors priority despite these clauses (Gelpern 2004). And if investors value pledges of assets or revenues when lending to sub-sovereigns, it is not clear to us why they would not value a similar pledge from a sovereign. To close, we add only that recent court decisions suggest that the enforcement problem may not be so dire after all. In *NML v. Argentina*, federal courts in New York issued an injunction forbidding Argentina to pay its restructured debt unless it pays holdout creditors in full. The injunction extends to a wide range of financial and other intermediaries, thus denying Argentina the information and advice it would need to defy the injunction (Weidemaier and Gelpern 2014).

The *NML* injunction is a mechanism for enforcing creditor priorities: the sovereign cannot pay A unless it first pays B. To eliminate the risk of such an injunction, a sovereign that wants to issue debt or make payments in contravention of an existing creditor's security interest must do so without involving any entities (including payment intermediaries) subject to US jurisdiction. Although the threat of an injunction does not prevent the sovereign from favoring a junior lender, it makes that course of action more costly for the sovereign and thereby creates some incentive to honor promises of seniority. For this reason, *NML v. Argentina* provides a nice natural experiment. If investors believe that courts will enforce promises of priority, such promises may begin to appear more frequently in sovereign bonds, especially those issued in New York. At the least, we would expect international financial institutions such as the IMF and World Bank to consider formalizing the priority status they has always been implicit in their loans.

4.4 Law, Listing and Currency – The Balancing Act

When issuing debt the sovereign must balance commitment and flexibility. Debt denominated in the sovereign's own currency, for example, allows greater debt management flexibility (e.g., the ability to reduce the debt through inflation), while debt denominated in foreign currency sends a more credible signal of the borrower's commitment to predictable monetary policy. The sovereign debt literature has examined this trade-off, although traditionally by examining the choice between foreign and domestic currency and between short- and long-term debt (e.g., Jeanne 2003, Calvo and Guidotti 1990).

If we are correct that contract terms matter, however, this balancing act requires the sovereign to consider much more than repayment currency and term structure. As we have noted, the choice between domestic and foreign law also involves a trade-off between flexibility and commitment. Bonds governed by domestic law are potentially easier to restructure without a formal default. Because default imposes costs on both investors and the sovereign, investors may grant this additional debt management flexibility when they trust the sovereign not to abuse it.

To this mix—currency, term structure, and governing law—we add the choice between listing on a local securities exchange and listing on a foreign exchange. The sovereign is not likely to directly control a domestic securities exchange, but it can wield a significant amount of power indirectly. Moreover, to the extent the disclosure and other rules of a foreign exchange are more stringent, listing on a foreign exchange may allow the sovereign to more credibly signal its commitment to repayment.

To our knowledge, there has been little effort to examine why sovereigns list on an exchange at all, much less the determinants of the choice of exchange. Nor has there been any effort to explore how these various choices between commitment and flexibility interact.

We would expect to see variance across issuers, and across time, in how sovereigns balance commitment and flexibility. For example, the choice of governing law, currency, jurisdiction, and listing may vary depending on the strength of the sovereign's domestic legal institutions and its credit ratings. Some countries, such as the United States and Germany, issue local-law and local-currency debt without submitting to the jurisdiction of foreign courts, and often without listing on an exchange. It may be that some sovereigns cannot issue any appreciable portion of their debt without agreeing to a full suite of foreign governance regimes: foreign currency, law, enforcement jurisdiction, and securities exchange. Likewise, it may be that a sovereign's debt profile, as measured by these variables, changes with its credit rating, domestic institutions, or other factors.

5. Conclusion

It may be that contracts, and the law in general, play only a modest role in the sovereign debt markets. But that role is larger than the near zero level of attention that is generally given to it in the literature. In this Essay, we have highlighted a handful of what we see as important open questions. Because we are lawyers, we have no doubt focused on questions that reflect our background and training. Indeed, one of our claims is that sovereign debt contracts reveal important information about the law itself, especially the customary international law of sovereign immunity. Our broader goal, however, is to expand the range of contract terms that are deemed worthy of serious inquiry. The current literature's focus on currency clauses, term structure, collective action provisions and governing law is a step in the right direction. But only a step.

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